KENJOL
CAPITAL MANAGEMENT

A Crude Effect on High Yield Bonds

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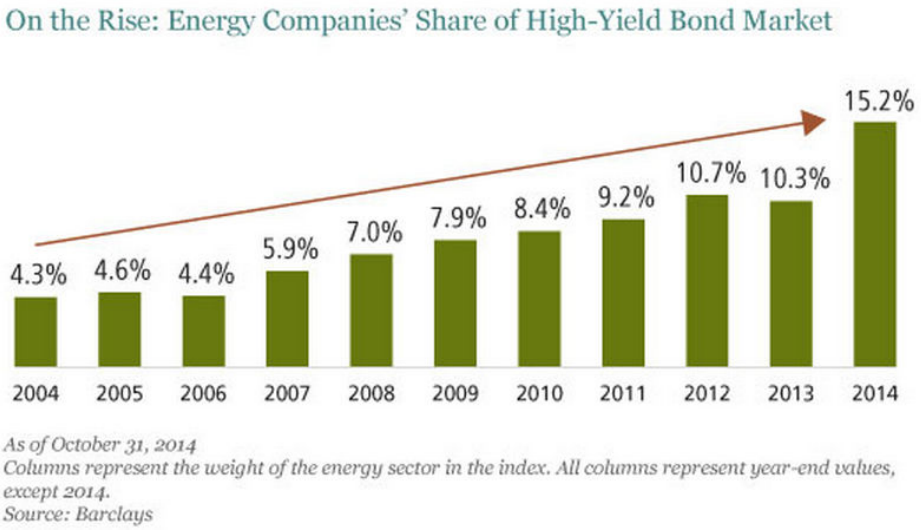
High yield bonds have remained volatile in the fourth quarter of 2014. Typically, increased volatility in this sector is a result of either changing economic conditions (a move higher in default rates) or a short-term change in interest rates. Investors in this segment have often overreacted to rising rates, only to see rates normalize soon and resume providing positive returns.

With economic conditions broadly improving, albeit slowly, and interest rates remaining very low, why are high yield bonds struggling to perform? The answer is in the oil fields.

Energy-sector high yield bonds were the epicenter of recent volatility in the global high-yield market. Crude oil prices have fallen more than 35% from their highs this summer over $105 / barrel, and they now sit around $66 / barrel. Between late August and mid-November, the US high-yield energy sector fell 6.2%, compared to a 1.7% decline in the broader US high-yield corporate-bond market[1].

Why does the oil price have anything to do with high yield bonds?

Since 2000, energy companies have invested some $1.5 trillion into operations—mostly exploration and production—and they've taken on a hefty share of debt to do it. Debt issued by energy firms today comprises more than 15% of the Barclays US High Yield Index, compared to less than 5% a decade ago (see the following chart).



[1] Alliance Bernstein. In Energy Revolution, Bond Investors Must Keep Their Heads.

With energy companies now accounting for just over 3.5 times as much of the high yield bond market today compared to 2004, the oil price and the associated perceived risk of energy company bonds has influenced the overall high yield market, especially its volatility.

Kenjol's use of active high yield managers allows for the ability to underweight or eliminate sector exposure. As such, the funds we currently hold have less exposure to energy bonds than the index. As often happens, however, nervous investors have thrown out the baby with the bath water. Even strong energy companies have seen their bonds discounted. The impact is big enough to make the broader high yield market struggle.

While no one knows if oil prices will fall further or stabilize near the current level, we believe in general that the high yield market is overreacting to lower oil prices. We expect more trouble for many small, highly leveraged companies which will result in some defaults. However, not all energy companies and certainly not all high yield names will suffer. The question today is how much contagion the rest of the high yield bond market will feel as a result of distress in some energy names.

Conclusion

2014 has proven a difficult year for high yield, especially in an environment we thought would be more favorable. While default risk remains low and the interest rate environment attractive, extraneous forces have given us a very volatile year. We think this is why active management has added less value than in past years. However, we are still very pleased with the long-term value the Kenjol high yield bond program delivered over the last 10+ years.

We continue to believe that high yield bonds are an attractive fixed income sector. At some point, the market for energy related high yield bonds will stabilize and a regression-to-the-mean rally can potentially deliver a strong year for high yield in 2015.