An interview with Donovan J. Paul, portfolio manager, INVESCO High Yield Fund

On the Prowl for Value Issues in the High-Yield Corporate Bond Market

In this month's Mutual Funds Workshop, John Markese describes the investment characteristics of high-yield corporate bond funds. These are funds that invest in high-yield "junk" bonds, which pay higher yields because of lower perceived credit worthiness.

There are a relatively small number of low-load high-yield bond funds, and even fewer that have been in existence for over 10 years. One older fund that has performed well, particularly recently, is the INVESCO High Yield Fund. The fund was the No. 2-performing domestic bond fund for the year ending June 30, with a return of 17.5%, compared to 15.2% for the average high-yield fund. For the last three years, the fund returned 12.6% compared to 12.1% for the average, and over the last five years the fund returned 11.0% compared to 11.2% for the average. (For more comparison statistics, based on year-end 1996 data, see page 3).

Currently, the fund has about $436 million in total assets.

In early July, portfolio manager Donavan Paul discussed the fund's investment approach with Maria Crawford Scott.

What is the investment objective of the fund?

As with most high-yield funds, our objective is to provide high current return. Around that, we wrap the concept that we need to achieve high total return. We can buy bonds rated as low as triple-C, and we can buy non-rated bonds, but we cannot buy defaulted bonds.

What kinds of companies issue these bonds?

One thing many people don't realize is that they're doing business every day with high-yield issuers. There's still this stigma about high-yield bonds stemming from the late 1980s—what I would call the "high-yield depression" and the awful performance that resulted from that. But the fact is every day almost all of us are doing business with many high-yield issuers. For example, most of the supermarkets in the country are high-yield issuers, most of the hospitals and nursing homes involve high-yield issues, almost all of the movie theaters are high-yield issuers, many of the restaurant chains are high-yield issuers, your cable-TV company is a high-yield issuer, many of the television stations and radio stations that you watch or listen to are owned by high-yield issuers, and I can go on and on.

What area of the high-yield bond market do you focus on?

We tend to have largely a single-B component to the fund at any given time. In our case, that will range from 60% to about 80%. Right now, I'm in the high 70s in the single-B category.

The typical high-yield mutual fund is somewhere in that same range, although at any point in time we might be more heavily weighted than other funds, or we might be a little lower weighted. Insurance companies, pension funds, and other institutional investors, on the other hand, tend to be more disproportionately double-B-type investors.

Why do you focus on the single-B component of the market?

We tend to think that the single-B sector offers the best risk/reward trade-off.

Traditionally, there have been a lot of institutional investors who are restricted to investment-grade securities, so an investor with no restrictions can exploit the double-B sector if you can identify the next company that's going to move up into the triple-B category. And increasingly nowadays you're dealing with other institutions whose charter limits them to the double-B side. So you can exploit that area of the market by proper identification of the single-Bs that are about to move up. Likewise, even in the high-yield mutual fund side of the business, there are some funds that cannot buy non-rated issues. Now, we don't think that the rating agencies are a required indication of creditworthiness. In my case, I've been doing this 21 years and I think I can pretty well judge how an issue would be rated by the rating agencies. So, sometimes we are able to exploit our high-yield competitors who have that kind of restriction.

A good example of that is Brooks Fiber Properties. It's a non-rated credit, but it's probably a pretty decent single-B issuer and the company's been talking lately about

INVESCO High Yield Fund is part of the INVESCO family of funds, P.O. Box 173706, Denver, Colo. 80217, (800) 525-8085, www.invesco.com.

getting the bonds rated. If they would do that, it might create some additional natural buyers for them and that would, of course, bid the price up.

We like to exploit those kinds of institutional inefficiencies, as well as the occasional so-called "fallen angel"—the investment grade issuers that fall into the high-yield groove because of credit problems. K-mart would have been one big example of that in the last couple of years. We owned K-mart bonds for a while, although we don't currently own them. That was a case where, if your charter required that you own investment-grade paper, you became a forced seller, and of course that kind of supply into the market caused a temporary depression in prices, and we went in to exploit that opportunity.

What does it mean to be diversified within the high-yield market?

In this sector of the market, you simply are not very well-diversified if you own only 10 or 20 of these things. In our portfolios, we typically will own anywhere from 70 to 90 names, and some of the bigger funds will own a couple hundred names. I think that's getting a little bit too diversified, but certainly if you've got just 10 issues and you run into one with big problems, *you've* got a big problem, too. And so we think it's critical to be well-diversified in this sector.

What is your basic approach—how do you select issues in which to invest?

We tend to use a thematic approach, identifying the kinds of things that we want to own, and that results in a focus on certain industries. I usually refer to the themes as the hunting ground, because I consider myself a predator, and if you're a predator, you go to where the animals are. In this case, what we're really trying to do is, through a theme, identify a hunting ground. And the kind of animal we're looking for are companies that we think have the best fundamental prospects for gradually improving creditworthiness, as well as those with the highest prospect for 'positive events'—for instance, a takeover by an investment-grade company.

Right now, my favorite hunting grounds are: Cable television; television and radio broadcasting; communications, with a focus on rural cellular and on the competitive local exchange carriers—CLECs in the trade; near-death-experience born-again deleveragers; and special situations.

Because of these themes, our biggest concentration right now is probably in the communications area—we have a lot of rural cellular and competitive local exchange carriers. That would probably be followed by the television and radio guys. Cable is still pretty well-sized in our portfolio, although it's probably competing right now with the near-death-experience, born-again deleverager theme.

And what, exactly, is 'the near-death-experience, born again deleverager' theme? Do you mean industries that have almost gone under?

Yes, I like that term, and I always try to use USG as my prototype to describe it. Prior to their leveraged buyout, it was an investment-grade company. But then it went through Chapter 11 in 1993, and the reason they went broke wasn't because it was a bad company, it's just that they had a bad capital structure. It wasn't appropriate to have a cyclical firm like that leveraged up the way they were. They emerged from bankruptcy with management declaring that they were going to return to investment-grade status, they made a commitment to use 50% of their free cash flow to pay down debt, and they carried through on that. When we got involved with them, they had already started doing those things—they had actually reduced their debt by as much as $400 million. So we got involved when they were a single-B trading at 300 basis points over comparable Treasuries, and today they've done exactly what they told us three years ago they were going to do. We stuck with them through that whole time and today their bonds are trading at about 120 basis points over comparable Treasuries [i.e., the bond's price rose]. Now on that kind of bond, that equates to about a 10-point gain on top of the 10% yields you were getting on the securities. So, this is a company that went through bad times, they learned from that, but they're not in bad times now.

What we like to find, frankly, are management teams where they're generally 60-years-old or older, and they have a lot of their personal net worth tied up in their company's stock. Again, that gives them sort of the born-again deleverager motivation. We played that theme fairly hard with USG.

Although you are investing in bonds, it seems as if you analyze them the way you would a stock.

I think that's right. The way I describe it to people is that we are bottom-up value bond investors. In addition, we are trying to create alpha-based returns—returns that are due to the specific issuer or issue that we get involved with.

Issuer-specific, of course, involves such things as improving credit situations. But issue-specific is important, too, and I'll give you the example of USG again. USG had all kinds of issues in their capital structure, but what you wanted to be involved with were the ones that were non-callable, because if they experienced credit improvement, their other paper was going to trade up until it hit the call price.

The portfolio turnover of the fund is relatively high—for how long do you typically plan on holding the bonds?

It varies a lot. If something falls into one of our themes, we could wind up being holders for one to three years. But we may tactically trade within those issues. For instance, getting back to the USG example, at one time we knew the company was going to be a big buyer of their own 8¾s, so we tried to get in front of the company, bought all the 8¾s that we could, marked them up a few points and then sold them to the company and rolled the money back into the USG 8½s. So, that kind of value trading will go on even inside the themes.

Something else that we do a lot of is the special situation theme, which is really not a specific theme, it's just that we will get involved with situations where there is a risk arbitrage type of play. Unannounced deals are the best example. Last year, for example, our equity sector analysts were convinced that the Bally's and Hilton merger was actually going to occur, and it was on reasonably friendly terms. But Bally's Park Place had first mortgage bonds on the Atlantic City operations that you could buy at about 160 basis points over the Treasuries. Furthermore, there really aren't any investment-grade industrial issuers like a Hilton who have outstanding first mortgage bonds, and they generally don't like to live with the convenants that are in those kinds of issues, so we had high expectations that Hilton would make a tender offer for the debt. So in August and in September, we were buying Bally's Park Place's papers at 160 basis points off Treasuries, and sure enough, in December, as the deal concluded, Hilton made a tender offer—they didn't want those convenants, they didn't want a first issue outstanding, and they offered to buy the bonds from us at 50 basis points over Treasuries. That meant we made up 4 points of capital gain on top of an almost 11% coupon that we collected in that time. Now that increases your turnover because obviously, we only owned the bonds from August to September into the middle of December. So our participation in those sorts of things will also increase the turnover. But we view them generally as relatively low-risk.

What kind of interest rate risk do investors in the fund face?

Not as much as many people think. In the case of high-yield bonds, the academic studies have shown only about a 40% correlation with interest rates to performance, and they show only about a 50% correlation with the equity market on performance. Some of the better-quality issues, the double-B names, for example, will trade more closely-linked to interest rates. So, you have to be conscious of that—if you have an interest rate outlook that is not good for bonds, then you have to be cautious in owning the higher-quality bonds.

In the high-yield market, you're generally focused less on interest rates, but more on the creditworthiness or the prospects for improving creditworthiness.

What about the overall economic cycle, for instance, heading into a recession?

That's one of the key issues in the high-yield market—is a recession looming out there? In that situation, fund investors are subject to a couple of risks. One is just plain old spread widening [the difference between bond yields and Treasuries gets larger, indicating price drops on the bonds]. Two, of course, is the risk of increasing defaults. Both of those things are going to take away from your total return. My approach is that I always assume I'm going to own something during a recession, so when I'm buying an issue or an issuer, I ask myself, "Can this business survive that kind of environment?" And what tends to happen is that I don't invest much in cyclicals. Cyclicals are inherently dangerous to have highly leveraged because of the economic cycle and the difficulty in predicting when recessions are going to occur. I also tend to be biased against economically sensitive issuers. That's really part of the fallout of the near-death-experience deleverager theme—those situations were primarily cyclicals, and what we were trying to look for were companies whose creditworthiness was going to get disconnected from their otherwise cyclical business nature. My other themes, as you can see, are involved in industries that aren't economically sensitive.

And, of course, if we feel that the economic outlook is not so good, we might upgrade creditworthiness and issuers that are more double-B-like, and we would try to minimize our exposure to triple-Cs.

What would cause you to sell a holding?

We typically set objectives—just like the stock guys might have a 12-month price point, we will have a spread objective relative to other issues in the market. That gives us some rough ideas, not unalterable, of where we think a particular bond will no longer represent value. When that happens, we review the market climate and the prospects for the issuers, and we may modify our expectations and hang on or we may go ahead and sell.

That, of course, is assuming things have gone well. Now, the flip side of that is, what happens if it doesn't work out? Well, part of the process is to monitor these on a daily basis, and we do that through constant communication with the companies or competitors, with our Wall Street resources, different news services—we watch all kinds of things, including stock prices. But, if our initial expectations are not being realized—for instance, maybe bad things start to happen, then our antennae go up. And we have what we call a cockroach theory: bad news is much like a cockroach—when you see one, there's usually more. So, when a company starts to experience a problem, a lot of times the first one is followed by other problems. Now, we don't, in each and every case, sell our securities at the first bad news, but if we can't realistically establish that that first bad news is an exception, it's a sufficient trigger for us to begin a methodical movement out of the securities. And if we see a second problem, it's usually the kiss of death for the issuer for us. Our view is that there's something here that we're missing and we're better off not owning this right now. And I am never lacking for good ideas—I almost always have more ideas than I have capital, so I can easily go elsewhere.