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CANADA AND THE HIGH YIELD DEBT MARKET

For many years, the Canadian debt market has been largely an investment grade market, with most Canadian public debt issues having been rated in or above the triple-B category. Major exceptions to this were "fallen angels" – companies that started out as investment grade and then deteriorated – or specialized corporate structures, in particular the income trusts.

Many large companies that were non-investment grade have taken advantage of the option of raising funds in external high yield markets, like the United States, although a few – most notably Videotron Ltee and Baytex Energy Trust in recent months – have issued in Canada.

Prospects for a Canadian High Yield Debt Market

Currently, the most widely held high yield debt instruments in Canada are income trust issues. Canadian high yield bond mutual funds typically hold income trusts as the majority of their investments. Many of those trusts will have to convert to a conventional corporate form in 2011, but they will still require financing, which many observers see as a possible entrée to a more conventional high yield debt market.

Most of the other high yield debt in Canada is in the form of bank loans on the books of Canadian banks. For a serious high yield market to develop, first, the banks would have to decide that it made strategic sense to move those assets (or at least some of them) off their books and re-distribute them to non-bank institutional investors. That in turn would require existing institutional investors, or retail investors via mutual funds, to be willing to step up and buy the high yield assets. This was a critical part of the evolution of the high yield bond and leveraged loan markets in the United States, as described below.

But what is the likelihood of both of those things occurring – the income trusts morphing into high yield borrowers and the banks beginning to sell off their high yield loans to outside investors – and even if they did, will that be enough to jump start a Canadian high yield market? Many observers are doubtful that there is enough of a critical mass of high yield issuers – even including the converted income trusts – to entice institutional investors, currently comfortable with largely investment grade portfolios, to adopt new behaviours and analytical skill sets. Likewise, they believe that Canadian banks, having survived the recent financial crisis better than banks in most other financial markets around the world, have little incentive to adopt new strategies that would dramatically change the current "buy-and-hold" approach to their loan portfolios.

Offsetting this may be restlessness among investors generally – in Canada and elsewhere – who have been largely disappointed with the performance of their equity portfolios over the past decade. To them, the prospect of "fixed income" as promised by high yielding investments may look very attractive. U.S. investors, in particular, worried about future prospects of U.S. stocks and the U.S. economy in general, may be attracted by high, stable yields like those offered by Canadian income trusts or their post-2011 successor vehicles. For these investors, the prospect of additional gains from the long term strengthening of the Canadian dollar would be icing on the cake.

Predicting financial market evolution – especially after the events of the past two years – is a foolhardy exercise, but we foresee the following general trends:

- Many income trusts will convert to corporate status, will be rated non-investment grade and will still need to raise public debt – hence there will be a local demand for high yield finance;
- Each year, some companies currently borrowing from their local banks will reach that stage – in terms of size, creditworthiness, financial sophistication – where they realize that they can find additional financing options (private placements, public debt markets, etc.) and potentially better terms by "graduating" to the high yield debt market, creating additional issuer demand for high yield debt.
- Investors – retail and institutional – will see that there are "equity-like" returns to be made in fixed income by moving further down the credit-risk spectrum.
- Banks and investment firms will see opportunities in all of this, and will gradually encourage more borrowing clients to issue high yield debt and create additional investment vehicles (e.g., mutual funds, etc.) and platforms to enable investor clients to buy, hold and trade it.

Investment Grade vs. High Yield Debt

There is a reason why high yield debt markets don't just spring up overnight. While it may be true that "credit is credit" and "debt is debt" up and down the credit spectrum, in reality the markets for investment grade debt and non-investment grade (i.e., high yield) debt are very different. The primary difference is in the type of risk being taken by investors.

Investment grade debt involves primarily interest rate risk, with credit risk being a secondary consideration. The term "fixed income" has traditionally been used to describe investment grade debt and to differentiate it from equity, where the income is not fixed, but is instead theoretically unlimited. But the emphasis on the term "fixed" income suggests that the primary risk is not that an investor won't get their money back, but rather that because the amount they will get back is "fixed" and therefore unchangeable, that it will be worth less in a future environment. For example, an existing ten-year bond paying 6% per annum has to be marked down in price when interest rates on newly-issued bonds go up to, say, 8%. To most traditional investors in such bonds – if they were issued by investment grade companies – the risk of a drop in the price of the bond due to interest rates rising is more tangible and immediate than the risk of the issuer failing to pay at maturity.

Investors use the term "duration" to quantify the risk represented by a bond's sensitivity to interest rate changes. A bond with a duration of, say, seven years would normally lose 7% of its value for every 1% increase in interest rates. So a 3% increase – a significant increase in rates – would result in a 21% loss in bond market value. Managing these types of risks requires a bond portfolio manager to focus closely on macroeconomic trends (interest rates, central bank policy, etc.) and to be prepared to take actions – bond purchases and sales, hedging activities, etc. – as necessary.

Investors in high yield bonds have much more than interest rate risk to worry about. Historical studies that track global default rates by rating category show that high yield (i.e., non-investment grade) debt has defaulted at about 15 times the rate of investment grade debt. For example, about 14% of outstanding high yield debt defaulted in 2009. So investors that focus on high yield debt have to devote a lot more of their resources to credit analysis, as opposed to interest rate trends.

Migration of Investor Platforms

Investment professionals who are expert at doing some of these things – like analyzing macroeconomic trends and managing interest rate risk – are not necessarily also trained and experienced at evaluating and managing credit risk. So typically investor platforms start out specializing in one or the other, and then add the additional expertise if and when they increase their investment appetite. In the United States, for example, the banking industry started out primarily focused on credit risk – lending directly

to their corporate customers and holding the loans in portfolio until maturity. Institutional investors – pension funds, endowment funds, insurance companies – tended to be the typical fixed income players in what was predominantly an investment grade public debt market. So you had big companies – largely rated investment grade, except for previously rated investment grade firms that had become "fallen angels" – that borrowed in the public markets from institutional investors largely focused on interest rate risk; and you had smaller companies that, had they been rated would have been non-investment grade, still borrowed directly from banks and occasionally from an insurance company via the private placement market.

That was the situation in the United States until about 25 years ago, when the first of two major developments happened that opened the public debt markets to high yield issuers. The first was the large-scale introduction of high yield bonds by Michael Milken and his colleagues at investment bank Drexel Burnham Lambert. This was facilitated on the investor side by the growth of the mutual fund industry, and – in particular – the rise of high yield bond funds as a competitor and/or complement to equity funds. More recent, and perhaps even more important, was the shift by major U.S. and European banks from a business model where they made loans to their clients and held them on their books to maturity, to one where they originate loans and distribute them to other banks and investors, keeping only a relatively small piece in their own portfolio.

This transition from essentially a traditional "commercial banking" model to an "investment banking" model, where a bank's fees for underwriting and distributing loans came to overshadow its traditional "spread income" from lending at a higher rate than its cost of funds, was driven by several factors:

- Bank mergers, where the surviving bank typically did not want to lend as much in total to the same borrower as the two merging banks previously did;
- The introduction of "portfolio theory" to commercial banks, which led many banks to diversify away from their natural "skewed" customer loan bases; and
- The realization by many banks' management that they could increase their return on assets and capital by using their balance sheets more efficiently generating fee income instead of booking assets permanently.

Along with these strategic change drivers, there was also a recognition that the traditional investment bank compensation model was more generous than the typical commercial banking pay model, which eased and even encouraged the behavioural and cultural transition.

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