



Active is: Converting fallen angels to saints

May 2020

With global growth having collapsed under the impact of the coronavirus, rating agencies have been swift to downgrade companies, with many sizeable issuers already falling into high yield and more are expected in the coming months. Rather than a threat, we believe this could be an attractive opportunity for canny investors.

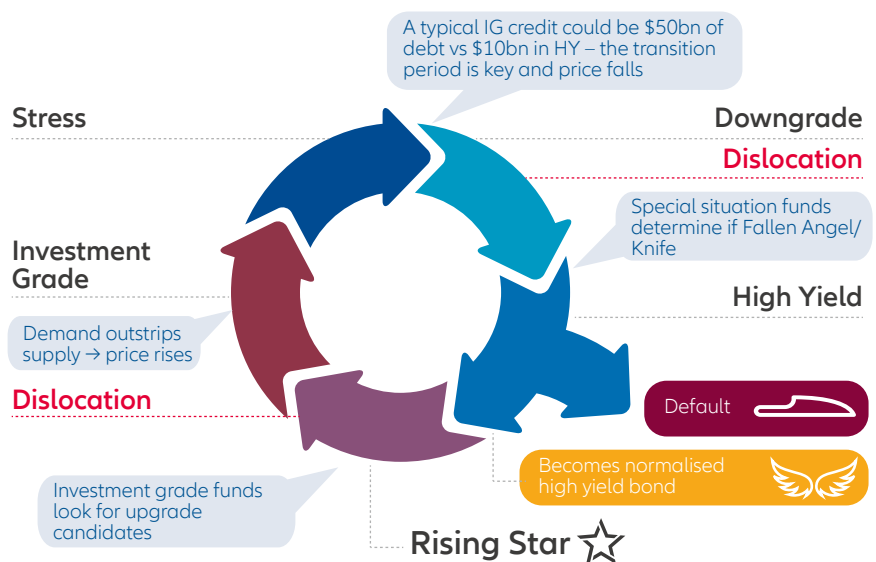
Credit spreads are currently pricing in close to the worst downgrade data seen over the last 30 years and in our view more than compensate for the downside risks in BBB-rated issues. We also observe that fallen angels typically outperform as economies emerge from recession, and have taken advantage of this in our portfolios.



David Newman
CIO Global High Yield

Even before the coronavirus crisis, there had been much written the explosion in BBB-rated debt, and the amount that could be downgraded to high yield. There could be up to \$900bn of "fallen angels" in the coming downgrade cycle according to some of the more pessimistic rating agency forecasts; this represents around 45% of the whole high yield market. During the transition from investment grade to high yield there is likely to be significant price dislocation and there will be bonds that trade materially cheaper than credit fundamentals suggest.

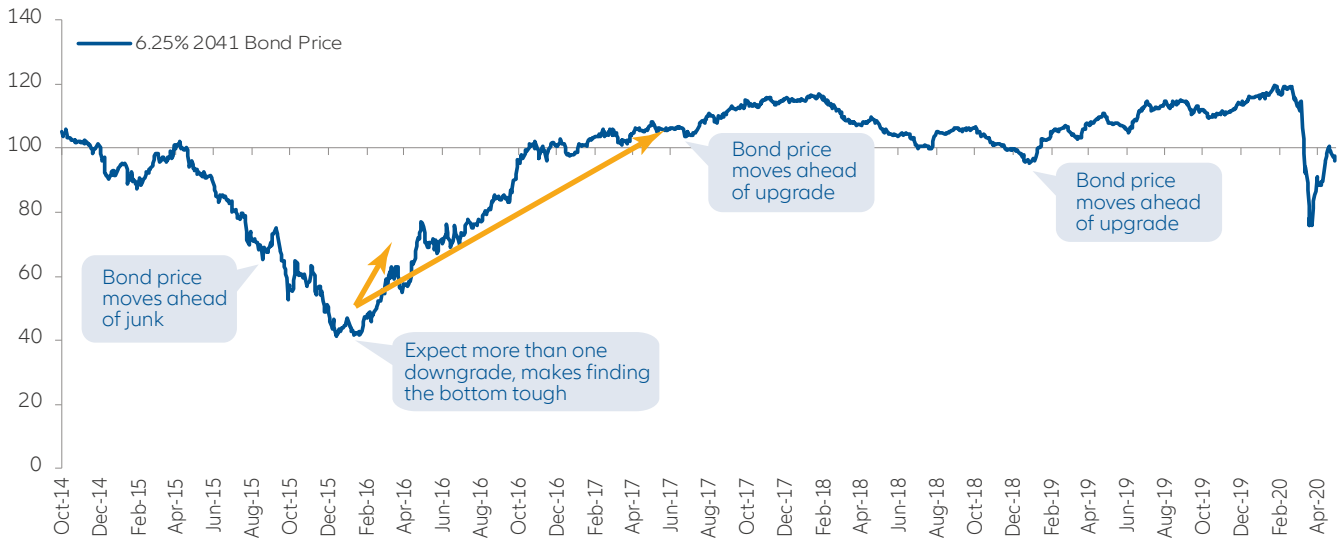
The graphic below illustrates a typical corporate credit lifecycle. The primary driver of the dislocation is that many of the fallen angel candidates have c\$50bn debt. The largest existing High Yield tickers are around \$15bn. So loose bonds need to be cheap to encourage an overweight position; over time the price should normalise if the credit profile warrants it.



Allianz Global Investors, for illustrative purposes only.

Case Study

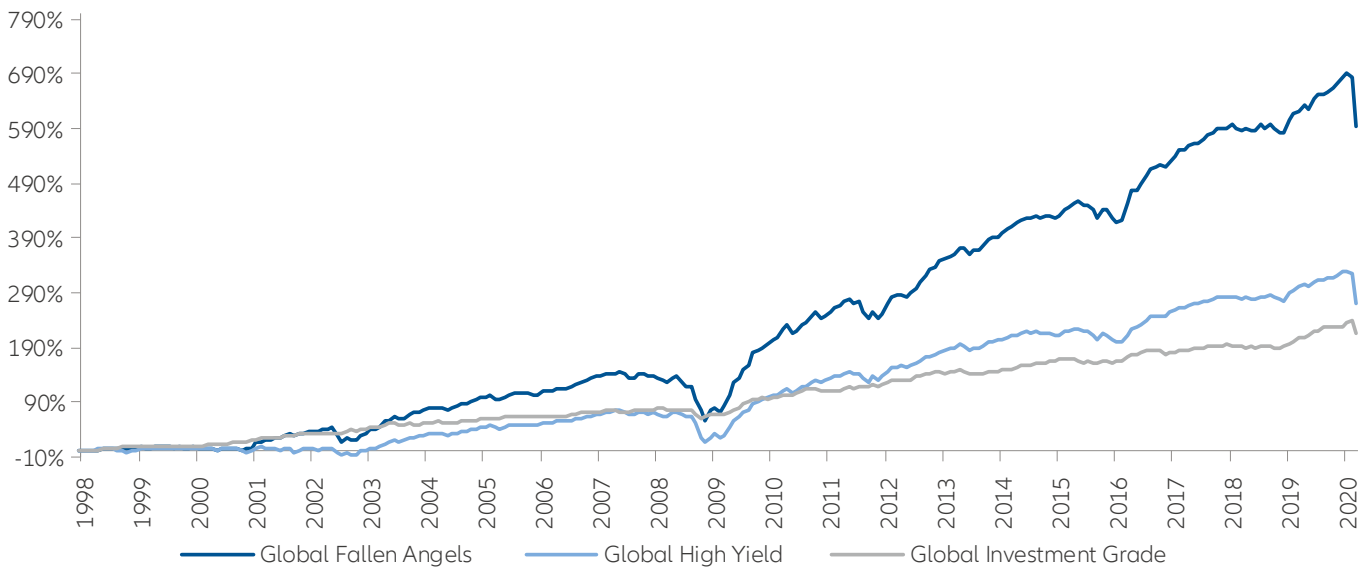
Global Mining Company (2013-20)



Source: Bloomberg. Past performance is not a reliable indicator of future results

Looking at the above example from a mining company, there are two potential trades. The first, illustrated by the yellow arrow, is the dislocation trade, buying at 55 and selling at 70 five months later, for a 32% return. Assuming the proceeds are kept in cash for the rest of the year at 0%, the annualized return is c.13%. The second trade illustrated by the green arrow is a longer term fallen angel strategy, buying at 55 and selling 28 months later at 110, for an annualized return of c.52%.

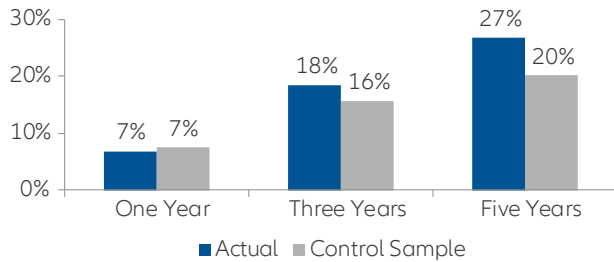
What is also interesting is how well fallen angels perform versus either investment grade or high yield. Below we compare the ICE BofAML Global Fallen Angels index vs Global High Yield and Global Investment Grade indices over the past 22 years. As can be seen in the chart and table below, the returns of the fallen angel index look attractive, though they do come at the price of increased volatility over investment grade and broad high yield.



Source: Bloomberg, to March 2020. Returns in USD hedged terms. Past performance is not a reliable indicator of future results.

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Cumulative Rising Star Rates for Fallen Angels and a Control Sample of Similarly-Rated Non-Fallen Angels at Firm Level



Source: Allianz Global Investors, Moody's, to Q1 2019. Past performance is not a reliable indicator of future results

There are of course some names that get downgraded and continue to fall – sometimes even default within a year of being investment grade. In a stressful situation like that, sometimes it makes sense to revert to basics and think about the canons of lending. A 2014 Moody's study found only 28% of fallen angels subsequently returned to investment grade; our own research to Q1 19 yielded similar results (27%). This is higher than a similarly rated control group however, as the chart on the left shows. This is why an active strategy is important – avoiding the “falling knives” is key. Away from fraud, falling knives are hard to pinpoint, but environmental liabilities, product obsolescence and failure of management teams to recognise secular changes combined with a short term liability structure are fairly common themes.

Why invest now?

BBB and BB Credit spreads are pricing in close to the worst downgrade data seen over the past 30 years. In BBB, the biggest cost is being downgraded – as long as there isn't a default – this is a mark to market loss caused by the higher spread BB bonds command multiplied by the duration of the bond. By the time you migrate to B – the cost of defaults is higher than the cost of a downgrade hence this strategy focuses on BBB and BB. We aim to capture the high costs borne by original BBB investors to the advantage of new investors.

| [4Q 2018; 2Q 2013; 3Q 2011] | GDP | Date | A | BBB | BB | B | CCC | Fallen Angels | Equities (S&P 500) |
|-----------------------------|-------|--------|-----|-----|------|------|------|---------------|--------------------|
| Going into recession | 2.9% | Sep-18 | 13% | 13% | 10% | 6% | -5% | 7% | 2% |
| Emerging from recession | 1.1% | Dec-18 | 13% | 16% | 16% | 14% | 9% | 17% | 29% |
| | 3.1% | Mar-19 | -4% | -8% | -14% | -18% | -29% | 9% | -21% |
| Going into recession | 3.6% | Mar-13 | 1% | 2% | 6% | 7% | 10% | 9% | 19% |
| Emerging from recession | 0.5% | Jun-13 | 7% | 10% | 11% | 11% | 14% | 15% | 22% |
| | 3.2% | Sep-13 | 6% | 9% | 8% | 7% | 7% | 11% | 17% |
| Going into recession | 2.9% | Jun-11 | 9% | 9% | 8% | 6% | 3% | 6% | 3% |
| Emerging from recession | -0.1% | Sep-11 | 11% | 12% | 18% | 18% | 25% | 20% | 27% |
| | 4.7% | Dec-11 | 10% | 12% | 14% | 15% | 20% | 22% | 13% |
| [2008 Financial Crisis] | GDP | Date | A | BBB | BB | B | CCC | Fallen Angels | Equities (S&P 500) |
| Going into recession | 2.0% | Jun-08 | 0% | 5% | 1% | -7% | -10% | 3% | -28% |
| During recession | -1.9% | Sep-08 | 19% | 22% | 21% | 15% | 30% | 39% | -9% |
| | -8.2% | Dec-08 | 16% | 31% | 45% | 48% | 97% | 65% | 23% |
| Emerging from recession | -5.4% | Mar-09 | 22% | 33% | 41% | 47% | 110% | 68% | 47% |
| | -0.5% | Jun-09 | 15% | 20% | 23% | 21% | 46% | 32% | 12% |
| [2001 Tech Recession] | GDP | Date | A | BBB | BB | B | CCC | Fallen Angels | Equities (S&P 500) |
| Going into recession | 2.1% | Jun-01 | 9% | 4% | -3% | -3% | -11% | 0% | -19% |
| During recession | -1.3% | Sep-01 | 11% | 3% | -4% | 1% | -10% | -7% | -22% |
| Emerging from recession | -8.2% | Dec-08 | 16% | 31% | 45% | 48% | 97% | 65% | 23% |

Source: Allianz Global Investors, twelve month forward returns in USD terms. Past performance is not a reliable indicator of future results.

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The AllianzGI fallen angel experience

AllianzGI's Global Fixed Income team has been running its proprietary Credit Watch Model since 1999 and this has had a great success in identifying fallen angels ahead of time. This has helped to prepare us for buying opportunities in our high yield accounts, also helped by the fact that our analysts cover their universes seamlessly across investment grade and high yield. Thus when a "new" fallen angel enters the market, we already have an in depth knowledge of the credit issues. We have also used our proprietary High Yield Credit Filter since 2010 which provides a good starting point for fundamental credit analysis and can help to distinguish between fallen angels and falling knives.

A Selective approach to Global High Yield

The strategy aims to generate close to high yield returns, but with volatility closer to investment grade. The strategy has a lower yield than traditional High Yield strategies but aims to generate extra returns from credit improvement and spread compression. We have had no defaults in Selective Global High Yield and our ratio of identifying rising stars has been above that of the BB/B universe in 7 of 10 years that we have been running the strategy:

| | 2010 | 2011 | 2012 | 2013 | 2014 | 2015 | 2016 | 2017 | 2018 | 2019 | Average |
|---------------|------|------|------|------|------|------|------|------|------|------|---------|
| BB/B universe | 986 | 780 | 1179 | 1239 | 1387 | 1447 | 1355 | 1190 | 1289 | 1307 | 1216 |
| BB/B upgrades | 23 | 41 | 51 | 43 | 47 | 42 | 43 | 46 | 47 | 45 | 43 |
| | 2.3% | 5.3% | 4.3% | 3.5% | 3.4% | 2.9% | 3.2% | 3.9% | 3.6% | 3.4% | 3.6% |
| SGHY issuers | 113 | 119 | 148 | 174 | 168 | 154 | 176 | 178 | 177 | 182 | 159 |
| SGHY upgrades | 2 | 9 | 11 | 5 | 6 | 9 | 3 | 10 | 8 | 12 | 8 |
| | 1.8% | 7.6% | 7.4% | 2.9% | 3.6% | 5.8% | 1.7% | 5.6% | 4.5% | 6.6% | 4.7% |

Source: Allianz Global Investors. Universe = ICE BofA ML Global BB/B High Yield Index (HW40). Past performance is not a reliable indicator of future results.

Since inception (2010), the strategy has delivered on its goals: generating returns ahead of investment grade and the peer group, particularly in "risk-off" periods.



Source: Allianz Global Investors, Bloomberg, Morningstar. This share class has performance data calculated prior to the inception date, 2016-10-31. This is based upon an extended track record, using the track record of Rogge Selective Global High Yld Bd USD (ISIN: IE00B771F765), and is in accordance with Morningstar's Extended Performance Methodology paper. Data as at 31/03/2019. Past performance is not a reliable indicator of future results.

Selective High Yield – reasons to invest

- Track record with substantially lower volatility than the peer group
- Has and will focus on fallen angels but with no defaults in its history
- Has identified numerous upgrades to Investment

Conclusion

- We should not be overly fearful of the coming wave of fallen angels - many of the potential downgrades are sound businesses that we believe will not fall below BB and many will return to investment grade
- Analysis shows that buying fallen angels immediately after a credit event can generate strong returns and that as an asset class, performance can be particularly strong when emerging from a recession
- The risk of falling knives means that active management is key
- AllianzGI's strong fundamental research team plus proprietary High Yield Credit Filter and Credit Watch Models give us an edge to manage this strategy effectively and our Selective Global High Yield track record proves this

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