Trusting in INCOME

The City Merchants High Yield Trust Limited (CMHY) and the Invesco Enhanced Income Limited (IPE) investment companies are both focused on paying a consistent level of income. CMHY currently targets an annual dividend of 10p per share while IPE has an annual target of 5p per share[1].

One of the key differences between the two companies is borrowing. Both investment companies have this facility, but our approach with CMHY is to do so only on a short-term tactical basis. Typically, such borrowing might represent between 5-10% of the company's Net Asset Value (NAV). An example of its use might be if we saw a significant re-pricing of the high yield market, we might use borrowing to increase exposure to areas where we see value and therefore potentially enhance returns. As well as the capacity to do so on a tactical basis, IPE maintains a long-term structural level of borrowing. This approach means that the company can hold higher quality high yield bonds with the borrowing used to potentially enhance the level of income paid out.

Positioning

The two companies' current holdings can be split into three broad categories: income generators, subordinated financials and credit intensive bonds. Combined, the first two categories typically account of around 85% of the portfolio with the credit intensive allocation and cash making up the remainder.

1 Income generators

This category forms the core of both funds and is made up of bonds issued by non-financial corporates. The bonds typically pay a high level of yield to compensate for the issuing companies' high level of borrowing. To manage the risk of the issuer not being able to make interest payments and repay its debt (credit risk) we undertake thorough due-diligence on each position and hold a diversified portfolio of around 50 bonds. The determining factor in making an investment is whether the bond pays an appropriate level of compensation for the risk of holding it. To determine this, we seek to get a comprehensive understanding of the credit risk. However, in recent years the influence of central banks has made this more challenging.

2 Banks and subordinated financials

This has been an important sector across all the Henley managed fixed income portfolios since the global financial crisis. At the time of the crisis, there was huge uncertainty with the survivability of the financial system being called into question. This degree of uncertainty meant that we were able to buy bonds at very attractive prices. Today, the market has moved on. Banks are in a much stronger position than they were at the time of the crisis. As a result,

the opportunity within this sector is now no longer about capital gains, but about income. For example, the ICE BofAML index of Contingent Capital (CoCo) bonds (the most junior type of bond issued by banks) currently offers a yield to maturity of 6.3%[2]. Given the relatively attractive levels of yield available within this sector, banks and insurers have become an important source of income for the investment companies.

3 Credit intensive

The final category of bonds we hold are what we call credit intensive issuers. This part of the market is bigger than it has been for several years and represents a different opportunity beyond just the income that the first two categories can offer. In the investment companies these bonds represent around 10-15% of the portfolio. Holdings in this category might include a troubled company that has a turn-around plan that we believe in. Often such bonds trade well below par (the amount the issuer will repay on maturity of the bond) and have double digit yields. The premise with such investments is that if our analysis is correct, then we would expect to earn at least part of the return on these bonds from capital gains as the bond's price moves back towards par.

Outlook

After a period of challenging performance at the end of 2018, high yield bonds markets have had a strong start to 2019. Indeed, the European currency high yield bond market has had its strongest start to the year since 2012. However, this recovery has not been universal with the dispersion in returns creating some investment opportunities.

One of the key catalysts of the rally this year has been the pivot by central banks toward more accommodative monetary policy. This pivot is one of several similarities between 2018/19 and 2015/16. On both occasions, markets were confronted by concerns over global economic growth, China and trade tensions and the central bank response. However, it is worth noting that in 2017 central banks were increasing liquidity through quantitative easing. Today, the stimulus is more limited.

Overall, therefore while valuations have become more attractive, the wider fundamentals are not as strong as they were a year ago, but as we have seen central banks can have a significant impact on markets and so we need to be cognisant of this, but still focus on valuation. This mixed outlook leads us to be cautious, but constructive on the asset class during 2019. ■

Investment risks

The value of investments and any income will fluctuate (this may partly be the result of exchange rate fluctuations) and investors may not get back the full amount invested.

When making an investment in an investment company you are buying shares in a company that is listed on a stock exchange. The price of the shares will be determined by supply and demand. Consequently, the share price of an investment company may be higher or lower than the underlying net asset value of the investments in its portfolio and there can be no certainty that there will be liquidity in the shares.

The portfolios have a significant proportion of high-yielding bonds, which are of lower credit quality and may result in large fluctuations in the NAV of the products.

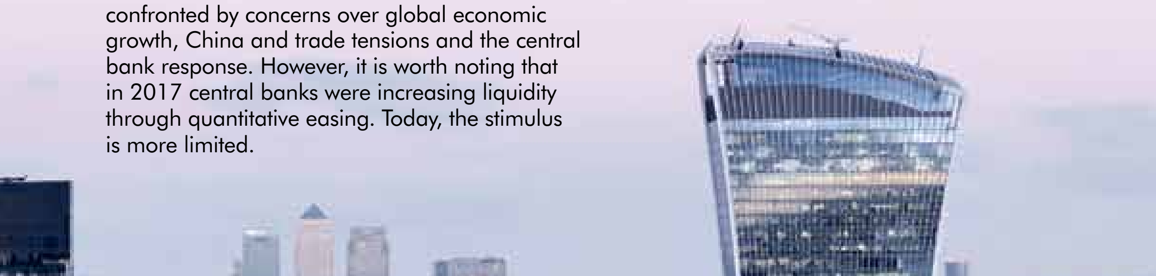
The products use derivatives for efficient portfolio management which may result in increased volatility in the NAV.

The use of borrowings may increase the volatility of the NAV and may reduce returns when asset values fall.

The products may invest in contingent convertible bonds which may result in significant risk of capital loss based on certain trigger events.

1. Please note that there is no guarantee that these dividend targets will be achieved.

2. Yield to Maturity is the total return anticipated on a bond if held to maturity with all payments reinvested at the same rate.



Important information: Data as at 30 April 2019 unless otherwise stated. Where individuals or the business have expressed opinions, they are based on current market conditions, they may differ from those of other investment professionals and are subject to change without notice. This article is marketing material and is not intended as a recommendation to invest in any particular asset class, security or strategy. Regulatory requirements that require impartiality of investment/investment strategy recommendations are therefore not applicable nor are any prohibitions to trade before publication. The information provided is for illustrative purposes only, it should not be relied upon as recommendations to buy or sell securities. For more information on our products, please refer to the relevant Key Information Document (KID), Alternative Investment Fund Managers Directive document (AIFMD), and the latest Annual or Half-Yearly Financial Reports. This information is available using the contact details shown.

Invesco

Rhys Davies

Portfolio Manager and Senior Credit Analyst
Invesco

Rhys began his investment career within the Henley-based Product Support team in January 2002 before moving to the Fixed Interest team in November 2003. In 2014 he was appointed deputy fund manager for the City Merchants High Yield Trust Limited and Invesco Enhanced Income Limited.

He holds a BSc (Honours) in Management Science from the University of Manchester Management School and is a CFA charterholder.

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