SHORT-TERM HIGH YIELD

Investment Insight | Series VI

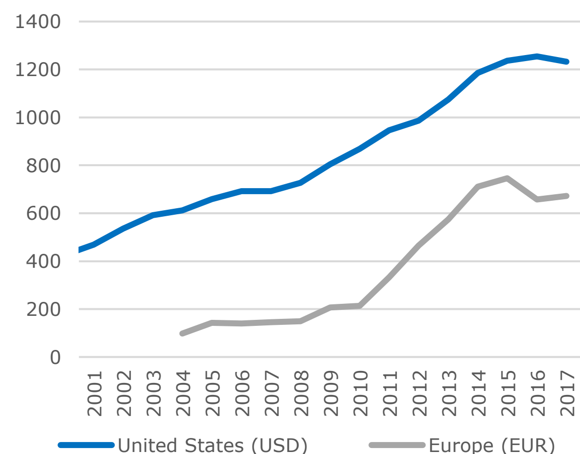
In a series of articles, we discuss and present investment opportunities we actively use in our building blocks to form our absolute return portfolios. So far, we discussed "Structured Credit", "Direct Lending", "Indian Bonds", Secured Lending and Equity Long/Short. In series VI we introduce short-term high yield, which is one of our highest conviction themes in our Fixed Income/Credit bucket. Due to the fact that credit spreads are historically on a very low level and that we face a cycle of rising interest rates, it will be even more important to be more selective in your high yield exposure.

What is High Yield?

In general, High Yield instruments are bonds or loans with a below investment grade rating, hence below "BBB" from S&P or "Baa" from Moody's. Due to the higher risk of default, these instruments offer a higher yield than investment grade bonds. High yield bonds are less sensitive to interest rate risk than their investment grade counterparts as a result of the higher coupon, which serves as a buffer. In fact, high yield is more linked to the overall economic growth and the idiosyncratic credit risk of the underlying. Loans are even less affected by interest rate duration based on their floating rates. Loans exhibit adjustable interest rates (Libor plus credit spread) and therefore are able to benefit from rising interest rates.

Historically until 1980 high yield bonds were just outstanding bonds of previously investment grade rated issuers, or so called "fallen angels". In the 1980s the investment banks, headed by Drexel Burnham Lambert created the modern high yield by selling new bonds from non-investment grade rated companies to finance mergers, acquisition or leveraged buyouts and created the modern high yield. Since then the global high yield market has rapidly developed (Chart 1) and high yield debt is now used for common corporate undertakings.

Chart 1: Size of High Yield Market in billions



Source: Fitch / Alpinum Investment Management

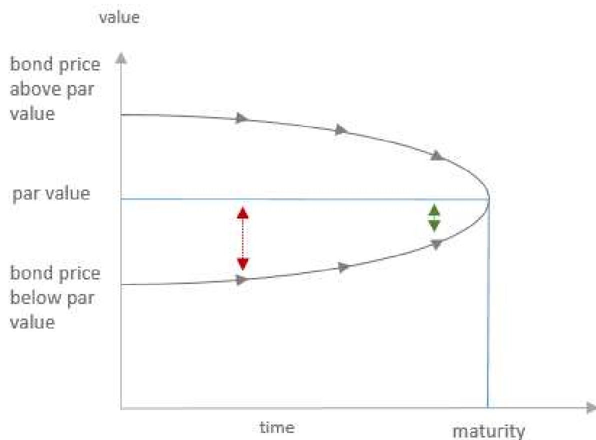
Why short-term high yield?

High-yield instruments usually have shorter maturities compared to their higher-quality counterparts, which helps to reduce the interest rate duration. This characteristic is well shown by comparing the durations of the Bloomberg Barclays U.S. Corporate High-Yield versus Bloomberg Barclays Investment Grade Corporate Index. The first exhibits a duration of 4.05 versus the latter with 7.42. During a rising interest rate environment, low duration is preferred as these bonds are less sensitive to interest rate changes.

Looking at maturities between 12 to 24 months, which we like the most, sensitivities to a change in interest rates or credit spreads are even lower. Any

change in interest rates or credit spreads will lead to mark-to-market price changes of the bond. That said, the effect will be less and the recovery much faster for short-term bonds with a duration of only 1-2 years. This is the so-called "Pull-to-Par" effect, which means that the bond's price moves towards its face value as it approaches maturity (Chart 2).

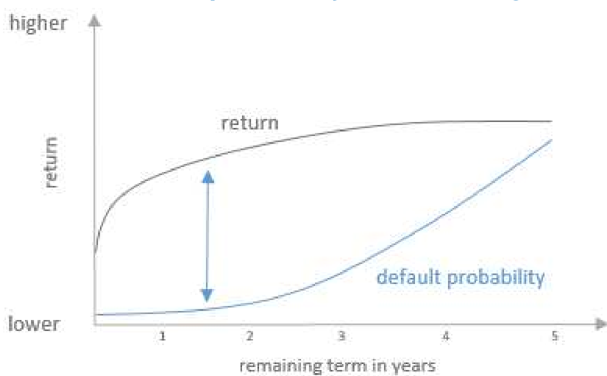
Chart 2: Pull-to-Par effect



Source: Alpinum Investment Management

Due to the short maturity of 1-2 years, the bonds' default rates are typically lower (Chart 3). As all the bonds of an issuer receive the same rating, indifferent of their duration, short-term bonds offer an above-average risk compensation.

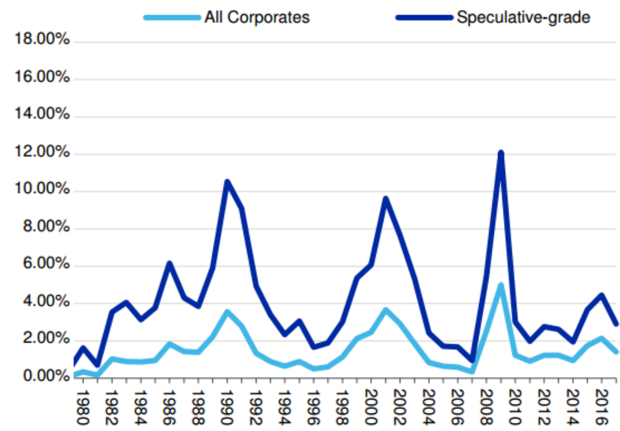
Chart 3: Default probability vs. remaining life



Source: Alpinum Investment Management

As shown in chart 4, since 1983 the issuer-weighted annual default rate, is below historical average (1.6%/4.2%) and end up for all corporates at 1.4% and 2.9% for speculative-grade, respectively, in 2017.

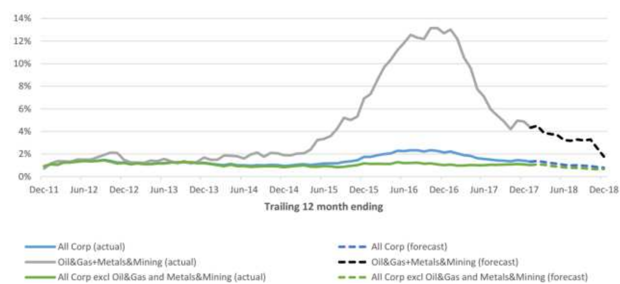
Chart 4: Historical default rates



Source: Moody's Investors Service

Further analysis of the default rates shows that they are mainly driven by cyclical sectors. In 2017, 31% of defaults were from commodity sectors, especially Energy Oil/Gas and Metals/Mining. The retail sector accounts for another 14%. In a growing economy, sector-specific issues mostly affect the default rates. Chart 5 shows the volatility of the commodity sectors default rate compared to all other sectors combined.

Chart 5: Historical default rates



Source: Moody's Investors Service

Our strategy to the benefit of our clients

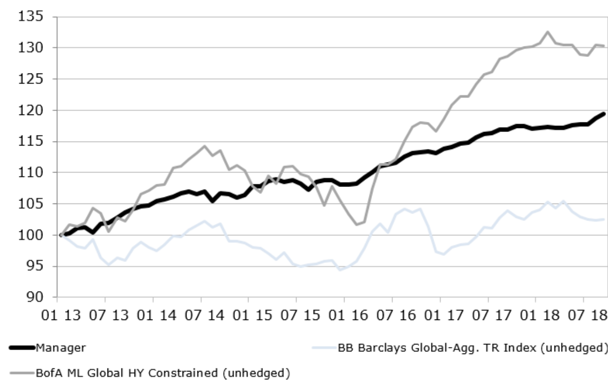
The key to success is to setup a smart, cost-efficient structure in combination with the right manager selection. Thanks to our network, we could win over one of the most sophisticated US manager in this particular asset class. A customized mandate allows us to aim for an attractive yield combined with minimal drawdown risk. Our mandate focuses on short-term corporate credit by investing in high yield bonds and loans with maturities between 12 to 24 months. This segment offers the most attractive risk/return metrics. To decrease the drawdown risk, the mandate structurally

avoids investing in credit from cyclical sectors such as commodities and retail.

The manager's mindset is a blend of long only investing with an absolute return approach. **We are looking for the right philosophy not just an implementation of a strategy.**

Thanks to his disciplined risk management, the manager provides steady and stable returns over time. Starting in early 2013, the manager achieved an annualized return of 3.2% with a risk (standard deviation) of 1.8%. In comparison to the Bank of America Merrill Lynch Global High Yield Index that achieved an annualized return of 4.8% but exhibits a much higher risk of around 5.5% p.a.

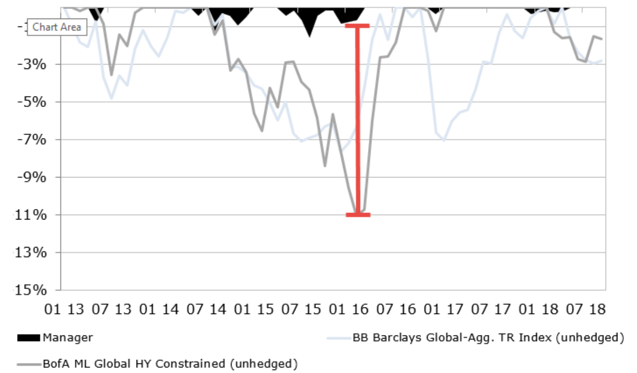
Chart 6: Reality check Part I



Source: Bloomberg / Alpinum Investment Management

Chart 6 shows the manager's capabilities in managing drawdowns. As can be seen in below underwater chart measuring the max drawdown of the manager compared to the Global Bond index and the High Yield Index.

Chart 6: Reality check Part II



Source: Bloomberg / Alpinum Investment Management

During extreme events, such as 2015 until early 2016, where we had a free fall in energy and other commodity prices resulting in a grounding of bonds related to these sectors as well as a spill-over of the price decline to the whole High Yield Index caused by spread widening, the manager was still able to minimize the damage to a minimum. This unique situation highlighted in red, where the high yield index was down -11% versus our mandate down -0.9% clearly shows his competitive edge.

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