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MARCH 2022

# HIGH YIELD SWEETSPOTS: SHORT DURATION BONDS AND FALLEN ANGELS

HIGH YIELD HAS EMERGED AS ONE OF OUR FAVOURED ASSET CLASSES FOR THE MID-CYCLE. WITHIN IT, WE BELIEVE SHORT DURATION BONDS AND FALLEN ANGELS OFFER THE GREATEST POTENTIAL FOR COMPELLING CARRY AND CAPITAL GAINS.

## EXECUTIVE SUMMARY


In an environment of geopolitical uncertainty, rising inflation and monetary policy normalisation, we believe investors should consider high yield given its limited interest rate risk, improving corporate profitability and deleveraging trends.

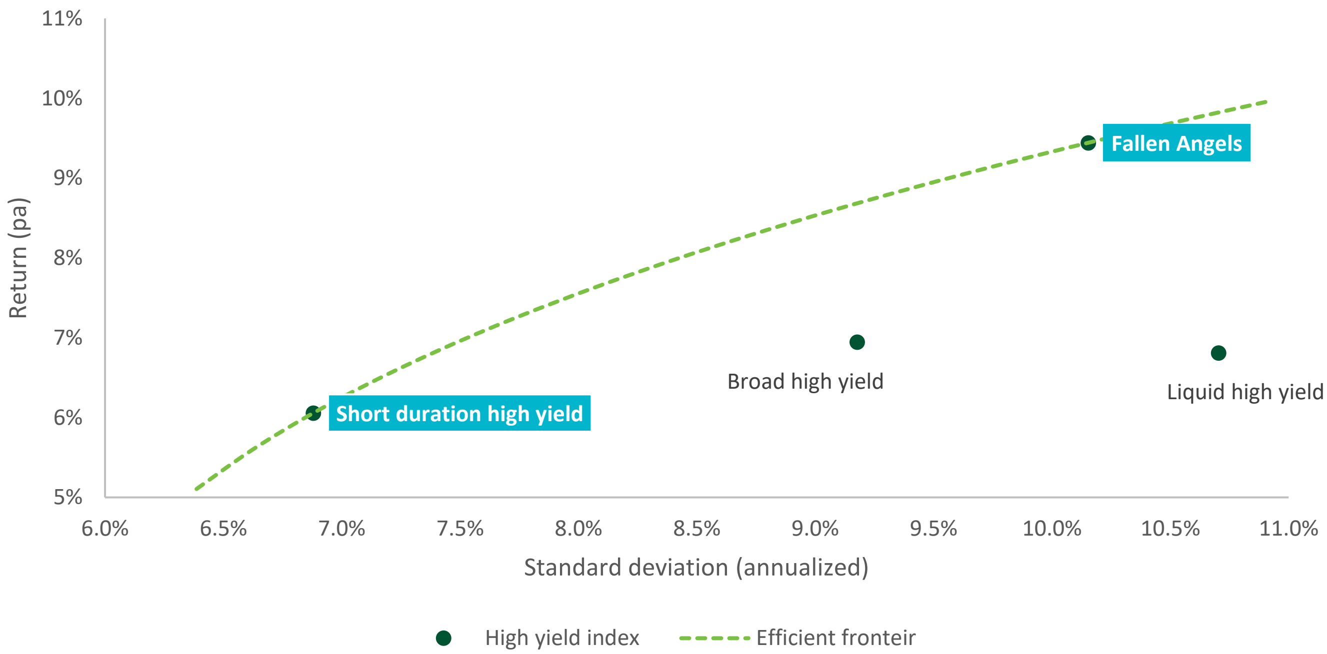
Within high yield, we believe short duration high yield and fallen angels offer compelling ways to generate higher levels of *carry* in fixed income and greater *price stability* than broader high yield markets and other risk assets.

- Short duration and fallen angels have historically sat on the 'efficient frontier' within the high yield market
- Short duration offers an outsized yield premium, in our view, despite its short-dated nature
- Fallen angels (former investment grade companies) have historically offered the greatest potential to benefit from capital gains from rising stars (bonds upgraded to investment grade).


## SHORT DURATION AND FALLEN ANGELS SIT ON THE EFFICIENT FRONTIER WITHIN HIGH YIELD

Historically, short duration high yield and fallen angels have delivered superior returns to other high yield segments (Figure 1). As such, those looking to allocate to high yield should, in our view consider a combination of allocations to both strategies.

Figure 1: Short duration and fallen angels are the high yield efficient frontier[1]



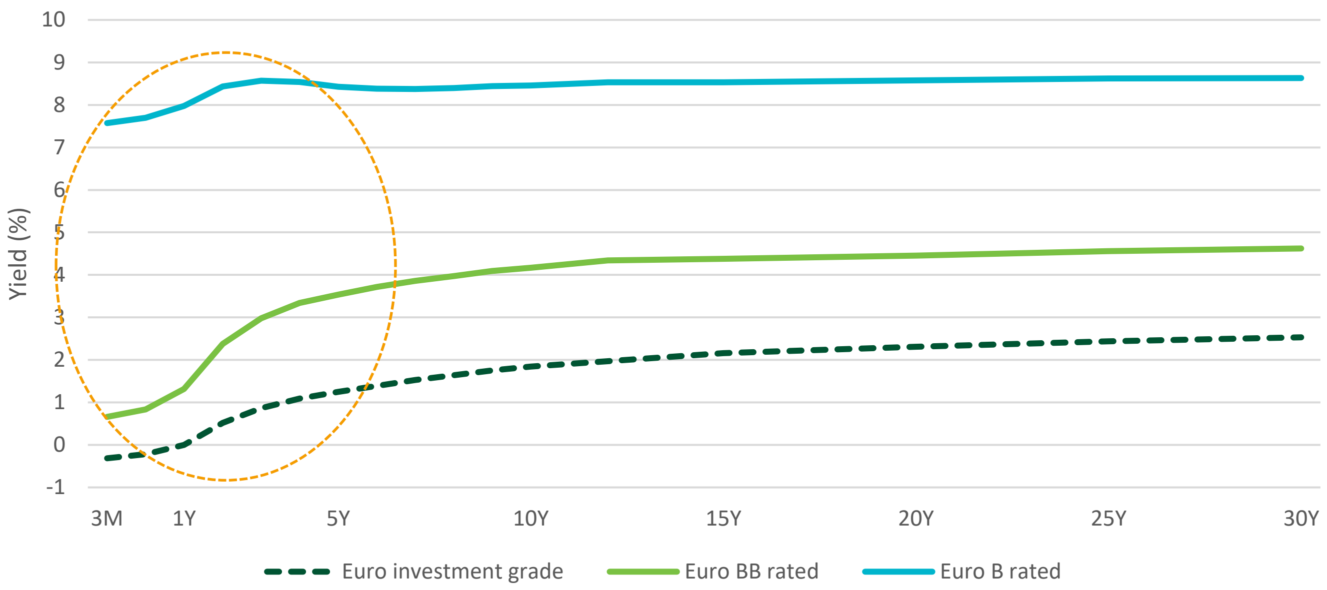

[1] US market figures. Bloomberg, Insight calculations. October 2004 (inception of the broad high yield index) to February 2022

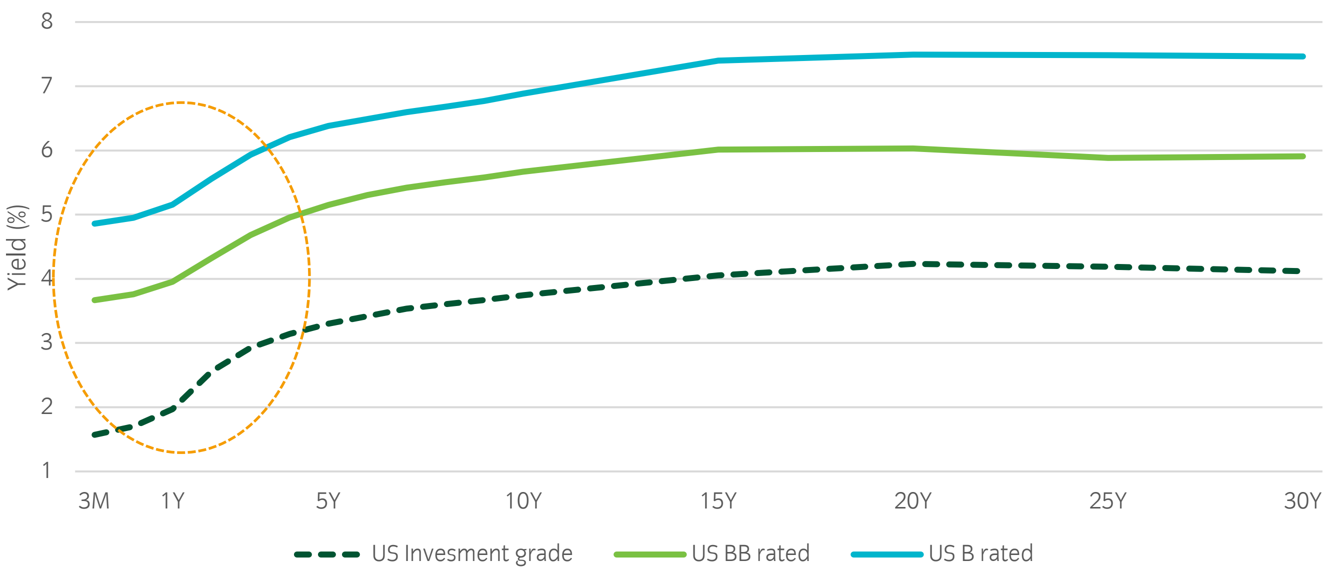
## 1) SHORT DURATION HIGH YIELD: COMPELLING CARRY AND PRICE STABILITY

Short duration high yield bond investors have the most visibility into corporates' ability to repay short-dated bonds, by analysing their liquidity positions. Short duration bond portfolios also tend to be the most liquid, given the frequency of maturities, and prices tend to be stable given the "pull to par" effect.

Despite this, short duration high yield bonds still tend to offer a large yield premium over investment grade bonds (Figure 2). In our view, this is because high yield companies often receive a single credit rating for their long and short-term debt, unlike investment grade issuers and this limits the number of investors able to purchase them.

**Figure 2: High yield bonds have a single credit rating regardless of maturity, which can result in compelling premium at the front-end[2]**

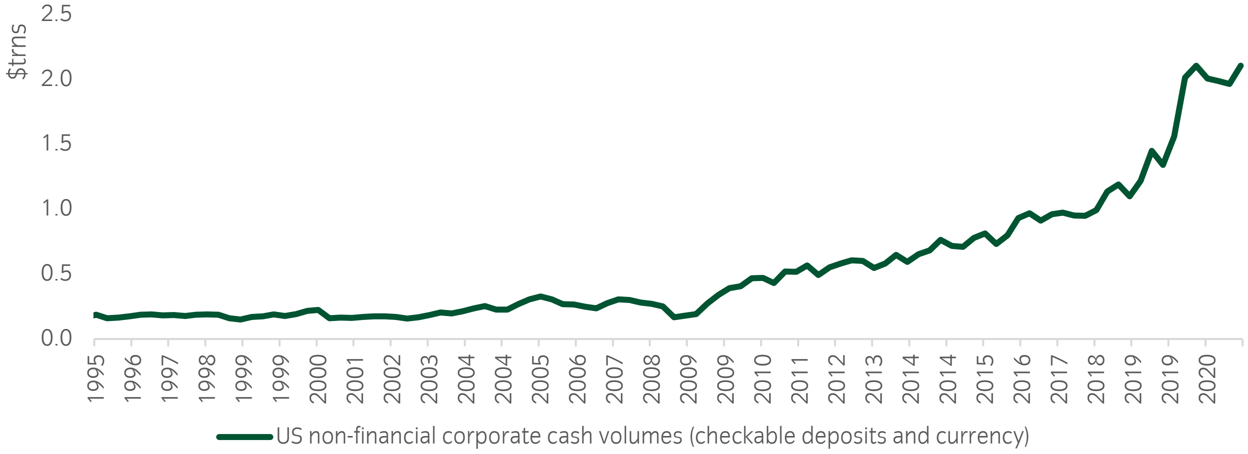



This is also despite the fact that corporate liquidity positions are currently particularly healthy, as many companies built large liquidity buffers during the beginning of the pandemic as a buffer against uncertainty (Figure 3).

[2] Bloomberg, March 2022

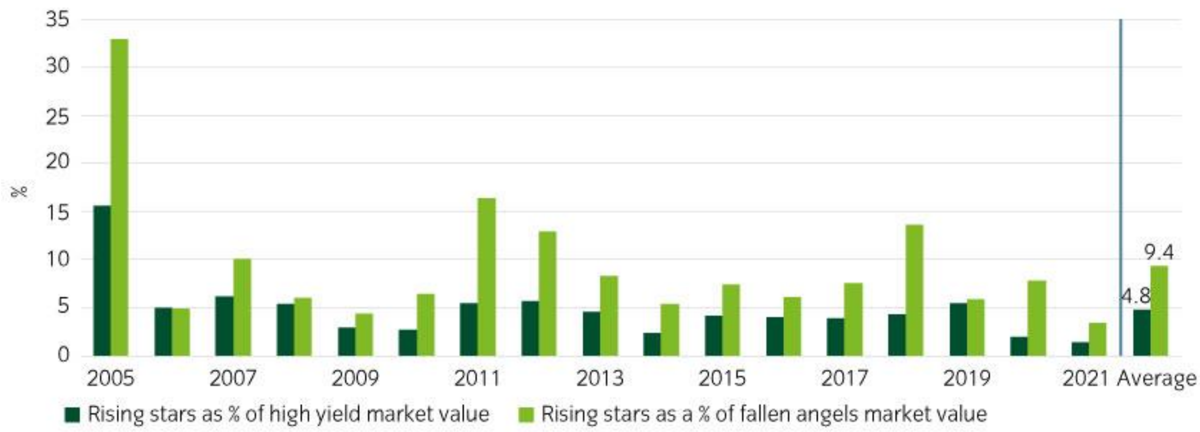
Figure 3: Corporate liquidity for near-term maturities is still around record highs, good news for short duration investors[3]




## 2) FALLEN ANGELS – THE GREATEST POTENTIAL FOR CAPITAL GAINS

In our view, fallen angels, are one of the few areas that offer compelling prospects for material capital gains at this stage of the cycle. This is because the fallen angels market has historically been twice as likely to incubate future rising stars than the broad high yield market (Figure 4). Rising stars benefit from 'forced buying' from investment grade accounts during the period in which they receive an upgrade.

Figure 4: Rising stars have been almost twice as likely to come from the fallen angels market than the broad high yield market[4]




Furthermore, fallen angels have tend to offer higher credit ratings than other high yield companies (Figure 5).

Figure 5: Fallen Angels have the highest credit quality within high yield[5]

| As of October 2021 | Broad HY | Liquid HY | Short duration HY | Fallen Angels |
|---|---|---|---|---|
| Ba exposure | 51% | 39% | 52% | 87% |
| B exposure | 37% | 50% | 36% | 10% |
| Caa and lower | 12% | 11% | 12% | 3% |

## BOTH SHORT DURATION AND FALLEN ANGELS POTENTIALLY OFFER PROTECTION AGAINST RISING RATES

High duration bonds have historically performed well through periods of rising rates.

Over the seven periods since 2004 in which 10-year Treasury yields rose by 1% or more, short duration high yield bonds were particularly well-insulated given their low interest rate risk exposure. Fallen angels have also fared well, with gains from credit spread tightening compensating for losses from interest rate risk (Figure 6).

[3] FRED, December 2021

[4] Bloomberg, February 2022

[5] Bloomberg, February 2022

Note that the following figures exclude the additional return from call premia, earned when callable bonds are redeemed early. This is more likely to positively impact short duration bonds than Fallen Angels (as investment grade bonds are rarely callable).

Figure 6: Both short duration and fallen angels have historically performed well during the seven periods since 2004 that 10-year Treasury yields have risen by 1%[6]

| | Short Duration HY Corp | | | Fallen Angels Corp | | |
|---|---|---|---|---|---|---|
| | **Total Return** | Spread Return | Rate Return | **Total Return** | Spread Return | Rate Return |
| Jun 05 – Jun 06 | 6.17% | 3.30% | 2.87% | 2.25% | 4.27% | -2.02% |
| Dec 08 – Dec 09 | 50.83% | 42.61% | 8.22% | 73.08% | 75.52% | -2.44% |
| Aug 10 – Mar 11 | 9.48% | 7.97% | 1.51% | 10.25% | 13.42% | -3.18% |
| Jul 12 – Dec 13 | 14.71% | 13.84% | 0.87% | 17.45% | 21.61% | -4.15% |
| Jul 16 – Dec 16 | 5.09% | 5.17% | -0.08% | 5.48% | 10.18% | -4.70% |
| Aug 17 – Oct 18 | 4.24% | 2.16% | 2.08% | 2.40% | 5.48% | -3.07% |
| Jul 20 – Mar 21 | 8.98% | 8.90% | 0.08% | 9.93% | 15.57% | -5.64% |
| Simple Average | 14.22% | 11.99% | 2.22% | 17.26% | 20.86% | -3.60% |

**Lower rate sensitivity**

**Greater spread compensation**

## BOTH SHORT DURATION AND FALLEN ANGELS MAY OFFER A WAY TO PLAY CORPORATE DELEVERAGING TRENDS

High yield companies need to grow their equity faster than their debt to make good on their interest payments, such as by expanding their businesses, selling assets or reducing debt. This provides a natural impulse for well-run companies to deleverage among.

### Short duration

Deleveraging trends benefit short duration bonds by increasing the frequency of call events. When companies deleverage, they are often able to finance at more favourable terms, incentivising them to redeem their existing issues early and issue new bonds. Investors in callable bonds in growing companies are more likely to benefit from bonds gravitating to their call price (which is typically a significant premium to par). This is most likely to benefit short duration investors able to pinpoint callable bonds with the best prospects of early redemption.

### Fallen Angels

Fallen angels that successfully delever will have a shot at returning to investment grade status, thus benefiting from "forced buying" from investment grade accounts as they return to mainstream indices.

## PLAYING SHORT DURATION HIGH YIELD

Investors can consider separate approaches for capturing beta and alpha in short duration high yield. Either on a standalone basis or together as a complementary strategies.

### 1) Efficient Beta approach: Capturing index returns reliably

Investors may wish to consider capturing the returns of the Short Duration High Yield Index[7], which contains bonds with maturities of 5-years or less. This can be considered a standalone strategy or a complement to a dedicated alpha-only strategy.

Rather than a traditional active or passive strategy, we believe this is best done through an Efficient Beta approach, as it can aim to minimise the drag from trading costs and target systematic sources of alpha,

[6] Bloomberg, February 2022

### 2) Pure Alpha: Capturing unconstrained alpha value opportunities globally

A "pure alpha" benchmark-agnostic strategy that seeks the most attractive value opportunities across the globe, exploiting the widest range of absolute and relative value opportunities, may offer a wider range if return sources, relative value possibilities and increased diversification.

Such managers should be able to freely target callable bonds (i.e. bonds with longer maturities than five years, but that the manager expects likely to be redeemed early, either because the issuer can refinance more cheaply or with fewer covenant restrictions having reduced leverage) which have the potential to offer a yield premium.

Pure alpha managers should also have greater latitude to be opportunistic and contrarian, such as deploying cash from redemptions opportunistically when markets sell off. They should also build portfolios with a focus on security selection.

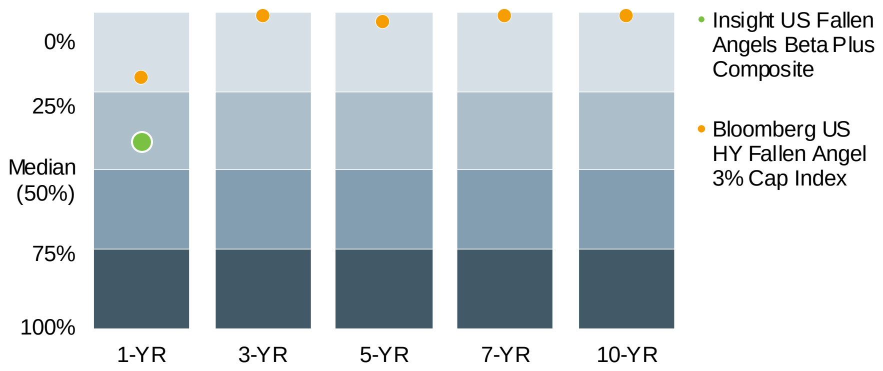
## PLAYING FALLEN ANGELS

The Fallen Angels market is a relatively constrained opportunity set, making it difficult for traditional active and passive strategies to overcome transaction costs to deliver returns in line with or in excess of the Fallen Angels Index[8].

We therefore believe an Efficient Beta approach, that minimises transaction costs through basket trading and uses quantitative processes to systematically target alpha can help investors harness the full potential of an allocation to Fallen Angels.

We see this as an attractive opportunity as the Fallen Angels universe has consistently delivered higher returns than all the other passive and active high yield strategies in the eVestment universe for periods over 1-year (Figure 10).

Figure 10: The Fallen Angels universe has consistently outperformed the high yield active and passive market[9]




## CONCLUSION: BE CONSIDERED WHEN OPTING FOR HIGH YIELD

We believe investors should seriously consider high yield credit at this stage of the economic cycle, particularly through strong corporates growing into their capital structures. However, in an environment of rising rates and geopolitical uncertainty, we believe short duration high yield and fallen angels offer the most compelling prospects for price stability and capital gains.

[9] eVestment, December 2021, Please refer to the risk disclosures at the back of this document. Source: eVestment Alliance. Returns greater than one year are annualised. US High Yield and US Fallen Angel are the eVestment US High Yield Universe; Euro High Yield and Global are the eVestment Euro High Yield Universe and eVestment Global High Yield Universe respectively; EMD Local Currency is the eVestment Emerging Markets Universe. Composite expenses, including management fees and other expenses were deducted from these returns. Insight High Yield Beta Composite is shown net of fees 30bp management fee. Insight US Fallen Angels Beta Plus Composite is shown net of fees 45bp management fee. Insight Efficient Beta Emerging Markets Debt – Local Currency Beta Composite is shown net of fees 30bp management fee. Performance is shown in USD.

## FIND OUT MORE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