Post Advisory Group

The Case for High-Quality Short Duration High Yield

By Dan Ross and Sofia Jimenez

In a rising interest rate environment characterized by elevated inflation, and with a growing consensus that a recession may be near, investors may struggle to find a fixed income alternative that provides healthy yield, avoids excessive interest rate risk, mitigates credit risk, and maintains sufficient liquidity.

Key Takeaways

- High-quality short duration high yield provides attractive risk-adjustment returns relative to other fixed income asset classes.
- When managed with a focus on quality, the asset class can offer similar credit risk to investment grade, with a better return profile.
- The asset class provides better downside protection than other fixed income alternatives, and more quickly recoups drawdowns.
- Structural inefficiencies in the market and optionality embedded in high yield bonds create attractive investment opportunities.

While the broader US high yield market may be more vulnerable to rising long-term interest rates and credit spread widening, a subset of the high yield market — high-quality short duration high yield — stands out as a “port in the storm” that can provide healthy returns with more limited volatility than other assets within fixed income. Many US asset allocators have been slow to recognize high-quality short duration high yield as an asset class of its own, but the market segment has attracted increasing attention over the past decade from global investors (primarily in Europe and Japan) who recognize the opportunity to earn attractive yields with lower levels of credit and duration risk. Some of the risk and liquidity benefits of short duration high yield are embedded in the nature of the asset class — less interest rate risk than longer duration credit, credit risk can be easier to assess in the short-term than the long-term, outsized moves lower in bond prices result in bigger yield changes given the shorter maturity profile (which in turn can attract buyers more quickly). But because defaults are more common in short duration high yield than in the broader high yield market (since defaults are most commonly driven by near-term debt maturities), a conservative investment philosophy and a focus on credit underwriting are critical elements of a high-quality short duration strategy.

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High-quality short duration high yield, whether it is part of a broader fixed income allocation or a standalone strategy that can act as a cash surrogate, may not only reduce risk and volatility, but can also increase return potential. The efficient frontier curve, based on 10 years of historical data, suggests that adding high-quality short duration high yield can shift the portfolio frontier upward, providing higher return for a given measure of risk and increasing portfolio efficiency:

Portfolio Efficient Frontier

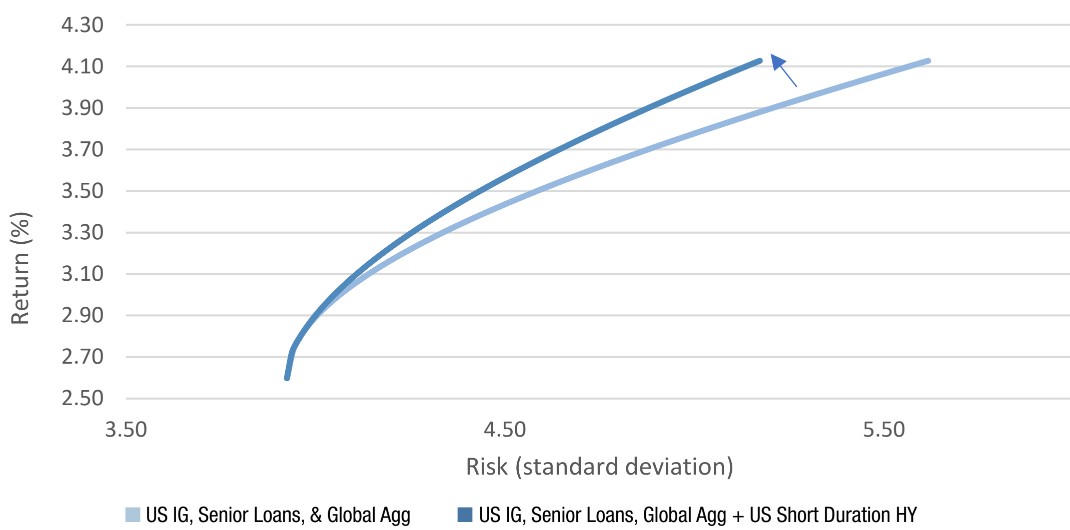

TABLE 1: AS OF JUNE 30, 2023. SOURCE: MORNINGSTAR

The portfolio with short duration consists of (1) ICE BofA 1-5 BB US Cash Pay High Yield Constrained Index, which is a subset of the broader high yield index tracking the performance of U.S. dollar denominated publicly issued corporate debt with a credit rating of BB and maturity profile of 1-5 years, (2) ICE BofA US Corps & Govs, which is a broad-based benchmark that measures the performance of U.S. dollar denominated investment grade debt publicly issued in the U.S. domestic market, including U.S. treasury, U.S. agency, foreign government, supranational and corporate securities, (3) Morningstar LSTA Leveraged loan index which is a broad index designed to reflect the performance of U.S. dollar facilities in the leveraged loan market, and (4) ICE BofA Global Broad Market Index which which tracks the performance of investment grade debt publicly issued in the major domestic and eurobond markets, including sovereign, quasi-government, corporate, securitized and collateralized securities.

AN ASSET CLASS OF ITS OWN

The short duration high yield market is a subset of the broader high yield market, consisting of sub-investment grade corporate bonds with a maturity profile generally less than 5 years. The addressable universe is large and diverse; excluding bonds rated CCC or lower, there are more than 520 issuers with roughly $578 billion (par value) of bonds outstanding that mature in less than 5 years, with an average maturity of 3.3 years and effective duration of approximately 2.4 as of Q2 2023[1]. The par value of this part of the market has more than doubled since the end of 2009. Additionally, floating-rate senior loans can be used as a tool in high-quality short duration portfolios – since they have similar characteristics to high-quality short duration bonds, and in many cases, there is significant overlap in the senior loan and high yield markets. Excluding loans rated CCC or lower, the senior loan market totals more than $1.2 trillion of par value across more than 1,000 unique issuers[2].

[1]Source: ICE BofA 1-5 Year BB-B US Cash Pay High Yield Constrained Index
[2]Source: Morningstar LSTA Lev Loan Index

The difference in maturity and duration profile stems from the fact that the majority of high yield corporate bonds, unlike investment grade bonds, can be (and are often) repaid by the issuer well in advance of their final maturity. This dynamic creates optionality not only for the issuer, but also for investors, who can often benefit when good-quality companies choose to leave outstanding bonds with above-market coupons (especially in a rising interest rate environment) — we refer to this as "good extension risk." The high frequency of maturities, and increased yield sensitivity to downward price shifts in short duration ultimately creates an appealing liquidity profile. In addition, reduced duration has several significant implications for the asset class's risk profile (covered in detail later) which set it apart from broad high yield.

A good proxy for high-quality short duration high yield is the ICE BofA 1-5 Year BB US Cash Pay High Yield Constrained Index (the "Index"). All bonds in the Index have a final maturity of between 1 and 5 years (although many of them are callable at the option of the issuer prior to their final maturity); all are in the highest-rated segment (BB) within the US high yield market. As illustrated below, high-quality short duration high yield has a significantly more attractive yield profile than most other fixed income asset classes (and only modestly lower than the broader US high yield market), but with substantially less interest rate risk (as measured by duration):

Yield Relative to Duration

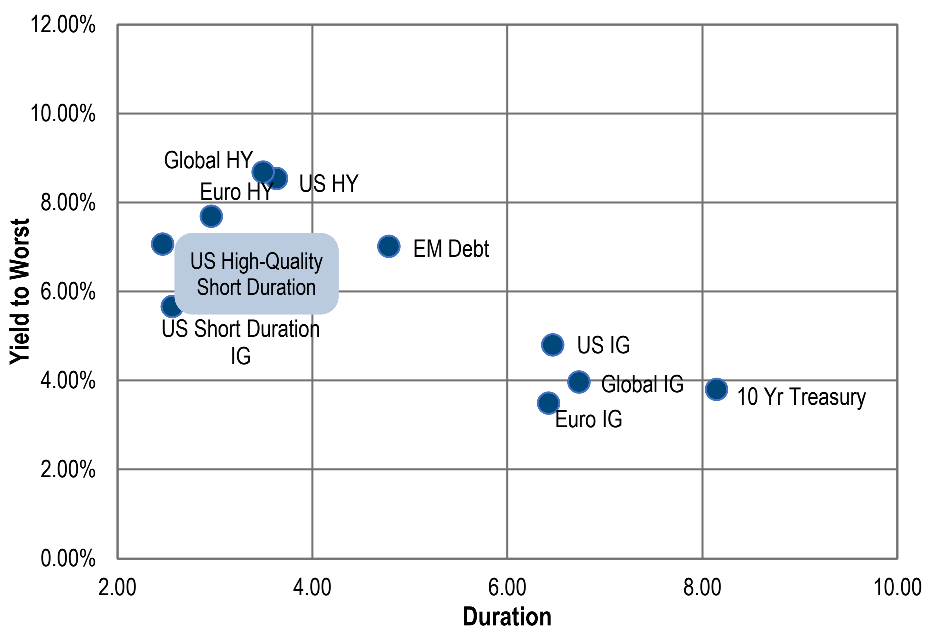

TABLE 2: AS OF JUNE 30, 2023. SOURCE: ICE INDEX PLATFORM, BARCLAYS LIVE

US High Yield refers to the ICE BofA US High Yield Index, US High-Quality Short Duration HY refers to the ICE BofA 1-5 BB US Cash Pay High Yield Constrained Index, Global High Yield refers to the ICE BofA Global High Yield Index, Euro High Yield refers to the ICE BofA European Currency High Yield Index, EMD refers to the ICE BofA Emerging Markets Corporate Plus Index, US Investment Grade refers to the ICE BofA US Corporate & Government Index, Global Investment Grade refers to the ICE BofA Global Broad Market Index, and Euro Investment Grade refers to ICE BofA Euro Broad Market Index.

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CONSISTENT LONG-TERM PERFORMANCE

Over the last 10 years, high-quality short duration high yield has generated strong performance, both on an absolute and risk-adjusted basis. The Index generated an annualized return of 4.15% — significantly better than returns for US investment grade bonds (including short duration investment grade), global high yield and investment grade bonds, and US Treasury bonds. Notably, this performance took place during a period that was characterized (until recently) by low (and generally declining) interest rates, which were an important tailwind for the investment grade market (although much less impactful for short duration). Within high yield, while returns for high-quality short duration were modestly lower than for the broader high yield and short duration high yield markets, risk-adjusted performance (as defined by Sharpe ratios) were much better. Sharpe ratios for high-quality short duration were indeed the highest among all fixed income asset classes below:

Historical Performance

		10-Year Annualized Returns (%)	10-Year Standard Deviation	10-Year Sharpe Ratio
US	US High Yield	4.34	7.50	0.45
	US High-Quality Short Duration High Yield	**4.15**	**5.10**	**0.62**
	US Senior Loans	4.07	5.40	0.57
	US Investment Grade	1.67	4.64	0.15
	US Short Duration Investment Grade	1.97	2.76	0.36
	10 Yr Treasury	0.89	6.70	-0.01
Global	Global High Yield	3.64	8.10	0.33
	Global Investment Grade	0.28	5.70	-0.12
European	European High Yield	1.86	11.37	0.08
	European Investment Grade	-0.93	8.77	-0.22
Emerging Markets	Emerging Market Debt	2.70	6.03	0.28

TABLE 3: AS OF JUNE 30, 2023. SOURCE: ICE INDEX PLATFORM, BARCLAYS LIVE

US High Yield refers to the ICE BofA US High Yield Index, US High-Quality Short Duration High Yield refers to the ICE BofA 1-5 Year BB US Cash Pay High Yield Constrained Index, , US Senior Loans refers to the Morningstar LSTA Leveraged Loan index, US Investment Grade refers to the ICE BofA US Corporate & Government Index, US Short Duration IG refers to the ICE BofA 1-5 Year US Corporate Index, Global High Yield refers to the ICE BofA Global High Yield Index, Global Investment Grade refers to the ICE BofA Global Broad Market Index, European High Yield refers to the ICE BofA European Currency High Yield Index, European Investment Grade refers to the ICE BofA Euro Broad Market Index, Emerging Market Debt refers to the ICE BofA Emerging Markets Corporate Plus Index.

RISK PROFILE

There are two primary risks associated with investing in fixed income assets: duration (interest rate) risk and credit risk. A successful fixed income strategy effectively addresses both of these risks. By its nature, short duration high yield is insulated from interest rate risk relative to other fixed income asset classes like investment grade credit and more traditional US and European high yield credit — duration risk is (by definition) lower in the short duration high yield market. This can be beneficial in a rising interest rate environment. The short-term structure of the asset class often results in a relatively rapid recapture of short-term volatility. Also, a bond with a short maturity will see a much greater change in its yield as its price moves, relative to a bond with longer maturity — in a weaker market, this generally results in smaller price declines for shorter maturity bonds (provided that the market is not concerned about default risk).

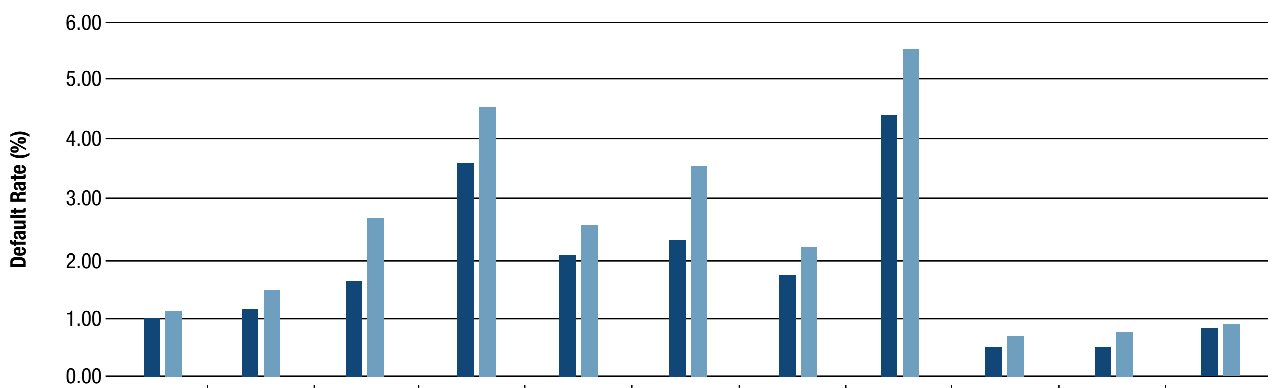
Credit risk, therefore, is the most important risk to manage in short duration high yield, especially if investors are concerned about rising default activity. When it comes to credit selection, “getting it right” is extremely important — defaults can have a significant impact on the returns for any fixed income strategy, as recovery rates for high yield bonds can be 50% or lower. An active short duration high yield manager can successfully mitigate this credit risk, however, by doing rigorous, bottom-up credit analysis to assess a company’s short-term outlook and default risk. For one thing, it is generally easier to forecast a company’s performance over a shorter period of time versus a longer one. Also, a detailed understanding of a company's established sources of liquidity (e.g., cash, unused bank lines, unencumbered assets), as well as their covenant flexibility (and limitations), can allow a manager to gain comfort in the company's ability to address its near-term debt obligations even during challenging market environments. In this way, a short duration high yield strategy focused exclusively on high-quality credits, managed in a way that maintains extensive credit quality oversight, can further mitigate credit risk. With a focus on sectors and credits that have more defensive qualities, a manager of high-quality short duration high yield can create a portfolio with a similar credit risk profile as investment grade, but with much better yields (and less duration risk).

IMPORTANCE OF QUALITY AND CREDIT ANALYSIS

Of course, high yield issuers have lower credit ratings than their investment grade counterparts for a reason — they generally have higher debt burdens relative to their earnings and cash flow, and are viewed as more "risky" investments for that reason. Yields tend to be higher because investors need to be paid for the incremental credit risk they are taking, and specifically, for the risk that high yield issuers default with more frequency than their higher-rated counterparts. Default rates for US high yield issuers have averaged around 2% over the last decade, versus around 0.1% for US investment grade issuers[3].

Issuer defaults are driven most commonly by maturities — in other words, companies that are performing poorly tend to be able to avoid defaults until they face a near-term bond maturity that they are unable to refinance. Accordingly, historical default rates — measured as a proportion of the overall market — have not surprisingly been higher for the short duration high yield market than for the broader high yield market. Importantly, though, default rates for higher-quality short duration have been much lower — while the overall short duration high yield market (as measured by the ICE BofA 0-5 Year US High Yield Constrained Index) has experienced an average default rate of approximately 2.5% over the last decade, the average default rate for the higher quality ICE BofA 1-5 Year BB-B US Cash Pay High Yield Constrained Index over the same period has been approximately 0.7%. Moreover, the highest quality segment within short duration high yield — the Index — has seen no defaults over the last 10 years.

Default Rate by HY Index



	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	2Q23
ICE BofA HY Index	0.98	1.13	1.67	3.66	2.06	2.31	1.80	4.40	0.46	0.50	1.08
ICE BofA 0-5 Year HY Index	1.10	1.43	2.74	4.55	2.56	3.54	2.13	5.49	0.68	0.61	1.24
ICE BofA 1-5 Year BB HY Index	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00

TABLE 5: AS OF JUNE 30, 2023. SOURCE: ICE INDEX PLATFORM, CALCULATED AS 12M ISSUER WEIGHTED DEFAULT %

[3]Source: ICE Index Platform. As of 06/30/2023. ICE BofA US High Yield Constrained Index to represent US high yield issuers and ICE BofA US Corporate & Government Index to represent US investment grade issuers.

It is also worth noting that the overall quality of the US high yield market has improved significantly over the last 10+ years, which should have a positive impact on prospective default rates (all things being equal). The proportion of the highest-rated bonds (rated BB) has increased from less than 40% to 46% of the broader short duration universe since 2009.

US Short Duration HY Index Composition Rating

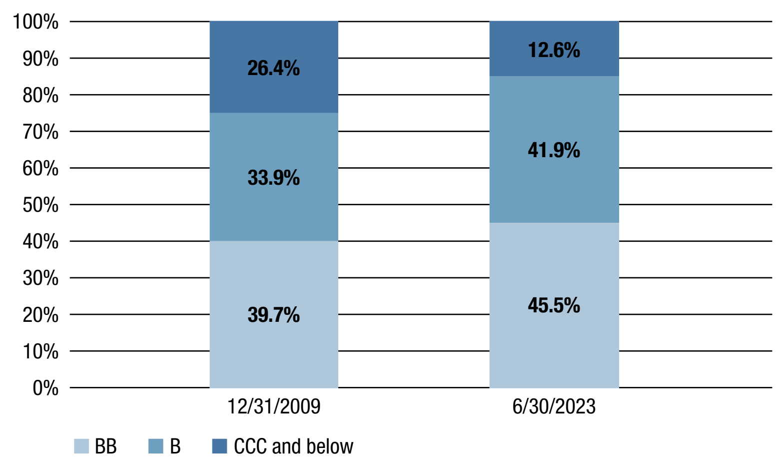


TABLE 6: SOURCE: ICE Index Platform
US SHORT DURATION HY REFERS TO THE ICE BOFA 0-5 YEAR US HIGH YIELD CONSTRAINED INDEX

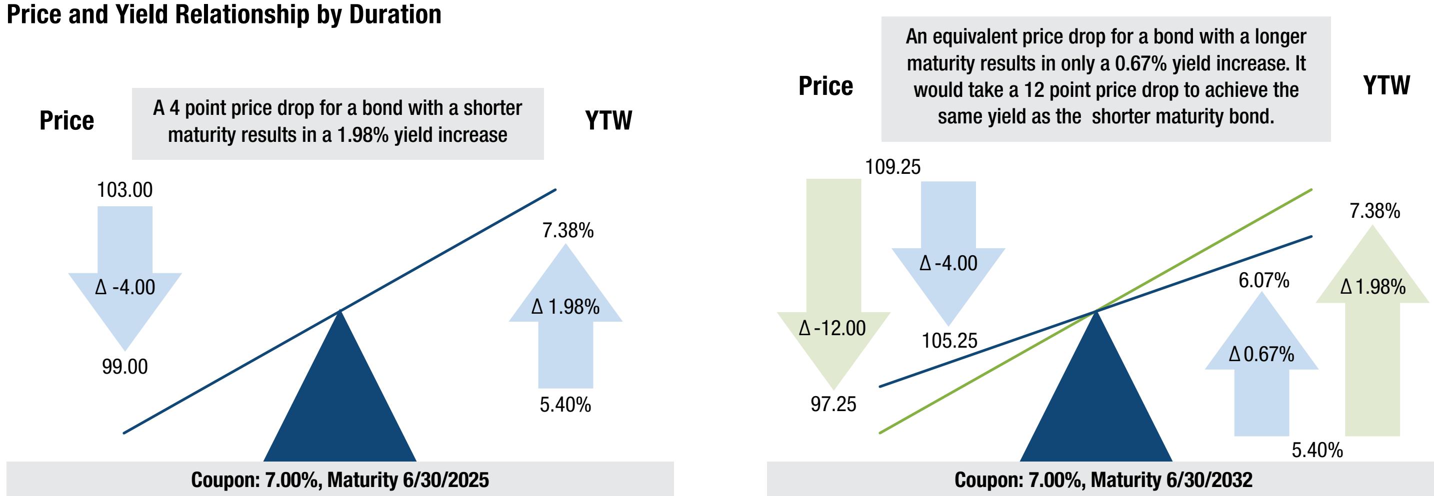
STRUCTURAL INEFFICIENCIES IN THE MARKET CREATE OPPORTUNITY

There are certain structural inefficiencies in the short duration high yield market that can create attractive investment opportunities. First, there is generally lower demand for short duration high yield bonds among high yield managers, as managers tend to be focused on maximizing yield and convexity — generally found in bonds with more duration (and longer maturities). In addition, short duration high yield bonds are frequently sold into the market, often with less price sensitivity than one might expect to find for longer duration bonds. This can happen in markets that are rallying, as managers "chase" yield and convexity in longer-duration bonds (often in the new issue market, which tends to be active in strong markets) by selling high-quality short duration bonds that have less upside and total return and convexity potential. But it can also happen initially in weak markets, when managers facing redemptions look to sell those bonds whose prices have declined less than others — as a general matter, these tend to be high-quality short duration bonds.

These dynamics not only can cause mispricing in the short duration high yield market, but also lead to increased liquidity as these bonds become available in both types of markets. It is also important to note, however, that because short duration bond yields are more sensitive to price changes, liquidity for these bonds can benefit in extended market weakness: a relatively small move downward in price for a short duration bond results in a big move upward in yield, which in turn attracts buyers, which can limit the downside move in these bonds.

By way of example, take two bonds with the same coupon (7.0%) but different maturities (one a 3-year maturity, one a 10-year maturity), which have similar yield profiles. If the price of each bond moves down by 4 points, the yield to worst (YTW), or the lowest possible yield that can be received on a bond with an early retirement provision, for the short duration bond increases by almost 2 percentage points (1.98%), whereas the 10-year bond yield increase by less than 70 basis points (0.67%). The longer duration bond would need to see a price drop of 12 points to result in a yield to worst improvement equivalent to the short duration bond. The increased yield of the short duration bond attracts investors, which benefits liquidity in periods of extended market weakness.

Price and Yield Relationship by Duration



DRAWDOWN PROTECTION

The dynamic described above is evident in various recent periods of market weakness. The short-term structure of the asset class generally results in a smaller price decline than for longer-maturity bonds, and often results in a relatively rapid recapture of short-term volatility. High-quality short duration high yield has consistently provided better downside protection than other fixed income alternatives, and has more quickly recouped drawdowns in specific market events.

Period Drawdowns by Asset Class

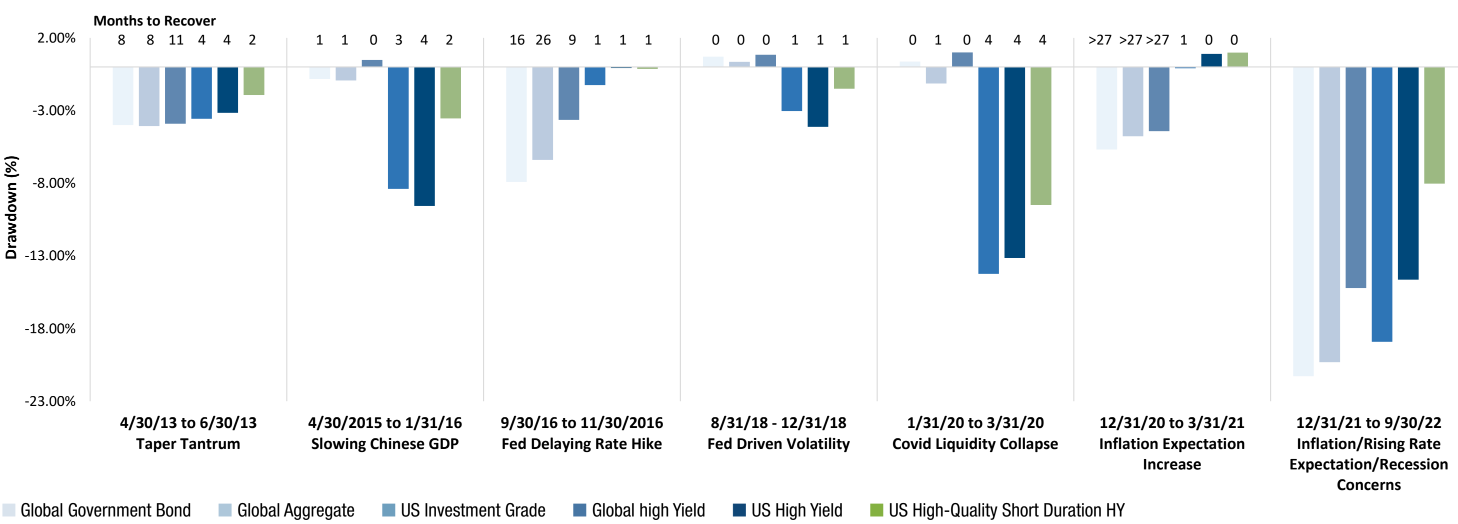


TABLE 4: SOURCE: ICE INDEX PLATFORM, BARCLAYS LIVE

US Investment Grade refers to the ICE BofA US corporate & Government Index, Global High Yield refers to the ICE BofA Global High Yield Index, US High Yield refers to the ICE BofA US High Yield Index, US High-quality Short Duration HY refers to the ICE BofA 1-5 BB US Cash Pay High Yield Constrained Index.

UNDERAPPRECIATED OPTIONALITY

The “callability” feature of most high yield bonds, which allows the issuer the right (but not the obligation) to repay the bond with specified repayment premiums at specific points in time, is a unique characteristic that has important implications for the short duration high yield asset class. Approximately 78%[4] of US high yield bonds (by par value) are callable prior to their final maturity (as opposed to so-called “bullet” bonds, which cannot be called prior to maturity without the issuer making bondholders whole on all of its remaining interest payments). A bond’s call feature creates an optionality on part of both the issuer and the lender; this optionality is generally not found in fixed income asset classes outside of the high yield market. Many high yield issuers are “aspirational,” with a desire to improve credit metrics over time; having callable bonds allows these issuers to take advantage of these better credit metrics more quickly by refinancing bonds early at lower interest rates, if their credit spreads improve (and/or if risk-free interest rates decline relative to when the bond was originally issued).

To Illustrate Examples of this Optionality:

- Consider a bond with a high coupon relative to the issuer’s current long-term borrowing costs, that is not yet callable — a hypothetical bond issued with a 10% coupon in a weak market environment a few years earlier, maturing in 3.5 years, that becomes callable in 6 months with a 5-point pre-payment penalty. Let’s assume that company can issue a new 10-year bond at a 5% coupon. The market will likely assume the issuer will redeem the bond at its first call in 6 months, at a 5-point premium to par (including the prepayment penalty) — in doing so, the company will save 5 points of coupon (by issuing a bond with a 5% coupon instead of a 10% coupon), so the prepayment penalty has a 1-year payback. Even if risk-free interest rates increase, or if credit spreads widen, the issuer is still likely to redeem the bond at its first call — creating the opportunity for a manager of high-quality short duration to buy it with limited credit and duration risk.
- Now consider the same bond; 6 months have passed, and the bond has not been called — it is now a “rolling call.” There may be issuer-specific reasons the company has chosen to wait to refinance the bond. These reasons can often be better understood by a manager that is focused on bottom-up credit research — perhaps the company is waiting on an asset sale and intends to use the proceeds to refinance the bonds; it could be that the company is undertaking a strategic alternatives process (that may include a sale of the business), and does not want to “lock in” breakage costs associated with a new bond that a buyer may not want to assume. These rolling call bonds provide positive optionality — the realized yield generally increases the longer the bond remains outstanding, while at the same time providing downside protection (because the bond could be called at any time).

DEVELOPING A SHORT DURATION STRATEGY

When allocating capital to high yield short duration, selecting a manager who has a robust underwriting and credit monitoring process is critical in mitigating credit risk. The broader short duration high yield market can have elements of negative self-selection, as good-quality companies tend to be more proactive in refinancing their shorter-dated maturities, while bonds of lower-quality companies often remain outstanding longer because those companies have more limited market access. Also, credit- and industry-specific developments can have outsized impacts on short duration bonds, so it is important that a manager be nimble in proactively identifying issues that could impact default risk to “get out of the way” if concerns arise. An experienced short duration high yield manager focused on capital preservation can take advantage of the structural inefficiencies, maximizing the risk-adjusted returns of the strategy while mitigating credit risk.

[4]Source: Bloomberg

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WHY INVEST NOW?

High-quality short duration high yield has provided stronger absolute returns than most other fixed income asset classes over time. Unlike alternative asset classes like private credit, the asset class provides good liquidity in both strong and weak markets — and benefits (relative to private credit) from significantly less investor attention and focus in the current market environment (a supply/demand technical that should be a relative tailwind for future performance).

In a rising interest rate environment with high inflation and growing recession risk, this resilience may prove critical. And current dollar-price discounts on high-quality short duration high yield bonds (with the Index trading at an average dollar price of approximately 95 as of Q2 2023) offer increased opportunity for capital appreciation, in addition to consistent (and attractive) coupon income. And with the recent sharp increase in high-quality short duration yields seen in 2022 (the Index reporting an average yield to worst of more than 7% as of Q2 2023), other asset classes will struggle to provide such yield with equivalent safety.

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The index returns are provided for purposes of comparison and do not reflect fees or expenses. Unlike the funds, which are actively managed and periodically may maintain a cash position, an index is unmanaged and fully invested. There is no correlation between the performance of the index and the strategies employed in the management of the funds. The comparison of performance to the indices may be inappropriate because the portfolio is not as diversified, and may be more or less volatile than the index.

References to US High Yield refers to the ICE BofA US High Yield Index, which tracks the performance of US dollar denominated below investment grade corporate debt publicly issued in the US domestic market. Qualifying securities must have a below investment grade rating (based on an average of Moody's, S&P and Fitch), at least 18 months to final maturity at the time of issuance, at least one year remaining term to final maturity as of the rebalancing date, a fixed coupon schedule and a minimum amount outstanding of $250 million.

References to the ICE BofA 1-3 Year BB US Cash Pay High Yield index refer to a subset of the ICE Bank of America High Yield Index and is a higher quality segment of the high yield corporate debt market since this index only includes BB1 through BB3, inclusive, rated corporate debt publicly issued in the U.S domestic market with less than three years remaining to final maturity. Allocations to an individual issuer will not exceed 2%.

References to the ICE BofA 1-5 Yr BB/B High Yield Cash Pay Constrained Index refer to the ICE BofA 1-5 Year BB-B US Cash Pay High Yield Constrained Index (JVC4) which tracks the performance of all securities in The ICE BofA US Cash Pay High Yield Index that are rated BB1 through B3, based on an average of Moody's, S&P and Fitch, with a maturity less than five years, but caps issuer exposure at 2%.

References to the ICE BofA 0-5 Year High Yield index refer to the ICE BofA 0-5 Year US High Yield Constrained Index, which tracks the performance of short-term U.S. dollar denominated below investment grade corporate debt issued in the U.S. domestic market with less than five years remaining term to final maturity, a fixed coupon schedule and a minimum amount outstanding of $100 million, issued publicly. Allocations to an individual issuer will not exceed 2%.

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References to Global HY index refer to the ICE BofA Global High Yield Index, which tracks the performance of USD, CAD, GBP and EUR denominated below investment grade corporate debt publicly issued in the major domestic or eurobond markets.

References to European High Yield refers to the ICE BofA European Currency High Yield Index, which tracks the performance of EUR and GBP denominated below investment grade corporate debt publicly issued in the eurobond, sterling domestic or euro domestic markets.

References to the Emerging Market Debt index refers to the ICE BofA Emerging Markets Corporate Plus Index, which tracks the performance of U.S. dollar and euro denominated emerging markets non-sovereign debt publicly issued in the major domestic and eurobond markets. To qualify for inclusion an issuer must have risk exposure to countries other than members of the FX G10, all Western European countries, and territories of the U.S. and Western European countries. The FX-G10 includes all Euro members, the US, Japan, the UK, Canada, Australia, New Zealand, Switzerland, Norway and Sweden. Individual securities of qualifying issuers must be denominated in U.S. dollars or euro, must have at least one year remaining term to final maturity, at least 18 months to final maturity at point of issuance, and a fixed coupon. In addition, bonds of qualifying issuers must have at least 250 million (EUR or USD) in outstanding face value.

References to the Global Investment Grade index refers to the ICE BofA Global Broad Market Index, which tracks the performance of investment grade debt publicly issued in the major domestic and eurobond markets, including sovereign, quasi-government, corporate, securitized and collateralized securities.

References to the US Investment Grade index refers to the ICE BofA US Corporate & Government Index, which tracks the performance of US dollar denominated investment grade debt publicly issued in the US domestic market, including US Treasury, US agency, foreign government, supranational and corporate securities. Qualifying securities must have an investment grade rating (based on an average of Moody's, S&P and Fitch). In addition, qualifying securities must have at least one year remaining term to final maturity, at least 18 months to final maturity at point of issuance, a fixed coupon schedule and a minimum amount outstanding of $1 billion for US Treasuries and $250 million for all other securities.

References to the IG Corporate Index refer to the ICE BofA U.S. Corporate & Government Index, which tracks the performance of US dollar denominated investment grade debt publicly issued in the US domestic market, including US Treasury, US agency, foreign government, supranational and corporate securities.

References to the US Short Duration IG index refers to the ICE BofA 1-5 Year US Corporate Index, which is a subset of ICE BofA US Corporate Index including all securities with a remaining term to final maturity less than 5 years.

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