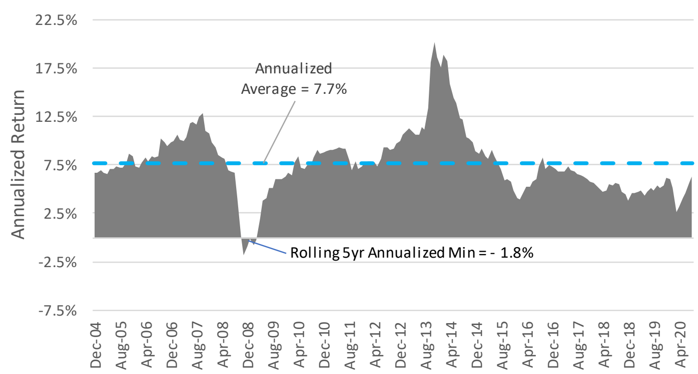
SKYView: A Strategic Allocation to US High Yield

US high yield markets gave up some gains in the week ended September 25, as a new surge in coronavirus cases, limited progress on an additional round of stimulus measures in the US, and continued political uncertainty weigh on sentiment. Notwithstanding well-known risk factors, year-to-date total returns in the high yield space (we use the ICE BofA US High Yield Index, ticker H0A0, as our proxy) are only modestly negative (-1.1%), while equity indices have already crossed into positive territory (the S&P 500 Index is up over 2% as we write this briefing). Though valuations now approach median levels despite ongoing uncertainty, we nevertheless remain optimistic about the high yield asset class owing to attractive average rolling return streams in the context of maximum drawdowns. In this *Weekly Briefing*, we make the case for a strategic – rather than a tactical – allocation to US high yield.

Investing in an asset class after a significant rally can prove a difficult psychological obstacle to overcome, even if an argument can be made that recoveries have not been as sharp and valuations have not moderated as quickly as ancillary investment options (all are among the reasons we continue to like US high yield, incidentally). But rather than go down this route, we instead frame the case in favor of US high yield bonds from a longer-term perspective. Below (left side), we display a time series of annualized rolling 5-year returns of the ICE BofA US High Yield Index (H0A0), our data set beginning in January 2000. As demonstrated in the graph, average annualized rolling 5-year returns have been approximately +7.7% for H0A0, in-line with average annualized rolling 5-year returns for the S&P 500 Index (right side) over the same timeframe. Assuming an investment horizon of five years, the worst annualized return you could have achieved investing in H0A0 was -1.8%, a period that contains market exposure through the depths of the Global Financial Crisis. For the same average annualized return, the rolling return minimum for the S&P 500 Index was -6.6%, and occurred at approximately the same time.

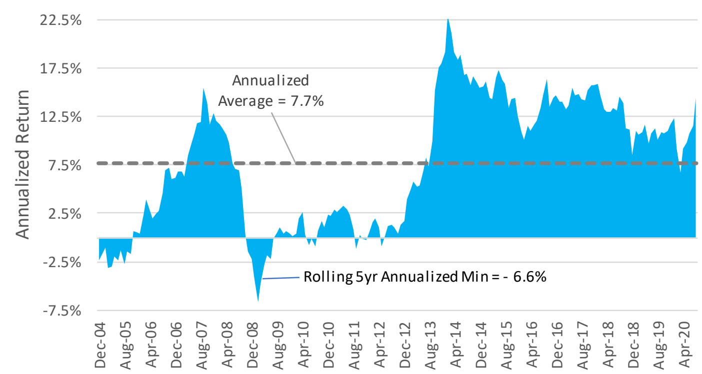
Annualized Monthly Rolling 5-Year US High Yield Returns

ICE BofA US High Yield Index (H0A0)



Annualized Monthly Rolling 5-Year S&P 500 Returns

S&P 500 Index (SPX)

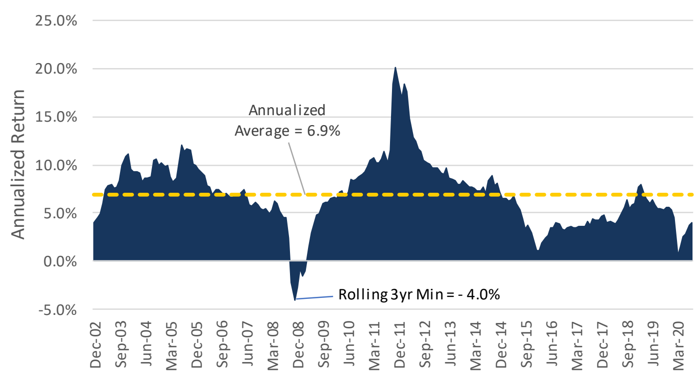


Source: SKY Harbor, ICE BofA Indices

An investment in short duration US high yield would have further limited downside. Below, we display annualized rolling returns (on both a 3yr and 5yr basis) of the ICE BofA 1-5 Year BB-B US Cash Pay High Yield Constrained Index (JVC4). In both cases, average annualized returns have been approximately +6.9%. Assuming an investment horizon over a 5 year basis, the worst annualized return you could have achieved was -0.1%, which also includes market exposure through the Global Financial Crisis. Put another way, a five year investment in short duration high yield over the last two decades has almost always led to positive annualized returns. If you invested at the absolute worst period in time (going back to January 2000), your resulting 5-year average annualized return would have been -0.1%. In our view, this dynamic significantly reduces the risk of timing the market poorly.

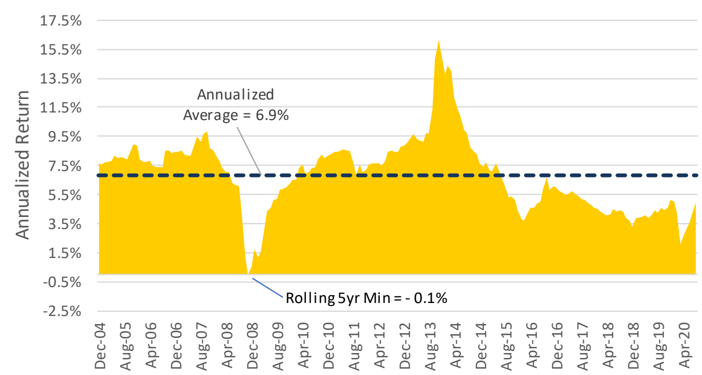
Annualized Monthly Rolling 3-Year Short Duration High Yield Returns

ICE BofA 1-5yr BB-B US Cash Pay High Yield Constrained Index (JVC4)



Annualized Monthly Rolling 5-Year Short Duration High Yield Returns

ICE BofA 1-5yr BB-B US Cash Pay High Yield Constrained Index (JVC4)



Source: SKY Harbor, ICE BofA Indices

For comparison purposes, we ran the same analytics for ancillary asset classes, including US investment grade corporates (we use the ICE BofA US Corporate Index, ticker C0A0, as a proxy), mortgage backed securities (we use the ICE BofA Mortgage Backed Securities Index, ticker M0A0, as a proxy), the S&P 500 Index (SPX) and the Russell 2000 Index (RTY). The table below summarizes average annualized rolling returns for each (both on a 3yr and 5yr basis), as well as the minimum annualized return, all using a series of monthly datapoints going back to January 2000.

Annualized Monthly Rolling Returns: Average vs. Minimum by Index

based on monthly data since January 2000

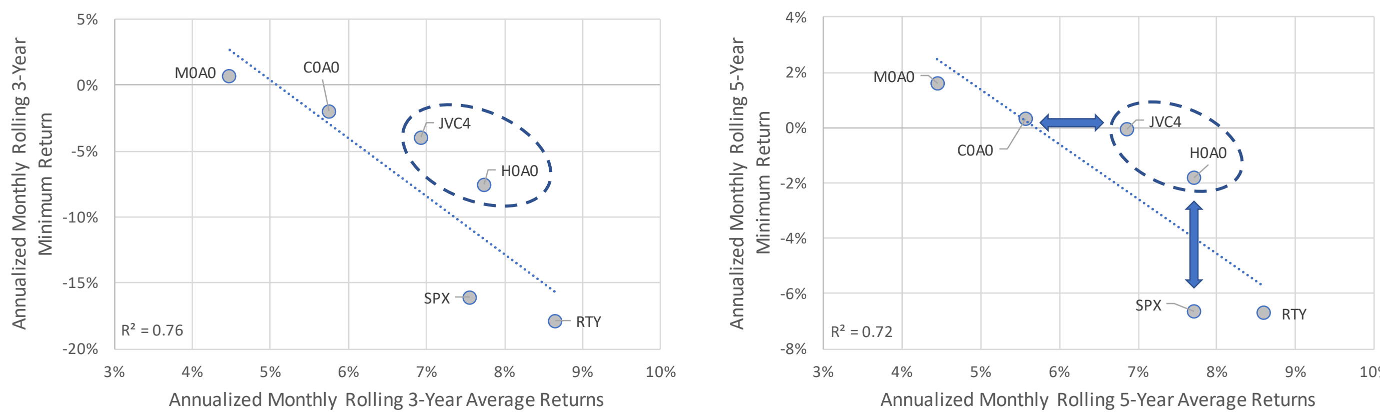
Index	Ticker	Monthly Rolling 3-Year Returns (Annualized)		Monthly Rolling 5-Year Returns (Annualized)	
		Average	Minimum	Average	Minimum
ICE BofA US High Yield Index	H0A0	7.7%	-7.6%	7.7%	-1.8%
ICE BofA 1-5yr BB-B US Cash Pay High Yield Constrained Index	JVC4	6.9%	-4.0%	6.9%	-0.1%
ICE BofA US Corporate Index	C0A0	5.7%	-2.0%	5.6%	0.3%
ICE BofA US Mortgage Backed Securities Index	M0A0	4.5%	0.7%	4.5%	1.6%
S&P 500 Index	SPX	7.6%	-16.1%	7.7%	-6.6%
Russell 2000 Index	RTY	8.6%	-17.9%	8.6%	-6.7%

Source: SKY Harbor, ICE BofA Indices, Bloomberg

Perhaps more clearly exhibited graphically, below we present the same average and minimum annualized rolling return data (3yr to the left, 5yr to the right) in scatter plots. In general, we note that both short duration (JVC4) and broad market (H0A0) high yield indices place above the all-index trend line. More specifically, we highlight (with blue arrows below) the relatively attractive annualized average vs. annualized minimum return characteristics of high yield bonds. In particular, US high yield (H0A0) has provided similar average annualized monthly rolling 5-year returns as US equities (SPX), albeit with minimum annualized monthly rolling 5-year returns that are nearly 500 bps less negative. Alternatively, note that US short duration high yield (JVC4) has provided similar minimum annualized monthly rolling 5-year returns as US investment grade corporates (C0A0), albeit with average annualized monthly rolling 5-year returns that are ~ 130bps higher. By these measures, we view the downside risk vs. return metrics as being favorable in the high yield space relative to ancillary asset classes.

US High Yield (broad and short duration) Score Well in the Trade-Off Between Annualized Average Returns and Annualized Minimum Returns

based on monthly data since January 2000



Source: SKY Harbor, ICE BofA Indices, Bloomberg

Owing to the benefits of diversification, elevated breakevens, and strong risk-adjusted returns, we continue to find US high yield bonds attractive from a strategic asset allocation perspective. Acknowledging the tremendous difficulty in timing markets, we highlight relatively strong average annualized returns of US high yield bonds in the context of modest drawdowns. As such, and despite a rally across risk assets over the last several months, high yield continues to screen attractively relative to ancillary asset classes, in our view.

Important Disclosures and Disclaimers

Past performance does not guarantee future results. The referenced indices are shown for informational purposes only and are not meant to represent the AXS Investments Funds. Investors cannot directly invest in an index.

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