Portfolio Manager Insights

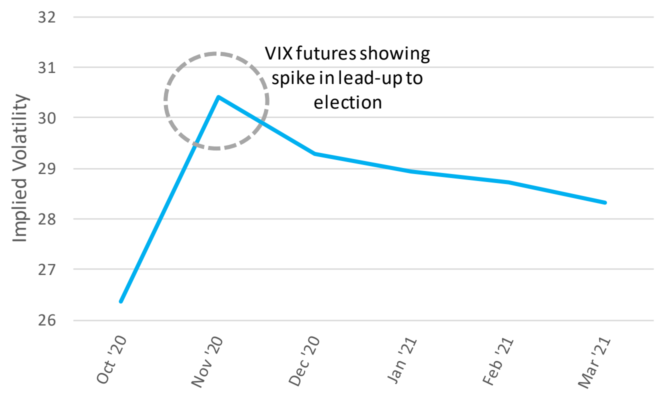
SKYView: Valuing Resiliency Ahead of Volatility

An uptick in volatility spread across risk asset classes in early October, at least in part driven by a rise in confirmed coronavirus cases (including the President and several key White House officials) and news that the administration was halting stimulus talks until after the election. While Trump's health has since improved and stimulus measures appear back on the table, investors remain concerned that markets remain susceptible to downside surprises. In this *Weekly Briefing*, we examine the resiliency of various segments of the US high yield market by measuring downside return capture.

Perhaps one of the most polarizing races in decades, the 2020 US Presidential election appears poised for a record turnout of the electorate. At the same time, candidate health issues and a surge in mail-in ballots have certain constituencies concerned about polling integrity and the peaceful (and timely) transition of power, all of which have contributed to a spike in VIX futures and measures of economic policy uncertainty hovering around record-high levels.

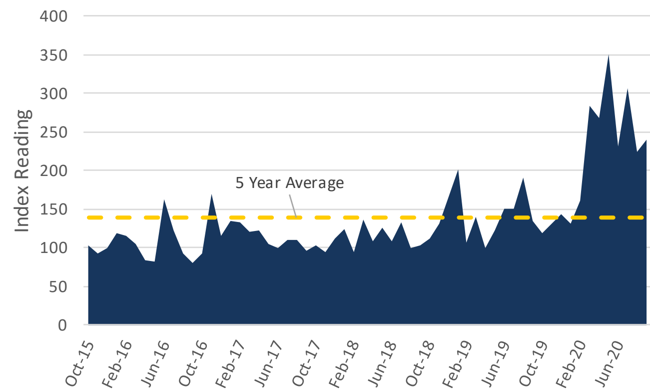
VIX Futures Imply Election Volatility

data at October 8, 2020



US Economic Policy Uncertainty Composite Index Elevated

monthly data, trailing 5 years



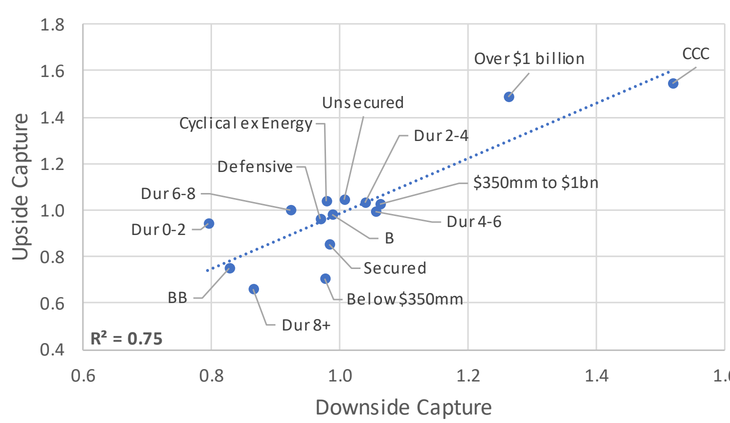
Source: SKY Harbor, Bloomberg, Baker, Bloom & Davis

With the potential for heightened volatility and uncertainty on the horizon, we think it prudent to understand the resiliency of various segmentations of the market, even if sustained stress is not our base case assumption. To do this, we separated a time series of performance streams (going back to January 2000) into positive and negative monthly return categories. Next, we compared various market segmentations (rating, duration, issue size, risk type, etc.) to the ICE BofA US High Yield Index, calculating upside and downside capture metrics. Results are presented in the table below, and we highlight segmentations with a downside capture of less than 1.0 (historically, more resilient than the index in negative return months) in grey. While results by rating bucket were as expected (BBs captured less downside than the index, CCCs captured more), other buckets proved less intuitive. By duration, the very shortest and very longest buckets have afforded investors the best downside protection, as have smaller issues relative to larger issues. Differences in underlying holder bases, as well as the impact of fund flows on market technicals, likely explain some of these results. Interestingly, widely accepted sector groupings of "Defensive" and "Cyclical" credits, in aggregate, showed very little differentiation in downside protection.

Total Return Capture Relative to the ICE BofA US High Yield Index (H0A0)

monthly data since January 2000, grey highlights denote downside capture < 1

Rating Bucket	Down Months	Up Months	Ratio
BB	0.83	0.75	0.91
B	0.99	0.98	1.00
CCC	1.52	1.55	1.02
Duration Bucket	**Down Months**	**Up Months**	**Ratio**
Dur 0-2	0.79	0.94	1.19
Dur 2-4	1.04	1.03	0.99
Dur 4-6	1.05	0.99	0.94
Dur 6-8	0.92	1.00	1.09
Dur 8+	0.86	0.66	0.76
Size Bucket	**Down Months**	**Up Months**	**Ratio**
Below $350mm	0.98	0.70	0.72
$350mm to $1bn	1.06	1.02	0.96
Over $1 billion	1.26	1.49	1.18
Risk/Security Bucket	**Down Months**	**Up Months**	**Ratio**
Defensive	0.97	0.96	1.00
Cyclical ex Energy	0.98	1.04	1.07
Secured	0.98	0.85	0.87
Unsecured	1.01	1.04	1.04



Note: Automotive, Basic Industry, Capital Goods, Leisure, Real Estate, Retail, Technology and Transportation assumed to be "Cyclical ex Energy"; Banking, Consumer Goods, Healthcare, Financial Services, Insurance, Media, Services, Telecom and Utility assumed to be "Defensive."

Source: SKY Harbor, ICE BofA Indices. Past performance does not guarantee future results.

Given somewhat ambiguous findings using traditional cyclicality groupings, we next calculated return capture by sector. As demonstrated in the table below, Healthcare, Utility, and Consumer Goods credits have historically provided the greatest protection for investors when index returns turned negative. Less intuitively, Basic Industry credits have been more resilient than we would have anticipated, as have Capital Goods – perhaps reflecting some bias for asset-heavy companies in times of uncertainty. For additional granularity, we broke down some of the more diverse sectors into industry sub-groupings before calculating downside and upside return capture metrics.

Sector Total Return Capture Relative to H0A0

monthly data since January 2000

	Down Months	Up Months	Ratio
Automotive	1.07	1.78	1.67
Banking	1.17	1.13	0.97
Basic Industry	0.92	0.78	0.85
Capital Goods	0.77	0.71	0.93
Consumer Goods	0.74	0.63	0.85
Energy	1.17	1.01	0.86
Financial Services	1.19	1.59	1.33
Healthcare	0.61	0.67	1.10
Insurance	0.92	1.03	1.12
Leisure	1.19	1.28	1.08
Media	1.11	0.87	0.78
Real Estate	1.39	1.19	0.85
Retail	0.89	0.98	1.10
Services	0.80	0.98	1.22
Technology & Electronics	1.14	1.28	1.12
Telecommunications	1.18	1.09	0.92
Transportation	0.94	0.68	0.72
Utility	0.65	0.88	1.35

Industry Total Return Capture Relative to H0A0

monthly data since January 2000

Sector	Industry	Down Months	Up Months	Ratio
Basic Industry				
	Bld & Const	0.90	0.87	0.97
	Building Mats	0.80	0.90	1.12
	Chemicals	0.78	0.71	0.90
	Forestry/Paper	0.94	0.57	0.61
	M&M ex Steel	0.96	0.79	0.82
	Steel	1.19	0.76	0.64
Capital Goods				
	A&D	0.84	0.73	0.87
	Div Cap Goods	0.90	0.67	0.75
	Machinery	0.66	0.64	0.96
	Packaging	0.67	0.69	1.03
Energy				
	E&P	1.29	1.17	0.91
	Gas Distrib.	1.01	0.85	0.85
	Integrated Energy	1.72	0.55	0.32
	Oil Field Equip & Svcs	1.38	0.89	0.65
	Oil Ref & Mkt	0.99	0.80	0.81

Source: SKY Harbor, ICE BofA Indices

While our view of the US high yield market remains constructively optimistic, we cannot ignore indications of rising volatility and uncertainty on the horizon, particularly because such readings often coincide with risk-off sentiment. Using our calculations of total return capture relative to H0A0 in negative returning months, we are able to marginally increase weightings to the more resilient parts of the market. In particular, a modest bias toward higher-rated credit (BB), a barbell approach to duration (Dur 0-2, 6-8), and a preference for smaller issues (Below $350mm) may prove prescient ahead of an expectedly contentious election.