Focus on income: The case for credit exposure in fixed income portfolios

In a yield-starved world, strategies focused on credit may be preferable to the typical aggregate approach.
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When investors decide to add fixed income exposure to their portfolios, they often default to an aggregate approach, such as a fund based on the Bloomberg Barclays US Aggregate Index (the Agg). However, in an environment starved for yield, there’s a strong case to be made for considering credit strategies—those focused primarily on bonds of corporations. Choosing a portfolio benchmarked to the Bloomberg Barclays US Corporate Index (as a proxy for the corporate bond market) might be appropriate for investors seeking a yield boost while maintaining robust diversification benefits.

It makes sense that investors could expect higher potential returns for accepting more risk versus investing in the Agg, which is dominated by safe-haven U.S. Treasuries and lower-yielding mortgage-backed securities (Figure 1). Presumably, investors get compensated with higher returns for their additional credit risk. But if there’s greater credit risk, does that mean that default risk also is in play? Is the potential for added yield of credit worthwhile?

Scrutiny of the rolling five-year forward-looking cumulative loss experience for investment-grade credits indicates that five-year losses are actually quite small. When compared to option-adjusted spreads (OAS) for credit, investors are more than compensated—many times over, in fact—for any default risk (Figure 2).

The returns that credit investors aim to capture are not just compensation for credit risk, but also reflect the structural nature of fixed income trading.
How can investors have the potential to be so well-compensated for what amounts to only a marginal increase in risk when investing in credit? That is akin to investors getting a “free lunch” when portfolio management theory teaches us that there is no such thing. The answer lies in the tremendous inefficiencies of the fixed income market. The returns that credit investors aim to capture are not just compensation for credit risk, but also reflect the structural nature of fixed income trading.

Consider that the U.S. fixed income market is vast—with an investable universe of over three million individual securities outstanding versus just thousands of publicly traded U.S. equity securities. The necessary analysis that prudent bond investors need to undertake is significant, not to mention the fact that fixed income securities trade mostly over the counter in limited pools of liquidity.

This higher return from investment grade credit portfolios comes in the form of higher initial yield (the “starting yield”), particularly as one targets a specific duration for the portfolio. Duration is a measure of interest rate risk for the price of a bond or fixed income portfolio. An investor can choose a particular level of rate sensitivity for his or her fixed income investment—that is to say, a particular duration target—and then the portfolio with the higher starting yield is likely to be the one with that also delivers the higher overall return over time.

Of course, extending duration is one way of bringing more income to the starting yield. This would involve taking more interest rate risk, and greater risk (of any nature) should receive compensation in the form of greater return. But accepting greater duration should only be done knowledgeably, and it comes with some very real uncertainties. The challenges include the difficulty in forecasting interest rates, the need for a steeper yield curve (to provide the necessary returns from extending further along the curve), and the higher attendant volatility that comes from the impact of fluctuations in interest rates on the portfolio (i.e. the rate sensitivity).

Past performance is no guarantee of future results.
Index performance does not reflect the deduction of advisory fees, brokerage or other commissions and other expenses. One cannot invest directly in an index.

Source: Bloomberg, Long-Term Bond Returns under Duration Targeting.

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Ultimately, we believe that there’s a strong case for a credit tilt in many fixed income portfolios.
Ample diversification

One of the key arguments for the Agg is its diversification, given that it covers a wide swath of investment-grade dollar-denominated bonds, including Treasuries, government-related and corporate securities, and an array of MBS, ABS and CMBS securities. Most investors inherently understand the tangible benefits in holding different types of fixed income securities that move in different directions from the same market forces. This serves to stabilize returns and insulate a portfolio from volatility.

However, it may surprise investors that both credit and Agg portfolios perform similarly with respect to equities over the long term. Both have a low and negative correlation to equities and so, in that respect, offer similar diversification benefits. Examining daily changes in the valuations of the S&P 500 and comparing them with those in the Bloomberg Barclays US Corporate Total Return Value Unhedged and the Agg indicate that the latter two move very closely together (Figure 4).

Similarly, research shows that over the past decade during sudden equity market sell-offs in which the S&P 500 falls by 10% or more in price, with at least a 50% recovery before the next correction, credit can help to provide ballast to the portfolio, in addition to that provided by the Agg (Figure 5).

Of course, credit does not provide quite as much stability as does the Agg given the corporate exposure that is common to both corporate credit and equity. However, any gap may be compensated for by the potentially higher returns from credit.

Ultimately, we believe there’s a strong case for a credit tilt in many fixed income portfolios. Its inclusion suggests higher potential income based on a higher expected starting yield. And income, as we know, is the primary driver of long-term fixed income returns. The inclusion of credit to an overall investment portfolio may bring the potential for overall higher risk-adjusted returns while also offering appropriate diversification benefits.

Footnotes

1 The Bloomberg Barclays US Aggregate Bond Index is a broad-based flagship benchmark that measures the investment grade, US dollar-denominated, fixed-rate taxable bond market. The index includes Treasuries, government-related and corporate securities, Mortgage Backed Securities (agency fixed-rate pass-throughs), Asset Backed Securities and Commercial Mortgage Backed Securities (agency and non-agency).

2 The Bloomberg Barclays US Corporate Bond Index measures the investment grade, fixed-rate, taxable corporate bond market. It includes USD denominated securities publicly issued by US and non-US industrial, utility and financial issuers.

3 Option-adjusted spread (OAS) is the yield spread which has to be added to a benchmark yield curve to discount a security’s payments to match its market price. It’s used to help investors compare cash flows and, ultimately, valuations.

4 The S&P 500® Index is a stock market index that measures the stock performance of 500 large companies listed on stock exchanges in the United States. It’s a widely followed proxy for the performance of domestic stocks.
Consider the investment objectives, risks, charges and expenses of the USAA Mutual Funds carefully before investing. To obtain a prospectus or summary prospectus containing this and other important information visit www.usaa.com/prospectus. Read it carefully before investing.

All investing involves risk, including potential loss of principal.

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