The long term case for sub-investment grade credit

January 2023

Institutional investors tend to have long-term investment horizons which reflect their long-term portfolio objectives. Therefore, we believe that it is important to review long term returns across asset classes when considering allocations to sub-IG credit. In the analysis below we compared historical sub-IG credit to public equity and evaluated the differences between loans and high yield bonds.

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Our analysis uncovered 3 reasons as to why it may make sense to have a long-term allocation to sub-IG credit:

1) Over rolling 3-year holding periods, sub-IG credit rarely exhibits negative returns and exhibits far lower volatility than public equities, as evidenced by relative performance during the Global Financial Crisis (GFC)

2) Longer holding periods significantly reduce how often negative return outcomes occur in sub-IG credit

3) Entry points matter and today's credit spreads signal attractive prospective returns

Our findings are drawn from the analysis provided below:

Sub-IG credit rarely exhibits negative returns over rolling 3-year holding periods

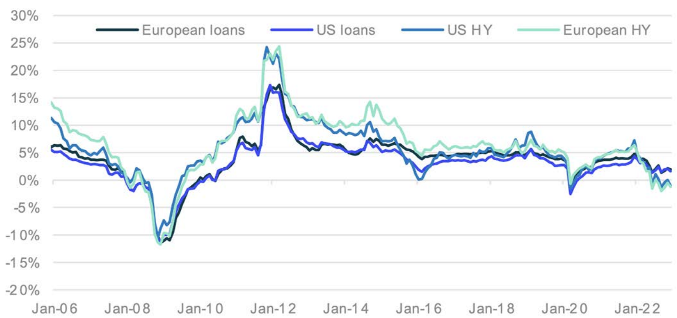
We analysed rolling 3-year holding period returns for sub-IG credit and broad equity indices from January 2006. The returns were calculated as the annualised total return for the asset class over short-term US T-bill returns for the same holding period. This creates a return premium over short- term risk-free rates and controls for higher and lower interest rate regimes. The x-axis date is the return achieved at the end of the holding period, i.e. January 2006 reflects the annualised return between January 2003 to January 2006.

Focusing on the graph which shows the rolling 3-year credit returns, it is not only rare, but occurs only in exceptional circumstances that an investor with a 3-year hold has lost on an investment in sub-IG credit.

Many would argue that the same point could be made for equities, however during the GFC, credit outcomes were superior due to lower magnitude drawdowns in percentage terms and fewer negative return data points overall. The resumption of positive returns occurs much sooner in credit post the GFC.

The selloff in risk assets in 2022 has resulted in 3-year high yield returns producing negative outcomes, while loans and equities remain positive.

Sub-IG Credit – 3-year rolling USD hedged annualised return over US T-Bill index

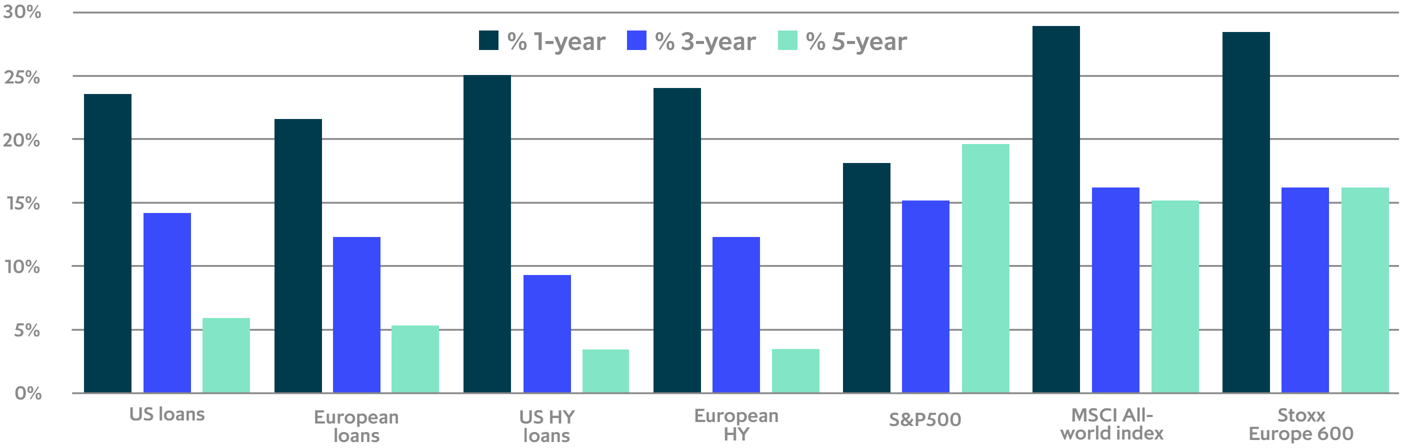


Past performance is not necessarily indicative of future results.
Source: Data from January 2006 to December 2022. All returns are annualised and USD hedged. European loans:CS WELLI, US Loans:CS LLI, US High Yield:ICE BoAML HCNF, European High Yield: ICE BoAML HPID.

Equities – 3-year rolling USD hedged annualised return over US T-Bill Index

Past performance is not necessarily indicative of future results.
Source: Data from January 2006 to December 2022. All returns are annualised and USD hedged. Equity indices: S&P 500, MSCI All-world, Stoxx Europe 600.

Frequency of negative holding period returns for 1,3 and 5 year holding periods



n=204	1-year	3-year	5-year	% 1-year	% 3-year	% 5-year
US loans	48	29	12	24%	14%	6%
European loans	44	25	11	22%	12%	5%
US HY	51	19	7	25%	9%	3%
European HY	49	25	7	24%	12%	3%
S&P 500	37	31	40	18%	15%	20%
MSCI All- world index	59	33	31	29%	16%	15%
Stoxx Europe 600	58	33	33	28%	16%	16%

Past performance is not necessarily indicative of future results.
Source: CS LLI, CS WELLI, ICE BoAML HCNF, ICE BoAML HPID, S&P 500, MSCI All-world, Stoxx Europe 600. 1) January 2006- December 2022. 2) Number of negative outcomes were counted from the monthly data for 1-year, 3-year and 5-year outcomes between January 2006 and December 2022, indicating the effect of holding period length on frequency of negative return outcomes.

Longer holding periods significantly reduce the frequency of negative return outcomes in sub-IG credit

We evaluated how the length of the holding period impacts the frequency of negative returns. We looked at the 1-year, 3-year and 5-year holding period returns over T-bills for each month between January 2006 and December 2022 and counted the number of negative outcomes. This is summarised in the table and chart above.

The data shows that 1-year holding periods have a relatively high frequency of negative outcomes in all asset classes, across both credit and equities. If you lengthen the holding period from 1 to 3 years, it improves the outcome significantly for all asset classes, except for the S&P 500, where the improvement is small. However, if you lengthen the holding period from 3 to 5 years, it reduces the occurrence of negative outcomes in credit to extremely low levels (<6% of all observations), but created limited-to-no improvement in equities.

Longer holding periods of 3 or 5 years significantly reduce the frequency of negative return outcomes in sub-IG credit markets. If we compare this to public equity, we found that negative returns are more frequent across all holding periods and longer holding periods have a less beneficial impact on this metric. In our view, this is consistent with the relative fundamental risk in each asset class. Credit is a high ranking, contractual interest, fixed maturity asset class, whereas equity is a lower-ranking, variable income, perpetual (no maturity) asset class.

Institutional investors taking a long-term perspective should incorporate these historical insights because drawdown avoidance and consistency of performance are important considerations when determining strategic asset allocations. We find significant outperformance of sub-IG credit versus public equity on these metrics.

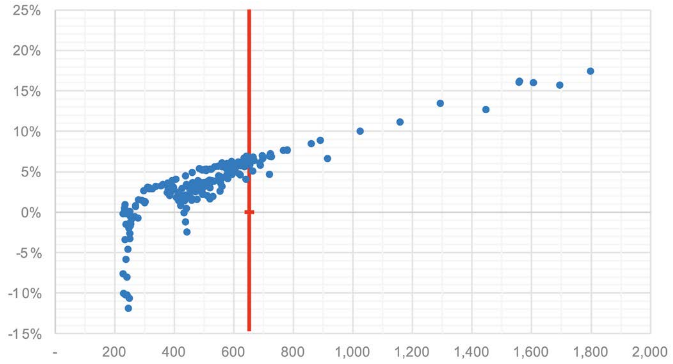
Today's credit spreads signal attractive prospective returns

Entry points are also important in impacting holding period return outcomes. We reviewed how the historical starting credit spread affects holding period return outcomes.

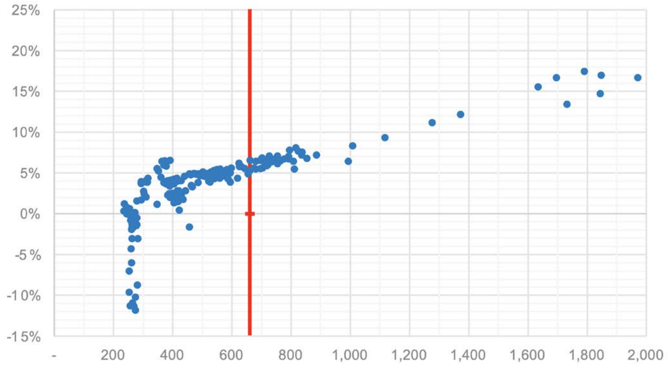
The charts below compare credit spread datapoints from January 2006 (x-axis) to the subsequent 3- year annualised holding period return(y-axis). The red lines overlay current(December 2022) credit spreads for each asset class.

Relationship between credit spread & 3-year returns

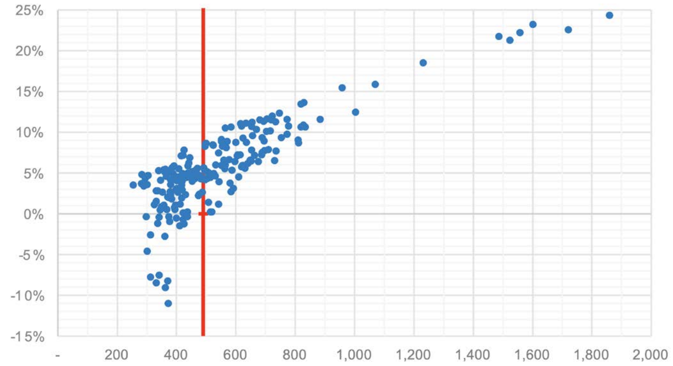
US loans: 3-year DM vs 3-year ann. return over T-Bills (3-years forward)



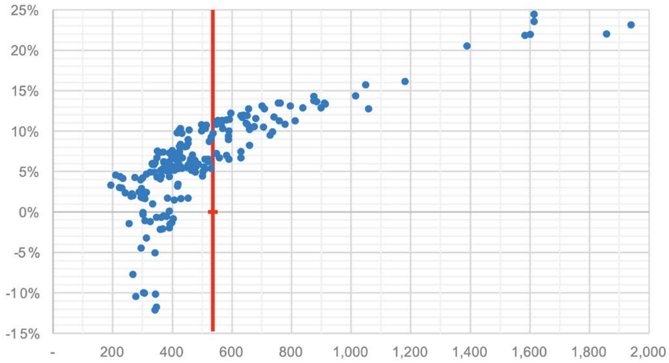
European loans: 3-year DM vs 3-year ann. return over T-Bills (3-years forward)



US HY: Spread vs gov't vs 3-year ann. return over T-Bills (3-years forward)



European HY: Spread vs gov't vs 3-year ann. return over T-Bills (3-years forward)



Past performance is not necessarily indicative of future results.
Source: CS LLI, CS WELLI, ICE BoAML HCNF, ICE BoAML HPID, January 2006- December 2022. Each data point is the credit spread at the beginning of 3-year annualised holding period return between January 2006 and December 2022.

The loan indices have a strong positive relationship between credit spreads (3-year discount margin) and holding period return, with today's credit spreads consistent with a ~4-7% return outcome, based on historical data. The level of starting credit spread that leads to negative return outcomes is more than 200bps tighter than today's levels.

The high yield indices also have a positive relationship between credit spread (spread-to-worst vs. government bonds) and holding period return, but not as strong as it is for loans. Today's credit spreads are consistent with a wider range of outcomes: ~5-12% in European HY and ~0-9% in US HY. The proximity of today's credit spread to spreads consistent with negative return outcomes is close in Europe and even closer in the US.

These graphs demonstrate that entry points matter. Investing at today's credit spread has historically produced ~4-7% annualised positive returns over short-term risk-free rates (rolling T- bills), over a 3-year holding period, with high consistency. Entry points matter for high yield too, however the dispersion is much higher, with historic returns ~0-12% above T-bills.

CONCLUSION

Our analysis endorses a constructive view on credit, both on an absolute basis and relative to equities. Credit has historically been a lower volatility, more reliable route to positive return outcomes, particularly for investors with longer time horizons.

Within credit, we currently prefer loans to high yield. Though past performance is not a guarantee of future returns, history indicates a 4-7% premium is available in loans given starting credit spreads. Given current T-Bill yields of 4.5% and 3-year treasury yields of 3.8%, 7.8-11.5% total returns are achievable on a USD-hedged basis. US high yield outcomes are less clear cut on this basis: current credit spreads are closer to levels historically associated with negative or zero return premia over T- Bills.

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