Short-Duration Credit Solutions

By Christopher Harms, VP, Fixed Income Portfolio Manager, & Gene Morrison, CFA, VP, Fixed Income Product Manager

KEY TAKEAWAYS

- Short-duration credit offers yield over duration-matched Treasurys with potentially less volatility for investors willing to assume credit risk and cede some liquidity.
- The universe is broad and includes US investment grade credit, securitized credit, emerging market corporates and bank loans.
- Custom solutions can fit a range of risk/return objectives and portfolio roles, including cash substitute, yield and future value targeting, and cash flow matching.
- Short-duration credit strategies can have merit in a variety of economic and interest rate regimes.

Persistently low yields have continued to vex fixed income investors. Investing in negative real interest rates at the short end of the Treasury yield curve represents an opportunity cost, but reaching for yield in longer-dated securities introduces greater duration risk when rates eventually edge higher. Some investors dissatisfied with these tradeoffs are looking to short-duration credit.

Short-duration credit strategies can address the yield/duration conundrum by taking credit risk to increase yield while maintaining short interest rate and spread duration. Looking beyond recent market conditions, short-duration credit may be well suited to strategies such as buy-and-hold or cash flow matching in a variety of economic and interest rate regimes.

In this discussion, we highlight the short-duration credit universe and the range of investment objectives it aims to meet.

Why Short Duration?

We examined risk and reward across the maturity spectrum by looking at ten-year performance for four Barclays credit indices with similar assets but varying tenors. For the decade ended December 31, 2014, the two shorter-duration indices produced more modest returns than either the core or long indices. But as shown on the following page, on a risk-adjusted basis, the shorter-duration indices earned the highest Sharpe ratios, 0.95% and 0.89%, signifying a potentially compelling risk/return profile for investors with nearer-term goals.

ATTRACTIVE RISK-ADJUSTED RETURN

INDEX	SHARPE RATIO
Barclays US 1-3 Year Credit	0.95
Barclays US 1-5 Year Credit	0.89
Barclays US Credit	0.73
Barclays US Long Credit	0.57

Sources: eVestment, data as of December 31, 2014.

More Than Treasurys: The Short-Duration Credit Universe

Investors often think of short-duration assets in terms of US Treasurys and investment grade credit. However, the varied universe includes securitized credit, bank loans and emerging market corporates, all of which offer a yield advantage over duration-matched Treasurys with generally less rate sensitivity, as shown in the table below. And at any given time, these sectors are potentially in different phases of the credit cycle.

Based on an assessment of valuation and the credit cycle, investors can exploit these sectors' distinct features to construct diversified portfolios. It is important to note that to build a portfolio with a yield advantage and less volatility, investors must assume credit risk and potentially sacrifice some liquidity.

SHORT-DURATION SECTOR	INDEX	MARKET VALUE (MIL)	CREDIT RATING	LIQUIDITY	YIELD TO WORST (%)	SPREAD (BPS)	DURATION (YEARS)	5-YEAR SHARPE RATIO
US Treasurys	*Barclays US Treasury 1-5 Year Index*	$3,884,659	AAA	Highest	0.95	-	2.64	1.30
US Investment Grade Credit	*Barclays US Credit 1-5 Year Index*	$2,106,473	A/A-	Good	1.80	76	2.73	1.81
Securitized Credit • **ABS** • **RMBS** • **CMBS**	*BofA Merrill Lynch ABS & CMBS Index*	$927,870	AAA	Good/Fair	1.79	98	2.42	2.45
Emerging Market Corporates*	*JP Morgan CEMBI Broad Diversified 1-3 Year Index*	$47,981	BBB	Fair	4.21	356	1.96	1.91
Bank Loans**	*S&P/LSTA Leveraged Loan Index*	$797,472	B+	Fair	5.42	LIBOR+ 561	0.10	1.50

Sources: Sharpe ratios from eVestment, JP Morgan; credit ratings from Standard & Poor's; all other data from Bank of America Merrill Lynch (securitized credit), Barclays (US Treasurys, US investment grade credit), S&P/LSTA (bank loans), JP Morgan (emerging market corporates). All data as of December 31, 2014.

**For emerging markets corporates, blended spread (spread over the US Treasury curve at the average life point) is shown.*

***For bank loans, yield to maturity and discounted spread (3-year life, data excludes defaults) are shown; duration is estimated by Loomis Sayles.*

All indexes are unmanaged and do not incur fees. You cannot invest directly in an index.

Custom Short-Duration Solutions

Short-duration credit can be a good fit for cash investors who are tired of negative real rates and who crave capital protection in the event of a rate rise, but the asset class is not strictly a rising rate solution. As shown below, short-duration credit can be tailored to specific risk, liquidity and maturity preferences, helping it pursue a number of investment objectives throughout the business and interest rate cycles.

SHORT-DURATION SOLUTIONS	FOR INVESTORS SEEKING	STRATEGY OVERVIEW
BROAD MARKET Move from cash to short duration	Higher yield than money market and passive strategies, and less duration sensitivity than intermediate or core portfolios	Portfolio invests in 1- to 5-year maturities across all broad IG fixed income sectors
BUY & MAINTAIN Customize a strategy aimed at consistent yield and a future value target	To minimize trading costs and value fluctuations at end of investment horizon	Fixed maturity portfolio may reinvest or withdraw coupons and principal paydown
CASH FLOW MATCHED Customize a strategy around cash flows needed to fund multi-year projects	Income accumulation and to avoid selling securities at potentially inopportune times	Portfolio utilizes modeling to match coupon and maturity payments to known cash needs
SHORT PLUS Invest further out on the risk spectrum to maximize yield potential	Yield, a broader toolkit and diversification benefits	Strategy invests tactically to capitalize on different phases of the business and credit cycles

This reflects the current opinions of the investment team and views are subject to change at any time without notice.

Deep Research at the Core

Research expertise is a requisite for any credit strategy. In short-duration investing, where confidence in credit selection is a leading priority, a robust research infrastructure that delivers deep macro, sovereign, credit, securitized and quantitative insights is critical. Individual short-duration strategies may draw heavily on specific areas of expertise—for example, macro expertise is needed to tactically shift sector allocations in broad market and short plus strategies, and quantitative analysis and modeling are essential for cash flow matched portfolios. Loomis Sayles' dedicated research groups can generate perspectives that cut across markets and bring a variety of insights and tools to the investment process.

Conclusion

After years of low bond yields, investors are watching and waiting for signs of a reversal. Many short-duration credit portfolios can deliver capital preservation and attractive risk-adjusted returns as yields rise; however, these strategies can be relevant in a variety of economic and interest rate regimes. For near-term investors willing to assume credit risk and sacrifice some liquidity for higher yield, any short-duration credit strategy could potentially fit the bill. The art comes with understanding the fundamental and technical subtleties of each sector, and combining them precisely to suit the risk/reward and cash flow demands of each particular investor.

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Disclosure

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