

High Yield Market Timing: More Miss than Hit

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In our meetings with consultants and institutional investors, we frequently hear that investors understand the risk and return pattern of the high yield market but that absolute credit spreads today are too low to justify an allocation to the sector. Some investors have articulated strategies such as “buy the market at 600bp, sell it at 400bp.” The sector is perceived to be “rich” because 1) its credit spread is presently lower than its historical average and 2) the economy is “overdue” for a downturn, which will drive default rates above their currently low levels. The second of these ideas is commonly articulated in the business press in a series of anthropomorphisms about the economy. It is described as “tired,” or the sustained expansion is “long in the tooth.” And it is said that we are “late in the cycle,” although a look at the interval between past recessions reveals more of a random walk than a cycle. We believe what investors mean is that the longer an expansion continues, the more likely a correction is – that is, that growth inherently strains an economy to a breaking point, generating imbalances which increase the chances of recession in the next period. These macroeconomic questions, and whether it is “really different this time,” are a subject for another paper.

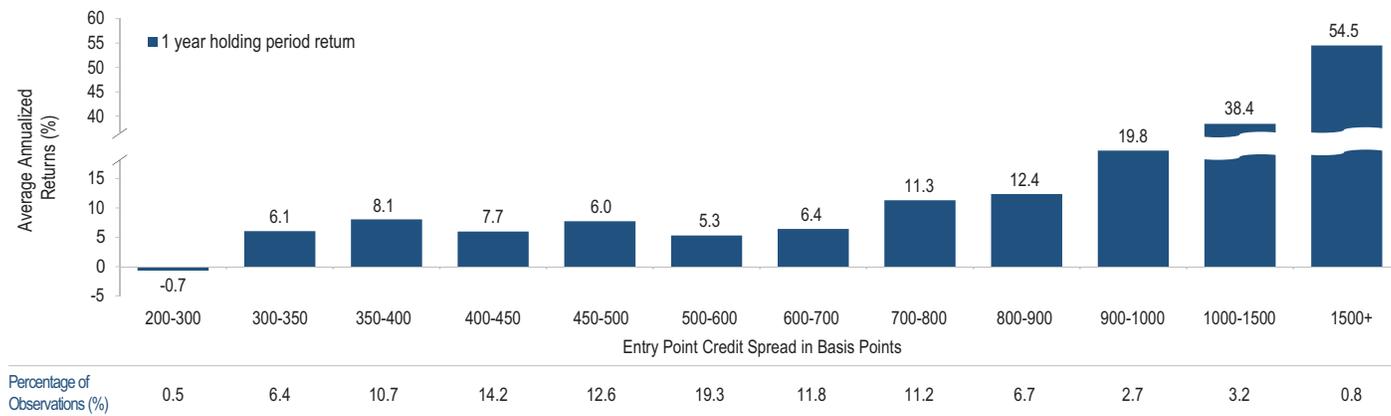
In this essay, we focus on narrower and more empirical questions: historically, have higher-spread entry points into the high yield market been associated with higher realized returns? That is, does a tactical rule like “buy at 600bp, sell at 400bp” generate meaningfully better returns than a

strategic, long term allocation to the sector? Is the spread at entry a good predictor of returns? If there is such a relationship, is it robust across all ranges of credit spreads, or is it more applicable at the (less common) tails of the spread distribution? The answers turn out to be surprisingly clear, counterintuitive, and even surprising.

We analyzed these questions with monthly spread and return data from the Credit Suisse High Yield index from January 1986 (the beginning of the Index time series) to February 2018. Figure 1 shows the one year returns for all monthly entry points, sorted by 12 intervals of credit spreads, generating 374 separate trials. Since the high yield market has traded between 300bp and 500bp almost half of the time, the spread intervals within this “normal” trading range are narrowed to just 50bp (e.g., 300 to 350bp) in order to provide better granularity with respect to these observations.

The chart is visually striking in that the expected relationship between entry spread and subsequent returns seems to be powerfully present, but only at spreads in excess of 700bp... where the market trades only 25% of the time. At these elevated spreads, the relationship between incremental promised spread and incremental realized return is continuously positive – what mathematicians call a “monotonic” relationship. But during the 75% of months when the market trades between 300bp and 700bp, there is no relationship at all.

FIGURE 1 | One Year High Yield Holding Period Returns by Entry Credit Spread



Source: Data are from the Credit Suisse High Yield Index, January 1, 1986 to February 28, 2018.

Figure 2 and Figure 3 recapitulate the analysis using three year holding periods (350 trials) and five year holding periods (326 trials), with similar results. (Note the difference in the scaling of the y-axis as we transition from one year to longer holding periods).

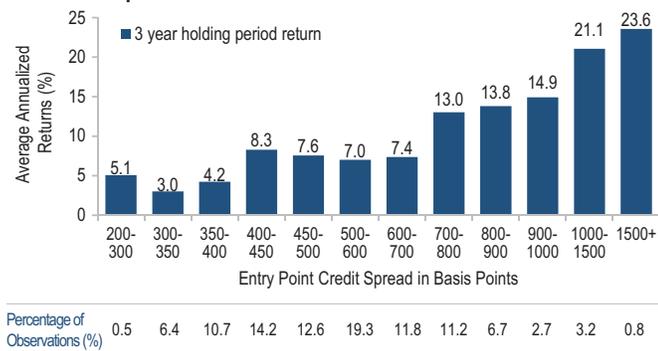
Figure 4 looks in a more detail at the relationships between “normal” entry point spreads of 300-700bp and one, three, and five year holding period returns using scatter plots. If higher entry spreads were associated with higher realized returns, the points in the plots would demonstrate a cloud pattern which would rise as we moved from left to right on the x-axis. Again, we see the counterintuitive result that investing at entry point spreads of 300, 400, 500, or 600bp has produced no difference in realized returns. Evidently, there is more to this decision than just looking at raw spreads.

The results we observe for the sub-700bp trading ranges should really not be surprising to students of capital asset pricing theory. Credit spreads are not derived in a vacuum. Spreads are equilibrium prices set in a reasonably liquid and well-functioning market, which can be sold short in the cash or derivatives markets if bonds are overvalued. Investors make estimates of default losses over their investment horizons, subtract those from promised returns, and buy or sell depending on how the resulting expected default-adjusted return (and its expected volatility) compare to expected returns and volatilities of other asset classes. If the market is unbiased in its estimation of future default losses – that is, it tends to over-forecast and under-forecast default losses in roughly the same proportion – the lack of a relationship between promised spread and realized return is exactly what we should expect. We believe this does occur; high yield portfolio managers spend most of their time

developing, explicitly or implicitly, forecasts of default losses at both the security and universe level, and strategists publish extensively on the subject. Even if some investors do buy or sell on the basis of promised spreads only – and we have seen that there are a considerable number who do – we believe that there is enough marginal, mobile capital which does make explicit default loss forecasts (and acts upon them) to produce the pattern we see in the four charts.

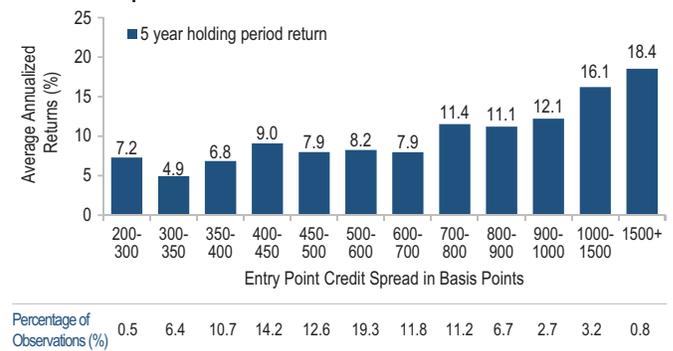
What changes when the market trades at over 700bp? Why does the market then behave in an apparently structurally different way? Investors know that in a recession or credit crunch, default rates will rapidly rise to three or four times their historical levels. Under these conditions, very recent experience is more heavily weighted in market participants’ forward-looking estimates, and high yield spreads behave as if the higher default loss levels are now “the new normal.” This view persists until investors can perceive a turn for the better, which may consist of improvement in the real economy or the deployment of fiscal and monetary policies which they believe will shorten the recession. Risk premia move higher in all markets, and we read in the newspapers of a “flight to quality.” Policy makers debate whether the downturn can be “contained” or will instead become a “contagion.” The truth is that no one can know the length or severity of the downturn in real time, and even whether an apparent bottom in GDP will be followed by a recovery or an even worse decline, as occurred during 1937 in the Great Depression or was often prophesied as the much-feared “double dip” of 2009. The same is true of market downturns in the high yield market which come in response merely to an anticipated, rather than actual, recession. In general, conditions in the real economy during these periods, and the

FIGURE 2 | Three Year High Yield Holding Period Returns by Entry Credit Spread



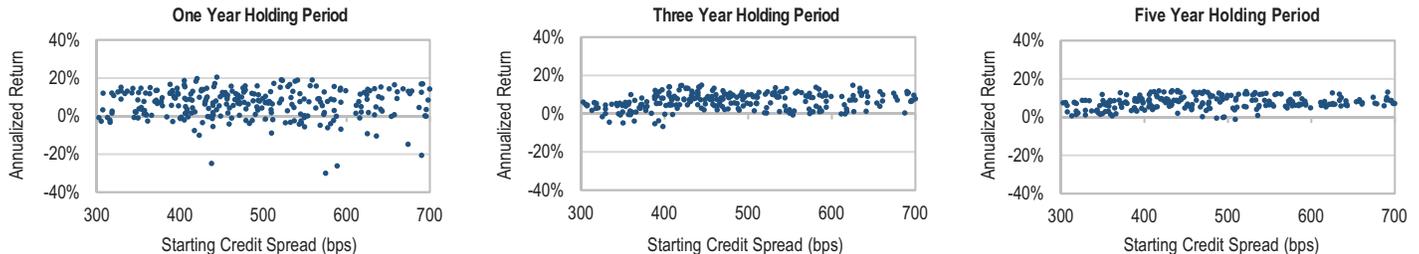
Source: Data are from the Credit Suisse High Yield Index, January 1, 1986 to February 28, 2018.

FIGURE 3 | Five Year High Yield Holding Period Returns by Entry Credit Spread



Source: Data are from the Credit Suisse High Yield Index, January 1, 1986 to February 28, 2018.

FIGURE 4 | High Yield Market Annualized Performance and Starting Spread Pairs
Annualized Returns for Starting Credit Spreads between 300 – 700 bps (1986 – 2018)



Source: Credit Suisse, MFIM.

policy response thereto, usually present real and rational reasons why the market should be trading at a wide spread.

We might hypothesize that investments made at times of market stress (and thus high credit spreads) would show much higher standard deviations. It is certainly true that when spreads are very high, monthly volatility is higher. But here we are using standard deviation to look at the variation in one, three and five year holding period returns – the horizontal variability across the set of holding period returns, not the period-to-period volatility within the monthly time series themselves. It is the former concept of risk which matters to all but the most short-term investors, who will endure monthly volatility if they can be fairly confident that they will achieve predictably good results over a three or five year time horizon. The results are presented in Figure 5.

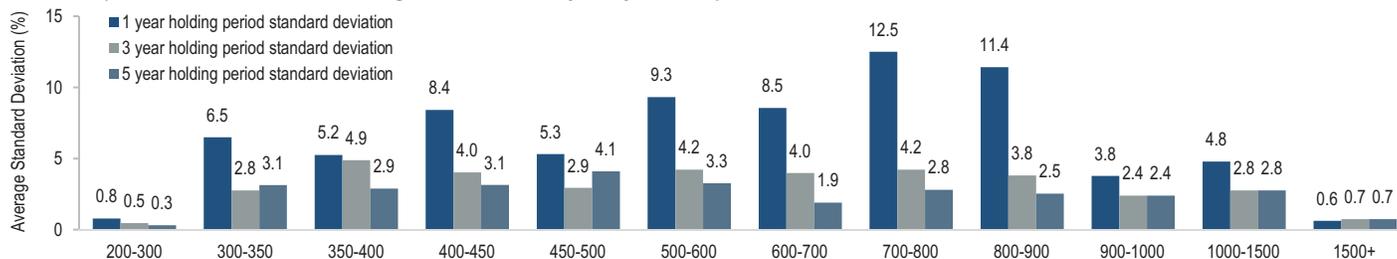
This is again counterintuitive: results of investments made when spreads are high are not at all more variable than investments made in more stable environments. There is more variability in one year returns, as we would expect, than in multiyear returns. But the volatility is not monotonic with respect to spreads even for one year returns, and three and five year returns are not more variable at all. This suggests that high spreads historically have been genuine buying opportunities even when adjusting for risk – the marginal suppliers of high yield capital do overestimate future default rates when current default rates are high, which is another way of saying that not enough capital enters the sector to price securities in line with their actual risk of default. Recapitulating, we conclude that in the 75% of time when the market trades in a “normal” range of 300 to 700bp, it fairly accurately estimates future defaults, and so a 400bp level is not a reliable sell signal and a 600bp spread

is not a reliable buy signal. In the 25% of the time that the market trades in excess of 700bp, the spread is a reliable buy signal for an investor with the risk tolerance to hold the position for three or more years.

There are structural and intuitive reasons why this is so. Once highly elevated, default rates do show reversion to the mean, and rather rapidly. In a recession, the weakest bonds default (with most converted to equity) and thus leave the universe. Meanwhile, new issuance is dramatically reduced, and becomes heavily dominated by comparatively high-quality credits. Both of these effects rather quickly improve the average quality of bonds outstanding, and when a recession ends, investors are justifiably enthusiastic about companies which have just demonstrated that they can survive the greatest stress the high yield market can pose. Meanwhile, the Fed adopts an accommodative monetary policy, helping some marginal borrowers refinance maturities which cannot be paid down out of free cash flow. As a result, bond prices for survivors are quickly bid up, with the result that the high yield market regains ground lost during drawdowns with astonishing speed.

The rapidity with which the high yield market recovers losses is shown in Figure 6, which shows the ten largest drawdowns (measured with peak to trough month end index values) in the history of the market since 1986. The largest drawdown occurred before and during the Great Recession in 2007 – 2008, when the market declined by 31.84% – a loss which it fully recouped after just 10 months. On three other occasions, the market declined by over 10%, and it recovered in 5, 5, and 6 months. Across all ten declines, which averaged 10.99%, the average recovery time has been 5 months. By way of contrast, between August 2000

FIGURE 5 | Standard Deviations of Holding Period Returns by Entry Credit Spread

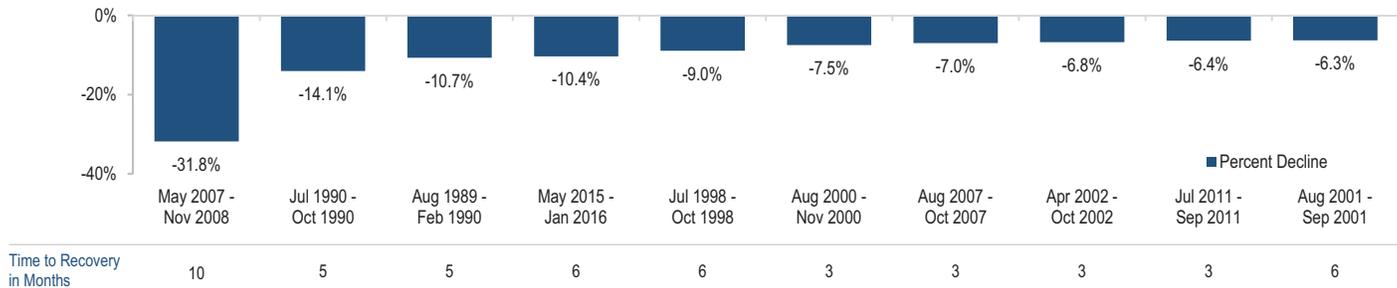


Standard deviations are measured across period returns and aren't standard deviations within time series themselves.

Source: Data are from the Credit Suisse High Yield Index, January 1, 1986 to February 28, 2018.

FIGURE 6 | High Yield Time to Recovery

- Worst ten drawdowns in the high yield market since 1986
- Average percent decline is -10.99% and the drawdown is fully recovered in 5 months



Source: Credit Suisse, MFIM.

and September 2002, the S&P 500 (with dividends reinvested) lost 44.7%, which required 49 months to recoup. In the Great Recession, the S&P 500 index fell by 50.91% from October 2007 to February 2009, and it required 37 months to make up the loss. Between March 2000 and October 2002, the NASDAQ index lost 78 percent, and it took 64 months to recoup the lost ground. Real assets display similarly long recovery periods.

When we look at this concept of recovery time, we realize that the idea of mis-timing the market entails less downside than investors in other risky asset classes are used to. The average downturn in Figure 6 lasted 5 months, and so did the recovery. So even in the worst case of a purchase infelicitously timed just before a market decline occurs, on average the result is a zero return over a combined (decline and recovery) interval of 10 months. For this reason, we believe investors should be long term, strategic holders of the asset class. About 25% of the time, they have historically earned a low-teens return. In the other 75% of the time, they have earned an average return of about 7% regardless of the promised spread, punctuated by periods of losses which are brief and are quickly recovered.



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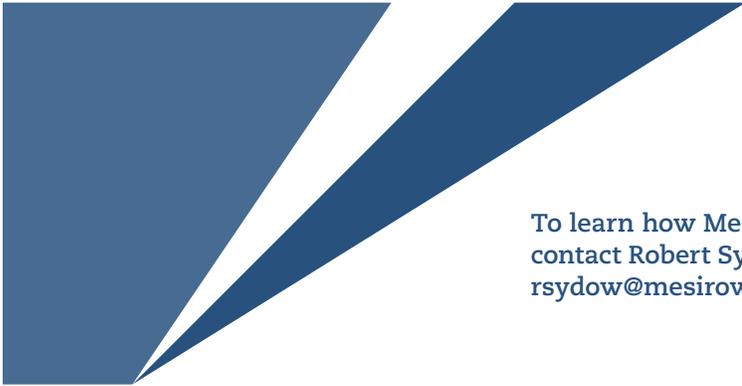
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