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FEATURED SOLUTION

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The Best Time to Accumulate Long Credit Bonds May Be Now

Rene Martel, FSA, CFA
Executive Vice President
Product Manager

Mohit Mittal
Managing Director
Portfolio Manager

Plan sponsors have an opportunity to beat the rush for long credit and take advantage of historically wide spread levels to earn attractive yields – all while cancelling out exposure to duration risk as they wait for higher interest rates.

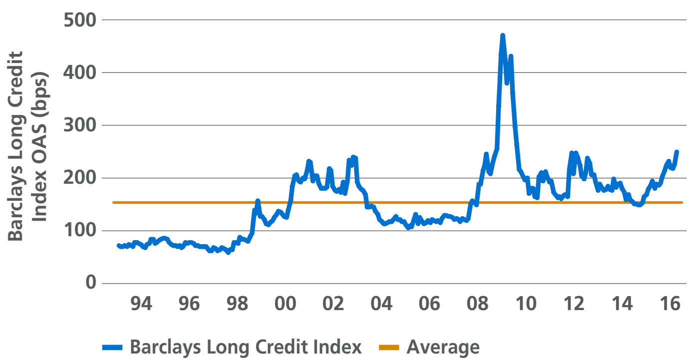
A consensus has emerged within the corporate defined benefit plan community that many plan sponsors will acquire a large amount of long-dated credit bonds over the next several years as they seek to de-risk their plans. However, many plans have delayed this move in the belief that interest rates are likely to rise in the near term.

While forecasting interest rates is a perilous exercise, it is understandable that plan sponsors are not lining up to acquire long duration bonds amid today's low interest rates. Yet it's important to recognize that postponing the purchase of long credit bonds is not merely a call on long-term Treasury rates; it also implicitly expresses a view that long-dated credit spreads are unattractive.

WIDER THAN (ALMOST) EVER

Other than for a short period at the height of the global financial crisis in 2008–2009, long-dated investment grade credit spreads have not been as wide as they are now in more than two decades (see Figure 1).

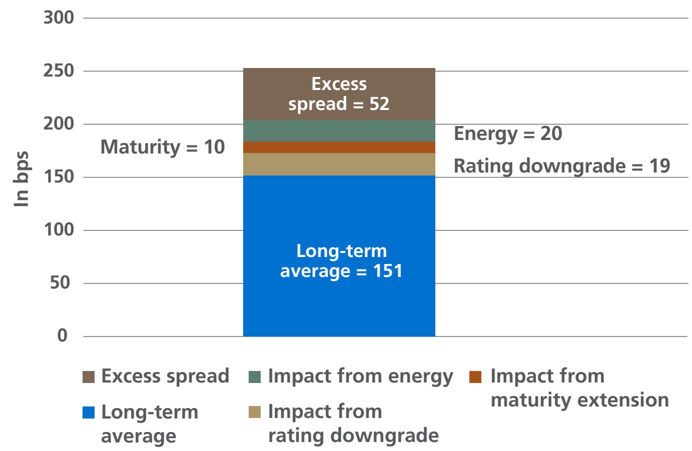
Figure 1: Long-dated investment grade credit spreads are wide by historical standards



Source: Barclays as of 31 January 2016

While a certain amount of the differential between the current spread level and its long-term average can be explained by fundamental factors or recent market events, we believe a significant portion is not justified (see Figure 2). We remain constructive on credit while recognizing near-term volatility. We expect it to benefit from improving demand/supply technicals as monetary policy normalizes, stable corporate fundamentals in a New Neutral growth environment and attractive valuations relative to historical levels. We believe now is an excellent entry point for long credit investors – especially for corporate plan sponsors already planning to acquire these bonds in the future.

Figure 2: Long credit spread breakdown



Source: Barclays Long Credit Index as of 31 January 2016

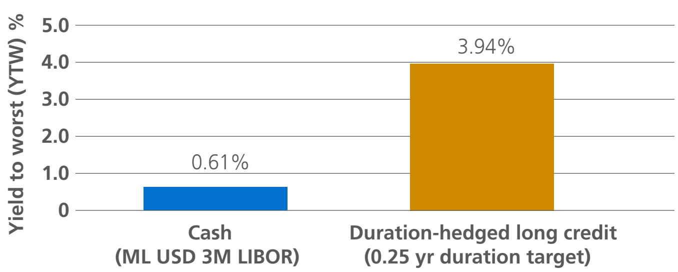
WHAT ABOUT RISING INTEREST RATE RISK?

In the event that long-term interest rates rise meaningfully – as expected by plan sponsors delaying the purchase of long credit bonds – long-dated spreads would likely tighten on the back of increasing demand and diminishing supply. As compensation for rate and credit risk are at opposite poles from a value perspective, defined benefit plans should consider unbundling the timing decision.

In practice, that would mean purchasing long credit bonds now (as opposed to delaying) but hedging the associated duration risk with derivatives until interest rates reach a level where the plan sponsor is comfortable adjusting duration exposure. This would enable plan sponsors to isolate their views on long-term Treasury rates without sacrificing the opportunity to garner spread exposure at attractive levels – an exposure that they are effectively short versus liabilities.

With the combination of wide long credit spreads and negative swap spreads, plan sponsors can build a near-zero duration portfolio with a yield potential of almost 4% (Figure 3) as of 31 January 2016.

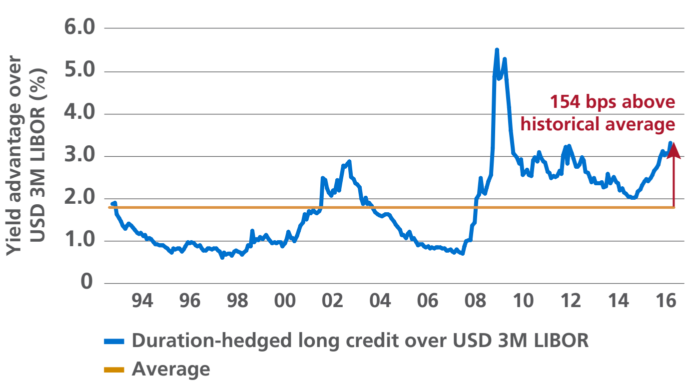
Figure 3: Earn close to 4.0% in yield potential without taking duration risk



Source: Barclays Long Credit Index and Bloomberg as of 31 January 2016

The ability to generate such a yield advantage over cash on a duration-hedged long credit portfolio is a rare opportunity (see Figure 4). And if one expects spreads to tighten in a rising rate environment, this strategy could generate significant return potential in a year when interest rates increase materially.

Figure 4: Historical yield advantage of duration-hedged long credit



Source: Barclays Long Credit Index and Bloomberg as of 31 January 2016

More specifically, the yield advantage over Libor of the strategy was 3.3%, or 150 basis points (bps) over its historical average on 31 January 2016. If that excess over the historical average were to fall by just half (from 150 bps to 75 bps), the duration-hedged long credit structure could potentially generate a return north of 10%. Even if rates and spreads were to hold steady, investors could potentially earn almost 3.5% over equivalent-duration cash. Not bad for a fixed income portfolio in a low or rising rate environment.

PUTTING IT ALL TOGETHER

Waiting until rates are higher may not be the optimal strategy to acquire long credit bonds. Instead, plan sponsors should consider buying long credit bonds now, while hedging the associated duration risk until rates rise to a level that they are more comfortable with. This would enable plan sponsors to:

1. Potentially earn an attractive 3.9% yield on a duration-less portfolio as they wait for rates to rise, thereby possibly reducing the negative drag associated with waiting.
2. Potentially earn a double-digit return on an investment grade fixed income portfolio in a rising rate environment.
3. Significantly simplify the operational process of extending duration once rates do rise. It is much more straightforward to simply unwind a derivatives position as opposed to joining the potentially large crowd that likely will try to acquire long credit bonds after a meaningful increase in interest rates.
4. Improve credit-spread match relative to liabilities at a time when this risk is elevated given wide spread levels.

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Barclays U.S. Long Credit Index is the credit component of the Barclays US Government/Credit Index, a widely recognized index that features a blend of US Treasury, government-sponsored (US Agency and supranational), and corporate securities limited to a maturity of more than ten years. It is not possible to invest directly in an unmanaged index.

Newport Beach Headquarters
650 Newport Center Drive
Newport Beach, CA 92660
+1 949.720.6000

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