wtw

Alternative credit, why now?

Potential for stability of returns through (high) income and low duration

wtwco.com

Executive summary

- We believe the majority of long-term investors could benefit from allocating to diversified credit strategies that offer high carry and short duration
- In the following paper we will make the case for increasing or establishing diversified credit investments to take advantage of the current credit environment and increase portfolio resilience
- After adjusting for potential defaults we believe the current credit market offers one of the best trade-off's for income to risk that we have seen in the past decade and we are positioning portfolios accordingly
- Despite recent turmoil in the banking industry we have seen diversified credit investment hold up well and potential tightening of lending by traditional sources may make certain segments even more attractive today

In 2022, credit markets experienced one of their worst performance years on record. The Bloomberg Barclays Aggregate Bond Index (the "AGG Index" and the '40' within the famous 60/40 allocation) experienced its worst calendar year of performance since its inception in 1976, returning -13%. However, for a year where concerns about a potential recession dominated the headlines, more credit-sensitive, "lower-quality" assets such as high yield bonds and leveraged loans actually outperformed the AGG index, with high yield bonds returning -11%* and leveraged loans returning -0.8%*. Key to understanding this dynamic is the underlying interest rate sensitivity of various credit asset classes.

One of the unique aspects of the 2022 market environment was the aggressiveness of the Fed in raising interest rates. Not since the 1970s had the Fed tightened so far so quickly. The speed and size of the Fed rate hikes surprised market participants and had a direct, negative impact on bond returns. A bond's underlying sensitivity to changes in interest rates is measured by its duration. The greater a bond's duration, the greater its sensitivity to changes in interest rates. A general rule of thumb is that for every 1% increase in interest rates, a bond's price will decline by 1% for each year of duration.

*Source: ICE Data Services as of December 31, 2022

Exhibit 1 shows the high-level characteristics of the US Aggregate Bond Index vs. the US High Yield Index and the WTW Best Ideas model, our preferred implementation route for Alternative Credit. What stands out is the significantly higher interest rate sensitivity of the Aggregate Bond Index, which is in part a function of its lower yield to maturity. This inefficiency, as measured by yield per unit of duration (the amount of yield you are receiving per year of interest rate risk) can lead to interest rate positioning, as opposed to credit quality, dominating the return profile in periods of interest rate volatility as was clearly illustrated in 2022. Interestingly, as shown in Exhibit 2, even in periods of moderately falling interest rates, higher carry lower duration assets, all else equal, are expected to outperform as their higher starting yields offset the smaller interest rate driven price gains.

Looking forward, we believe there are three key reasons to favor high carry, short duration strategies:

1. Uncertain rate path

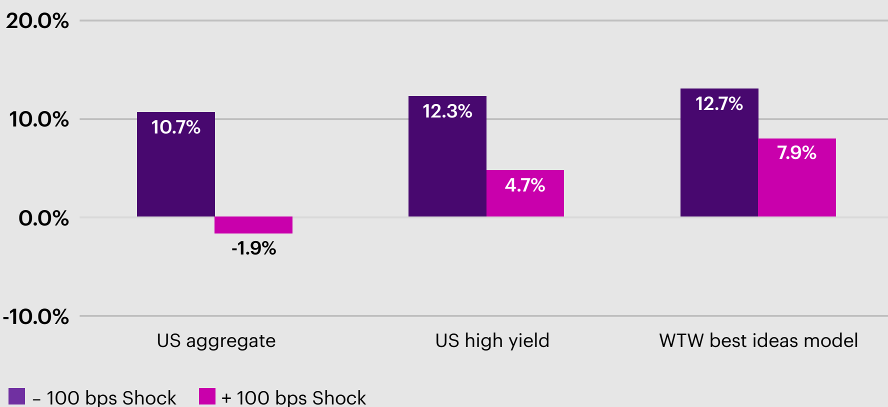
The interest rate volatility that defined 2022 has continued into 2023 and the future path of interest rates remains highly uncertain. The recent banking turmoil has only added to this uncertainty. However, as shown in Exhibit 3, market participants are now pricing in monetary easing later this year, despite inflation remaining well above the Fed's long-term target. Should the Fed instead continue with its current tightening cycle because of continued high inflation, tight labor markets or some other factor, interest rate sensitive assets will experience price headwinds similar to 2022. We would argue that this is a risk credit investors don't need to take and, given the current inverted shape of the yield curve, one investors are not being compensated for with additional yield.

Exhibit 1.

As of 3/31/23	Duration	Yield to maturity	Yield per unit of duration	Avg. credit quality
US aggregate	6.3	4.4%	70 bps	AA
US high yield	3.8	8.3%	224 bps	B
WTW best ideas model (hypothetical)	2.4	10.7%	446 bps	BB

Source: **Past performance and hypothetical performance is not a reliable indicator of future returns.** Performance is shown net of investment manager and net of WTW fee of 38 bps. Securities and derivatives trading in which the portfolio funds engage are speculative and involve a substantial risk of loss. Source: WTW, Factset, ICE Data Services. HY Index is: ICE BofA US High Yield Index. Agg Index is: ICE BofA US Broad Market Index. WTW Best Ideas Model is comprised of 30% High Yield/ Loans, 25% Securitized, 20% Emerging Market Debt and 25% Private Credit. Underlying strategies in model are chosen from a total population of managers from the corresponding asset classes via the WTW manager research process. The volatility of an index is materially different from that of the model results with which the index is compared.

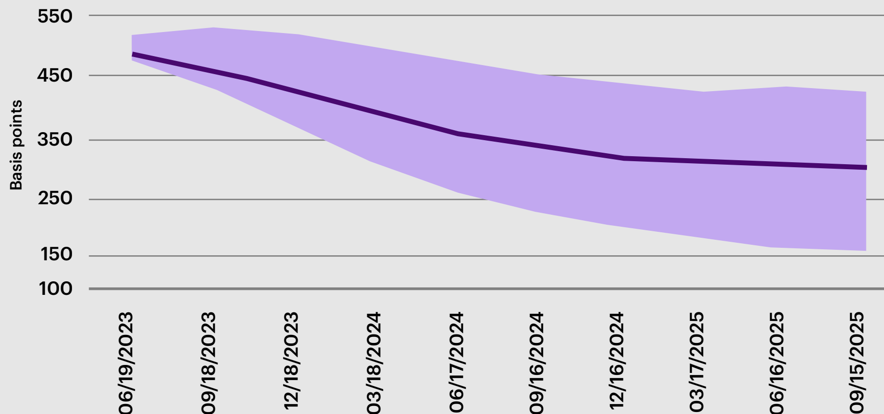
Exhibit 2. **Hypothetical 1 yr total return**



Source: WTW. Assumes a 100bps instantaneous yield shock using the duration and YTM from Exhibit 1. Data as of March 31, 2023

Exhibit 3. **The expected future path of the three-month average Fed funds rate**

Current target range: 475 - 500 basis points

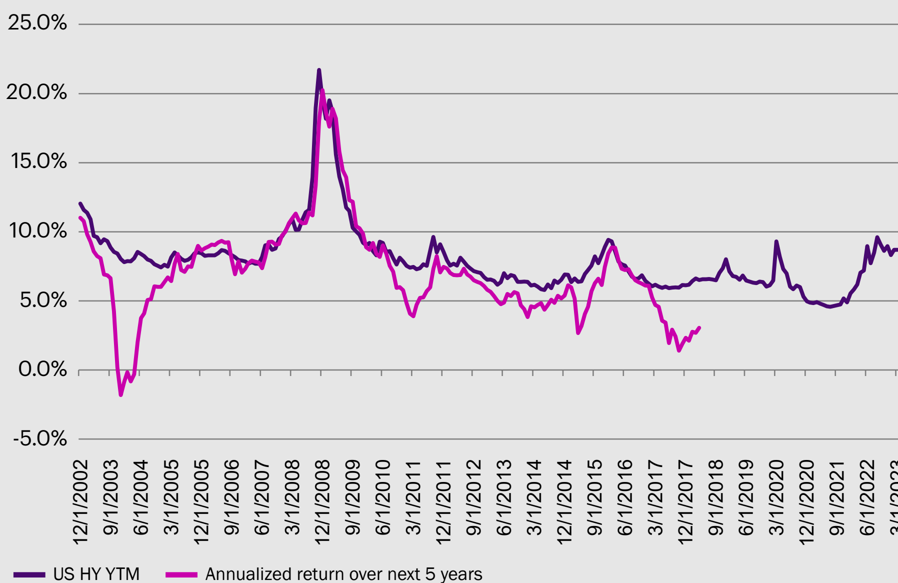


Source: Federal Reserve Bank of Atlanta. As of March 31, 2023

Given the high level of starting yields, spread levels across corporate credit markets near historical averages and modest default expectations, we have reason to believe that income (as opposed to price) will be the primary component of credit returns looking forward.

2. High starting yields

The rise in cash rates over the course of 2022 has left starting yields across credit asset classes well above their post-GFC medians. The increase in starting yields has been further supported by a widening in spreads, with US High Yield spreads currently around 500 bps, up approximately 150 bps from 2021 averages. As shown in Exhibit 4, historically, we believe one of the best predictors of future return potential across credit asset classes is the level of starting yields. The key question for any credit investor to ask then is whether or not starting yield levels are providing a fair level of compensation for potential defaults and credit losses. Default rates across the US HY universe have averaged 3.6% per annum over the past 20 years. In 2020, as a result of the COVID pandemic, default rates spiked to 5.2%. Ratings agencies are predicting default rates for the coming year in the range of 3-4%. Assuming recovery rates in-line with historical averages (40%) this implies credit losses of 1.8-2.4% per annum, which are more than covered by current spread levels. For alternative credit solutions that are able to generate higher yields without a corresponding decrease in credit quality, excess spread return potential is expected to be even greater.



3. Returns driven by income

In periods of heightened uncertainty, a stable return stream is increasingly valuable. Given the high level of starting yields, spread levels across corporate credit markets near historical averages and modest default expectations, we have reason to believe that income (as opposed to price) will be the primary component of credit returns looking forward. This is particularly true for higher carry, lower duration strategies where a reduced sensitivity to interest rate movements better allows for a realization of return potential generated from income regardless of the future path of interest rates.

Conclusion

2022 was a challenging year for credit investors as price declines from rising interest rates more than offset income returns from coupons. Generally speaking, the greater a credit asset's duration the more vulnerable it was to the 2022 market environment. Given the heightened uncertainty of future rate paths, we believe this risk remains. Looking forward we see high carry, low duration strategies as better positioned to outperform as high starting yields that include attractive levels of excess spread (particularly for alternative credit strategies less correlated to broader corporate credit markets) offer a stable return profile driven by income as opposed to more volatile price movements.

Whether your objective is to diversify from equity risk or generate income for liquidity needs, we believe now is the time to consider including diversified high carry and low duration credit strategies in portfolios.

To learn more about WTW's Diversified Credit solutions or how we can help improve your portfolio resilience contact us below

Contact Info

Dakota Burke
Senior Portfolio Specialist
dakota.burke@wtwco.com

Zachary Paris
Portfolio Manager
zachary.paris@wtwco.com

John Delaney,
Lead Portfolio Manager, Alternative Credit
john.delaney@wtwco.com

This document was prepared for general information purposes only and does not take into consideration individual circumstances. The information contained herein should not be considered a substitute for specific professional advice. In particular, its contents are not intended by Towers Watson Investment Services, Inc., and its parent, affiliates, and their respective directors, officers, and employees (WTW) to be construed as the provision of investment, legal, accounting, tax or other professional advice or recommendations of any kind, or to form the basis of any decision to do or to refrain from doing anything. The information included in this presentation is not based on the particular investment situation or requirements of any specific trust, plan, fiduciary, plan participant or beneficiary, endowment, or any other fund; any examples or illustrations used in this presentation are hypothetical. As such, this document should not be relied upon for investment or other financial decisions and no such decisions should be taken on the basis of its contents without seeking specific advice. WTW does not intend for anything in this document to constitute "investment advice" within the meaning of 29 C.F.R. § 2510.3-21 to any employee benefit plan subject to the Employee Retirement Income Security Act and/or section 4975 of the Internal Revenue Code.

This document is based on information available to WTW at the date of issue, and takes no account of subsequent developments. Past investment performance is not indicative of future performance. In producing this document WTW has relied upon the accuracy and completeness of certain data and information obtained from third parties. This document may not be reproduced or distributed to any other party, whether in whole or in part, without WTW's prior written consent, except to the extent required by law.

Views expressed by other WTW consultants or affiliates may differ from the information presented herein. Actual recommendations, investments or investment decisions made by WTW, whether for its own account or on behalf of others, may differ from those expressed herein.

About WTW
At WTW (NASDAQ: WTW), we provide data-driven, insight-led solutions in the areas of people, risk and capital. Leveraging the global view and local expertise of our colleagues serving 140 countries and markets, we help you sharpen your strategy, enhance organizational resilience, motivate your workforce and maximize performance. Working shoulder to shoulder with you, we uncover opportunities for sustainable success — and provide perspective that moves you. Learn more at wtwco.com.

wtwco.com/social-media

Copyright © 2023 WTW. All rights reserved.
WTW-108560/05/2023

wtwco.com