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A Life of Illusion

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Already, we are hearing renewed chatter about "rising interest rates." We've heard it for almost a decade. Looking at the table below, rates today are generally where they were last year. Granted, the Fed has engineered higher short rates, but the 30-year long bond yield is virtually unchanged.

Yield Curve Changes

	1/4/2016	1/24/17
3 Month	0.16	0.50
2 Year	1.03	1.19
5 Year	1.73	1.93
10 Year	2.24	2.47
30 Year	2.99	3.05

Source: Bloomberg

When concerns of rising rates intensify, managers come up with new strategies to capitalize on client fears. Thinking of these strategies reminds me of the Joe Walsh song, "A Life of Illusion." I won't comment here on the illusion of hedge fund benefits. Over the long run, it rarely pays to stray from the fundamentals of fixed income being the anchor in an asset allocation framework.

In the late 90's/early 00's, the popular trend was "Core Plus." The Asian crisis and the Lehman bankruptcy proved the strategy to be "Core Minus." (See my letter "Core Plus or Core Minus" dated June 2002). In recent times, the fad has been "Unconstrained." It was meant to deliver significant alpha when rates rise. They never told you how poorly it would perform if rates didn't rise.

It appears the new "flavor of the month" is "Credit." Let's look through the confusion and examine the merits of Credit mandates. Let's start with annualized returns and Sharpe ratios (risk adjusted returns) for the Intermediate Credit Index and the Intermediate Government/Credit Index for different time frames (shown below). Also added is the percent of BBB-rated securities in both.

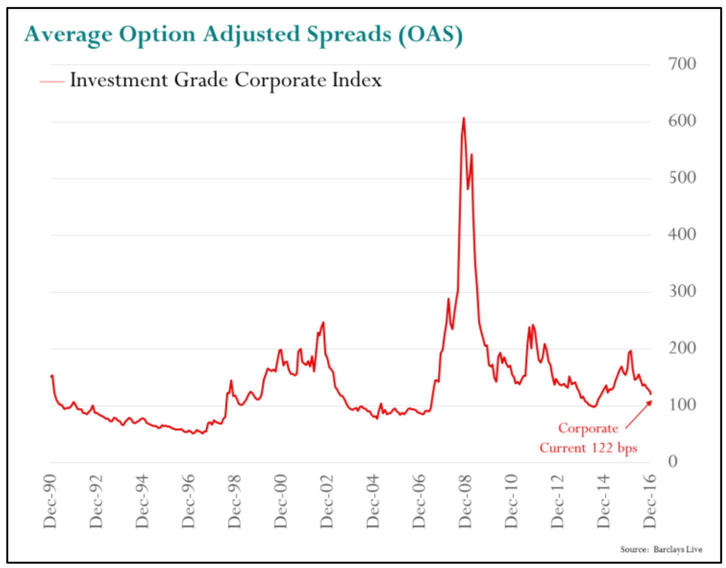
Index Comparison

Returns as of 12/31/2016	1 Year	3 Years	5 Years	10 Years	25 Years	30 Years
Barclays US Int. Govt./Credit	2.08	2.09	1.85	3.84	4.77	5.24
Barclays US Int. Credit	3.68	2.90	3.29	4.74	5.42	6.01
Sharpe Ratios as of 12/31/2016	**1 Year**	**3 Years**	**5 Years**	**10 Years**	**25 Years**	**30 Years**
Barclays US Int. Govt./Credit	0.64	0.88	0.81	1.08	0.85	0.84
Barclays US Int. Credit	1.12	1.12	1.19	0.95	0.82	0.84
% BBB as of 12/31/2016	**2016**	**2013**	**2011**	**2006**	**1996**	**1991**
Barclays US Int. Govt./Credit	16.9	13.4	10.8	11.1	4.9	4.4
Barclays US Int. Credit	42.2	37.6	31.1	29.7	21.9	20.9

Source: eVestment, GH&A Resources

In the table, the Intermediate Credit Index returns are higher than the Intermediate Government/Credit Index returns. But, how much risk was taken to achieve the returns? Looking at Sharpe ratios, over longer time periods the Credit Index provides little advantage. Recent history is skewed by the extraordinary performance of credit post-Lehman. And, these numbers are gross of fees. Keep in mind that a Credit mandate will have a higher fee. More striking is the deterioration of quality. The Credit Index now contains a whopping 42% in BBB-rated issues, clearly making it extremely volatile historically.

Now, let's look at corporate bonds, the driver behind Credit. Below is a graph of spreads (extra yield over treasuries) for the Investment Grade Corporate Index since 1990. Clearly, with today's spreads at tight levels, credit offers little relative value. Furthermore, corporates had an excellent 2016 as measured by excess return (return isolating spreads). In fact, it was the fourth best year since 1990, making it very unlikely to repeat anytime soon.



So, when you consider risk-adjusted returns, current spreads, outlook for spreads, recent excess returns, higher fees and the high level of BBB's, chasing Credit mandates today is but another Illusion!

Sometimes, I can't help but feeling that I'm living a life of illusion
And oh, why can't we let it be
And see through the hole in the wall of confusion
I just can't help but feeling I'm living a life of illusion.

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