

BlackRock

A systematic approach to high yield credit





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Summary

- We believe it's possible to build high yield strategies that are systematically well positioned not only to seek to deliver downside mitigation when investors need it most, but also seek to deliver potentially better upside participation when high-yield bond markets rebound.
- Historically, high yield markets are an asset class that has exhibited sharp mean reversion patterns after outsized down periods (see Figure 3). The challenge for most high yield managers is the ability to oscillate between offensive and defensive positioning during these periods of heightened volatility.
- An analysis of the eVestment high yield universe confirms the average high yield manager is positioned to prioritize risk mitigation over alpha generation. By clustering high yield performance by market regime, we can better observe the defensive nature of active managers in this asset class. We view this as the Achilles' heel of both average, and even most top quartile high yield managers.
- In this paper, we more closely examine the performance of high yield managers during periods of market stress, followed by quick market rallies. We detail how even among the top quartile of high yield managers, many are not suited to fully capture the rebounding nature of this asset class and offer a systematic counter perspective to this traditional approach.

Does good defense in credit markets mean giving up offense?

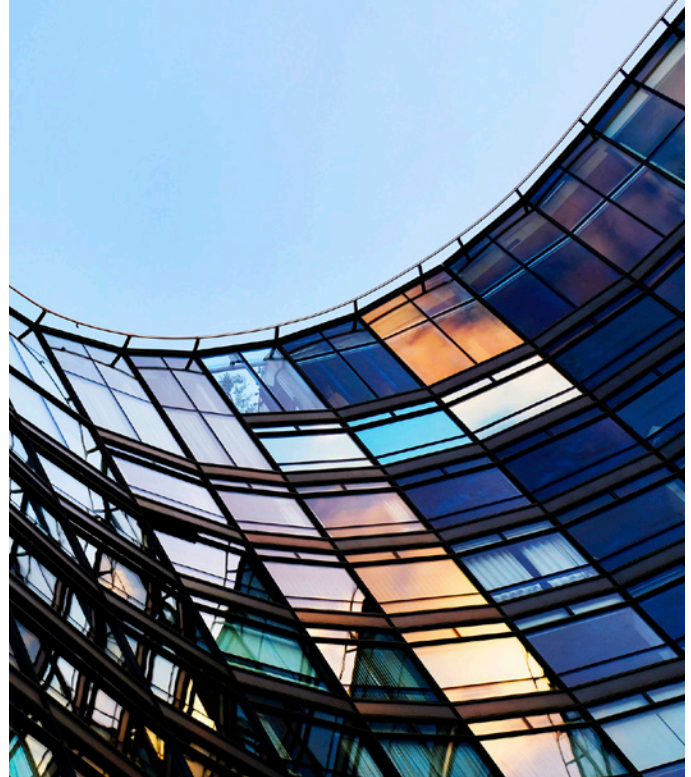
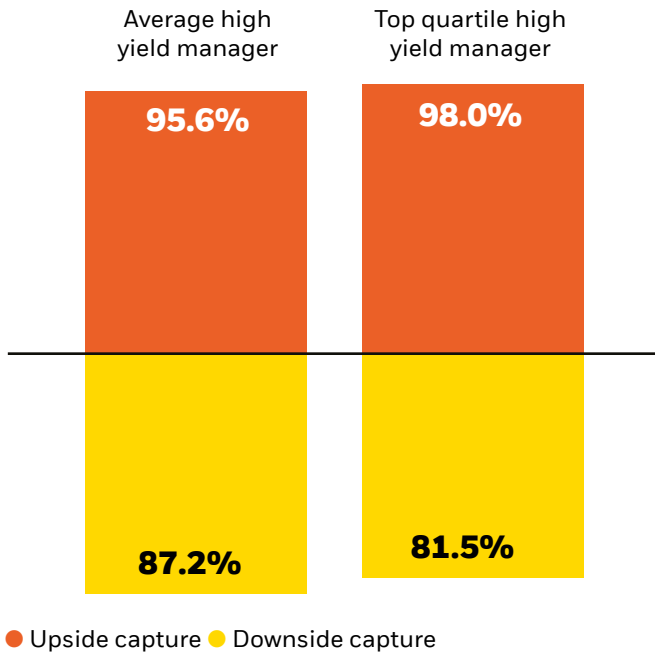
As the Federal Reserve embarked on its fastest rate hiking campaign in decades, both risky and haven assets suffered in 2022. The S&P 500 Index fell over 18% in 2022, U.S. high yield was down over 11% and even the S&P U.S. Aggregate Bond Index, the fixed income exposure investors generally rely upon as a ballast to risk assets, was down over 13%.¹ After a punishing 2022, a new regime of heightened macroeconomic risk and elevated market volatility has presented new challenges for investors to navigate in an effort to reach for yield, while still remaining defensively positioned.

The fallout of persistent rate hikes are still materializing, most visibly in regional bank failures early in the year and subsequent market responses. After losing over 11% in 2022, U.S. high yield markets have delivered over 4% total return in 2023, as of the end of March.² Given the underperformance of the asset class last year, defensive

strategies were rewarded as high-quality bonds outperformed low-quality bonds, evidenced by BB-rated bonds posting an excess return over Treasuries of -2.2% and triple C-rated bonds being down -10.5%.²

The asymmetric return profile of high yield bonds cautions most portfolio managers to position for downside risk rather than upside potential. An analysis of eVestment data between 2003-2023, found the majority of high yield managers set out to build defensive portfolios irrespective of the macroeconomic regime. Figure 1 illustrates the defensive nature of managers in this asset class by comparing upside and downside capture ratios of the average vs. top quartile managers. Figure 1 shows the average manager tends to participate in 87.2% of down markets and 95.6% of up markets. This illustrates how the average U.S. high yield manager is building a “defensive” exposure largely by creating a portfolio that has a lower beta than the broad index. And while top quartile managers do differentiate themselves by participating in less downside and more upside than the average manager, they still fail to fully participate in high yield returns in up market regimes.

Figure 1: The power of less downside capture
eVestment average high yield manager vs. top quartile manager capture ratio 2003-2023



The figures shown relate to past performance. Past performance is not a reliable indicator of current or future results. Source: Chart by BlackRock using data from eVestment as of 3/31/2023.

¹ Source: Bloomberg, as of 3/31/2023. ² Source: Bloomberg, returns of the ICE BofA High Yield Constrained Index as of 3/31/2023.

This trend was evident throughout 2022, as the average U.S. high yield manager outperformed their benchmark by 0.47%.³ At first blush, this outperformance seems like a positive outcome, but did it come at the cost of lost upside potential?

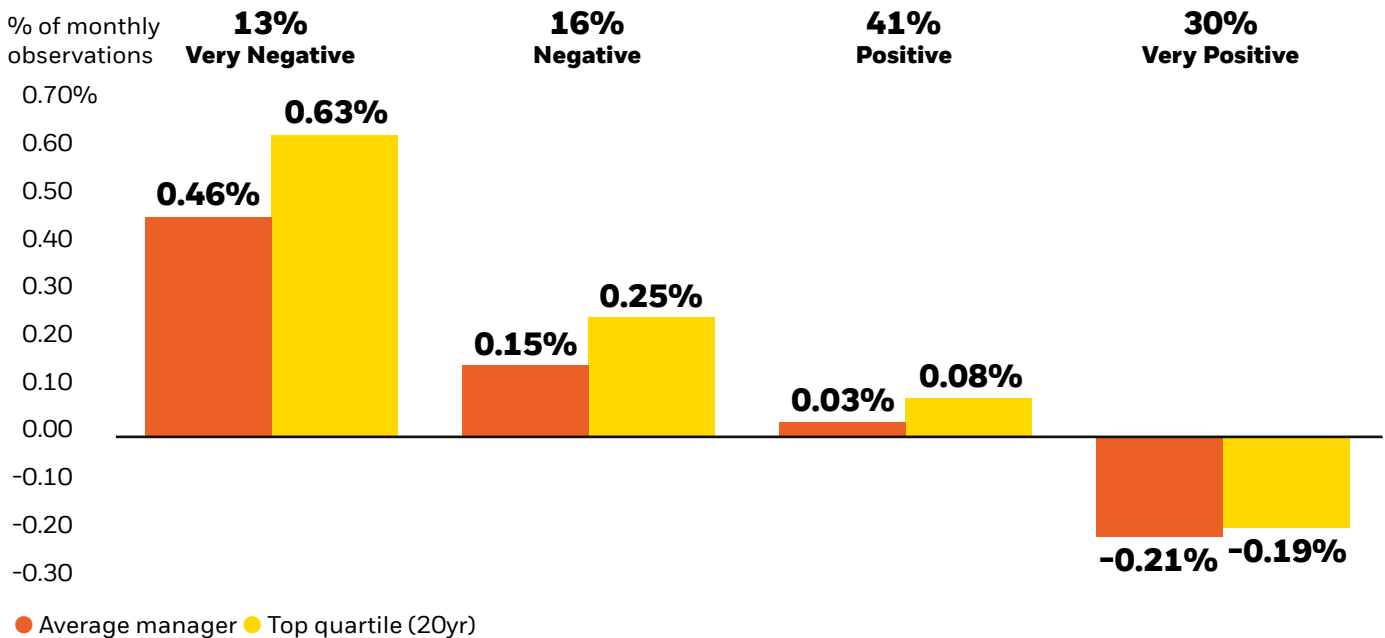
As seen in the long-term data in Figure 1, both the average and top quartile high yield managers have delivered downside mitigation. Where the average, and even most top quartile managers, have fallen short has been in their ability to capture upside performance as markets rotate. By clustering high yield performance by regimes, we can observe the defensive profile of active managers.

Using the returns of the ICE BofA High Yield Constrained Index,⁴ we found that U.S. high yield markets generally

oscillate between four monthly performance regimes. We defined these four regimes as <1.5% (“Very Negative”), >=-1.5%<0% (“Negative”), >=0 - <1.5% (“Positive”), and >1.5% (“Very Positive”). We saw that high yield managers deliver the bulk of their excess returns in “Very Negative” regimes, and trailed index performance in “Very Positive” regimes (see Figure 2). When accounting for the average management fee of active high yield managers (which is 49 bps⁵ for a separate account), net of fees excess returns would be negative in all regimes except “Very Negative” regimes. It is also important to note that the total of “Positive” and “Very Positive” regimes (169 months) vastly outnumber the total of “Negative” and “Very Negative” regimes (71 months), emphasizing the importance to deliver upside participation, *in addition to downside mitigation*, over the long run.

Figure 2: High yield excess return by performance regime

Average high yield manager vs. top quartile manager monthly excess return 2003-2023

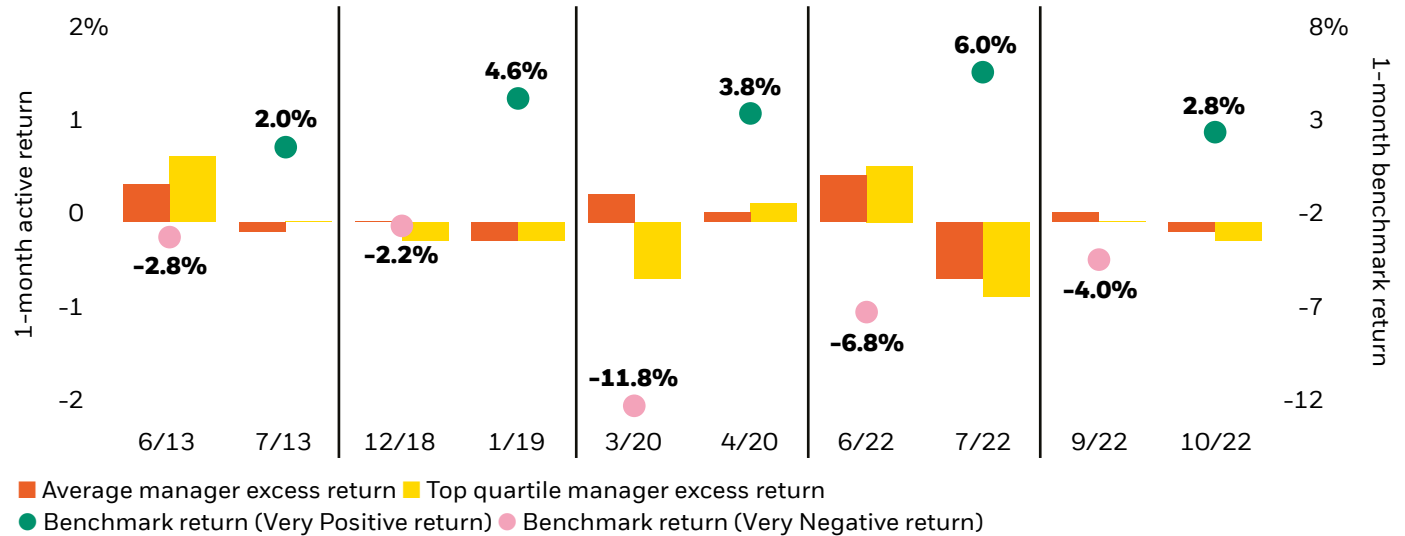


The figures shown relate to past performance. Past performance is not a reliable indicator of current or future results. Source: Chart by BlackRock using data from eVestment, using monthly return data from March 2003 to March 2023. eVestment uses data which is manager self-reported and only includes managers that opt into reporting. Top quartile managers are the average top 25% of managers with the highest total return over a 20-year period. Average manager is the average return for all managers vs. the ICE BofA HY Constrained Index over 20 years. Past performance does not guarantee future results.

³ Source: eVestment, excess returns are gross of fees as of 12/31/2022. ⁴ The ICE BofA US High Yield Index is market capitalization weighted and is designed to measure the performance of U.S. dollar denominated below investment grade corporate debt publicly issued in the US market. ⁵ Source: eVestment as of 3/31/2023.

Figure 3: Downside mitigation without upside capture

Excess active manager returns during “Very Negative” to “Very Positive” performance regimes 2013-2023



The figures shown relate to past performance. Past performance is not a reliable indicator of current or future results.

Source: Chart by BlackRock using data from eVestment as of 3/31/2023, gross of management fee. **Top quartile managers are the average top 25% of managers with the highest total return over a 20 year period. Average manager is the average return of all managers vs the ICE BofA HY Constrained Index over 20 years. Past performance does not guarantee future results.**

A review of recent periods of market stress (in Figure 3), including the 2013 taper tantrum, 2018 tightening of financial conditions, 2020 COVID drawdown and spread widening in 2022, we can observe the defensive dynamic among both average and top quartile active managers. Importantly however, in the months where rapid transitions between “Very Negative” and “Very Positive” performance regimes occurred, the same group of managers were unable to capture upside as the broader market snapped back. In many cases, these managers gave up more excess return in subsequent “Very Positive” regimes than was mitigated on the downside during “Very Negative” regimes. In today’s environment, as market drawdowns are commonly followed by quick rebounds, employing a defensive strategy that relies on beta tilts alone would likely lead to underperformance in a market rebound as shown in Figure 3.

As noted in our recent [systematic fixed income outlook](#), dramatic swings in both the market narrative and market performance reflect rapid shifts in policy expectations. The U.S. Federal Reserve has now turned its focus to realized inflation rather than inflation forecasts. This means short run changes in inflationary data and other economic indicators will have an outsized impact on policy expectations, and as a result, market behavior.⁶ We have

seen this play out in dramatic swings in asset performance as we noted above with the sharp rebounds in asset performance year to date in 2023 vs 2022. We believe high yield strategies should be well positioned to deliver both downside mitigation and participate in market upswings.

Systematically navigating credit risk

Investors who rely on high yield bonds to generate incremental return understand that periods of market stress can result in increases in downside risk. Most high yield strategies prioritize mitigating this risk, as indicated in Figure 1. But there are potential solutions to manage downside risk, along with seeking to maximize upside return potential. A systematic approach benefits from the opportunity to cover thousands of high yield issuers daily. Unlike fundamental managers, systematic financial models are less susceptible to bias in the investment process. Our models employ strict criteria to identify entry and exit points on securities. This approach seeks to lessen the risk of emotions playing a role in closing winning positions too early or holding onto losing positions too long.

⁶ BlackRock Systematic. “Peak inflation arrives. Now what?” Winter 2023.

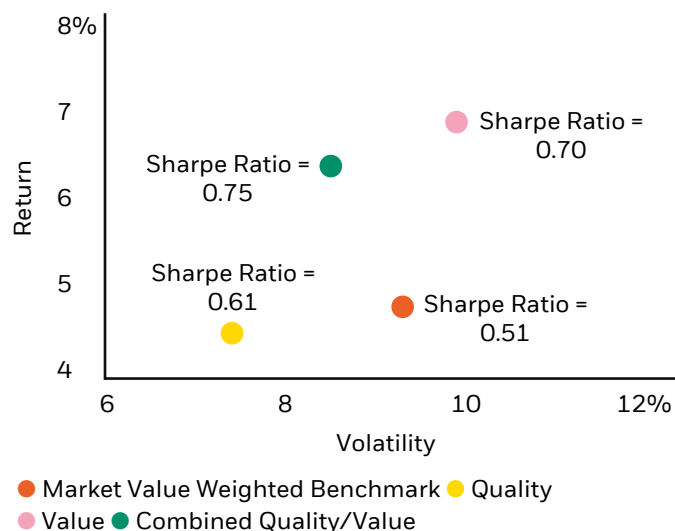
A systematic investment approach to credit also prioritizes an ability to embed defensive positioning that may help protect investors when they need it most, during down market environments. Our proprietary probability of default signal that has underpinned all of our credit strategies for over 20 years has successfully identified 74% of the defaulted bonds in the ICE BofA High Yield Index within 24 months of its default since 2010.⁷ Our probability of default signal centers on a simple economic assumption that default occurs when the value of a firm’s assets fall below the value of its liabilities. The probability of default model uses accounting, market data of equity and bond instruments, bond ratings, and other economic variables to estimate the probability of default for the issuer over a forward looking 12-month period. A full balance sheet approach is taken in assessing credit quality, not dissimilar to fundamental credit analysis to evaluate risk. We believe defensive outcomes are key to integrate in credit strategies to counter the asymmetrical nature of credit markets.

The science of security selection

Unlike many high yield managers, we don’t believe that upside should be sacrificed at the expense of downside mitigation. We believe the best outcomes in credit markets are possible through improved security selection using quality and value insights rather than beta tilts. Despite the unfavorable asymmetry of risk and return in credit markets, it is not always prudent to be looking for safety, irrespective of the macro-economic environment. A strategy that is flexible enough to balance downside mitigation and still participate in strong market regimes is imperative to help investors navigate today’s markets. An uncertain economic outlook, increased volatility in asset pricing and sharp asset class reversals demand a strategy that offers flexibility to counter market reactions to further shifts in monetary policy.

Our high yield strategies are built on the foundation of a quality screen, which can help mitigate losses in a portfolio during periods of market decline. Using our proprietary probability of default signal, we screen out the names with the highest default probability. In a portfolio where you are solely screening for higher quality bonds, you would achieve a defensive outcome, but also lower overall total return, evidenced in Figure 4. Intuitively, reducing default risk results in a higher quality portfolio, but that also comes at the expense of total return.

Figure 4: Improved returns and Sharpe ratios when combining insights



The figures shown relate to past performance. Past performance is not a reliable indicator of current or future results.

Source: BlackRock, as of March 31, 2023. Shows the market value weighted returns of the bonds in the ICE BAML U.S. HY Corporate Bond Index. Index data was rerun and updated by BlackRock from 2004-2022. Benchmark portfolios were constructed by market value weighting the BAML U.S. High Yield Corporate universes. Quality portfolios were constructed by screening the lowest quality quintile and market value weighting the remaining universe. Volatility calculated as standard deviation of monthly returns.

To counterbalance our quality screen, we seek to evaluate credit value at the same time. We identify bonds that have compelling default-adjusted spread, meaning those that you are being compensated with a wider spread, adjusted for the default risk you’re being asked to take. Combining these insights can lead to higher Sharpe Ratio as well as higher return than the overall high yield market.

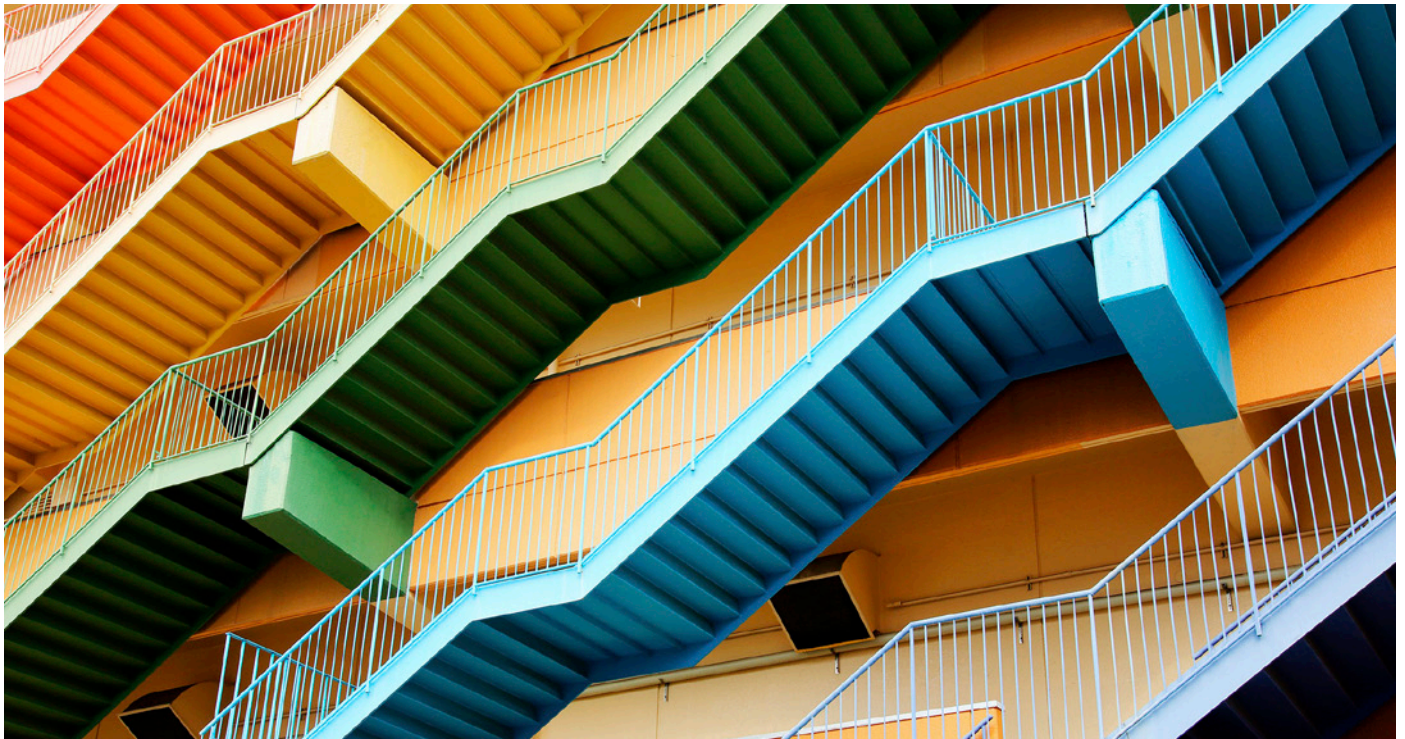
While this approach is not overly complex, the daily application of our proprietary systematic default insights to the high yield universe, alongside a disciplined combination of both quality and value insights, is what can help achieve a better optimized risk and return tradeoff. Put another way, as default risk increases, investors may want to consider avoiding buying riskier assets in order to achieve potentially higher yields. Simultaneously, as default risk declines, investors’ search for yield may prove beneficial. Quality screens can help protect high yield investors on the downside, while adding value screens can help improve upside participation. This complementary approach also can help investors avoid attempts to try to time economic regimes.

⁷ Source: BlackRock, ICE BofA ML as of 3/31/2023, using data since January 2010.

Seeking to capture alpha opportunity in high yield

Across high yield and investment grade credit approaches, a combination of credit model signals help us align risk characteristics to help ensure our portfolios exclude any unintended sector, ratings, or duration deviation from relevant benchmarks. Our portfolio construction framework has evolved over decades, is enhanced by our systematic expertise, and enriched by signals that seek to capitalize on the inherent biases in credit markets. Our systematic approach to high yield credit markets allows us to have a view on thousands of bond issuers daily.

We believe the best outcomes in credit markets are possible through improved security selection that helps mitigate downside risk and is well positioned to capitalize on market rotation. Our financial models employ strict criteria to identify entry and exit points on each security, which means anticipating and countering the impact of monetary policy, geopolitical headwinds or pinpointing the next recession is already built into the framework that underpins each of our systematic credit strategies. We believe investors should be able to systematically capture upside opportunities in the high yield segment of credit markets, without losing sleep over fears of downside risk in their portfolio.



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