Go Wide for Outperformance

Ryan Preclaw, CFA
+1 212 412 2249
ryan.preclaw@barclays.com

With limited room for index-level spread tightening, we believe that sector selection is an important source of relative value outperformance. Historically, starting spread has been a useful predictor of outperformance for the widest-trading sectors, with 1bp of extra spread over the U.S. Corporate Index resulting in up to 2bp of extra annualized excess return. While there are a no fundamental Overweight sectors among the five widest, we see the potential for outperformance in uncovered sectors including paper and airlines, as well as in sectors such as cable, pipelines, oilfield services, and life insurance that are fundamental Overweights and still wider than the index.

With the U.S. Corporate Index nearing a limit from which further aggregate spread tightening may be difficult (see *Spread Limit* for details), we believe that sector selection remains one of the most reliable ways to generate outperformance. In 2012, starting spread was an important predictor of sector-level returns (see *Sector Selections* for details), and while the relationship has been less definitive this year, all but one of the ten widest industries at the start of the year have outperformed the U.S. Corporate Index year-to-date.

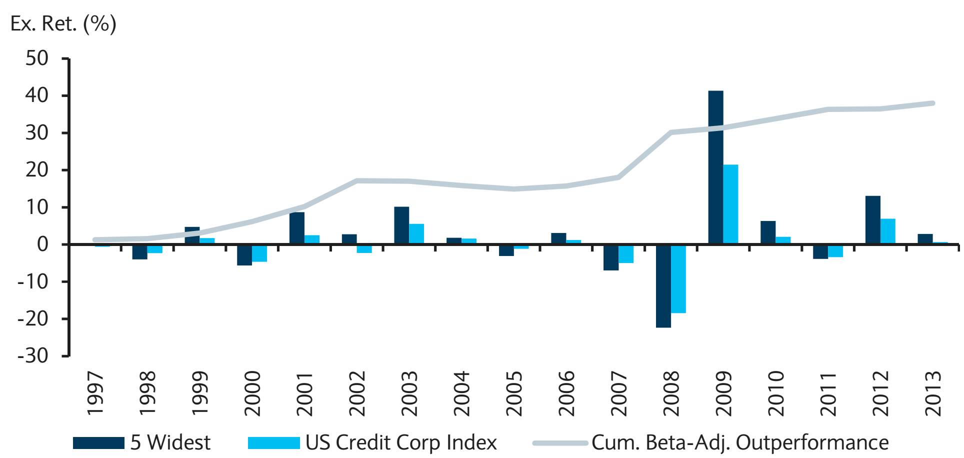
The Widest Sectors Outperform

To understand how consistent this relationship is, we compared sector performance with starting spreads going back to the beginning of 1997. Based on those data, we believe that starting spread is a useful predictor of the outperformance of sectors versus the index. Over the past 16 years of monthly data, an extra basis point of sector spread (relative to the index spread) has been worth about 2bp of annualized excess return over the index.

To illustrate the value of this effect, we look at the performance of the widest sectors at the start of each year over the subsequent twelve months. We use the equal-weighted average of the five widest sectors for simplicity.

On average since 1997, the five widest sectors outperformed the U.S. Corporate Index by more than 250bp per year (Figure 1). The outperformance holds for different numbers of sectors: the single widest sector at the beginning of each year outperformed by >450bp/year, and the 10 widest outperformed by more than 100bp per year.

FIGURE 1
Widest Spread Sectors Outperform the Index, Even after Adjusting for Their Higher Beta



Source: Barclays Research

Given that sectors generally become wide for a reason, we would expect the widest sectors to be higher risk than the index as a whole, and they are. The beta between the average performance of the five widest sectors and the U.S. Corporate Credit Index is about 1.6. Even after adjusting for that risk, however, the wider sectors still outperform the index. The median beta-adjusted outperformance of the five widest sectors is about 150bp per year. In addition, the five widest sectors have had Sharpe ratios about four times that of the index.

Beyond the average risk, there are attractive features to how the risk is distributed across time. The beta between the widest sectors and the index is lower (although still above one) in years when the index generates negative returns and higher in years when the index has positive returns – in effect, the widest sectors have a natural hedge against macro moves. Figure 2 illustrates this positive convexity – the five widest sectors generate median excess returns of 6% in years when the index is up, about triple the median index performance in those years. But in down years for the index, the median performance of the five widest sectors is only -4%, about half again worse than the index down-year median of -3%.

FIGURE 2

The Widest Sectors Outperform Strongly in Up Years for Credit, but Underperform Only Modestly in Down Years

	Median Return of U.S. Corp Index	Median Return of Five Widest Sectors	Ratio
Index Up Years	2.1%	6.3%	3.0x
Index Down Years	-2.8%	-3.9%	1.4x

Source: Barclays Research

2008 and 2009 provide a stark demonstration of the beta asymmetry. Heading into 2008, the five widest sectors were home construction, non-captive consumer finance, other non-bank financial firms, airlines, and financing companies. The average performance over the following year was dismal – negative 22% by the end of 2008. But that was only about 4pp worse than the U.S. Corporate Index, which dropped more than 18% the same year. After the sharply down year of 2008, the new five widest sectors (lodging, REITs, airlines, building materials, and life insurers) had an average excess return of more than 40% in 2009, beating the index return by about 20pp.

Why Do We Think This Works?

We see at least two main reasons to believe that this result is real and repeatable. The first is simply the extra income. The widest-trading sectors start with a natural advantage over the index in the form of extra cash flow in each year. This probably accounts for at least some of the comparative outperformance in down years – on price moves alone, the widest sectors are probably closer to in the market move, but the extra spread gives those sectors more of a cushion (in down years) or a bigger boost (in up years). Extra carry is not the whole story – the regression results indicate that 1bp of extra spread is worth nearly 2bp of extra annualized return, suggesting to us that there is also some contribution from spread compression. In our view, the easiest explanation is simply that sectors benefit from mean reversion in the factors that pushed them to be the widest. Whatever these factors are – changes in market conditions, regulatory shifts, technological changes, cycles in underlying markets, trends in M&A, or others – they are more likely to revert to means at the sector level than at the single-name level. Sectors are less subject to idiosyncratic risks than single names, and there is potential for weakness in a given name ultimately to offer benefits to other industry participants.

Not an Investable Strategy, but Guides Where to Look for Outperformance

We believe this provides a useful framework for considering where to concentrate overweights in portfolios. That said, there are many caveats:

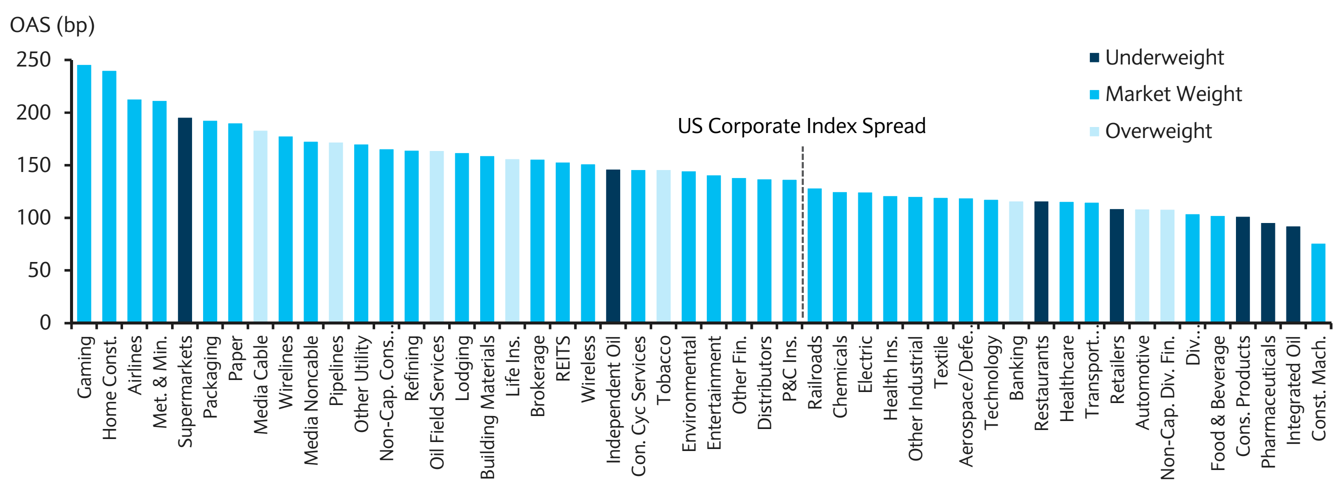
- First, this framework describes how sectors have performed, but is not an investable strategy. Investors cannot easily or cheaply replicate entire sectors, and sometimes the widest sectors are too small or concentrated to be useful to larger investors.
- While starting spread is both a statistically and economically significant predictor of the following year's returns, it accounts for only a very small share of the total variation in sector returns. Thus, the results for any given sector in any given year can vary widely from what the starting spread might predict.
- After adjusting for risk, the effect is not identical across all ranges for starting spreads. While the widest spread sectors generate beta-adjusted outperformance, the sectors that trade tightest do not underperform by a comparable amount. For example, the five tightest spread sectors versus the index had a beta lower than one (consistent with the lower risk suggested by their spreads) and performed exactly in line with the index after the beta adjustment.
  - Splitting things into quartiles, the worst-performing block was that just tighter than the index (the lower-middle quartile), although the effect does not have much statistical significance. In our interpretation, while we can look for outperforming sectors at the wide end of the spread range, the underperformers do not necessarily come from the tightest end of the spectrum

Notable Sectors

Considering the current distribution of sectors, we note that the ratio of our fundamental analysts' Overweights/Underweights is higher in the wider-trading end of the spectrum (Figure 3). Looking at the wider-trading sectors for potential opportunities, we highlight the following:

FIGURE 3

Overweights Are Concentrated in the Widest Spread Sectors, Underweights in the Tightest



Source: Barclays Research

- Of the five widest-trading sectors, gaming and home construction may have potential for upside, but are small: each has only two issuers, and together they have just over $3bn of debt outstanding.

- Airlines may have potential, but the sector is not covered by our fundamental team. It seems reasonable that an improving economic environment would benefit an industry with high operating leverage, and recent merger activity creates the potential for margin enhancement.

- Metals & mining was raised to Market Weight from Underweight by Harry Mateer in September (see *Metals & Mining Raise to Market Weight – Definitely Not at the Tights*). At the time, it was the third-widest sector, trading at a spread of 234bp; since then, it has tightened about 20bp as the index has tightened less than 10bp. We remain cautious on industry fundamentals, especially underlying commodity prices. That said, credit appears to be pricing in a worse outcome than either equity or commodity spot prices, suggesting room for the sector to tighten even if fundamentals remain challenged.

- The supermarket sector is rated Underweight by Priya Ohri-Gupta on the basis of the fundamental ratings on the sector's constituents (see *Maintain Underweight on Safeway, Given Reports of Possible Buyout; Lower Delhaize to Market Weight*). In her view, the preponderance of idiosyncratic factors that have pushed the sector to its wides will continue to pressure spreads for the immediate future. Given that this sector remains among the widest, we recommend revisiting it when some of the company-specific risks have been resolved.

While at the moment there are no Overweight-rated sectors among the five widest, there are a number wider than the index average. Danish Agboatwala is Overweight cable media, although at least some of the outperformance has already occurred and further tightening from here likely depends on the resolution of M&A concerns in the industry. Harry Mateer is overweight pipelines and oil field services based on industry fundamentals. Life insurance has already strongly outperformed the Corporate Index this year after starting 2013 as the second-widest sector.

Analyst Certification

I, Ryan Preclaw, CFA, hereby certify (1) that the views expressed in this research report accurately reflect my personal views about any or all of the subject securities or issuers referred to in this research report and (2) no part of my compensation was, is or will be directly or indirectly related to the specific recommendations or views expressed in this research report.

Important Disclosures:

Barclays Research is a part of the Corporate and Investment Banking division of Barclays Bank PLC and its affiliates (collectively and each individually, "Barclays"). For current important disclosures regarding companies that are the subject of this research report, please send a written request to: Barclays Research Compliance, 745 Seventh Avenue, 14th Floor, New York, NY 10019 or refer to http://publicresearch.barclays.com or call 212-526-1072.

Barclays Capital Inc. and/or one of its affiliates does and seeks to do business with companies covered in its research reports. As a result, investors should be aware that Barclays may have a conflict of interest that could affect the objectivity of this report. Barclays Capital Inc. and/or one of its affiliates regularly trades, generally deals as principal and generally provides liquidity (as market maker or otherwise) in the debt securities that are the subject of this research report (and related derivatives thereof). Barclays trading desks may have either a long and / or short position in such securities, other financial instruments and / or derivatives, which may pose a conflict with the interests of investing customers. Where permitted and subject to appropriate information barrier restrictions, Barclays fixed income research analysts regularly interact with its trading desk personnel regarding current market conditions and prices. Barclays fixed income research analysts receive compensation based on various factors including, but not limited to, the quality of their work, the overall performance of the firm (including the profitability of the investment banking department), the profitability and revenues of the Fixed Income, Currencies and Commodities Division and the potential interest of the firm's investing clients in research with respect to the asset class covered by the analyst. To the extent that any historical pricing information was obtained from Barclays trading desks, the firm makes no representation that it is accurate or complete. All levels, prices and spreads are historical and do not represent current market levels, prices or spreads, some or all of which may have changed since the publication of this document. Barclays produces various types of research including, but not limited to, fundamental analysis, equity-linked analysis, quantitative analysis, and trade ideas. Recommendations contained in one type of research may differ from recommendations contained in other types of research, whether as a result of differing time horizons, methodologies, or otherwise. Unless otherwise indicated, Barclays trade ideas are provided as of the date of this report and are subject to change without notice due to changes in prices. In order to access Barclays Statement regarding Research Dissemination Policies and Procedures, please refer to https://live.barcap.com/publiccp/RSR/nyfipubs/disclaimer/disclaimer-research-dissemination.html. In order to access Barclays Research Conflict Management Policy Statement, please refer to: http://group.barclays.com/corporates-and-institutions/research/research-policy.

Explanation of the Barclays Research High Grade Sector Weighting System

Overweight: Expected six-month excess return of the sector exceeds the six-month expected excess return of the Barclays U.S. Credit Index, the Pan-European Credit Index, or the EM Asia USD High Grade Credit Index, as applicable.

Market Weight: Expected six-month excess return of the sector is in line with the six-month expected excess return of the Barclays U.S. Credit Index, the Pan-European Credit Index, or the EM Asia USD High Grade Credit Index, as applicable.

Underweight: Expected six-month excess return of the sector is below the six-month expected excess return of the Barclays U.S. Credit Index, the Pan-European Credit Index, or the EM Asia USD High Grade Credit Index, as applicable.

Explanation of the Barclays Research High Grade Credit Rating System

The High Grade Credit rating system is based on the analyst's view of the expected excess returns over a six-month period of the issuer's index-eligible corporate debt securities relative to the Barclays U.S. Credit Index, the Pan-European Credit Index or the EM Asia USD High Grade Credit Index, as applicable.

Overweight: The analyst expects the issuer's index-eligible corporate bonds to provide positive excess returns relative to the Barclays U.S. Credit Index, the Pan-European Credit Index, or the EM Asia USD High Grade Credit Index over the next six months.

Market Weight: The analyst expects the issuer's index-eligible corporate bonds to provide excess returns in line with the Barclays U.S. Credit Index, the Pan-European Credit Index, or the EM Asia USD High Grade Credit Index over the next six months.

Underweight: The analyst expects the issuer's index-eligible corporate bonds to provide negative excess returns relative to the Barclays U.S. Credit Index, the Pan-European Credit Index, or the EM Asia USD High Grade Credit Index over the next six months.

Rating Suspended (RS): The rating has been suspended temporarily due to market events that make coverage impracticable or to comply with applicable regulations and/or firm policies in certain circumstances including where the Corporate and Investment Banking division of Barclays is acting in an advisory capacity in a merger or strategic transaction involving the company.

Coverage Suspended (CS): Coverage of this issuer has been temporarily suspended.

Not Rated (NR): An issuer which has not been assigned a formal rating.

For Australia issuers, the ratings are relative to the Barclays U.S. Credit Index or Pan-European Credit Index, as applicable.

Explanation of the Barclays Research High Yield Sector Weighting System

Overweight: Expected six-month total return of the sector exceeds the six-month expected total return of the Barclays U.S. High Yield 2% Issuer Capped Credit Index, the Pan-European High Yield 3% Issuer Capped Credit Index excluding Financials, or the EM Asia USD High Yield Corporate Credit Index, as applicable.

Market Weight: Expected six-month total return of the sector is in line with the six-month expected total return of the Barclays U.S. High Yield 2% Issuer Capped Credit Index, the Pan-European High Yield 3% Issuer Capped Credit Index excluding Financials, or the EM Asia USD High Yield Corporate Credit Index, as applicable.

Underweight: Expected six-month total return of the sector is below the six-month expected total return of the Barclays U.S. High Yield 2% Issuer Capped Credit Index, the Pan-European High Yield 3% Issuer Capped Credit Index excluding Financials, or the EM Asia USD High Yield Corporate Credit Index, as applicable.

Explanation of the Barclays Research High Yield Credit Rating System

The High Yield Credit Research team employs a relative return based rating system that, depending on the company under analysis, may be applied to either some or all of the company's debt securities, bank loans, or other instruments. Please review the latest report on a company to ascertain the application of the rating system to that company.

Overweight: The analyst expects the six-month total return of the rated debt security or instrument to exceed the six-month expected total return of the Barclays U.S. 2% Issuer Capped High Yield Credit Index, the Pan-European High Yield 3% Issuer Capped Credit Index excluding Financials, or the EM Asia USD

High Yield Corporate Credit Index, as applicable.
Market Weight: The analyst expects the six-month total return of the rated debt security or instrument to be in line with the six-month expected total return of the Barclays U.S. 2% Issuer Capped High Yield Credit Index, the Pan-European High Yield 3% Issuer Capped Credit Index excluding Financials, or the EM Asia USD High Yield Corporate Credit Index, as applicable.
Underweight: The analyst expects the six-month total return of the rated debt security or instrument to be below the six-month expected total return of the Barclays U.S. 2% Issuer Capped High Yield Credit Index, the Pan-European High Yield 3% Issuer Capped Credit Index excluding Financials, or the EM Asia USD High Yield Corporate Credit Index, as applicable.
Rating Suspended (RS): The rating has been suspended temporarily due to market events that make coverage impracticable or to comply with applicable regulations and/or firm policies in certain circumstances including where the Corporate and Investment Banking division of Barclays is acting in an advisory capacity in a merger or strategic transaction involving the company.
Coverage Suspended (CS): Coverage of this issuer has been temporarily suspended.
Not Rated (NR): An issuer which has not been assigned a formal rating.

Barclays Bank PLC Frankfurt Branch distributes this material in Germany under the supervision of Bundesanstalt für Finanzdienstleistungsaufsicht (BaFin).
This material is distributed in Malaysia by Barclays Capital Markets Malaysia Sdn Bhd.
This material is distributed in Brazil by Banco Barclays S.A.
This material is distributed in Mexico by Barclays Bank Mexico, S.A.
Barclays Bank PLC in the Dubai International Financial Centre (Registered No. 0060) is regulated by the Dubai Financial Services Authority (DFSA). Principal place of business in the Dubai International Financial Centre: The Gate Village, Building 4, Level 4, PO Box 506504, Dubai, United Arab Emirates. Barclays Bank PLC-DIFC Branch, may only undertake the financial services activities that fall within the scope of its existing DFSA licence. Related financial products or services are only available to Professional Clients, as defined by the Dubai Financial Services Authority.
Barclays Bank PLC in the UAE is regulated by the Central Bank of the UAE and is licensed to conduct business activities as a branch of a commercial bank incorporated outside the UAE in Dubai (Licence No.: 13/1844/2008, Registered Office: Building No. 6, Burj Dubai Business Hub, Sheikh Zayed Road, Dubai City) and Abu Dhabi (Licence No.: 13/952/2008, Registered Office: Al Jazira Towers, Hamdan Street, PO Box 2734, Abu Dhabi).
Barclays Bank PLC in the Qatar Financial Centre (Registered No. 00018) is authorised by the Qatar Financial Centre Regulatory Authority (QFCRA). Barclays Bank PLC-QFC Branch may only undertake the regulated activities that fall within the scope of its existing QFCRA licence. Principal place of business in Qatar: Qatar Financial Centre, Office 1002, 10th Floor, QFC Tower, Diplomatic Area, West Bay, PO Box 15891, Doha, Qatar. Related financial products or services are only available to Business Customers as defined by the Qatar Financial Centre Regulatory Authority.
This material is distributed in the UAE (including the Dubai International Financial Centre) and Qatar by Barclays Bank PLC.
This material is distributed in Saudi Arabia by Barclays Saudi Arabia ('BSA'). It is not the intention of the publication to be used or deemed as recommendation, option or advice for any action (s) that may take place in future. Barclays Saudi Arabia is a Closed Joint Stock Company, (CMA License No. 09141-37). Registered office Al Faisaliah Tower, Level 18, Riyadh 11311, Kingdom of Saudi Arabia. Authorised and regulated by the Capital Market Authority, Commercial Registration Number: 1010283024.
This material is distributed in Russia by OOO Barclays Capital, affiliated company of Barclays Bank PLC, registered and regulated in Russia by the FSFM. Broker License #177-11850-100000; Dealer License #177-11855-010000. Registered address in Russia: 125047 Moscow, 1st Tverskaya-Yamskaya str. 21.
This material is distributed in Singapore by the Singapore branch of Barclays Bank PLC, a bank licensed in Singapore by the Monetary Authority of Singapore. For matters in connection with this report, recipients in Singapore may contact the Singapore branch of Barclays Bank PLC, whose registered address is One Raffles Quay Level 28, South Tower, Singapore 048583.
Barclays Bank PLC, Australia Branch (ARBN 062 449 585, AFSL 246617) is distributing this material in Australia. It is directed at 'wholesale clients' as defined by Australian Corporations Act 2001.
IRS Circular 230 Prepared Materials Disclaimer: Barclays does not provide tax advice and nothing contained herein should be construed to be tax advice. Please be advised that any discussion of U.S. tax matters contained herein (including any attachments) (i) is not intended or written to be used, and cannot be used, by you for the purpose of avoiding U.S. tax-related penalties; and (ii) was written to support the promotion or marketing of the transactions or other matters addressed herein. Accordingly, you should seek advice based on your particular circumstances from an independent tax advisor.