Previously published in the U.S. Credit Alpha
4 May 2018

Dealing with Disappearing Dispersion

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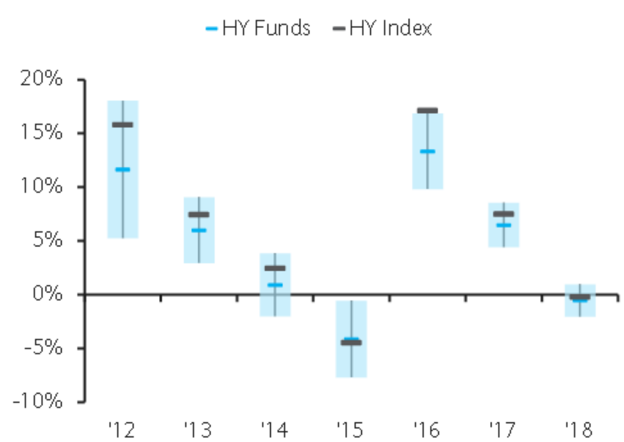
With just over one-third of the year complete, high yield's performance remains underwhelming relative to 2017's 7.5% total return. While the year-to-date excess return is 1.07% through May 2, total return, the more relevant measure for most investors, has vacillated around breakeven for much of the past month. It is worth noting that while spread carry has almost fully offset the price hit from the increase in Treasury yields, essentially unchanged spreads have underperformed their historical beta to rates (see *Fuller Cushions in Low-Quality Short Duration*). We believe this is at least partially explained by the technical headwind of approximately $25bn of outflows year-to-date from high yield mutual funds and ETFs, among other factors. Against this backdrop, Figure 1 shows that year-to-date high yield fund returns as captured by Lipper are largely clustered around both the US High Yield Index return and the fund average. But we expect a broadening of realized returns as the year progresses.

Proponents of active management in fixed income would argue that this year's more difficult and choppy market is the type of environment where active managers are expected to deliver the benefits of active over passive management to their clients. It is still early in the year, but the emergence of a more normally distributed performance for actively managed funds around the index return when compared with the more negative skew of prior years is a tentative but encouraging confirmation of that assertion. Note that in the challenging year of 2015, dispersion of fund net returns was similarly more normally distributed around the US High Yield Index return, with the average mutual fund return after fees and transaction costs just edging out the index return. Figure 2 shows that 20% of 2017's top 50 performers are among the top performers year-to-date as well. That is the highest percentage of top performers maintaining their leadership among their peer set in the following period since 2012, despite a different market environment so far this year compared with 2017.

What does the opportunity set look like now? Figure 3 shows the dispersion of single-name yields continuing to trend lower through 2018, approaching the lows of mid-2011 (headed into the US debt ceiling crisis) and late 2014 (before the distress in commodity markets

FIGURE 1

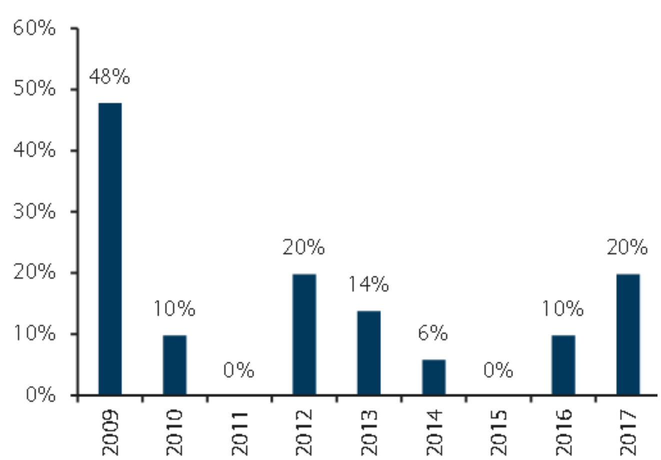
Distribution of High Yield Mutual Funds' Net Total Returns Relative to the US High Yield Index



Note: Shaded blue area reflects the +/- one standard deviation band. We consider the average returns for a fund universe of 618 high yield funds as the most recent data point. The 2018 returns reflect annualized standard deviation.
Source: Lipper, Bloomberg, Bloomberg Barclays Indices

FIGURE 2

Percentage of Each Year's Top 50 Performing High Yield Funds Remaining among Leaders in the Following Period



Source: Lipper, Barclays Research

started to affect high yield more unevenly). Putting aside a detailed discussion of more fundamental factors such as the direction of Treasury yield changes and corporate earnings, we also see from Figure 3 that dispersion of single-name total returns in any quarter is directly related to the starting dispersion of yields across the high yield market – the lower the dispersion of yields, the lower the dispersion of single-name returns.

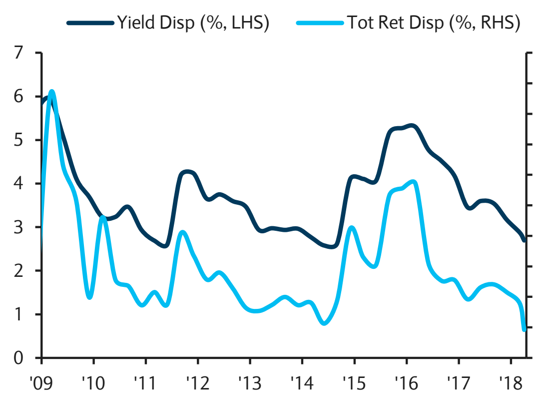
Simply put, for the broader market, the declining dispersion of single-name yields suggests limited alpha opportunities given an increasingly narrow set of valuations. More likely, managers may implement changes in strategy, deviate from the benchmark duration and credit quality mix, or prove to be particularly adept at market timing to differentiate themselves from their peer group. But despite the continued narrowing of dispersion in valuations, Figure 4 notes that the distribution of mutual fund returns year-to-date is similar to the the distribution of performances in 2017, as measured by the percent of the peer group in each cohort. The generally higher macro volatility in 2018 compared with 2017 has provided an alternate source of differentiation through market timing rather than credit selection.

What are the implications for investors? We believe three themes are worth noting as ways to generate portfolio alpha absent a market-wide, macro-sourced move in spreads that results in higher yield dispersion:

- We recently highlighted that investors no longer receive attractive compensation solely from moving down in quality, out in duration, or into marginally less liquid 144a securities. Instead, we see incremental value in select unsecureds of matched pairs when risk adjusted (see *Overcoming Unsecured Insecurities*).
- Recent vintage, large tranche deals ("on-the-run" issues) have underperformed the rest of the high yield market as managers have de-risked and satisfied outflows using the highest turnover segments of the market. If more balanced mutual fund/ETF flows continue, we would expect a reversal in this basis as investors re-risk into these on-the-run securities (see *Tallying Trading*).
- Reflecting the continuing market-wide decline in yield dispersion, we observe a similar trend within most sectors as well: yield dispersion within sectors has fallen with the exception of a few sectors driven by idiosyncratic risk events (autos, metals & mining, and technology). In the absence of a significant increase in the dispersion of valuations within sectors, Barclays' fundamental research analysts have concentrated on catalyst-driven ideas and core views (see *High Yield Top Ideas after the Rally*).

FIGURE 3

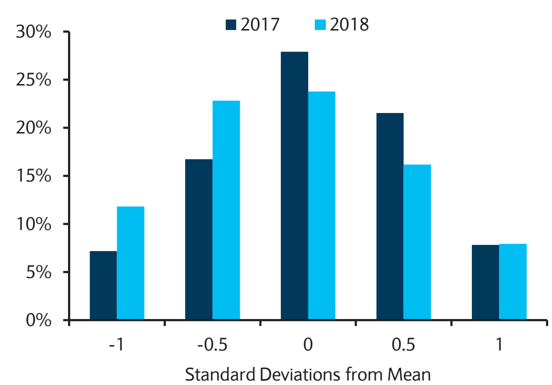
Tracking Dispersion of Ticker-Level Yield-to-Worst versus Dispersion of Total Returns



Source: Barclays Research, Bloomberg Barclays Indices

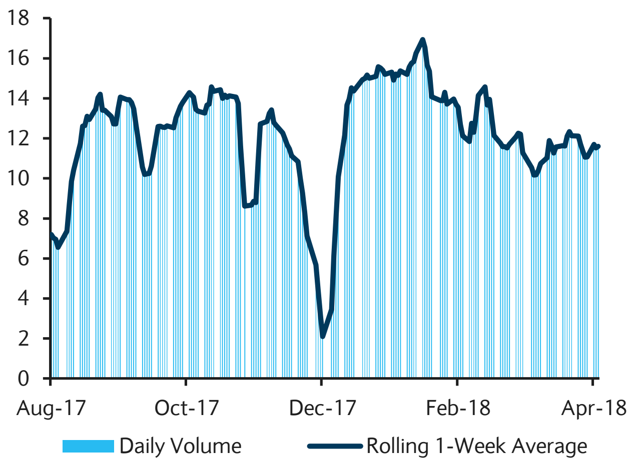
FIGURE 4

Distribution of Fund Performance in 2017 and 2018 by Standard Deviations from the Peer Group Mean



Source: Lipper, Bloomberg Barclays Indices

High Yield Average Institutional Trade Volume ($bn)

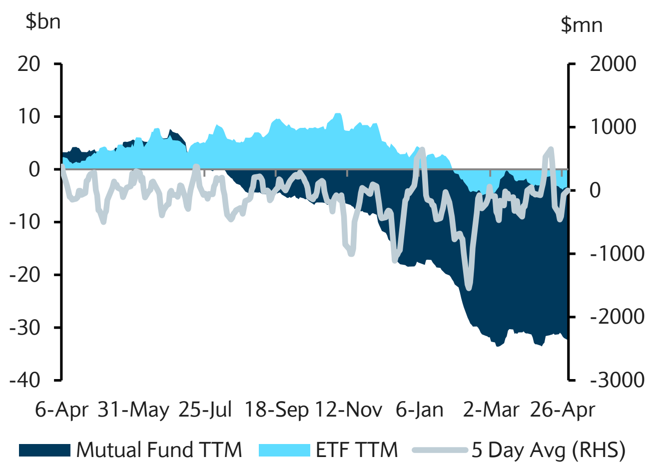


Note: Includes both registered and 144A volumes. Source: FINRA TRACE

On-the-Run HYCDX versus US High Yield Index (bp)

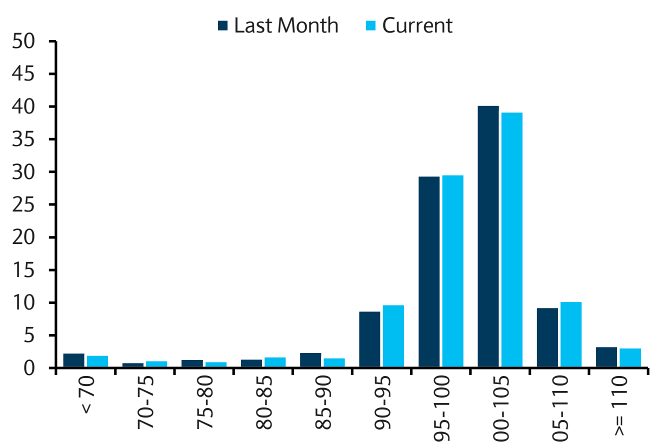
Source: Barclays Research

Flows to High Yield Mutual Funds and ETFs



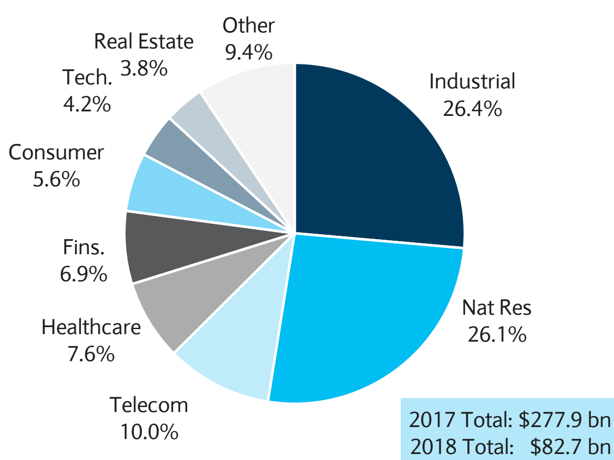
Note: Daily reporters only. Source: EPFR

High Yield Index Price Distribution by Par (%)



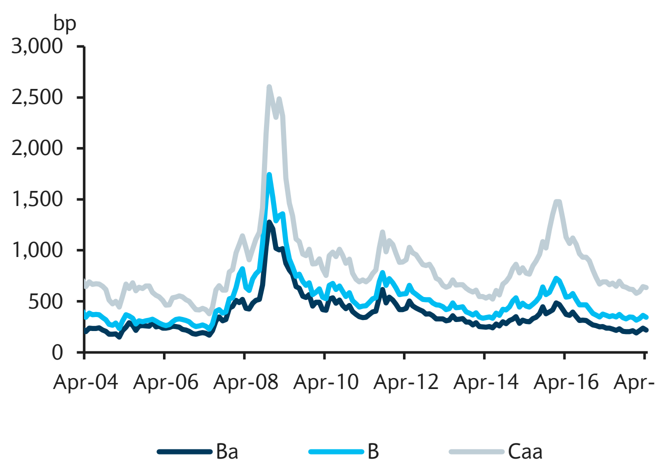
Source: Barclays Research

High Yield Supply by Sector



Source: Barclays Research

High Yield Spreads by Credit Quality



Source: Bloomberg Barclays Indices

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