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## Go Wide for Outperformance

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 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.

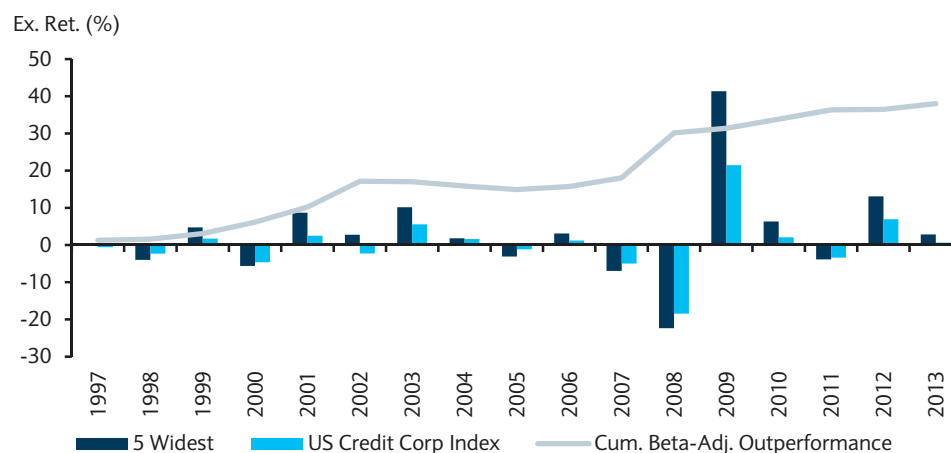
### The Widest Sectors Outperform

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

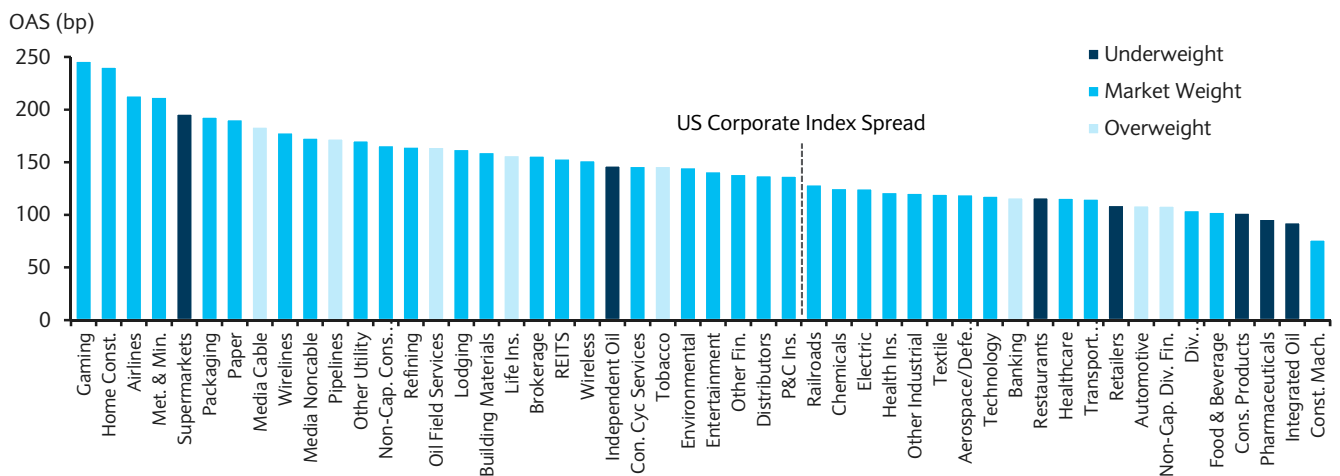
We believe this provides a useful framework for considering where to concentrate overweights in portfolios. That said, there are many caveats:

- 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 widest 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.

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