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Systematically Selecting Securities to Simulate Sectors

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With little room for upside from owning investment grade credit, we believe that a useful source of relative value comes from increasing exposure to the widest sectors. Buying every credit in a sector is impractical, but a tradable tracking portfolio can be an effective way to gain such exposure. Historically, a 25-bond portfolio has been effective in matching the performance of the five widest sectors and would have generated 100-200bp more excess return than the U.S. Corporate Index with a higher Sharpe ratio. An illustrative portfolio designed to track the current five widest sectors – metals & mining, midstream pipelines, oil field services, life insurers, and wireline telcos – is rated one notch lower than the index, but offers about double the spread compensation that would be expected just from its ratings differential.

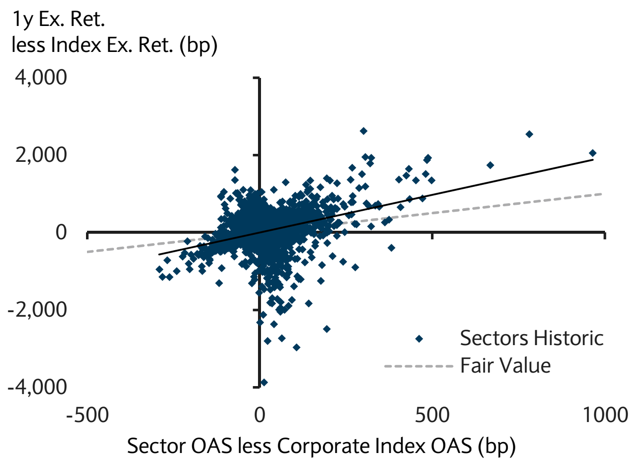
With investment grade spreads seemingly settled into a tight trading range – the Corporate Index OAS has closed between 98 and 103bp on more than 80% of days in the past six months – we believe that outperformance depends on finding relative value in the index. In our view, investors can frequently do better than the benchmark by concentrating their portfolios in wider-trading sectors. In the past, we have suggested that investors tilt their portfolios toward out-of-favor sectors. To move beyond simply tilting exposures, a small tracking portfolio is a way to systematically turn sector performance into an actionable strategy.

Bonds in the Widest Sectors Outperform

In the November 2013 *U.S. Credit Focus: Go Wide for Outperformance*, we presented evidence that the sectors that trade widest relative to the overall index perform better, even after adjusting for their higher risk. Figure 1 demonstrates the effect: if the strategy was simply one of buying higher-beta securities, we would expect the average relationship between sector OAS and excess return to track the "Fair Value" line. The actual relationship is above fair value, suggesting that the widest sectors are receiving more-than-expected compensation for their additional risks.

FIGURE 1

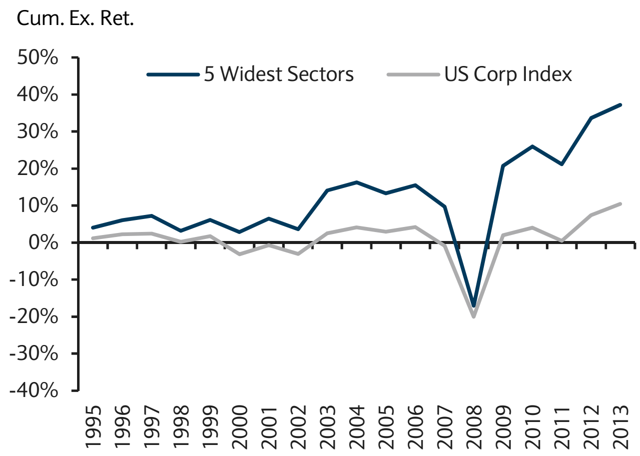
Sectors with Wide Spreads Have Higher-Than-Expected Excess Returns



Source: Barclays Research

FIGURE 2

The Five Widest Sectors Have Consistently Returned More Than the Corporate Index



Note: Assumes equal-weighted quarterly cohorts held for one-year rolling periods. Source: Barclays Research

This is not a recent phenomenon. Looking back to 1995 (Figure 2), we see that a strategy of buying the five widest sectors has generally done better than the index. The average magnitude of outperformance has been similar before and after the 2008 financial crisis, suggesting that this has been a sustainable strategy. Average annual excess returns of the five widest sectors since 1995 were 200bp (median about 220bp), versus an average excess return of 55bp (median 117bp) for the U.S. Corporate index.

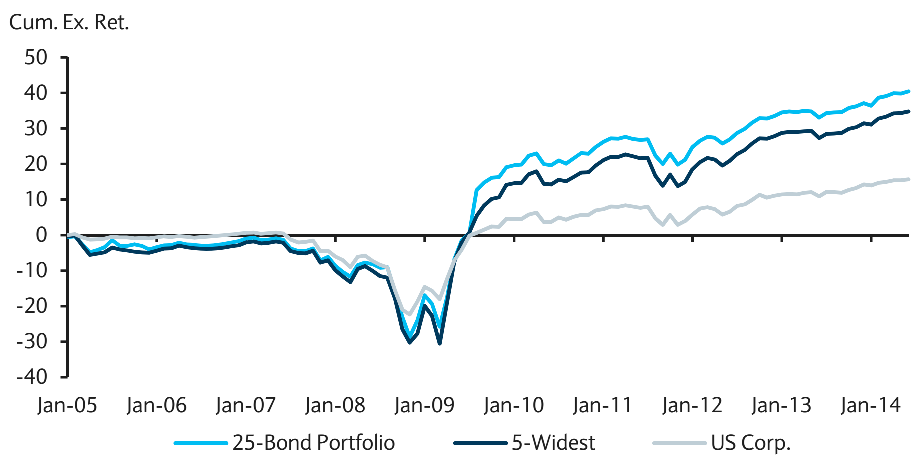
Widest-Sector Performance Can Be Approximated by a Tradable Tracking Portfolio

While buying exposure to an entire sector of the credit index is impractical, it is possible to closely simulate the overall performance with only a small subset of bonds. As a proof of concept, we use the portfolio optimizer built into Barclays' POINT to build historical tracking portfolios using the following constraints:

- Minimize historical tracking error to five widest sectors as of the start of each year
- Limited to 25 bonds
- Restricted to the five widest sectors that each represent at least 50bp of the total index by market value
- Market-value weighted
- Rebalanced annually

We view these constraints as illustrative of how a tracking portfolio can be built, but by no means the only ones that would work. Investors could add further restrictions in terms of single-name concentration, issue size, liquidity, bid-ask, or other factors. While further constraints are likely to add some tracking error, we think there are many ways to create portfolios that will perform similar to the five widest sectors.

FIGURE 3
A 25-Bond Portfolio Closely Tracks the Performance of the Five Widest Sectors



Source: Barclays Research

Apart from a single month in 2009 when the tracking portfolio ran well ahead, our illustrative 25-bond tracking portfolio closely matches the performance of the five widest sectors (Figure 3). The annualized absolute deviation is 60bp, versus almost 200bp of average outperformance versus the Corporate Index. The five-widest tracking portfolio's annualized median return is more than 100bp higher than that of the U.S. Corporate Index, and although it does have higher volatility, it also has a higher Sharpe ratio.

FIGURE 4

Tracking Portfolio Captures the Outperformance of the Five Widest Sectors Strategy

	Tracking Portfolio	Five Widest Sectors	U.S. Corporate Index
Average Annual Excess Return	426bp	366bp	165bp
Median Annual Excess Return	306bp	324bp	204bp
Annualized Standard Deviation	921bp	926bp	569bp
Sharpe Ratio	0.46	0.40	0.29
Avg Annual Deviation vs Sectors Strategy	60bp		

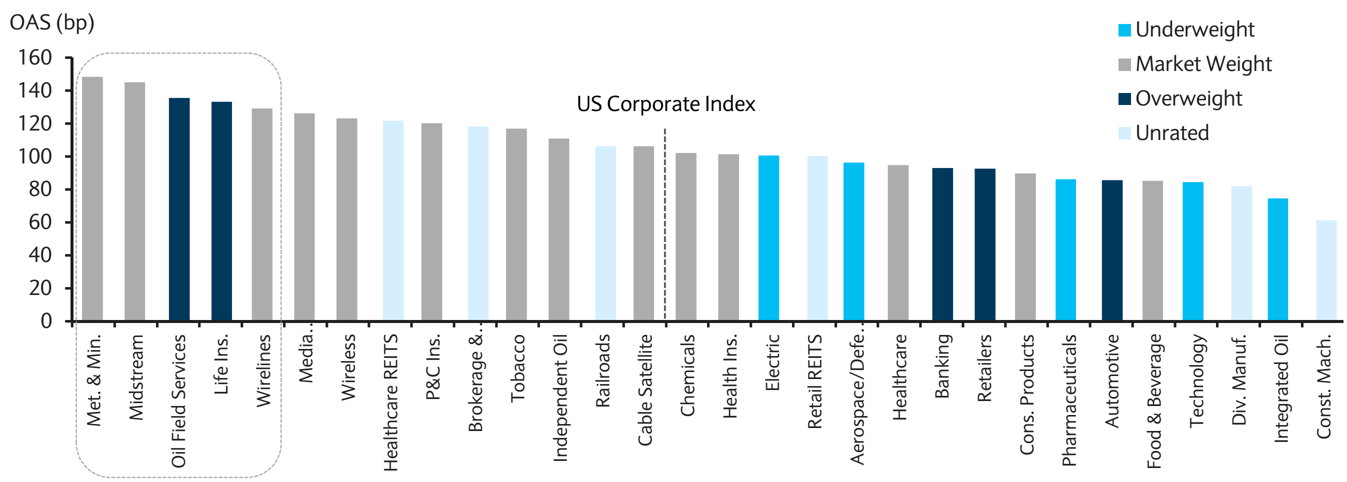
Source: Barclays Research

Current Opportunities

Limiting sectors to those representing at least 0.5% of the index by market value, the widest five sectors in the U.S. Corporate Index are metals & mining, midstream pipelines, oil field services, life insurers, and wireline telcos (Figure 1).

FIGURE 5

The Five Widest Sectors Are Metals & Mining, Midstream, Oil Field Services, Life Insurance, and Wireline Telcos



Source: Barclays Research

Using the same constraints listed above in POINT's portfolio optimizer results in the portfolio listed in Figure 6. A few things stand out. First, the average rating is Baa1/Baa2, one notch lower than the A3/Baa1 average for the U.S. Corporate Index. The spread on the portfolio is wider than we would expect from ratings alone: the average spread value for a single notch between A3 and Baa2 is 20bp, but the portfolio average OAS is 45bp wider than the index. The duration of the tracking portfolio is similar to that of the U.S. Corporate Index, at just over eight years.

The portfolio in Figure 6 was built with few constraints and a primary focus on minimizing tracking error, but investors could consider other factors. It could be optimized to lower trading costs, increase liquidity, match the index duration more precisely, or use other dimensions. That said, we view this portfolio as a viable option for executing a five widest sectors strategy. Investors seeking outperformance in this environment could consider it a reasonably reliable way to generate higher carry and higher expected return while taking on only modestly higher risk.

FIGURE 6

Five Widest Sectors Tracking Portfolio Is Rated One Notch Lower Than U.S. Corporate Index, but Trades with 45bp Wider OAS

Bond	Sector	Weight in Tracking Portfolio	Issue Outstanding Market Value ($bn)	OAS (bp)	OAD	Index Rating
MET 5.7 06/15/35	Life Insurance	3.4%	$1.2	125.9	13.1	A3
PFG 8 7/8 05/15/19	Life Insurance	3.3%	$0.4	108.8	3.9	BAA1
HIG 5 1/8 04/15/22	Life Insurance	4.0%	$0.9	97.4	6.4	BAA3
AFL 3 5/8 06/15/23	Life Insurance	3.7%	$0.7	102.0	7.6	A3
GLENLN 6 10/15/15	Metals & Mining	1.2%	$0.4	104.2	1.1	BAA2
VALEBZ 8 1/4 01/17/34	Metals & Mining	2.5%	$1.0	278.9	11.0	BAA1
RS 6.2 11/15/16	Metals & Mining	5.6%	$0.4	164.8	2.0	BAA3
ABXCN 6.95 04/01/19	Metals & Mining	2.6%	$0.9	100.0	3.9	BAA2
RIOLN 3 1/2 03/22/22	Metals & Mining	3.1%	$1.0	83.0	6.6	A3
RIOLN 2 7/8 08/21/22	Metals & Mining	5.3%	$1.0	91.2	7.1	A3
BHP 5 09/30/43	Metals & Mining	3.4%	$2.8	121.0	16.1	A1
EPD 7.034 01/15/68	Midstream	9.1%	$0.8	214.5	3.0	BAA3
EPB 6 1/2 04/01/20	Midstream	3.6%	$0.6	135.1	4.7	BAA3
PAA 3.65 06/01/22	Midstream	5.8%	$0.8	106.0	6.7	BAA2
ETP 3.6 02/01/23	Midstream	6.1%	$0.8	156.0	7.3	BAA3
SEP 4 3/4 03/15/24	Midstream	4.1%	$1.1	129.0	7.7	BAA2
RIG 6 03/15/18	Oil Field Services	5.3%	$1.1	157.1	3.2	BAA3
ESV 4.7 03/15/21	Oil Field Services	3.6%	$1.6	136.3	5.6	BAA1
T 5.35 09/01/40	Wirelines	3.2%	$3.8	165.8	14.9	A3
T 4.35 06/15/45	Wirelines	4.0%	$2.9	148.9	16.7	A3
VZ 6.55 09/15/43	Wirelines	3.7%	$13.4	175.1	14.6	BAA1
VZ 4.862 08/21/46	Wirelines	3.9%	$4.6	155.6	16.7	BAA1
VZ 5.012 08/21/54	Wirelines	2.8%	$5.6	164.8	17.7	BAA1
Portfolio			$49.8	147.0	8.2	Baa1/Baa2
U.S. Corporate Index				103.4	7.9	A3/Baa1

Source: Barclays Research

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