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High-yield strategies take baton from long duration to end 2016

Andrew Susser

By Trilbe Wynne

High-yield strategies were the top performers in fixed income for the year ended Dec. 31, according to Morningstar Inc.'s separate account/collective investment trust database.

Eight of the top 10 fixed-income strategies in the separate account universe for the 12-month period were in Morningstar's high-yield bond category, a dramatic change from the year ended Sept. 30 in which long-duration strategies occupied eight of the top 10 spots.

The Credit Suisse High Yield index returned 18.39% for the year ended Dec. 31, the median domestic high-yield fixed-income return was 14.21% and the median return for the entire domestic fixed-income universe was 3.18% for the period.

"In early 2016, there were stories about the price of oil plummeting that forced a sell-off. Following the resolution of that, high yield started an aggressive comeback," said Emory Zink, fund analyst, fixed-income strategies at Morningstar in Chicago.

Ms. Zink said 2016 was a "risk-on year" in which high-yielding sectors performed well. In the same period, longer-duration bonds became less attractive as many managers began to expect more frequent interest rates increases, she said.The Bloomberg Barclays U.S. Long Government/Credit Bond index returned 6.67% for the year ended Dec. 31 and the median return for long-duration strategies was 6.98% for the one-year period.

"It's an interesting time to be a bond investor," Ms. Zink said. "With the new presidential administration, there are a lot of potential changes that could happen. Changes to the corporate tax rate, infrastructure spending, and relationships with global trading partners could affect where the opportunities are in the market."

MacKay Shields LLC's select high-yield composite claimed the top spot on the one-year list with a gross return of 26.27%.

The strategy holds about 100 issues in "a concentrated portfolio of higher yielding corporate bonds," said Andrew Susser, portfolio manager and head of the high-yield division at MacKay Shields in New York. "As of Dec. 31, the portfolio's exposure to CCC-rated credit was higher than that of the broader high-yield market."

While many investors were avoiding the energy and metals and mining sectors in early 2016, during a time of commodities market stress, Mr. Susser said the select high-yield strategy added issues that the firm believed were trading at "significant discounts to their long term."

The strategy, he said, also focused on 'fallen angels' in the commodity sectors, purchasing bonds at attractive prices.

Philadelphia-based Penn Capital Management Co. Inc.'s distressed total return strategy was second with a one-year gross return of 23.31%.

Nuveen Asset Management LLC's high-yield strategy was third, with a gross return of 22.82%.

Focusing more on credit risk than interest-rate risk, the strategy buys across the high-yield spectrum from below CCC to BB, while being overweight in B and CCC, said Nuveen's Jeffrey T. Schmitz, vice president and portfolio manager, high-yield credit, who is based in Minneapolis.

"CCC have outperformed dramatically and are likely to continue to perform well, given strong fundamentals, so we'll remain overweight fairly noticeably," Mr. Schmitz said.

TCW Group Inc.'s AlphaTrak strategy ranked fourth for the 12 months ended Dec. 31 with a gross return of 21.67%. The strategy also topped the list of top performers for the year ended Sept. 30.

Morningstar classifies AlphaTrak as ultrashort fixed income but TCW considers it an enhanced equity indexing strategy.

Steve Kane, group managing director and generalist portfolio manager in the fixed-income group at TCW in Los Angeles, said "the strategy seeks to add alpha relative to the S&P 500 index by using S&P 500 futures to get index exposure and actively manages the collateral backing the futures using short-term fixed-income securities to enhance returns above the S&P 500 index."

AlphaTrak's fixed-income component is diversified across bond issues including Treasuries, short-term corporate bonds, asset-backed securities, and agency and non-agency mortgage-backed securities. Mr. Kane said about 15% of AlphaTrak's fixed-income allocation is invested in non-agency MBS, which drove much of the strategy's return for the year.

"The economy has been strong," Mr. Kane said. "The housing market has recovered. The payments that these borrowers are paying are increasingly going to principal. When the loans are being paid down, there's a much lower likelihood of default. This has been a very powerful force."

Logan Circle Partners LP's high-yield strategy rounded out the top five with a gross return of 20.08% for the period.

The strategy took advantage of price dislocations in the energy exploration and production sector early in 2016, when many investors were wary of the risk of lower-rated commodities, then capitalized when energy markets stabilized and prices adjusted later in the year, said Timothy L. Rabe, senior portfolio manager and head of high yield at Logan Circle in Philadelphia.

The strategy primarily holds BBB- through CCC-rated issues across a range of sectors, including energy, technology, telecommunications and media.

TCW tops 5-year returns

High-yield strategies also dominated the list of top performers for the five years ended Dec. 31. Nine of the top 10 were in Morningstar's high-yield bond category and seven of the strategies were also among the top performers for the five years ended Sept. 30.

The annualized return for the Credit Suisse High Yield index was 7.2% for the five years ended Dec. 31, the median domestic high-yield bond return was 7.14% and the entire domestic fixed-income universe returned an annualized 2.94% for the five years ended Dec. 31.

Two TCW strategies topped the list of five-year returns. TCW's AlphaTrak strategy led the list with an annualized gross return of 17.59%, and TCW's opportunistic mortgage-backed securities strategy was in second place with an annualized gross return of 11.83% for the five years ended Dec. 31. (Returns for all periods of more than one year are compound annualized figures.)

The opportunistic MBS strategy is "100% focused on the non-agency residential MBS market and these pools have cleaned up. The worst borrowers defaulted fairly quickly. What remained was inherently stronger," TCW's Mr. Kane said.

Nomura Corporate Research and Asset Management Inc.'s high-yield total return institutional strategy ranked third on the five-year list with an annualized gross return of 10.32%.

Stephen Kotsen, managing director and portfolio manager at NCRAM in New York, said individual credit selection, based on the firm's "strong horse" philosophy of identifying companies that can pull their debt load through economic cycles, was the key driver of the strategy's performance during the five-year period.

"Due to balance sheet management, a number of companies issued equity, which lowers their leverage and improves their creditworthiness," Mr. Kotsen said.

NCRAM's high-yield total return institutional strategy was also in sixth place on the one-year list with a gross return of 20.02% for the year ended Dec. 31.

Oaktree Capital Management (OAK) LP (OAK)'s European high-yield strategy was in fourth place on the five-year list with an annualized gross return of 10.27%.

The high-yield portfolio is diversified across 80 to 90 European holdings, with a "tendency to prefer" B-rated issues, said James Turner, London-based managing director and portfolio manager of European high yield at Oaktree.

"They tend to be companies that have very strong free cash flow, the ability to delever, to make sure that the companies can see through a business cycle and cover their interest," Mr. Turner said.

He also said much of the strategy's performance is driven by the downside protection of individual credit risk assessments rather than the pursuit of yield through sector allocation.

"The main way we believe we get most of our alpha is by avoiding defaults. We have an unofficial motto: If you avoid the losers, then the winners take care of themselves," Mr. Turner said.

Wilmington, Del.-based DuPont Capital Management Corp.'s high-yield strategy rounded out the top five on the five-year list with an annualized gross return of 10.22%.

JPMAM at top in CITs

J.P. Morgan Asset Management (JPM) claimed the top two spots in the domestic collective investment trust universe for the one-year period ended Dec. 31. The JPMCB public bond fund was in first place with a 17.38% net return, followed by JPMCB corporate high yield with a net return of 14.98%.

"Over the course of the year, we were well positioned as the high-yield market benefited from strong risk demand while global economic growth stabilized and commodity markets improved," said Greg Tell, managing director and global head of fixed income client portfolio management at J.P. Morgan Asset Management.

Capital Group Cos.' global high-yield DB fund was in third place with a one-year net return of 14.94%, followed by American Century Investments' U.S. high-yield corporate bond fund with 14.46% and Fidelity Institutional Asset Management's high yield core institutional strategy with a one-year net return of 14.22%.

The one-year median return for the CIT universe was 3.05%.

Amalgamated Bank's ultra construction loan strategy led the list of five-year CIT returns with an annualized net return of 7.87% for the period ended Dec. 31.

J.P. Morgan's JPMCB corporate high-yield strategy was in second place with an annualized net return of 7.6%, followed by Eaton Vance (EV) Corp.'s EB high yield with 7.56%.

Two additional strategies from J.P. Morgan Asset Management rounded out the top five. The JPMCB high yield fund was in fourth place with 7.11% and JPMCB mortgage credit opportunity was in fifth place with an annualized 7.1%.

The five-year median return for the CIT universe was 2.69%.

All data for Pensions & Investments top-performing managers report are provided from Morningstar's global separate account/ collective investment trust database. The data for the rankings on which this story is based were pulled Feb. 1.

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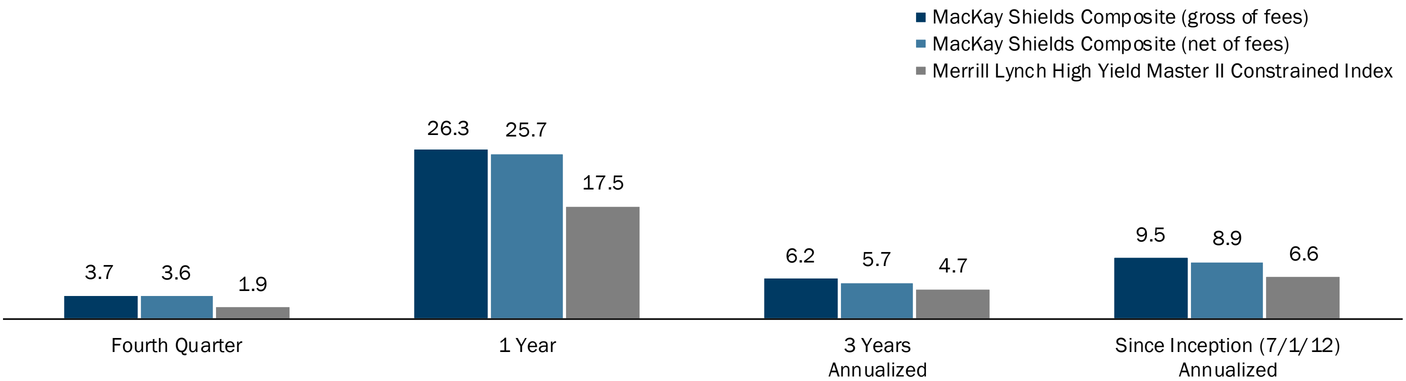
SELECT HIGH YIELD
Performance

MACKAY SHIELDS

Composite Returns (%)

Period Ending December 31, 2016



Composite Disclosures

Calendar Years	MacKay Shields Composite (gross of fees)	MacKay Shields Composite (net of fees)	Merrill Lynch High Yield Master II Constrained Index	Composite 3-Yr St Dev	Merrill Lynch High Yield Master II Constrained 3-Yr St Dev	Firm Assets (Mil)
2016	26.3	25.7	17.5	7.8	6.0	94,540
2015	-5.1	-5.6	-4.6	5.8	5.3	89,196
2014	0.1	-0.4	2.5	N/A	N/A	91,626
2013	12.5	11.9	7.4	N/A	N/A	80,331
2012 (Since 7/1)	11.4	11.1	7.9	N/A	N/A	78,371

The Select High Yield Composite includes all discretionary high yield select accounts managed with similar objectives for a full month, including those accounts no longer with the firm. This strategy seeks to earn a yield higher than the broad high yield market while maintaining a significantly stronger credit profile than the average CCC bond. The Select High Yield Composite was formerly called the High Yield Stressed Composite. Composite performance reflects reinvestment of income and dividends and is a market-weighted average of the time-weighted return, before advisory fees and related expenses, of each account for the period since inception. Gross-of-fees composite performance reflects reinvestment of income and dividends and is a market-weighted average of the time-weighted return, before advisory fees and related expenses, of each account for the period since inception. Net-of-fees composite performance is derived by reducing the quarterly gross-of-fees composite returns by .125%, our highest quarterly fee. Policies for valuing portfolios, calculating performance, and preparing compliant presentations are available upon request. Performance is expressed in US Dollars. The composite creation and inception date is 7/1/12. All portfolios in the composite are fee-paying portfolios. There can be no assurance that the rate of return for any account within a composite will be the same as that of the composite presented. **Past performance is not indicative of future results.**

MacKay Shields LLC, an SEC-registered investment adviser, claims compliance with the Global Investment Performance Standards (GIPS®) and has prepared and presented this report in compliance with the GIPS standards. The firm has been independently verified from January 1, 1988 through September 30, 2016. The verification report is available upon request. Verification assesses whether (1) the firm has complied with all the composite construction requirements of the GIPS standards on a firm-wide basis and (2) the firm's policies and procedures are designed to calculate and present performance in compliance with the GIPS standards. Verification does not ensure the accuracy of any specific composite presentation. A complete list of composite descriptions is available upon request. The primary benchmark for this composite is the BofAML High Yield Master II Constrained Index. The Credit Suisse High Yield Index was the primary benchmark until 9/30/16. It was removed due to data transparency issues. The benchmark was changed retroactively because returns for the two indices were not meaningfully different through 9/30/16. The correlation of monthly index returns from composite inception through 9/30/16 was 0.997. Indices do not incur management fees, transaction costs or other operating expenses. Investments cannot be made directly into an index. The BofAML High Yield Master II Constrained Index is referred to for comparative purposes only and is not intended to parallel the risk or investment style of the portfolios in the MacKay Shields Composite. A blended benchmark which also used to be shown was removed on 12/31/15 because the broad market benchmark was deemed more representative of the composite's objectives. Internal dispersion is calculated using the equal-weighted standard deviation of annual gross returns of those portfolios that were included in the composite for the entire year. The three-year annualized standard deviation measures the variability of the composite and the index returns over the preceding 36-month period. The standard deviation is not presented for periods prior to 2015 because the composite did not have a three-year track record.

For years ending 2016–2012 the number of accounts was five or fewer; therefore, the internal dispersion of portfolio returns is not applicable. Year-end composite assets (mil) were: 2016, $47; 2015, $37; 2014, $39; 2013, $39; 2012, $35.