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Featured G

Balancing Objectives: How We Generate Income While Preserving Capital

The lead portfolio managers of our Global Multi-Sector strategies, Gary Herbert and Brian Kloss, team up to discuss two objectives that are increasingly important for investors: delivering attractive income coupled with capital preservation. It is even more challenging to deliver these goals in a manner that also reduces portfolio volatility and correlations with other components of one's broad portfolio. Gary will explain how the team finds income opportunities, by highlighting past examples. Brian will follow up with another blog on capital preservation.

The post-global financial crisis (GFC) investment climate has been characterized by periods of financial and commodity market volatility, and the steady decline in G10 bond yields. Developed market bond yields have remained persistently low over the last few years, with several recently retreating into negative territory. This environment has presented challenges for investors who are interested in risk-adjusted income opportunities.

We believe a fixed-income portfolio can provide attractive, stable income and capital preservation if one considers a global opportunity set. The ideal approach must be flexible, aware of relevant risk benchmarks, and allocate to opportunities in a more significant and focused manner when they present themselves.

Perhaps the best way to understand the process is to review where we have taken risk during the last 10 years. Markets have been punctuated by many mini-slowdowns and recession scares over the past decade, yet these periods may be value opportunities for income-oriented investors.

Two specific examples highlight the opportunities we capitalized on:

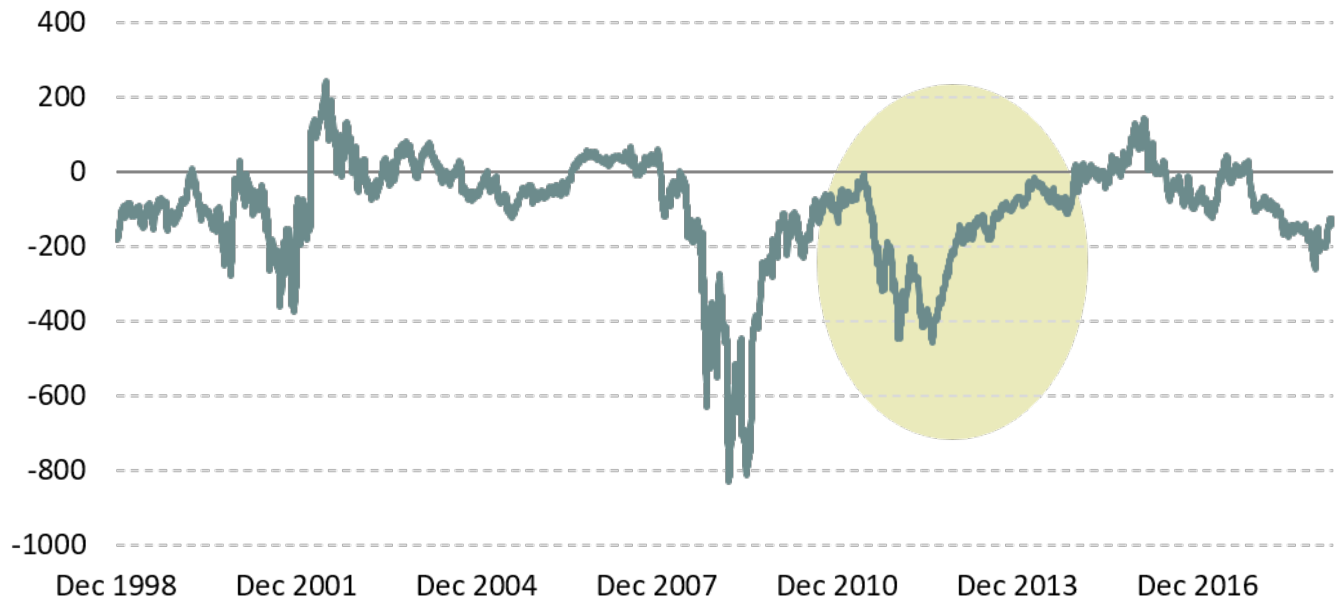
1. The European sovereign debt crisis and the subsequent repricing of European and U.K. credit relative to the U.S. and
2. The energy sector revaluation throughout 2015 and early 2016.

The European Sovereign Debt Crisis

Let's examine the European sovereign debt crisis from 2011-12 first. European policymakers did not respond to deteriorating economic conditions quickly enough and corporate credit yields rose alongside sovereign bond yields, though not to the same degree as during the GFC. At the time sterling- and euro-denominated corporate credit offered the best value relative to U.S. corporate bonds. Our allocation was concentrated in the European high yield credit market, particularly issuance rated single-B and BB. European credit spreads compressed after the European Central Bank (ECB) pledged to do "whatever it takes." Two years later, in 2014, the central bank implemented its asset purchase program, which significantly compressed credit spreads even further. Chart 1 and Chart 2 highlight the valuation anomalies relative to history and the multi-year value opportunity that we were able to capitalize upon.

Chart 1: OAS Spread: U.S. High Yield B Minus European B

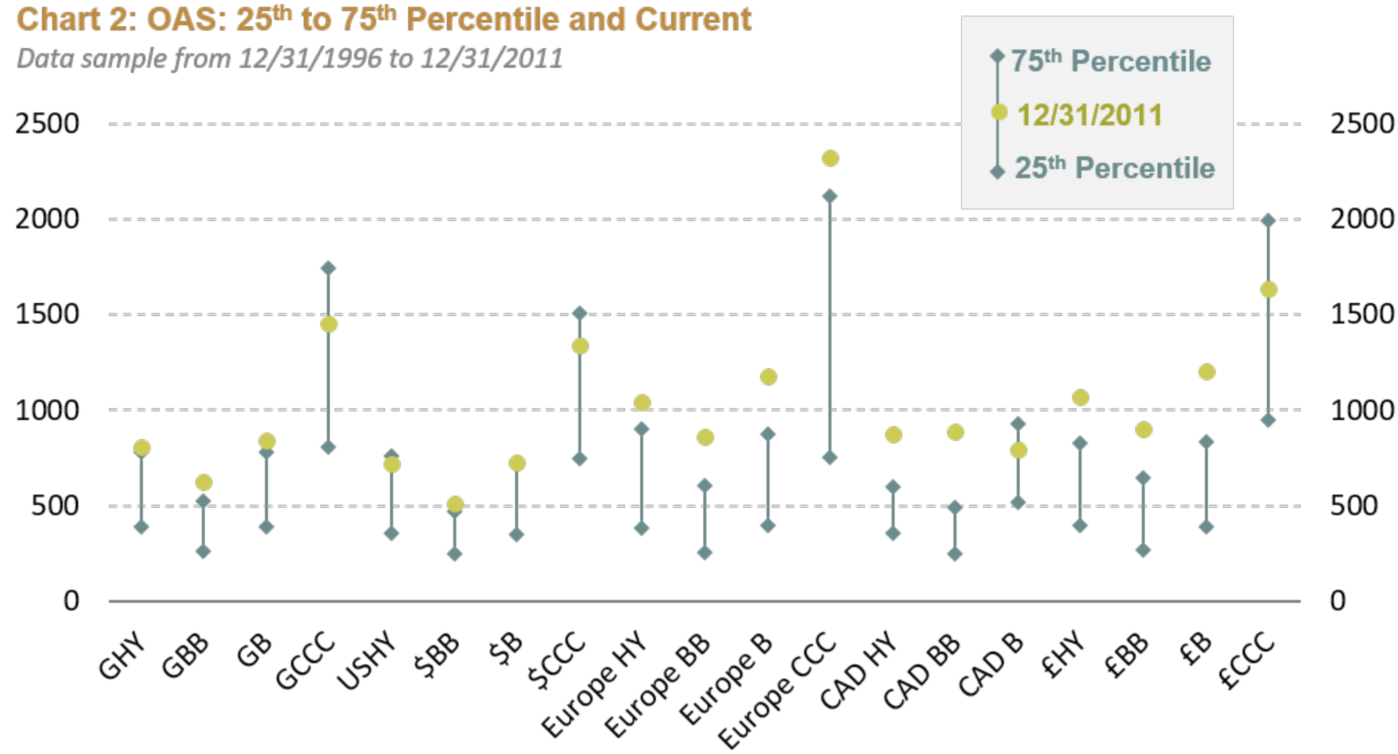
BPs, As of 3/28/2019



Source: Bloomberg (© 2019, Bloomberg Finance LP), Bank of America Merrill Lynch

Chart 2: OAS: 25th to 75th Percentile and Current

Data sample from 12/31/1996 to 12/31/2011



Source: Bloomberg (© 2019, Bloomberg Finance LP), Bank of America Merrill Lynch

The U.S. Energy Sector

Now, let's examine the U.S. energy sector from the opportunity presented in 2015-16—which became particularly opportunistic in early 2016. Following the collapse in crude oil prices over the prior two-year period, spreads on high yield credit in the energy sector topped 500 basis points versus investment grade corporate bonds. We chose to focus on better quality segments of the U.S. energy market. Spreads compressed significantly due to industry consolidation, low cost of borrowing, and the eventual recovery in crude prices. Chart 3 and Chart 4 again highlight the historical valuation anomaly and the opportunity across the quality spectrum.

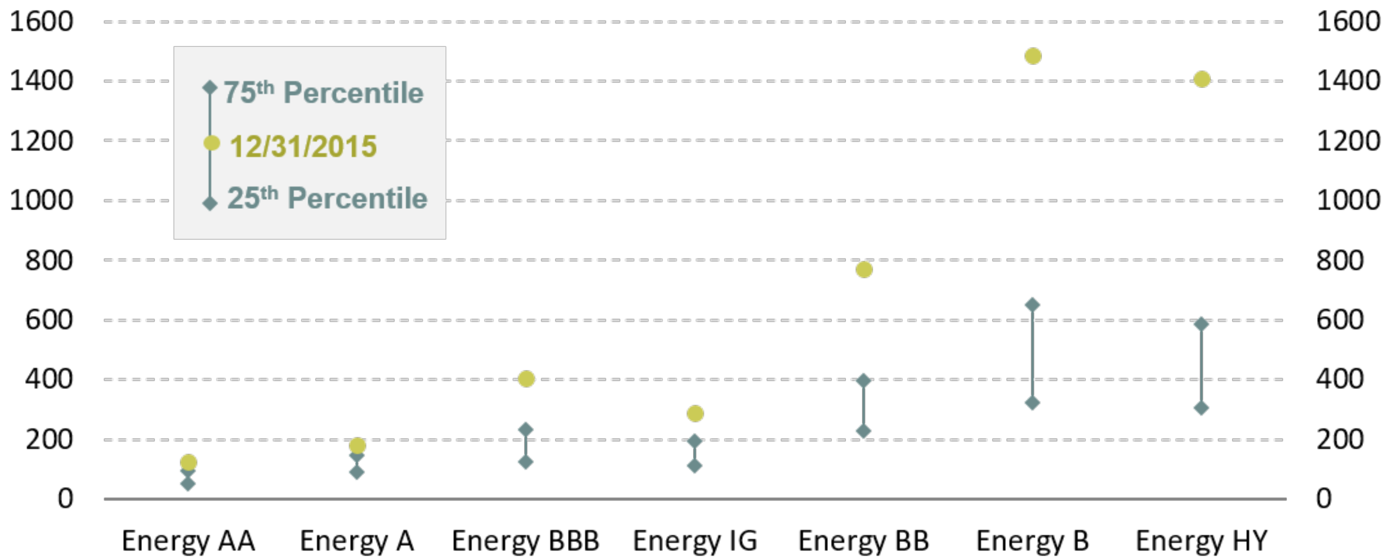
Chart 3: Energy BBB

As of 1/31/2018

Source: Bloomberg (© 2019, Bloomberg Finance LP), Bank of America Merrill Lynch

Chart 4: Energy OAS: 25th to 75th Percentile and Current

Data sample from 12/31/1996 to 12/31/2015



Source: Bloomberg (© 2019, Bloomberg Finance LP), Bank of America Merrill Lynch

Next week, Brian will examine how this approach reduces volatility at the portfolio level and broadly minimizes correlations with other asset classes—which are notable components of our capital preservation efforts.

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