The Appeal of Short Duration Credit in Strategic Cash Management

Yields more than compensate cash managers for taking on minimal credit risk.

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IN BRIEF

- Credit-sensitive bonds have historically had a limited place in cash management, but today tiered strategies are being used that allow a role for short-term credit securities.
- The excess spread on credit-sensitive bonds more than compensates for their minimal default risks, in part because of liquidity and market risk.
- But illiquidity and short-term volatility should not be a major concern for cash with an investment horizon of a year or longer.
- Outcomes for strategic cash investors can be further improved by diversifying among sectors and retaining the option to hold to maturity.

Given the potential for losses in even high-quality credit, cash managers sometimes assume that credit risk has no place in their cash management strategy, and this assumption was only reinforced by the events of 2008. Widely held generalizations often create market opportunities, however, and this is no exception. We believe cash managers can use short credit in core and strategic cash management strategies in a way that will enhance their returns without significantly increasing their risk.

We are not alone in this view. In the field of cash management, perceptions about credit are changing. According to JP Morgan's Global Liquidity Investment Peer View, one in five corporate cash managers is currently using short or ultra-short maturity bond funds for longer term cash needs, a 53% increase over the last two years. Several factors, including rising rates, diminished estimates for stock and bond returns, and money market reforms are bringing about a re-evaluation of credit's role in cash management.

An increasingly popular approach allocates cash across a spectrum defined by needed liquidity and risk tolerance (see Table 1). Using this framework, corporate cash managers, hospital systems, and endowments, among others, are now utilizing investments with longer-term maturities and credit sensitivity for their excess cash reserves.

TABLE 1. CASH MANAGERS ARE ALLOCATING CASH BY LIQUIDITY NEEDS AND RISK

Operating Cash	Core Cash	Strategic Cash
Time Horizon: 0-3 months	**Time Horizon:** 3-12 months	**Time Horizon:** Over 12 months
Use: Unexpected cash needs, business operating expenses (e.g. payroll)	**Use:** Periodic cash need	**Use:** Not intended for specific expenditures
Objective: Capital preservation	**Objective:** Capital preservation, incremental yield	**Objective:** Total Return, incremental yield
Risk: Ultra Low Volatility	**Risk:** Low Volatility	**Risk:** Conservative
Money Market Funds Bank Deposits	Ultra Short Bond Strategies	Short Term Bond Strategies

Source: Lord Abbett

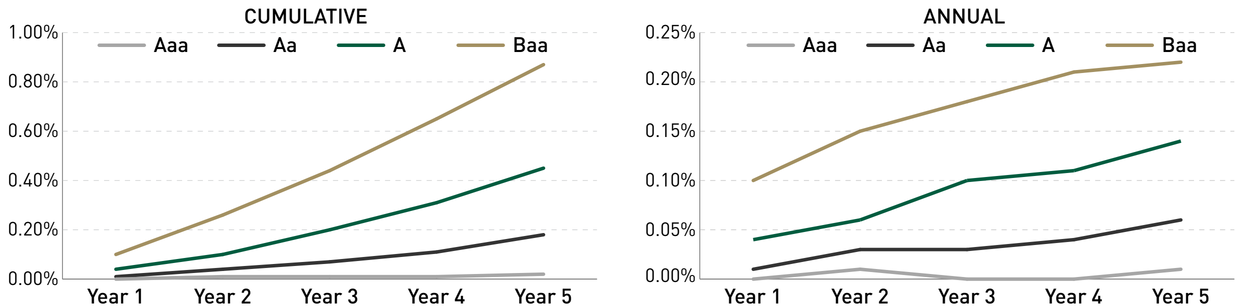
Using longer-term securities in cash management is relatively simple, while making use of credit is less straightforward. Term solutions involve merely matching the term of an asset to that of a liability, and as long as the yield curve is sloped positively, this helps ensure additional return while also neutralizing the active risk of interest rate movements. In contrast, determining how credit can be used as a cash management solution requires further examination.

THE HISTORY OF LOSS RATES AND CREDIT SPREADS: THE CREDIT SPREAD PUZZLE

To help determine the amount of credit risk that is appropriate for strategic cash management, we can examine average loss rates at various levels of quality. Chart 1 combines default frequency with severity of default to show one-year loss rates for U.S. corporates (one year from cohort formation). For high-quality issuers, losses are negligible over a one-year period. For Baa-rated corporates the annual loss rate is just over 0.10%, and for A-rated corporates it is just 0.04%.

In fact, an investment-grade credit usually requires multiple years before it becomes so stressed that it defaults. But even five years after cohort formation, the lowest investment-grade credits (Baa) have, on average, a loss rate of less than 0.90%.

CHART 1. AVERAGE CREDIT LOSS RATES BY LETTER RATING, 1983-2017



Source: Moody's and Lord Abbett. Based on average default rates and senior unsecured bond recoveries measured on issuer-weighted basis.

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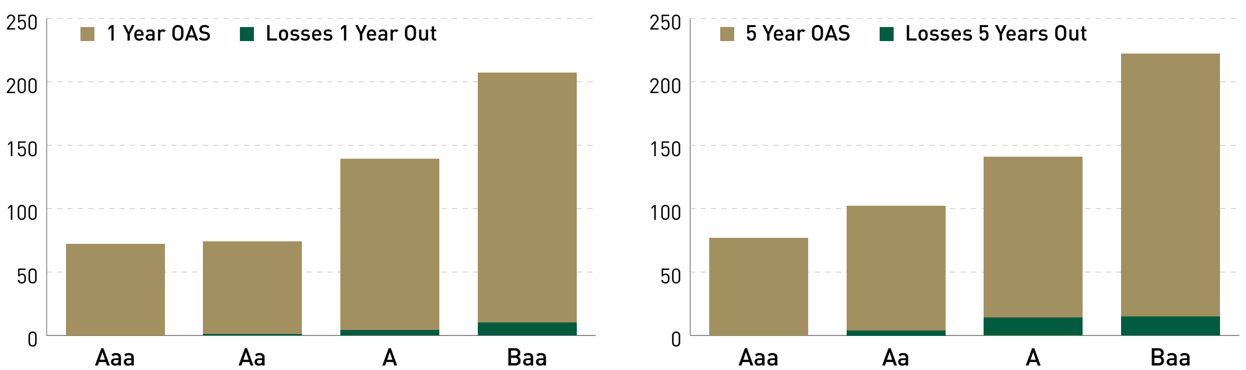
In contrast to these negligible loss rates are the average yield spreads. Chart 2 compares those average loss rates with average spreads over the tenors, and typically the payment received far outweighs the average loss, especially among shorter-term credits. Thus, investors are typically well-rewarded for taking on minimal credit risk.

CHART 2. AMONG INVESTMENT-GRADE CREDITS, YIELD SPREADS MORE THAN COMPENSATE FOR LOSSES, 1998-2017



Source: Moody's and Lord Abbett. Yield spread data covers 2000-2017. Losses cover 1998-2017. Loss data based on following a cohort of bonds for 1 and 5 years.

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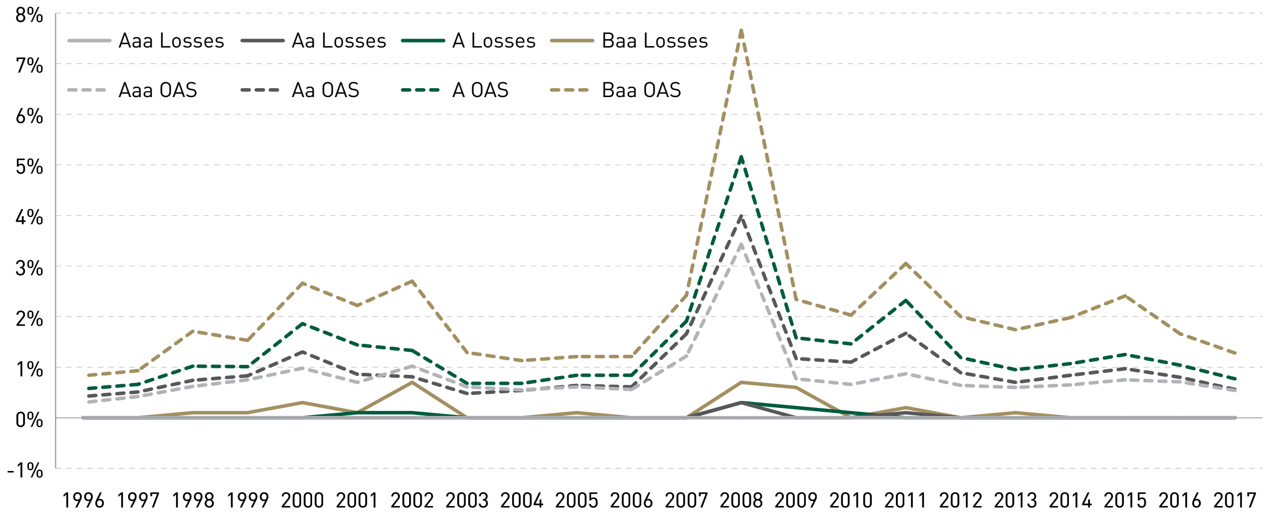
There is, of course, a good deal of volatility around these loss events, and that is partly why investors are compensated with such high average credit spreads. Examining historical loss rates from 1983 to 2017 (Chart 3), we see that even in extremely difficult economic environments, such as 2008, the loss rate of Baa-rated credits barely rose above 0.7% annually. Comparing this extreme loss rate with a current spread of 1.58% on Baa/BBB issues and an average spread of 2.11% over the last 20 years,[1] we see that the normal investment-grade credit spread more than compensates the investor for even potentially extreme losses.

CHART 3. ANNUAL CREDIT LOSS RATES AND YIELD SPREADS BY LETTER RATING, 1996-2017



Source: Moody's and Bloomberg.

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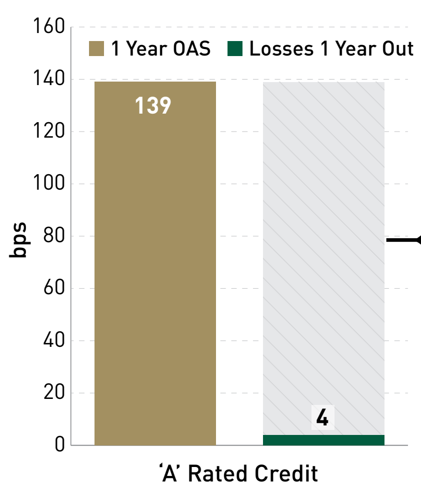
So why, then, are credit spread levels so high? This conundrum is known as the "credit spread puzzle," and it was first identified by researchers in the early 1980s. Using Robert Merton's model of credit spreads (based on the allocation of dynamic firm value to equity and debt holders), they found that spreads predicted by the model were far below those observed empirically. Since then, academics and market participants have generally agreed that the large spread in corporate yields that is not explained by their default rate is due to a combination of factors. These include:



Taxes: Treasury interest is taxable at the federal level, but exempt from state and local taxes. Corporate bond interest is subject to federal, state and local taxes. So, for many investors, the required return on Treasuries is less than if the tax features were equivalent.

Liquidity premium: Compared to like-term Treasuries, which are used in the spread calculation, corporate bonds are typically less liquid, particularly in times of stress, and therefore carry additional spread to compensate an investor for that risk.

Systematic risk premium: The periods in which corporate bonds perform poorly and go into default generally occur exactly when investors don't want them to — because the rest of their portfolio is also suffering. Diversifying among issuers by sector, business model, and quality can alleviate this tendency but cannot eliminate it completely. Corporate bonds, therefore, carry some spread premium for the non-diversifiability of this risk.

Source: Moody's and Lord Abbett. Yield spread data covers 2000-2017. Losses cover 1998-2017. Loss data based on following a cohort of bonds for 1 and 5 years.

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THE OPPORTUNITY FOR STRATEGIC CASH MANAGERS

By almost every estimate, the majority of the spread on an investment-grade credit is due to the factors listed on the previous page, not expected losses or even worst-case losses. And this is especially true for shorter-term maturities and higher-quality issuers (Chart 2).

Thus, strategic cash managers, who have time horizons of a year or more, are in a special position. The price volatility that comes with liquidity risk and sensitivity to the market risk premium, those "other" components of credit spreads, are potentially not very important to strategic cash managers. It's well established that year-to-year volatility is not very important to a disciplined retirement investor with a 20-year horizon, and the return that compensates for that volatility provides that investor with a greater opportunity to achieve a long-term financial goal.

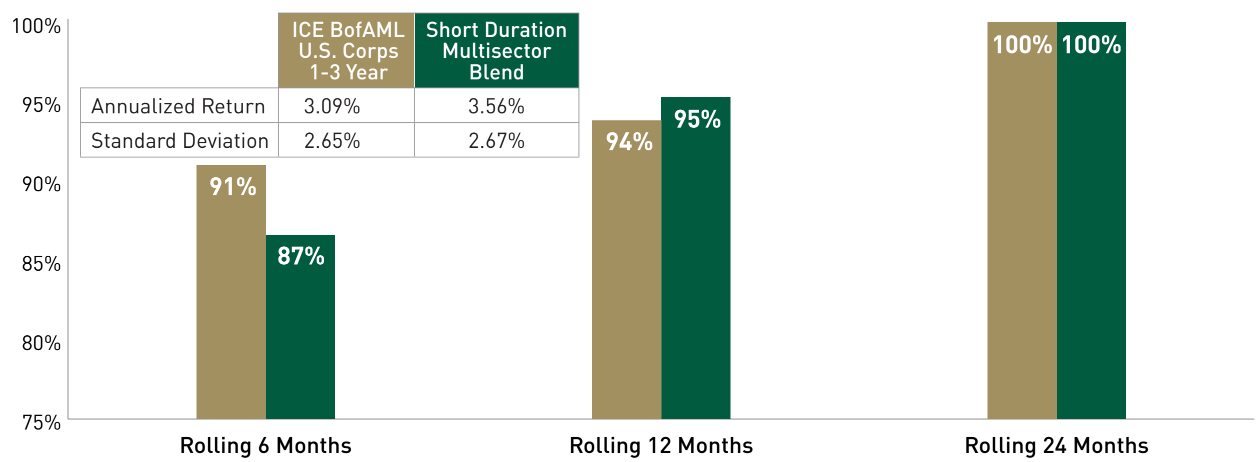
In the same way, short-term price volatility in credit-sensitive bonds due to their liquidity and market risk should not be a major concern for a strategic cash investor. Because holding periods are longer for this strategic cash "bucket," these investors have the option to hold short-term bonds to maturity. By waiting out the price volatility, a longer-term holder can earn the benefits of that spread compensation while incurring only a fractional risk of actual principal losses. As we've shown, spreads vastly overcompensate investors for that particular risk. Moreover, a credit-focused bond manager with deep research capabilities has the potential to minimize even these minor losses and to seek even better yields in spaces with attractive fundamentals.

To capitalize on the excess spread relative to expected losses, the bond manager must be able to exercise the option to hold a bond to maturity. Ideally, therefore, the cash manager's expected holding period should be in the neighborhood of the weighted average life of the bonds in the portfolio.

Chart 4 shows that historically in short-term investment-grade credit, the probability of return of principal over moderate holding periods is very high. In nearly 100% of rolling 12-month periods between January 1, 2008 and July 31, 2017, the total return on the ICE BofAML 1-3 Year US Corporate Index was positive. This is because in each of these 12-month periods, a good portion of the bonds mature, and defaults are usually negligible and modest even in crisis periods. In other words, in short-term investment-grade credit, the near absence of defaults means that any price volatility that has occurred has had little impact on total returns.

CHART 4. RETURN OF PRINCIPAL: HISTORICAL LIKELIHOOD FOR SHORT-TERM CORPORATE BONDS AND BLENDED SHORT CREDIT

Percentage of Time Periods with Positive Returns



Source: Bloomberg and Lord Abbett.

Short Duration Multisector Blend includes 30% ICE BofAMLUS Corps 1-3 Year, 30% BbgBarcCMBS 1 -3.5Year, 15% ICE BofAMLABS Fixed Rate 0-3 Year, 15% BbgBarcHY 1-3 Index, 10% BBgBarcUS Govt/Credit 1-3 Year.

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ADDITIONAL BENEFITS OF A DIVERSIFIED ASSET MIX

Even the relative safety of a portfolio of short-term corporate bonds can be enhanced further. As we noted earlier, a good part of the yield premium on corporate bonds is due to their limited diversifiability. A portfolio can be diversified among sectors, business models, location, and quality, but as 2008 proved, credit crises can make correlations among these factors quickly go to 1.

Including other asset classes in a short credit portfolio can add diversification benefits and, in many cases, yield. In addition, it can increase the opportunity set for an asset manager to rotate among sectors and find pockets of opportunity and liquidity.

In structured products, the corporate credit spread puzzle is often magnified. Loss rates are generally comparable to like-quality corporates,[2] but spreads are similar or larger. With structured products, migration risk, the chance that a credit will receive a rating downgrade, can be dramatically reduced with investor-friendly deal structures. In contrast to corporate entities, which are sometimes encouraged by cheap leverage to lower their credit quality, spread trapping mechanisms in structured products often improve tranche quality under normal economic conditions.

As Chart 4 illustrates, a blend of short credit asset classes has historically improved the likelihood of a positive total return, though at the cost of some added price volatility. Put simply, with holding periods of a year or longer, the yield advantage of a multi-sector, short credit portfolio tends to add to returns, even in difficult periods.

We believe tiered cash management programs that utilize short credit can provide extra return and safety of principal over moderate holding periods. The excess spread on credit-sensitive bonds more than compensates for their minimal risks, which can be reduced further by opting for a diversified pool of credits and retaining the option to hold to maturity. ■

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[1] Based on the ICE BofAML BBB US Corporate Index as of 10/31/2018.

[2] According to Moody's, one year default rates for A-rated and BBB-rated ABS were .1% and .3%, respectively, from 2000-2016. One-year default rates for A-rated and BBB-rated CMBS were .1% and .4%, respectively, during the same period. Loss rates will vary but generally can be estimated at roughly half of default severity.

IMPORTANT INFORMATION

A Note about Risk: The value of investments in fixed-income securities will change as interest rates fluctuate and in response to market movements. Generally, when interest rates rise, the prices of debt securities fall, and when interest rates fall, prices generally rise. Bonds may also be subject to other types of risk, such as call, credit, liquidity, interest-rate, and general market risks. High-yield securities, sometimes called junk bonds, carry increased risks of price volatility, illiquidity, and the possibility of default in the timely payment of interest and principal. Moreover, the specific collateral used to secure a loan may decline in value or become illiquid, which would adversely affect the loan's value. Longer-term debt securities are usually more sensitive to interest-rate changes; the longer the maturity of a security, the greater the effect a change in interest rates is likely to have on its price. Lower-rated bonds may be subject to greater risk than higher-rated bonds. No investing strategy can overcome all market volatility or guarantee future results. Statements concerning financial market trends are based on current market conditions, which will fluctuate. There is no guarantee that markets will perform in a similar manner under similar conditions in the future.

Diversification does not guarantee a profit or protect against loss in declining markets.

GLOSSARY

Duration is a measure of the sensitivity of the price of a fixed-income asset to a change in interest rates and is expressed in years.

Yield to maturity is the rate of return anticipated on a bond if held until it matures. Yield to maturity assumes all the coupon payments are reinvested at an interest rate that equals the yield-to-maturity. The yield to maturity is the long-term yield expressed as an annual rate.

Yield is the annual interest received from a bond and is typically expressed as a percentage of the bond's market price.

Tenor is the amount of time left for the repayment of a loan or until a financial contract expires.

The **ICE BofAML 1-3 Year BBB US Corporate Index** is an unmanaged index comprised of U.S. dollar denominated investment grade corporate debt securities publicly issued in the U.S. domestic market with between one and three year remaining to final maturity.

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