Tabula insights: is interest rate duration a drag on your Euro high yield allocation?

TABULA

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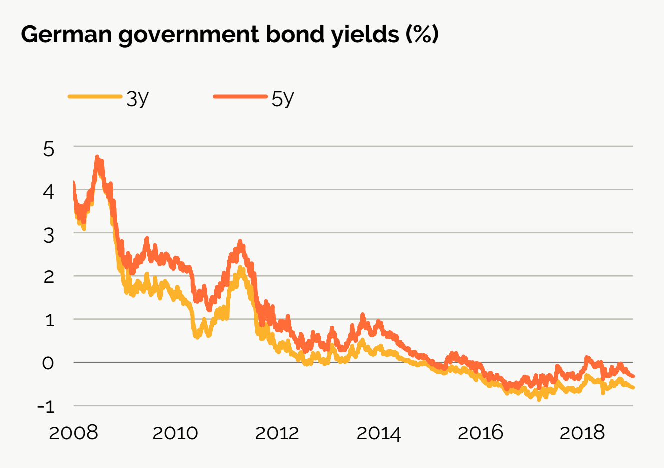
The attractive yield on high yield corporate bonds often comes with significant interest rate risk. With rate hikes looming, this may be unwelcome. CDS indices like iTraxx Crossover give you credit exposure *without* direct interest rate risk and are now accessible in ETF format.

Is interest rate duration worth the risk?

Investors typically increase duration to achieve a higher yield. Within the high yield market, where yield is driven by interest rates *and* credit spreads, you'd expect a higher return from both components when you buy longer maturity bonds.

However, if we look at the interest rate component in isolation, its contribution in recent years has been unimpressive. Chart 1 shows yields on 3y and 5y German government bonds. As you would expect, 5y yields have typically exceeded 3y yields. However, since late 2015, yields on even 5y bonds have been negative.

Given the expectation of ECB rate hikes towards the end of 2019, it may make sense to minimise this interest rate exposure. It's not enhancing the yield and will be a drag on bond prices if rates rise.



Data: Bloomberg, 31 December 2018

Longer-term credit spreads *are* attractive

Chart 2 shows the curves for iTraxx Crossover and German government bonds. Not only are spreads on the credit curve higher than interest rates over the spectrum, but the credit curve is also substantially steeper.

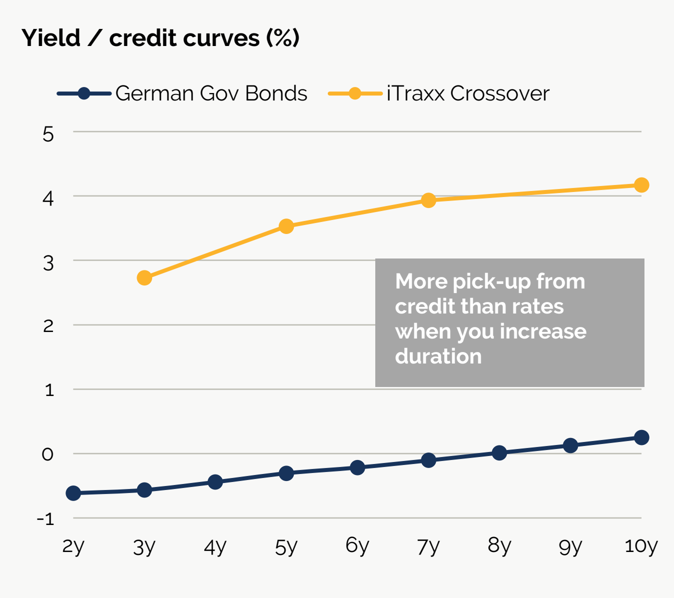
Reduce interest rate duration in passive portfolios

For passive investors who have a positive view on corporate credit but are concerned about rate rises, there are two common ways to reduce interest rate duration.

An investor can hedge duration risk. However, this comes at a cost *and* increases the operational burden.

Alternatively, there are ETFs tracking short-term bond indices. These have lower duration (typically around 2y, compared to around 3.5y for a standard ETF) but the investor also misses out on the credit duration in longer-term bonds. The yield on the iBoxx Euro Liquid High Yield Index is 4.7%[1], compared to only 3.3%[1] on the iBoxx Euro Liquid High Yield 1-3y Index, its short-term counterpart.

However, there is a third and more efficient option. Taking credit exposure via CDS indices rather than cash bond indices removes direct interest rate duration risk altogether, while maintaining credit duration.



Data: Bloomberg, 31 December 2018

[1] As of 31th Dec. 2018

CDS indices are becoming more accessible

High yield credit exposure with high liquidity and minimal interest rate risk

Since their introduction in 2001, CDS indices like iTraxx and CDX have become the default instruments for active credit trading. These indices are baskets of reference entities with standardised trading terms, central clearing and significant liquidity. They are widely used by specialist fixed income managers to take long or short exposure, without the interest rate risk inherent in cash bonds.

iTraxx Crossover, published by IHS Markit, is the established CDS benchmark for the European high yield market. Tabula has worked with Markit to develop an investible, total return version of the index, now available via a UCITS ETF.

UCITS ETF for tactical or long-term HY credit allocations

iTraxx Crossover

- 75 European sub-investment grade entities selected according to liquidity
- Equal weighting, avoiding over-exposure to single names
- Mainly corporate exposure, excluding traditional financial issuers
- New series published every six months
- 3, 5, 7 and 10 year maturities
- Average daily turnover of around $1.8bn on the current 5y series in H2 2018[2]

iTraxx European Crossover Long Credit Index

- Investible total return version of iTraxx Crossover 5y
- Reflects the return from taking credit risk on the current series
- Current yield of 4.0%[3]
- Calculated by IHS Markit

Tabula UCITS ETF

- Trades on London Stock Exchange
- No need to sign ISDA or manage collateral
- Can be used for tactical or long-term allocations

Visit tabulaim.com for full details.

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[2] Source: Bloomberg, as at 31 Dec 2018

[3] Expected 12m yield as at 31 December 2018

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