Tabula insights: using credit to enhance a traditional bond/equity portfolio

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Replacing equity with credit in a simulated European bond/equity portfolio improved long-term performance, reduced drawdowns and enhanced risk-adjusted returns over 1, 3, 5 and 10 years

This strategy, and variations on this theme, can be readily implemented with ETFs

Credit spreads as a substitute for equity

There is a clear intuitive link between equity and corporate credit. However, because corporate bonds also have interest rate risk, they have differing performance characteristics. When you strip out the interest rate component, the pure credit exposure behaves more like equity.

Credit default swaps (CDS) allow investors to take long or short credit exposure without the interest rate risk inherent in corporate bonds. Initially developed as hedging tools, CDS are now the default instruments for credit exposure and are widely used by specialist fixed income managers. As they become more accessible, including via ETFs, they could play a useful role in multi-asset portfolios too. Here, we look at whether substituting credit for equity in a simulated portfolio could improve returns, on an absolute and risk-adjusted basis.

Three sample portfolios

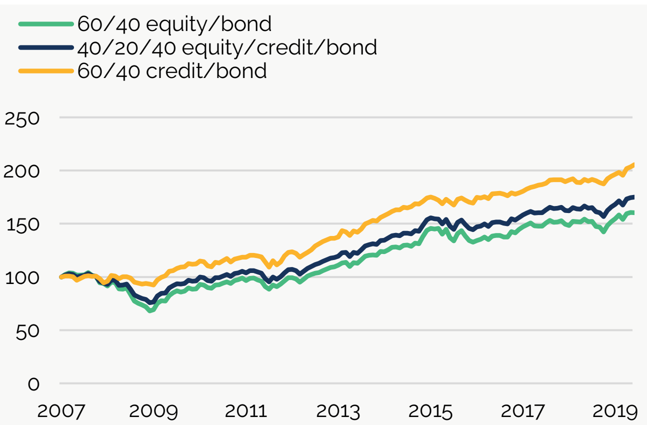
We constructed three portfolios using major European equity and bond benchmarks and the iTraxx European Performance Credit Index, a levered European credit index with primarily investment grade exposure and minimal interest rate risk (*details overleaf*). The portfolios were rebalanced monthly.

Traditional 60/40 equity and bond
60% MSCI Europe, 40% Bloomberg Barclays Euro Aggregate Bond

Blend 40/20/40 equity, credit, bond
40% MSCI Europe, 20% iTraxx European Performance Credit Index, 40% Bloomberg Barclays Euro Aggregate Bond

Non-traditional 60/40 credit and bond
60% iTraxx European Performance Credit Index, 40% Bloomberg Barclays Euro Aggregate Bond

Portfolio performance since 2007



	Return (Ann.)	Volatility	Sharpe ratio	Max draw-down
60/40 equity and bond	3.9%	8.9%	0.39	34.6%
40/20/40	4.6%	7.7%	0.53	26.6%
60/40 credit and bond	6.0%	6.4%	0.83	9.1%

	Sharpe ratio			
	1y	3y	5y	10y
60/40 equity and bond	0.71	0.83	0.62	0.88
40/20/40	0.95	1.00	0.75	0.99
60/40 credit and bond	1.74	1.39	1.07	1.15

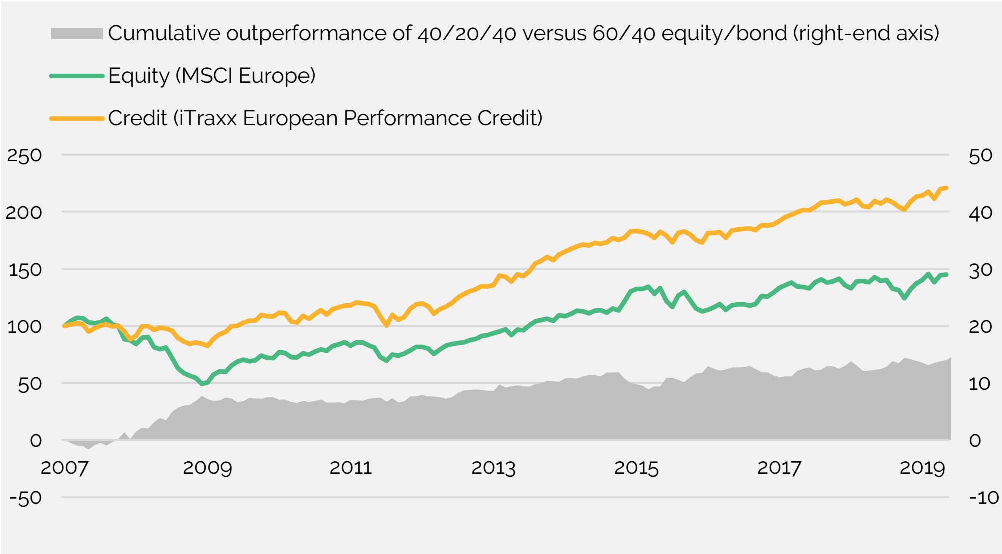
Data: Tabula/Bloomberg, 31 March 2007 to 30 August 2019. ITraxx European Performance Credit Index inception: 20 March 2007. Equity performance is net total return. Bond performance is total return. Performance of the credit index Is simulated by IHS Markit. ***Regulatory risk warning:*** *Past performance (actual or simulated) is not a reliable Indicator of future returns.*

Credit has delivered equity-like performance, but with lower drawdowns

When does the credit component add most value?

The chart shows the outperformance of the 40/20/40 portfolio, with 20% credit, relative to the traditional 60/40 portfolio, plus the individual equity and credit indices. While these indices have been highly correlated, the credit index had lower drawdowns, particularly during the financial crisis.

Substituting 20% of the equity allocation with credit enhanced performance during the financial crisis and in more recent periods of market turmoil. Underperformance has tended to be in strong equity market rallies, for example in early 2015.



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Liquid and accessible credit exposure via Tabula ETF

About the iTraxx European Performance Credit Index

Developed by Tabula in partnership with IHS Markit, the index provides diversified exposure to European corporate credit, primarily investment grade. It reflects the return from selling protection on the current series of iTraxx Europe 5y (investment grade) and iTraxx Crossover 5y (sub-investment grade). It takes total market exposure of 300%, allocated in an 80/20 ratio to iTraxx Europe and iTraxx Crossover respectively.

The iTraxx European Performance Credit Index is available via a Tabula ETF trading on the London Stock Exchange (TCEP LN). Visit TabulaIM.com for full details.

Contact us

We are happy to provide detailed analysis of these portfolios or to discuss other ways to use our credit ETFs in portfolio construction.

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