Tabula insights:
Is timing credit worth it?

October 2019

This paper assesses the value of market timing in European credit, using the case of a CDS based strategy.

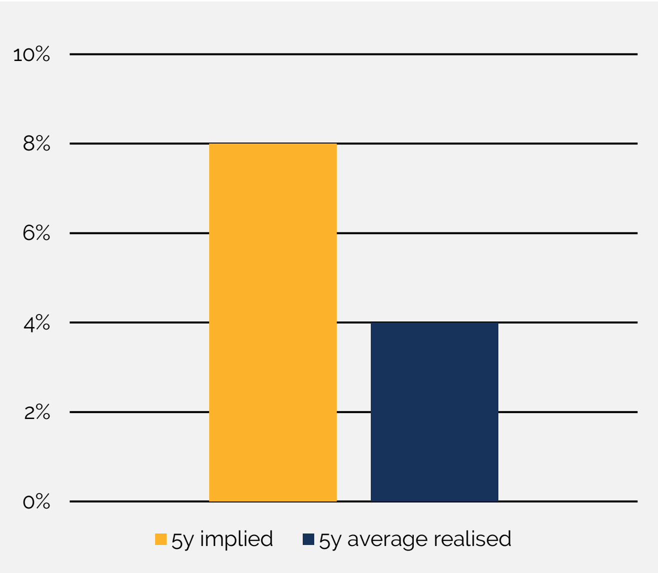
Is timing credit worth it?

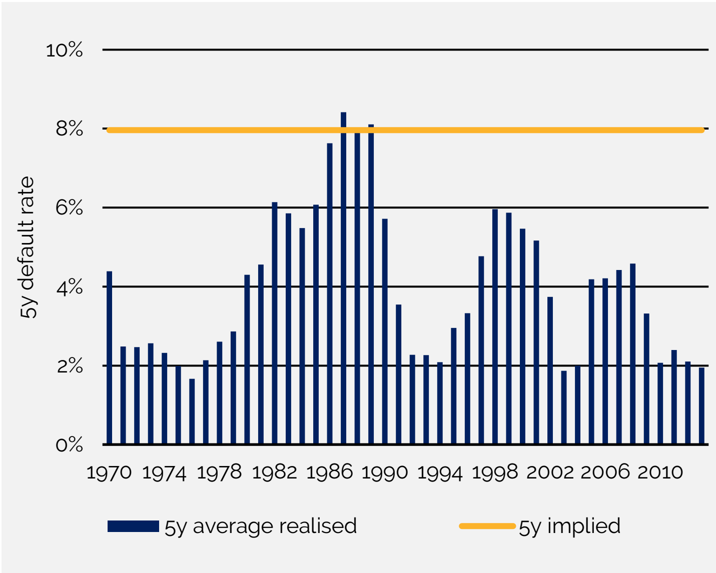
With absolute spread levels in European credit compressing to near historic lows on the back of central bank measures, investors are questioning the attractiveness of the buy-and-hold approach. This whitepaper assesses the value of weathering market volatility and staying long in a CDS-based credit strategy with a twelve-year performance history in effort to profit from the ongoing carry and roll-down of the credit curve. This approach is tested in comparison to three momentum indicator-based trading strategies to examine whether attempting to time credit spreads to determine entry points would have meaningfully improved performance.

Why access credit with CDS?

CDS indices are the most broadly traded credit instruments with tight bid/offer spreads and deep liquidity. Accessing credit risk premia without the interest rate component inherent to cash bonds, enables investors to more effectively capture the dislocation between implied and realised default rates. By concentrating liquidity, indices trade more efficiently than single name CDS or comparable bond products. Central clearing of actively traded indices reduces counterparty risk and allow easy scaling of exposure with standardised contract terms.

The strategy used to invest in European spreads in this whitepaper is the iTraxx European Performance Credit Index (ITRXPRFL) which scales up exposure to two highly liquid and established indices, the iTraxx Europe 5y and iTraxx Crossover 5y. It takes total market exposure of 300%, with 80% allocated to investment grade and 20% to high yield via a protection seller position, making it effectively long credit. As seen below, the premium resulting from the difference between realised and implied default rates has been a persistent feature of the index in almost every year since 1970:





Data: Moody's Annual Default Study - Corporate Default and Recovery Rates, 1920-2017. Implied default rates as of 7th May 2019. Regulatory risk warning: Past performance is not an indicator of future results.

Additionally, the index offers a second source of income by rolling contracts in the underlying indices. All else equal, a protection seller generates a positive "roll" return when the credit curve is upward sloping. Due to the persistent steepness of the credit curve, this component has provided an additional source of income at a time of historically low European government bond yields as well as during periods of relatively low spread levels, contributing 2.6% to the past one-year return of 6.9%.

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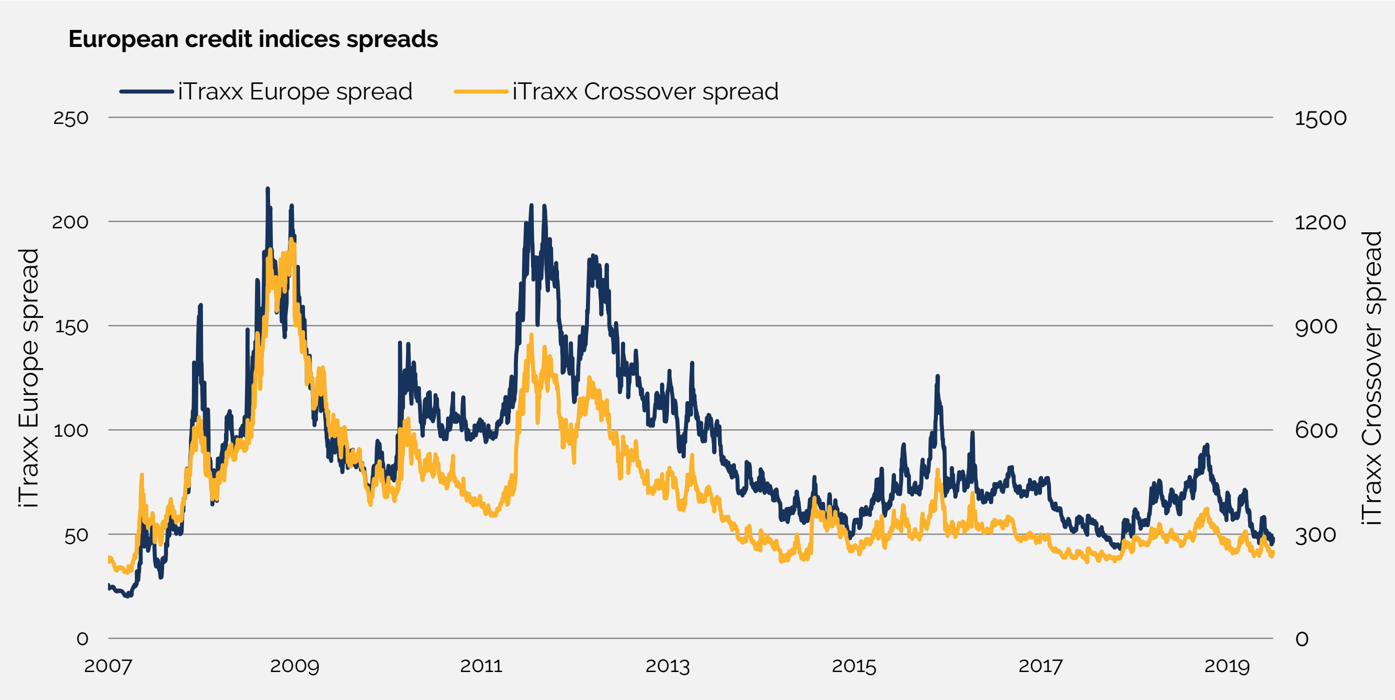
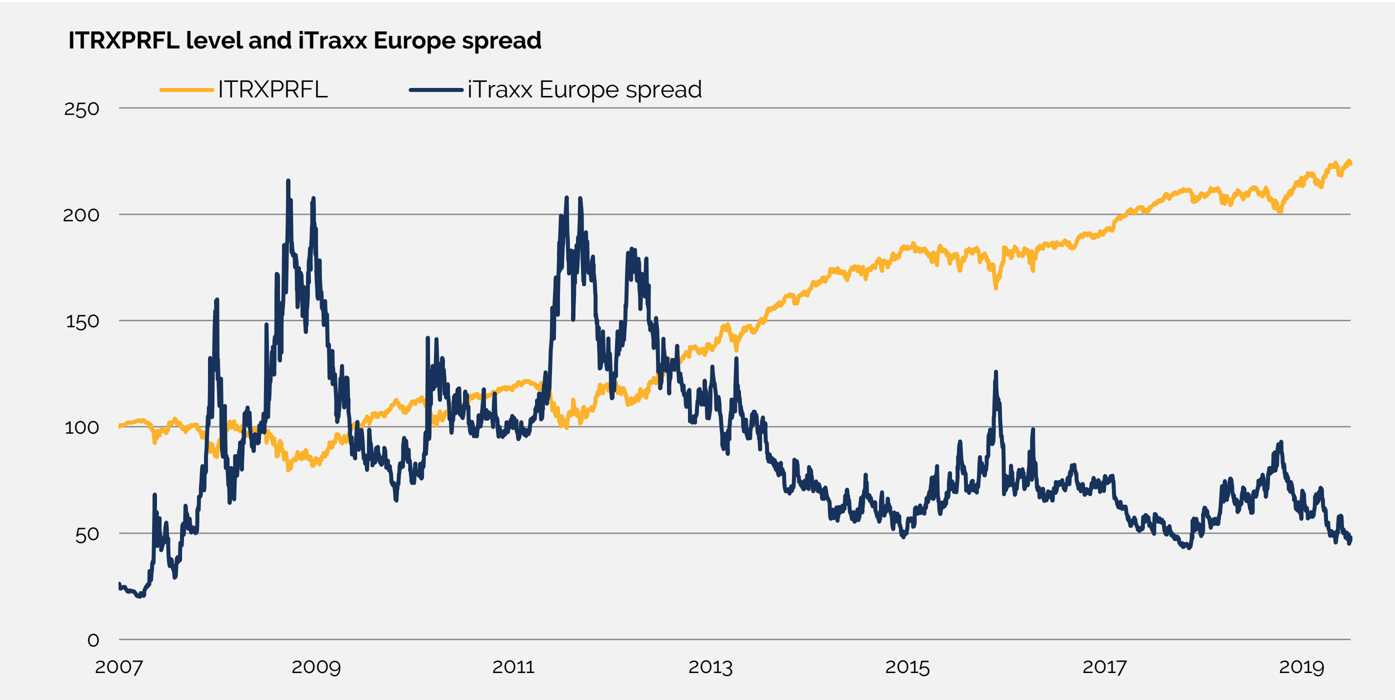
Due to the high correlation of spreads in the two underlying indices, as shown below, this paper takes the iTraxx Europe as the benchmark for indicating spreads in European investment grade credit as this is the main component of the credit strategy.



Data; Tabula, for the period from index inception on 20 March 2007 to 17 September 2019.
Regulatory risk warning: Past performance is not an indicator of future results.

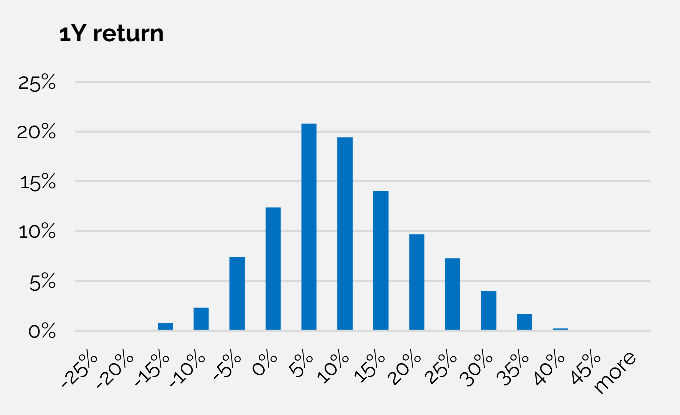


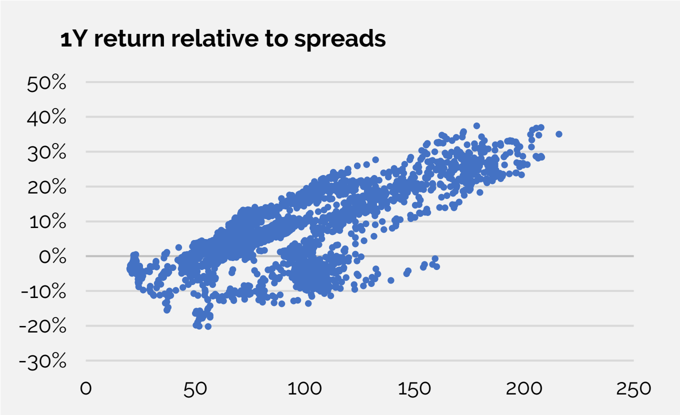
Data: Tabula, for the period from index inception on 20 March 2007 to 17 September 2019.
Regulatory risk warning: Past performance is not an indicator of future results.

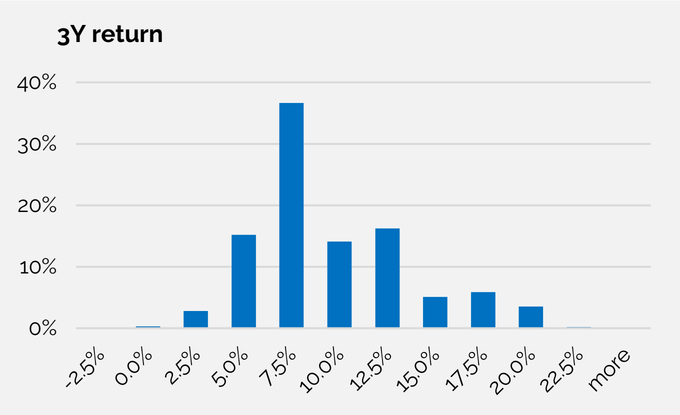
Are Spreads a good indicator for future performance?

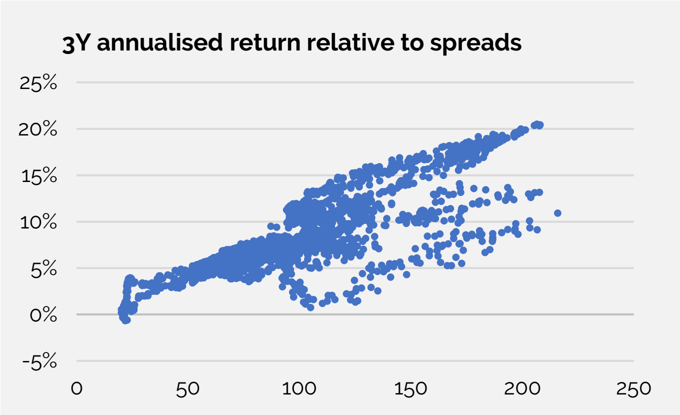
To examine the relationship between absolute spread levels and performance we analysed the performance of the strategy over different time horizons based on the spread levels at the time of entry.

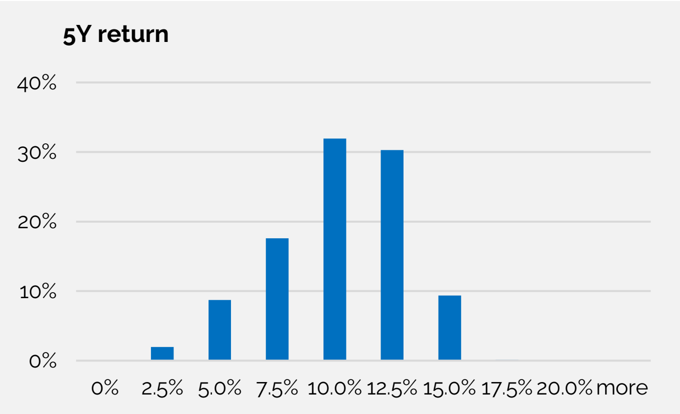
The below charts break down the annualised returns relative to spread levels over one, three and five-year time periods since inception using daily returns:

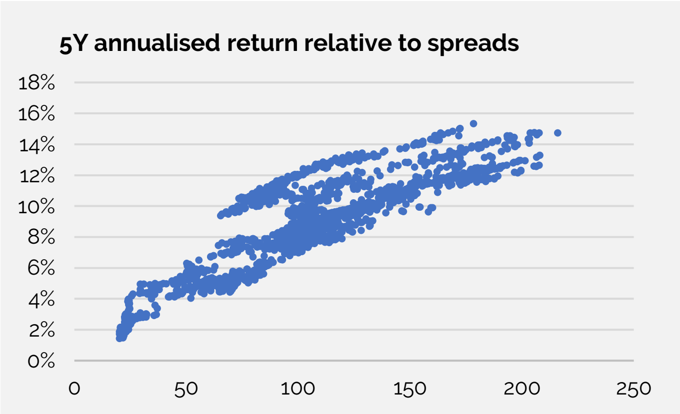












Data: Tabula, for the period from index inception on 20 March 2007 to 17 September 2019.
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Returns were positive 76.8% of the time over the one-year period and increased to 99.7% of the time on an annualised basis, once the time period was extended to three years. This rose to 100.0% of the time over the five-year period. A broadly positive relationship between absolute spread levels and returns, but also a higher dispersion can be seen over the three-year horizon.

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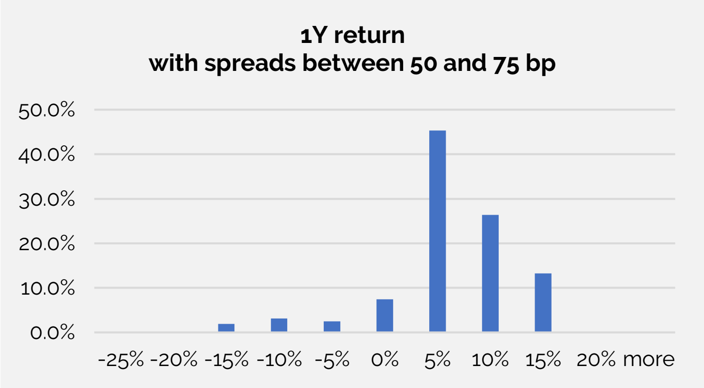
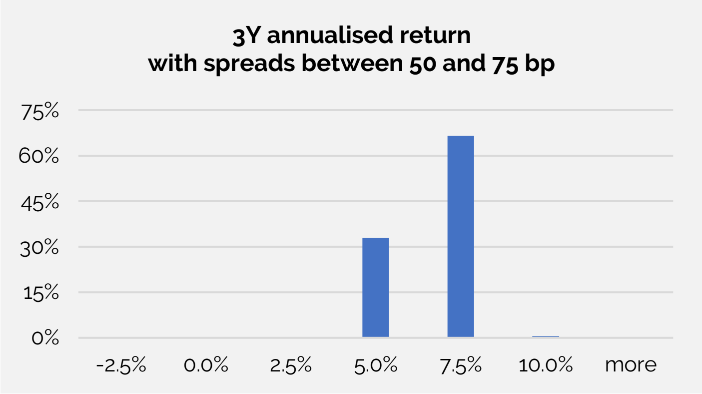
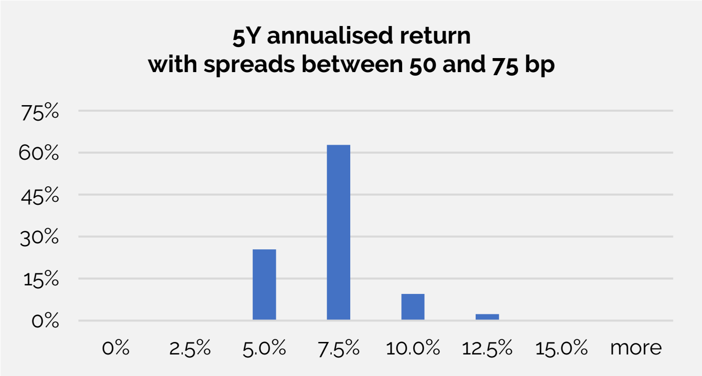
Are low spreads a bad entry point?

Next, we examine index performance with spread levels at the lower end of the range to assess whether this would significantly reduce returns. The below charts illustrate performance with spreads at levels reflective of current conditions at between 50 and 75 bp; this has constituted the range for spread levels for 37% of the time since 2007.

The credit strategy delivered largely positive performance even at low spreads







The results challenge the belief that low spreads constitute a bad entry point

Data: Tabula, for the period from index inception on 20 March 2007 to 17 September 2019. Regulatory risk warning: Past performance is not an indicator of future results.

The performance improves to being positive 84.9% of the time over the one-year period, 99.5% of the time over three years, and 100% of the time over five years, indicating that low spreads were generally a good entry point over the last twelve years.

Would attempting to time the market have made a significant difference?

We tested simulated momentum strategies which sought to capture market trends on 20, 60 and 120-day bases. In these strategies, buy actions were enacted when prices were higher than the past moving day average for five consecutive days and sell actions when prices fell below the average over the same period. A transaction cost of 10bps was applied to every buy and sell transaction.

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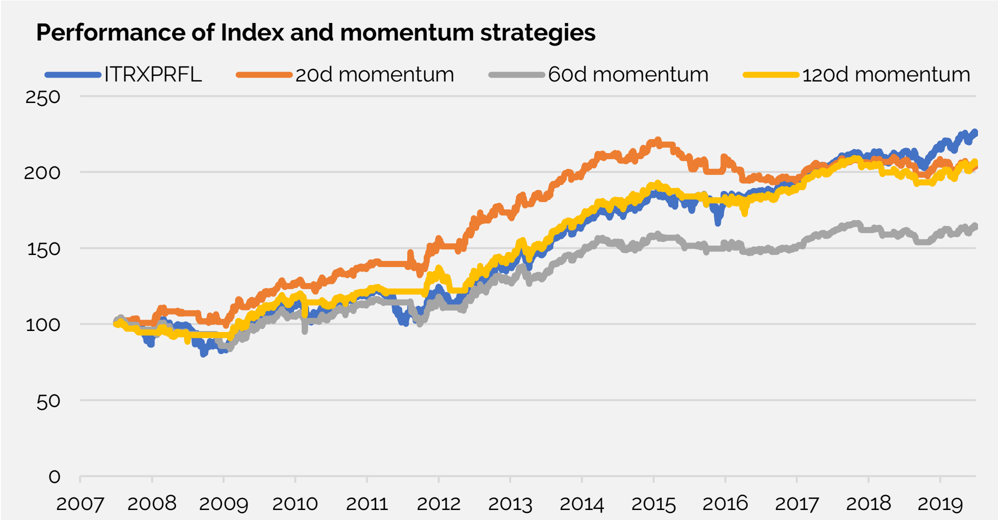
Buy and hold is comparable to 20, 60 and 120-day momentum strategies

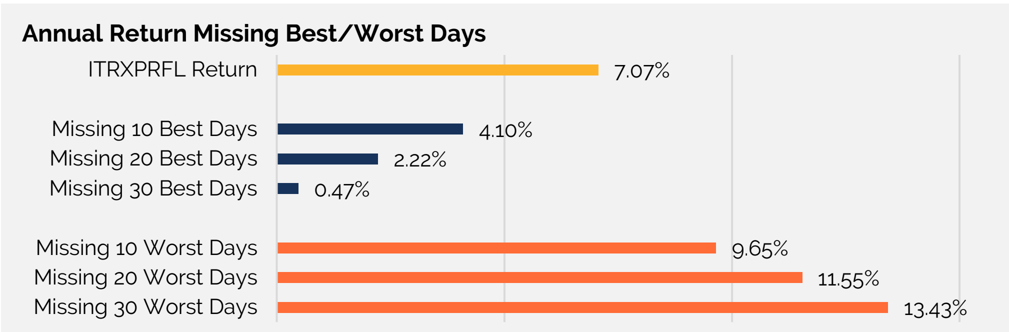
The following charts indicate that attempting to capture upward and downward market trends would not significantly improve performance compared to a buy-and-hold of the strategy. The 20-day based indicator had a period of outperformance but gave away the advantage over the last five years, resulting in an underperformance over whole period. The 60-day based strategy resulted in meaningful worse results and the 120-day based strategy performed mainly in line with a buy-and-hold approach, yet underperformed in the last two years.



	Days of positive returns		
	One-year	**3-year (ann.)**	**5-year (ann.)**
ITRXPRFL	77.1%	99.7%	100.0%
20-day momentum	74.1%	75.7%	93.6%
60-day momentum	67.6%	100.0%	100.0%
120-day momentum	77.0%	100.0%	100.0%

Data: Tabula, for the period from index inception on 20 March 2007 to 17 September 2019.
Regulatory risk warning: Past performance is not an indicator of future results.

Furthermore, while a hypothetical "perfect active timing strategy" that successfully misses the worst days in the market each year could improve returns, missing the best days can negatively impact returns to a similar degree (see below chart).



Data: Tabula, for the period from index inception on 20 March 2007 to 17 September 2019.
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The strategy is available as a UCITS ETF (TCEP)

Considering that a perfectly executed active timing strategy is practically impossible, and the index has delivered positive performance even at low spread levels over the last twelve years, there appears to be a strong case for the buy-and-hold approach.

The iTraxx European Performance Credit Index is available for trading via the Tabula European Performance Credit ETF (ticker: TCEP) on the London Stock Exchange and BX Swiss.

Get in touch to find out more or visit **www.tabulaim.com**

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