Virtus Investment Partners

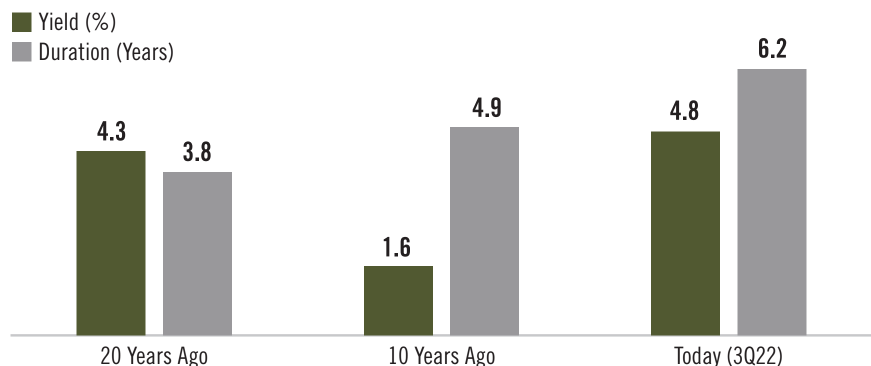
The Case for Short Duration High Income

Short duration high yield bonds may offer attractive income at lower levels of volatility and rate risk compared with equities.

It's no secret that fixed income has had a rough year due to market concerns over rising rates, inflation, and recession risk. Traditional core bond performance was particularly hard hit due to long-term secular trends. Over the last 20 years, the Bloomberg U.S. Aggregate Index – a representative snapshot of traditional core bond performance – has declined in yield while its duration increased, leaving investors with less protection from rising rates and inflation, and diminishing potential for total returns.

As the market hits the reset button on prices to take these concerns into account, investors are seeking alternative opportunities to gain income while offsetting losses. A strategy that focuses on short duration high yield debt issued by both public and private companies may provide rate risk and inflation protection and relatively attractive yield with less overall volatility than equities.

BLOOMBERG U.S. AGGREGATE INDEX – DURATION AND YIELD



Past performance is not indicative of future results. Source: Bloomberg LP. Index: Bloomberg U.S. Aggregate Bond Index. As of September 30, 2022.

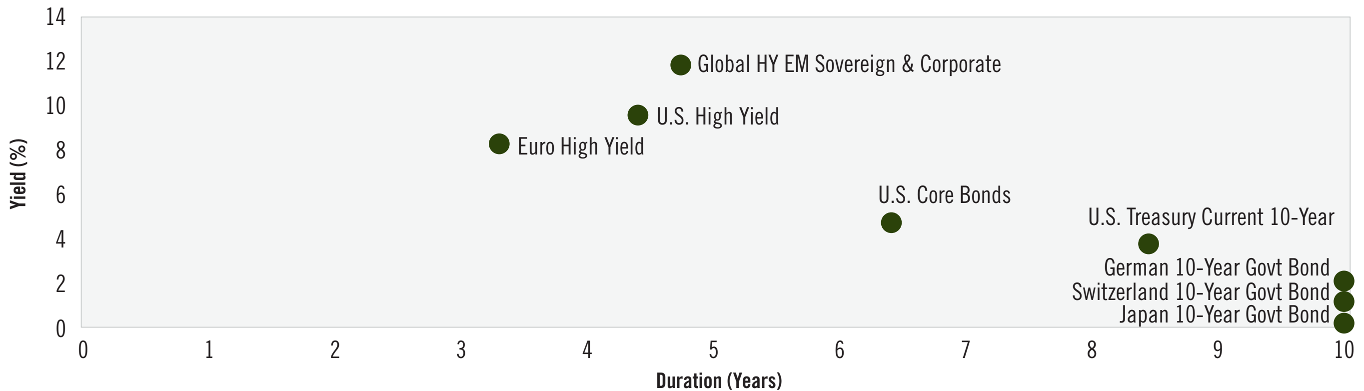
Short duration high yield may mitigate rate and credit risk

With inflation prints still worryingly high, the Fed has communicated that its mandate to tame inflation will not subside anytime soon – meaning that there's risk of more rate hikes ahead, even taking the existing hikes under account.

Furthermore, the market is increasingly worried about the possibility of these aggressive rate hikes tipping the economy into a recession. But short duration high yield might bring a mitigation strategy that effectively addresses both concerns.

As an asset class, short duration U.S. high yield offers lower duration and higher yield compared with core bonds, leaving it less exposed to duration risk and enabling its prices to reset at a faster clip to take advantage of the yield pick-up from rising rates.

DURATION RISK: MARKET YIELDS AND DURATION



Past performance is not indicative of future results. Source: Bloomberg LP. As of September 30, 2022. U.S Core Bonds: Bloomberg Aggregate Bond Index. U.S. High Yield: ICE BofA U.S. High Yield Master II. Euro High Yield: ICE BofA Euro High Yield Index. U.S Treasury Current 10-Year: ICE BofA U.S. Treasury Current 10-Year Index. Global HY EM Sovereign & Corporate: ICE BofA Global High Yield Corporate & Sovereign Index. The German 10-Year Government Bond matures April 2032, Japan 10-Year Government Bond matures March 2030, and Switzerland 10-Year Government Bond matures May 2032.

And while it's true that high yield could suffer in the event of a recession, we believe a strategy focused on shorter-duration high yield bonds, with the option to also invest meaningfully in floating rate loans, would still help outperform the core bond index and potentially deliver superior relative returns.

Short duration high yield may offer strong performance with a smoother ride

Though high yield bonds have historically shown a stronger correlation with equities than U.S. Treasuries, there are important differences between the two asset classes. For one, while stock gains rely on corporate earnings growth and valuation multiples, high yield bond returns rely on regularly scheduled coupon payments and yield. This means that high yield bonds behave differently than equities, though the two often generate similar returns, because the underlying asset has a claim on some recovery in the event of a borrower default.

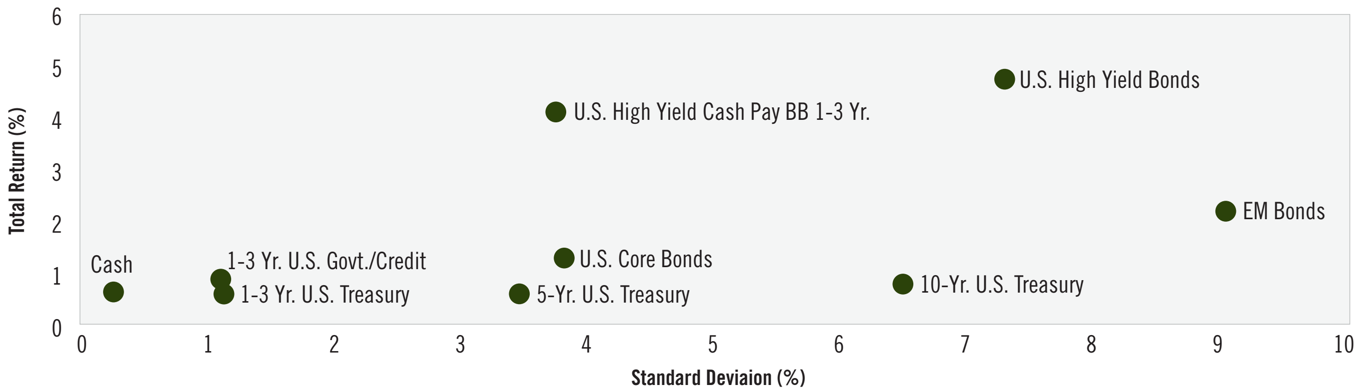
HIGH YIELD BONDS VS. EQUITY MARKETS (7/1/83 – 9/30/22)

	Annualized Return	Standard Deviation	Return Per Unit of Risk	Rolling 3-Year Periods		
				Best	Worst	% Negative
High Yield	8.06%	8.41%	1.0	26.4%	-7.6%	5%
Large Cap Equity	10.68%	15.17%	0.7	33.3%	-16.1%	14%
Small Cap Equity	8.47%	19.48%	0.4	32.0%	-17.8%	11%

Past performance is not indicative of future results. As of September 30, 2022. Source: JPMorgan Research, Standard & Poor's, FTSE Russell, Bloomberg. As of September 30, 2022. The High Yield, Large Cap Equity, and Small Equity Markets are represented by the Bloomberg U.S. Corporate High Yield Index, S&P 500® Index, and the Russell 2000® Index, respectively. Returns were calculated using monthly data and begins with the inception of the Bloomberg High Yield Credit Index on 7/1/83.

Within high yield, shorter duration bonds may offer an even more attractive risk/return profile for investors seeking liquidity and risk-adjusted income. High yield bonds with shorter duration may provide better protection around rate risk while delivering higher total returns at lower levels of volatility compared with 10-year U.S. Treasuries, equities, or U.S. high yield. This may be especially relevant as inflation remains a headline risk and the economy slows amid rising rates.

HISTORICAL RISK/RETURN OF U.S. FIXED INCOME LANDSCAPE



Past performance is not indicative of future results. Source: FactSet: ICE Data Services; Morningstar. Short Duration High Yield Bonds: ICE BofA 1-3Y BB US Cash Pay High Yield Index; U.S. Core Bonds: Bloomberg U.S. Aggregate Bond Index; EM Bonds: JPM EMBI Global Core Index; U.S. High Yield Bonds: ICE BofA U.S. High Yield Index; 1-3 Year Govt/Credit: ICE BofA U.S. Corp & Govt 1-3 Year Index; 10-Yr U.S Treasury: ICE BofA U.S. Treasury Current 10 Year Index; 5-Yr U.S. Treasury: ICE BofA U.S. Treasury Current 5 Year Index; 1-3 Yr U.S. Treasury: ICE BofA U.S. Treasuries 1-3 Year Index; Cash: ICE BofA 3-Mo U.S. Treasury Bill Index.

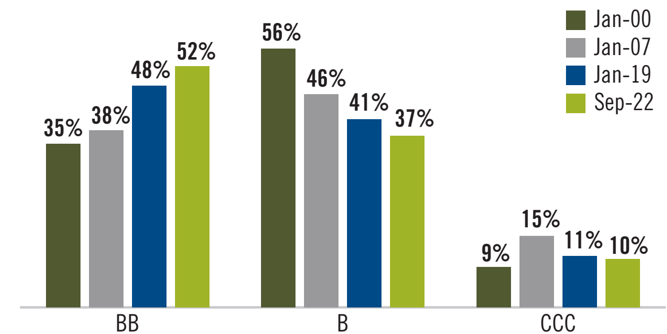
High yield looks healthier than in recessions past

Another silver lining is that high yield bond issuers – the corporate borrowers of high yield debt – currently show historically low default rates. While the broader macroeconomic picture suggests that this rate may be set to rise over the next few months, that rise starts from a historically low 0.96%, according to J.P. Morgan's credit research. Even if default rates triple, this would still fall well short of the default rates during the COVID recession.

Furthermore, corporate balance sheets for high yield issuers show average net interest coverage ratios at a record high at around 5.3x – the highest on record – implying that these issuers are generally equipped to weather a certain threshold of slowed economic growth and higher cost of borrowing.

For further context, the current high yield market is the highest rated in history. Compared with 2000, BB-rated bonds have now grown to comprise a greater share of the index, while B-rated bonds have steadily become a smaller share of the index.

HIGH YIELD CREDIT QUALITY COMPOSITION JANUARY 2000-SEPTEMBER 2022



Source: Bloomberg LP. Index: ICE BofA U.S. High Yield Constrained Index. As of September 30, 2022.

This isn't to say that high yield as an asset class is indiscriminately solid. Individual issuers, particularly certain CCC-rated companies and borrowers with lower interest coverage ratios and weak cash flow, will feel the headwinds from recession threats, rising rates, and inflation. As default rates and distress levels are forecast by consensus to increase in the coming quarters, credit selection will be key to avoid undue credit risk as the market's risk-off sentiment persists.

Newfleet's history

Identifying relative value within an ever-shifting credit cycle is the foundation of Newfleet's process. Newfleet has managed portfolios with diversified fixed income sectors – including out-of-index credits – since the early 1990s, broadening its approach as new sectors have evolved.

Newfleet can recognize new opportunities early thanks to the experience and expertise of its senior sector specialists. Collaboration, a cornerstone for Newfleet, is rewarded, and the investment team is compensated based on how well the multi-sector strategies perform overall, not on specific sector contributions.

Newfleet's process drives strong risk-adjusted returns using a complementary combination of skilled credit analysis and active portfolio management. By focusing on high quality companies while exploring dynamic trading opportunities, the team can take advantage of structural inefficiencies in the fixed income market to generate income while limiting downside risk.

About Newfleet Asset Management

Newfleet Asset Management, distinguished by its longstanding multi-sector approach, dynamic structural integration, experience, and culture of collaboration, has a proven track record of successfully navigating the fixed income markets to consistently generate excess returns over full market cycles.

About Virtus Investment Partners

Virtus Investment Partners (NASDAQ: VRTS) is a distinctive partnership of boutique investment managers singularly committed to the long-term success of individual and institutional investors. The company provides investment management products and services through its affiliated managers and select subadvisers, each with a distinct investment style, autonomous investment process, and individual brand.

To learn more about solutions designed to seek high current income while minimizing volatility, please contact us at 800-243-4361 or visit virtus.com

INDEX DEFINITIONS

The **Bloomberg U.S. Aggregate Bond Index** is a broad-based benchmark that measures the investment grade, U.S. dollar-denominated, fixed-rate taxable bond market, including Treasuries, government-related and corporate securities, MBS (agency fixed-rate and hybrid ARM pass-throughs), ABS, and CMBS. The **Bloomberg U.S. Corporate High Yield Index** is an unmanaged, U.S. dollar– denominated, nonconvertible, non-investment-grade debt index. The index consists of domestic and corporate bonds rated Ba and below with a minimum outstanding amount of $150 million. The **ICE BofA US Cash Pay High Yield Index** tracks the performance of U.S. dollar denominated below investment grade corporate debt, currently in a coupon paying period, that is publicly issued in the U.S. domestic market. The **ICE BofA 1-3 Year BB US Cash Pay High Yield Inde**x is a subset of the ICE BofA US Cash Pay High Yield Index including all securities with a remaining term to final maturity less than 3 years and rated BB1 through BB3, inclusive. The **ICE BofA U.S. High Yield Constrained Index** tracks the performance of U.S. dollar denominated below investment grade corporate debt publicly issued in the U.S. domestic market but caps issuer exposure at 2%. The **ICE BofA Euro High Yield Index** tracks the performance of Euro denominated below investment grade corporate debt publicly issued in the euro domestic or eurobond markets. Qualifying securities must have a below investment grade rating (based on an average of Moody's, S&P, and Fitch). The **ICE BofA 1-3 Year U.S. Corporate & Government Index** is a subset of ICE BofA U.S. Corporate & Government Index including all securities with a remaining term to final maturity less than 3 years. The **ICE BofA Global High Yield Corporate & Sovereign Index** tracks the performance of the below investment grade global debt markets denominated in the major developed market currencies. The **JPMorgan EMBI Global Core Index** is a broad, diverse U.S. dollar denominated emerging markets debt benchmark that tracks the total return of actively traded debt instruments in emerging market countries. The **Russell 2000® Index** is a market capitalization weighted index of the 2,000 smallest companies in the Russell Universe, which comprises the 3,000 largest U.S. companies. The **S&P 500® Index** is a free-float market capitalization-weighted index of 500 of the largest U.S. companies. The indexes are calculated on a total return basis. The indexes are unmanaged, their returns do not reflect any fees, expenses, or sales charges, and are not available for direct investment.

IMPORTANT RISK CONSIDERATIONS

Credit Risk: If the issuer of a debt instrument fails to pay interest or principal in a timely manner, or negative perceptions exist in the market of the issuer's ability to make such payments, the price of the security may decline. **Debt Instruments:** Debt instruments are subject to greater levels of credit and liquidity risk, may be speculative and may decline in value due to changes in interest rates or an issuer's or counterparty's deterioration or default. **High Yield Fixed Income Securities:** There is a greater risk of issuer default, less liquidity, and increased price volatility related to high yield securities than investment grade securities. **Market Volatility:** The value of the securities in the portfolio may go up or down in response to the prospects of individual companies and/or general economic conditions. Price changes may be short- or long-term. Local, regional, or global events such as war (e.g., Russia's invasion of Ukraine), acts of terrorism, the spread of infectious illness (e.g., COVID-19 pandemic) or other public health issues, recessions, or other events could have a significant impact on the portfolio and its investments, including hampering the ability of the portfolio's manager(s) to invest the portfolio's assets as intended. **Issuer Risk:** The portfolio will be affected by factors specific to the issuers of securities and other instruments in which the portfolio invests, including actual or perceived changes in the financial condition or business prospects of such issuers. **Interest Rate:** The values of debt instruments may rise or fall in response to changes in interest rates, and this risk may be enhanced for securities with longer maturities. **Prospectus:** For additional information on risks, please see the fund's prospectus.

The commentary is the opinion of the Virtus. This material has been prepared using sources of information generally believed to be reliable; however, its accuracy is not guaranteed. Opinions represented are subject to change and should not be considered investment advice or an offer of securities.

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