"Still… in this world only winter is certain." – George R.R. Martin, *A Dance with Dragons*

September 9, 2016

Tranquility

If you have ever visited our Hampton office at this time of year, you can probably appreciate why this is where we choose to work and live. Autumn in New Hampshire is typically characterized by comfortable temperatures, colorful foliage, and the ubiquity of pumpkin flavoring. Recent years have been quite typical in this regard. Take, for instance, the autumn of 2014. That autumn the skies were cobalt blue, the sun shined brightly, a calm breeze blew through the air, and Dunkin Donuts served pumpkin spice lattes and muffins. For those of us at Perspecta, these were all (mostly) good things. From our pristine campus at Liberty Lane, the world felt like a tranquil place.

Then, suddenly, the New England winter of 2014-2015 happened.

That winter, as you may recall, was one for the record books. Boston experienced its single greatest winter snowfall on record, picking up 110.6 inches. Fifty miles to the north in Hampton, 56.5 inches of snow fell in February alone.[1] That month, it seemed as though a major storm would strike us every two or three days. Gusty winds, slippery roads, and blinding snows became the norm, making our daily commutes an adventure. Our Liberty Lane campus became quite the winter wonderland. The tranquility we experienced in autumn was gone in what seemed like an instant. As we get set to enjoy another wonderful autumn, in the back of our minds we are all thinking, "How bad will winter be this year?"

Today, the markets appear as tranquil as the typical autumn in New Hampshire. In the U.S., Treasury yields are hovering near historic lows while the S&P 500 continues to make new, all-time highs. News that the market would typically find difficult to absorb (e.g. Brexit, terrorism, rising energy prices, failed coups, etc.) has been overwhelmed by the unprecedented level of commitment to low rates from central banks

[1] Source: National Weather Service and NOAA.

in Europe and Asia. Investors from across the globe are piling into relatively high yielding U.S. stocks and bonds, causing valuations to become extended. This benign state of the world was recently commented on in the Wall Street Journal, which noted that the dog days of summer were the least volatile in more than two decades.[2]

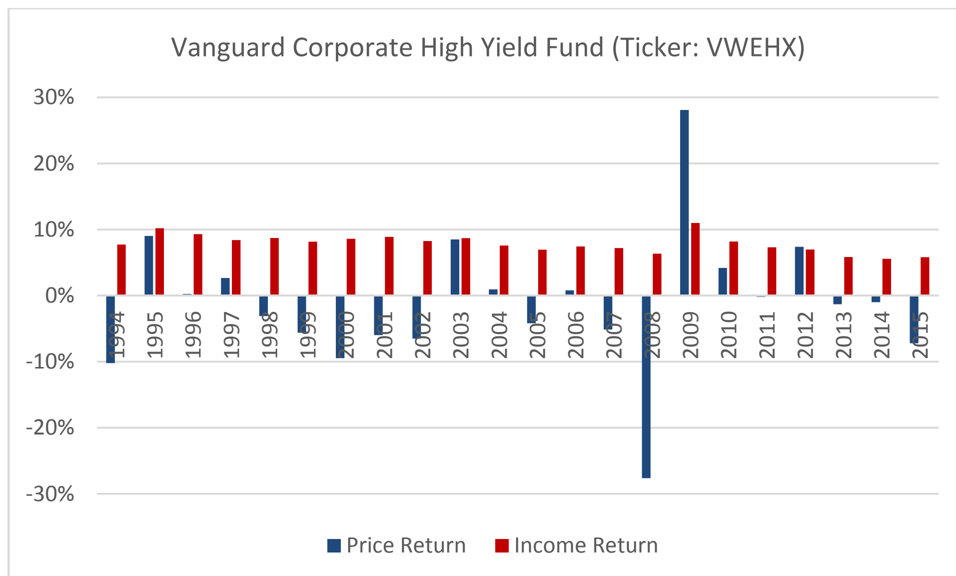
At Perspecta, we haven't forgotten the New England winter of 2014-2015. Similarly, we haven't forgotten previous periods of market volatility. In our view, higher inflation and higher interest rates remain highly likely looking out over the next several years. Or, to put it another way, winter is coming.

The question remains: how are we preparing for it?

U.S. Corporate High Yield

One way in which we are preparing for a world of higher inflation and higher interest rates is by putting money to work in short duration, U.S. corporate high-yield bonds. For those of you who are less familiar with the high-yield market, the following background should provide some helpful context as to why we like this particular asset class.

High-yield bonds, which we categorize as those with speculative grade ratings (i.e. below BBB- for S&P and below Baa3 for Moody's), have historically played a unique, debt and equity "hybrid" role in a diversified portfolio. As noted by the New York Times, the high-yield market has historically captured 80 percent of the gain in the S&P 500 index with just about half its volatility.[3] The superior risk adjusted returns are explained in part by the large coupon payments associated with these bonds. To illustrate this point, consider the Vanguard High Yield Corporate Fund, an actively managed fund with approximately $19.6B in AUM. From 1994 to 2015, this fund generated a positive +6.7% total annual return. However, coupon payments (i.e. income return) contributed a positive +7.9% to total annual return during this period while bond price changes (i.e. price return) was actually a drag of negative -1.2% on total annual return.[4] ***The overwhelming impact of large and consistent coupon payments on total annual returns helps reduce the volatility of high-yield as an asset class.***



[2] *It's Getting Scarily Quiet in the Stock Market*, The Wall Street Journal; August 23, 2016.
[3] *Junk Bonds Are Steadier Than You Might Think*, The New York Times; April 10, 2016.
[4] Source: Bloomberg.

Of course, volatility isn't the only way to define risk. One other way in which risk can be defined in this context is the likelihood of default and subsequent loss of principal. On this basis, high-yield bonds have performed well. Historically, the default rate in the high-yield bond market has averaged 4.2% while the recovery rate (i.e. the value recouped by bondholders through bankruptcy or restructuring) has averaged 48.8%.[5] ***Therefore, a basket of high-yield bonds which replicates the broader market should, in theory, expect to lose roughly 2.1% per year to defaults across the credit cycle. While not a trivial figure, it is one that should be more than fully offset by coupon payments made by the remaining issuers held in the portfolio.*** Between the limited volatility and the fairly low incidence of loss, this asset class doesn't strike us as particularly risky for those seeking higher levels of income relative to higher quality, lower yielding alternatives.

Regardless of how we define risk, the historical results achieved by this asset class are impressive and support the argument that long-term oriented investors should allocate a meaningful percentage of their portfolio to it. However, as mentioned above, our bias at this time is toward a short duration portfolio. The reason is simple: shorter duration mitigates interest rate risk. If higher inflation and higher interest rates materialize in the years ahead, as we expect they will, the flexibility provided by a short duration portfolio of high-yield bonds will allow us to take advantage. Simply put, this approach allows us to earn an attractive yield in the near-term while lowering our sensitivity to changes in interest rates caused by higher inflation over the longer-term.

In many ways, we view short duration, U.S. corporate high-yield as a "snow blower" that can help our portfolios manage the next difficult winter.

Recent Results

The short duration, U.S. corporate high-yield bond market, as measured by the BAML 1-5 Year U.S. High Yield Index, has performed well this year, advancing +13.0% year-to-date as of August 31st.[6]

In our view, the U.S. corporate high-yield market has performed well this year due to the aforementioned quantitative easing programs in place at central banks across Europe and Asia, as well as the recovery in energy prices that has occurred since mid-February. On the first point, the effects of monetary policy have been widespread. The 10-Year U.S. T-Note now yielded just 1.58% at the end of August and government yields in many developed economies are now negative. These historically low interest rates have driven income-oriented investors to seek shelter in higher yielding asset classes, including U.S. corporate high yield. On the second point, the run in energy prices since mid-February has improved the outlook for energy credits and provided a jolt to the broader sector. These credits struggled mightily in 2015 as energy prices collapsed and drilling activity slowed. Nonetheless, the energy sector remains a significant component of the U.S. corporate high-yield market, constituting about 14.5% of the BAML 1-5 Year U.S. High Yield Index. This sector has risen +21.1% year-to-date, second only to the +30.7% rise of the basic materials sector, which itself constitutes another 9.5% of the index.

Regular readers of our investment outlooks may be wondering how Perspecta's internally managed, short duration, U.S. high-yield strategy has performed this year. Well, our results have fared even better than the BAML 1-5 Year U.S. High-Yield Index: our composite portfolio has advanced +15.9% through August 31st. Since its May 2011 inception, our composite has generated a +6.0% annualized return, beating the BAML 1-5 Year U.S. High-Yield Index by +80bps/year.[7]

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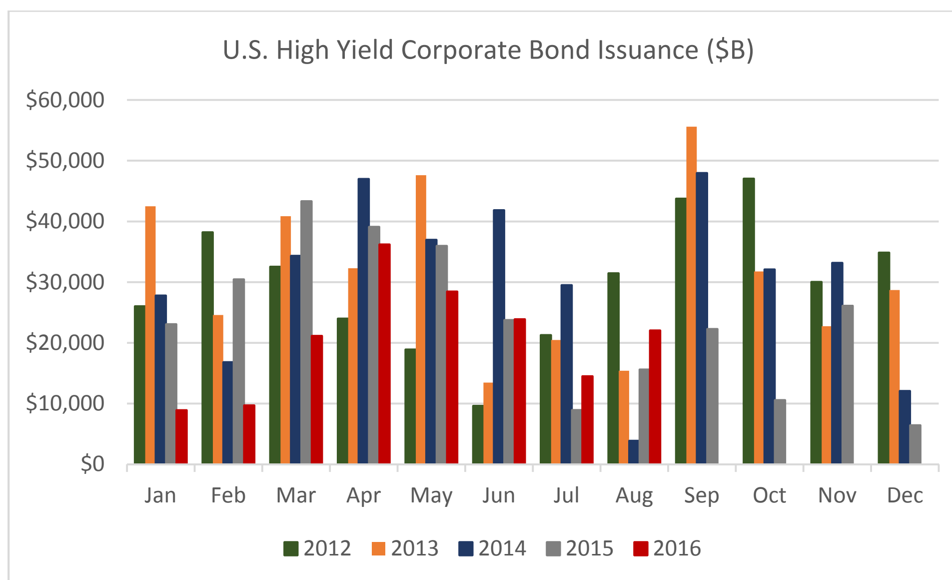
[5] *Corporate Default & Recovery Rates*, Moody's Investors Service; February 29, 2016.
[6] Source: Bloomberg.
[7] Perspecta performance is gross of fees and reflects our U.S. High-Yield composite as of 8/31/2016.

Outlook

Looking ahead, we believe the outlook for U.S. corporate high-yield remains positive. Modest growth in GDP, steady employment trends, and a very gradual pace of rate hikes by the U.S. Federal Reserve should help keep default rates from increasing rapidly. At 3.5%, default rates remain about -40bps below their average since 1988. While spreads are less attractive than they were at the start of the year, they remain within 30bps of their average since 1988 at 5.6%.[8] After starting the year off slowly, the market for new high-yield issues, a barometer of market sentiment, has recovered nicely as well.[9]



Moreover, we think that our short duration, U.S. corporate high-yield strategy is even more attractive than the short duration, U.S. corporate high-yield market as a whole. Consider the following summary statistics for Perspecta's U.S. corporate high-yield composite relative to the benchmark.

	Avg. Maturity	Current Yield	Yield to Worst	Composite Rating
Perspecta	2.3 Years	8.6%	7.9%	B-
BAML 1-5 Year	3.7 Years	7.1%	6.7%	B+

Conclusion

It seems that nearly all market commentary of late has centered on how difficult it is for income oriented investors to earn an attractive yield. Well, we believe that short duration, U.S. corporate high-yield offers a compelling yield in the near-term while allowing investors to maintain flexibility to adjust when inflation and interest rates move higher. We don't believe that locking in low rates for long-time periods makes much sense at this stage and would suggest investors avoid making these kinds of commitments in the current market environment.

Wherever you live and work, enjoy your autumn… and get ready for winter!

Robert C. Walker Jr., CFA
Perspecta Trust, LLC

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[8] Source: JP Morgan.
[9] Source: Bloomberg.