Take out insurance against the next downturn of corporate bonds: buy the quality factor

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The Quality factor has already been established as a value-creating investment strategy in connection with equities, but the strategy can also be successfully applied in connection with corporate bonds.

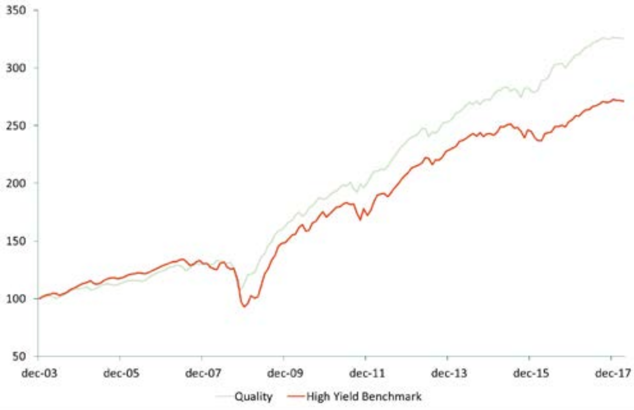
Quality versus growth

The quality factor is based on simple intuition: Investment in profitable and market-leading companies with healthy balance sheets will yield a higher return in the long term because they always generate positive cash flows. A risk premium strategy based on the quality factor will, indeed, select strong and robust companies that are profitable independent of the economic cycle.

Investment in growth companies may often seem very attractive in positive markets. As long as the market is positive, they can generate very decent returns, but if the market is subject to a correction, the entire gain will, unfortunately, often be lost. Growth companies often generate impressive earnings during cyclical upturns, but they are necessarily not that good at generating free cash flows. The reasons for this are often major investment programmes or massive credit sales. Once the economic cycle turns, growth will come to an end, and generally there will be no cash flow to continue the investment programme or, at worst, to repay debts.

Often the quality factor will work in the opposite way: moderate returns in positive markets, but limited losses during a market correction. The quality factor will offer a long-term relative return by moderating losses during a market correction relative to benchmark. Companies with very strong competitive power, low leverage and strong profitability will typically have good buffers against adverse economic trends. Irrespective of the surrounding economic situation, these companies have a solid ability to generate cash flows.

The quality factor cannot forecast a crisis, but companies with high scores on the quality factor will often perform better than the market when a crisis sets in. However, the factor cannot protect against negative returns during serious crises, but usually the returns will be better than those of the benchmark and most other factor strategies.

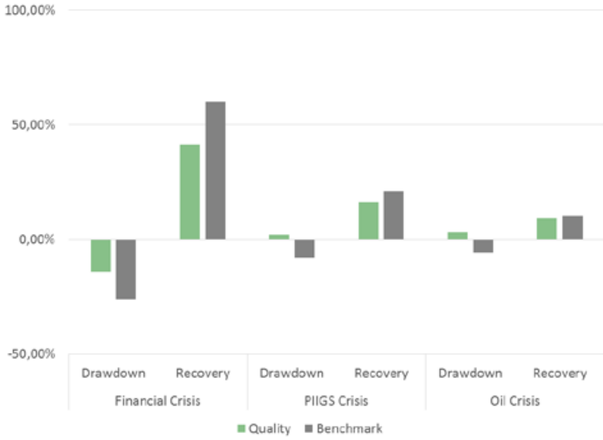


The chart shows the value development of the quality factor and global high yield since 2003. The long-term return for the quality factor is higher than that for benchmark due to small corrections during the financial crisis (2008), the PIIGS crisis (2011) and the US shale oil crisis (2015). Source: Jyske Capital.

Trading costs and the estimation of quality

Profitable and market-leading companies with healthy balance sheets are not created overnight. Typically, this will be a process over several years. Hence an investment strategy based on the quality factor will have a very low rate of turnover. Considering the very high trading costs for corporate bonds, the strategy will offer an advantage, for instance, relative to momentum strategies, which often result in a very high rate of turnover and hence very high trading costs. On the other hand, the quality factor resembles a buy-and-hold strategy due to the low rate of turnover. Investors buy robust companies and keep them throughout a crisis.

How is the quality factor estimated? Today there is extensive literature on the quality factor in an equities setting where the quality factor is typically estimated on the basis of key figures on profitability, size, leverage and stability in earnings. As the quality factor works in the same way for both corporate bonds and equities, a number of the key figures can be used again. For corporate bonds, the quality factor is estimated, among other things, on the basis of the companies' ability to transform earnings into free cash flows. If a company is able to transfer earnings to free cash flows over a large number of years, it may be considered a robust company that is able to withstand cyclical fluctuations.



Drawdown shows the return for the quality strategy and the global high yield benchmark from the top to the bottom during the financial crisis in 2008, the PIIGS crisis in 2011 and the USD shale oil crisis in 2015. Recovery shows the return one year after the bottom of the three crises. It appears from the chart that the quality factor outperforms benchmark during the three crises. Source: Jyske Capital

Long term rewards

The challenge of pursuing a quality factor strategy is that the strategy cannot keep up pace during a so-called bull market. Financial markets may often be positive over several years, while corrections are often strong, yet short-lived. The reward will materialise in the long term - not in the short term, nor in the medium term.

If investors do not have the patience to wait for the gain from the quality factor, they can attempt to 'time' the market and attempt to guess when to enter and exit the quality factor. However, often that proves to be very difficult. Often investors end up 'crying wolf' much too often and hence paying an abundance of trading costs. In particular, it may turn out to be very expensive to trade in and out of the corporate bond market based on false signals. Other investors assume too high risk as they are convinced we have entered a new world where everything keeps going up. Often such investors incur large losses when a correction sets in.

The solution to the problem may be a multi-factor approach - combining value, momentum and quality. In this way, investors will not lag behind in positive markets, nor have they ‘waived insurance’ when the correction sets in. In other words, they enjoy the good qualities from the quality factor without having to worry about timing the market.

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