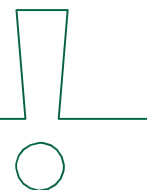


Corporate bonds: Robust return trough the credit cycle with a multi factor approach

Words by Martin Nybye Sørensen, Mikael Venø Munksgaard and Michael Holte Christensen, Jyske Capital

Exploiting factor risk premiums in equities has become common over the last twenty years – but there is still a lack of comparable strategies in corporate bonds. Jyske Capital has pioneered the approach with strong results.

Financial uncertainty and the incentive for multi factor investing

The financial markets are volatile and changes in economic cycles are hard to predict. Forecasting the outcome of potential crises is extremely difficult - will the Italian government crisis lead to a new PIIGS crisis, is the selloff in emerging markets the start of a new emerging market crisis or will tax cuts in the US lift growth even more? Will this potential crisis vaporize portfolio returns this time or will you end up “crying wolf” repeatedly ending up with transaction cost and misted opportunities that will erode portfolio returns?

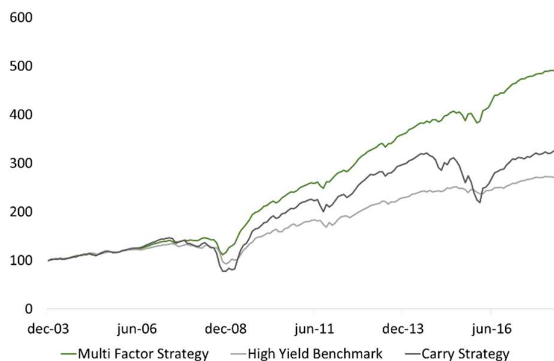
Instead of trying to predict the next major crisis, Jyske Capital uses a robust multi factor approach to manage corporate bonds. The multi factor strategy achieves superior returns compared to the high yield benchmark and the approach mitigate the worst drawdowns without removing the upside potential.

Components and performance of the multifactor model

The multi factor model of Jyske Capital is working with three main groups of factors driving excess return: Value, Momentum, and Quality. The role of Value is to select bonds that are mispriced compared to the fundamental credit quality of a company. High-ranking value bonds usually do well in a positive economic cycle, but returns are typically negative in the beginning of a crisis. The Momentum factor’s function is to find positive trending companies or exclude negative trending companies. Momentum works as an early warning factor. The role of Quality is to provide robustness in negative markets. High-ranking quality bonds are usually not interesting in positive markets, but mitigate drawdowns in distressed markets.

Each of the individual factors react differently to the changing economic cycles. The Value factor is the best performing single factor from a total return perspective, but it is also the most volatile and has the biggest drawdowns in negative markets. At the other end of the spectrum is Quality, where returns are lower but less volatile. Investing in the factors individually requires a view of the state of the economic cycle. Put differently, the correlation between the individual factors is low. By combining the factors, we get a model that is more robust through the changing economic cycles due to the low correlation between the factors.

Returns – Multi Factor, Benchmark and Carry



Source: Jyske Capital

The multi factor strategy achieves superior returns compared to the high yield benchmark, with similar risk as the benchmark. A classic carry strategy – buy the bonds with the highest yields – underperforms the multi factor strategy and risk is significantly higher.

Trying to exploit factor risk premiums in equities has become quite common over the last twenty years. Today, you can invest in equity ETFs where the factor strategies are mechanically implemented. In corporate bonds, it is quite a different story - there are no EFTs based upon factor strategies. Factor strategies are significantly harder to implement due to low liquidity and the more complex instruments in corporate bonds. On the positive side, the risk premiums in corporate bonds are underexploited compared to the more mature equity market. Hence, the relative return potential is likely higher.

The important role of due diligence

Our solution to solving liquidity and complexity issues is combining the output of the factor model with an in depth due diligence process. The starting point is the top ranking bonds from the factor model - the individual bonds from this group of high-ranking bonds are going through further scrutiny in our due diligence process. The process includes a validation of the factors going into the quantitative model, and thereafter the company is evaluated by the portfolio management team according to sector and issuer-specific factors along five pillars: business strategy, competitive strength, financial position, capital structure / funding and ESG.

It is notoriously difficult to predict the direction of the corporate bond markets and there is always potential risks to derail performance - but with a structured factor approach, the portfolio is much better off during various different economic cycles.

Important information (disclaimer)

This material has been prepared by Jyske Capital, which forms part of Jyske Bank A / S, and which is supervised by the Danish Financial Supervisory Authority.

This material has been prepared solely for information purposes for the investors to whom the material has been handed out. Under no circumstances is the in- formation aimed at persons residing in or in a similar way attached to a jurisdiction where it is unlawful

to make such offer or solicitation. The information is never addressed to persons resident in the US or per- sons who have a similar attachment to the US.

The presentation is not an offer or a solicitation to buy or sell financial products and / or financial in- struments. We urge investors always to contact their own advisers for individual information about invest- ments, tax issues, etc. before buying or selling finan- cial instruments.

The information is copyrighted by Jyske Capital and must not be represented or reproduced in any other way without acknowledgement of source. Jyske Capital has taken all reasonable care to ensure that the infor- mation in this presentation is as correct as possible and information is received from sources which Jyske Capital finds reliable. Jyske Capital shall not be liable for any direct or indirect losses due to incomplete or erroneous information.

Past performance, movements in market prices and forecasts of future performance and movements in market prices are not reliable indicators of future performance or price fluctuations. Performance and / or price development may be negative. The price of and return on an investment may fall as well as rise, among other things because of fluctuations in market prices and exchange rates.

The information in the presentation is subject to changes in market conditions, in returns, dividends, prices, exchange rates, interest rates, fees and charg- es and other payments, and tax circumstances, etc. Errors and omissions excepted.

None of the information in this document should be regarded as investment advice. Investors are advised to contact a personal advisor with respect to investment, tax issues, etc. before buying and selling. Past performance is not a reliable indicator of future performance and price development. Performance and/or price development may be negative.

Publisher:

Jyske Capital
Vestergade 8-16
8600 Silkeborg Denmark

www.jyskecapital.com