A robust Corporate Bond Multi-Factor Strategy in a volatile market

Author

Mikael Venø Munksgaard

Senior Vice President, Portfolio Manager

Mikael Venø joined Jyske Bank in 2006 and have 21 years of experience in the financial markets.

Facts about Jyske Capital Corporate Bonds

The Jyske Capital Corporate Bond Team manages 2.0 bn EUR across global HY and EUR IG. This article refers only to model-related performance and does not reflect the performance of any underlying investment strategy. For actual portfolio performance see: Corporate Bonds Quarterly Comment

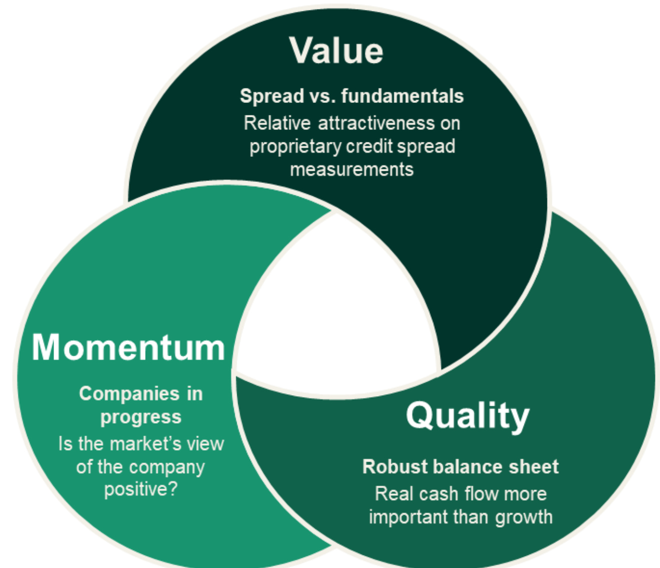
Introduction

Almost 2 years ago, we argued that a multi-factor strategy can offer effective and consistent identification of bonds and therefore, lead to robust outperformance against the global high yield benchmark. As volatility has now returned to market in 2022, we wish to write an updated version in relation to the current market situation. This time around in the shape of long forgotten inflation and interest rate increases.

Our focus in this paper is therefore primarily on the performance of the multi-factor strategy during the current environment of inflationary pressure, high energy prices and interest rate volatility. To shed more light on the matter, we compare the current performance of the multi-factor strategy to previous crisis such as the COVID-19 crisis. Our proprietary multi-factor strategy was incorporated into our global corporate bond process in May 2012 and based on our decade long experience we will also discuss implementation issues.

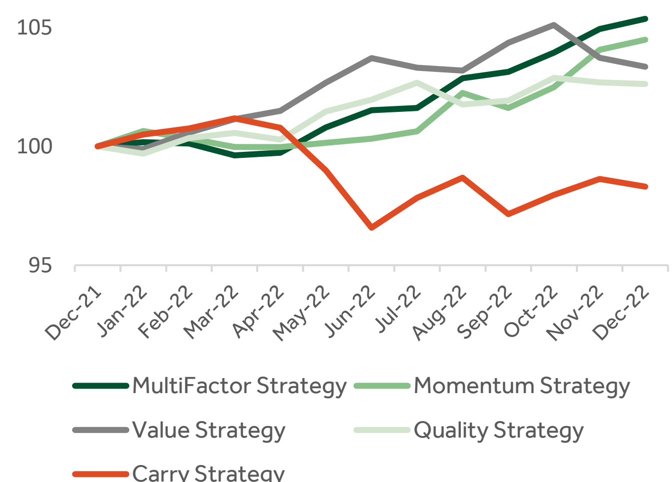
Our multi-factor strategy

The aim of our corporate bond multi-factor strategy is to utilize and benefit from structural and behavioral anomalies in credit markets. It is, however, not aiming to predict the timing and length of a market crash, interest rate volatility or inflation. It is not a top-down timing strategy, but a bottom-up strategy where the aim is to generate robust excess performance through the cycle. The multi-factor strategy is a combination of Value, Momentum and Quality factor strategies, inspired by the original work of Farma and French (1993). Here, it is tailored to work with the complex nature of credit markets, while identifying a unique set of credit risk factor scores for all issuers. Each single factor outperforms the market in the long run, but they play very different roles through the business cycle, in which the model ranks bonds accordingly to expected outperformance (or underperformance). By utilizing the fact that risk premium factors historically perform differently through market cycles their low or even negative correlation makes it is possible to combine all three into a multi-factor strategy that shows very attractive performance attributes.



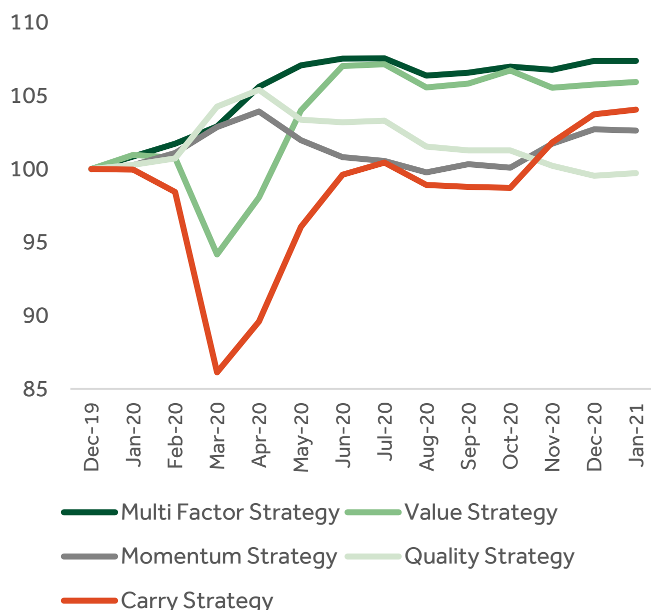
The Value factor is constructed from an extended structural credit model by Merton. The Value factor estimates the level of market mispricing compared to the fundamental credit quality of the issuer. The Momentum factor is constructed from equity data to find positively or negatively trending companies. The Quality factor provides robustness in negative markets by identifying companies with strong balance sheets and cashflows.

Relative Performance of Factor Strategies in 2022



Cumulative relative performance of top quintile for the different factor strategies, against the global high yield benchmark, during the first leg of the 2022 inflation crisis. The Carry strategy is not included in the multi factor strategy. Returns are ex. cost. Source: Jyske Capital and ICE

Relative Performance of Factor Strategies during COVID-19



Cumulative relative performance of top quintile for the different factor strategies, against the global high yield benchmark, during the COVID-19 crisis. The Carry strategy is not included in the multi factor strategy. Returns are ex. cost. Source: Jyske Capital and ICE

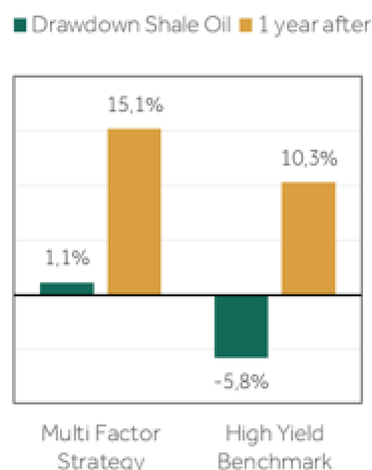
The single factor strategies have delivered excess return in line with our expectations. Momentum and Quality being the best performing factor strategies during the downturn, which are in line with previous crisis, like the COVID-19 crisis. A sign of the "flight to quality" effect and capture of negative momentum signals. The Value strategy usually drives performance in positive markets. During this crisis the Value strategy been lagging the benchmark in the beginning of the of the crisis. As expected, it is now starting catch up.

On the other end of the spectrum, the Carry strategy have massively underperformed. The Carry strategy buys bonds with the top 20% highest spreads. It is not included in the multi-factor strategy. Once again, in line with previous crisis.

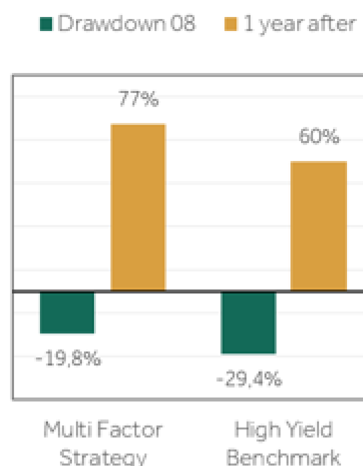
Combining the Value, Momentum and Quality strategies secures a robust outperformance thus far in 2022. If the multi-factor strategy performs as in previous crisis, we expect it not to miss out on the upside when the market returns to positive due to the low correlation between the factors. However, as mentioned earlier, the factor strategy should not be viewed as a timing strategy. The robust outperformance delivered during the first leg of the energy/inflation crisis in 2022 does not guarantee against further volatility and drawdowns.

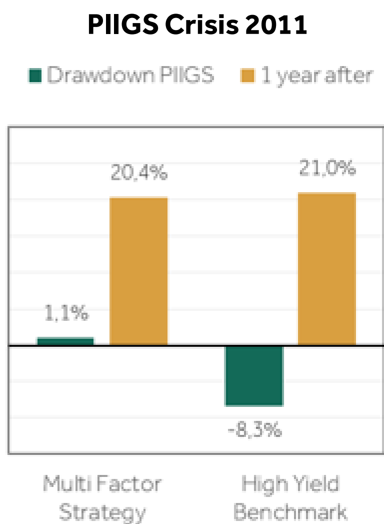
The multi-factor strategy has also managed to outperform the corporate bond market during former periods of crisis. Consistently, it has managed to reduce drawdowns without losing the upside when the market turns.

US Shale Oil Crisis 2015



Financial Crisis 2008





the graphs compare the max drawdown returns for the multifactor strategy and for the high yield benchmark during past crises. The 1 year after returns are calculated as total return 1 year after bottom benchmark value. Returns are ex. cost. Source: Jyske Capital and ICE

Implementation is the key

The main problem with a multi-factor strategy in corporate bonds is the very high complexity of corporate bonds. Many Corporations issue bonds with different maturities, calls, different seniorities and different covenants. The liquidity of bonds changes over time and even for the individual corporation there can be differences in the liquidity between their bonds. All making it significantly harder to build a model and implement it compared to equity.

Implementation therefore becomes the key to utilize the factor risk premiums in corporate bonds. The high yield market is complex, even in a normal business environment. This complexity is highly magnified during a market crash. During the most volatile period of the COVID-19 crisis, corporate bond ETF's was struggling to maintain a low tracking error and some of the index providers cancelled the rebalancing of their high yield benchmark in March 2020. The reason was the evaporation of liquidity during March 2020. Bid/offer spreads widened significantly. The 2022 inflations crisis has not seen quite the same liquidity issues as in March 2020. Yet, liquidity has become scares, making it more difficult to sell bonds, and, even in some odd cases, to buy bonds.

The extreme v-shaped recovery of the COVID-19 crisis made it even more challenging to implement a factor strategy in corporate bonds. The very large movement in spreads and fundamental data led to increased volatility in factor risk premiums. This would typically require above normal rebalancing of the portfolio. Considering the large transaction cost in high yield and lack of liquidity during a crisis, rebalancing can become very expensive in an automated process. Implementing an automated multi-factor strategy in high yield is therefore extremely difficult. There is a high risk of ending up in an unwanted corner solution due to a collision of rigid trading rules and the lack of liquidity during a crisis.

It is therefore essential for the strategy to be anchored within a qualitative process. Combining the multi-factor strategy with a strong fundamental credit analysis, assessment of liquidity, market experience and a thoroughly portfolio implementation can utilize the best of both worlds. Hereby achieving superior and robust performance through the cycle – even in an extreme v-shaped crisis like the COVID-19 crisis or in the 2022 inflationary environment.

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