Market Insight

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Sidestepping the Relative Value Trap in Credit

For the typical credit investor, the general rule of thumb when considering the relative value of a bond is that “wide” equals “cheap”. This premise suggests that investors should buy the issues trading wider than the overall market and allow the spread carry and the potential mean reversion of spreads to drive portfolio outperformance. While this application of relative value is relatively useful in a generic and fairly static mid-cycle environment, this simplistic approach breaks down in a changing world — such as when cyclical or secular forces are reshaping an industry or when a credit cycle is turning.

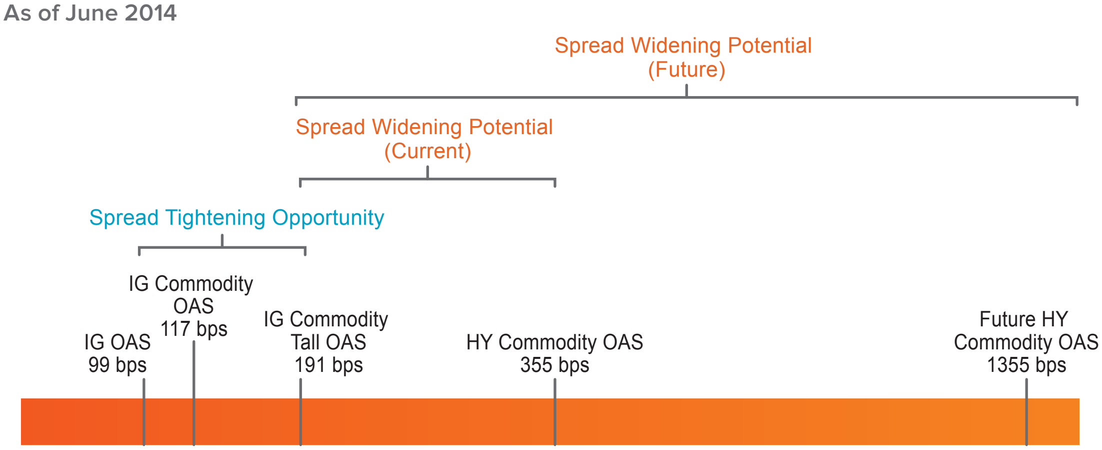
In this note we examine this potential relative value trap and offer some portfolio positioning considerations in light of the current investment environment. And while we illustrate our points using the recent carnage in commodities — which has driven energy industry spreads to the widest level on record relative to the overall investment grade corporate market — the principles also are applicable to other periods of sector distress, such as the technology, media and telecommunications (TMT) crisis in the early 2000s, the housing and financials collapse of 2007–09 and whatever inevitably comes next.

Static Upside/Elastic Downside

While the upside potential of a credit investment tends to be relatively static and easy to define, the potential downside can change significantly and this elasticity must be accounted for when making relative value assessments. Figure 1 highlights the importance of this distinction, providing a snapshot of the relative value landscape among commodity issues in June 2014, when prices had not yet entered a clear downward trend and oil was still around $100 per barrel, as well as a potential future scenario based on historical data. As you can see, the option-adjusted spread to Treasuries of the entire investment grade (IG) market was about 100 bps in mid-2014, while the average IG commodity bond was trading at about 117 bps. The tail of the IG commodity complex (which we can define as future “fallen angels” — i.e., issuers whose ratings ultimately would decline from investment grade to high yield) was trading at 191 bps. At nearly twice the spread of the overall IG index, this cohort was offering the appearance of potentially compelling relative value. Given the average high yield commodity issuer spread of 388 bps, the presumed downside of 197 bps was meaningful but not catastrophic.

Figure 1. Spread Widening Potential Can Change Significantly

As of June 2014



Source: Bloomberg, Voya Investment Management

In a more typical scenario in which an idiosyncratic event leads to the downgrade of that issuer, this type of analysis would normally provide a fair lens through which to assess relative value. However, it does not work well in the event of cyclical or secular change, failing as it does to capture the fixed nature of the upside opportunity and the elastic nature of the downside potential. A cyclical or secular event severe enough to impact an entire industry such that multiple investment grade issuers are pushed into high yield territory (or BB issuers are driven down to B, and so on) is also likely to negatively impact comparable HY issuers (or other wider-trading names) and push their spreads wider too. By the time the downgrade occurs, the spreads used for the relative value comparison — and thus the potential downside of the investment — likely will have changed, perhaps significantly for the worse.

While future spread levels cannot be known with certainty, history does provide a guide as to where industry spreads may go in a distressed scenario and provides a better basis for an initial relative value assessment. As such, the more likely downside risk of the IG tail is represented in Figure 1 by the point to the far right of the continuum. As you can see, we peg the average distressed high yield commodity issuer spread at 1,355 basis points — and thus the widening potential at 1,112 bps — which dramatically alters the relative value calculation and suggests that the potential incremental carry of the investment does not adequately compensate for the downside risk.

Don't Confuse Value With Low Price or Wide Spread

Another aspect that investors sometimes fail to consider is that a relative value assessment of rich versus cheap is essentially a bet against the market — sometimes a bond is low priced or has a wide spread for a reason. Figure 2 illustrates this point. In June 2014, before oil prices began their downtrend, the IG commodity complex (metals & energy) was trading at a spread of around 131 bps. The IG commodity issuers that remained IG rated from June 2014 through December 2015 were trading at 126 bps in June 2014. The eventual fallen angels within the commodity complex, on the other hand, were trading at 191 bps in June 2014.

For investors to purchase these high-spread IG commodity issuers on the view that they were cheap, they had to implicitly bet that the market was wrong in its assessment of the spread downside and probability of downgrades. With the benefit of perfect hindsight, the market was right, at least in terms of identifying the higher-risk pool of issuers. In fact, the IG commodity issuers that were trading the tightest in June 2014 are still trading the tightest today, though their spreads have widened to 385 bps from 126 bps. That widening pales in comparison to that suffered by the highest-risk issues, to 1,488 bps from 191 bps. Of course, in retrospect the best trade would have been to own none of the issuers in this space, but an industry underweight of that magnitude would likely make many investors feel uncomfortable.

Figure 2. Cheaper Issues Widened as Commodity Complex Suffered

	Option-Adjusted Spread	
	June 2014	**December 2015**
IG Commodity	131 bps	471 bps
IG Commodity Survivors	126 bps	385 bps
IG Commodity Fallen Angels	191 bps	1,488 bps

Source: Bloomberg, Voya Investment Management

Scaling the Bet to Mitigate Risk

At present the energy industry presents an unusual investment opportunity, as spreads relative to the overall IG market are at the widest trading level on record. The key question, however, is still whether the industry is truly cheap or just low priced. While the payoff profile of the energy industry is almost certainly better than it was in June 2014 — and the downside more limited — a rigorous relative value assessment requires more inputs. Not only should it involve an appraisal of the catalysts that might facilitate issuer- or sector-specific events, it must incorporate such considerations as an estimation of the potential upside and downside of the investment and an evaluation of the associated probabilities of various return scenarios.

Further, regardless of their expectations for the energy industry, credit investors must consider the best way to manage exposure to the space. (For perspective, note that the IG metals industry comprises only 3% of the IG index, while the energy industry comprises a more notable 11%.) One relatively simple approach is to calibrate the potential portfolio return impact within the commodity complex by creating an index-neutral position across issuers and then adjusting the issuer weightings up or down proportionately to achieve a desired over- or underweight. Using this positioning approach along with the historical returns of the metals and energy industries relative to the index shows that the impact of moderately sized (+/- 6% of the index) bet would likely be relatively modest to an IG portfolio.

Most investors will apply a security selection lens to overweight or underweight certain issuers. While this approach is perfectly fine, it should be noted that security selection can magnify the performance impact. As such, investors should be careful not to unintentionally double down on their bets by buying the widest-trading names in a wide industry and then also overweighting the industry (or vice versa). While investors often fear being left behind by being under exposed to the tail of an industry, an overly aggressive weighting to wide-trading issuers within a wide-trading industry, if wrong, can be catastrophic.

Conclusion

While commodity credits may appear cheap on the surface, there are a number of things investors should keep in mind when assessing relative value within industries undergoing cyclical or structural change.

- The downside spread levels of comparable issuers are likely to be worse than they currently appear in the marketplace. Cyclical and secular forces severe enough to threaten an array of issuers within an industry are also likely to materially re-price the entire industry wider by the time the risks becomes more obvious.
- Bonds that are low priced or wide in spread may not be cheap. A careful assessment of potential issuer, industry and macro catalysts is required to identify the bonds that are truly cheap.
- To safeguard against unintended, outsized portfolio performance results, investors should consider the potential probability-weighted payoff profile of the bonds and scale the individual issuer and aggregate industry bets appropriately considering conviction levels and the potential portfolio performance impact.

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