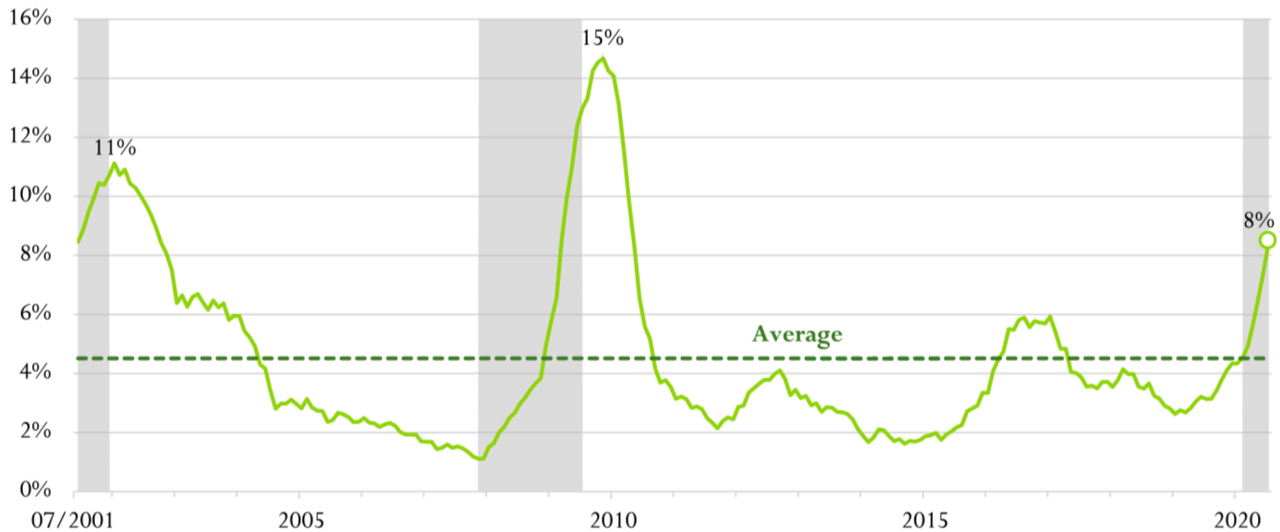
How Tactical High Yield Income Strategies Handle Rising Defaults

An eye-catching rise in corporate default rates has investors wondering whether now is a good time to invest in high-yield corporate bonds. We believe investors should be cautious about using default rates to try to time the market. Bond prices tend to reflect rising credit risk *before* default rates rise; historically, defaults are a lagging indicator. However, systematic tactical trend following can potentially help investors manage high yield default risk.

The Default Rate Is a Slow, Noisy Signal

Investors who focus on corporate bond defaults can easily get caught wrong-footed. Default rates in high-yield bonds have spiked above their longer-term average four times in the past 20 years: during the dot-com bust, during the Great Recession, during the 2015 Shale Bust, and during the 2020 COVID outbreak. In each of the three past cases, the market has tended to predict a rise in credit risk before defaults started piling up. After each crisis passed, defaults only tended to fall well after the next bull market was underway. This makes intuitive sense: company management will often delay default as long as possible, even as worsening economic conditions become obvious to bond investors.

U.S. Speculative-Grade Default Rates



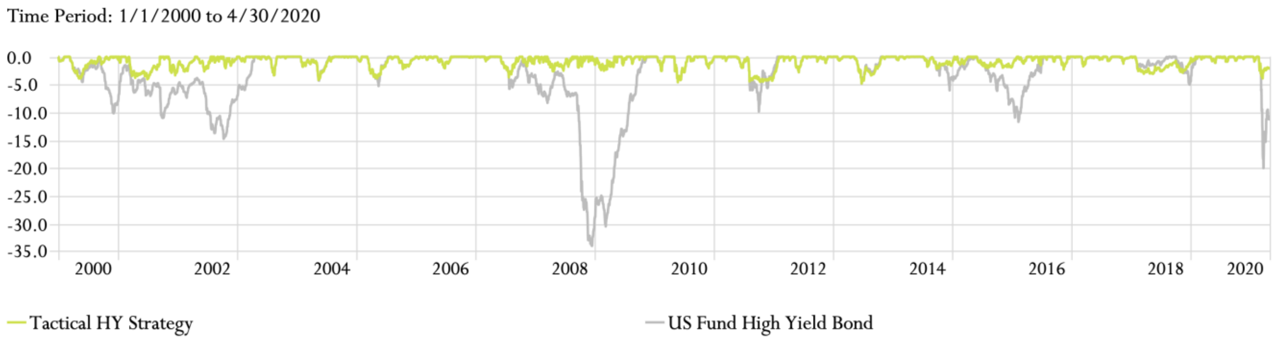
Source: Moody's.

Investors who focus too intently on spiking default rates could be double-counting information the market has already accounted for. This makes the default rate a slow, noisy signal – and potentially useless for timing the high-yield bond market.

Tactical High Yield Strategies Can Help Manage Credit Risk

The misleading nature of the default rate reinforces the lesson: Discretionary market-timing decisions in high yield credit often leave investors worse off for their efforts. Meanwhile, systematic trend-following strategies in high yield credit have a strong track record in helping investors avoid portfolio drawdowns during periods of market stress. The following chart compares passive investment in high yield credit with a systematic 200 day moving average tactical timing strategy applied to the same high yield index.

High Yield vs. Tactical High Yield Drawdown



Source: Morningstar. The Tactical High Yield Strategy is defined by buying the Morningstar High Yield Category when it closes above its 200-day moving average the prior day. The strategy entirely switches to exposure of the Bloomberg U.S. Treasury 3-5 Year Total Return Index when the Morningstar High Yield Category closes below its 200-day moving average.

We believe investor should be cautious about focusing too intently on corporate defaults. However, statistically validated timing strategies have historically stood a good chance of helping investors manage high yield credit risk.

Conclusion

Corporate default rates are often a slow, noisy signal. If history is a guide, the recent spike in high yield defaults could just as easily be a contrarian buy indicator as a sign of trouble ahead. Whatever the default rate is telling us, we believe investors should rely on systematic tactical strategies with a stronger track record for managing risk. Investors who let their strategies do the work can potentially avoid biased market timing mistakes.

Important Risk Information

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