DISCUSSING FACTOR INVESTING AND HIGH-YIELD BONDS

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On last week's podcast, we spoke to Ben Lavine, Chief Investment Officer of 3D Asset Management, and Martin Fridson, Chief Investment Officer of Lehmann Livian Fridson Advisors, LLC. The first half of the conversation focused on how 3D Asset incorporates factor-based portfolio strategies into global asset allocation exchange-traded fund (ETF) portfolios. In the second half, the focus turned to the current state of the high-yield bond market with Fridson. Below are some highlights of the podcast:

With Ben Lavine, we discussed:

- How 3D Asset was founded originally as a Dimensional Fund Advisors TAMP (turnkey asset management program) but transitioned to providing factor-based ETF portfolio strategies due to their belief in the benefits of the ETF structure. The 3D Asset models focus on global diversification, long-term strategic investing and factor-based investing. In many ways, 3D Asset was trying to replicate the small-cap and value tilts from Dimensional Fund Advisors (DFA) with the improved ETF structure.
- Why and how 3D incorporated factor investing into the fixed income markets using an enhanced core index for their aggregate bond exposure. 3D Asset is also a firm that does not utilize high-yield bonds due to their correlation to equities and usage of fixed income only in investment grade.
- How the typical active core bond manager will tilt exposures around credit and duration risk but that many of these things can be done systematically.

In our conversation with Martin Fridson, we discussed:

- Spreads are currently tight due to fundamentals being sound. Default rates are expected to be only around 3% over the next 12 months, when the historical average is around 4.5%[1]–although there are not many "average-looking" years with high variance. According to Fridson, the economy is not growing quickly, but fast enough to prevent high-yield bonds from defaulting.
- Given the risk levels Fridson sees in the market place, historical spreads from Fridson's fair value model would suggest a normal high-yield bond spread of 600 basis points (bps) over Treasuries. Spreads are currently at 375 bps–225 bps lower than normal.[2] A level of 125 bps would be an extreme in Fridson's work–so current spreads are at an "extreme" of extreme levels of overvaluation in his work.

- In the income category, Fridson sees better value in preferred securities, REITs and master limited partnerships, which are still feeling the aftershocks of the drop in oil prices. However, some of these businesses connected to oil are more like toll roads putting oil through pipelines that should be less sensitive to drops in oil prices.
- How Fridson sees ETFs impacting the high-yield bond market. There is market-wide fear that ETFs will accentuate declines in the next big downturn, with ETFs dumping securities. Fridson’s view is that downturns in the high-yield market are always ugly and naturally liquidity can dry up during those times. The dealers making markets in bonds feel no obligation to stand in and buy bonds going down, and, therefore, the dealers tend to just step aside during sell-offs. Fridson’s basic view is that speculators who utilize ETFs today had other vehicles to achieve exposure in prior markets—so that in many ways today’s marketplace is little different.

It was a pleasure speaking to both Fridson, one of the true experts in the high-yield bond category, and Lavine, one of the early adopters of factor investing in building ETF portfolios. Listen to the full conversation here:

[1]Source: Julie Hammond, “Predicting Bond Default Rates: Martin Fridson’s Method,” 70th CFA Institute Annual Conference, 8/22/16.

[2]BofA Merrill Lynch US High Yield Option-Adjusted Spread at 374 bps as of 5/31/17 (https://fred.stlouisfed.org/series/BAMLH0A0HYM2)

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DEFINITIONS

Factor-based : Strategies that focus on groups of firms thought to share common attributes, be it in terms of their fundamentals or their share price behavior.

High Yield Corporate (Bond) : a type of corporate bond that offers a higher rate of interest because of its higher risk of default.

Small caps : new or relatively young companies that typically have a market capitalization between $200 million to $2 billion.

Value : Characterized by lower price levels relative to fundamentals, such as earnings or dividends. Prices are lower because investors are less certain of the performance of these fundamentals in the future. This term is also related to the Value Factor, which associates these stock characteristics with excess returns vs the market over tim.

Correlation : Statistical measure of how two sets of returns move in relation to each other. Correlation coefficients range from -1 to 1. A correlation of 1 means the two subjects of analysis move in lockstep with each other. A correlation of -1 means the two subjects of analysis have moved in exactly the opposite direction.

Investment grade : An investment grade is a rating that signifies a municipal or corporate bond presents a relatively low risk of default.

Active : Funds that attempt to outperform the market by selecting securities a portfolio manager believe to be the best.

Credit : A contractual agreement in which a borrower receives something of value now and agrees to repay the lender at some date in the future.

Duration : A measure of a bond's sensitivity to changes in interest rates. The weighted average accounts for the various durations of the bonds purchased as well as the proportion of the total government bond portfolio that they make up.

Spread : Typically refers to a difference between a measure of yield for one asset class and a measure of yield for either a different subset of that asset class or a different asset class entirely.

Fundamentals : Attributes related to a company's actual operations and production as opposed to changes in share price.

Basis point : 1/100th of 1 percent.

Treasury : Debt obligation issued by the U.S. government with payments of principal and interest backed by the full faith and credit of the U.S. government.

Real estate investment trust (REIT) : Investment structure containing a basket of different exposures to real estate, be it directly in properties or in mortgages. Returns predominantly relate to changes in property values and income from rental payments.

Master limited partnership (MLP) : Investment structure where holdings typically must derive most of their cash flows from real estate, natural resources or commodities, combining the tax benefits of a partnership–taxes occur when holders receive distributions–with the liquidity of a publicly traded company.

Liquidity : The degree to which an asset or security can be bought or sold in the market without affecting the asset's price. Liquidity is characterized by a high level of trading activity. Assets that can be easily bought or sold are known as liquid asset.