

“Where’s the Sweet Spot in the Global Bond Market?”

Presented to
Washington DC Association of Money Managers

October 30, 2013
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A tennis racquet has three separate sweet spots



The Three Investment Sweet Spots

APPLICATION

METHODOLOGY

Strategic Asset Allocation

Sharpe Ratio

Dynamic Asset Allocation - Long Horizon

Relative Value

Dynamic Asset Allocation - Short Horizon

Beta

Application: Strategic Asset Allocation

Methodology: Sharpe Ratio*

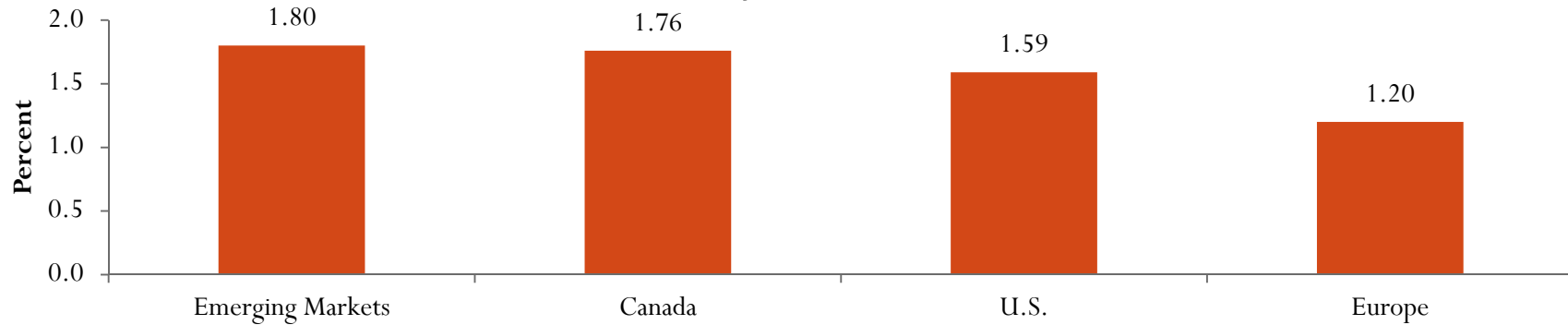
(Note: Optimal mix also depends on correlations of assets)

$$* \frac{\text{Mean Return of Asset} - \text{Mean Return of Risk-Free Asset}}{\text{Standard Deviation of Mean Return of Asset}}$$

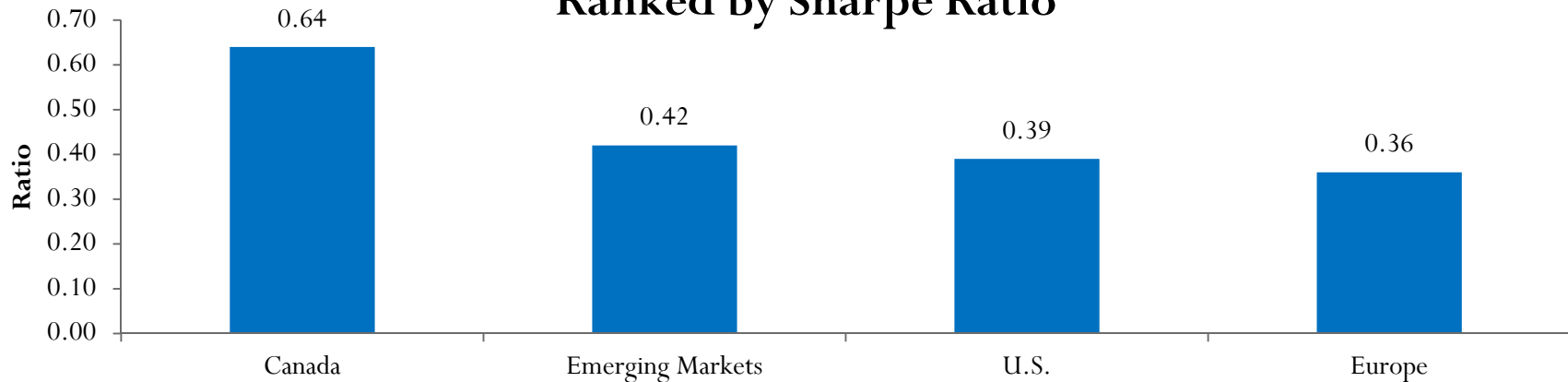
Risk-free asset for all calculations is Three-Month T-Bill

Investment Grade Corporates by Region Quarterly, 2003-2012

Ranked by Total Return



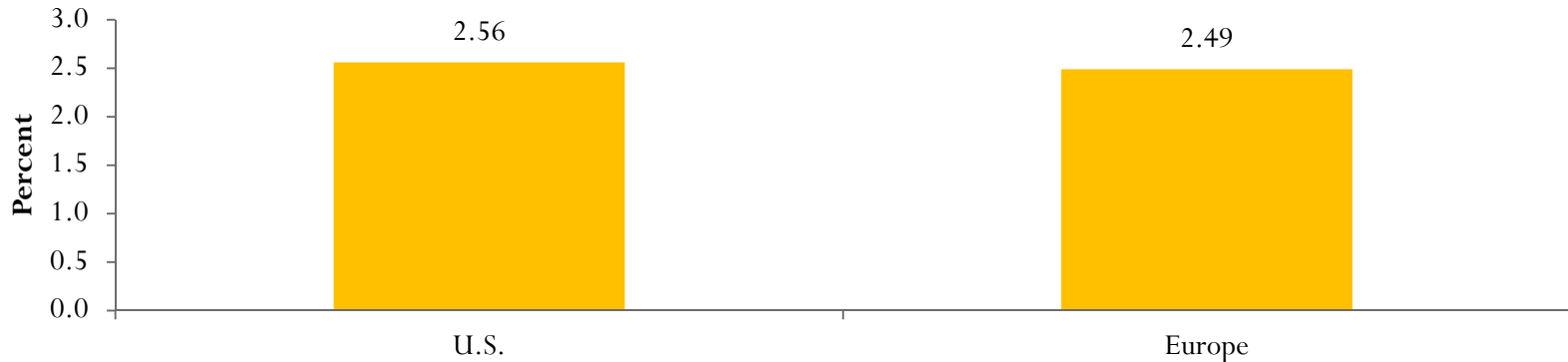
Ranked by Sharpe Ratio



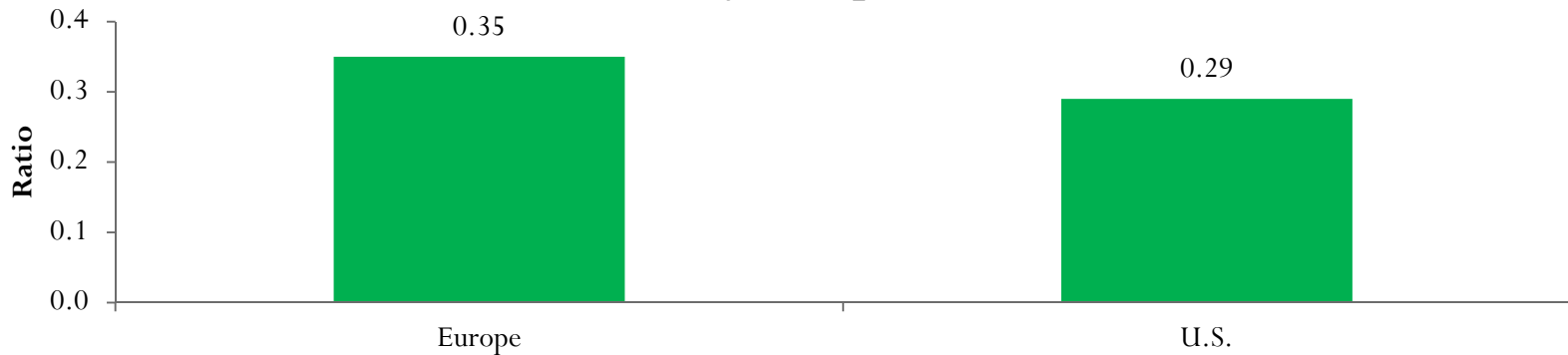
Source: BofA Merrill Lynch Global Research; used with permission

High Yield Corporates by Region Quarterly, 2003-2012

Ranked by Total Return



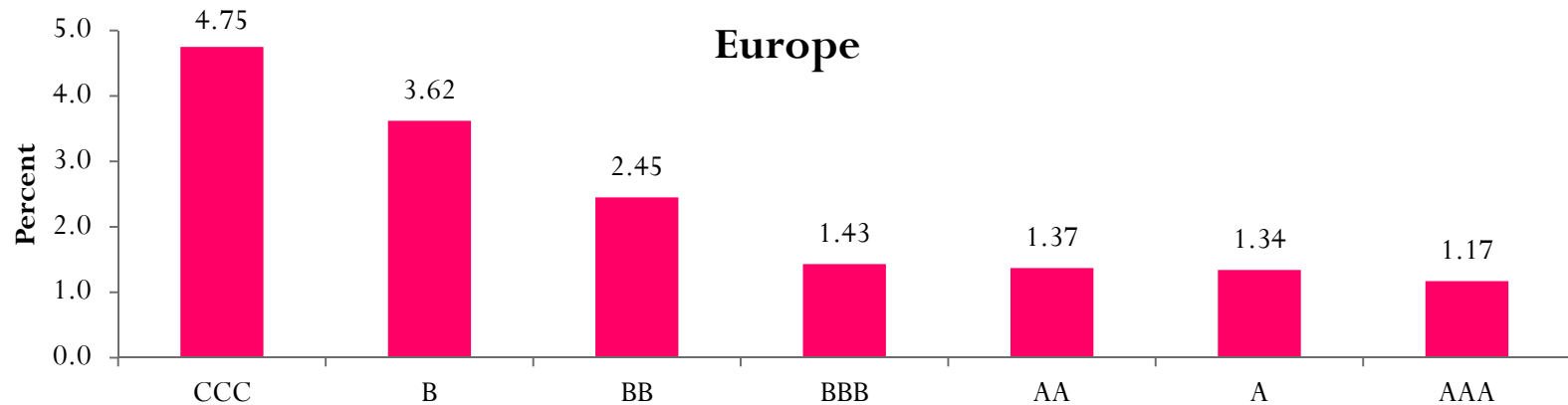
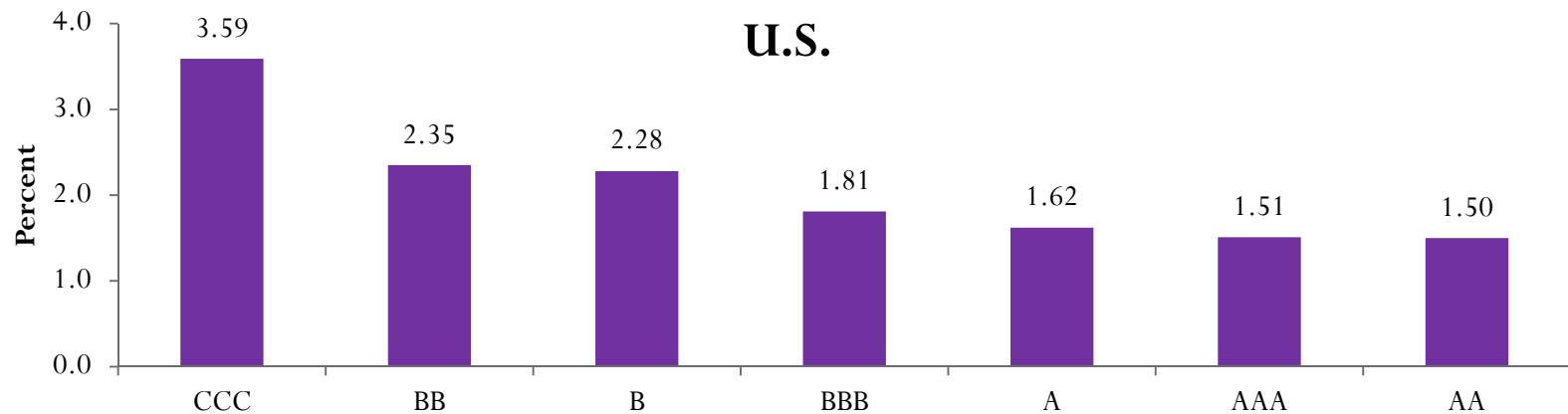
Ranked by Sharpe Ratio



Source: BofA Merrill Lynch Global Research; used with permission

Corporates by Rating Quarterly, 2003-2012

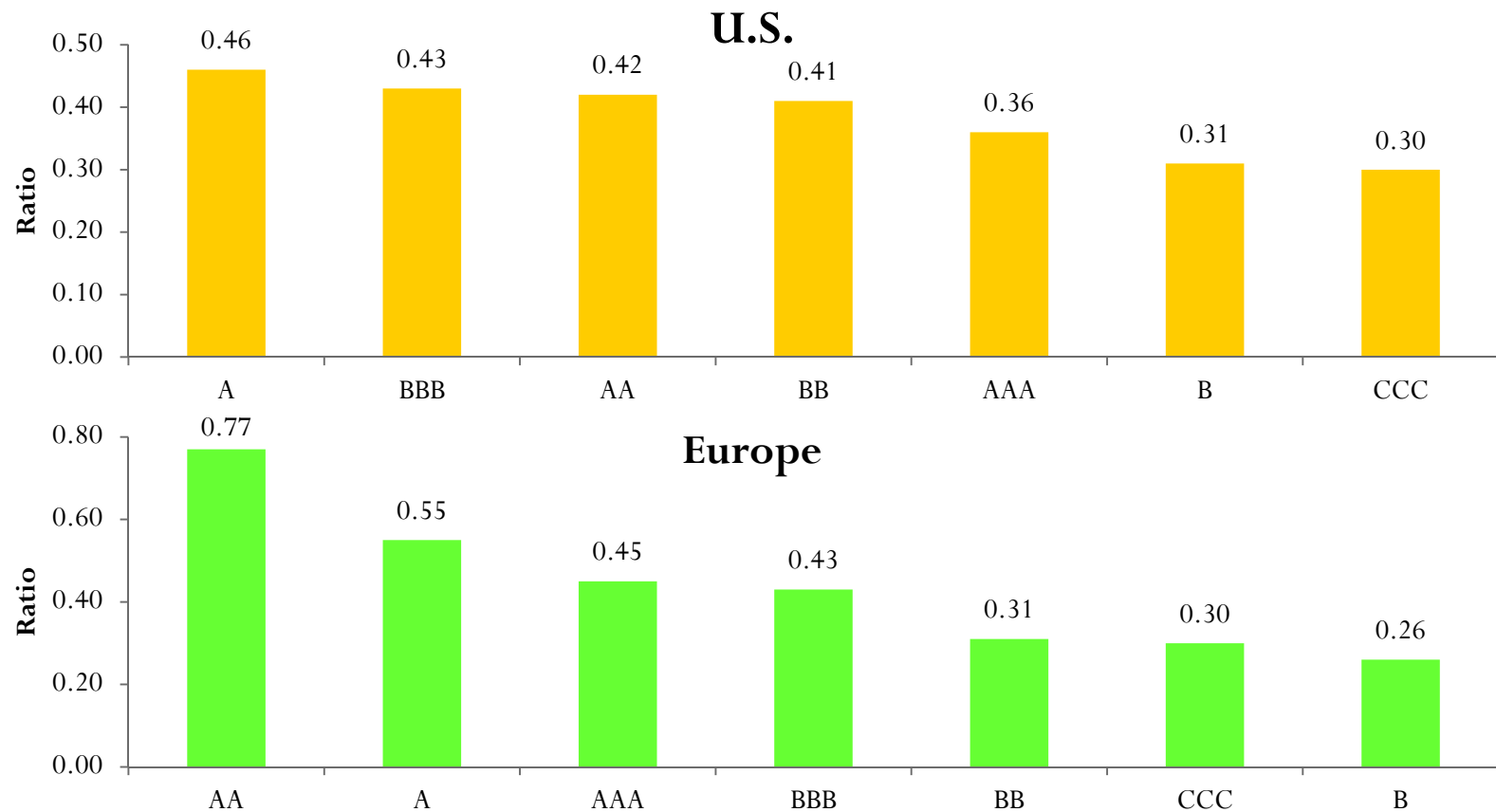
Ranked by Total Return



Source: BofA Merrill Lynch Global Research; used with permission

Corporates by Rating Quarterly, 2003-2012

Ranked by Sharpe Ratio



Source: BofA Merrill Lynch Global Research; used with permission

Application: Dynamic Asset Allocation- Long Horizon

Methodology: Relative Value

Relative Value of Categories

FridsonVision Model Output – September 30, 2013

Rating	OAS (Basis Points)				<u>Actual-Fair Value</u> Standard Deviation
	Actual	Fair Value	Historical Mean*	Standard Deviation	
BB	351	392	397	208	-19.71%
B	466	545	591	278	-28.42%
CCC	850	833	1228	609	2.79%

Cheapest group at this date is CCC

*Monthly December 1996 – December 2012

FridsonVision Model of Option-Adjusted Spread

A A
I L
R U
E

Explanatory Variables:

- Credit Availability (from Federal Reserve Survey of Senior Loan Officers)
- Industrial Production
- Capacity Utilization
- Speculative-Grade Default Rate
- Five-year Treasury Yield

Relative Value of Industries

Problem #1

- If Gaming is wide versus Banking, does that reflect a difference in how those industries are viewed or a wide spread between the two industries' average ratings (B3 and BB2)?

Note: This discussion focuses on U.S. high yield

Source: BofA Merrill Lynch Global Research; used with permission

Solution: Equalized Rating Mix (ERM)

Multiply median OAS for each rating category across all industries by its percentage of the industry's market value (MV)

Example: Cable +Satellite TV September 30, 2013

<u>Rating</u>	<u>% of MV</u>	×	<u>Median OAS (Basis Points)</u>	=	<u>ERM OAS</u>
BB1	0.00	×	308	=	0.00
BB2	12.31	×	334.5	=	41.18
BB3	59.46	×	365	=	217.03
B1	6.06	×	388	=	23.51
B2	10.30	×	433	=	44.60
B3	7.29	×	529.5	=	38.60
CCC1	4.57	×	615	=	28.11
CCC2	0.00	×	763	=	0.00
CCC3	0.00	×	1178	=	0.00
CC	0.00	×	2205	=	0.00
C	0.00	×	24083	=	0.00
	<u>100.00</u>				<u>393</u>

Note: Column totals are subject to rounding

Source: BofA Merrill Lynch Global Research; used with permission

Problem #2

- An industry may look cheap based on its ERM OAS, but its wide spread may be justified by negative rating outlooks.
- Solution:
 - Add Net Ratings Prospects to analysis
 - Net Ratings Prospects reflects outlooks and watchlistings
 - Unit of calculation is issuers

$$\frac{\% \text{ Positive} - \% \text{ Negative}}{\% \text{ Positive} + \text{Percent Stable} + \% \text{ Negative}}$$

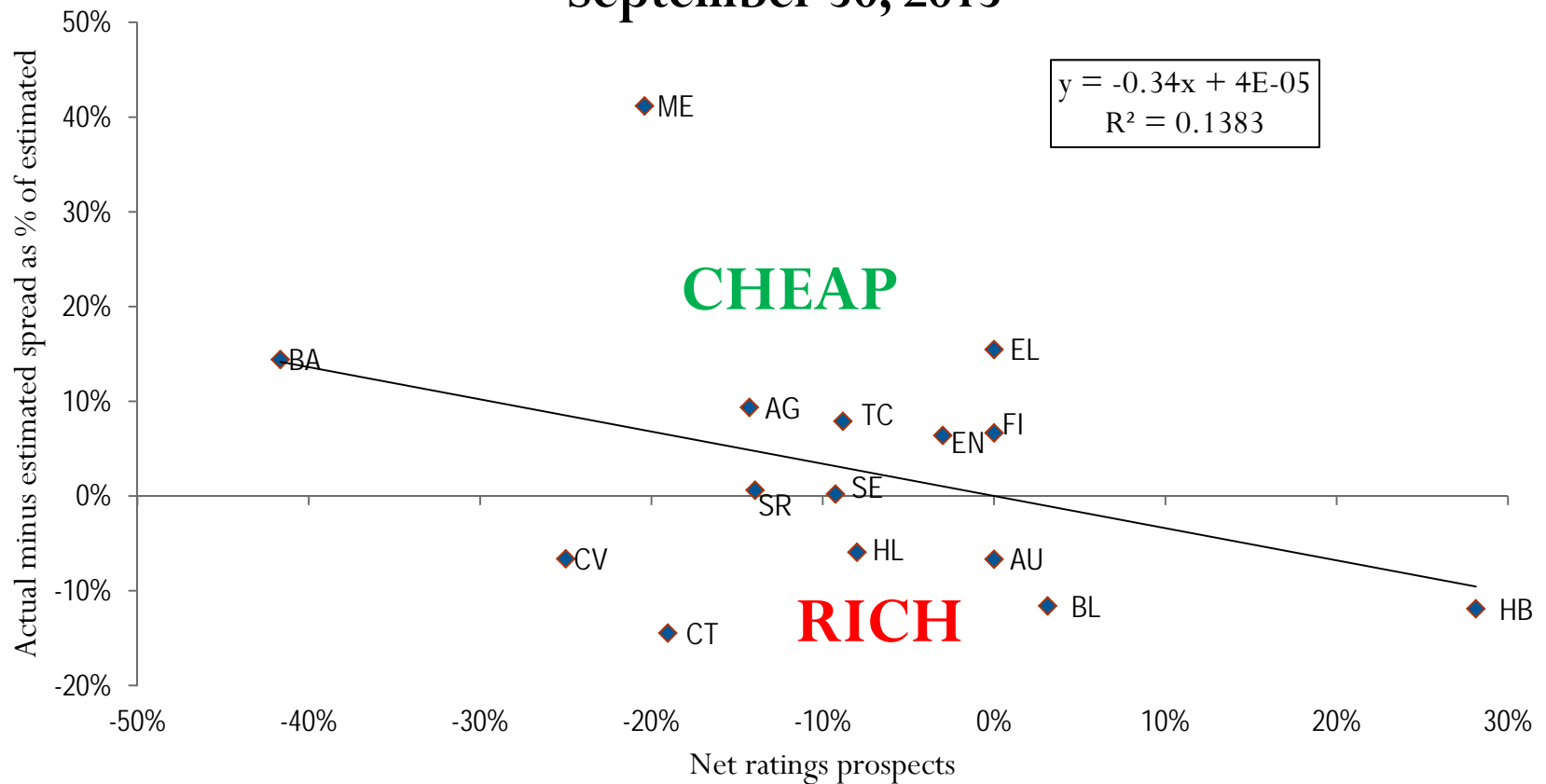
Major High Yield Industry Ranked by ERM Valuation

September 30, 2013	Symbol	Actual - Estimated OAS as % of Estimated	Net Ratings Prospects
Metals & Mining	ME	41.18%	-20.41%
Utility	EL	15.47%	0.00%
Banking & Thrifts	BA	14.41%	-41.67%
Gaming	AG	9.36%	-14.29%
Telecommunications	TC	7.89%	-8.82%
Diversified Financial Services	FI	6.67%	0.00%
Energy	EN	6.39%	-2.99%
Super Retail	SR	0.61%	-13.95%
Services	SE	0.21%	-9.26%
Healthcare	HL	-5.93%	-8.00%
Cable & Satellite TV	CV	-6.62%	-25.00%
Automotive & Auto Parts	AU	-6.67%	0.00%
Building Materials	BL	-11.60%	3.13%
Homebuilders & Real Estate	HB	-11.90%	28.13%
Containers	CT	-14.46%	-19.05%

Sources: BofA Merrill Lynch Global Research, used with permission; Bloomberg

Relative Value Analysis for U.S. High Yield Industries

September 30, 2013

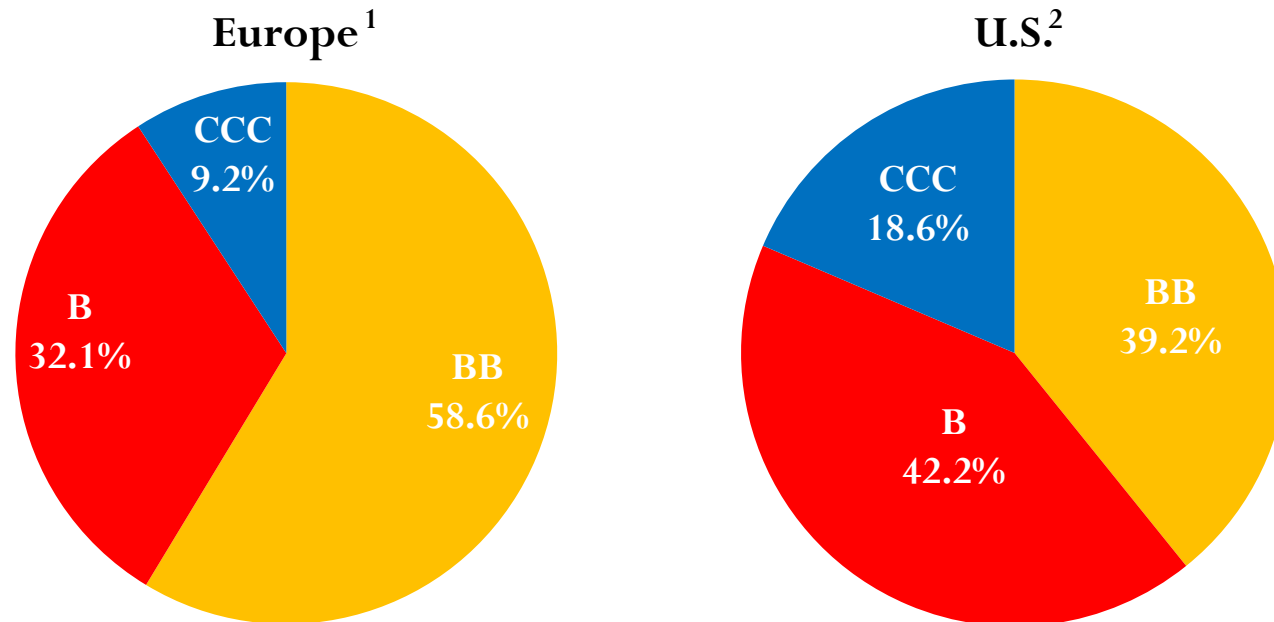


Sources: BofA Merrill Lynch Global Research, used with permission; Bloomberg

Relative Value: U.S. versus Europe

Equalized Ratings Mix necessary because of wide disparity in ratings distribution:

Market Value by Rating High Yield Excluding Financials – September 30, 2013



Note: Subject to rounding.

1. Euro Non-Financial High Yield Constrained Index (HEAD)

2. U.S. Non-Financial High Yield Constrained Index (HCNF)

Source: BofA Merrill Lynch Global Research; used with permission

- **Problem:**

Even if U.S. is priced richer than Europe at every rating level, its overall spread may be greater than Europe's because of the higher U.S. concentration in the lower rating categories.

Hypothetical Illustration

<u>Region</u>	<u>Rating</u>	<u>Spread</u>		<u>Market Weight</u>		<u>Index Spread</u>
Europe	BB	400	×	60%	=	240
	B	600	×	30%	=	180
	CCC	1200	×	10%	=	120
						<hr/> 540
U.S.	BB	375	×	40%	=	150
	B	550	×	45%	=	248
	CCC	1100	×	15%	=	165
						<hr/> 563

- **Solution:**

Use median spreads for the U.S. and European rating categories but weight both by the U.S. market value percentages of the rating groups.

Range of ERM Differentials 2003-2012, Quarterly

Europe – U.S.
(Basis Points)

149.1 or more

48.2 to 149.0

20.1 to 48.1

-12.1 to 20.0

-12.0 or less

Europe's
Valuation

Very Cheap

Moderately Cheap

Fairly Valued

Moderately Rich

Very Rich

Source: BofA Merrill Lynch Global Research; used with permission

ERM Differential

September 30, 2013

Europe – U.S. = 48.4 bps

Bottom Line: Europe is Moderately Cheap versus U.S.

Source: BofA Merrill Lynch Global Research; used with permission

Application: Dynamic Asset Allocation- Short Horizon

Methodology: Beta

General Role for Short-Term Performance

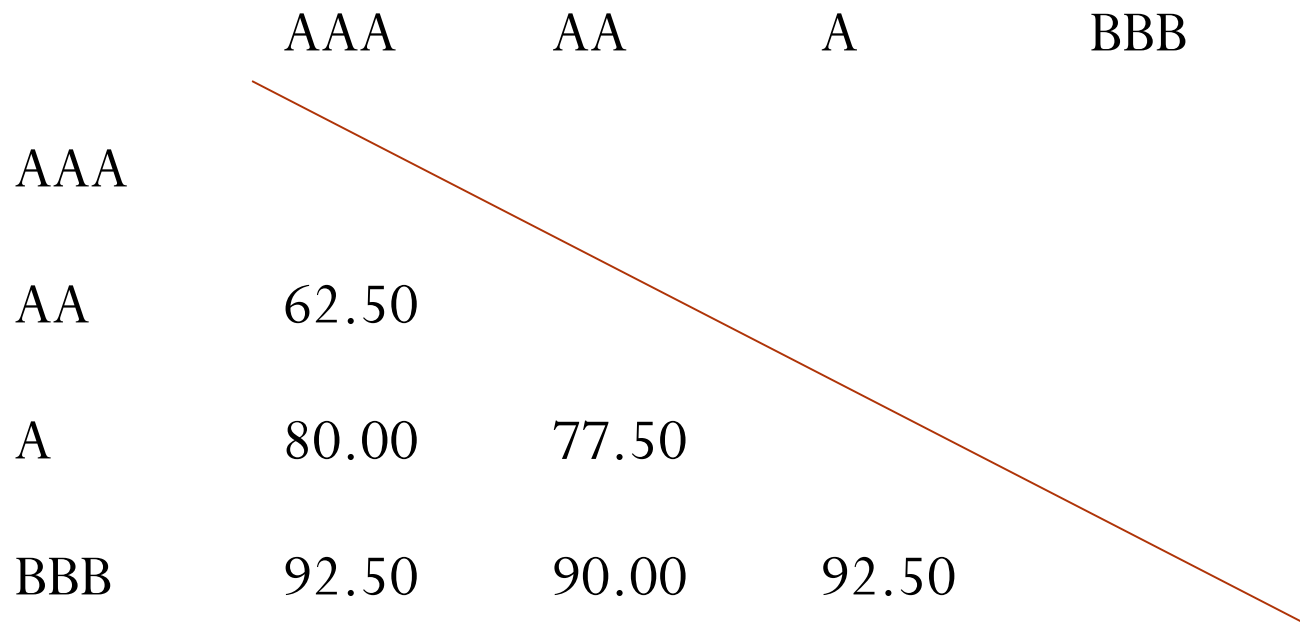
Relative Return is not determined by relative value:

- When the credit risk premium (OAS) increases:
 - Lower-rated group outperforms higher-rated group.
- When the credit risk premium (OAS) decreases:
 - Higher-rated group outperforms lower-rated group.

Classification of Outcomes

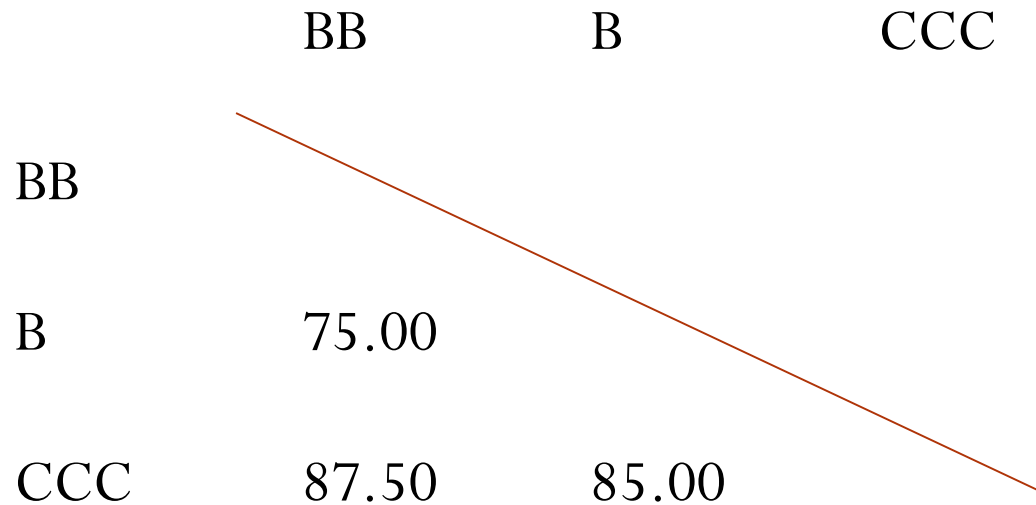
	Higher-Rated Group Outperforms	Lower-Rated Group Outperforms
Index's OAS Widens	CORRECT	INCORRECT
Index's OAS Narrows	INCORRECT	CORRECT

Percent of Correct Outcomes U.S. Investment Grade 2003-2012, Quarterly



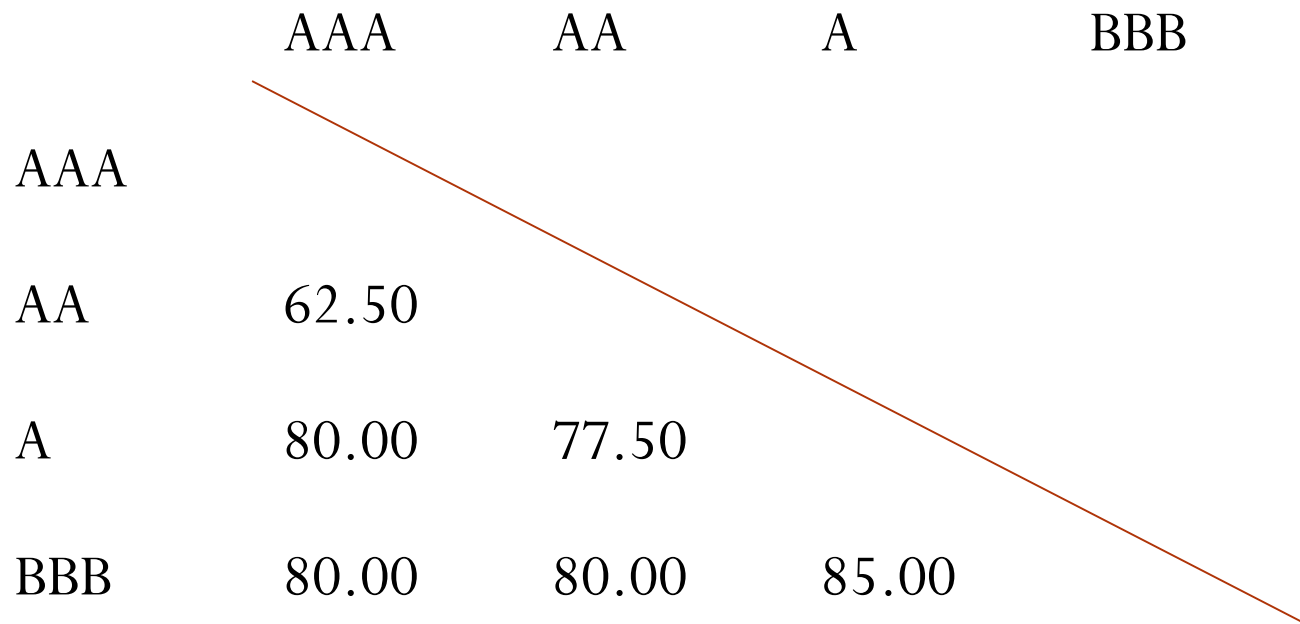
Source: BofA Merrill Lynch Global Research; used with permission

Percent of Correct Outcomes U.S. High Yield 2003-2012, Quarterly



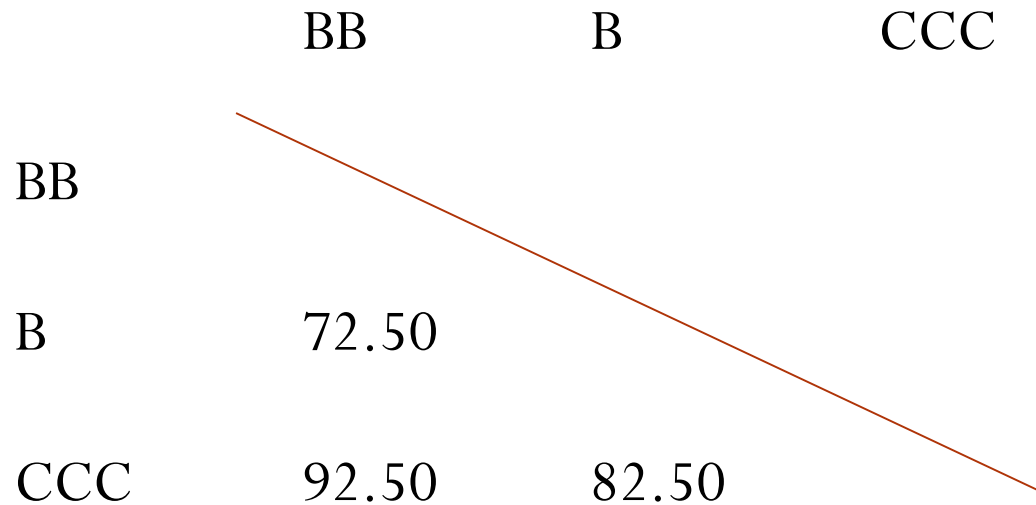
Source: BofA Merrill Lynch Global Research; used with permission

Percent of Correct Outcomes European Investment Grade 2003-2012, Quarterly



Source: BofA Merrill Lynch Global Research; used with permission

Percent of Correct Outcomes European High Yield 2003-2012, Quarterly



Source: BofA Merrill Lynch Global Research; used with permission

Incorrect Outcomes Coincide with Small Movements in Index's OAS

Results for Selected Rating Groups Mean Change in Absolute Value (Basis Points)

<u>Region</u>	<u>Comparison</u>	<u>Correct Outcomes</u>	<u>Incorrect Outcomes</u>	<u>Difference</u>	<u>t-statistic</u>
U.S.	AA vs A	41.1	10.2	30.9	3.2
Europe	AA vs A	30.9	6.2	24.7	4.2
U.S.	BB vs B	136.8	69.7	67.1	1.8
Europe	BB vs B	175.9	81.8	94.0	2.1

Note: Calculations are subject to rounding. t-statistic of 2.0 or greater indicates statistical significance.

Source: BofA Merrill Lynch Global Research; used with permission

Bottom Line on Short-Horizon Dynamic Asset Allocation

- To profit from overweighting and underweighting rating groups in a single trial, you must correctly predict the direction of the credit spread and the change must be of sufficient magnitude.

Note: If the percentage of correct outcomes is 85%, you must predict the direction of the credit spread accurately 60% of the time, to achieve a 51% success ratio.

THANK YOU VERY MUCH!
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