



## SHORT BUT SWEET: OPPORTUNITIES IN HIGH YIELD

From the runways of Milan to the showrooms of New York, fashion trends come and go. Certain bellwethers, such as the length of a woman's skirt, regularly change with the times. In fact, some market pundits have historically used the lengths of skirts to help predict market direction. In 1929, Wharton economist George Taylor coined the term Hemline Indicator. Backed by his research on the stock market and hemlines, Mr. Taylor theorized that when an economy is doing well, women tend to wear shorter skirts. In other words, a rise in hemlines would indicate the economy was growing and the stock market should improve. Although parallels may not appear evident, the investment world and fashion world share similarities.

In fixed income, while new funds and strategies come and go, some things always remain fashionable. Yield and compounding are mainstays of investing and provide a powerful combination that has proven difficult to beat. In the current environment of extremely low benchmark interest rates, the search for attractive yields has never been more pronounced. Importantly, though, these same low rates pose significant risks. The bond market's sensitivity to changes in rates, deemed its duration risk, is at all-time highs. Thus, a modest increase in interest rates can hand investors significant capital losses.

### High Yield Short Duration

The goal of maximizing yield without undue duration and credit risk may appear quite challenging. However, a short duration high yield strategy enables investors to attain each

of these goals. As we mentioned in a previous thought piece, the case for a strategic high yield allocation in one's portfolio is compelling. The asset class has the envious attributes of low correlation to other asset classes, high current income, the potential for capital gains, and the ability to perform quite well in a rising rate environment.

As illustrated in the table below, high yield short duration provides far superior risk-return attributes to broad equity indices. Furthermore, the short duration approach produced similar returns to more traditional high yield strategies with much improved Sharpe ratios (a measurement of return per each unit of risk). Thus, one can argue that this less risky short duration high yield strategy should warrant a permanent allocation for most investors.

For certain investors, and at specific times within a market cycle, the risk-return attributes may suggest different strategies within high yield. In early 2009, for example, while any overweight in credit produced superior returns, the lowest-quality bonds rebounded the most. As yield spreads have now normalized and we face a slow, difficult recovery, a higher-quality, short duration high yield approach may be an ideal choice.

### Not Too "Short"

Although one may set various parameters for the short duration approach, we believe the strategy should focus on high yield bonds with a maximum maturity of five years and an average modified duration approximating three

Risk Return Comparison	3 Years Ending 12/31/10		10 Years Ending 12/31/10	
	Return	Sharpe	Return	Sharpe
High Yield - Short Duration <sup>1</sup>	9.93	0.60	9.49	0.68
High Yield – All <sup>2</sup>	10.13	0.45	8.60	0.49
Russell 2000	2.23	0.05	6.33	0.17
S&P 500	-2.86	-0.14	1.41	-0.05

Source: Bloomberg

1: Index: ML US High Yield Corp Cash Pay 1-5 Years

2: Index: ML US High Yield Master II

Source: eVestment Alliance

years. Senior loans, sometimes called bank debt, can also be a prudent enhancement to this strategy. Rarely more than five years in maturity, bank debt is ranked the highest in the capital structure, which enables it to have the first call right to company assets, and its floating-rate structure translates into little or no duration risk.

As stated earlier, the short duration approach dampens volatility while still providing for high income and the opportunity for capital gain. Importantly, the shorter maturities within a diversified portfolio result in a very modest portfolio duration and, thus, mitigate downside risk during general market corrections. In fact, the short duration universe comprises a high concentration of callable cushion bonds that historically have a much lower volatility. The near-term maturity also enables improved analytical insights which reduce company-specific uncertainty. Furthermore, earlier maturities may be preferable over *pari-passu* bonds (those with equal right to payment) with later maturities. When firms struggle with their debt loads, the first maturities often have the best negotiating power within each debt class, sometimes even above a more senior debt tranche.

While some may root for the reemergence of short skirts in the hopes of its predictive value for our financial markets (or for other prurient reasons), sometimes “too short” can become problematic. Recognizing investors’ desire for reduced interest rate risk, “ultra-short” high yield strategies have recently surfaced. The investable universe for these strategies is often narrowed to a three year maximum maturity and duration of under two years. The statistics for different high yield duration strategies are displayed below.

With fewer eligible securities in the ultra-short universe, investors may face heightened idiosyncratic risk due to the necessity for larger positions. Unlike other market sectors, one should be extremely suspicious of high yield bonds that

are very close to maturity. In particular, with our current conducive market conditions, most any issuer wishing to raise funds can easily do so. Thus, one should have a healthy skepticism toward maturities of less than one year since they have not yet been refinanced. Most likely, these firms have questionable underlying fundamentals, causing their bonds to carry significant default risk. Regardless of overall market performance, ultra-short bonds are unlikely to properly compensate the investor for the sizeable refinancing risk.

### Fashionable High Yield

Historical data has clearly shown that the high yield market has produced solid risk-adjusted returns over the past thirty years. Due to the generous coupon on high yield bonds, investors have the opportunity for relatively high income and low market volatility, with only rare principal losses. Given its attractive risk-adjusted returns and relatively low correlation to other assets, high yield is an excellent complement and a true diversifying component to an overall portfolio.

With a nascent recovery upon us, the fashion world should expect shorter hemlines and investors should prepare for higher interest rates. We believe short duration high yield provides investors with considerable income while further mitigating volatility. Importantly for today’s historically low interest rate environment, a shorter duration portfolio can provide increased protection against the potential for rising long-term rates. High yield short duration strategies offer the opportunity for consistent returns and stable income, and should be included as part of a long-term strategic portfolio allocation.

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<b>High Yield Index Attributes</b>			
As of 12/31/2010			
	<b>Traditional High Yield<sup>1</sup></b>	<b>Short Duration High Yield<sup>2</sup></b>	<b>Ultra Short High Yield<sup>3</sup></b>
Maturity	7.03	3.52	2.08
Yield	7.85	7.74	7.09
Modified Duration	4.81	2.90	1.85

Source: Bloomberg

1: Index: ML US High Yield Master II

2: Index: ML US High Yield Corp Cash Pay 1-5 Years

3: Index: ML US High Yield Corp Cash Pay 1-3 Years

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