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Industry Voices

Commentary: The solution for yield-seeking allocators may be hiding in plain sight

By Greg Shea and Steven Kindred

In mid-March 2020, the yield on the 10-year Treasury dipped below 1%. The benchmark rate hasn't exceeded 3% for more than two years and is likely to stay low for the foreseeable future after Federal Reserve Chairman Jerome Powell effectively ruled out hikes until at least 2023. This persistent downward pressure on rates has led institutional investors to increase allocations to income-generating assets such as levered loans and real estate to achieve the returns needed to meet long-term obligations, typically about 7% annually.

Though the dollar value of the high-yield market rose by 48% over the past decade, levered loans grew nearly three times faster at 140%. And while growth in institutional real estate investment is more difficult to measure, a good proxy, according to industry consultants, is net assets in the NFI-ODCE index, a compilation of 26 open-end commingled funds pursuing core, U.S.-based real estate strategies. The assets tracked by this index soared by 254% during the past 10 years, more than quintupling the growth of the high-yield market. However, when it comes to total return, income, credit risk and liquidity, real estate and levered loans may not turn out to be the best choice.

Measuring throughout a full economic cycle, from before the global financial crisis through 2020, the total return generated by high-yield bonds was 7.31%, outperforming real estate by 2 percentage points and levered loans by nearly 3 percentage points. Real estate prices rebounded strongly from the 2008-2009 downturn during the past decade, driving overall strong returns in the sector. Yet, over the past five years, high yield has again outperformed the other two asset classes on a total return basis.

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FIGURE 1 Annualized total returns

	Prior to GFC to 4Q 2020	Last 10 years	Last 5 years
Bloomberg Barclays 2% Capped (high yield)	7.31%	6.79%	8.57%
NFI-ODCE index (real estate)	5.28%	9.88%	6.21%
S&P LSTA index (levered loans)	4.38%	4.32%	5.24%

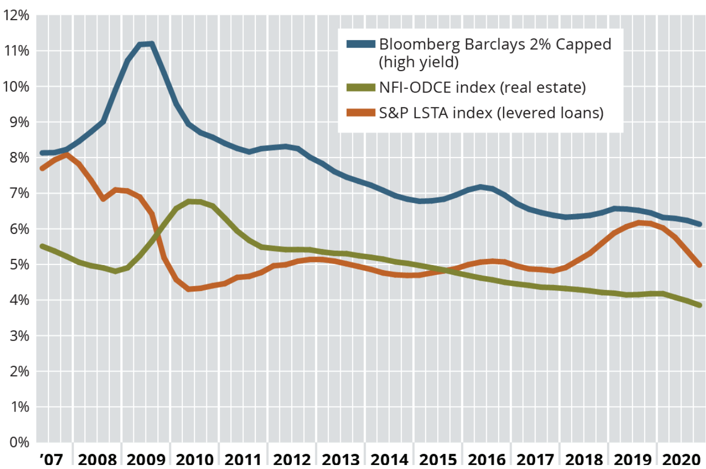
Note: Prior to GFGC to 4Q 2020 = June 30, 2007-Dec. 31, 2020; last 10 years = Dec. 31, 2010-Dec. 31, 2020; last 5 years = Dec. 31, 2015-Dec. 31, 2020

And dating back to before the global financial crisis, high yield's trailing annualized income return — the coupons paid from the underlying high-yield bonds and levered loans in their respective indices — has consistently outperformed levered loans and real estate, where income return for the NFI-ODCE index is calculated as property-level income less expenses, divided by property value.

This underperformance by real estate and levered loans comes against a backdrop of deteriorating credit quality for both asset classes.

"BB" is the highest quality rating in the high-yield universe, and while the number of bond issuers with a rating of BB or better climbed to 54% of the ICE BofA U.S. High Yield index by Dec. 31, 2020, from about 42%

FIGURE 2 **Trailing annual income returns by asset class**



a decade prior, the proportion of levered loan issuers with BB or better ratings slid to about 30% from about 47% over the same period, according to the S&P/LTSA Leveraged Loan index. Moreover, the coronavirus has exposed duress in real-estate sectors including commercial office space, which may be adversely impacted by a permanent increase in work-from-home trends; retail, which is struggling as a fundamental shift to online shopping accelerates; and hotels, which could feel the impact of a potential reduction in business travel.

Another emerging sign of stress in real estate is a rise in commercial mortgage-backed securities delinquency rates. After staying consistently below 1% for at least seven years pre-pandemic, the rate surged to as high as 9.4% in June 2020 and remained above 7% at the end of the fourth quarter, according to Trepp, a commercial real estate data provider.

To compound the differences between the three asset classes, market liquidity also favors high-yield bonds. It is one thing to accept less liquidity for higher returns or higher-quality assets, but as noted above, neither of those attributes is present in levered loans nor real estate. About $300 billion of high-yield bonds are traded each month, about five times the total for levered loans, according to the Loan Syndications and Trading Association and the Trade Reporting and Compliance Engine. In addition, settling trades can be challenging. It takes one to three days to settle a high-yield trade vs. an average of seven days for a loan, which can stretch to 20 days for distressed issuers.

Liquidity in the real estate sector is even more problematic. NFI-ODCE funds accept redemption requests on at least a quarterly basis. Payouts are subject to capital availability and, unlike high-yield and levered loans, are ultimately at the manager's discretion. This can create a queue for withdrawals — a potential frustration for allocators keen to put capital to work elsewhere.

So, while assets such as real estate and levered loans may initially seem compelling to allocators scouring the investment universe for yield, in the current environment they can offer an unattractive combination of lower total returns, lower income, lower quality, lower trading volume and increased trade settlement costs. A more attractive proposition may therefore be thoughtfully chosen investments in high-yield bonds.

Greg Shea is a senior portfolio manager on the quality high-yield strategy and Steven Kindred is a senior fixed-income analyst at Segall Bryant & Hamill. Both are based in Denver. This content represents the views of the authors. It was submitted and edited under Pensions & Investments guidelines but is not a product of P&I's editorial team.