

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](#):

1Source: Julie Hammond, "Predicting Bond Default Rates: Martin Fridson's Method," 70th CFA Institute Annual Conference, 8/22/16.

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

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