Why It's Time for a Barbell Strategy

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As economic cycles enter their later stages, investors sometimes find that they're taking too much risk to generate income. There's a strategy that can help—and we think now is the time to use it.

Pairing high-yield corporate bonds and other credit assets with high-quality government debt in a dynamic "barbell" strategy has been a good way to generate income while limiting downside risk. This is mainly because the return streams tend to be negatively correlated; one does well when the other struggles, and a manager can alter the weightings as valuations and conditions change.

A barbell approach can work at any time in a market cycle, but we think conditions today are especially ideal for it—in particular, for investors who want to limit their downside risk without giving up too much income. Here are three reasons to lift a barbell today:

1. You're not being paid to take all that credit risk. Most credit assets are expensive today. Take the US high-yield market. The average yield spread—the extra yield over comparable government bonds—has averaged 3.94% over the first nine months of the year. That's well below the long-run average (dating back to January 1, 1994) of 5.46%.

This should be a concern for investors who reduced duration—a measure of interest-rate sensitivity—when interest rates were rising and overallocated to credit. That was a common strategy in 2018 as the US Federal Reserve (the Fed) delivered four interest-rate increases and economic growth was strong.

Here's the problem: both actions reduce the defensive nature of a bond portfolio in a risk-off environment. At 10 years and counting, the US credit cycle is one of the longest on record. At some point, the expansionary period will end and the downturn phase will begin. We're not quite there yet, but we think we're getting closer—and so does the Fed, which has already cut rates twice this year.

With trade volume collapsing, we expect 2020 to be the worst year in a decade for the world economy. And while we don't expect a US recession, we do think the economy will slow, and we're watching to see if a manufacturing slowdown starts to affect consumer spending. That likely would mean more Fed rate cuts to come and, if necessary, even more aggressive easing.

All of this tells us two things. First, investors who are overweight credit aren't being properly compensated for the risk. Second, there's no reason to fear duration. The possibility of slower growth ahead means interest-rate exposure should help to cushion your portfolio against volatility and drawdown risk.

2. US yield curves are flat. This happens when long-term yields aren't as high as they normally are relative to shorter and intermediate yields. Why does this matter? Because when the curve is flat, returns tend to be stronger in higher-quality securities and lower in some of the bond market's riskiest segments.

With a barbell, a manager can rebalance investors' portfolios as the curve flattens by tilting toward higher-quality, interest-rate-sensitive securities at the expense of the riskiest sectors of the credit market. This makes a portfolio more liquid. Should credit markets sell off, investors can sell their outperforming US Treasuries and other highly liquid quality assets and rebalance toward higher-risk assets at more attractive prices.

When it comes to the credit side of the barbell, flat curves make higher-quality, intermediate maturity bonds more attractive than longer ones because they deliver more yield per unit of duration, with the sweet spot somewhere between three and five years.

3. You can reduce volatility without giving up too much return. To see what we mean, let's look at a couple of potential barbell strategies.

The first is a barbell with 65% of its assets in US Treasuries and 35% in high yield. We call this a risk-weighted barbell because credit is typically twice as volatile as interest-rate-sensitive assets, so investors would have to hold more rate exposure to even out the risk weighting on each side. The second is a 50/50 construction that excludes CCC-rated junk bonds—the riskiest slice of the high-yield universe. We'll call this a risk-managed barbell.

Over the past 20 years, both strategies would have comfortably outperformed US Treasuries and provided 75% to 80% of the average annualized return of US high yield. But as *Display 1* shows, both would have had better returns per unit of risk than either US Treasuries or high yield.

The Trade-off Between Risk and Return

20 Years Ending September 30, 2019

Sharpe Ratio (Return per Unit of Risk)	
US Treasuries	0.7
Aggregate	0.9
Risk-Weighted Barbell	1.0
Risk-Managed Barbell	1.0
High Yield ex CCCs	0.7
High Yield	0.6

As of September 30, 2019

Historical analysis does not guarantee future results.

Aggregate is represented by the Bloomberg Barclays US Aggregate Bond Index; US Treasuries is represented by the Bloomberg Barclays US Treasury Index; high yield is represented by the Bloomberg Barclays US High-Yield 2% Issuer Capped Index; high yield ex CCCs is represented by the Bloomberg Barclays US High-Yield Ba/B 2% Issuer Capped Index; risk-managed barbell is represented by 50% US Treasuries and 50% high yield ex CCCs—rebalanced monthly; risk-weighted barbell is represented by 65% US Treasuries and 35% high yield—rebalanced monthly. The data points represent 20 years annualized.

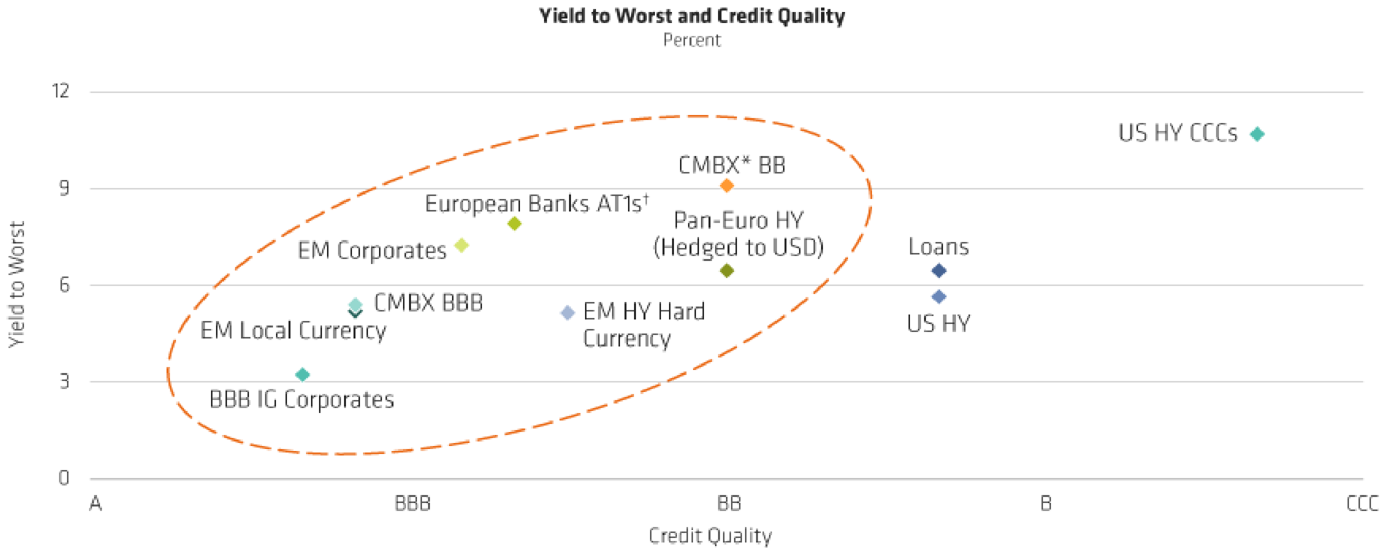
Source: Bloomberg Barclays and AllianceBernstein (AB)

Within credit for example, blending exposure to high-yield bond sectors with positions in select emerging-market debt and US commercial mortgage-backed securities and other securitized assets offers a good mix of credits that can generate high levels of income.

In fact, these sectors are among those that offer a better combination of yield and quality than traditional high-yield bonds *(Display 2)*, underscoring the importance of taking a global, multi-sector approach to return-seeking assets.

In Credit, Look Beyond Traditional High-Yield Bonds

Many Sectors Offer Better Combinations of Yield and Quality than US High Yield (HY)



Through September 30, 2019

Past performance and historical and current analysis do not guarantee future results.

*CMBX is an index that tracks the commercial mortgage-backed securities market

†AT1: additional tier 1 bonds are subordinated bank debt that can be written off in a crisis

EM: emerging-market; IG: investment-grade

Source: Bloomberg Barclays and J.P. Morgan

After a decade of expansion, financial markets may finally be approaching a turning point. For bond investors, that means finding a way to keep the income flowing while also shielding your portfolio from the full effect of higher volatility and slower growth. The way we see it, the time to act is now.

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