

Subject: Addition of dedicated high yield corporate credit to portfolios
 Date: April 2020

Rationale: We believe the recent dislocations in the capital markets have created an opportunity for a measured allocation to high yield corporate credit.

- The spread (incremental yield) available in the high yield arena is now at approximately 770 basis points, well above the ten-year average of 480 basis points. This level of additional compensation has historically been an attractive entry point for the thoughtful investor.

High Yield Spreads and Subsequent returns



Source: Eaton Vance, ICE BofA US High Yield Index as of March 24, 2020

- Current valuations (spreads) imply default rates well above what we have experienced in recent years and above what occurred during the financial crisis in 2008-2009.

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Implied default rates by different spread level and recovery rate assumptions

		CREDIT SPREADS (bps)									
		500	600	700	800	900	1,000	1,250	1,500	2,000	
RECOVERY-RATE ASSUMPTIONS	ANNUAL DEFAULT RATES	40%	8.3%	10.0%	11.7%	13.3%	15.0%	16.7%	20.8%	25.0%	33.3%
		20%	6.3%	7.5%	8.8%	10.0%	11.3%	12.5%	15.6%	18.8%	25.0%
		0%	5.0%	6.0%	7.0%	8.0%	9.0%	10.0%	12.5%	15.0%	20.0%
	5YR CUMULATIVE DEFAULT RATES	40%	41.7%	50.0%	58.3%	66.7%	75.0%	83.3%	104.2%	125.0%	166.7%
		20%	31.3%	37.5%	43.8%	50.0%	56.3%	62.5%	78.1%	93.8%	125.0%
		0%	25.0%	30.0%	35.0%	40.0%	45.0%	50.0%	62.5%	75.0%	100.0%

Source: Eaton Vance

Historical Annual Default Rates – U.S. High Yield

2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019
11.2%	2.5%	2.8%	2.8%	2.4%	1.8%	4.3%	5.0%	2.2%	2.2%	2.0%

Source: Western

- An extraordinary amount of stimulus being directed at the crisis, including the Fed’s stated attention to support the high yield arena specifically, may add a measure of stability to markets going forward.

Strategy: We have targeted a dedicated commitment equaling up to 10% of portfolios’ fixed income allocation to high yield, sourcing the investment from portfolios’ other anchor fixed income mandates.

- We have selected PIMCO’s high yield offering to execute this implementation. PIMCO is an experienced, well-credentialed investor in the high yield space with a compelling long-term track record. While the team has the ability to invest across the high yield quality spectrum, it tends to focus its efforts within the higher quality tiers. This area of the opportunity set offers, in our estimation, particularly compelling opportunities currently and may offer a margin of safety given the continuing unsettled investing environment.

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