NEUBERGER BERMAN

CHRIS KOCINSKI
Co-Head of U.S. High Yield

JOSEPH LIND
Co-Head of U.S. High Yield

Short Duration High Yield: Replacing Rates Risk With Credit Risk

Historically low and flat yield curves, paired with lengthening duration, have created cash flow and diversification challenges for investors in core government and other investment grade bonds. The problems are particularly acute for Property & Casualty insurers, which need current income to meet short-term liabilities and smooth their underwriting results, but have limited appetite for the wide asset-liability duration gap, rate risk and volatility that would likely accompany a search for yield in longer-dated bonds.

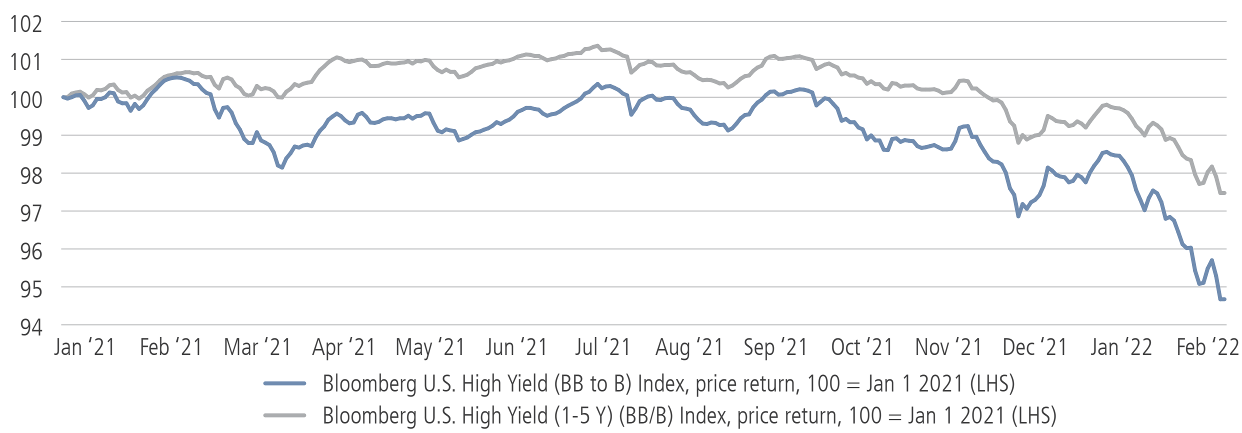
Some are turning to private debt, thereby taking a controlled amount of illiquidity risk. We think short duration high yield bonds in the public market can go a long way toward solving the same challenge, however. The questions for investors are: can a shorter duration exposure sustain a similar level of yield, do high yield issuers present too much default risk, and can they meet the increasing demand for sustainable investing?

In today's environment, duration makes a difference.

Figure 1 indicates that, since the start of 2021, an investor that favored a shorter-dated index of BB/B rated high yield bonds is likely to have outperformed one who stuck with the full BB/B market by almost three percentage points—with virtually all of that outperformance coming from the lower interest rate risk.

At Neuberger Berman, we think that bond markets are still not fully pricing for structurally higher inflation, which would suggest that shorter-dated bonds could be in for more of the kind of outperformance seen since last September.

FIGURE 1. SHORT DURATION HAS BEEN OUTPERFORMING, LARGELY DUE TO INTEREST RATE RISK



Source: FactSet. Data as of February 7, 2022. For illustrative purposes only. **Past performance is no guarantee of future results.**

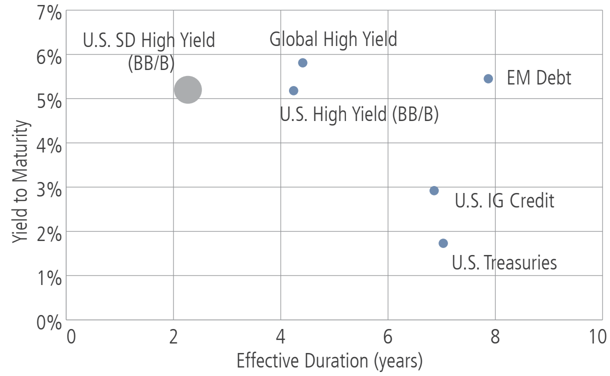
Do the downside and volatility benefits of lower interest rate sensitivity come in exchange for lower yield?

The data in Figure 2 suggests that, if anything, the opposite is the case. Yield and spread in the short-duration index are in fact slightly higher, despite average maturity being cut by half. Among the broad universe of fixed income opportunities, high yield in general, and short duration high yield in particular, appears to be one of the most efficient ways to optimize the yield-duration trade-off.

We have also shown how short duration exposure can substantially reduce regulatory capital charges, using the Solvency II Solvency Capital Requirement for reference. The 14.34% charge for the short duration BB/B index is only slightly higher than that for five-year BBB corporate bonds.

FIGURE 2. CUTTING DURATION DOES NOT NECESSARILY MEAN CUTTING YIELD

	Bloomberg U.S. High Yield (BB/B) Index	Bloomberg U.S. High Yield (1-5 Y) (BB/B) Index
Yield to Maturity	5.18%	5.20%
Yield to Worst	4.99%	4.84%
Option Adjusted Spread	300 basis points	312 basis points
Effective Duration	4.24 years	2.27 years
Average Maturity	6.55 years	3.52 years
Solvency II Solvency Capital Requirement	23.15%	14.34%



Source: FactSet. Solvency II –Solvency Capital Requirement is the Spread Risk SCR as defined under the Solvency II Delegated act of 2014, as calculated by Neuberger Berman. Data as of February 7, 2022.
Indices used: Bloomberg U.S. High Yield (1-5 Year) (BB/B) Index for U.S. Short Duration High Yield (BB/B), Bloomberg U.S. Aggregate Government Treasuries Index for U.S. Treasuries, Agg, Bloomberg U.S. Aggregate Credit Corporate Investment Grade Index for U.S. IG Credit, Bloomberg Global High Yield Index for Global High Yield, Bloomberg U.S. High Yield (BB/B) Index for U.S. High Yield (BB/B), JPM EMBI Global Index for EM Debt. For illustrative purposes only.
Historical trends do not imply, forecast or guarantee future results.

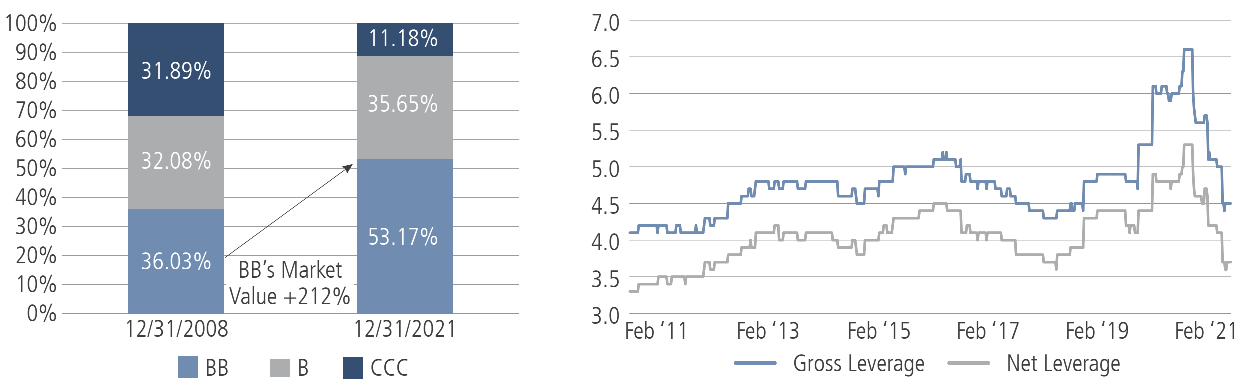
Higher yield and spread on the near end of the credit curve is not always a positive sign. It may indicate that default risk is perceived to be higher because an economic slowdown is anticipated over the next year or two. The current, extremely high level of inflation and its implications for tighter monetary policy and financial conditions raise the probability of that outcome.

That said, we believe reassurance comes from the marked improvement in credit quality among high yield issuers. At the end of 2008, there was $262m worth of U.S. high yield bonds with the top BB rating, or just over one third of the market; by the end of 2021, the amount had risen to $817m, more than half of the market.

Through the whole of 2021, the constituents of the ICE BofA U.S. High Yield Index suffered a default rate of just 0.36%. The most recent forecast from Neuberger Berman's Fixed Income team is for a 0.74% default rate in 2022 rising to a still modest 1.14% through 2023, as a higher volume of refinancing becomes necessary. This remains well below the long-term average default rate for high yield. Moreover, when defaults are this uncommon, we believe that prudent bottom-up credit analysis and active portfolio management stands a high chance of weeding them out.

FIGURE 3. IMPROVING QUALITY AMONG U.S HIGH YIELD ISSUERS

Evolution of credit ratings and aggregate leverage in the ICE BofA U.S. High Yield Index



Source: Bank of America. Data as of December 31, 2021. For illustrative purposes only. **Historical trends do not imply, forecast or guarantee future results.**

There may be concern that a shift downward in credit rating means a shift downward in environmental, social and governance (ESG) scores, perhaps due to the higher environmental impact of the dominant high yield sectors, or perceptions that governance is less robust than it is at investment grade companies.

Again, we believe that active management can help to answer those concerns.

The UN-supported Principles for Responsible Investors (PRI) recognizes Neuberger Berman with an A+ rating for Fixed Income ESG Integration. Our proprietary ESG score—the NB ESG Quotient—is based on multiple quantitative data sources and qualitative analyses for every issuer in our client portfolios. The NB ESG Quotient is a key component of our internal credit ratings and can help to identify ESG risks that could cause deterioration in an issuer's credit profile. Internal credit ratings are notched up or down based on the NB ESG Quotient. The analyses feeding this process comes from our credit research team rather than a centralized ESG group within the firm or an external ESG rating service. This enables our specialists to use their sector expertise to customize criteria for each industry, using the Sustainability Accounting Standards Board ("SASB") as a starting point, and to apply governance assessment that is specific to the non-investment grade universe and consistent across industries.

We find that it is possible to reconcile this level of ESG rigor while maintaining yields, spreads and financial risks in line with the full market. For example, we have been able to construct large multi-asset credit portfolios that remain aligned with the return, risk, duration and credit-quality requirements of clients, and of equivalent broad market indices, while cutting financed Scope 1 and 2 carbon intensity by as much as 50%.

It is sometimes assumed that fixed income investors have no influence because they lack shareholder voting rights. We take the opposite view. Achieving the ambitious goals of the 2015 Paris Climate Agreement requires substantial shifts in capital allocation. Lenders, as providers of new capital and critical refinancing, have a key role in directing it toward companies that are creating climate solutions or adapting to a low carbon economy, and away from carbon-intensive industries with no possibility of alignment.

Between July 2020 and June 2021, our fixed income teams conducted 1,514 engagement meetings, 61% of them at CEO or CFO level, focusing on areas for improvement identified through our ESG Quotient scoring process, with the goal of reducing credit risk and aligning issuer actions with common frameworks, including the Sustainable Development Goals ("SDGs") and climate transition.

At least 90% of the high yield issuers we invest in are covered by this engagement program: we believe issuer engagement plays an important role in helping an active manager maintain portfolio yield while improving ESG performance.

In summary, we think short-duration high yield could be an under-explored option for investors who need current income to meet short-term liabilities, but cannot afford the interest rate risk that would accompany a search for yield in longer-dated bonds. We believe concerns about credit and ESG risks are overstated relative to fundamentals, and that both can be substantially mitigated through active management. For Property and Casualty insurers, in particular, we think the asset class represents an attractive opportunity.

Index Definitions

The Bloomberg U.S. High Yield Bond Index measures the USD-denominated, high yield, fixed-rate bond market, rated BB or B by S&P or the equivalent rating by Fitch or Moody's. The Bloomberg U.S. High Yield (1-5 Year) (BB/B) Index measures that part of the market with maturities of five years or less.

The Bloomberg U.S. Aggregate Government Treasuries Index measures the performance of Treasury bonds from the Bloomberg U.S. Aggregate Bond Index, a broad base, market capitalization-weighted bond market index representing intermediate term investment grade bonds traded in the U.S.

The Bloomberg U.S. Aggregate Credit Corporate Investment Grade Index measures the performance of corporate bonds from the Bloomberg U.S. Aggregate Bond Index, a broad base, market capitalization-weighted bond market index representing intermediate term investment grade bonds traded in the U.S.

The Bloomberg Global High Yield Index is a multi-currency measure of the performance of the global high yield debt market which brings together the Bloomberg U.S. High Yield, Pan-European High Yield, Emerging Markets Hard Currency High Yield Indices.

The J.P. Morgan Emerging Markets Bond Index (EMBI) Global Index measures total returns for traded hard currency debt instruments in the emerging markets.

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Neuberger Berman
1290 Avenue of the Americas
New York, NY 10104-0001

www.nb.com