

**INVESTMENT NOTE: APRIL 13, 2022****Short Duration High Yield: Still A Timely Income Solution**

Short duration high yield ("SDHY") is a unique investment solution. We believe it offers a compelling risk/reward profile that has led many investors to actively allocate to this strategy as a lower duration, higher income alternative to short duration investment-grade (IG) credit and is a potentially attractive addition to core fixed income exposures. The dramatic market movements seen around the COVID-19 pandemic, as well as more recent interest rate and geopolitical impacts, highlight the necessity to offer investment strategies that are both resilient and provide attractive risk-adjusted returns. This report illustrates several examples of how and why a high quality short duration high yield strategy can help investors capture incremental yield in a low-yield and/or rising rate environment, while seeking to minimize risk.

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- SDHY combines high coupon income with opportunities to add alpha, managing the portfolio through calls, tenders and other credit-specific catalysts, while mitigating interest rate risk.
- With negative correlation to U.S. Treasuries, superior "duration coverage" and a moderate level of volatility, we believe it is a compelling alternative to short duration investment-grade (IG) credit and an attractive addition to core fixed income allocations.
- We believe in-depth credit research and prudent active management are critical to identifying alpha potential and discerning "money good" credits.

**Introduction**

Many institutional and high net worth investors alike have increasingly allocated to SDHY with the goal of enhancing the returns of low-yielding investment grade and U.S. Treasury bond portfolios. We have also witnessed investors utilizing SDHY as a complement to core fixed income allocations. In addition to a very low duration profile, SDHY offers important benefits such as incremental income generation over investment grade fixed income alternatives and the potential to help minimize volatility/drawdowns for overall fixed income allocations. Today's uncertain economic environment and still low global rates by historical standards has led investors to explore ways to increase income yield while balancing credit and interest rate risk, particularly given the outlook for a continued rise in rates. Key to this analysis is finding the optimal mix of yield, volatility, and duration that results in enhanced income while limiting potential capital losses.

For the purpose of this analysis, we define the universe of short duration high yield as the ICE BofA 0-2 Year Duration BB-B U.S. High Yield Constrained Index (H42C). Much more than simply shortening the

tenor and duration of a broad high yield exposure, this index omits the lowest rated issues, which we believe is appropriate for investors seeking to mitigate downside volatility and capital losses. When investing in SDHY, the primary objective is to capture the high coupon income while avoiding negative credit events and add value through owning bonds with attractive optionality through calls and tenders and credit selection of misrated "money good" issuers.

Since the publication of our initial analysis in June 2012, the 5-year U.S. Treasury yield has risen meaningfully to 2.46% as of March 31, 2022, versus approximately 0.75% then (please see **Exhibit 1** below). The volatility in the 5-year yield during this time period has also been dramatic, with a range of as much as 290 basis points. The yield was as high as 3.09% in November of 2018 and as low as 0.19% in August of 2020. Over the trailing nine-year period ending March 31, 2022, the short duration high yield universe (H42C) returned 3.43%, comparing favorably to 1.73% for the U.S. 1-3 Year Investment Grade Corporates (C1A0), 2.07% for the U.S. 1-5 Year Investment Grade Corporates (CVA0), and 2.07% for The Bloomberg Barclays Capital U.S. Aggregate Bond Index (LBUS). In this report, we examine the current data and re-examine the merits of SDHY versus other alternatives and consider the benefits of its inclusion within a diversified, core fixed income allocation.

### Exhibit 1. 5-year U.S. Treasury Yield 6/1/2012 - 3/31/2022



### Merits of Short Duration High Yield

*Enhanced Returns.* For many investors, the premise of allocating to the shorter durated debt of high yield companies is simple: rather than earn next to nothing in cash and much of the investment grade fixed income universe, clip the higher coupon in "money good" credits with ample near-term liquidity while seeking to avoid defaults. Active portfolio management and in-depth credit research are critical to the execution of such a strategy. Beyond simply modeling the issuers' financials, investors must develop insights into how the management teams of high yield companies intend to manage their balance sheets and address near-term financing needs.

Understanding these nuances helps managers potentially add alpha through prudent credit selection, while preserving principal and ultimately earning attractive coupon income. While investors may experience some market-to-market volatility in times of significant stress (please see Volatility & Return section below), we believe the thesis for SDHY as part of a fixed income portfolio or tiered cash management program is sound.

### Yield-to-Likely™

*Structural Alpha Opportunities and Yield-to-Likely™*. An important aspect of SDHY is gauging the appropriate yield in light of the fact that the majority of bonds in the high-yield market are callable and can be redeemed at various call dates prior to maturity. As a result, it is critical to consider the impact of embedded options on a bond's potential return profile and duration. It is important to note that market convention in pricing high-yield callable bonds is to quote the corresponding yield-to-worst and duration-to-worst for a given price. From a yield perspective, the resulting quoted yield will be the lower and more conservative outcome of the multiple redemption scenarios. This ensures specific income or yield requirements will still be met even in the worst scenarios. However, our experience has proven that yield-to-worst can often-times be an overly conservative metric for an actively managed strategy. This is particularly true when callable bonds are trading at premiums above their call prices. A key driver of this dynamic is the fact that an issuer's decision to call or redeem its bonds is not solely based on refinance economics such as payback period and NPV, but more often driven by company specific motivations and circumstances. Some motivations beyond refinance economics can include the following:

- Issuer is seeking to make a large acquisition that may require additional debt financing and looking to delay refinancing to occur in conjunction with the acquisition so as not to harm or frustrate investors.
- LBO sponsor may be approaching the end of its investment horizon on a portfolio company, or a bond's issuer is either in process or seeking to be acquired and not pursuing a refinancing of currently callable debt that would likely result in new call protection premiums making the target less appealing and more costly to potential suitors.
- Issuer is awaiting conclusion of a strategic review that could result in a sale, spinoff, or IPO of certain significant assets or the entire company, all of which can be an extended process.
- Issuer is awaiting the benefit of improved operational trends over several quarters or expected/targeted credit rating improvement in anticipation of more favorable refinancing terms.
- Issuer is looking to remove onerous covenant provisions tied to a specific bond indenture that could incentivize them to redeem the bonds early due to the additional financial flexibility incentives.
- Issuer seeking to coordinate redemption timing with other upcoming callable bonds or refinancing opportunities, or senior management may simply be philosophically averse to paying large premiums to redeem bonds even if payback economics justify.
- Issuer seeking to redeem bonds early due to rising rate expectations.

These are just a few of the multitude of company-specific circumstances that will ultimately drive the timing of refinancing and redemption decisions. As a result, yield-to-worst (YTW) for bonds trading at a premium can often-times not be the best indicator of the likely yield. Likewise, the current yield (coupon divided by price) is not an accurate judge of yield either as amortizations of premium or discount in price must be factored in as well thus

impacting a bond's ultimate realized yield. So, the question becomes "What is a better or additional estimate of yield to consider?" We refer to it as "Yield-to-Likely" (YTL)<sup>™</sup> – a proprietary metric that typically lies somewhere between YTW and Current Yield and incorporates our insights into when bonds are most likely to be redeemed (or not called). When bonds are trading at premiums to par, this YTL<sup>™</sup> metric tends to fall much closer to the yield-to-maturity (YTM) which also lies between the YTW and current yield as it incorporates the amortization of a bond's premium over time. Investors may be able to capture greater yields and returns with more informed assumptions beyond the standard worst-case metric. Through in-depth research of catalysts driving the call and tender activity on each individual issue, a skilled manager can potentially add value and evaluate when bonds are most likely to be called to determine the yield to that more "likely" call date. Strong bottom-up fundamental research process can help a manager to understand issuers' financing needs and seize upon idiosyncrasies within the SDHY universe. The illustration below demonstrates a currently callable bond example at purchase. It highlights how quickly a bond's yield can ramp beyond the yield-to-worst if it remains outstanding as well as the meaningful incremental yield that can be captured when a manager's likely call date may differ with market expectations.

### Short Duration Callable Bond Example

Bond Purchase Information		First (Worst) Call	+30 days	+60 days	Likely Call*	Maturity	
Coupon	7.75%						
Final Maturity	2/1/2026						
Purchase Date	1/1/2022	Call Date	2/1/2022	3/1/2022	4/1/2022	5/1/2022	2/1/2026
Purchase Price	104.34	Call Price	103.875	103.875	103.875	103.875	100
Yield-to-Worst	2.0%	Annualized Yield	2.0%	4.7%	5.6%	6.1%	6.5%
Duration-to-Worst	0.08						

\* Manager estimate.

As shown in the above theoretical example, the Yield-to-Likely<sup>™</sup> of this particular bond is 6.1%, representing an incremental annualized return of over 410 basis points above the quoted YTW. If this bond is called at the earliest opportunity, a yield-to-worst return would be realized. But if the call date is ultimately later than this date (but prior to maturity), then it's possible for an investor to achieve enhanced returns in a lower risk manner, without having to look to bonds with higher credit or default risk to capture higher yields.

While past performance is never a guarantee of future success, looking back historically provides a valuable perspective at how this favorable dynamic with callable bonds has played out. Over the past 10 years, 86% of the callable bonds owned within the Shenkman Capital Short Duration Composite did not come out at the first call date. These bonds were either called well after (or before) their first call dates resulting in measurable incremental returns beyond their first call and/or "worst" yield calculations for investors. Approximately 69% of callable bonds were called after their first call dates, and on average over 17 months past the first call date. While approximately

17% of callable bonds were redeemed at make-whole premiums before their first call date, on average over six months prior to their first call date.

With a YTW of 4.7%, Current Yield of 6.3%, and Yield-to-Maturity of 5.4% as of March 31, 2022, SDHY (H42C) implies what we believe is an attractive Yield-to-Likely™ metric for higher quality portfolios.

*Alternative Solution to Investment Grade Duration Risk.* Many investors have reached the conclusion that the yield an investor receives from traditional investment grade strategies, as reflected by the Bloomberg Barclays Capital U.S. Aggregate Bond Index (LBUS) or the ICE BofAML U.S. Corporate Index (COAO), does not adequately compensate for the interest rate risk that the investor assumes today. The yield and duration metrics of investment grade fixed income, as shown in **Exhibit 2** below, support such a conclusion. While investors in those fixed income segments may not be taking on significant credit risk, they are in fact taking on meaningful duration and interest rate risk.

### Exhibit 2. Yield & Duration Comparison Data as of 3/31/2022

	Yield-to-Worst	Average Coupon	Yield-to-Maturity	Duration-to-Worst
U.S. Aggregate <sup>1</sup>	2.92%	2.44%	2.92%	6.84 years
U.S. IG Corporate <sup>2</sup>	3.63%	3.57%	3.64%	7.79 years
Short Duration High Yield <sup>3</sup>	4.73%	6.43%	5.42%	1.13 years

<sup>1</sup>U.S. Aggregate is based on the Bloomberg U.S. Aggregate Bond Index.

<sup>2</sup>U.S. IG Corporate is based on the ICE BofA U.S. Corporate Index (COAO).

<sup>3</sup>Short Duration High Yield is based on the ICE BofA 0-2 Year Duration BB-B U.S. HY Constrained Index (H42C).

Source: ICE Data Indices, Barclays, Shenkman Capital.

Given the meaningful interest rate risk in investment grade fixed income (i.e., duration>yield), the next logical question is, "What is the alternative?" Over the past 10 years, SDHY has exhibited a correlation of -0.12 to the 5-year U.S. Treasury note. That is, when the 5-year U.S. Treasury note sold off and interest rates rose, SDHY has tended to outperform. Conversely, short duration investment-grade corporate bonds had positive correlations to the 5-year U.S. Treasury note (+0.33 and +0.41 for 1-3 year investment-grade corporates and 1-5 year investment-grade corporates, respectively, over the trailing 10-year time period), thus tending to lose value when interest rates rose (please see **Exhibit 3** below).

**Exhibit 3. Correlation to 5-year U.S Treasury Note**  
 Data as of 3/31/2022

	Trailing 5-Year	Trailing 10-Year
Short Duration High Yield <sup>1</sup>	-0.26	-0.12
U.S. 1-3 Year IG <sup>2</sup>	0.26	0.33
U.S. 1-5 Year IG <sup>3</sup>	0.29	0.41

<sup>1</sup>Short Duration High Yield is based on the ICE BofA 0-2 Year Duration BB-B U.S. HY Constrained Index (H42C).

<sup>2</sup>U.S. 1-3 Year IG is based on the ICE BofA 1-3 Year U.S. Corporate Index (C1A0).

<sup>3</sup>U.S. 1-5 Year IG is based on the ICE BofA 1-5 Year U.S. Corporate Index (CVA0).

Source: ICE Data Indices, eVestment.

While investing in SDHY entails incrementally more credit risk than other short duration and broader fixed income alternatives, we believe one can help mitigate credit risk via active management, fundamental research and portfolio diversification. Although investment grade short duration options are higher credit quality, they have lower yields and greater interest rate sensitivity, making them potentially less attractive options in a low and/or rising rate environment. This is an important consideration as there is only so much that can be done to limit capital losses in investment grade portfolios when rates rise. To illustrate, we compare characteristics of SDHY to those of investment grade short duration benchmarks as well as the broader investment grade benchmark in **Exhibit 4** below.

Also included in **Exhibit 4** below is a measure we refer to as "duration coverage," or the amount of yield per unit of duration (YTW and/or YTM divided by DTW). For SDHY, it is also sometimes useful to consider YTM/DTW in particularly low yield environments where YTW may be depressed as most bonds are not redeemed at their first and/or worst call. Currently, short duration investment grade bonds provide less compensation to investors for the interest rate risk they are assuming.

**Exhibit 4. Short Duration HY vs IG Bonds**  
 Data as of 3/31/2022

	Short Duration HY <sup>1</sup>	U.S. 1-3 Year IG <sup>2</sup>	U.S. 1-5 Year IG <sup>3</sup>	U.S. IG Corporate <sup>4</sup>
Average Price	\$102.47	\$99.81	\$99.09	\$99.95
Current Yield	6.28%	2.93%	3.01%	3.57%
Yield-to-Worst	4.73%	2.88%	3.13%	3.63%
Yield-to-Maturity	5.42%	2.92%	3.17%	3.64%
Modified Duration-to-Worst	1.13 years	1.88 years	2.77 years	7.79 years
Duration Coverage (YTW/DTW)	4.19x	1.53x	1.13x	0.47x
Estimated Return after +100 bps Curve Shift <sup>5</sup>	2.92%	1.08%	0.48%	-3.54%

<sup>1</sup>Short Duration High Yield is based on the ICE BofA 0-2 Year Duration BB-B U.S. HY Constrained Index (H42C).

<sup>2</sup>U.S. 1-3 Year IG is based on the ICE BofA 1-3 Year U.S. Corporate Index (C1A0).

<sup>3</sup>U.S. 1-5 Year IG is based on the ICE BofA 1-5 Year U.S. Corporate Index (CVA0).

<sup>4</sup>U.S. IG Corporate is based on the ICE BofA U.S. Corporate Index (COA0).

<sup>5</sup>Assuming an upward parallel shift in the U.S. Treasury yield curve as an instant shock, netted against YTW as a proxy for 12mo performance, all else being equal.

Source: ICE Data Indices, Bloomberg, Shenkman Capital.

In the above illustration on the previous page, we also consider the effect of a 100 basis point upward parallel shift in the yield curve over a one-year period. All else equal, short duration investment-grade corporates lose a meaningful portion of their yield as rates rise. In contrast, SDHY's meaningful current yield provides much higher incremental cushion to overcome the capital depreciation, resulting in an estimated 2.92% return. In an environment of rate hikes and balance sheet normalization, we believe duration risk in investment-grade fixed income clearly appears to be meaningfully higher, especially across non-maturity constrained corporates where the lack of duration coverage is most evident.

Another potential benefit of investing in SDHY in rising rate environment involves its still relatively short final maturity tenor and related higher level of corporate action activity and turnover. As an indicative example given our experience in portfolios, in any given year, the volume of calls, tenders and maturities in a typical Shenkman Short Duration Composite portfolio can range from 28% to 65%+ of the portfolio, with an average of approximately 45%+ per year. As these bonds are called, redeemed and maturing, this situation creates natural inflows within the portfolio that can be reinvested at higher yields in a rising rate environment. Investment grade portfolios have very low exposures to callable bonds and therefore will tend to see much less corporate action activity.

*[Performance in Rising Rate Environments](#)*. Given the dramatic rise in Treasury yields over the past several weeks and months, we believe a look at more recent relative performance year-to-date 2022 and in specific past rising rate environments is instructive. See **Exhibit 5** below. While each period has its own unique circumstances and conditions, the data supports the longer-term correlations and general view that duration and duration coverage are among the more important drivers of returns in periods of rising rates. As a result, SDHY (H42C) posted positive returns in all the rising rate environments displayed below, in contrast to many of the fixed income segments noted in the exhibit and elsewhere in this report.

### Exhibit 5. Returns During Period of Rising Rates

	5/1/2013 – 12/31/2013	9/1/2017 – 9/30/2018	8/1/2021 – 3/31/2022
SDHY (H42C)*	2.75%	3.92%	0.06%
U.S. IG Short Duration 1-3 (C1A0)	0.91%	0.80%	-3.67%
IG Short Duration 1-5 (CVA0)	0.39%	0.06%	-5.03%
High Yield Bonds (H0A0)	2.49%	3.86%	-3.33%
Investment Grade (COA0)	-3.15%	-1.32%	-8.74%
Barclays US Agg (LBUSTRUU)	-2.89%	-1.69%	-6.92%
ICE BofA Current 5yr Treasury (GA05)	-3.15%	-2.88%	-7.01%
ICE BofA Current 10yr Treasury (GA10)	-9.14%	-5.56%	-8.16%
5-Year Treasury Change in Yield	+107 bps	+125 bps	+177 bps
10-Year Treasury Change in Yield	+136 bps	+94 bps	+112 bps

\*Short Duration High Yield is based on the ICE BofA 0-2 Year Duration BB-B U.S. HY Constrained Index (H42C).  
Source: ICE Data Indices, Bloomberg, Shenkman Capital.

*Volatility & Return.* An attractive aspect of SDHY is that as bonds near maturity or likely call dates, the key drivers of price volatility often shift toward credit-specific factors, so the influence of macro drivers diminishes, resulting in less volatility from swings in global risk sentiment. For instance, when Coronavirus rocked the global financial markets in the first quarter of 2020, the S&P 500 Index and broad high yield market (H0A0) plummeted nearly 20% and 13%, respectively, while SDHY limited the decline to 6.7%, which was closer to the drawdown seen with investment grade corporates (COA0) which declined 4.0%, despite benefiting from a 125 basis point decline in the 10-year US Treasury to 0.67% at March 31, 2020.

Notwithstanding that SDHY's historical volatility is higher than that of its investment-grade counterparts, we believe that investors appear well-compensated given SDHY's moderate level of volatility, particularly in light of the potential for alpha opportunities and relatively attractive downside protection. **Exhibit 6** illustrates that over the last 10+ years, the incremental risk of SDHY has been rewarded, as exemplified by higher risk-adjusted returns across the various short duration alternatives.

#### Exhibit 6. Annualized Risk & Return Comparison 4/30/2006 - 3/31/2022

	Short Duration HY <sup>1</sup>	U.S. 1-3 Year IG <sup>2</sup>	U.S. 1-5 Year IG <sup>3</sup>
Cumulative Return	130.57%	60.08%	74.65%
Annualized Return	5.36%	3.00%	3.56%
Standard Deviation	4.80%	2.58%	3.27%
Sharpe Ratio	0.91	0.77	0.78%

<sup>1</sup>Short Duration High Yield is based on the ICE BofA 0-2 Year Duration BB-B U.S. HY Constrained Index (H42C).

<sup>2</sup>U.S. 1-3 Year IG is based on the ICE BofA 1-3 Year U.S. Corporate Index (C1A0).

<sup>3</sup>U.S. 1-5 Year IG is based on the ICE BofA 1-5 Year U.S. Corporate Index (CVA0).

Source: ICE Data Indices, eVestment.

*Beneficial Addition to a Diversified Fixed Income Portfolio.* SDHY is part of an often overlooked asset class when creating or managing a diversified fixed income portfolio. We believe the SDHY segment is particularly compelling given the uncertain economic and market environment, especially as investors search for income, risk mitigation and risk-averse returns. Inclusion of an actively managed high quality and SDHY strategy can provide diversification within the fixed income segment of an overall portfolio given its low correlation with the broad intermediate-term bond market, as measured by the Bloomberg Barclays U.S. Aggregate Bond Index (see **Exhibit 7** below). In addition, an allocation to the strategy may act as a hedge against rising interest rates due to its negative to low correlation with the ICE BofA Current 10-Year US Treasury Index (GA10).

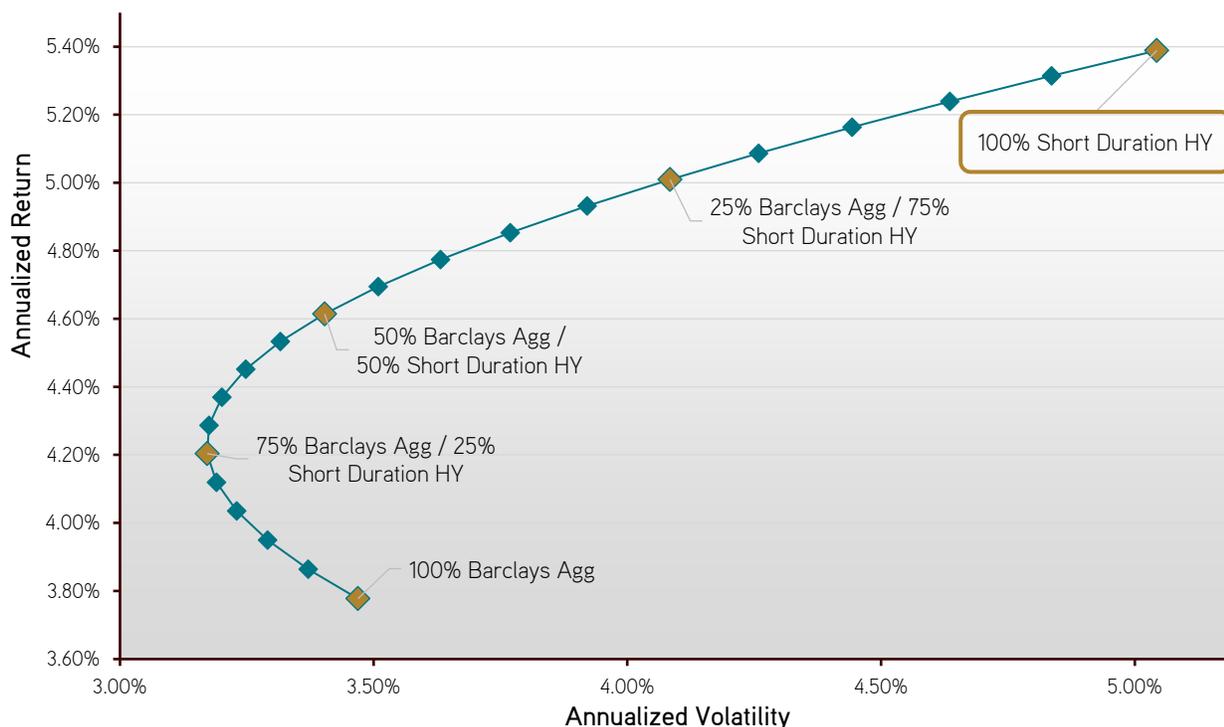
**Exhibit 7. Short Duration High Yield and Index Characteristics Since Inception**  
4/30/2006 - 3/31/2022

	St. Deviation	Jensen Alpha	Beta	Sharpe Ratio	Correlation to SDHY	Returns
Short Duration High Yield*	4.80%	3.39%	0.39	0.91	1.00	5.36%
ICE BofA Current 10-Year US Treasury Index (GA10)	7.01%	-1.71%	1.78	0.43	-0.19	4.04%
Bloomberg Barclays US Aggregate Bond Index (LBSTRUU)	3.34%	0.00%	1.00	0.82	0.26	3.78%

\*Short Duration High Yield is based on the ICE BofA 0-2 Year Duration BB-B U.S. HY Constrained Index (H42C).  
Source: ICE Data Indices, Barclays, eVestment.

The below chart shows how adding a SDHYbond allocation to the Bloomberg Barclays U.S. Aggregate Bond Index can potentially help increase returns while reducing volatility. With negative correlation to U.S. Treasuries, superior "duration coverage" and a moderate level of volatility, we believe SDHY is an attractive addition to core fixed income allocations.

**Exhibit 8. Efficient Frontier: Barclays Agg and Short Duration High Yield**  
4/30/2006 - 3/31/2022



\*Short Duration High Yield is based on the ICE BofA 0-2 Year Duration BB-B U.S. HY Constrained Index (H42C).  
Source: Shenkman Capital, Barclays, Bloomberg

## Conclusion

This updated analysis continues to support our belief that SDHY allocations benefit investors' fixed income portfolios. With a unique set of investment characteristics, SDHY continues to provide a potentially attractive income solution to challenges faced by corporate treasurers, institutional allocators and high net worth investors, particularly in an environment where rates remain low by historical standards as well as in periods of rising rates. SDHY bonds provide income generation, minimal duration risk and the potential for alpha opportunities over stated YTWs and other fixed income alternatives. When included as part of a core fixed income allocation, it can increase a portfolio's income while lowering duration and volatility, reducing drawdowns for overall fixed income allocations. In our view, the asset class's negative correlation to U.S. Treasuries, superior duration coverage and risk-adjusted return profile makes this subset of high yield a compelling alternative to investment-grade strategies and a potentially attractive addition to core fixed income allocations. We believe the successful execution of a short duration strategy requires in-depth credit research and conservative active management in order to maximize "Yield-to-Likely"<sup>TM</sup> alpha while preserving principal.

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