

Investor Positioning, Part 1

A study of mutual fund portfolios

- **Overview:** In an effort to better understand investor positioning, we examined the holdings of approximately 50 mutual fund portfolios. One thing that we found interesting was how the risk / reward relationship of the typical fund is evolving — more risk, less yield.
- **Underweights to Cover:** The typical high-grade manager is still somewhat wary of select money center banks, particularly JPM, GS, and MS. We disagree, and would move to increase holdings of these credits.
- **Overweights to Sell:** As a rule of thumb, we are wary of credits that trade with a wide positive basis as it may signal that strong technicals in the cash market are overwhelming fundamental risk metrics. A number of the largest overweight positions are ones that trade with a significant positive basis, including DOW, HPQ and XRX. We would reduce exposure to these names.
- **What's Better, Cash or Synthetic Cash?** In an era of limited liquidity there is a strong desire to hold high cash balances, but the tradeoff is that the 0% yield on the cash holdings is difficult to offset elsewhere in this low yield environment. We examined how the risk profiles of the typical fund would change if "synthetic cash" was held instead of cash itself.

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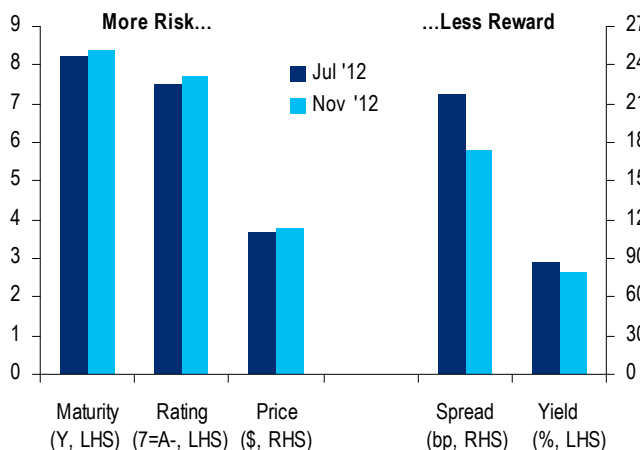
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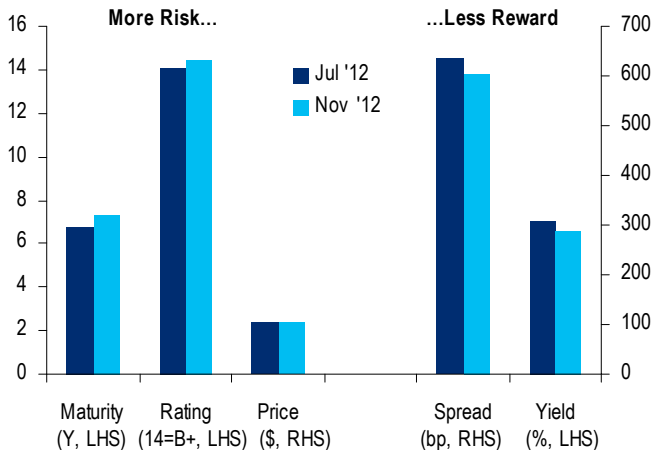
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Figure 1. Characteristics of the typical HIGH-GRADE mutual fund. More risk, less spread & yield



Source: Citi Research, Bloomberg
Note: As of July 16, 2012 and November 16, 2012

Figure 2. Characteristics of the typical HIGH-YIELD mutual fund. More risk, less spread & yield



Source: Citi Research, Bloomberg
Note: As of July 31, 2012 and November 16, 2012

See Appendix A-1 for Analyst Certification, Important Disclosures and non-US research analyst disclosures.

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Investor Positioning, Part 1

In an effort to better understand of investor positioning we scrolled through the holdings of 26 high-grade and 25 high-yield mutual fund portfolios. While there were no dramatic changes since the last time we went through this exercise in July, we did see evidence that the migration into riskier assets remains intact. For example, the dollar price in the typical high-grade portfolio increased almost \$4 (from \$109.4 to \$113.3), the average maturity lengthened 0.2 years, and the average rating of portfolio constituents declined as well (Figure 4). And we observed the same migration in the typical high-yield portfolio (+\$1.2, +0.5 years; Figure 4).

While we certainly don't disagree with this risk-on strategy in the near-term, we are very cognizant of how the risk / reward relationship is evolving. That is, the typical portfolio is earning significantly less despite taking on more risk. Spreads declined by 44 bp and 34 bp in the typical high-grade and high-yield portfolio, respectively, and yields dropped by 0.35% and 0.4%. Bottom line: we're still bullish, but reluctantly so.

In our study we found five other points worth noting, including characteristics of portfolio overweights and underweights, underweight positions that we would cover, overweight positions that we would sell, and the impact of using "synthetic cash" for the typical fund.

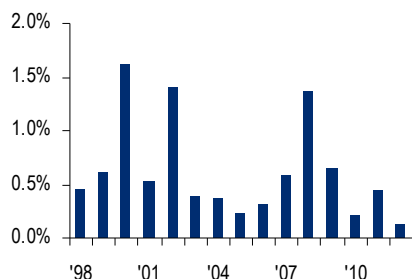
Figure 4. The typical mutual fund is taking more risk but getting paid less

	Typical High-Grade Mutual Fund			Typical High-Yield Mutual Fund		
	Jul '12	Current	Change	Jul '12	Current	Change
<i>Longer maturity, higher price, lower rating...</i>						
Maturity	8.2Y	8.4Y	+0.2Y	6.8Y	7.3Y	+0.5Y
Price	\$109.4	\$113.3	+\$3.9	\$104.2	\$105.4	+\$1.2
Rating*	7.5	7.7	+0.2	14.1	14.4	+0.3
<i>...but less yield and spread</i>						
Spread	217 bp	173 bp	-44 bp	636 bp	602 bp	-34 bp
Yield	2.9%	2.6%	-0.35	7.0%	6.6%	-0.4%

Source: Citi Research, Bloomberg

Note: As of November 16, 2012 for current; as of July 16 for HG and as of July 31 for HY; based on 26 HG and 25 HY mutual funds; *7 = A-; 8 = BBB, 14 = B+, 15 = B

Figure 3. Implied probability of default in the high-grade market is at its lowest level ever



Source: Citi Research
Note: As of November 19, 2012

1. Ratings of overweights & underweights

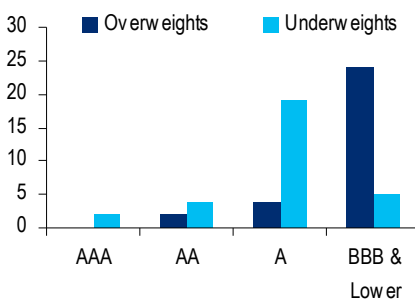
After a few years of below average defaults, 1-year default risk in the high-grade market is at its lowest level ever, according to our quantitative strategy team's model (Figure 3). Given this backdrop, the typical manager is quite complacent about near-term default risk (including ourselves), and as a result managers are willing to move down in credit quality to pick up additional yield.

To put this down-in-quality move into perspective, we compared the weight of each holding in the average mutual fund portfolio to the weighting of the credit in the indices. In Figure 5 (next page) we show the top 30 over- and underweight positions and see that investors are less inclined to hold single-A or higher rated paper among their overweights (5 credits of the top 30 fall into this category).

Conversely, the majority of overweight positions are triple-B or lower (25 of 30), showing us that the move down in quality is clear. For high-yield funds, the same down-in-quality trend holds (Figure 6), although it seems that investors still prefer to avoid the large, LBO'd names.

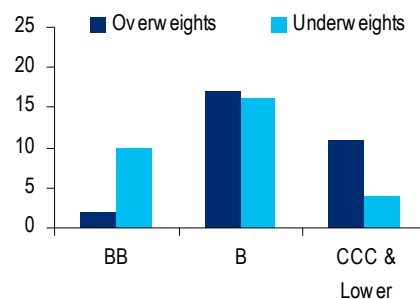
In the near term, we do not disagree with this down-in-quality positioning, but as we have pointed out in *Re-leveraging Corporate America, Part 1* (dated November 8, 2012), companies are more and more willing to increase leverage, often to the benefit of shareholders (*Down to the Wire - Companies race to announce special dividends before YE* dated November 28, 2012). At some point the tide will turn, and the market will discover that lower-quality corporates are just that. Further, we are always cautious of a crowded position, as a change in sentiment can move spreads quickly. **But that is tomorrow's concern.**

Figure 5. Credit rating of top 30 over- and underweights in high-grade



Source: Citi Research, Bloomberg
Note: Based on 26 HG mutual funds; average of Moody's and S&P rating as of November 16, 2012

Figure 6. Credit rating of top 30 over- and underweights in high-yield



Source: Citi Research, Bloomberg
Note: Based on 25 HG mutual funds; average of Moody's and S&P rating as of November 16, 2012

2. For HG managers – underweights to cover

The typical high-grade manager is still somewhat wary of select large money center banks, in particular JPM, MS and GS. While JPM makes up about 2.5% of the high-grade index, for example, the average manager only has 2% of his portfolio invested in the name, resulting in a 0.5% underweight. GS and MS are also meaningful underweights, at 0.21% and 0.19%, respectively (Figure 7).

Figure 7. “SHORT-COVERING” candidates...names that the typical HG manager is underweight but perhaps shouldn't be

	Holdings			Characteristics		
	HG Index	Mutual Fund	Difference	Avg Rating	Spread	6-month Spread Range
JPM	2.46%	1.95%	-0.51%	A2 / A	127 bp	114 bp - 240 bp
GS	2.01%	1.80%	-0.21%	A3 / A-	199 bp	176 bp - 389 bp
MS	1.72%	1.54%	-0.19%	A3 / BBB+	221 bp	206 bp - 516 bp
Average	2.07%	1.76%	-0.30%	A3 / A-	183 bp	165 bp – 382 bp

Source: Citi Research; Note: As of November 29, 2012; based on November index constituents

We disagree with the average manager, and would now move to increase holdings of these credits. (And we would advocate overweighting money center banks in general heading into 2013.) From a fundamental perspective many of the concerns surrounding the industry have been more or less addressed, and we believe those banks with diversified operations are better suited to weather the current low yield, low liquidity environment.

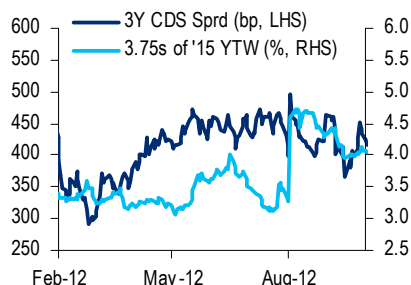
And although banks have tightened dramatically this year, the three names highlighted above trade on average 30 bp wide of the broad market (150 bp) and could tighten further in a reach for yield environment. **Time to cover.**

3. HG managers — mind the basis!

As a rule of thumb, we are wary of credits that trade with a wide positive basis. In our view the cash / CDS disconnect is often the result of strong technicals in the cash market overwhelming fundamental factors (e.g., default risk). We don't necessarily recommend trading the basis, but instead favor using it as a signal to identify cash bonds that may be susceptible if the firm technicals ever wane.

ArcelorMittal (MTNA) is a good example of how vulnerable the cash market can be when the technicals shift. In Figure 8 we present the 3-year CDS spread for MTNA versus the yield for the 3.75s of '15. Earlier in the year, the basis was significantly positive, but when the downgrade occurred in August the yield on the bond was 140 bp higher after the dust settled, while the CDS barely moved (17 bp). In this case, the CDS was a more accurate proxy for fundamentals, and cash valuations realigned with fundamentals.

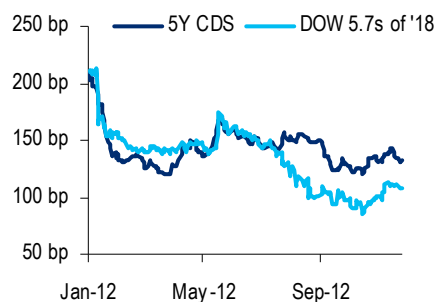
Figure 8. MTNA CDS vs. cash bond



Source: Citi Research
Note: As of September 30, 2012

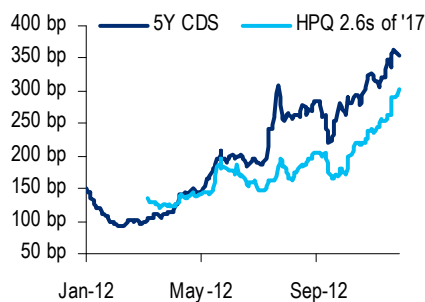
When examining the largest overweight positions of the typical high grade fund, we found that a number of the names trade with a significant positive basis. These include DOW, HPQ and XRX (Figure 9 to Figure 11). Now with two strikes against them in our book (large positive basis, crowded trade), the third strike is operating in currently challenged end markets. **As such, we advocate scaling out of these overweights.**

Figure 9. DOW cash / CDS basis



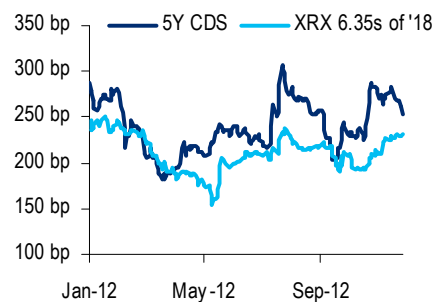
Source: Citi Research
Note: As of November 27, 2012

Figure 10. HPQ cash / CDS basis



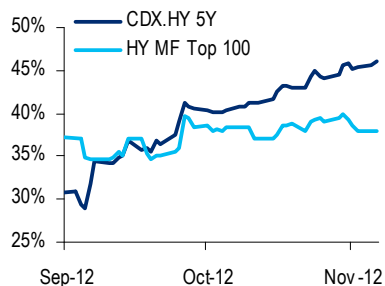
Source: Citi Research
Note: As of November 27, 2012

Figure 11. XRX cash / CDS basis



Source: Citi Research
Note: As of November 27, 2012

Figure 12. Pair-wise correlation for the typical high-yield mutual fund portfolio lower than the broad market



Source: Citi Research
Note: As of November 6, 2012

4. HY managers using the primary market

In the high-yield space we were surprised to see the extent to which overweight positions were comprised of issues from smaller credits. For example, of the top 30 overweights, 19 of them had less than \$1 bn in index eligible debt outstanding (e.g., Sonic Automotives, Michael Foods, etc.).

But looking a bit closer it makes sense, as it appears that the typical manager was using the primary market to gain this exposure. For example, the typical PM is overweight CONCON bonds by almost 0.2% (0.03% vs. 0.21%), and it seems managers just bought and held the new deal – 10.125s of '20 – in July. It is worth noting is that 33% of the top 30 overweight positions (by market value) were done through bonds issued this year (e.g., Ryerson, Level 3, etc.).

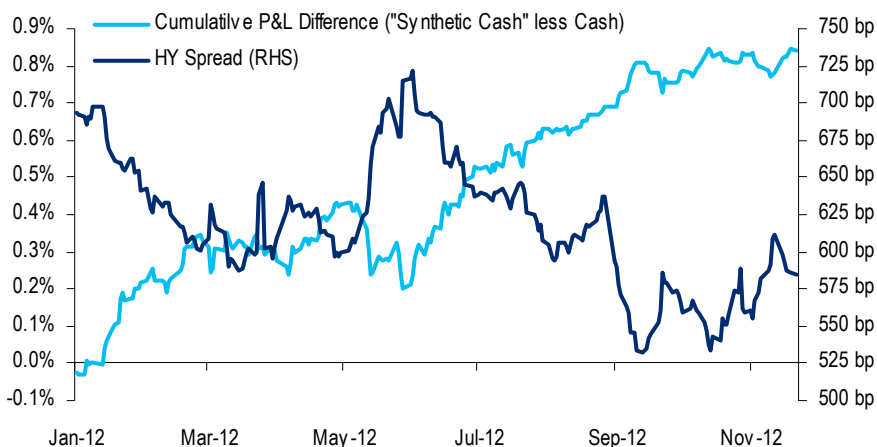
This strategy can be effective. One impact of adding more off-the-run names is that pair-wise correlation is lowered, which in turn increases a PM's ability to generate alpha via credit-picking. We calculated the pair-wise correlation among the top 100 issues held by the typical high-yield mutual fund and for CDX.HY constituents, and see that the correlation for the typical fund is lower than the index (Figure 12).

The downside, of course, is that one is reliant on good allocations and must be okay with the limited liquidity. **We see little reason why this trend will change in the period ahead.**

5. What's better, cash or synthetic cash?

In an era of limited liquidity there is obviously a strong desire to hold relatively high cash balances just in case redemptions pick up, but the tradeoff, of course, is that the 0% yield on the cash holdings is difficult to make up elsewhere in this low yield environment. Several high-yield managers recently asked how their risk / reward profiles would change if they held a cash surrogate, such as one of the main ETFs or a CDX + Treasury position, as a substitute for a portion of their cash positions.

Figure 13. Cumulative P&L difference in holding 5% in cash and 5% in "synthetic cash"



Source: Citi Research, Bloomberg
Note: As of November 26, 2012; based on straight average of 100 top HY MF holdings by MV

We examined this question in the context of the typical high-yield fund manager and assume a cash balance of 5%. The typical cash surrogate pays a dividend of about 6.7%, so an investor could invest 5% of his portfolio in this asset and earn more than the alternative of 0%. With this substitution, the typical fund's overall yield would increase 34 bp.

We analyzed the volatility and total return of the typical high-yield portfolio this year, again assuming 5% was held in a cash surrogate versus cash in hand (Figure 13, previous page). We see that the cumulative P&L difference is fairly large, due to both the extra yield and the extra beta. **The extra beta weighed on performance during the sell-off this spring, but not enough to offset the extra coupon.**

Appendix A-1

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