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The Right Risk for the Reward: The Role of Quality in Short Duration Fixed Income

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Introduction

Investors frequently need a safe, short-term allocation for earmarked assets or excess cash in portfolios. Whether anticipating a near-term liability, waiting for a more opportune time to invest in risk-assets, or debating their future investment strategy, a safe, liquid option with limited downside is a logical solution for funds that are intended for future use. However, in today's low interest rate environment, a cash or money market allocation offers little to no income, creating significant opportunity cost for an investor who sits in cash for any length of time. In this paper, we examine the merits and objectives of a Short Duration fixed income allocation, as well as the downside of stretching too far to generate returns.

The Case for a Short Duration Fixed Income Allocation Instead of Cash

Short Duration bond funds can invest in a wider range of fixed income securities than money market funds, which can broaden the opportunity set and lead to higher levels of income and total returns compared to cash equivalents. Examining rolling one-year periods over the last 20 years, short-term investment grade bonds have outperformed T-bills 84% of the time, by an average of 1.60%. What's more, short-term bond returns are rarely negative. In fact, rolling one-year returns for the BofA ML 1-3 year corporate and government bond index have been negative during only one period in the last 20 years (-0.19%), meaning returns have been positive 99.6% of the time.

Exhibit 1: Short Duration Bond Returns

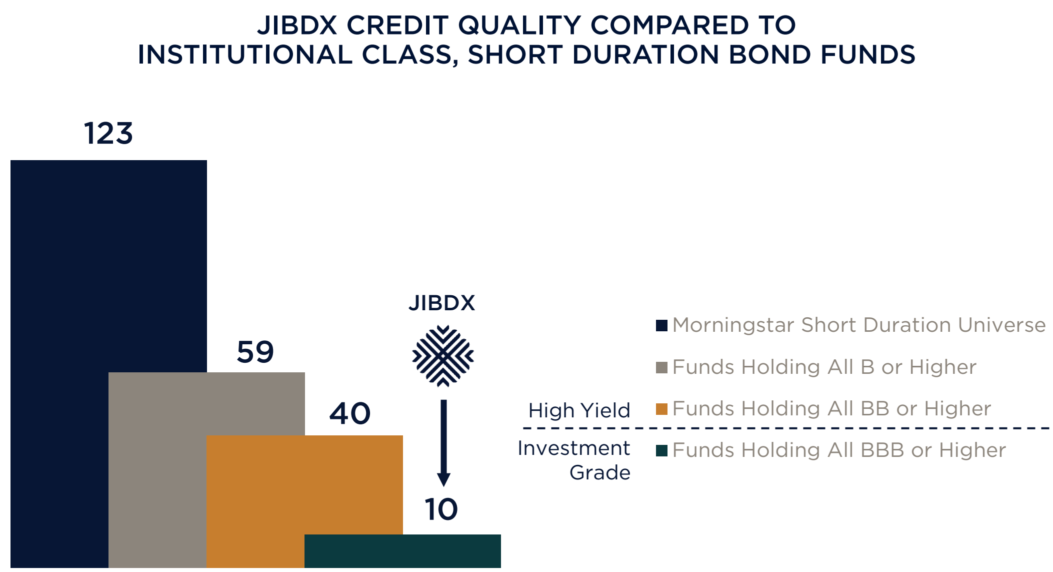
SHORT DURATION BOND RETURNS	
Average 12m Return	+2.98%
Average Excess Return vs. Cash	+1.60%
% of Time Positive	99.6%
Worst 12m Return	-0.19%
# Observations	241

Source: eVestment and Bloomberg Data from 6/30/2001 – 6/30/2021. Short Duration Bond represented by the ICE BofA ML 1-3 Year Corp. & Gov. Index; Cash represented by the ICE US 1-Mo. Treasury Bill Index.

The Danger of Reaching for Returns

As shown in Exhibit 1, a Short Duration fixed income allocation of investment grade bonds frequently out-earns cash with very limited downside. However, in an effort to generate increased returns, many Short Duration fund managers stretch for yield, moving down in quality in order to generate more income. In many cases, Short Duration managers even buy "junk" bonds rated below investment grade for Short Duration allocations. In fact, out of 123 institutional class funds in Morningstar's Short Duration universe, only 10 qualify as "BBB or higher."

Exhibit 2: JIBDX Credit Quality Compared with the Morningstar Short Duration Universe, Institutional Share Class Funds



The above chart compares the credit quality of JIBDX (the Johnson Institutional Short Duration Bond Fund) to all other rated Institutional class mutual funds within the Morningstar universe "US Fund Short-Term Bond". Each category indicates the number of funds within the universe that contain no holdings below the given rating.

Source: Morningstar as of 8/11/2021

While the higher yield offered by junk bonds may boost long-term total returns, it does so by introducing a volatile, equity-like risk/return component into an asset class that should be high-quality, liquid, and resilient, particularly during times of stress. Furthermore, it is precisely during these times of stress when the investor may have an unanticipated need for cash or seek to rebalance out of Short Duration opportunistically into risk-assets. Exhibit 3 shows the performance of High Yield fixed income and Short Duration High Yield during the worst 10 quarters for the S&P 500.

Exhibit 3: Comparison of High Yield and Short Duration High Yield During the Most Recent 10 Worst Quarters for the S&P 500

QUARTER	S&P 500	CORPORATE HY	SHORT DURATION HY
Q4 2008	-21.94%	-17.88%	-12.74%
Q1 2020	-19.60%	-12.68%	-13.46%
Q2 2002	-17.28%	-2.93%	-3.33%
Q2 2001	-14.68%	-4.23%	-2.27%
Q3 2011	-13.87%	-6.06%	-8.46%
Q4 2018	-13.52%	-4.53%	-3.50%
Q2 2002	-13.40%	-6.41%	-5.40%
Q1 2001	-11.86%	6.36%	-0.41%
Q2 2010	-11.43%	-0.11%	-1.81%
Q1 2009	-11.01%	5.98%	5.95%
Average	**-14.86%**	**-4.25%**	**-4.54%**

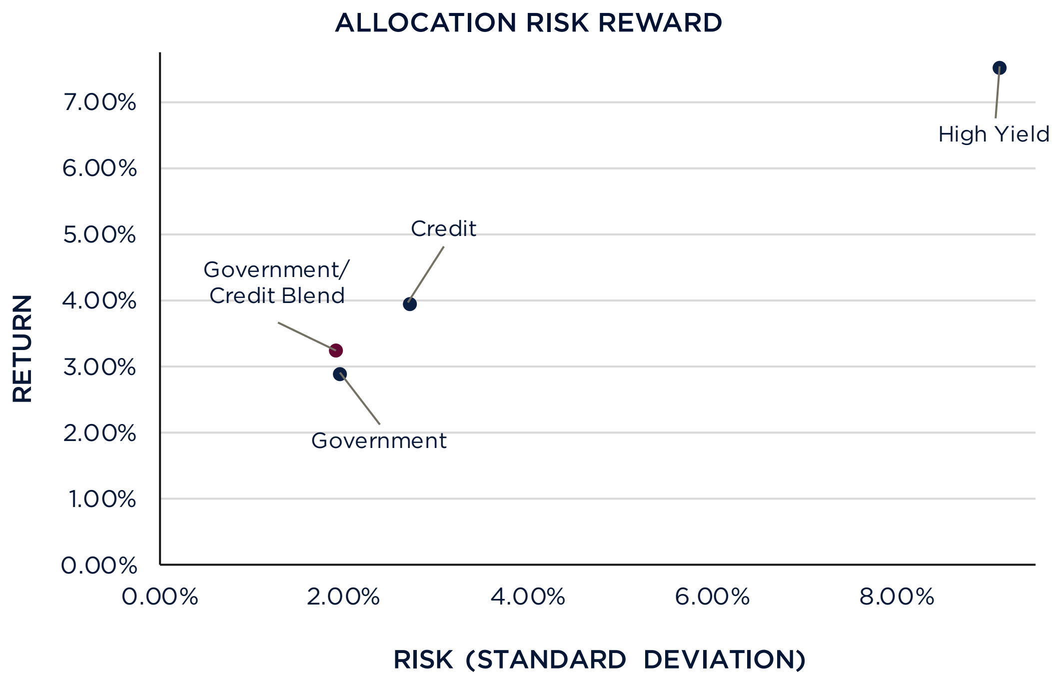
Quarterly returns shown for the most recent 10 worst quarters for the S&P 500. Source: Bloomberg Data as of 6/30/2021, Corporate HY represented by the Bloomberg Barclays Corporate High Yield Index; Short Duration HY represented by the Bloomberg Barclays Corporate High Yield 1-5 Year Index.

While most would expect that High Yield has typically generated negative returns during risk-off periods, they may be surprised to learn that **Short Duration High Yield has exhibited greater downside on average than the broader High Yield market**. Since many investors in the Short Duration space express a preference for safety and liquidity, an allocation to High Yield within their portfolios should be avoided.

Is There a Sweet Spot for Better Returns without Too Much Risk?

Given that the downside of including High Yield in a Short Duration allocation is clear, investors may then ask whether they should include any credit component in their Short Duration bond allocation whatsoever. We strongly believe the answer is yes! The increased income generated from investment grade corporate bonds provides a boost to total returns without increasing downside risk, and the potential for corporate bond spreads to tighten during periods of economic strength can help act as a buffer against rising interest rates. As a result, a blended allocation of government securities and corporate bonds has historically provided higher returns, lower standard deviation, and better risk-adjusted returns than government securities alone as shown below.

Exhibit 4: The Sweet Spot for Short Duration Risk/Reward



SHORT DURATION ALLOCATION	SHARPE RATIO	INFORMATION RATIO	MAX DRAWDOWN	WORST PERIOD
Government	0.83	0.86	-1.80%	-1.59%
Government/Credit Blend	1.02	1.04	-1.87%	-1.62%
Credit	0.99	0.98	-7.63%	-4.66%
High Yield	0.68	0.68	-31.46%	-13.02%

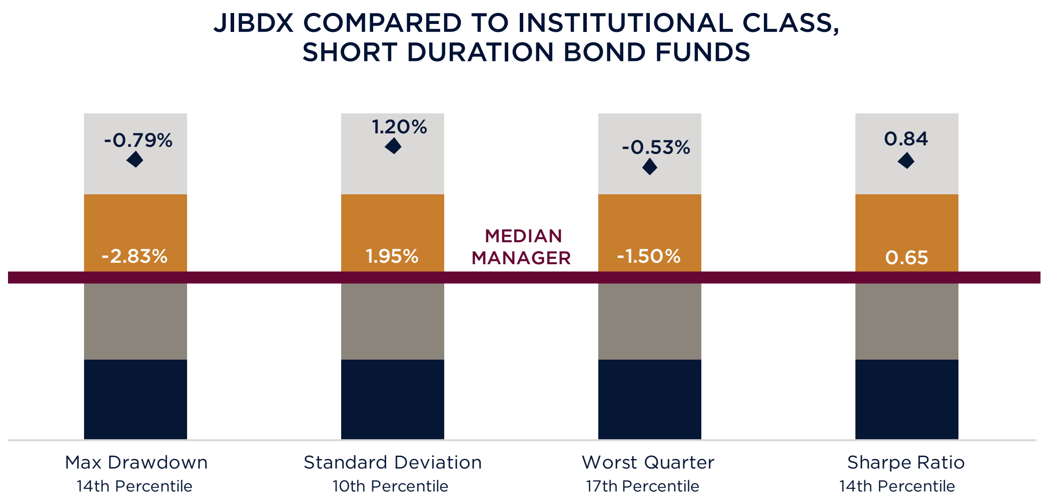
Source: eVestment and Bloomberg Data from 6/30/2001 – 6/30/2021. Government represented by the Bloomberg Barclays 1-5 Yr. Gov. Index; Government/Credit Blend represented by the Bloomberg Barclays 1-5 Yr. Gov/Cred Index; Credit represented by the Bloomberg Barclays 1-5 Yr. Credit Index; High Yield represented by the Bloomberg Barclays Global High Yield Corporate 1-5 Yr. Index.

What Makes Johnson Different?

We believe Johnson stands out from its competitors by implementing our “Quality Yield” investment discipline across all of our fixed income portfolios. This discipline is built on the belief that fixed income plays two crucial roles within asset allocations. First and foremost, we believe fixed income should serve as the anchor of a portfolio – providing stability and protection, especially during periods of economic and market volatility. Second, fixed income should be a consistent and reliable source of compounding income. Our “Quality Yield” investment discipline seeks to accomplish these mutual objectives by blending a structural tilt toward investment grade spread sectors with a strict quality credit selection process. As a result, we seek to build portfolios that maximize yield and total return while also providing reliable downside risk protection to the portfolio.

This approach is particularly unique in the Short Duration space, where many managers allocate to low-quality securities, which can risk jeopardizing their investors' objectives of safety and stability. Johnson Institutional Short Duration Bond Fund does not compromise on quality which has led to strong risk-adjusted results over time and throughout a variety of market environments. Exhibit 4 below illustrates that point, showing that the Johnson Short Duration Bond Fund (JIBDX) has posted top quartile metrics in maximum drawdown, standard deviation, worst quarter, and Sharpe ratio over the last 10 years.

Exhibit 5: JIBDX Performance Compared with the Morningstar Short Duration Universe, Institutional Class Funds



The above chart compares JIBDX (the Johnson Institutional Short Duration Bond Fund) to all other rated I-share mutual funds with 10 or more years of returns within the Morningstar universe "US Fund Short-Term Bond".

Source: Zephyr and Morningstar as of 6/30/2021

Summary

In summary, we have shown that a Short Duration fixed income allocation can boost returns by making use of short-term assets or transitory cash in portfolios. However, we caution against stretching for yield in a portion of the portfolio that is intended to be safe, particularly by introducing High Yield or "junk" bonds to the allocation. Finally, we propose that there is an ideal risk/reward sweet spot for Short Duration by utilizing both government bonds and high-quality credit. We believe that through our "Quality Yield" investment discipline, the Johnson Short Duration Bond Fund provides a consistent balance of generating income in the portfolio while remaining focused on the safety provided by high-quality bonds.

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Glossary of Terms:

Bloomberg Barclays 1-5 Year Credit Index *is an index consisting of investment grade corporate debt securities with maturities of one to five years. It is unmanaged and unavailable for investment.*

Bloomberg Barclays 1-5 Year Government/Credit Index *is an index consisting of Treasury or government agency securities and investment grade corporate debt securities with maturities of one to five years. It is unmanaged and unavailable for investment.*

Bloomberg Barclays 1-5 Year Government Index *includes U.S. Treasury and agency obligations having maturities of 1 to 5 years. It is unmanaged and unavailable for investment*

Bloomberg Barclays Global High Yield Bond Index *is a multi-currency measure of the global high yield debt market. The index represents the combination of the US High Yield, the Pan-European High Yield, and Emerging Markets (EM) Hard Currency High Yield Indices.*

Bloomberg Barclays U.S. Corporate High Yield Bond Index *is a market value-weighted index which covers the U.S. non-investment grade fixed-rate debt market. The index is composed of U.S. dollar-denominated corporate debt in Industrial, Utility, and Finance sectors with a minimum $150 million par amount outstanding and a maturity greater than 1 year. The index includes reinvestment of income.*

ICE BofA ML 1-3 Year U.S. Corporate & Government Index *tracks the performance of U.S. dollar denominated investment grade debt publicly issued in the U.S. domestic market, including U.S. Treasury, U.S. agency, foreign government, supranational and corporate securities. ICE BofA 1-3 Year U.S. Corporate & Government Index is a subset of ICE BofA U.S. Corporate & Government Index including all securities with a remaining term to final maturity less than 3 years.*

ICE US 1-Month Treasury Bill Index *is an unmanaged index that measures returns of one-month Treasury Bills.*

Short-Term Bond Morningstar Universe *is comprised of portfolios invest primarily in corporate and other investment-grade U.S. fixed-income issues and typically have durations of 1.0 to 3.5 years. These portfolios are attractive to fairly conservative investors, because they are less sensitive to interest rates than portfolios with longer durations. Morningstar calculates monthly breakpoints using the effective duration of the Morningstar Core Bond Index in determining duration assignment. Short-term is defined as 25% to 75% of the three-year average effective duration of the MCBI.*

S&P 500 Index *is a Market-capitalization weighted index that includes the 500 most widely held companies chosen with respect to market size, liquidity, and industry.*

The financial benchmarks shown in this paper are provided for illustrative purposes only, are not representative of the JIBDX investment strategy, are unmanaged, reflect reinvestment of income and dividends and do not reflect the impact of advisory fees.

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JAM's policies for valuing portfolios, calculating performance and preparing compliant presentations, as well as a complete list of composite descriptions are available upon request. Please contact our office at 513.389.2770 or 3777 West Fork Road, Cincinnati, OH 45247. All returns reflect the reinvestment of investment income (dividends and/or interest) and capital gains. Valuations and returns are stated in U.S. dollars. Trade date accounting is used. Portfolio returns are calculated using time weighed return methodology on a monthly basis. Net returns shown reflect gross performance less the highest fee schedule for this strategy. Actual client returns would also be reduced by brokerage commissions, custodial fees, and other client paid expenses detailed in JIC's Form ADV Part 2A.