A L T E R N A T I V E   I N V E S T I N G

Consistency of Carry Strategies in Europe

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The advent of European Monetary Union (EMU) coincided with major changes in European investor behavior, including reduced home-country bias and greater performance orientation. Yield-seeking and risk-taking strategies grew more popular — investors shifted money from governments to credits, extended duration across the curve and raised their equity allocations. All these strategies were implemented to raise the expected return of the portfolio, but they also increased the risk of capital losses, which soon became painfully apparent.

In this chapter, the authors focus on strategies in the European bond market that involve shifting money from government bonds to higher-yielding credits. Most carry strategies — overweighting high-yielding assets and underweighting low-yielding assets — seem to add value in the long run, but some strategies appear more risky than others. Specifically, they show that carry strategies are especially consistently profitable at short maturities. Indeed, they argue that among various structural tilts that real-money investors can make in their portfolios, replacing short-dated government debt with safe credits offers the best reward for risk.

They find similar patterns in all markets we examine — and present results from European and U.S. swap-government spread markets and credit markets. However, they add two caveats: (1) the results are not as compelling for leveraged investors than for real-money investors because the former need to factor in funding spreads and (2) the consistency of outperformance is not as robust when investors go further down the credit curve than when they only shift from governments to highest-grade credits.

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