

DECISION BRIEF

Dedicated Spending Sleeve: IG/HY Allocation

Scope	This <i>brief</i> describes the investment-grade/high-yield (IG/HY) weighting of Rain Dog's dedicated spending sleeve—the credit-shock constraint that sets it and the allocation at each rung of the 1–5-year ladder.
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1. Summary

Rain Dog's dedicated spending sleeve funds near-term client spending from a ladder of target-maturity bond ETFs ("bullet funds") held to maturity, so the growth portfolio is rarely or never forced to sell equities during a downturn. This brief sets the IG/HY weighting at each rung of the 1–5-year ladder and defines the credit-shock reasoning behind it.

Decision. The sleeve is planned at the IG SEC yield across both its IG and HY holdings. High yield is added where it can raise realized yield, in amounts structured so each rung will still deliver at least ~98% of its planned spending at maturity even in a credit shock the size of 2008–2009. In normal years the HY yield advantage accrues to the client as surplus in the maturity year; in a shock it is consumed absorbing defaults. The adopted schedule by spending horizon is 90/10, 80/20, 70/30, 65/35, and 60/40 (IG/HY) for years 1 through 5—clamped conservatively below what the shock analysis permits.

2. Scope & Application

This brief covers the IG/HY weighting and its credit-shock rationale. It does not cover sleeve sizing, instrument selection, or the decision to deploy the strategy with a specific client.

3. Selection Criteria & Methodology

3.1 Selection Criteria

The weighting is set against the following criteria:

- **Fund the goal first**—The weighting maximizes yield, subject to a high likelihood of funding the time-sensitive spending goal. Where higher return and reliable funding conflict, it errs on the side of likelihood of funding the goal.
- **A 98% floor under a severe shock**—Each rung must deliver at least ~98% of its planned spending dollar at maturity under a worst-placed 2008–2009-scale credit shock. There is no requirement to fund 100%; accepting a 1–2% shortfall in a small minority of years (under roughly 5–10%) is acceptable in exchange for higher returns in the majority.
- **Conservative by construction**—Every soft input is set to err toward funding the spending goal reliably, including selection of the worst recent shock, assumption of a lower crisis recovery rate, keeping the credit for HY seasoning small, using a carry surplus below what is observed, and clamping final HY ratios below the computed maximums.
- **Held to maturity**—Funds are held to maturity. Interest-rate and mark-to-market risk are removed by design and are not factors in the weighting.

3.2 Methodology

The spending sleeve exists to fund near-term client spending in the vast majority of market environments so that the client's growth portfolio assets do not need to be sold during a downturn. The sleeve uses bullet funds held to maturity to reduce or eliminate interest-rate risk. HY is used in addition to IG to mitigate the reduced performance arising from setting funds aside for a spending sleeve vs. keeping them in the growth portfolio. The specific IG/HY ratio is tuned to mitigate the risks posed by a severe credit shock. The design criteria for the sleeve is that spending in the shock and post-shock years will be covered at the ~98% level or better.

Loss model. A target-maturity ETF held to maturity carries no mark-to-market loss: its price can fall and fully recover by the terminal date, and the strategy never forces a sale. The only event that permanently reduces a rung's terminal distribution is a realized default, net of recovery. Permanent loss on a rung therefore $\approx$ realized defaults over the holding period $\times$ loss given default.

Planning basis. Both the IG and HY portions of each rung are planned at the IG SEC 30-day yield, which already embeds expected (priced-in) default losses. The HY-minus-IG SEC-yield delta is treated as excess carry: it shows up as surplus for the client in a normal maturity year, and as the buffer that absorbs losses in a shock year.

No double-counting. The shock test stresses only defaults in excess of the priced-in baseline. Two conservative assumptions are stacked and deliberately left in as margin: the per-rating default inputs are 1981–2024 averages that already contain past shock years; the constraint then applies the 2008–2009 shock.

Per-horizon calibration. For each horizon, the maximum HY weight is derived in steps: (1) take the worst-placed shock—the single worst year at horizon 1, the worst two-year episode at horizons 2–5; (2) apply a seasoning discount for near-maturity survivorship to get the effective shock default; (3) multiply by loss given default (with 30% recovery) for the gross loss; (4) subtract the carry surplus accrued to maturity on survivors; (5) the result is the net HY shortfall per dollar of HY; (6) the maximum HY weight is $2\% \div$ net shortfall (derived from the 98% worst-case funding floor); (7) the adopted weight is clamped below that maximum. The current numbers are in §6.

Year-1 clamp. At horizon 1 the computed maximum is slack—one year of exposure produces little cumulative default even in a shock—yet HY is clamped hardest there. The constraint is that year-1 money will be spent in the very short term with no time to recover and no recourse to top up a shortfall from the growth portfolio—and maximizing certainty of near-term funding is the sleeve's core purpose. The clamp is a model-risk decision for the time that has the least margin for error.

4. Background & Research

4.1 Why this approach

High-yield default risk is not constant over a bond's life—it is hump-shaped by age. The New York Fed's work on aggregate HY default rates found that defaults are most likely about three years after issuance; newly issued bonds have recently raised cash, and near-maturity survivors have demonstrated resilience and are prioritized for refinancing. A target-maturity HY fund in the last 6–18 months of its life is therefore not a fresh full-cycle HY portfolio, and full-cycle default rates overstate its risk. This is what makes short rungs conditionally safer and lets the model take a seasoning credit at the near end.

It is also why HY belongs in the sleeve at all. At longer horizons, the HY-minus-IG SEC-yield delta (roughly 2%/yr) compounds on the surviving bonds and, held to maturity, self-insures the bounded loss from a shock. Because that carry accrues with time, the maximum affordable HY weight rises with horizon rather than falling—the opposite of a conventional glide path.

Original-maturity assumption. The seasoning credit assumes these funds hold bonds with roughly 4–6-year original maturities, because that is where HY issuance clusters. The credit is material at horizons 1–3 and slight at year 4; by year 5 it is gone and the 5-year rung is assigned the full shock. Because Rain Dog does not normally use dedicated spending sleeves with horizons longer than 5 years, this analysis does not extrapolate beyond the 5-year ladder.

Near-maturity HY exit. In recent return data, the near-maturity HY fund underperforms IG over short windows—consistent with lumpy defaults in the residual CCC sleeve as the fund winds down. The operating rule is to exit the HY fund by October of the year before maturity; the IG fund can be held into the maturity year at little cost as it transitions to cash. This is a final-year timing rule, distinct from the annual roll-down of the IG/HY ratio.

Three reference points inform the calibration. First, average one-year U.S. corporate default rates by rating (S&P, 1981–2024) show why the CCC sleeve dominates HY loss math:

Rating	Average one-year default rate
AAA	0.00%
AA	0.03%
A	0.06%
BBB	0.18%
BB	0.67%
B	3.16%
CCC/C	12.00%

Second, the speculative-grade default environment across 2005–2024 (S&P, selected years), showing how far shock years stand above the ~1–2% benign baseline. In those years, defaults on CCC/C can reach 25% or higher.

Year	Spec-grade default rate	Environment
2005	1.50%	Benign
2006	1.18%	Benign
2007	0.91%	Benign
2008	3.71%	Shock onset
2009	9.89%	Shock
2020	5.54%	Shock (COVID)
2021	1.68%	Benign
2022	1.94%	Benign
2023	3.71%	Elevated
2024	3.94%	Elevated

The worst consecutive two-year window is 2008 + 2009 = 13.6% cumulative; the single worst year is 2009 at 9.89%. These are the shock magnitudes used in §6.

Third, the resulting reading of HY suitability by remaining maturity (Month 0 is December of the year before the bullet fund matures):

Horizon	Credit-risk interpretation
0–6 mo	Very short default window; survivor effect meaningful; cash transition underway
6–12 mo	Best zone for higher return from seasoned HY
12–18 mo	More room for defaults but seasoning still relevant
2 yr	Seasoning benefit weaker; some target-maturity benefit remains
3–4 yr	Most credit risk still ahead; not yet true late-life survivor zone
5+ yr	Full risk still ahead

4.2 Alternatives considered

- **Full-cycle HY default rates**—Rejected as the near-end inputs. They ignore seasoning and overstate both early-life and late-life default risk for HY funds.
- **Yield-to-worst as the planning return**—Rejected. YTW does not include default expectations; the SEC yield is more conservative and is used as the planning basis.
- **Higher IG at the longer rungs**—Rejected. The HY self-insures against shock events at longer horizons, and adding IG at long horizons would forgo the carry that reduces the gap with the growth portfolio. However, the sleeve is sized based on SEC yield of the IG rungs; carry beyond that is treated as a bonus.
- **Higher HY at the near rungs**—Rejected. The constraint permits it (the year–1 maximum is slack), but the carry pickup is thin and the loss would be taken on the rung spent first, with no recourse.
- **An all-IG sleeve**—Rejected. It forgoes affordable, shock-survivable yield at the longer horizons where carry reliably covers the modeled loss.

5. References

5.1 Related Documents

- Rain Dog Financial, target-maturity bond ETF selection *Decision Brief*.
- Rain Dog Financial, dedicated portfolio strategy *Decision Brief*.
- Rain Dog Financial, household asset-location *Decision Brief*.
- Rain Dog Financial, Investment Forecast Model documentation.

5.2 Data Sources

- YCharts—fund-level SEC yield, total return, AUM, and credit-quality data.
- S&P Global Ratings—corporate default and recovery studies, 1981–2024.
- Federal Reserve Bank of New York—high-yield default and bond-aging research.
- FRED—rate and market reference series.

5.3 References

- S&P Global Ratings, annual global corporate default and rating transition study (rating-level and speculative-grade default rates).
- S&P Global Ratings, U.S. recovery study (senior-unsecured recovery rates).
- Federal Reserve Bank of New York, Understanding Aggregate Default Rates of High Yield Bonds; Altman–Kishore, bond aging and seasoning.
- iShares iBonds and Invesco BulletShares fund documentation (defined-maturity mechanics, terminal distribution, credit-quality mix).

6. Key Calibration Numbers

Global assumptions:

Parameter	Value	Note
Shock magnitude	13.6%/2 yr	Worst recent credit shock: 2008 (3.71%) + 2009 (9.89%). Horizon 1 uses the single worst year, 2009 = 9.9%.
Recovery rate	30%	Loss given default 0.70; below the ~45% long-run senior-unsecured mean, reflecting lower recoveries in a shock.
Seasoning	Hump by remaining maturity	Small discounts (10/20/20/10/0% over years 1–5). A judgment input for the aging/survivor effect, directional from NY Fed research, not a published figure.
Carry surplus source	HY/ IG SEC–yield delta	Taken below the observed delta; sourced from SEC yield, not trailing return (which carries mark-to-market noise).
Planning rate	IG SEC yield	Applied to both IG and HY holdings; the HY delta is client upside in normal years and the shock buffer in bad ones.
Coverage floor	≥ ~98% at maturity	Directional: a 1–2% shortfall is acceptable in a small minority of years.

Per-horizon calibration and the adopted schedule. This table is based on spreads current as of 9/4/2026 with Year 1 planned as 2028 bullet funds. This table is time-dependent and reconstructed each time a dedicated spending sleeve is funded.

Year	Magnitude of worst shock	Seasoning discount	Shock with seasoning	Gross loss (30% recovery)	1-year carry surplus	Carry surplus to maturity	Net HY shortfall	Max HY	Adopted HY
1	9.9%	10.0%	8.9%	6.2%	1.43%	1.43%	4.8%	42%	10%
2	13.6%	20.0%	10.9%	7.6%	1.89%	3.32%	4.3%	47%	25%
3	13.6%	20.0%	10.9%	7.6%	1.87%	5.19%	2.4%	82%	40%
4	13.6%	10.0%	12.2%	8.6%	1.99%	7.18%	1.4%	100%	50%
5	13.6%	0.0%	13.6%	9.5%	1.77%	8.95%	0.6%	100%	50%

Max HY = 2% ÷ net HY shortfall. Adopted HY is clamped below it. The maximum rises with horizon because carry surplus to maturity grows faster than the net shock loss past year 2.

Customization. The adopted schedule is the conservative default. For more risk-tolerant clients the HY weight at years 2–5 can be raised substantially toward the computed maximums and remain supported by the shock analysis. Year 1 is not a customization lever: the HY allocation is held low for the near-term-certainty reasons above.

7. Notes & Disclosures

Rain Dog Financial® is a trade name of Rain Dog LLC.

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Revision history

Version	Date	Change	By
1.0	2026-07-02	Initial issue.	SCM