

Consider Active Management in the Idiosyncratic High-Yield Bond Market

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KEY TAKEAWAYS

- Some investors have turned to passive ETFs to get exposure to the high-yield bond market.
- The market structure and liquidity of the high-yield bond sector makes replicating the return of a high-yield index difficult. This may have contributed to the relative underperformance of the two largest high-yield ETFs.
- Flows generated by investors seeking short-term exposure to high-yield ETFs have resulted in exceptional asset-flow volatility.
- Investors seeking long-term high-yield exposure may be better served by an actively managed mutual fund that uses research and trading insights to thoughtfully allocate capital to the most attractive sectors and issuers, with the goal of superior risk-adjusted performance.

In an earlier paper, we outlined why the addition of high-yield (HY) bonds to a diversified portfolio has the potential to enhance its risk-and-return prospects (see *Leadership Series* article, “High-Yield Bond Funds in a Diversified Portfolio,” Mar.

2016).¹ In this paper, we address why we think exposure to the HY market can be more effectively achieved through an active mutual fund versus a passive exchange traded fund (ETF).

For investors looking for an intermediate- to long-term allocation to HY, we believe active mutual funds are an appropriate vehicle because credit selection—the overwhelming source of risk in a HY bond portfolio—is best managed with a flexible strategy incorporating intensive research to help identify and value credit risk. While the goal of passive ETFs is to match the performance of their benchmarks, active mutual funds attempt to outperform their benchmarks, and with this approach comes the risk that they may underperform.

In certain liquid, transparent asset classes, such as large-cap equities and investment-grade bonds, ETFs may be effective investment vehicles. Passive HY products, however, may not offer investors a similar experience, because such products attempt to replicate the return of a HY index that is constructed purely by using a rules-based methodology. The cost of managing a HY portfolio that evolves in step with a rules-based index can lead to underperformance (Exhibit 1).

Passive HY ETFs constrained in navigating market

Passive ETFs are constructed to deliver returns in line with a stated benchmark, and to accomplish this, a portfolio manager attempts to replicate the benchmark’s characteristics. However, within such a distinct segment of the bond market,

¹ HY bonds are not appropriate for all investors. While they generally offer higher yields compared to investment-grade bonds, HY bonds can also have increased risks including credit and default risk. As with all investments, investors should carefully balance all potential benefits and risks before investing.

elements of the benchmark replication process can weigh on HY ETF performance and risk characteristics (Exhibit 2).

Replication

- In an attempt to replicate its benchmark, a HY ETF strives to maintain similar issue and industry allocations. Without having the flexibility to reduce positions relative to the benchmark, a passive HY ETF can end up maintaining exposure to companies while their fundamentals deteriorate. On the other hand, passive ETFs can also miss opportunities to overweight improving credits before they reach full valuation.
- Passive ETFs may be forced sellers of defaulted securities that are removed from benchmarks at the worst possible time. ETFs may also suffer underperformance due to the cost of buying securities as they are added to a benchmark. Active managers, on the other hand, can institute a variety of trading and portfolio management strategies. For example, managers may hold defaulted securities to maximize recovery through a restructuring, or choose whether to participate in the new issue market to take advantage of relative value opportunities as they arise.
- HY ETFs typically rebalance monthly in an effort to adhere to benchmark rules. This can mean buying and selling securities in markets with unfavorable technicals, which can generate implementation costs for the portfolio.

- Investors in the two largest passive HY ETFs² are not getting exposure to the broad HY market. Instead, the ETFs are replicating custom-designed indexes containing fewer than 50% of the issues in the more commonly cited Bank of America Merrill Lynch U.S. High Yield Index.³ These indexes have parameters in place to enhance portfolio liquidity. While on the surface, a focus on liquidity appears judicious, it is not “free” and is reflected in a bond’s yield. For example, since 1996, the Bank of America Merrill Lynch U.S. High Yield 100 Index, a proxy for a liquidity-sensitive benchmark, has historically averaged 74 basis points less yield than the broader Bank of America Merrill Lynch U.S. High Yield Index.⁴
- Like other fixed income indexes, HY benchmarks are capitalization weighted. Therefore, they are predisposed to having

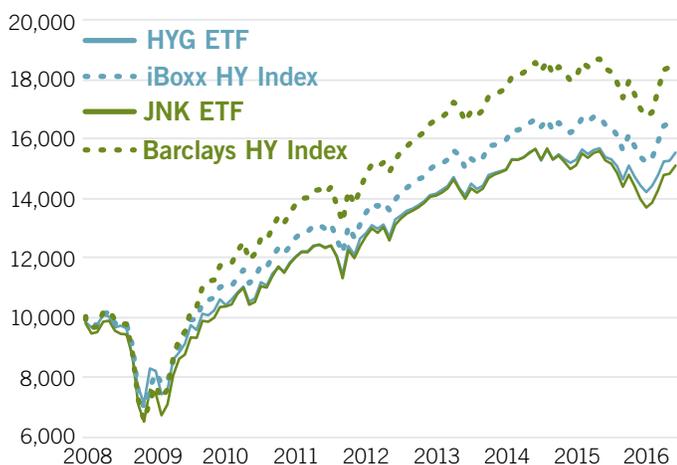
2 As of June 30, 2016, the largest HY ETFs were BlackRock Fund Advisors’ iShares iBoxx U.S. Dollar High Yield ETF and SPDR Barclays High Yield Bond ETF. They accounted for approximately 70% of total HY ETF assets. These ETFs did not represent the entire HY ETF asset class and other products may have performed differently during the same timeframes. Source: Bloomberg Finance, L.P.

3 Markit iBoxx USD Liquid High Yield Index and the Barclays High Yield Very Liquid Index.

4 Bloomberg, Bank of America Merrill Lynch, Fidelity Investments, as of Jun. 30, 2016.

Exhibit 1 The performance of the largest HY ETFs has lagged benchmarks

Growth of \$10,000, Jan. 2008–Jun. 2016



BlackRock Fund Advisors’ iShares iBoxx U.S. Dollar High Yield ETF (HYG –inception Apr. 4, 2007) vs. Markit iBoxx High Yield Index. SPDR Barclays High Yield Bond ETF (JNK–inception Nov. 28, 2007) vs. Barclays High Yield Very Liquid Index. Source: Bloomberg Finance L.P., as of Jun. 30, 2016. Standard performance data can be found on page 4.

Exhibit 2 The largest HY ETFs have lagged benchmarks and experienced significant tracking error

Risk-Adjusted Annualized Returns and Tracking Error

Jan. 2008–Jun. 2016	Return	Standard Deviation	Sharpe Ratio	Tracking Error
iShares iBoxx \$ HY ETF (HYG)	5.31	12.80	0.39	5.56
Markit iBoxx USD Liquid HY Index	6.18	11.53	0.51	–
SPDR® Barclays HY Bond ETF (JNK)	5.15	14.21	0.32	4.68
Barclays HY Very Liquid Index	7.52	13.41	0.54	–

Data based on price returns. Benchmarks used in tracking error calculations: HYG vs. Markit iBoxx USD Liquid High Yield Index, JNK vs. Barclays High Yield Very Liquid Index. Source: Morningstar, as of Jun. 30, 2016.

significant weightings of the largest HY debt issuers, which may not be optimal and may weigh on index and ETF results.

- Within the HY market, portfolio liquidity is a factor that needs to be managed. An active portfolio manager has multiple levers to consider when managing fund liquidity. Beyond maintaining a cash balance, an active manager has the flexibility to pick and choose the most appropriate securities to enhance a portfolio’s liquidity profile. In contrast, passive HY ETFs are constrained by the rules of their benchmarks. This can mean creating portfolios with the largest issues of the largest debt issuers—not necessarily a favorable attribute.

Trading: ETF flexibility...at a cost

- For certain investors, intraday trading flexibility can be an attractive feature of ETFs. However unlike other asset classes with ETFs, the trading flexibility of HY ETFs may come at a cost to performance.

According to Lipper, from 2013 to 2015, HY ETFs experienced more than twice the volatility in asset flows as did HY mutual funds on an asset basis (Exhibit 3).

This flow volatility may cause Authorized Participants to drive up pricing of large ETF constituent bonds when net

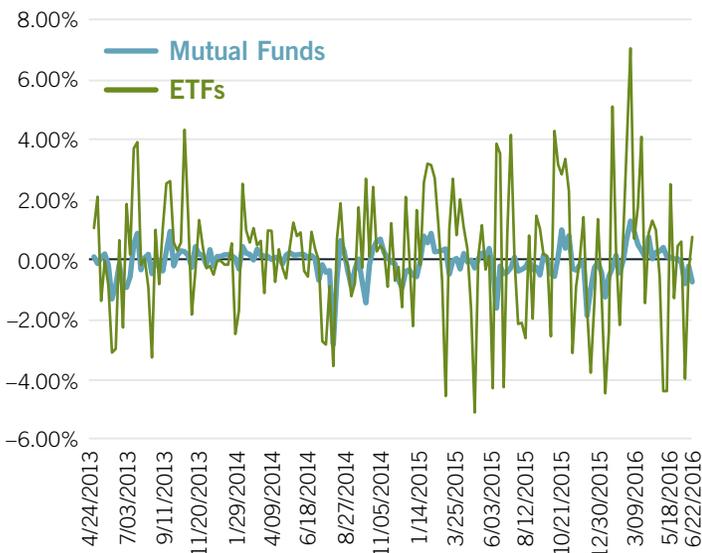
flows are positive and vice versa when net flows are negative. Also, ETFs trade at a discount or premium to NAV throughout the day. Investors buying ETFs above NAV or selling below NAV may be incurring additional costs.

- HY ETF management fees at 40 to 50 basis points are relatively high compared with other passive ETFs, such as investment-grade bond or large-cap equity, which often charge single-digit fees. In addition, this is not the only “cost” investors may incur. Consider that, in some instances, investors pay a brokerage commission to buy and then to sell an ETF. Lastly, similar to a mutual fund, an ETF’s performance is net of fees. However, an active fund has the potential for outperformance to offset fees.

Consider active management for exploiting the distinctive characteristics of the HY bond market

Investors whose risk tolerance and investment objectives align with high-yield investing could stand to benefit from HY bond attributes in their diversified portfolio over an entire credit cycle—i.e., the potential for diversification, capital appreciation, and income. Those investors should consider actively managed HY bond funds supported by substantial research and trading resources, sound portfolio construction, and disciplined risk management.

Exhibit 3 HY ETFs demonstrate significant flow volatility
Mutual Fund and ETF Asset Flows



Source: Lipper, Fidelity Investments, as of Jun. 30, 2016.

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In general the bond market is volatile, and fixed-income securities carry interest rate risk. (As interest rates rise, bond prices usually fall, and vice versa. This effect is usually more pronounced for longer-term securities.) Fixed-income securities also carry inflation, credit, and default risks for both issuers and counterparties. (Unlike individual bonds, most bond funds do not have a maturity date, so holding them until maturity to avoid losses caused by price volatility is not possible.)

Stock markets, especially foreign markets, are volatile and can decline significantly in response to adverse issuer, political, regulatory, market, or economic developments.

Lower-quality bonds can be more volatile and have greater risk of default than higher-quality bonds.

Foreign securities are subject to interest rate, currency exchange rate, economic, and political risks.

ETFs are subject to market fluctuation, the risks of their underlying investments, management fees, and other expenses.

Unlike mutual funds, ETF shares are bought and sold at market price, which may be higher or lower than their NAV, and are not individually redeemed from the fund.

Investing involves risk, including risk of loss.

Past performance is no guarantee of future results.

Diversification and asset allocation do not ensure a profit or guarantee against loss.

All indexes are unmanaged. You cannot invest directly in an index.

	Average Annual Price Return (%) Periods ending Sep. 30, 2016			
	3Q	1 Year	5 Year	LOF
BlackRock Fund Advisors' iShares iBoxx U.S. Dollar High Yield ETF*	4.42	12.44	7.30	5.68
Markit iBoxx USD Liquid HY Index	5.09	12.07	7.57	6.60
SPDR Barclays High Yield Bond ETF**	4.51	12.97	6.93	5.34
Barclays HY Very Liquid Index	5.42	12.38	8.16	7.94

*Expense ratio: 0.50%. Inception date: Apr. 4, 2007.

Source: Morningstar, as of Oct. 10, 2016.

**Expense ratio: 0.40%. Inception date: Nov. 28, 2007.

Source: Morningstar, as of Oct. 10, 2016.

Index definitions

Barclays U.S. High Yield Very Liquid Index (VLI) is a component of the Barclays U.S. Corp High Yield Index that is designed to track a more liquid component of U. S. dollar-denominated, high-yield, fixed-rate corporate bond market. The U.S. High Yield VLI uses the same eligibility criteria as the U.S. Corp High Yield Index but includes only the three largest bonds from each issuer that have a minimum amount outstanding of \$500 million (U.S. dollars) and are less than five years from issue date. **Markit iBoxx U.S. Dollar Liquid High Yield Index** This index comprises the most liquid U. S. dollar-denominated sub-investment-grade issues. **Bank of America Merrill Lynch U.S. High Yield Index** tracks the performance of U.S. dollar-denominated below-investment-grade corporate debt publicly issued in the U.S. domestic market. **BofA Merrill Lynch U.S. High Yield 100 Index** is designed to emulate, as closely as possible, the risk characteristics of the BofA Merrill Lynch U.S. High Yield Constrained Index with a comparatively small basket of securities. Rebalancing rules are geared toward selecting the most liquid HUCO constituents while minimizing turnover. Third-party marks are the property of their respective owners; all other marks are the property of FMR LLC.

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