Debunking the High Yield Index and High Yield ETFs

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The debate between active and passive management that has reverberated for years in equity markets is now shifting to fixed income. We believe it is critical for investors to understand the intricacies of passive management in high yield fixed income. There are meaningful differences between equity and high yield index construction and passive alternatives.

Unlike most equity indices, broad market high yield indices such as the Bank of America ML U.S. High Yield Index (the "High Yield Index") cannot be replicated and are not investable alternatives. The investable passive alternatives, which are all exchange-traded funds ("ETFs"), seek to replicate benchmarks that represent only the most liquid portion of the broad-market high yield index. As discussed below, these highly liquid benchmarks have underperformed the High Yield Index, and the ETFs have, in turn, underperformed their highly liquid benchmarks. Finally, a much higher percentage of active high yield managers have outperformed the investable passive alternatives than has been the case in the equity markets.

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Differences Between the High Yield Index and Conventional Equity Indices

One of the most important differences between debt index construction and equity index construction is how weightings are determined. For a conventional equity index like the S&P 500 or Russell 2000, index weight is determined by market capitalization. To a large extent, market capitalization is driven by value creation for shareholders. For example, Apple, Inc. is the largest index constituent in the S&P 500. Apple has a strong balance sheet, generates ample free cash flow, and has a dominant market position in its industry. As we go down the list of largest constituents in the index, Microsoft Corp., Exxon Mobil Corp., Johnson & Johnson, and Amazon.com, Inc. all share similar characteristics.

High yield index weights, on the other hand, are not determined by value creation. Instead, they are determined by the amount of debt outstanding. Sprint Corp. is the largest weighting in the High Yield Index. Sprint has more than $35 billion of debt outstanding with a market capitalization of around $35 billion. It has historically burned cash and is the weakest player in a competitive four player market. Sprint does not have the same access to capital and cost of capital as AT&T, Inc. or Verizon Communications, Inc., and it has a lower quality product offering. Sprint also has 15 bonds currently outstanding varying in size with different covenants, seniority in the capital structure, tenors, and coupons and thus different risks.

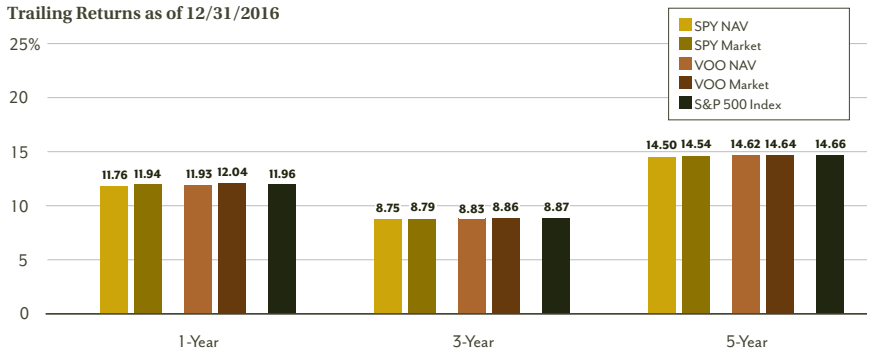
Most equity indices can be replicated with very low transaction costs and expenses (0.01% for large institutional investors in a large cap U.S. index). In contrast, the High Yield Index cannot be replicated. When looking at the High Yield Index, according to data provided by Trade Reporting and Compliance Engine (TRACE), about 8% of the Index does not trade during any given month in institutional size ($1 million or greater), while approximately 27% of the Index trades less than four times per month in institutional size.

Another impediment to replicating the High Yield Index is the unique characteristics of distressed high yield bonds. This part of the market fluctuates in size, depending on market conditions, but historically has been anywhere between 1% and 30% of the high yield market. These bonds have credit-specific fundamental issues and can be difficult to source when ownership transitions from traditional asset managers to hedge funds. Many bonds that became distressed during the financial crisis were bought by hedge funds and other nontraditional investors. As the market rebounded in 2009 and into 2010, the new owners were reluctant to sell these positions at market prices, and traditional managers as well as ETFs dramatically underperformed the 57.5% total return of the High Yield Index in 2009.

High Yield ETF Challenges

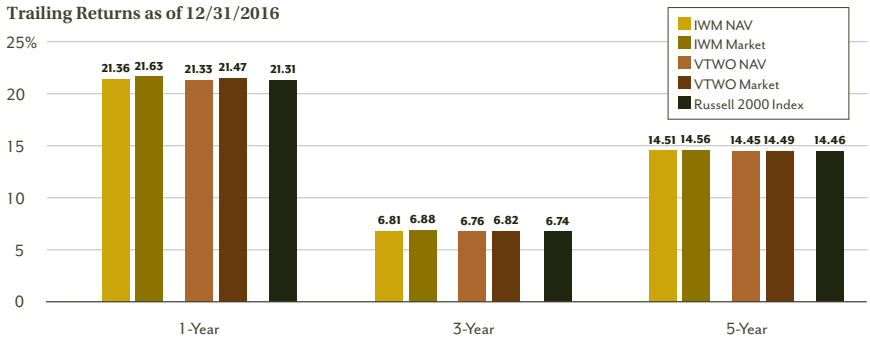
ETFs have been constructed to provide broad exposure to a number of asset classes and often to replicate the performance of a stated index. Passive equity ETFs that track the S&P 500 Index or the Russell 2000 Index, such as the SPDR® S&P 500® ETF ("SPY") and Vanguard S&P 500 ETF ("VOO") in Figure 1 or the iShares Russell 2000 ETF ("IWM") and Vanguard Russell 2000 ETF ("VTWO") in Figure 2, do so with near complete index replication, bear low transaction costs, generally have very low fees, and provide returns very similar to one another as well as the index, i.e. they have very low tracking error (Figure 3).

FIGURE 1: EQUITY ETFs EFFECTIVELY REPLICATE THE S&P 500 INDEX



Source: Morningstar Direct

FIGURE 2: EQUITY ETFs EFFECTIVELY REPLICATE THE RUSSELL 2000 INDEX



Source: Morningstar Direct

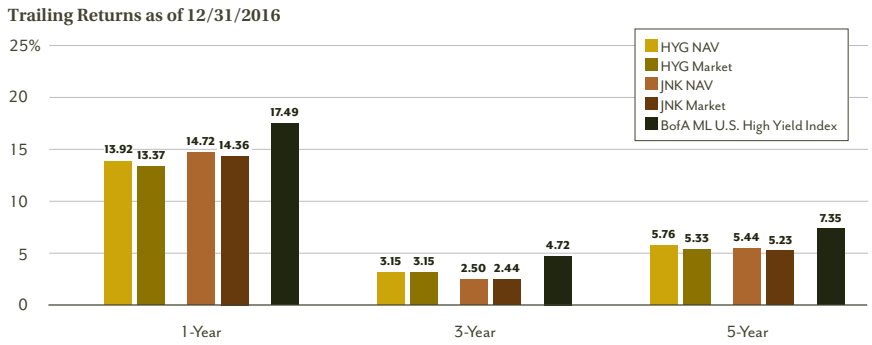
FIGURE 3: ETF EXPENSE RATIOS AND TRACKING ERROR

			Tracking Error (%)		
ETF	Annual Report Net Exp. Ratio	Tracking Error Relative to:	1-Year	3-Year	5-Year
SPY	0.09%	S&P 500 Index	0.04%	0.04%	0.03%
VOO	0.05		0.01	0.02	0.02
IWM	0.20	Russell 2000 Index	0.04	0.04	0.04
VTWO	0.15		0.03	0.03	0.03
HYG	0.50	BofA ML U.S. High Yield Index	1.34	1.13	1.06
JNK	0.40		0.87	0.88	1.00

Source: Morningstar Direct

The high yield ETFs are another story. The two largest high yield ETFs, iShares iBoxx $ High Yield Corporate Bond ETF ("HYG") and SPDR Bloomberg Barclays High Yield Bond ETF ("JNK"), are shown in Figures 3 and 4. HYG has over 1,000 bonds and JNK has over 800 bonds compared to over 2,000 in the High Yield Index. One might surmise that HYG and JNK could sample the broad high yield market effectively and deliver returns that are sufficiently close to the High Yield Index. This is not the case and, in fact, HYG and JNK use highly liquid segments of the broader market as their benchmarks. These highly liquid indices have underperformed the High Yield Index, and in turn, HYG and JNK have underperformed the highly liquid indices.

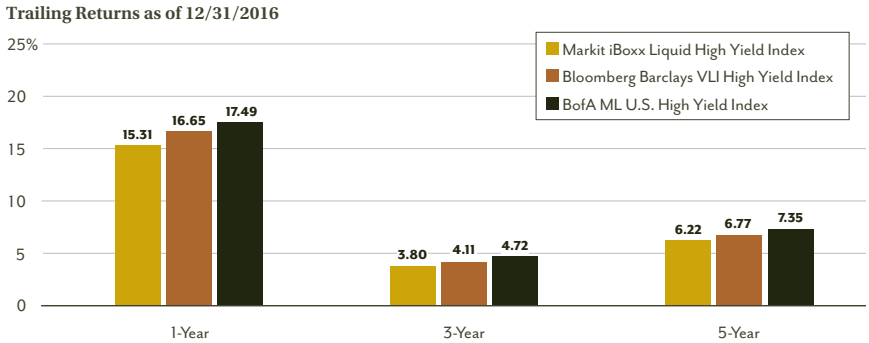
FIGURE 4: HIGH YIELD ETFs HAVE UNDERPERFORMED THE HIGH YIELD INDEX



Source: Morningstar Direct

In recent years, the highly liquid indices have underperformed the High Yield Index (Figure 5) because, in our opinion, the most liquid portion of the High Yield Index is chronically overvalued. First, the most liquid high yield bonds are issued by companies that are the largest borrowers in the high yield market. As discussed above, the largest companies in the S&P 500 Index are typically strong businesses, while it would be dangerous to make that generalization about the largest borrowers in the high yield market. Second, the large ETFs and large actively managed high yield funds seemingly pay up for the perceived liquidity offered by the largest borrowers.

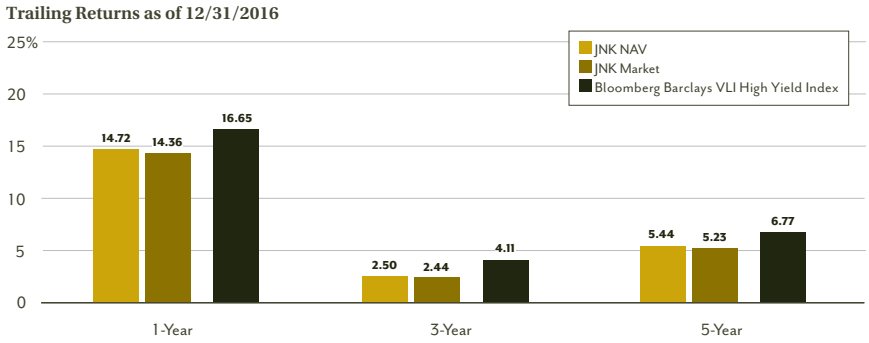
FIGURE 5: COMPARISON OF HIGH YIELD INDICES



Source: Morningstar Direct

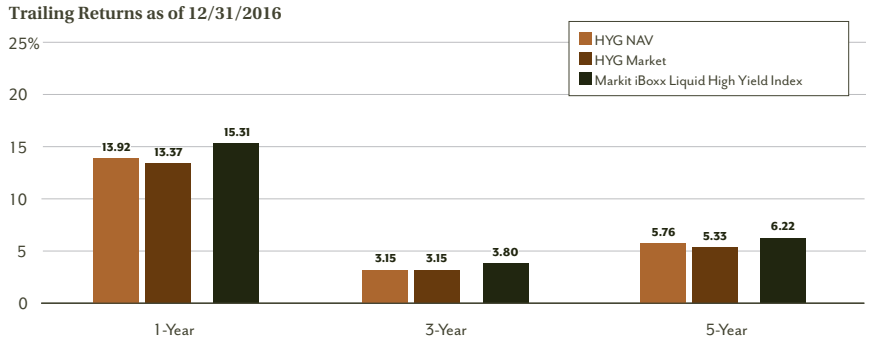
We believe HYG and JNK have underperformed their highly liquid benchmarks, Bloomberg Barclay's VLI High Yield Index and Markit iBoxx Liquid High Yield Index (Figures 6 and 7), because of their expenses and transaction costs.

FIGURE 6: ETFs HAVE UNDERPERFORMED THEIR HIGHLY LIQUID BENCHMARKS



Source: Morningstar Direct

FIGURE 7: ETFs HAVE UNDERPERFORMED THEIR HIGHLY LIQUID BENCHMARKS



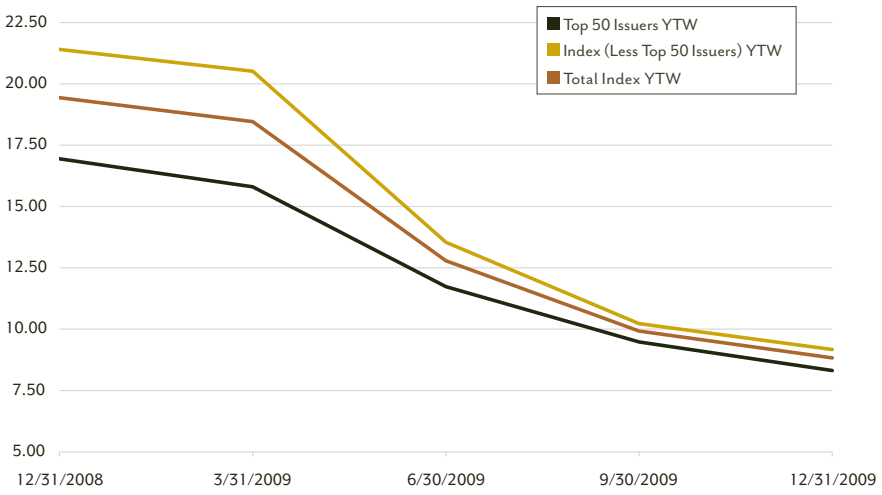
Source: Morningstar Direct

"We believe portfolio decisions should come down to a fundamental understanding of what you own and why you own it."

Actively Managed High Yield Funds Have Performed Well Against Investable Passive Alternatives

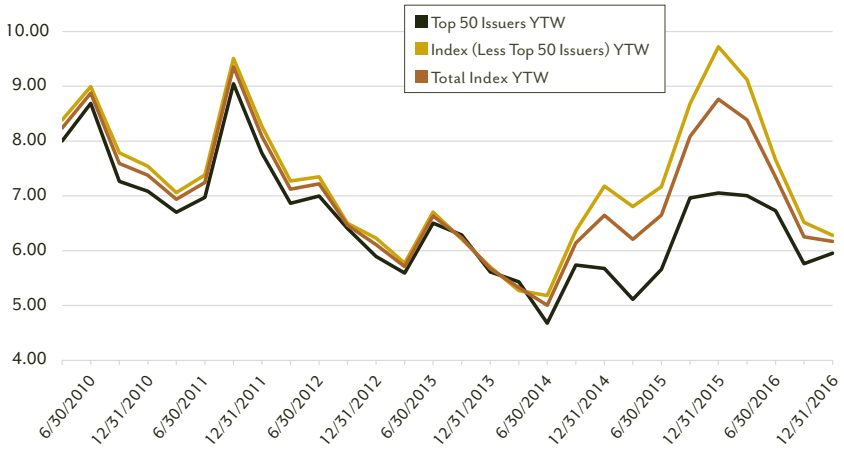
As discussed above, the investable passive alternatives are benchmarked against highly liquid subsets of the high yield market which we believe are chronically overvalued (Figures 8 and 9). Active managers can concentrate more in the less liquid and often more attractively valued portion of the high yield market.

FIGURE 8: YIELD-TO-WORST (YTW) OF HIGH YIELD MARKET VS. TOP 50 ISSUERS (2008 – 2009)



Source: Bank of America Merrill Lynch

FIGURE 9: YIELD-TO-WORST (YTW) OF HIGH YIELD MARKET VS. TOP 50 ISSUERS (2010 – 2016)



Source: Bank of America Merrill Lynch

When comparing costs between fixed income ETFs and actively managed funds, the differential is relatively small. The management fees on JNK and HYG are 21 and 11 basis points lower, respectively, than the average active high yield fund. Investors should also consider other explicit expenses and implicit costs such as capital gains, bid-ask spreads, market impact costs, and tracking error. Taking all of these costs into account, our judgment is that the passive investable high yield alternatives are actually higher cost than many actively managed high yield funds.

As shown in Figure 10, for the rolling five-year periods ending December 31, 2012-2016, HYG and JNK have consistently ranked below the median on total returns and risk adjusted returns.

FIGURE 10: ACTIVE HIGH YIELD MANAGERS HAVE PERFORMED WELL COMPARED TO ETFs

Annualized Return and Sharpe Ratio for the Five-Year Period Ended

	12/31/2012		12/31/2013		12/31/2014		12/31/2015		12/31/2016	
	Return	Category Rank	Return	Category Rank	Return	Category Rank	Return	Category Rank	Return	Category Rank
HYG	7.67	70	15.01	80	7.85	59	4.22	54	5.76	71
JNK	7.50	75	16.87	42	7.90	57	3.53	77	5.45	79
	Sharpe Ratio	Category Rank	Sharpe Ratio	Category Rank	Sharpe Ratio	Category Rank	Sharpe Ratio	Category Rank	Sharpe Ratio	Category Rank
HYG	0.57	82	1.57	95	1.10	82	0.62	69	1.01	79
JNK	0.51	91	1.50	96	1.03	90	0.50	87	0.88	91

** Category percentile rank within the Morningstar U.S. OE High Yield Bond Category*

Source: Morningstar Direct

The Case for Active Management: How to Beat the Benchmark?

Since the financial crisis, we have seen an explosion of assets into the high yield asset class and the assets are concentrated in the hands of the largest managers. This contributes to the overreliance on the most liquid parts of the market, especially when coupled with the growth in ETFs. In a capacity constrained asset class, this evolution has created opportunities for managers that are willing to look different than the index.

Fortunately for investors, there are many different ways to generate excess returns in the high yield asset class. Active share is commonly discussed in the equity world but most fixed income investors focus on risk mitigation. We believe portfolio decisions should come down to a fundamental understanding of what you own and why you own it. Emphasis should not be placed on whether an issue is in an index or how big it is in the index. If we can analyze a business, understand the risks involved in the company and the bond, and believe we are being more than adequately compensated for risk, we want to own the bond in a meaningful way. If not, we won't own it. This common sense approach to investing is surprisingly uncommon in the high yield market.

Having a long-term temperament is critical to taking advantage of favorable investment opportunities. Managing a portfolio for the long term allows a manager to fully exploit the opportunities from overreactions to quarterly results, fund flows, and countless other sources of short-term noise. It also allows managers to be forward thinking as opposed to backwards looking.

Maintaining capacity discipline is also critical to delivering strong returns for active managers. The broad high yield market is a $1.4 trillion market, and a large portion of these assets are concentrated in the hands of a small number of market participants. The high yield market shares similarities to small cap equities in terms of market size and liquidity. The best opportunities can often be uncovered in smaller credits that may not be investable for the largest participants. Maintaining a portfolio of reasonable size is, in our opinion, critical to outperforming other active managers and the investable passive alternatives.

Finally, alignment of interest between the manager and client is essential. We recommend investors look at fund disclosures detailing portfolio manager ownership of the fund and ask how managers are compensated. While higher ownership levels do not guarantee success or an ethical manager, we believe they improve the client's odds of a positive experience.

Summary

The debate between active and passive management in high yield fixed income is very different than in equities. The broad high yield market cannot be replicated, and as a result, the investable passive alternatives seek to replicate highly liquid subsets of the high yield market. We believe those highly liquid subsets are chronically overvalued because they are dominated by the companies with the most amount of debt and market participants who need a lot of liquidity are forced to pay up for the liquidity that these companies offer. Further, the investable passive alternatives have not kept up with their highly liquid benchmarks because of expenses and transaction costs. Active managers, particularly those with reasonable asset levels, do not have the same constraints and, thus, over most rolling five-year periods, more than half of active managers have outperformed the investable passive alternatives, and they have done even better on a risk-adjusted basis.

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The views expressed are those of the authors as of January 31, 2017, are subject to change, and may differ from the views of other members of the firm or the firm as a whole. These opinions are not intended to be a forecast of future events, a guarantee of future results, or investment advice.

"Fortunately for investors, there are many different ways to generate excess returns in the high yield asset class."

– John McClain, CFA
Portfolio Manager

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Chief Investment Officer - Fixed Income and Portfolio Manager

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