The Case for Active Management in High Yield

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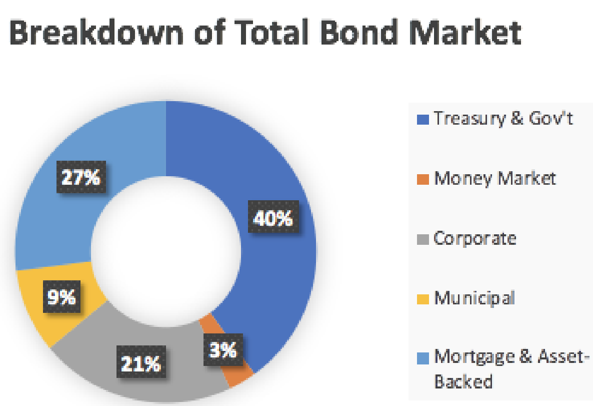
In the active-passive debate, investors are comfortable choosing active managers for their core fixed income funds. It's time to extend that to high-yield bonds.

It's no secret that investors have grown enamored with passive portfolio strategies in recent years, looking to index funds as a cheap way to gain exposure to stocks and other asset classes. But there's been an exception to the indexing craze: When it comes to core, investment-grade bonds, investors have been more than happy to stick with actively managed mutual funds.

Why? Part of it may be rooted in fears that when interest rates start to climb from their historic lows, index funds will be powerless to cushion the blow of falling bond prices. That's not the case with active managers. And over the past five years, investors have begun to recognize flaws in the way broad bond market benchmarks like the Barclays U.S. Aggregate Bond Index are constructed—flaws that index funds must mimic. Even indexing's biggest proponent, Vanguard's Jack Bogle, argued for years that "we've got to fix" the Barclays aggregate index because only around 30% of the benchmark is made up of corporate debt, while more than 70% sits in low-yielding government bonds.

Well, if index-construction issues are a reason to rethink passive, then there's a strong case to be made for investors to turn to active management to gain exposure to high yield bonds as well.



Source: SIFMA

The Problem with High Yield Indexes

Fixed income indexes have structural problems that are hard to overlook. While equity benchmarks are typically constructed based on a company's market value—or in some cases, fundamental factors such as earnings growth or dividend yield—bond indexes are weighted on total debt outstanding. In a stock index, the better a company is at creating wealth (via price gains, net income, or dividend payouts), the more its shares are represented in the benchmark. When it comes to bonds, issuers earn greater exposure in indexes based on how poor their balance sheets are due to indebtedness.

For an investment-grade bond index like the Barclays U.S. Aggregate, the risks are somewhat abated because the biggest debtor is the United States, which can print money to avoid defaulting.

When it comes to high yield, the biggest borrowers are individual corporations like Bausch Health Companies, a single-B-rated firm with a market capitalization of $8 billion but long-term debt of more than $24 billion; and Community Health Systems, a CCC-rated firm that had nearly as much long-term debt ($13.4 billion) in 2018 as it generated in revenues ($14.2 billion).

The active advantage: Active high yield managers aren't obligated to own the debt of any company. Northeast Investors Trust **(NTHEX)**, for example, has been utilizing a barbell approach consisting of short-duration, low-volatility bonds and core high yield debt on one end, and "special situation" out-of-index securities on the other.

Other Issues with HY Indexes

High yield indexes are imbalanced in another way. Non-investment grade companies often earn that classification based in part on the worrisome amount of debt they carry. And companies that borrow heavily are typically found in capital-intensive sectors such as telecom, consumer staples, and energy. Those sectors make up more than half of the high yield universe today, but only 22% of the market value of the S&P 500.

Add to this the threat lurking just outside of the high yield universe. At the low end of investment-grade sits BBB-rated credits. As corporations have gone on a borrowing spree lately, the BBB universe has swelled from a quarter of all investment-grade corporate bonds to nearly half. These bonds are not only the most vulnerable part of the investment-grade universe, BBB-rated nonfinancial securities are more levered now than they were heading into the financial crisis.

The active advantage: If BBB's become fallen angels, high yield index funds would be obligated to catch all the knives as they fall out of investment-grade indexes.

Consider how disruptive it would if just one BBB issuer—General Electric—were to slip into high yield. GE alone has roughly $100 billion in debt outstanding. To put that in perspective, the entire high yield universe is worth about $1 trillion. If GE were to become 10% of the high yield market, index funds would have to immediately dump 10% of their existing holdings to make room. Active managers, on the other hand, could be more circumspect and search the rubble looking only for the best values.

The Problem with Index Funds and ETFs

Even if you overlook the structural problems, there's another issue: Index funds do a lousy job of tracking high yield benchmarks. Part of it has to do with the breadth of the market. While an S&P 500 index fund only needs to buy and hold 500 of the biggest stocks, the ICE BAML U.S. High Yield Index consists of around 2,000 securities, many of which trade infrequently. The result: High yield ETFs have the highest tracking error in all of fixed income—67 basis points versus 1 to 6 bps for government bond ETFs, according to a recent analysis by MSCI.

The active advantage: Tracking error typically leads to performance drag, which explains why high yield ETFs often lag their benchmarks by a wider-than-expected mark. Over the past three years through April 30, 2019, the SPDR Bloomberg Barclays High Yield Bond ETF returned 6.9% annually. Meanwhile, the ICE BAML High Yield Index was up 7.8% and Northeast Investors Trust returned 7.4% annually.

The Advantage of Flexibility

Another risk may not materialize until the economy begins to falter. The high yield market is thinly traded relative to the much larger investment-grade universe. This poses a real quandary: In the event of a sharp downturn, passive high yield funds would be forced to unload illiquid securities quickly—possibly at fire-sale prices—to reflect market changes at the moment. On the other hand, active funds that invest in out-of-index bonds can avoid this initial bout of losses since they can factor in liquidity issues to their decision-making.

To be sure, in a real crisis like in 2008, the broad market would be affected too. But actively managed high yield funds would have the time and discretion to weigh short-term volatility against long-term opportunities. Index funds, on the other hand, would be forced to react to whatever is happening in the market—good or bad.

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