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Finding Gems in the Junkyard: Active Management in U.S. High-Yield Bonds

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Snapshot

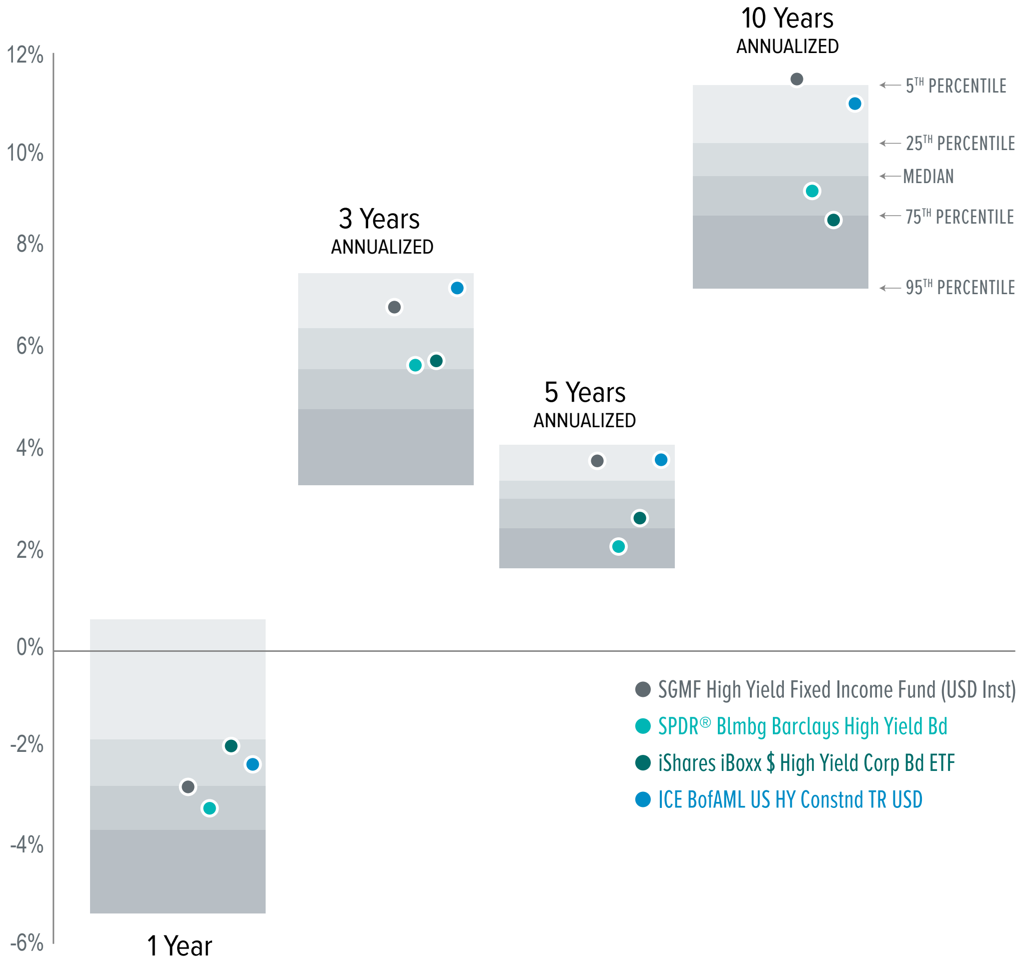
- ETFs have become a popular investment vehicle for investors.
- ETFs are often thought of as low-cost, passive investments that efficiently track a given index, but that's not always the case, especially when evaluating high-yield bond ETFs which often have higher fees and expenses than most investors expect.
- A thoughtfully constructed, actively managed portfolio may be a more attractive investment option for high-yield bonds.

Exchange-traded funds (ETFs) continue to increase in popularity as the passive vehicles took in over $315 billion in 2018, marking the second best year ever for ETF asset flows. Despite challenging market conditions, ETF assets under management ended 2018 at a rather robust $3.4 trillion (per ETF.com, 2018's $315B ETF Inflows 2nd Largest Ever, 3/1/19). Only about 31% of last year's inflows went to fixed-income ETFs; the overwhelming majority flowed into equity products. In terms of total ETF assets, just 19% were in fixed-income. One of the reasons for the equity versus fixed-income disparity in ETFs is the relative ease and efficiency with which equity indexes can be replicated compared to the difficulty in even attempting to replicate a fixed-income index.

High-Yield ETFs Haven't Measured Up

Two of the most popular high-yield ETFs as measured by assets under management, SPDR® Bloomberg Barclays High Yield Bond ETF (Ticker: JNK) and iShares iBoxx $ High Yield Corporate Bond ETF (Ticker: HYG), have struggled to perform in line with commonly used indexes such as the ICE BofAML US High Yield Constrained Index, which is a popular benchmark for actively managed high-yield bond funds. Further, with expenses of 0.40% (as of 31/10/18) and 0.49% (as of 29/6/18), respectively, neither ETF offers a true low-cost solution such as those available in equities.

Exhibit 1: ETF Performance Struggles



Source: SEI, Morningstar High-Yield Bond Category (U.S. database) as of 31/12/18

	1 Year	Annualized		
		3 Years	5 Years	10 Years
SGMF High Yield Fixed Income Fund (USD Inst)	-2.65%	6.89%	3.81%	11.56%
SPDR® Blmbg Barclays High Yield Bd ETF	-3.18%	5.76%	2.11%	9.24%
iShares iBoxx $ High Yield Corp Bd ETF	-1.93%	5.83%	2.69%	8.68%
ICE BofAML US HY Constnd TR USD	-2.27%	7.26%	3.83%	11.01%

SEI Fund performance is net.
All performance is in USD.
Data refers to Past Performance. Past performance is not a reliable indicator of future results.

Admittedly, the index can often be a challenging reference point for actively managed funds as well. Especially in times of positive economic growth, highlighted by low default rates, investors can frequently observe smaller, less-liquid offerings that do not trade well (if at all) outperform and drive index returns higher. But there are also a number of times when issues or entire segments of the high-yield market are excluded from the index, and this is an area where active management can make a significant difference.

Moving Away From the Index

By definition, active managers must be different than the index; one way to do this is to hold securities that exhibit similar characteristics to the index but for any number of reasons are not included. Bank loans represent a compelling segment of the high-yield market that is not included in the ICE BofAML US High Yield Constrained Index. With their floating rates, bank loans have comparatively lower duration than comparable bonds and therefore are less sensitive to interest-rate changes – a particularly attractive feature in times of rising interest rates. Additionally, bank loans sit above bonds in the capital structure and typically carry ratings that are equivalent to BB rated bonds. This means they carry less interest-rate and credit risk than typical high-yield bonds. It's not a "free lunch" however as investors must sacrifice some liquidity when compared to bonds, but we believe this tradeoff is worth the risk.

Collateralized loan obligations (CLOs) are another area of interest for SEI. These structured investments offer the potential for excess returns, though as with bank loans, they are often less liquid than traditional high-yield bonds.

The Outlook Remains Positive

Default rates among high-yield bonds have been below historical averages and we expect them to continue trending lower into early 2019. Yields meanwhile are more attractive than earlier in the year, the ICE BofAML US High Yield Constrained Index sports a yield to maturity of 7.98% as of 31/12/18 (source: BlackRock). High-yield issuers continue to be able to refinance and there is strong demand to cover new issuance. Meanwhile, yield spreads remain attractive relative to investment-grade bonds. Federal Reserve rate hikes are a persistent headwind, but Chairman Powell has indicated the pace of possible future hikes may be slowing. Meanwhile, with both fundamentals (low defaults, attractive yields) and technicals (refinancing, new issuance) appearing on solid footing, the high-yield bond market seems poised for gains.

OFFSHORE

Standardised Performance as at 31 December 2018

	1/1/18 – 31/12/18 (%)	1/1/17 – 31/12/17 (%)	1/1/16 – 31/12/16 (%)	1/1/15 – 31/12/15 (%)	1/1/14 – 31/12/14 (%)
SGMF High Yield Fixed Income – USD Inst Class	-2.65	7.43	16.78	-3.63	2.42
ICE BofAML US High Yield Constrained Index (USD)	-2.27	7.48	17.49	-4.61	2.51

Source: SEI Data Portal
Date of inception is 9/9/96.
Data refers to past performance. Past performance is not a reliable indicator of future results.

Performance shown is net of the Fund's operating expenses. Performance does not reflect management fees payable to SEI and any advisory fees that may be payable to the dealer. The rate of return shown is used only to illustrate the effects of the compound growth rate and is not intended to reflect future values of the Fund or returns on investment.

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SEI sources data directly from FactSet, Lipper, and BlackRock, unless otherwise stated. There are material differences between the investments discussed here including:

- *The SGMF High Yield Fixed Income Fund seeks to provide total return.*
- *The SPDR Bloomberg Barclays High Yield Bond ETF seeks to provide investment results that, before fees and expenses, correspond generally to the price and yield performance of an index that tracks the U.S. high yield corporate bond market.*
- *The iShares iBoxx $ High Yield Corporate Bond ETF seeks to track the investment results of an index composed of U.S. dollar-denominated, high yield corporate bonds.*

Liquidity: while the SGMF High Yield Fixed Income Fund offers daily liquidity, liquidity for the ETFs listed here depends on market activity.

For a comprehensive discussion of each investment's characteristics, please read the relevant prospectus.

Investment comparisons are for illustrative purposes only and not meant to be all-inclusive. To better understand the similarities and differences between investments, including investment objectives, risks, fees, and expenses, it is important to read the products' prospectuses. Funds in the same category may have different holdings, risks and performance. Competitors may have more than one fund in the category. The competitor funds shown here were selected because they are two popular ETFs based on assets under management.