ETFS— NO PANACEA FOR HIGH-YIELD REPLICATION

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Since the introduction of fixed income exchange-traded funds (ETFs) in 2002, the asset management industry has seen a seismic growth in the amount of assets and the number of products coming to market. ETFs were once seen primarily as an equity vehicle; however, fixed income ETFs have shown remarkable popularity, increasingly serving as a core placement in an investor's passive lineup. ETFs provide the advantage to investors of being able to access a portfolio of bonds that is standardized and exchangeable as a single security on a listed exchange. A primary drawback, however, is that fixed income ETFs cannot achieve full index replication. Instead, they must rely on a stratified sampling approach, which can result in a higher performance differential (sometimes referred to as tracking difference). This is due to the high number of issuers in a listed index, as well as the constrained liquidity stemming from dealer banks reducing their inventories of bonds.

Performance differentials are especially pronounced in the US corporate high-yield ETF market, due to the difficulty in replicating a full market cap index. We note the particularly high difference between the returns of the two largest high-yield bond ETF providers (BlackRock's iShares HYG and State Street's SPDR JNK) and the broad-based US high-yield index, represented by Bloomberg Barclays US Corporate High Yield Index.

It is important to note that HYG and JNK's stated benchmarks are the Markit iBoxx US Liquid High Yield Index and the Bloomberg Barclays High Yield Very Liquid Index, respectively. These two benchmarks possess the most liquid of high-yield issuers and exclude some of the smaller and less-liquid names. However, given most people use ETFs to provide the return of the market, typically represented by the broad-based index, we find it appropriate to measure the performance dispersion using the most comprehensive index option. This also provides an apples-to-apples comparison between HYG and JNK, which each use different methodologies to account for transaction costs. As of June 30, 2017, HYG and JNK had $16.95 billion and $11.17 billion in assets under management, respectively.

The first table compares the performance of HYG and JNK (both net of fees) against the broad market index over the past six years. For reference, we also show the performance of the median active manager in Mercer's US High Yield universe (gross of fees).[1] Over the past six years, the median manager not only had higher aggregate returns, but also had a lower excess return percentage than both HYG and JNK.

	HYG NAV return (%)	JNK NAV return (%)	Mercer US HY universe return	Bloomberg Barclays US corporate HY index (%)	HYG excess return (%)	JNK excess return(%)	Mercer US HY universe excess return (%)
2011	5.9	4.7	5.2	5.0	0.9	-0.3	0.2
2012	13.8	14.3	15.5	15.8	-2.0	-1.5	-0.3
2013	5.9	5.9	7.7	7.4	-1.5	-1.6	0.3
2014	2.0	1.2	2.6	2.5	-0.5	-1.3	0.1
2015	-5.6	-7.2	-2.7	-4.5	-1.1	-2.8	1.8
2016	13.9	14.8	14.6	17.1	-3.2	-2.4	-2.6
Average	6.0	5.6	7.1	7.2	-1.2	-1.6	-0.1
Cumulative	40.1	36.5	49.6	49.7	-9.6	-13.2	-0.2

Source: DataStream, MercerInsight

The second table shows the performance of the largest S&P 500 ETF (SPY) and the largest Bloomberg Barclays Aggregate Bond ETF (AGG) against their respective market indices.

	SPY return (%)	S&P 500 index return (%)	SPY excess return (%)	AGG return (%)	Barclays Agg index return (%)	AGG excess return (%)
2011	2.1	2.1	-0.1	7.6	7.9	-0.3
2012	15.8	16.0	-0.2	4.0	4.2	-0.2
2013	32.2	32.4	-0.2	-2.2	-2.0	-0.1
2014	13.5	13.7	-0.2	6.0	6.0	0.1
2015	1.3	1.4	0.0	0.5	0.6	-0.1
2016	11.8	12.0	-0.2	2.6	2.7	-0.1
Average	12.8	12.9	-0.1	3.1	3.2	-0.1
Cumulative	101.1	102.4	-1.3	19.7	20.5	-0.8

Source: DataStream, MercerInsight

[1] For reference, the median fee for an active high-yield manager in this universe is c.50 bps.

The tables highlight a number of important points for investors:

- The years 2015 and 2016 were particularly challenging years for high-yield index replication — and, as a result, for passive high-yield ETFs. The primary reason for the material underperformance of passive ETFs over this period was elevated price volatility. In 2015, the high-yield market was under strain from the drop in commodity prices, which negatively impacted the energy sector — a sector that comprises approximately 15% of the overall US high-yield market. Conversely, 2016 saw this sector recover. Further, the sudden influx of formerly investment grade rated "fallen angels" into the high-yield index in spring 2016 provided an additional challenge for replication, as these bonds were difficult to source and rallied almost immediately after inclusion.

- While active managers have struggled to keep up with the market in recent years (especially in 2016), the largest passive high-yield ETFs have materially underperformed both the broad market index and the median active manager (even after deducting typical fee levels) over a sustained period.

- Although some passive ETFs can do a good job of tracking broad market indices (for example, in US large cap equities), this is by no means true for all passive ETFs. Indeed, passive ETFs have struggled to match the broad market index return in emerging markets (both debt and equity) as well as in high yield.

CONCLUSION

Considering that high-yield ETFs employ a stratified sampling approach, it will always be challenging to track the index during times of increased market volatility. The high-yield market can move swiftly both in price volatility and in index composition, so there will often be times when the performance differential is significant. Investors should be mindful that the performance differentials for US high-yield ETFs will almost always exceed those of large cap equity or investment grade fixed income ETFs. Thus, for product categories such as high yield, where the broad market index is challenging to replicate and which experience material constituent turnover, we recommend taking an active approach to investing. Although achieving alpha in certain market environments can be challenging in high yield, those who believe they can simply capture the market beta through ETFs might be disappointed.

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