

*Rocaton*

INSIGHTS

*High Yield:*  
The Merits of  
Active Management

*January 2014*

203.621.1700 | [rocaton.com](http://rocaton.com)

© 2014, Rocaton Investment Advisors, LLC

## EXECUTIVE SUMMARY

Active management is widely adopted in fixed income given the over the counter nature of the asset class, the complexity of certain security types, and the differing objectives among the investor base. High yield stands out as an area where skilled active managers have historically delivered strong relative performance. The past five years, however, have been an anomaly, given that active high yield managers of all styles have generally lagged market indices.

### Recent Performance

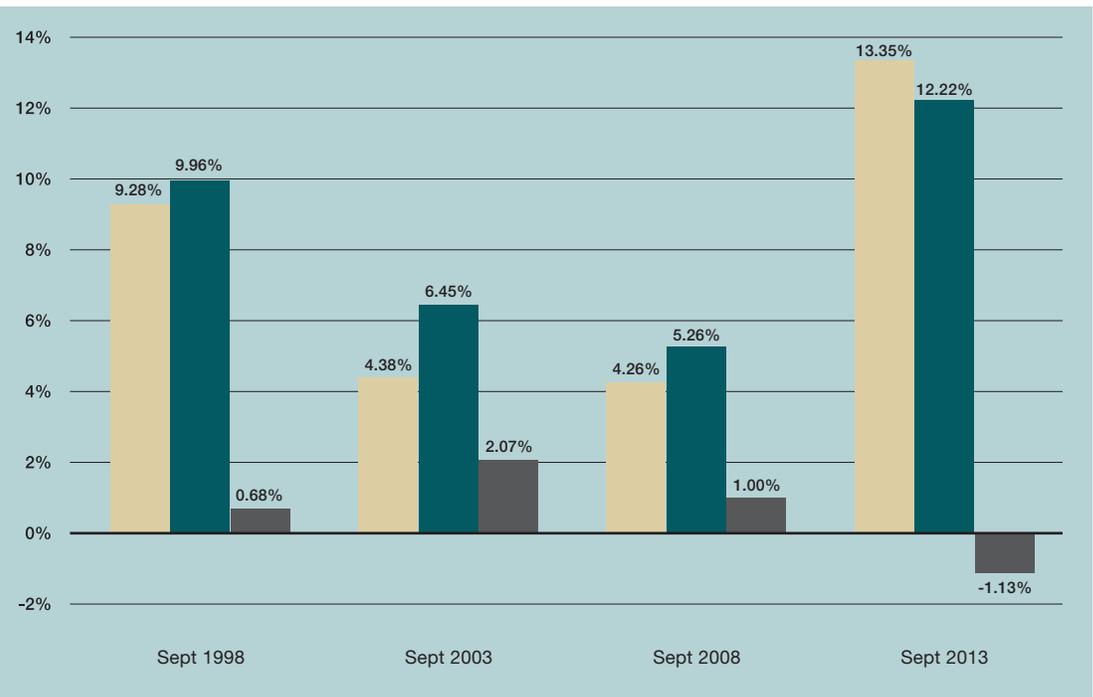
The median manager in the eVestment high yield universe has lagged the benchmark (BofA ML High Yield Master II Index) in most trailing periods ending September 30, 2013 on a gross of fee basis. Further, there have been several calendar years (most notably 2009) in which active managers performed very poorly on a relative basis. The median high yield manager in the eVestment Universe returned approximately 45% in 2009, while the benchmark rose approximately 58%. Chart 1, below, highlights how the median manager in the eVestment High Yield Universe has performed over various five-year trailing periods. Apart from the most recent five-year trailing period the median manager generated positive excess returns in every other five-year trailing period shown in the chart below.

**Chart 1:**  
Median High Yield  
Manager Trailing Five  
Year Excess Return

**Legend:**  
 Merrill Lynch US High Yield Master Index  
 eA High Yield Fixed Income Median Manager  
 Excess Return

Performance is annualized and gross of fees.

Source: eVestment Alliance, Merrill Lynch



The balance of this paper will provide possible explanations as to why active high yield managers have struggled to generate positive excess returns over recent trailing periods. Further, we will provide theoretical support for active management within high yield and finally we will delineate possible outcomes for active management moving forward.

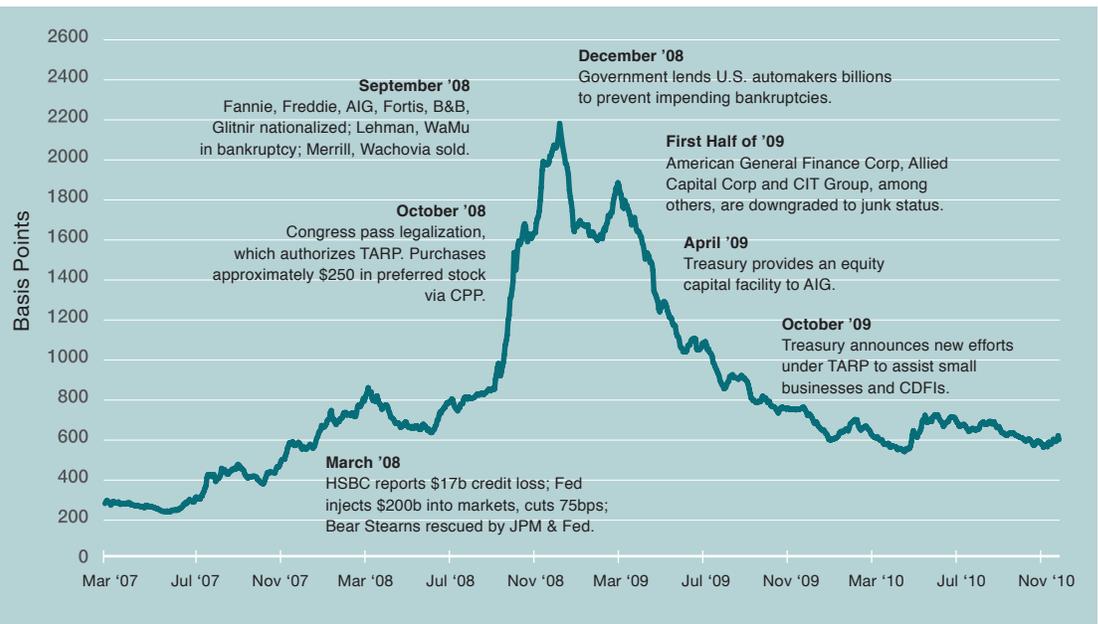
## Challenges for Active Managers:

As stated earlier, while skilled high yield managers have historically generated positive excess returns, there have been some noticeable headwinds that have made it challenging for managers in recent years.

- \* **Higher Quality Bias:** In general, managers that have had a higher quality bias may have lagged the broader benchmark over recent trailing periods, given the wide dispersion of returns across different credit quality segments. For example, the BofA ML HY CCC and Lower Index generated a 17.0% annualized return over the five-year trailing period ending September 30, 2013 while the BofA ML HY BB/B Index generated a return of 11.9% over the same time period. This large performance divergence is somewhat of an anomaly. Since the inception of these two indices in January of 1997, the BofA ML HY CCC has only outperformed the BofA ML HY BB/B Index by approximately 80 basis points, ending September 2013, on an annualized basis.
- \* **Underweight to Financials:** Historically, the financials sector was a small component of the high yield market (at the end of 2006 it was less than 2%). However, as of September 2013, financials made up approximately 11% of the market. An underweight to financials would have hurt performance over the last five years, ending September 30, 2013, as the BofA ML High Yield Financial Services Index returned over 21.0% while the broad market returned 13.4%. Anecdotally, we know that many managers had an underweight to financials. For many high yield managers, financials are not a natural part of the investing landscape. High yield managers often have difficulty getting comfortable with financials given the complex nature of their balance sheets, and for the simple reason that for financial companies, the “cost” of doing business is the interest on their liabilities.
- \* **Index Technical:** Some credits, particularly within financials, entered into high yield indices at low prices in 2008/2009. Therefore, the index was not affected by the initial fall in price, but it did benefit when the bonds recovered. For example, the average price for financials within the ML US Fallen Angel High Yield Index at the end of 2008 was \$28.6. The price rebounded to \$92.0 by the end of 2010.
- \* **Cash Drag:** Large inflows into the asset class over the past five years may have caused managers to hold slightly higher cash balances relative to history. To illustrate the effect of the potential cash drag on a high yield manager’s portfolio consider the following example. A strategy that had a 95% exposure to the BofA ML HY Master II Index and a 5% exposure to cash (as measured by the Merrill Lynch 3-Month U.S. Treasury Bill Index) would have underperformed the benchmark by approximately 65 basis points annualized over the trailing five-year period ending September 30, 2013. In particular, a larger than normal allocation to cash in 2009 would have been a major detractor given the rally high yield experienced.
- \* **Trading Costs:** Markets have become less liquid after the financial crisis, as dealers have had to shrink their balance sheets. This has increased the cost of trading. Managers estimate that trading costs alone will generally put them at a 50 basis point disadvantage to an index in a normal environment.

\* **Bail out:** Although the financial crisis caused a great deal of instability in the markets, the default experience among high yield issuers was not as severe as it was during other challenging periods for the high yield market (e.g. 2002). The unprecedented measures that the government took to provide liquidity to the markets may have allowed some high yield issuers to avoid default. Chart 2 highlights several of these measures. Fundamental credit research may have not paid off as these companies were essentially “bailed out.” In fact, the best performing strategy since the beginning of 2009 would have been to buy the worst high yield companies from the point of view of weakest balance sheets, and poor earnings. Rocaton believes this may not be a normal market outcome for high yield.

**Chart 2:**  
High Yield Spreads and  
Notable Events during  
the Financial Crisis



Source: United States Government Accountability Office, Merrill Lynch

## Why Active Management?

Given the recent struggles that high yield active managers have had beating the benchmark, investors might ask if it still makes sense to gain exposure to high yield via actively managed strategies. There are three questions that investors should ask themselves: Is passive implementation feasible? Should active managers, theoretically, be able to generate alpha? Do skilled active managers have the potential, moving forward, to generate positive excess returns?

There are a limited number of products available for investors to gain exposure to high yield bonds passively. Further, most of these products do not have a meaningful track record, and they have not tracked the market particularly well.

Several of the larger index providers offer commingled funds that are designed to track high yield indices. However, the predominant way that investors gain passive exposure to the high yield asset class is via the exchange traded fund (“ETF”) market. This market is dominated by two players, BlackRock and SSgA. Both ETFs and passive commingled funds are designed to track “liquid” high yield indices. As the name would imply, these liquid high yield indices tend

to contain the largest, most liquid credits. Therefore an investor buying these products would not expect to get exposure to the broad high yield market. In addition, high yield ETFs typically have an expense ratio of 0.40% - 0.50%, which is only modestly lower than the average fee for an actively managed high yield strategy. Further, the tracking error for these strategies has historically been quite high (approximately 50 basis points) relative to the tracking error that index funds in other asset classes (e.g. U.S. equity) experience. There are over 2,000 issues in the BofA ML High Yield Master II Index. Many of these issues tend to be quite illiquid, so it would be expensive, and practically speaking impossible, to own most of the bonds in the index.

Given that it is challenging to gain exposure to high yield passively, by default, most investors will gain exposure via active management. To reiterate the second question, should skilled high yield managers theoretically be able to generate alpha on a consistent basis?

High yield bonds have an asymmetric return profile (i.e. in most cases the potential magnitude of capital loss is much greater than the potential capital gain). That is to say, through strong credit research, managers may be able to minimize the default experience and negative credit events. As evidenced by Chart 3 below, generally the performance of the median high yield manager in the eVestment Alliance universe has been better than the benchmark during down markets.

**Chart 3:**  
U.S. High Yield Median  
Manager-Consistency Chart

Legend:

- Negative Excess Return ◆
- Zero Excess Return —
- Positive Excess Return ○

Chart reflects 84 rolling three year periods (Dec 1992 through Sept 2013) based on gross of fee, quarterly data.

Source: eVestment Alliance,  
Merrill Lynch



There are several other factors that support the assertion that skilled active high yield managers can add alpha:

- \* The market is less liquid and more inefficient relative to other asset classes (e.g. US Equity).
- \* The complexity of the balance sheets of high yield issuers, coupled with unique bond structures, create opportunities for strong credit analysis to add value.
- \* Insurance company regulations and other investor guideline constraints can create opportunities for total return investors.
- \* Rating agencies generally have been less effective in the non-investment grade space. Agencies have been criticized for being slow to make changes. Theoretically, this could cause the price of a high yield bond to deviate from its intrinsic value for a sustained period of time.
- \* There are inherent flaws in market capitalization weighted fixed income indices given that when a corporation issues more debt, it becomes a larger weight in the index. In some instances, more highly leveraged companies pose a greater credit risk. Unlike a benchmark, managers are not required to increase their exposure to a company as it issues more debt.

If we accept the argument that quality high yield managers should be able to add alpha, how should this guide our expectations in regards to active management prospectively?

### **Moving Forward?**

Although most high yield managers have similar opportunity sets in the sense they are investing predominantly in the bonds of companies that are below investment grade, there can be relatively large differences in the investment style of high yield managers. For the purposes of this paper we will characterize high yield managers as defensive, core, and opportunistic. While Rocaton does not have a preference for one particular style of manager, depending on the investor's objectives and current investment program, one style might be more suitable than another.

- \* **Defensive Managers** – Generally have a quality bias. These managers tend to have lower upside and downside captures ratios. In other words, we would expect these managers to potentially lag when the high yield market is rallying, and outperform in challenging markets. Further, these managers will have a difficult time keeping up with the broad high yield benchmark if bonds that are rated CCC materially outperform other credit quality segments. Defensive high yield managers may also find it harder to outperform the benchmark in a benign default environment.
- \* **Core Managers** – Generally a core high yield manager's portfolio will more closely resemble the benchmark, relative to a defensive manager, in terms of credit quality. Given that these managers typically do not have a quality bias, it may be easier for them to outperform in different market environments. That is not to say that a core high yield manager will always add alpha when the high yield market is rallying, but relative to a defensive high yield manager, the likelihood of a core manager outperforming when the market is rallying is greater given the composition of its portfolio.

\* Opportunistic Managers – Generally these managers actively shift the portfolio's beta, credit quality, industry allocations, or sector allocations. Some may make relatively significant allocations to out of benchmark securities (bank loans, equities, structured products, distressed debt, convertibles etc.). This categorization is broad and there are several sub-styles within it. Given the incremental latitude that these managers have, they should have the ability to outperform in different market environments. Given that these managers have additional latitude, and invest in a substantial amount of out-of-benchmark securities, there may be periods where an opportunistic manager's performance deviates quite significantly from the broad high yield market.

## Conclusion

Although active high yield managers have had difficulty outperforming the index, we believe that the impracticalities of implementing passively, and the theoretical support for active management, continue to make active management the preferred option for clients seeking high yield exposure. Further, we would assert that the recent environment created unique challenges for high yield managers. Some of the recent hurdles to strong relative performance may not be present moving forward. The return potential from capital appreciation is limited today given that the majority of the market is trading above par. Additionally, while defaults are currently below their historical average, markets are cyclical, and defaults are unlikely to stay at low levels indefinitely.

When selecting a high yield manager it is important to be cognizant of what type of style the manager employs. This will be helpful in terms of setting realistic performance expectations for managers. Further, understanding a high yield manager's style might be helpful for clients that have a multi-manager high yield structure, given that it may be desirable to combine managers with complementary styles to reduce risk and improve performance consistency.

Rocaton is registered as an investment adviser with the U.S. Securities and Exchange Commission. Rocaton's Form ADV, Part 2 is available upon request. The information included in this publication has been taken from sources considered reliable. No representations or warranties are made as to the accuracy or completeness of this information and no responsibility or liability (including liability for consequential or incidental damages) is assumed for any error, omission or inaccuracy in this information. This information is subject to change over time. This publication is not intended as investment advice. Before acting on any information contained in this material you should consider whether it is suitable for your particular circumstance. Any opinions expressed in this publication reflect our judgment at this date and are subject to change. No part of this publication may be reproduced or redistributed in any manner without the prior written permission of Rocaton Investment Advisors, LLC.