RBC Global Asset Management

Active management in high yield

Why should you allocate high yield to a specialist active manager?

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Executive summary

In fixed income markets, and particularly in high yield, it is our view that a specialist asset manager has important advantages at their disposal to generate excess net-of-fees returns versus a passive strategy:

- **Inherent challenges of high yield**
  The complexity of high yield market structures and instruments, the trading conditions, and high issuance turnover make execution more challenging than other asset classes.
- **Limitations of passive strategies**
  How high yield indices are constructed and rebalanced means that passive strategies experience higher tracking errors and typically underperform their index.
- **Advantages of an active approach**
  In high yield, active managers benefit from access to a broader opportunity set, alpha generation through active positioning and credit selection, and well-established trading relationships with access to primary issuance.

High yield markets: inherent challenges

High yield markets express greater complexities and more pricing anomalies than their equity counterparts. As a result, passive strategies are significantly less efficient in high yield than in other publicly traded markets:

Complexity of market structure and instruments

Usually, equity indices comprise a few hundred securities, which do not vary greatly over time. Fixed income indices, by contrast, can consist of thousands of over-the-counter bonds issued by many thousands of issuers. Likewise, high yield bonds often contain complex features, such as callability, subordination or covenant protection. These features can require careful analysis to incorporate them accurately into a valuation.

Figure 1: Index comparison

Index name	# Issues	# Issuers
ICE BofA US High Yield Index	1,871	886
S&P 500	503	500
ICE BofA European Currency High Yield Constrained Index	829	398
Euro STOXX 50	50	50

Source: RBC GAM, Bloomberg as at 31 July 2023.

Liquidity conditions and high trading costs

High yield trading continues to be largely conducted over the counter (rather than on an exchange). At RBC GAM, we typically invest in the most liquid capital structures; however, the high yield universe encompasses a long tail of issues from smaller or privately owned companies which tend to trade with lower liquidity than bonds from larger BB-rated companies. Although high yield conditions are significantly more liquid than asset classes such as leveraged loans and direct lending, high yield liquidity remains challenging versus, for instance, investment grade. This means price discovery can be relatively opaque and trading costs are often high. These conditions pose a challenge to passive ETFs that investors often use for short-term tactical positioning.

Higher index turnover

Equities are perpetual instruments, whereas fixed income instruments typically have set maturities. This means there is a near-constant flow of new primary issuance in fixed income markets. The average maturity of the securities in the ICE BofA US High Yield Index is approximately 5.2 years. New issues, maturities, calls, corporate actions (like tender offers), and credit rating changes create high turnover in fixed income indices such that their composition is continually in flux.

Passive allocation: limitations in high yield markets

For a longer-term investor seeking exposure to high yield markets, passive vehicles pose various limitations and have persistently underperformed benchmarks.

High tracking error

Whereas an equity investor can buy every stock in an index, the complexity and relatively lower liquidity in fixed income markets mean that it is expensive and difficult to buy the entire market and replicate the composition of an index. As a result, it is also challenging for an index fund to track the performance of its benchmark closely and tracking error for passively managed high yield strategies tends to be high relative to equities, leading to relative underperformance.

Index construction criteria

In equity markets, a compelling reason to track the market is that the benchmark is constructed to reward the success stories whose stock prices increase over time. By contrast, in bond indices, the most indebted issuers represent a larger proportion of the index since bond benchmarks are typically based on the entities that issue the largest volume of debt. This can cause overweight biases towards struggling names that are the largest debtors rather than stronger businesses with more sustainable capital structures.

Monthly index rebalancing

When an index rebalances its constituents, typically monthly, bond prices tend to rise or fall as passive investors are forced to resize positions. Fixed income benchmarks are governed by rigid rules for issuer inclusion, which may often rely on assessments from third-party credit rating agencies. Unlike passive strategies, active investors can position in anticipation of such decisions around inclusion and exclusion. The greater the volume of assets passively tracking benchmarks, the greater the distortions around index-rebalancing events will likely become.

Unintentional active share

In constructing a passive fund to reflect a representative sample of a complex and lower liquidity market like high yield fixed income, the passive fund manager must make many decisions that will cause the fund to become overweight and underweight market elements, thereby taking unintentional active risk positions. Besides these limitations, investors continue to dispute the broader implications of passive investing. For instance, will too high a proportion of passive investing distort markets?

Active management: advantages in high yield

For a specialist and experienced active manager, there are a rich set of opportunities to generate excess returns versus a passive strategy. Active strategies can focus on outperforming primarily through bottom-up credit selection and top-down credit allocation:

Fundamental analysis (credit selection)

As an active high yield strategy, an investor can conduct proprietary fundamental research across the full high yield universe to identify and take advantage of market inefficiencies, seeking out securities that they believe to be mispriced or mis-rated. The view is that effective analysis enables an active investor to avoid those issuers whose credit metrics are deteriorating and identify those most likely to experience a credit event that might materially impact performance (like a credit rating upgrade or downgrade). To further enhance the analysis, they may also incorporate a variety of environmental, social, and governance (ESG) factors in our research process.

Broader opportunity set

As an active manager, an investor can invest across the entire universe of high yield names regardless of whether they fall within a defined benchmark index. This enables the active manager to take advantage of opportunities across issuers of all sizes, both public and private, often in areas of the market where inefficiencies abound due to limited research coverage or lack of broad market participation. The opportunity also exists to opportunistically add off-benchmark exposures with attractive characteristics, such as floating rate notes (FRNs) or contingent convertibles. One can use liquid credit derivative instruments to quickly add or hedge exposures. Additionally, one can purchase new issues when launched rather than when they are added to benchmarks. Purchasing bonds via primary market opportunities is cost-efficient and a potential alpha source due to new-issue premiums.

Well-established trading relationships

An active manager can use their market experience and long-term relationships with bond dealers to source the specific deals and assets they want and gain valuable market insights. Through active management, one can be more opportunistic about the price at which they buy or sell a security, only acting when a compelling entry point or total return opportunity for our portfolio exists. Passive investors tend to be ‘price takers’, automatically purchasing bonds at issuance or transacting when a security enters or leaves the index.

Experienced team & corporate engagement

Active managers are more incentivized to engage with corporate issuers. An experienced investment team, have a greater ability to influence change in company behavior as active investors. For engagement on ESG-related matters, active investors are well-placed to encourage issuers to modify their behaviour to achieve better stakeholder outcomes. A robust approach to ESG integration enables one to implement views in a much more forward-looking manner than benchmark providers can do, offering the potential for superior ESG outcomes.

“For a specialist and experienced active manager, there are a rich set of opportunities to generate excess returns versus a passive strategy.”

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