Asset Class Perspective

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AEGON **INSIGHTS**

High Yield: The potential pitfalls of passive investing

Investors today have a wide range of options including active and passive strategies. This active versus passive debate has edged its way into fixed income in recent years as investors have continued to explore passive – or indexed – investment options that are designed to provide a relatively inexpensive way to gain broad-market exposure and pursue index-like returns.

While some passive equity funds have demonstrated an ability to generate index-like returns, there are limitations when it comes to passive investing in fixed income. This is especially true in the lower-quality or less liquid part of the market, such as high yield bonds. When it comes to high yield bonds, we firmly believe active management can offer additional benefits to investors who are considering an allocation to the asset class.

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The potential limitations of passive investing in high yield

An index-tracking approach for high yield bonds may come with various limitations. For one, debt indices are weighted by debt outstanding and as such if you track the benchmark, you essentially allocate the majority of your portfolio to the most indebted companies. Although many indices are capped at a maximum issuer weight of 2%, indices still have to take what they're given by the market. This was well-demonstrated by the large increases in index exposure to companies about to enter material financial distress before the dotcom and energy busts.

In addition, there is another crucially important point to consider when comparing active managers to indices. Passive fixed income is different to its equity market equivalent. In the context of the bond market, passive ETFs often are not designed to track 'the market'. For example, ETFs set their benchmarks as liquid subsets of the broader high yield universe. For example, the iBoxx $ Liquid High Yield index has around half the number of bonds in the ICE BofA US High Yield Index and of course the composition of the index is different in terms of ratings and sectors.

Further, ETFs are required to track a subset of the index because the actual index is meant to simulate perfect conditions. For example, it benefits from perfect liquidity and perfect allocation to new issues. Meanwhile, active managers operate in the real world, and ETFs face the same challenge.

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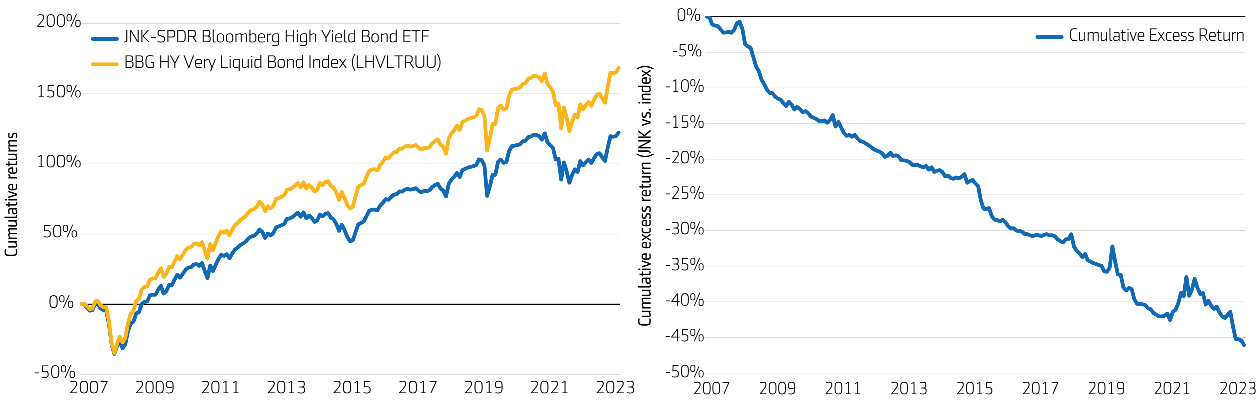
Most passive high yield ETFs have consistently underperformed their benchmarks since inception

Within the equity market, passive exchange-traded funds (ETFs) have generally been able to generate index-like returns given de-minimis transaction costs, ample liquidity and low fees that are typical of passively managed funds. As tempting as it may be to apply the same cost-saving concepts to fixed income, there are meaningful differences between equity and fixed income markets.

When it comes to equities, passive ETFs have historically kept pace with the broader equity market and their respective benchmarks, more or less. However, certain high yield passive ETFs have significantly lagged their respective benchmarks and the broader market. Although there are various ETFs in the marketplace, we can use one of the main High Yield ETFs to illustrate the historical performance. As shown below, the SPDR Bloomberg High Yield (JNK) fund has persistently lagged the index since inception in 2007.

Exhibit 1: SPDR Bloomberg HY ETF (JNK) vs. Bloomberg High Yield Very Liquid Index



Source: Aegon AM, Bloomberg. Based on monthly returns hedged to USD from 30 November 2007 to 31 March 2024. Includes JNK – SPDR Bloomberg High Yield Bond ETF and Bloomberg High Yield Very Liquid Bond Index. **Past performance does not predict future returns.** Data is provided for illustrative purposes only. Indices do not reflect the performance of an actual investment. It is not possible to invest directly in an index, which also does not take into account trading commissions and costs. All investments contain risk and may lose value.

We believe that many of the typical limitations of index-tracking for the high yield market can be overcome through active, high-conviction investing. When evaluating passive vs. active fixed income, key considerations can include trading costs, fees, and benchmark selection.

Trading costs and fees

Passively managed high yield strategies are likely to persistently underperform their high yield benchmark for two primary reasons: elevated trading costs and fees may result in a drag on performance versus the index.

There is a common perception that investing in an ETF provides benchmark-like returns. However, the benchmark that the ETF is tracking has embedded advantages over the ETF. The benchmark does not face trading costs and receives perfect allocations to new issues. On the other hand, the ETF must incur trading costs and is forced to buy the bonds at the current market price in an effort to replicate benchmark holdings. In a more liquidity strained asset class like high yield, the impact market liquidity may have on passive high yield ETF strategies should be considered, even if they do track a more liquid index. This turnover can result in meaningful trading costs for an asset class that tends to have a wider bid-ask spread. In times of stress, the liquidity factor may become increasingly important as replicating index holdings becomes more challenging, the ETF is forced to buy bonds regardless of the price.

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In addition, although passive funds typically charge lower fees than many active managers, these fees those fees still need to be factored into the fund's ability to generate competitive returns. Although active managers also charge fees and face trading costs, they are often able to implement more dynamic and flexible trading decisions as they strive to minimize trading costs while also maximizing value for clients. Ultimately, active managers can utilize their skill and expertise to implement a high-conviction approach that aims to more than compensate for the fees and trading costs.

Benchmark selection and high yield market representation

Benchmark selection is also an important consideration when evaluating passive high yield ETFs. Although passive equity funds can select benchmarks that are largely representative of the broader market, passive high yield funds are not designed to track the full high yield market.

For example, high yield ETFs set their benchmarks as liquid subsets of the broader high yield universe. The SPDR Bloomberg High Yield ETF (JNK) is managed against the Bloomberg High Yield Very Liquid Bond Index, which has around half the number of bonds in the broader ICE BofA US High Yield Index. In addition, the composition of the index is different in terms of ratings and sectors. As a result, investors that allocate to passive high yield ETFs are not getting full access to the broader high yield market, which can lead to missing out on key alpha-generating opportunities. Active managers, on the other hand, have flexibility to invest across the high yield market spectrum and utilize their expertise to evaluate liquidity and trading costs as they balance risk/return decisions and seek to maximize upside potential and minimize downside capture while generating strong risk-adjusted returns.

Passive vs. active high yield strategies

While passive portfolios may have a place in some investors' portfolios, an actively managed approach to high yield bonds may provide additional opportunities to outperform the benchmark. Using an active, high-conviction approach, managers strive to allocate clients' capital to their best ideas while avoiding index positions with inferior risk-return profiles. Active portfolio managers can uncover and exploit market inefficiencies by leveraging internal research and their experience navigating various market cycles. By constructing a portfolio with opportunistic variations to the index, active managers may be better positioned to produce returns that are meaningfully different than passive funds as they aim to generate enhanced value for clients.

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Investments in high yield bonds may be subject to greater volatility than fixed income alternatives, including loss of principal and interest, as a result of the higher likelihood of default. The value of these securities may also decline when interest rates increase.

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