It's Not the ETFs

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Strong demand has pushed high yield bond prices to new highs for the year, with the average price of the Barclays U.S. High Yield Index reaching $104.39. Retail inflows of $1.45bn last week took year-to-date flows back into positive territory following 13 consecutive days of outflows. Year-to-date flows now stand at $1.8bn, with most of that total coming from mutual funds. ETF assets have been volatile, with $2.2bn in inflows offset by $2.1bn in outflows.

ETF bonds are commonly perceived as more volatile than their non-ETF counterparts, and for good reason: ETF benchmarks explicitly target the more liquid part of the market. HYG and JNK, for instance, which together make up 77% of high yield ETF assets, are benchmarked to indices whose rules favor larger and more recently issued bonds – the two biggest determinants of liquidity. However, it is not immediately clear whether the higher volatility of ETF bonds is driven by the underlying characteristics of bonds in their benchmarks or whether ETF inclusion has a measureable effect on volatility in and of itself.

We set out to answer this question using JNK as a case study. We focus on JNK for several reasons. First, its benchmark (the Barclays U.S. High Yield Very Liquid Index) currently cuts off the number of bonds per ticker at the three largest (used to be the single largest), which allows us to create a control group of bonds that would otherwise be eligible but for their rank order in a large capital structure. In contrast, the HYG benchmark (iBoxx $ Liquid High Yield Index) includes all bonds above a certain size if the capital structure is large enough. Second and perhaps most important, the JNK benchmark is much easier for us to analyze given that it is a Barclays index.

We divide the U.S. High Yield Index into three buckets:

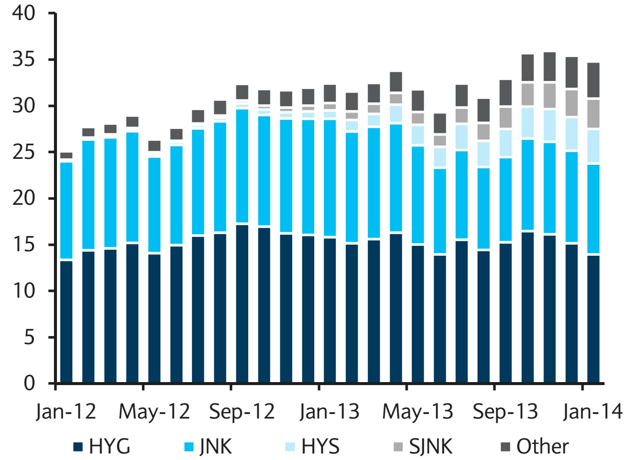
- ETF bonds: Bonds that are in the U.S. High Yield Very Liquid Index (VLI).
- Liquid Non-ETF bonds: Our control group, consisting of bonds that are large enough ($500mn+) and recent enough (< 5 years old) to be in the VLI, but do not make the top-three cut-off.
- ETF-ineligible bonds: Bonds that do not meet one or both of the VLI size/age constraints.

FIGURE 1
Cash and CDS Movers

High Yield Cash					
Best	**Px**	**Chg**	**Worst**	**Px**	**Chg**
RF 6.75 '25	93.70	+6.0	FRX 5 '21	106.00	+6.0
CVO 10.5 '16	104.00	+5.0	FRX 4.875 '21	106.00	+5.7
BAC 5.625 '35	98.00	+4.0	FRX 4.375 '19	105.63	+4.3
High Yield CDS					
Best	**5y**	**Chg**	**Worst**	**5y**	**Chg**
BOMB	319 bp	-10 bp	RRI	1.9 pts	+6.0 pts
CHK	202 bp	-9 bp	TOY	33.3 pts	+3.0 pts
FSL	292 bp	-10 bp	L	260 bp	+45 bp

Source: Barclays Research

FIGURE 2
High Yield ETF Assets in $bn



Source: Lipper

FIGURE 3

Statistics by VLI Inclusion and Eligibility

Characteristics	ETF Bonds	Liquid Non-ETF Bonds	ETF Ineligible
Count	688	174	1,275
Amount Outstanding ($bn)	610.3	152.1	453.2
Average Size ($mn)	887.0	874.1	355.4
Liquidity Cost Score (%)	1.14	1.00	1.63
Age (years)	1.90	1.88	4.11
Price ($)	105.0	104.7	103.2
Yield to Worst (%)	5.18	4.93	5.87
OAS (bp)	359	345	441
Maturity (years)	6.70	6.35	6.49
OAD (years)	4.21	4.07	3.84
Coupon (%)	7.10	6.85	7.73
Annualized Volatility (%)*	2.53	2.61	1.45

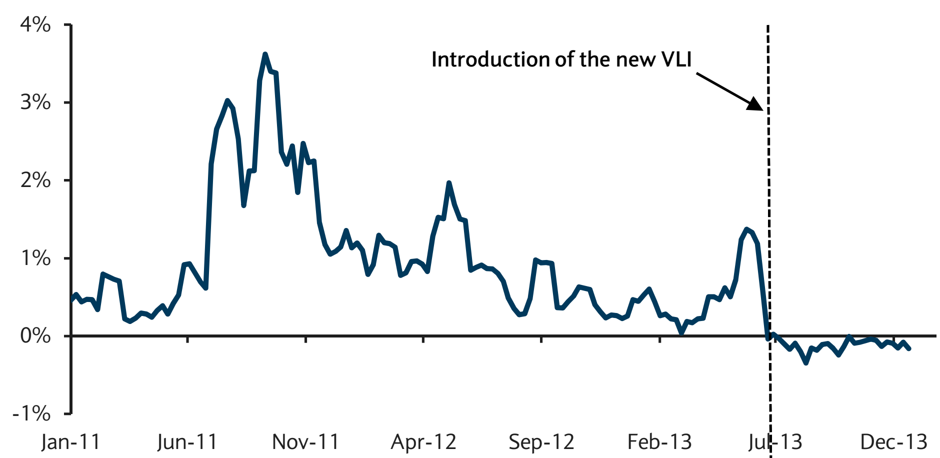
Note: Average volatility since July 1, 2013, when the new VLI rules became fully effective. Source: Barclays Research

While the ETF-ineligible bonds are clearly less liquid and less volatile than the other two groups, statistics show that there is not much discernible difference between ETF bonds and our liquid non-ETF control group (Figure 3). On some measures, such as age and Liquidity Cost Score (estimate of roundtrip trade cost), the control group appears nominally more liquid; on others, such as average bond size, the ETF bonds are marginally ahead.

Importantly, the control group is, if anything, slightly more volatile than the bonds included in the JNK portfolio. However, the same result does not hold if we go back to the old version of the VLI rules. As described in *Changes Are Afoot in High Yield*, the old rules are more restrictive, with a higher size threshold ($600mn), lower age (< 3 years), and eligibility extended only to the single-largest bond in any capital structure. This led to significantly more intra-capital structure discrepancies, as highlighted in *Trading the ETF Technicals*. Figure 4, however, suggests that, as expected, such technicals should be much less pronounced now. As it turns out, there is no ETF effect leading to higher volatility – it is just the liquidity of the underlying bonds.

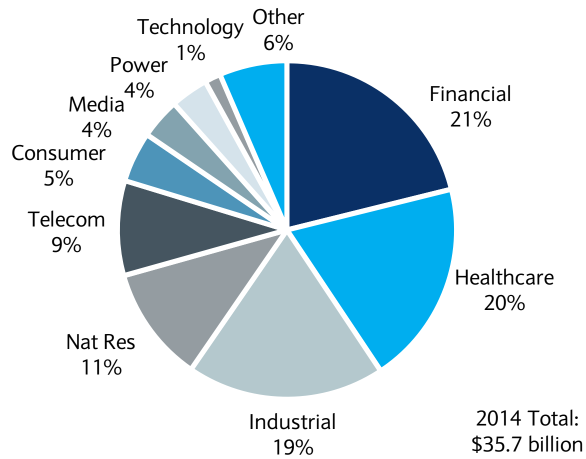
FIGURE 4

Volatility Differential: VLI versus Liquid Non-VLI Bonds



Source: Barclays Research

High Yield Supply by Sector – 2014 Year-to-Date



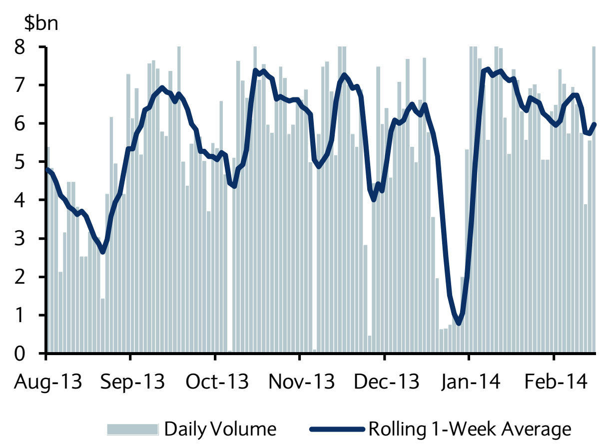
Source: Barclays Research

Top On-the-Run CDX Index Names by Weekly CDS Volume

	Notional Outstanding ($bn)		Volume – Week Ending 2/14/13 ($mn)
	Gross	Net	Gross
MIBA Insurance	49.7	1.5	1,069.2
Caesars Ent. Opco.	26.5	1.9	693.0
J.C. Penney	26.2	1.7	528.5
Lennar	21.8	1.1	486.5
ILFC	21.8	1.4	433.7
Dell	14.2	1.2	420.8
The Jones Group	19.9	0.8	394.7
Freescale	6.1	0.5	382.8
Centurylink	18.7	1.2	381.6
Clear Channel	18.3	1.1	350.9

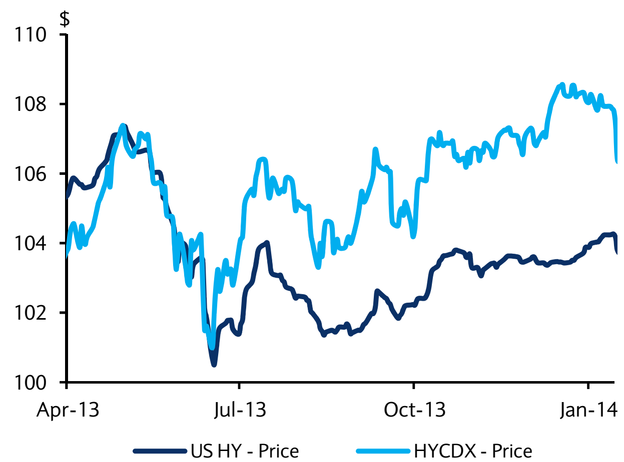
Source: Barclays Research

High Yield Average Institutional Trade Volume ($bn)



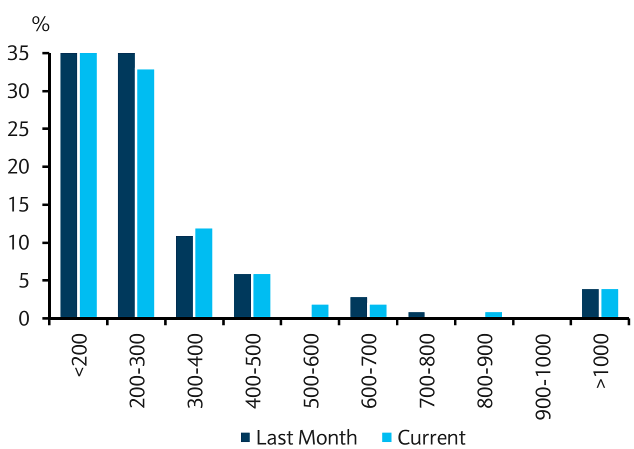
Source: Barclays Research

On-the-Run HYCDX versus U.S. High Yield Index



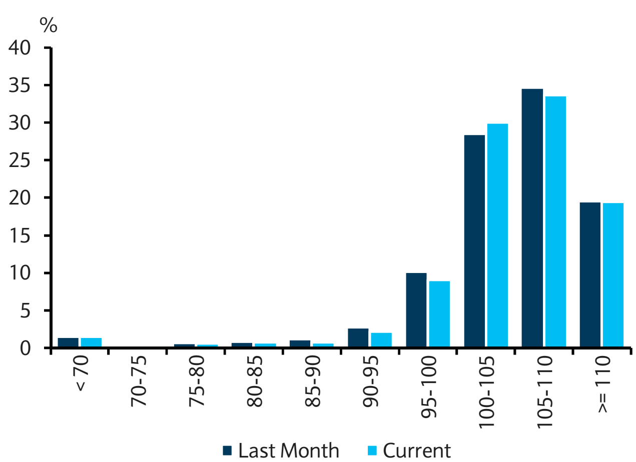
Source: Barclays Research

On-the-Run HYCDX Spread Distribution



Source: Barclays Research

High Yield Index Price Distribution by Par



Source: Barclays Research

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