High Yield

Transaction Costs Can Be a Real Drag on Fund Performance

CORE

While mutual funds have lagged this year, we find that transaction costs have weighed on performance more than positioning has. For ETFs, performance has been in line with benchmarks, as moves around NAV levels have normalized recently.

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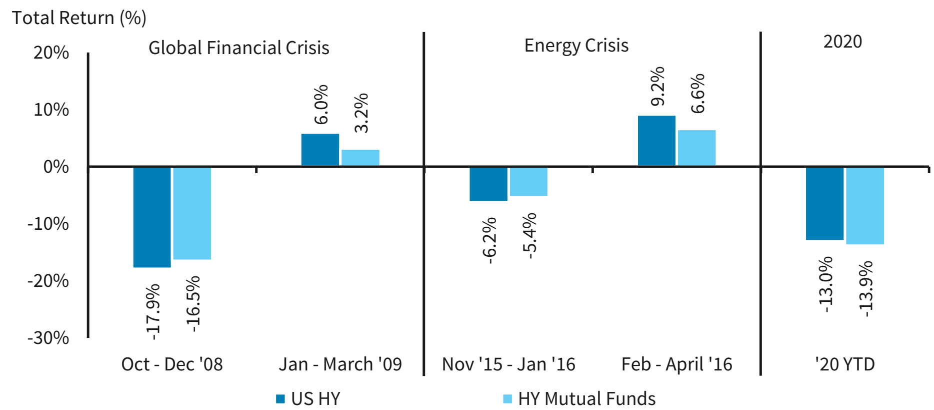
The high yield market continued to grind tighter this week, with spreads roughly 220bp tighter through Wednesday's close relative to the wides reached on March 23. There have been some green shoots in the market recently, with the new issue pipeline growing and a record retail inflow level reported last week (based on combined mutual fund and ETF flows). While retail funds are only a portion of the high yield buyer base, many investors look to this segment as a sign of investor sentiment.

For high yield bonds, retail funds make up approximately 20% of the buyer base in total, with ETFs accounting for roughly one-fifth of those retail funds and therefore ~4% of the high yield market (*Retail Inflows Drive Demand*). In past periods of market stress, actively managed funds outperformed the index during the sell-off period, so we look at 1Q20 to see if this trend is holding.

This year's sell-off has been unique in many ways, with the pace of the decline quicker than any in history, as spreads widened more than 700bp in a twenty trading day period ending March 23. For reference, the greatest move in spreads over a twenty trading day period was previously 580bp, occurring in fall 2008. This has presented a difficult environment for mutual funds faced with outflows and they have had difficulty keeping up with the index and underperformed by roughly 80bp thus far this year (Figure 1). Below, we provide a more detailed analysis in what has driven mutual funds to underperform the market, finding that elevating trading volumes (driven by large swings in flows) during a period of large bid/ask spreads have likely been the bigger drag on performance than beta positioning.

Although ETF performance has been better than that of mutual funds and the US HY Index thus far this year, these funds have performed close to in line with the indices to which they are benchmarked (which have different ratings, sector, and liquidity profiles). Despite extreme trading volatility in March causing large swings in NAV premiums for ETFs, these have normalized recently.

FIGURE 1. High Yield Index and Mutual Fund Returns in Periods of Market Stress



Note: Mutual fund returns are weighted average based on assets at start of period.
Source: Bloomberg, Lipper, Barclays Research

Elevated Trading Costs Have Been a Drag on Mutual Fund Performance

As mentioned above, mutual funds have underperformed the high yield market by roughly 80bp thus far this year. While we expect some drag in performance from management fees, the weighted average fund fee is just 50bp annually, which would represent under 20bp of drag thus far this year. As a result, mutual funds have underperformed the index by 60bp net of fees.

As is usually the case, higher-quality bonds have outperformed in the sell-off, with BBs besting CCCs by more than 10% in 1Q20. However, we do not believe the lower mutual fund returns necessarily imply that they have been overweight lower-quality or worse-performing sectors. In fact, a spot check of the ten largest high yield mutual funds tracked by Lipper points to managers actually having a slightly lower energy exposure than the market.

Additionally, mutual funds seem to have started the year broadly in line with the market in terms of beta exposure. Although they had underperformed the high yield index modestly to start 2019, they performed almost exactly in line with the index during the December rally when adjusting for fees. The high yield index returned 2% in December, led by lower quality, as CCC or lower rated credits' returns were 5.2%, while BB returns were just 1.2% (energy returned 5.3% during the month). If mutual funds had been overweight beta in December, the funds would have likely outperformed the high yield index.

Instead, we believe the underperformance thus far this year has been driven by managers' being forced to increase trading volumes during a period of greater bid/ask spreads. Mutual funds have had to manage extreme volatility in flows in recent weeks, with March of this year having the greatest outflows from mutual funds in a given month ever and last week's inflow being one of the largest on record. One way to measure this volatility is to look at the absolute level of flows per week as a percentage of fund assets. Thus far this year, the average weekly inflow or outflow has represented 0.6% of assets, much higher than during the financial crisis and slightly below the level during the energy crisis.

This fund flow volatility forces an elevated level of trading volumes during a period in which there is a greater cost of transacting. As highlighted by our Quantitative Portfolio Strategy colleagues recently, bid/ask spreads have reached levels not seen since the financial crisis and are well above the bid/ask spreads during the energy crisis (*COVID-19 and USD Corporate Bond Liquidity: Insights from Daily LCS*). As a result, the combination of increased volatility in flows and elevated bid/ask spread has resulted in transaction costs being a greater drag during 2020 than in any other period of stress, except potentially the financial crisis, when bid/ask was even wider, but flow volatility was lower. To put these numbers in context, if funds have been dealing with flows of 0.6% per week on average over the 14 weeks this year and those flows were more concentrated in the most volatile times, then average LCS (a measure of bid/ask spreads) faced by investors could be approaching 2% this year. This means that the drag on performance over the 14 weeks from just forced trading could be ~15bp (or much more for funds with more extreme flows) before we even address normal trading volumes from changes in credit views, refinancings and fallen angels. Higher cash balances could have helped offset some trading volumes, and cash obviously outperformed this year, but we do not think it was nearly enough to offset the increased trading costs.

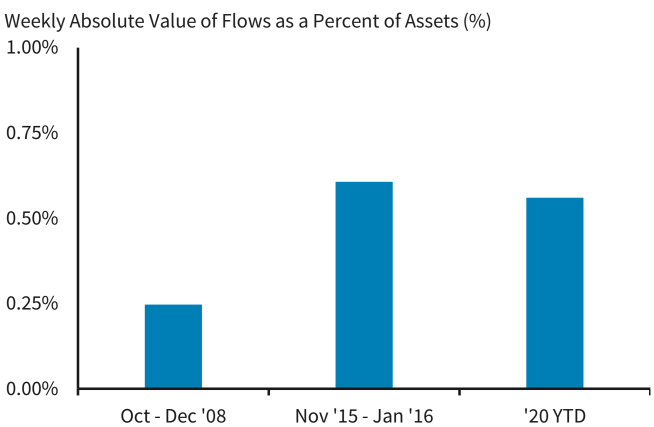
Since the market bottomed on March 23, mutual funds have performed more in line with the overall market. This indicates that some of the drag can be made up if the market stabilizes, but considering that transaction costs are still well above normal levels and past costs cannot be recouped, we do not expect the gap between fund performance and the market fully to close.

ETFs Benefit from Benchmark Outperformance

As noted above, performance for ETFs has been better than mutual fund thus far in 2020, with ETFs down 13% on average. ETFs primarily follow benchmarks with a substantially different makeup than the Bloomberg Barclays US High Yield Index, though, making return comparisons more nuanced. Many of these benchmarks have a liquidity hurdle, which results in a skew towards higher quality, which, unsurprisingly, has outperformed lower quality during the sell-off. As a result, we think that ETF performance needs to be viewed in the context of their benchmarks.

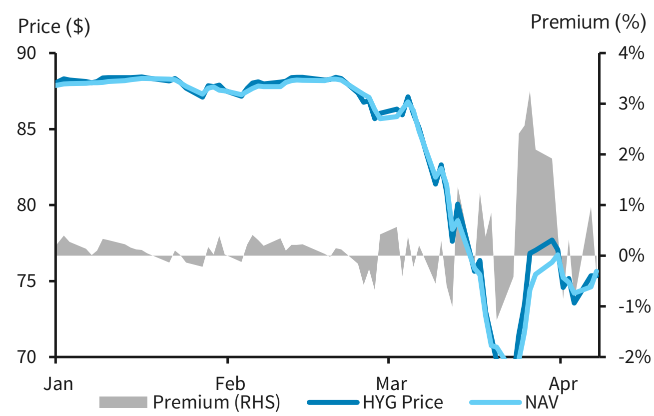
Although ETFs as a whole have tracked the liquid benchmarks they follow fairly well, there has been variance on a fund-by-fund level. The two largest ETFs, HYG and JNK, represent 30% and 14% of high yield ETF assets, respectively. HYG has underperformed its benchmark (iBoxx USD Liquid High Yield Index) by 30bp through April 7, while JNK has underperformed its benchmark (Bloomberg Barclays High Yield Very Liquid Bond Index, aka "VLI") by 90bp. However, analysing ETF performance is more nuanced than high yield mutual funds because changes related to premium/discounts to NAV can alter the results significantly. For example, as of April 7, HYG is also trading at a 0.40% discount to NAV, which accounts for all of the underperformance since it came into the year trading at a slight premium (Figure 3). In summary, during the extremes of March, ETF performance varied more than mutual funds in both directions due to moves around their NAVs, but as the market has normalized, the ETFs are currently tracking benchmarks fairly closely.

FIGURE 2. The Average Weekly Flows for Mutual Funds Are Well above Levels during the Financial Crisis



Source: Lipper, Barclays Research

FIGURE 3. HYG's NAV Is Tracking Price More Closely as Market Volatility Has Come Down since March



Source: Bloomberg, Barclays Research

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