ADVISOR PERSPECTIVES

High-Yield ETFs Miss the Boat...Again

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High-yield exchange-traded funds (ETFs) struggled last year, in part because energy bonds took a beating when oil prices fell. Does that make an ETF that avoids energy bonds a good idea? We don't think so.

At least one asset manager recently launched an ETF that invests in every high-yield sector except energy. The idea is to limit the risk of losses and default associated with low oil prices, which can make it hard for oil and gas companies to service their debt.

That may sound appealing to investors whose portfolios were hurt by plunging commodity prices in 2014 and 2015. But we think the approach is a short-sighted one.

Fighting the Last War

It's often said that generals embarking on a new war tend to use the tactics and strategies of the last one. In a similar vein, investors who run away from the entire energy sector today are reacting to the last crisis, not putting themselves in position to avoid the next one.

This is a familiar story. After the global financial crisis, credit investors avoided debt from financial companies, only to miss a sharp rally as the sector recovered.

Likewise, had an ex energy high-yield ETF existed at the start of the year, investors who bought it might be kicking themselves today. Why? Because oil prices—and many high-yield energy bonds—have rebounded sharply over the last few months.

The Problem with ETFs

A single-minded focus on the energy sector misses an even larger point about ETFs: they're a poor way to access the high-yield market because they passively track an index, depriving investors of the ability to pick and choose which bonds to buy and which to avoid.

A decline in energy bonds hurt ETF investors because by mid-2014, energy had become the biggest single sector in the high-yield indices that the ETFs track. ETF investors weren't heavily exposed to energy because they loved the bonds. They were exposed because they were tracking an index in which energy issuers made up the largest weight.

Had high-yield ETFs existed when the dot-com bubble burst, the same thing would have happened. Only that time, the culprit was the telecom sector, which had become the biggest weight in the index after years of heavy borrowing.

We consider this a healthy reminder of why passive fixed-income strategies often run into trouble. When you buy a bond index, you're lending the most to the biggest debtors, since issuing more debt increases a company's weight in the index. As we've seen, that's not an ideal strategy, especially in a market such as high yield.

A Poor Track Record

In fact, their passive approach helps explain why high-yield ETFs have consistently underperformed actively managed mutual funds.

Between January 1, 2008—shortly after the inception of the two largest US high-yield ETFs—and May 31, 2016, the average active high-yield manager, as measured by Lipper, delivered annualized returns of 6.03%. The top two ETFs returned 5.52% and 5.11%.

Unlike ETFs, active managers have flexibility to seek out value and limit risk. A manager troubled by the borrowing binge that energy companies were on over the last decade might have strategically reduced exposure before oil prices began to plunge. Later, she could have stepped in to buy specific bonds that looked undervalued relative to their credit fundamentals.

Tinkering with high-yield ETFs by excluding sectors is no substitute for skilled management. All it's likely to do is cause investors to commit one of the cardinal sins of investing: manage their money while looking in the rearview mirror.

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