RBC Global Asset Management

Active management: advantages in high yield

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We discuss why high yield benefits from an active management approach and why an approach which focuses on bottom-up credit selection and top-down credit allocation is well placed to outperform.

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. 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.

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.

This complexity of high yield market structures and instruments, the trading conditions, and high issuance turnover make execution more challenging than other asset classes. Furthermore, the way high yield indices are constructed and rebalanced means that passive strategies experience higher tracking errors and typically underperform their index.

In high yield, active managers also 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.

As an experienced active manager, we believe that the following differentiators enable this approach to generate excess returns:

- **Fundamental analysis (credit selection)**: as an active high yield specialist, we conduct our proprietary fundamental research across the full high yield universe to identify and take advantage of market inefficiencies, seeking out securities that we believe to be mispriced or mis-rated. Our view is that effective analysis enables us 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 our analysis, we also incorporate a variety of environmental, social, and governance (ESG) factors in our research process.
- **Broader opportunity set**: as an active manager, we can invest across the entire universe of high yield names regardless of whether they fall within a defined benchmark index. This enables us 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. We can also opportunistically add off-benchmark exposures with attractive characteristics, such as floating rate notes (FRNs) or contingent convertibles. We can use liquid credit derivative instruments to quickly add or hedge exposures. Additionally, we 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**: we use our market experience and long-term relationships with bond dealers to source the specific deals and assets we want and gain valuable market insights. Through active management, we can be more opportunistic about the price at which we 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 incentivised to engage with corporate issuers. Our investment team, who have an average industry experience of 17 years, have a greater ability to influence change in company behaviour 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. Our approach to ESG integration enables us to implement views in a much more forward-looking manner than benchmark providers can do, offering us the potential for superior ESG outcomes.

The recent regime change in investment conditions will prompt asset owners to reflect harder on what proportion of asset allocations can be directed to passive strategies without sacrificing net-of-fee returns.

In a world that continues to prove highly uncertain, active managers who have demonstrated skill in capitalising on volatility and uncertainty through their process, experience, capabilities, and skills should, in our view, have plenty of scope to continue to deliver sustainable alpha.

Portfolio Manager Perspectives

Our experts offer their perspectives on the latest developments in global credit and the state of the markets.

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