White Paper | November 2023

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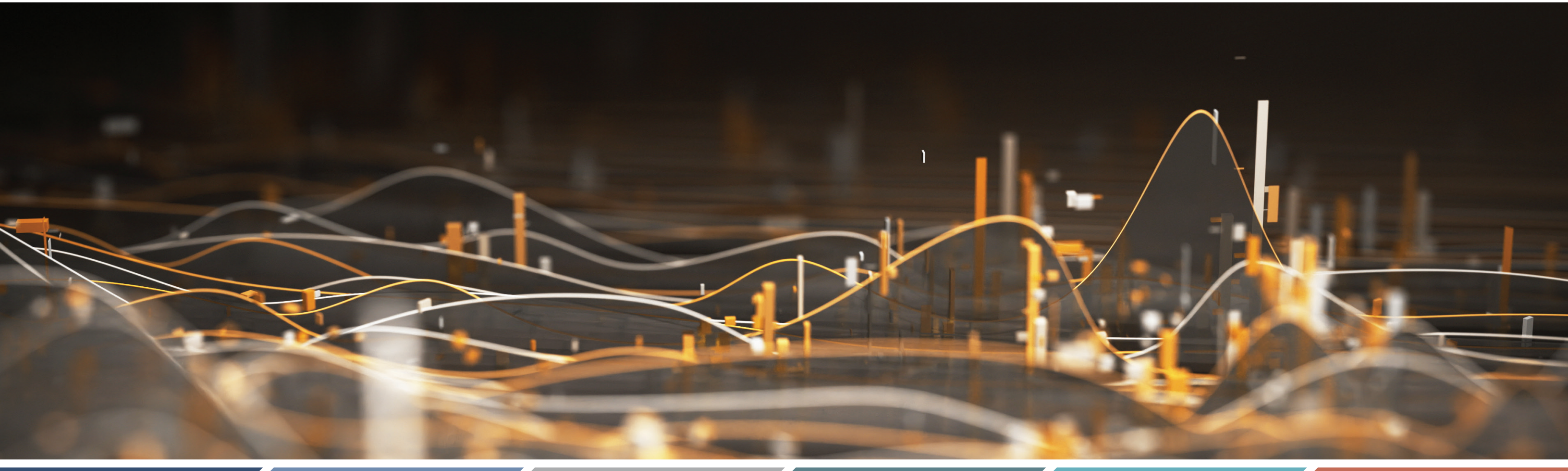


NON-INVESTMENT GRADE CREDIT TEAM

European High Yield: A Clear Case for Active Management

Passive high yield investing is not the same as passive equity investing.

High yield indices cannot be directly replicated, given the illiquidity of anywhere from 10% to 25% of the bonds listed in them. This means passive Exchange Traded Funds (ETF) are forced to lend indiscriminately to a subset of larger issuers which, by definition, also have the largest debt outstanding. This "sampling" of an index can result in unwanted exposures: to overvalued bonds; to risky issuers and even entire sectors that may be facing challenges; and to undesired environmental, social and governance (ESG) risks.

We regard this as particularly problematic in the current environment of rising credit differentiation and default risk among high-yield issuers, when active managers have a leg up in credit selection over passive ETFs. What follows are some key points on why we believe active management is preferable to passive in European high yield.

Executive Summary

- Unlike in equity investing, even the average European high-yield manager tends to outperform passive strategies.
- The need to trade more frequently than actively managed funds, including often during periods of market volatility, potentially adds hidden costs for passive investors.
- Downside risk management is critical for high-yield investors, who face limited upside return while facing the real possibility of defaults—and passive strategies allocate to the most indebted issuers with no fundamental credit analysis.
- Passive ESG ETFs tend to rely on ESG ratings that are backward-looking and unadjusted for financial materiality, and they do not allow for any proactive engagement with issuers.
- With interest rates at a post-2008 high and credit-spread dispersion and defaults on the rise, we believe active management is becoming increasingly critical for successful high-yield investment outcomes.

We see several reasons to consider an allocation to European high yield bonds at the moment, including attractive valuations and generally improved trends in corporate borrowing. But that doesn't mean investors should necessarily want indiscriminate exposure to the entire market.

Issuer credit quality varies widely and so do the risks. Active managers can analyze and differentiate among credits when investing new capital and when redeploying income and principal from bonds that mature or are tendered; they can add or reduce credit risk and manage portfolio duration in response to changes in the market environment; they can engage with issuers on ESG factors; and they can even add exposures from outside their benchmark indices in related asset classes such as floating-rate loans or asset-backed securities.

Investment Outcomes

We think this is why the performance of active European high yield managers has generally stacked up well against that of passive strategies. According to data from Morningstar, active European high yield managers in the top quartile of performance have beaten passive ETFs over the one-, three- and five-year periods by 262, 222 and 122 basis points, respectively, on an annualized basis.

FIGURE 1. EUROPEAN HIGH YIELD BOND FUNDS: ACTIVELY MANAGED FUNDS VS. PASSIVE ETFS

Annualized Total Returns (Net of Fees)

	1 Year	3 Years	5 Years
Top 25% of Active Managers	12.44%	2.57%	1.90%
Passive ETFs	9.82%	0.35%	0.68%
Difference	2.62%	2.22%	1.22%

Source: Morningstar Direct based on European high yield (EAA Fund EUR High Yield Bond active and passive excluding short duration funds). Data as of September 30, 2023.

Unlike with equity investing, however, where the performance of the average active manager is likely to be roughly the same as that of the benchmark index minus the difference in fees, with European high yield, investors do not need to find the highest performing managers to outperform passive strategies. In fact, over the three years to September 2023, when dispersion in credit spreads widened, the average net-of-fees total return of the entire universe of active European high-yield managers was higher than that of the average passive ETF by 27 basis points, annualized.

We believe this is due to three things: costs, the central importance of downside credit risk in high yield and the active management of ESG factors.

Costs: “Passive” ETFs Are Neither Passive Nor Cheap

Why have European high-yield passive ETFs been so popular with investors over the past few years? We believe it is due to the perceived low costs of ETFs and their intraday liquidity.

However, again unlike with large-cap equity investing, in an inherently less-liquid market such as high-yield bonds, those two characteristics work against one another. Intraday liquidity is really useful only for high-frequency or short-term traders; for longer-term investors it merely adds cost, as it can necessitate underlying trading in bonds that often have wide bid-ask spreads—especially during volatile market conditions. Moreover, in particularly sharp market downturns, there’s no guarantee that high-yield ETFs will be able to deliver the degree of liquidity as promised.

On top of the trading costs associated with managing intraday liquidity, ETF managers also need regularly to trade to rebalance portfolios, to manage tracking error against their benchmarks.

None of these costs is covered by an ETF’s published Total Expense Ratio, which expresses the product’s running costs (including management, custody, index-licensing and marketing) as a proportion of the fund’s value. For an asset class like high yield, the TER can thereby significantly understate the typical ETF’s true cost of ownership.

We think all this rather “un-passive” trading in relatively illiquid markets, which an active manager is not obliged to do, is an important reason why European high yield passive ETF returns have lagged those of actively managed funds, net of fees, over time. Furthermore, because active managers do not need to trade as much as an ETF manager, they can hold less-liquid bonds from smaller issuers that tend to come with a premium—bonds that ETFs often struggle to source and replicate, and which are a particular characteristic of the European high-yield market.

Risk Mitigation

Another cost to consider is the potential difference in credit losses between passive and active strategies.

Again, it is worth contrasting equity investing with high yield bond investing. A passive equity strategy exhibits price momentum and may become relatively highly exposed to companies with high valuations—witness U.S. large-cap equity indices on the eve of 2022, for example. Nonetheless, it is extremely rare for the equity of a large, listed company to lose all or almost all of its value in a short amount of time. Generally, a company is rewarded with a relatively large equity market capitalization for a reason: investors find it attractive.

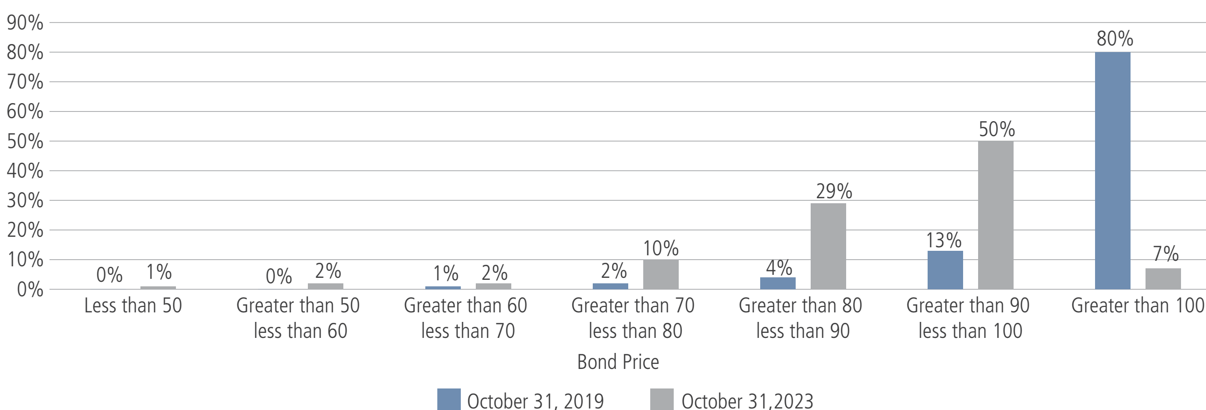
By contrast, bond market capitalization is a measure of indebtedness, and some high-yield bonds have the potential to lose a high share of value as a result of defaults or credit deterioration—and unlike with equity investing, there is a limit on the returns from even the best issuers’ bonds, and therefore a limit on how far they can offset credit losses elsewhere.

According to Bank of America, over the past five years, the average annual default rate for the broader European High Yield universe was 1.38%. But that was a period of very supportive conditions. During the Global Financial Crisis, the default rate peaked at 12%. We do not anticipate a return to those levels, but we do think higher rates and slowing economic growth is set to raise it over the coming months.

Passive index funds are exposed to all or almost all of this downside risk: they do not seek to mitigate credit deterioration or avoid defaults. Actively managed strategies that deploy disciplined credit underwriting and fundamentals-based credit selection to try to mitigate credit deterioration and avoid defaults—as well as identify attractive opportunities—therefore have a “head start” over passive strategies, in our view. We believe this is especially the case when active credit selection has more potential to be rewarded, as it is now. As figure 2 shows, while 93% of the European high yield market traded above 90c five years ago, today that pricing has dispersed significantly.

FIGURE 2. CREDIT PRICING IS SIGNIFCANTLY MORE DISPERSED THAN FIVE YEARS AGO

Proportion of the European high-yield market trading within various price buckets, October 2019 versus October 2023



Source: BlackRock Aladdin. Data reflects the ICE BofA European Non-Financial High Yield 3% Constrained Index. Data as of October 31, 2019 and October 31, 2023.

ESG Factors

The passive ESG ETFs available on the market tend to use ESG ratings as an input to their weighting schemes. We think that is suboptimal for three reasons. First, these ratings are based overwhelmingly on backward-looking data—they are, at best, a snapshot of the issuer at some point in the past. Second, they are rarely adjusted for financial materiality to the issuer—they may misstate the true extent of the financial risk being posed. And third, this approach to integrating ESG does not allow for any proactive engagement with issuers to identify and address financially material ESG factors.

We do not believe this approach serves investors well, especially given the evolving dynamics and standards in ESG investing.

At Neuberger Berman, we believe that considering financially material ESG factors on a forward-looking basis is an integral component of credit analysis, which helps to minimize exposure to those ESG risks that could adversely impact investment results. In addition, we believe constructive and proactive engagement with issuers can help to identify financially material ESG risks that may not appear in the available data, and begin to achieve enhancements in the issuer's risk profile that may take months or even years to become evident in its ESG ratings.

High-Yield ETFs: Overstated Benefits, Understated Risks

The perceived benefits of passive ETFs—cost-effectiveness, liquidity, efficiency—are not, in our view, compelling or clear-cut. Providing liquid access to a less-than-liquid underlying market comes with hidden costs.

But even if these benefits were more clear-cut, with interest rates back at pre-2008 levels, credit-spread dispersion widening and idiosyncratic credit issues on the rise, we believe active management is becoming increasingly critical for successful high-yield investment outcomes.

Index Definition

The **ICE BofA European Non-Financial High Yield 3% Constrained Index** is a modified market capitalization-weighted index of EUR denominated below investment grade corporate debt publicly issued in the euro domestic or Eurobond markets, with at least one year remaining to final maturity, a fixed coupon schedule and a minimum amount outstanding of €100mn. The index excludes bonds issued by the financial sector and caps issuer exposure at 3%.

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