Benchmarking High Yield Bonds:
The Case for a Peer Group vs. an Index

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Summary

It is critical to select the appropriate benchmark for both return and risk comparison to determine whether an investment manager is providing value within a particular strategy. The purpose of a benchmark, or measure of comparison, is to objectively determine if the investment manager added value through skill on a consistent basis within that strategy. The selection of a benchmark typically comes down to deciding on an index or a peer group. A peer group is a group of mutual funds or portfolios with similar client objectives and investment strategies. Funds and portfolios are compared with a peer group as a comparative measure of performance.

For certain institutional fixed income strategies, an index benchmark is less effective than a peer group when measuring the added value. We recommend using an institutional peer group rather than an index for a high yield bond benchmark.

Role of a Benchmark

Many of us grew up competing in various activities, whether they were athletics, music contests, beauty pageants, or debate competitions. We were typically pushed to excel, but with our parents or guardians providing support and telling us to "just do the best you can." In most of these activities, there was always a clear winner either by a quantitative score on the scoreboard or a more subjective decision by a contest judge. One thing was certain: There was a clear winner. The concept of winning was quite different growing up when compared with the incredibly competitive investment management industry of today. However, the philosophy of doing your best by comparing yourself with the right crowd does have merit in investing. It is critical to have the flexibility to become "best in class" by not being handicapped by inappropriate comparisons. How might this philosophy tie into the issue of benchmarking within the asset management industry? A quote from James Montier in the Financial Times newspaper may help answer that question.[1]

> *"The obsession with benchmarking also gives rise to one of the biggest sources of bias in our industry – career risk. For a benchmarked investor, risk is measured as tracking error. This gives rise to homo ovinus – a species concerned purely with where they stand relative to the rest of the crowd. This species is the living embodiment of Keynes' edict that 'it is better for reputation to fail conventionally than to succeed unconventionally.'"*

In the asset management industry, it's important to define what it means for an investment strategy to "win" and the role a benchmark can play in this determination. In a paper titled "Benchmarks for Global Portfolios," John C. Stannard of Frank Russell Company states simply that "a benchmark is a tool for evaluating the success of a process."[2] In order for the investment manager and the client to know how to keep "score," it is important to have the benchmark clearly understood by all parties. Selecting the wrong benchmark can not only set the bar too low, but also go against the objectives of the client. Defining the features of a benchmark is a good start:

Features of a Benchmark

Investable – An investment manager must be able to buy the securities to replicate the benchmark. This requirement is problematic for most bond indexes that are market capitalization weighted. For many bond indexes, the bonds are simply not offered. Consider the Barclays Capital Global High Yield xCMBS & xEMG 2% Capped Index, composed of 1,884 bonds, many of which rarely trade. One reason for the illiquidity is that insurance companies own roughly 15% of the high yield bond market. Insurance companies mainly own high yield bonds for the yield, or investment income, and have restrictions on realizing gains and losses. High yield bonds thus tend to be treated as buy-and-hold. Another reason is that structured products such as collateralized debt obligations (CDOs) own a large portion of the high yield bond market with a similar buy-and-hold mentality, causing bonds to be locked away for years.

With the Barclays index market value of roughly $761.7 billion, the average issue size is only about $400 million. This small average issue size helps explain why the high yield market is relatively illiquid and difficult to replicate. By comparison, the Barclays Capital U.S. Aggregate Index has an average issue size of approximately $1.5 billion.

The amount of idiosyncratic risk inherent within the index is another reason the high yield bond index is more difficult to replicate. Generally, other bond index returns are largely dictated by the Treasury yield curve, whereas high yield bond returns have a low correlation to Treasury bond returns. Returns in the high yield bond market have largely been specific to risk within the high yield bond market. An excerpt from Barclays Capital U.S. Credit Alpha on April 3, 2009, notes, "High yield investors tend to be less index sensitive than their investment grade counterparts. This is not to say that they ignore the index but rather they are more comfortable with moderate tracking errors given the highly idiosyncratic nature of the high yield market."

The use of an index for a benchmark for certain bond strategies has several disadvantages when it comes to investability when compared to equity strategies. These were defined by Reilly, Kao and Wright[3] as:

- The universe of bonds is much broader than stocks including various asset classes, capital structures and maturities.
- The universe of bonds is changing constantly, from new issues to various redemptions.
- The volatility characteristics of bonds change over time due to changing duration and convexity.
- Bonds are largely traded OTC in the secondary market making for illiquidity and pricing issues.

Barnhill, Maxwell and Shenkman[4] further defined the difficulties in using an index for high yield bonds:

- The range of quality is larger among high yield bonds than investment grade bonds.
- The universe of high yield bonds experiences more changes than that of investment grade bonds.
- The risk characteristics of high yield bonds experience greater and more rapid changes than those of investment grade bonds.
- The illiquidity and pricing problems within the high yield bond market are significantly higher than those encountered in the government and investment grade bond market.

Unambiguous – The investment manager and the client need to agree in advance on the objective and the benchmark for measuring this objective. Trying to create the perfect benchmark has ordinarily been an exercise in futility. A benchmark does not need to be complex; it should be straightforward and easy to understand. In addition, when multiple investment teams are managing a multi-asset class portfolio, the benchmark should tie all managers via an incentive structure to one common objective at the **total portfolio level**. It is critical to clearly tie the incentives of the investment team to the client's objective.

While an index may seem relatively straight forward, there are nuances that need to be understood before using a bond index as a benchmark. For example, the constituents and composition of the index are continually changing. In the Barclays Capital U.S. Aggregate Index, corporate bonds declined from over 40% of the index in 1976 to 19% in 2009, and mortgages increased from about 5% in 1976 to around 38% today; the index also has had significant swings in duration over the years. The Barclays Capital U.S. High Yield Index also has shown significant changes in composition; in 2001, the Communications industry represented 26% of the index compared with 15% today. Media-Cable was 9% in 2001 compared with 3% of the index today. The Triple C and below quality tiers (the most default prone tiers by a large margin) as a percentage of the index were 11.5% in 2001 compared with 28.5% today. These index composition changes cause frequent portfolio rebalancing, increasing transaction costs and ultimately causing doubt about whether the rebalancing is contributing to the client's objective.

In addition, indexes are constructed on arbitrary rules that differ from investment bank to investment bank. For instance, in the high yield bond market, the index rules at Barclays Capital differ from those used by JP Morgan, causing material differences in total returns. That was seen clearly in 2007 as illustrated below.

GLOBAL HIGH YIELD BONDS (HEDGED TO USD)

INDEX	TOTAL RETURN
Barclays Capital Global High Yield xCMBS & xEMG 2% Capped	1.9%
JP Morgan Global High Yield	2.9%

Sources: Barclays Capital Live, JP Morgan; as of December 31, 2007

Which index is the better representation of the high yield bond market? Index rules play an important part in determining an index's return and risk characteristics. Not only do many of the index rules seem arbitrary and differ from investment bank to investment bank, but they are not consistent over time. For example, many high yield indexes exclude bonds less than one year in maturity. It's unclear how this exclusion helps the client's objective. There also are characteristics that have not been consistent over the years for high yield indexes, including hybrids, 144As, PIKs, minimum issue size, and maximum issuer concentration.

Martin S. Fridson points out that the rules for high yield bond index construction have not been consistent over time: "If the index constructor devises new rules on the fly to maintain some semblance of objectivity, continuity is in turn undermined."[5] A clear example today is the increase in the Financials industry within the high yield bond indexes. Financials bonds recently downgraded from investment grade have increased from 3% of the high yield bond index on December 31, 2008, to 15% today. As a result, a number of high yield managers that use an index as a benchmark have asked investment banks to create a new index that excludes Financials for use as a new benchmark. Again, it's not clear whether this change contributes to meeting the client's objectives or is more for the convenience of the investment manager.

Prudent – Using a bond index for the benchmark requires the rather risky assumption that the index represents a prudently diversified allocation to the investment strategy. Investing is about evaluating risk and return expectations. An investment manager's ability to evaluate whether risk is priced appropriately should dictate portfolio construction for the client, rather than having the randomness of an index dictate portfolio construction. An investment manager who uses an index as a benchmark can easily fall victim to immunizing portfolio positions to the index. Imagine a volatile issue comprising a large percentage of the index (General Motors or CIT come to mind) and an investment manager who matches the index weighting based not on prudent analysis and evaluation, but on blindly reducing risk relative to the index. Consider those managers who "reduced risk" by matching the 26% index weighting in the Communications industry in 2001. In 2002 and 2003, the Communications industry was decimated as many bonds defaulted, with many recovery rates in the single digits. If clients had a better understanding of some of these concentrated risks and how they change over time, they might be less passive about selecting an index as a benchmark. It is the duty of investment managers to help educate their clients.

An index is better used as the investment **universe** rather than the benchmark. An investment manager's Investment Policy Statement takes the investment universe and provides a framework for controlling risk by, for example, limiting industry and issuer exposure and setting diversification guidelines. In other words, the Investment Policy Statement defines the acceptable risks in the portfolio, defining any style bias and leveraging the manager's skills. The manager's investment process within this framework is how the team evaluates risk and return while constructing a portfolio to generate alpha. While it is important to be aware of the index, the index should not dictate portfolio construction, especially at the expense of the client's objective.

Appropriate – The purpose of a benchmark is to objectively determine if the investment manager added value through skill on a consistent basis within a particular investment strategy. Thomas M. Richards explains that a "benchmark should be an investable portfolio that incorporates the prominent fundamental and performance characteristics of an investment manager's actual, active portfolios in the absence of active management."[6] Richards adds, "Essentially, the beta of the active portfolio versus the benchmark should be 1.0." Therefore, the difference in performance between the active portfolio and the benchmark should be due solely to the idiosyncratic risk that the manager has selected in the portfolio. Targeting a beta of 1.0 in a benchmark means neutralizing any market risk and also any investment style bias of the manager. This allows a client to make an apples-to-apples comparison by purifying the alpha generation capability of the investment manager. This appropriateness characteristic would challenge the use of a broad global high yield bond index such as the Barclays Capital Global High Yield xCMBS & xEMG 2% Capped Index to benchmark a high yield strategy with limitations to Triple-C rated bonds.

An index does not hold a cash balance. This can be a significant disadvantage for a manager who 1) manages an institutional mutual fund and relies on having a cash balance for redemptions, dividend distributions, or funding a currency hedge, or 2) manages a higher yielding fixed income asset class such as high yield bonds because a cash balance has historically caused a drag on portfolio returns. Transaction costs are irrelevant for an index, but they can be material for a fixed income portfolio, especially the varieties that are more illiquid such as emerging market debt and high yield bonds. In an index, bonds enter and leave monthly without any transaction costs, but an investment manager, whether active or passive, realizes the cost for trading bonds in the portfolio. For high yield bonds, this bid-ask spread, or transaction cost, has typically averaged about one point, which can contribute unnecessary costs if the manager is trying to replicate the index.

The Solution

In the asset management industry, it would be rare for an investment manager to be hired for outperforming an index yet underperforming the majority of peers within a similar strategy. It also would be rare for an investment manager to be fired for underperforming the index while outperforming peers. It is difficult to "win" and be considered "best in class" unless an investment manager has the flexibility to construct a portfolio and be compared with the best field of competitors. Index users should consider casting aside their security blankets, which can potentially disguise a lack of portfolio management aptitude or ability to evaluate and price risk when constructing portfolios.

A peer group benchmark can be more effective for certain bond strategies, especially high yield bonds. When comparing the four features of a benchmark to a peer group, some interesting differences arise.

Investable – With a peer group, an investor can invest directly with the investment managers in the peer group, unless that manager is at capacity. Of course, one may argue that if the peer group is 200 peers in size, then investability is unattainable. However, investors are evaluating options and the alternatives are either your strategy or one of the peers, making the peer group members clearly investable.

Unambiguous – In order to be "best in class," the investment manager must illustrate that the team's performance is competitive on both return and risk measures to the investment options, or peers. The peer group can be selected in advance with a certain targeted percentile ranking specified over a certain length of time. The peer group should be created by an independent, unbiased third party such as a consultant or independent database. While a potential downside is that peer groups can exhibit survivor bias as poor performing peers are closed over time, to be compared to "best in class," it seems logical that the poor performing peers would be discarded anyway.

Prudent – When a client allocates capital to a particular investment strategy, the client wants the best option available for reaching the objective. While an index is prudent for some strategies, using an index for others, such as high yield bonds, involves assumptions that can become problematic. There are assumptions made with going either the index route or the peer group route. Using an index assumes there is adequate diversification in the benchmark, while using a peer group assumes that each investment manager adheres to a prudent Investment Policy Statement, providing a risk framework. If a manager is skillful at pricing risk and constructing portfolios, an index can be more of an anchor, tying the manager to relative performance rather than the client's objective. In the end, the investment manager and client are left with the decision of going with an index that can bring on material flaws in prudent portfolio construction or a peer group of reputable investment processes.

Appropriate – While it is difficult to find a perfect benchmark for certain bond strategies, including high yield bonds, a peer group benchmark can offer a comparison of similar style strategies offered by the "best in class" managers in the market. Many of these managers compete for the same clients. While there are clear benefits of using a benchmark of similar style and strategy peers, many institutional consultants and clients also like to assess the value of the investment manager's style bias, if present, over time. However, this does not mean that a high yield strategy constrained to only BB bonds should use a peer group of high yield managers without a similar quality constraint. In the institutional high yield market, most managers have a style bias towards higher quality, providing a peer group benchmark that effectively has a beta close to 1.0 to an actively managed, higher quality high yield portfolio. To this measure, an institutional high yield bond peer group would seem to meet the appropriateness characteristic.

HIGH YIELD BOND BENCHMARK

FEATURE	INDEX	PEER GROUP
Investable	Many bonds not offered	Peers are an investment option
Unambiguous	Index rules and composition not consistent	Selection of consistent style of strategy
Prudent	Relies on index construction to meet objective	Allows manager to focus on objective
Appropriate	Falls short in measuring manager's skill	Measures skill versus "Best in Class"

Conclusion

While no benchmark is perfect, its main goal is to help the manager meet the client's objectives in a way that is measurable. For some bond strategies, an index benchmark may be appropriate; for others, a peer group is clearly more effective. It is important for both the investment manager and client to understand the pros and cons of each approach and to agree on their benchmark selection. Investment managers want to do the best they can and be considered best in class. Skillful managers should not let an index dictate portfolio construction, especially when an index is not the best reflection of risk parameters and performance objectives for the client, but should have the flexibility to construct portfolios using their proprietary evaluation of risk. Using a peer group for a benchmark in bond strategies such as high yield bonds promotes not only a best-in-class culture, but also keeps managers aware of the real competition.

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Todd Youngberg joined Aviva Investors North America, Inc. in 2008. He is responsible for overseeing all high yield strategies and managing the high yield business.

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Todd earned his bachelor's degree in business management from Central College and his master of business administration degree from Drake University. He holds the chartered financial analyst designation and is a member of the CFA Institute and the CFA Society of Chicago.

Footnotes

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