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Our verdict is in: Offshore high yield exchange-traded funds don't deliver

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Aberdeen

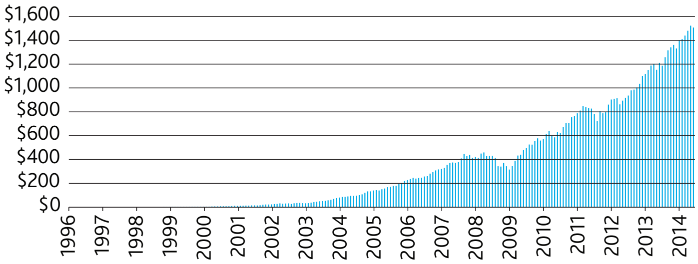
The explosive growth witnessed by ETFs in the US has dwarfed the growth rates seen in the mutual fund industry over the last 10 years. In fact, mutual fund assets across all asset classes have grown by 130%, while ETFs have grown at 1,489% over the last 10 years (See Charts 1 and 2).[A] Two of the most successful ETFs created are the State Street SPDR S&P 500 ETF (SPY)[B] and the Vanguard Total Bond Market ETF (BND).[C] In our opinion, these two funds have done a good job of giving investors what they want: market exposure or "beta risk"[D] at a cheap price.

As the industry has ventured into new asset classes such as the high yield sector, we believe that the evidence is becoming more apparent that this structure does not always deliver what investors would expect. Below is a graph of the growth in the US market for these two sectors but more recently we've seen these ETFs and their respective UCITS versions become available to offshore investors.

Now we recognize that, working for an active money manager (Aberdeen Asset Management PLC), one might believe that our view is biased and we have a personal interest in making unfavourable comparisons with our competition. While we acknowledge that this perception has some validity, in our view, this research paper provides supportive evidence that the overall performance of ETFs generally does not meet investors' expectations.

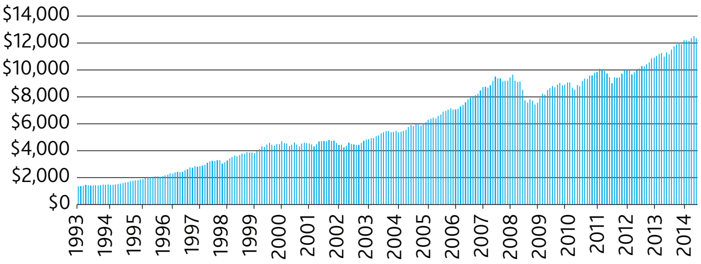
In an effort to understand what's happening behind the scenes, we think it's important to comprehend how an investor gets exposure to an ETF or buys shares and how an ETF investor creates liquidity or sells shares. For this transaction to take place, one needs the fund manager (which receives the order from its client) and an authorized participant (AP). An AP is expected to actually create and redeem shares. If there is a balance between purchases and sales, no shares will need to be created or redeemed. Under this scenario, the order will simply be executed by the exchange. An AP is "an entity chosen by an exchange-traded fund's sponsor to undertake the responsibility of obtaining the underlying assets needed to create an ETF."[E]

Chart1: Total US exchange-traded fund assets (in $billions)



Source: Strategic Insight, 31 July 2014. For illustrative purposes only.

Chart 2: Total US mutual fund assets (in $billions)



Source: Strategic Insight, 31 July 2014. For illustrative purposes only.

[A] Source: Strategic Insight, 31 July 2014.

[B] The SPDR S&P 500 ETF Trust seeks to provide investment results that, before expenses, correspond generally to the price and yield performance of the S&P 500 Index. The S&P 500 Index is an index of 500 selected common stocks, most of which are listed on the New York Stock Exchange, that is a measure of the US stock market as a whole. Indexes are unmanaged and have been provided for comparison purposes only. No fees or expenses are reflected. You cannot invest directly in an index.

[C] The Vanguard Total Bond Market ETF invests in more than 3,000 bonds representative of the broad, US investment-grade market.

[D] Beta is a measure of the volatility of a security or a portfolio in comparison to the market as a whole.

[E] Source: Investopedia, September 2014. The authorized participant borrows stock shares, often from a pension fund, places those shares in a trust and uses them to form creation units. These are bundles of stock varying from 10,000 to 600,000 shares, but 50,000 shares is what's commonly designated as one creation unit of a given ETF. Then, the trust provides shares of the ETF, which are legal claims on the shares held in the trust (the ETFs represent tiny slivers of the creation units), to the authorized participant. Because this transaction is an in-kind trade-that is, securities are traded for securities-there are no tax implications. Once the authorized participant receives the ETF shares, they are sold to the public on the open market just like stock shares. When ETF shares are bought and sold on the open market, the underlying securities that were borrowed to form the creation units remain in the trust account. The trust generally has little activity beyond paying dividends from the stock, held in the trust, to the ETF owners, and providing administrative oversight. This is because the creation units are not impacted by the transactions that take place on the market when ETF shares are bought and sold.

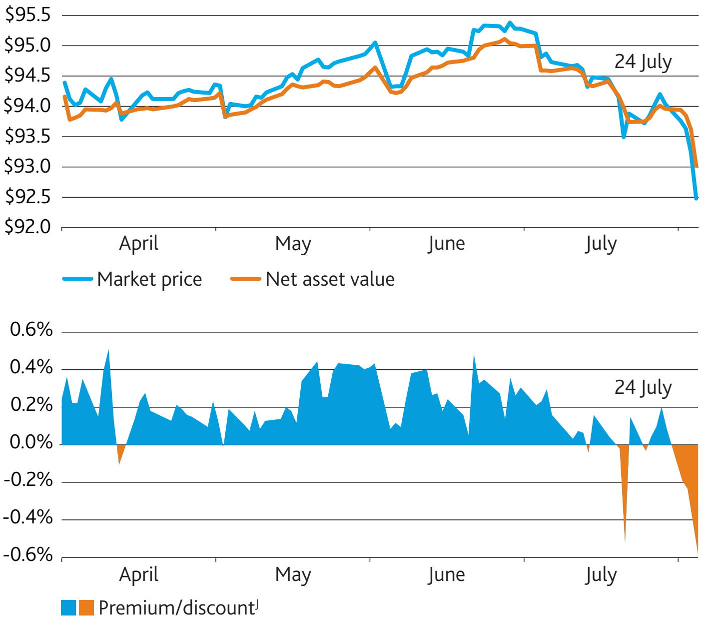
The AP seeks to make a profit by purchasing the underlying assets more cheaply than they are priced by the market and, subsequently, to sell those same assets at a higher price than what they are priced by the market. As a result of this process, the market price of an ETF can swing from a premium to a discount to its net asset value (NAV). This premium or discount will be very small for those asset classes that have very low transaction costs and very tight bid-to-offer spreads such as the S&P 500 Index or the US investment-grade fixed income market, as represented by the Vanguard Total Bond Market ETF (BND).[F]

This is not the case for the high yield market,[G] which typically trades with a 0.5-point bid-to-offer spread in normal times, while trading with wider bid-to-offer spreads when experiencing heightened volatility.

Let's look at recent activity in the high yield market when there was some selling pressure and spreads were widening. For the week ending August 6, 2014, investors pulled $7.1 billion from US high yield mutual funds, according to Lipper Analytical Services,[H] and much of this selling occurred in late July while during this period spreads widened 59 basis points.

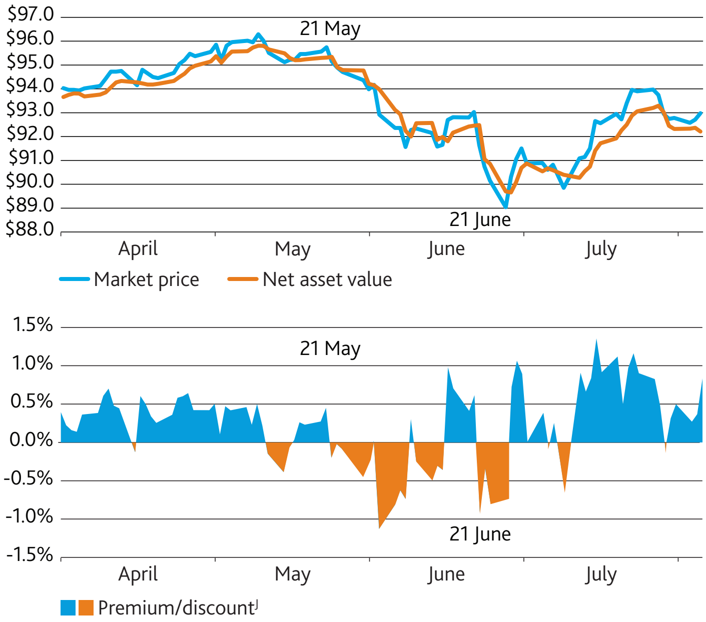
So, how did high yield ETFs fare during this downturn? Not very well, in our view. For example, from 24 July to 31 July 2014, the market price of iShares Global High Yield Corporate Bond UCITS ETF (HYLD) went from a 0.03% premium to a 0.27% discount. (See Chart 3.)[I] Therefore, when investors need the liquidity the most and are looking to sell into weakness, the ETF's market price moves sharply lower, offsetting much of the perceived benefits.

Chart 3: iShares Global High Yield Corporate Bond UCITS ETF performance: Market price vs. net asset value (31/3/14 to 31/7/14)



Source: Bloomberg, September 2014. For illustrative purposes only.
PAST PERFORMANCE DOES NOT GUARANTEE FUTURE RESULTS.

Chart 4: iShares Global High Yield Corporate Bond UCITS ETF performance: Market price vs. net asset value (1/4/13 to 31/7/13)



Source: Bloomberg, September 2014. For illustrative purposes only.
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iShares Global High Yield Corp Bond UCITS ETF is an exchange-traded fund (ETF) that seeks to track the performance of the Markit iBoxx Global Developed Markets Liquid High Yield Capped Index as closely as possible. The Markit iBoxx Global Developed Markets Liquid High Yield Capped Index is designed to reflect the performance of the global developed corporate high yield debt market. Indices are unmanaged and have been provided for comparison purposes only. No fees or expenses are reflected. It is not possible to invest directly in an index.

[F] The investment seeks the performance of a broad, market-weighted bond index. The fund employs an indexing investment approach designed to track the performance of the Barclays US Aggregate Float Adjusted Index, which represents a wide spectrum of public, investment-grade, taxable, fixed income securities in the United States, including government, corporate and international dollar-denominated bonds, as well as mortgage-backed and asset-backed securities, all with maturities of more than one year.

[G] The US high yield sector is represented by the Bank of America Merrill Lynch (BofA ML) US High Yield Master II Index, which tracks the performance of below-investment-grade US dollar-denominated corporate bonds issued in the US domestic market.

[H] Lipper Analytical Services is a leading global provider of mutual fund information and analysis to fund companies, financial intermediaries and media organizations.

[J] An ETF trades at a premium when its market price exceeds its NAV and trades at a discount when its NAV is higher than the market price.

Consequently, we believe that high-yield ETFs do not provide adequate liquidity. While investors are able to sell the shares, their market prices are volatile. The total return of iShares Global High Yield Corporate Bond UCITS ETF for the period of 24 July to 31 July 2014, was -1.29%, while the return for Aberdeen Global II – US Dollar High Yield Bond Fund (Class I2 shares at net asset value net of fees) was -0.48%. Therefore, it appears that the benefits of the lower fees and the liquidity sought by ETF investors were offset by the greater decline in the market price compared to the Aberdeen open-end fund. (Please see page 6 for Aberdeen Global II – US Dollar High Yield Bond Fund performance.)

Let's look at another period. In May 2013, after then- US Federal Reserve Chairman Ben Bernanke discussed reducing the central bank's asset purchase program, the bond market came under substantial selling pressure.

The yield on the 10-year US Treasury note rose nearly 140 basis points from the low in early May to the peak in early September 2013, according to Bloomberg (September 2014). Risk markets also experienced some selling pressure early in this period as higher interest rates threatened the "carry trade" that had worked well for so many markets for the last several years.

Exhibit 1

(31/12/07 – 30/6/14)	JNK[K]	HYG[L]	eVestment US High Yield Fixed Income Universe[M]	BofA ML US High Yield Master II Index
Annualised total return[N]	7.14%	7.11%	9.24%	9.73%
Annualised excess return[O]	-2.59%	-2.62%	-0.49%	-
Annualised standard deviation	15.7%	14.16%	10.49	12.39
Annualised Sharpe Ratio	0.43	0.48	0.87	0.76
Correlation[P]	92.6%	87.2%	96%	-
Beta	1.16	0.98	0.82	-
Annualised tracking error[Q]	6.3%	6.9%	3.9%	-

PAST PERFORMANCE IS NO GUARANTEE OF FUTURE RESULTS. For illustrative purposes only. Index performance is not an indication of the performance of the Fund itself. For complete Fund performance, please visit aberdeen-asset.uk.

Exhibit 2

(31/12/07 – 30/6/14)	JNK	Barclays Capital High Yield Very Liquid Index (LVHL)[R]
Annualised return	7.14%	9.98%
Annualised excess return	-2.84%	-
Annualised standard deviation	15.7%	14.73%
Annualised Sharpe Ratio	0.43	0.65
Correlation	94.2%	-
Beta	0.99	-
Annualised tracking error	5.3%	-

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Exhibit 3

(31/12/07 – 30/6/14)	HYG	iBoxx US Dollar High Yield Corporate Bond Index (IBOXHY)[S]
Annualised total return	7.11%	8.17%
Annualised excess return	-1.06%	-
Annualised standard deviation	14.16%	12.62%
Annualised Sharpe Ratio	0.48	0.62
Correlation	89.5%	-
Beta	0.99	-
Annualised tracking error	6.3%	-

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[K] SPDR Barclays High Yield Bond ETF.

[L] iShares iBoxx $ High Yield Corporate Bond ETF.

[M] The eVestment US High Yield Fixed Income Universe includes US fixed income products that invest primarily in high yield debt (as rated by Moody's or Standard & Poor's). Moody's and Standard & Poor's are international credit rating agencies that evaluate credit risk. Agency credit ratings are expressed as letter grades that range from "AAA" to "D" to communicate the respective agency's opinion of relative level of credit risk.

[N] Change in market price plus reinvested income.

[O] Excess returns versus the BofA ML US High Yield Master II Index.

[P] Correlation to the BofA ML US High Yield Master II Index. Correlation is a statistical measure of how two securities move in relation to each other.

[Q] Tracking error represents the divergence between the price behavior of a position or portfolio and the price behavior of a benchmark.

[R] The Barclays Capital High Yield Very Liquid Index includes publicly issued US dollar-denominated, non-investment-grade, fixed-rate, taxable corporate bonds that have a remaining maturity of at least one year and are rated high-yield (Ba1/BB+/BB+ or below) by Moody's, Standard & Poor's, and Fitch, respectively.

[S] The iBoxx US Dollar High Yield Corporate Bond Index is a rules-based index consisting of liquid US dollar-denominated, high yield corporate bonds for sale in the US, as determined by the index provider.

The high yield ETF again experienced some selling pressure, moving from a premium to a discount rather quickly. (See page 3, Chart 4.) In fact, the swing in the premium to discount was larger than in the period, observed above, moving from a 0.50% premium to a 0.21% discount between 21 May and 21 June 2013.[T]

This move produced a total return of -3.93%, underperforming the -3.23% total return of Aberdeen Global II – US Dollar High Yield Bond Fund (Class I2 shares at net asset value, net of fees). Why are we choosing these periods?

These were periods of market weakness, when spreads were widening and prices were falling—the time frames in which most of the selling takes place.

In an effort to avoid the appearance of "cherry-picking" specific points in time to support our view that the historical performance of ETFs is subject to higher volatility with poor long-term results relative to the overall US high yield market, we present the data in Exhibits 1-3. The two most popular ETFs, with combined assets in excess of $20 billion,[U] have a poor long-term track record in our view. The two funds' returns versus a broad high yield universe, such as the eVestment US High Yield Fixed Income Universe or the BofA US High Yield Master II Index, lag considerably. Equally important, by virtually every risk measure, including standard deviation, Sharpe Ratio and tracking error, we believe the ETFs are more risky. In Exhibits 1-3, we have provided comparisons among a relevant fund peer group, a commonly used US high yield index and two liquid indices that also might be appropriate for comparison purposes.

Summary

So, what conclusions may be drawn from our commentary on high yield ETFs? We believe investors considering allocations to the high yield sector should question whether high yield ETFs can deliver the investment results they seek. We think the facts speak for themselves: In the less liquid high yield sector, ETFs have a difficult time in delivering beta-like returns at a reduced price.

We believe that Aberdeen Global II - US Dollar High Yield Bond Fund may potentially provide both individual and institutional investors with the ability to take advantage of opportunities in the global high yield market. The Fund seeks to maximize total return, principally through a high level of current income, and secondarily through capital appreciation.

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[T] Source: Bloomberg, August 2014.
[U] Source: Bloomberg, August 2014.

Aberdeen Global II – US Dollar High Yield Bond Fund

Historical Performance Data

Total Returns (%)

	Cumulative as of 31 Aug 2014		Annualised as of 31 Aug 2014			
	3 Months	6 Months	1 Year	3 Years	5 Years	Since Inception
Fund (Inception date -31/7/01)	1.12	2.92	10.92	11.47	12.49	9.30
BofA Merrill Lynch US High Yield Master II Index[V]	1.02	2.99	10.62	10.81	11.53	9.59
Difference	0.09	-0.07	0.31	0.66	0.95	-0.29

Annual returns (%) - year ended 31/8/14

	2014	2013	2012	2011	2010
Fund	10.92	10.49	13.02	10.28	17.90

Calendar year performance (%)

	Year to date	2013	2012	2011	2010
Fund	6.22	9.47	16.53	6.44	15.62
Benchmark	5.83	7.42	15.58	8.09	12.70
Difference	0.40	2.05	0.95	-1.65	2.92

[V] The BofA America Merrill Lynch U.S. High Yield Master II Index tracks the performance of below-investment-grade U.S. dollar-denominated corporate bonds issued in the U.S. domestic market. Indexes are unmanaged and have been provided for informational purposes only. No fees or expenses are reflected. You cannot invest directly in an index.

Source: Aberdeen Asset Management, BNP Paribas.

Basis: Total return, gross of fees (USD).

Performance based on I Acc class, using prices struck at month-end close-of-business for comparability with the benchmark.

Benchmark: BofA Merrill Lynch US High Yield Master II Index from 01/01/12. Previously CSFB Upper Tier High Yield Index from 01/10/06 and CSFB High Yield Index prior.

Performance measured from 31/7/2001.

These figures are total return and gross of annual management and initial fees, to the extent that if these are paid, it will reduce performance from that shown.

The Aberdeen Global II - US Dollar High Yield Bond Fund was created by the transfer of the Aberdeen GlobalSpectrum Global High Yield Bond Fund (Dollar Hedged) into the Aberdeen Global II SICAV on 17/06/2008.

The historical track record shown prior to this date is indicative and reflects that of Aberdeen GlobalSpectrum Global High Yield Bond Fund (Dollar Hedged) which was launched on 10/07/2001.

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Important information

The value of investments and the income from them can go down as well as up and your clients may get back less than the amount invested.
Past performance is not a guide to future performance.

Contact details

Should you require any further information, please visit aberdeen-asset.com for details of your local Aberdeen representative.

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