High-yield bond ETFs have had a strong run in the past year, and some say they are going higher, while others warn of overexposure. The outlook for the segment may be unclear, but the disparity in performance among some of the high-yield bond ETFs isn't.

There's one fund that seems to be in a class of its own, at least in the past few years. The VanEck Vectors Fallen Angel High Yield Bond ETF (ANGL) is neither the oldest, the biggest, the most liquid or the most popular high-yield bond ETF.

For much of its life since it came to market almost five years ago, ANGL has been largely sitting quietly in the shadow of giants like the $16 billion iShares iBoxx $ High Yield Corporate Bond ETF (HYG) and the $12 billion SPDR Bloomberg Barclays High Yield Bond ETF (JNK).

But all of that seems to be changing as ANGL's performance stands out in a crowded segment of high-yield ETFs. In the past 12 months alone, investors have poured more than $550 million into ANGL, helping push the fund to about $715 million in assets under management today.

Look at how ANGL has performed relative to HYG and JNK in the past three years:
PRETTY SIMPLE SECRET SAUCE

That outperformance hinges on a secret sauce that’s really no secret. ANGL buys high-quality junk bonds, if you will—those that were originally issued as investment grade, but have just been downgraded to high yield. These bonds, as they drop into the junk bucket, are heavily oversold as investors (primarily institutional) dump them into the market to meet their mandates.

Because of that oversold nature, these bonds are poised to jump higher almost immediately when they are added to the portfolio. It’s an extra juice ANGL extracts from the market really well.

As Dave Nadig, CEO of ETF.com, recently put it, ANGL is “exploiting what is actually broken in the bond market.”

The way it all works is that investors own bonds at “different tranche levels,” he said. As soon as a downgrade takes place, these investors have to get out of those positions, pushing these bonds into oversold territory. That’s a “structural flaw,” he noted, and the key source of ANGL’s success.

DEFAULT RISK DOESN’T CHANGE MUCH

What’s also important to note is that these bonds now sit at the top of the high-yield segment, so their default rates aren’t that much higher than they were when they sat at the bottom of investment-grade level—an attractive feature for a segment that has default as one of its primary risks.

In the end, with 239 corporate junk bonds that were investment grade at the time of issuance, ANGL is heavily allocated to bonds rated BB—about 75% of the overall portfolio is in this segment, and another 20% is in bonds rated B. Roughly 95% of the portfolio is in the “Bs.”

By comparison, HYG has a 45% allocation to bonds rated BB, and another 37% in those rated B—that’s 82% total at those levels. Another 12% or so is tied to bonds rated CCC—a level that represents only about 3.8% in ANGL. And JNK, also with about 82% in bonds rated BB and B, has 17% of its portfolio in bonds rated CCC or lower.

Sector exposures also vary, and in the case of ANGL, it is its hefty allocation to energy that boded so well for the fund’s recent run-up. Energy was one of the most beaten-down sectors among high yield, and one of the big drivers of performance in this recovery rally.

ANGL has about 27% of the mix tied to energy. That’s roughly twice the allocation found in a fund like HYG.

UNCERTAIN FUTURE

Going forward, fundamentals for high-yield bonds could bode well for performance. Or not.

In a recent market outlook, Guggenheim, which is an ETF issuer well-known for its fixed-income expertise, said that a positive corporate earnings outlook, low default rates and expectations for higher rates—which tend to push investors to shorten duration and into credit—could all benefit high-yield bonds and the ETFs that own them.

As Guggenheim put it, the firm remains “constructive on high yield at current valuations.”
On the flip side, however, Guggenheim said it also remains aware of the possibility that this market is overextended. Any spikes in equity volatility could lead to high-yield spread volatility, the firm said. High yield is also susceptible to disappointments in economic data.

Spreads have tightened significantly—some 4 percentage points for the broad market in the past year—to levels below the 10-year average.

Whether positive fundamentals and a belief in the growth and reflation stories will drive this segment higher, or whether a breather is in store at these levels, remains to be seen. But ANGL’s performance is one for the books.

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<th>VANECK VECTORS FALLEN ANGEL HIGH YIELD BOND ETF (ANGL)</th>
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*Expenses for ANGL are capped contractually at 0.35% until at least September 1, 2017. Cap excludes certain expense, such as interest.

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The Moody’s rating scale is as follows, from excellent (high grade) to poor (including default): Aaa to C, with intermediate ratings offered at each level between Aa and Caa. Anything lower than a Baa rating is considered a non-investment-grade or high-yield bond.

Fund shares are not individually redeemable and will be issued and redeemed at their net asset value (NAV) only through certain authorized broker-dealers in large, specified blocks of shares called “creation units” and otherwise can be bought and sold only through exchange trading. Shares may trade at a premium or discount to their NAV in the secondary market. You will incur brokerage expenses when trading Fund shares in the secondary market. Past performance is no guarantee of future results. Returns for actual Fund investments may differ from what is shown because of differences in timing, the amount invested, and fees and expenses.

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Investing involves substantial risk and high volatility, including possible loss of principal. Bonds and bond funds will decrease in value as interest rates rise. An investor should consider the investment objective, risks, charges and expenses of the Fund carefully before investing. To obtain a prospectus and summary prospectus, which contains this and other information, call 800.826.2333 or visit vanek.com. Please read the prospectus and summary prospectus carefully before investing.