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Why Most Best-Performing Bond Funds Are CEFs

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Summary

- The top bond funds tend to be CEFs.
- These include most of the fantastic, well-known PIMCO bond funds, but many BlackRock funds too, as well as those of other issuers.
- An explanation as to why, plus some implications.
- This idea was discussed in more depth with members of my private investing community, CEF/ETF Income Laboratory. Learn More »

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Author's note: This article was released to CEF/ETF Income Laboratory members on August 21st, 2021.

While writing about the PIMCO Active Bond Exchange-Traded Fund (BOND), I noticed a very particular thing: the best-performing bond funds are almost always CEFs, and almost never ETFs.

For PIMCO, the best-performing bond funds are all CEFs. The best PIMCO ETF seems to be the PIMCO 0-5 Year High Yield Corporate Bond Index ETF (HYS) in 47th place.

Investment Vehicle	Add To My Content	Name	Symbol	Share Class	NAV Return (%) as of 09/09/2021	YTD (Cumulative)	1YR	3YR	5YR	10YR	Since Inception	Manager
CEF		FIXED INCOME, CORPORATE Corporate & Income Opportunity Fund	PTY	-	0.00	10.53	27.27	11.76	13.79	14.23	13.87 12/27/2002	Alfred T. Murata Mohit Mittal
CEF		FIXED INCOME, CORPORATE High Income Fund	PHK	-	-0.17	9.69	27.55	10.23	11.80	13.89	11.57 04/30/2003	Alfred T. Murata Mohit Mittal
CEF		FIXED INCOME, CORPORATE Corporate & Income Strategy Fund	PCN	-	-0.14	9.59	23.50	10.22	10.95	12.34	11.73 12/21/2001	Alfred T. Murata Mohit Mittal
CEF		FIXED INCOME, MULTI SECTOR Income Opportunity Fund	PKO	-	-0.08	8.09	18.83	9.52	11.37	11.16	11.63 11/30/2007	Daniel J. Ivascyn Alfred T. Murata Bryan Tsu
CEF		FIXED INCOME, CORPORATE Income Strategy Fund II	PFN	-	0.00	7.17	20.69	9.40	10.38	11.11	6.72 10/29/2004	Alfred T. Murata Mohit Mittal
CEF		FIXED INCOME, CORPORATE Income Strategy Fund	PFL	-	-0.09	7.82	22.53	10.06	10.66	11.06	7.51 08/29/2003	Alfred T. Murata Mohit Mittal
CEF		FIXED INCOME, MULTI SECTOR PCM Fund, Inc,	PCM	-	-0.10	8.19	19.79	8.30	10.74	10.64	9.22 09/02/1993	Daniel J. Ivascyn Alfred T. Murata Russell Gannaway Bryan Tsu
CEF		FIXED INCOME, MUNICIPALS California Municipal Income Fund II	PCK	-	0.00	3.06	7.62	8.73	5.28	8.96	4.95 06/28/2002	David Hammer
CEF		FIXED INCOME, MUNICIPALS Municipal Income Fund III	PMX	-	0.00	4.80	9.57	8.68	5.72	8.85	5.97 10/31/2002	David Hammer
CEF		FIXED INCOME, MULTI SECTOR Strategic Income Fund, Inc,	RCS	-	-0.15	5.26	15.55	7.59	7.62	8.77	8.45 02/24/1994	Daniel J. Ivascyn Daniel H. Hyman

(Source: PIMCO Corporate Website)

For BlackRock, the ten best-performing fixed-income funds are all CEFs. The best BlackRock ETF seems to be the iShares Core 10+ Year USD Bond ETF (ILTB), in a more respectable 26th place.

Ticker	Fund name Share class	YTD (%)	1Y (%)	3Y (%)	5Y (%)	10Y (%)	Incept (%)
BBN	Taxable Municipal Bond Trust	5.78	7.92	10.42	7.31	9.69	-
HYT	Corporate High Yield Fund	6.39	15.84	9.73	9.79	8.97	-
BKN	Investment Quality Municipal Trust	3.90	7.30	8.07	5.17	8.40	-
BTA	Long-Term Municipal Advantage Trust	8.25	13.58	8.85	6.18	8.32	-
BHK	Core Bond Trust	1.85	3.86	11.07	7.27	8.18	-
BTZ	BlackRock Credit Allocation Income Trust	3.57	9.83	10.94	8.25	8.16	-
BFK	Municipal Income Trust	4.82	8.74	7.45	4.71	7.59	-
MQT	MuniYield Quality Fund II	3.94	7.22	7.87	5.03	7.56	-
BLW	Limited Duration Income Trust	3.73	12.07	7.91	7.78	7.54	-
MHD	MuniHoldings Fund	4.41	8.45	7.32	4.56	7.53	-

(Source: BlackRock Corporate Website)

Although these results are not that thorough, I've only looked at two companies and glanced at fund returns, in my experience, the broader point is true. The best-performing bond funds are generally CEFs, while bond ETFs are rarely above average, with a couple of exceptions.

I thought to do an article explaining just *why* this is the case. This is more of a high level analysis and discussion, but hopefully of interest and use to investors.

In short, the best-performing bond funds are always actively managed, because a strong investment manager can consistently generate alpha and excess returns. ETFs are rarely actively managed, for historical and structural reasons. CEFs are usually actively managed, for historical reasons, and because, being closed to new investors, CEFs can focus on generating long-term shareholder alpha, and ignore short-term liquidity issues, inflows and outflows.

CEFs are simply a more appropriate structure for the more aggressive, successful strategies in the fixed-income space, which explains their (comparatively) strong performance.

Index Investing versus Active Investing

Let's start with the basics.

Index funds track the performance of an index, which is basically a basket of securities. As an example, the Vanguard Total Bond Market ETF (BND) tracks the Bloomberg Barclays U.S. Aggregate Float Adjusted Index, which includes most relevant investment-grade U.S. dollar-denominated bonds. BND does not take into consideration market conditions or security characteristics when investing, it simply invests in everything in the index. BND, understandably, invests in a *lot* of bonds.

Characteristics
as of 07/31/2021

Fund total net assets	$317.0 billion
Number of bonds	10099
Average effective maturity	8.6 years
Average duration	6.8 years
Yield to maturity	1.3%

(Source: BND Corporate Website)

Actively-managed funds, on the other hand, invest in a *select* number of securities. As an example, the BlackRock Core Bond Trust (BHK) (mostly) invests in investment-grade U.S. dollar-denominated bonds, same as BND, but only in a select number of these, which the fund's managers believe will perform particularly well. Investment managers generally take into consideration broader economic conditions and security characteristics when making investment decisions. BHK invests in a lot of bonds too, but much fewer than BND. Seems like most bonds didn't make the cut.

Key Facts

Net Assets as of Sep 09, 2021	$879,537,611	Size of Fund (Millions) as of Sep 09, 2021	$879.5 M
Share Class launch date	Nov 30, 2001	Exchange	New York Stock Exchange Inc.
Asset Class	Fixed Income	Morningstar Category	Intermediate Core Bond
Lipper Classification	Corp Debt BBB Leveraged	CUSIP	09249E101
Management Fee	0.50%	Gross Expense Ratio	0.92%
Shares Outstanding as of Sep 09, 2021	53,969,939	Number of Holdings as of Aug 31, 2021	1,740
Managed Assets as of Sep 09, 2021	$1,332,860,256.97	Premium Discount as of Sep 09, 2021	3.07%

(Source: BHK Corporate Website)

So, both funds focus on investment-grade bonds, but BND invests in *all* investment-grade bonds, while BHK invests in (hopefully) the best.

These two strategies have important implications for the funds and their shareholders.

Index funds, including BND, tend to be safer investments, due to their diversification.

Index funds tend to outperform the average actively-managed fund, because generating alpha is hard, and most investment managers are simply not up to the task. As an example, Morningstar has shown that only 27.5% of actively-managed core bond funds, BHK's industry subclassification, have outperformed the index.

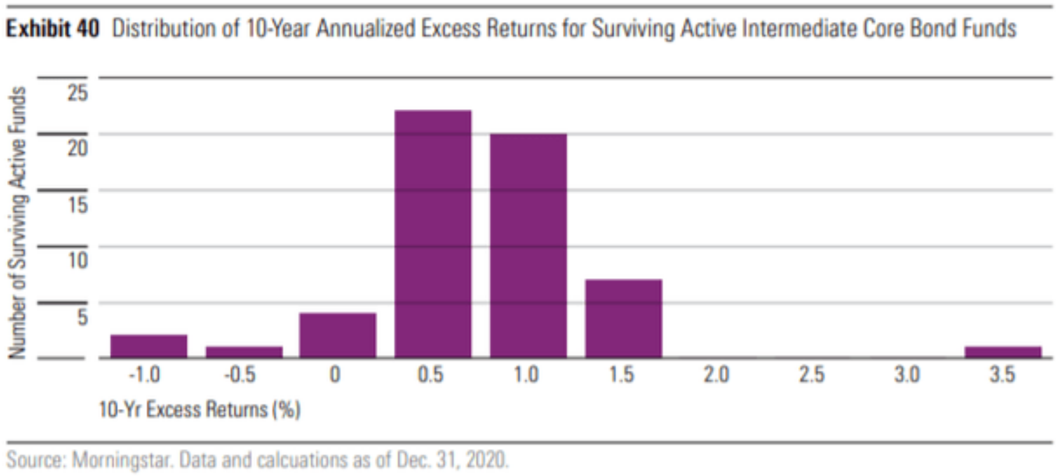
Exhibit 1 Active Funds' Success Rate by Category (%)

Category	1-Year	3-Year	5-Year	10-Year	15-Year	20-Year	10-Year (Lowest Cost) *	10-Year (Highest Cost)
U.S. Large Blend	31.1	30.0	16.5	8.4	11.2	12.8	17.2	4.1
U.S. Large Value	52.1	35.6	20.3	14.0	15.4	16.8	26.2	9.2
U.S. Large Growth	34.4	37.0	20.6	9.3	10.9	11.3	17.6	6.6
U.S. Mid Blend	21.6	23.8	13.4	11.9	6.3	8.7	29.6	7.4
U.S. Mid Value	76.8	49.6	44.2	12.5	30.8	—	16.7	8.3
U.S. Mid Growth	42.6	59.5	54.6	40.7	30.5	—	47.8	33.3
U.S. Small Blend	29.4	19.5	16.8	12.7	10.0	29.6	27.0	11.1
U.S. Small Value	46.2	27.4	23.1	29.3	31.3	—	35.0	15.0
U.S. Small Growth	60.1	55.2	54.0	41.2	28.4	—	46.7	36.4
Foreign Large Blend	56.0	41.5	26.7	20.0	14.0	14.6	35.9	17.9
Foreign Large Value	80.2	41.3	24.2	31.7	—	—	42.9	23.8
Foreign Small-Mid Blend	25.0	11.8	11.5	22.2	—	—	25.0	0.0
World Large Stock	53.3	42.0	30.8	30.4	32.0	—	34.8	21.7
Diversified Emerging Markets	69.6	59.6	48.1	45.4	35.7	—	58.3	33.3
Europe Stock	73.7	48.1	37.5	32.4	30.6	—	42.9	0.0
U.S. Real Estate	71.1	67.5	53.2	45.0	27.5	28.6	62.5	25.0
Global Real Estate	75.0	60.3	38.5	48.1	—	—	45.5	45.5
Intermediate Core Bond	53.7	38.5	34.5	27.9	15.9	9.7	47.4	11.1
Corporate Bond	48.4	35.5	49.1	40.5	—	—	37.5	25.0
High-Yield Bond	54.8	46.2	59.0	42.3	—	—	59.5	40.5

Source: Morningstar. Data and calcuations as of Dec. 31, 2020. *Green/red shading indicates that active funds in this fee quintile had above/below average success rates .

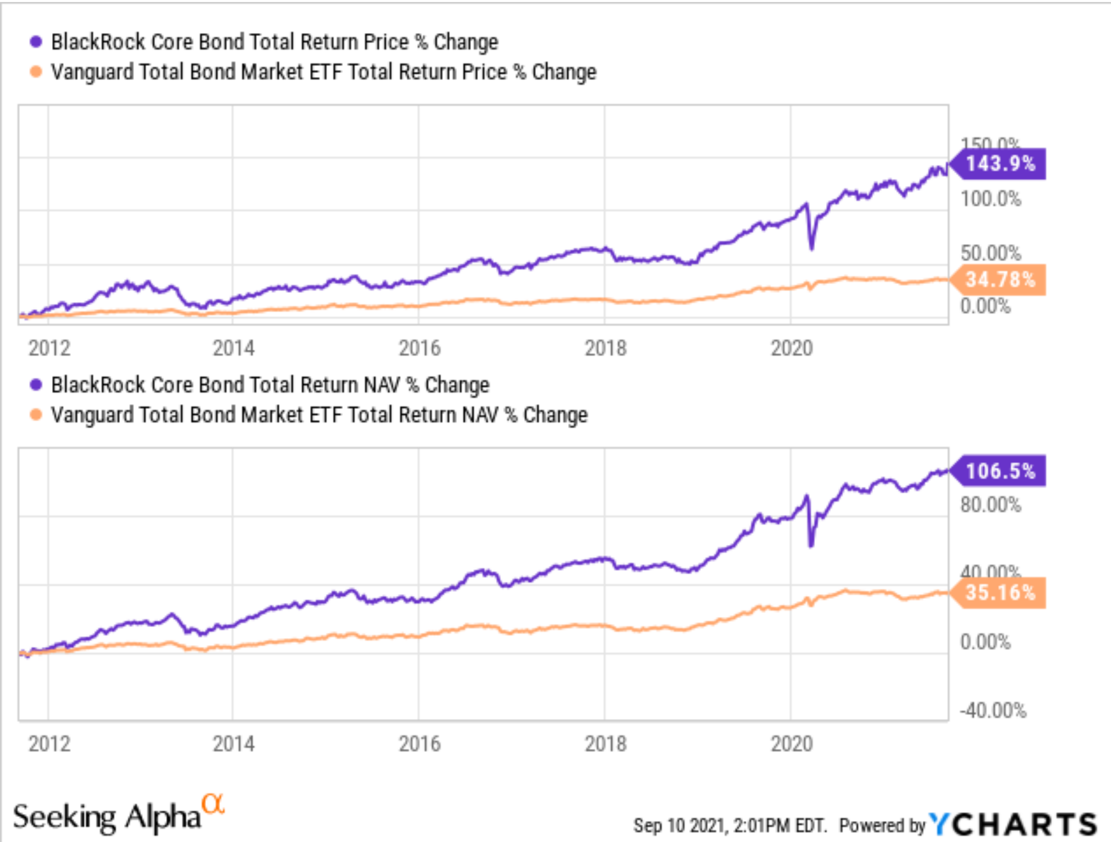
(Source: Morningstar Active/Passive Barometer)

Notwithstanding the above, the *best* actively-managed funds outperform the index, because the best investment managers *are* up to the task, and can consistently generate shareholder alpha. As per Morningstar, the best actively-managed core bond funds have outperformed their index by more than 2% per year for decades:



(Source: Morningstar Active/Passive Barometer)

BHK is one of the best actively-managed funds in its industry niche, as can be seen in the fund's outstanding performance, and as I explained in this recent article.



Data by YCharts

The best-performing investment funds will almost always be actively-managed funds like BHK, because a strong management team can consistently generate alpha, boosting returns. Index funds will generally be more reliable, but will very rarely be the best performers.

CEFs versus ETFs

The best-performing funds tend to be active for two reasons.

The first reason is almost an accident of history.

CEFs are generally older products, active investing was the norm in the past, and so most CEFs are actively managed.

ETFs are generally newer products, index investing is a more recent phenomenon, and so most ETFs are index funds.

There are many exceptions to the above, but it is a very real, important pattern.

The second reason has to do with structural differences between CEFs and ETFs, especially related to issues with the ETF creation/redemption mechanism for actively-managed bond funds. Matt Levine at Bloomberg has a fantastic, quite simple explanation of said mechanism here, and the BIS has another, more in-depth one here. My explanation borrows from Levine, but the conclusion/implications are quite different.

Let's say you have a vanilla S&P 500 index fund, like the SPDR S&P 500 Trust ETF (SPY). SPY takes investor funds, totaling just under $405 billion today, and invests these in S&P 500 stocks. SPY's share price equals $448, meaning that for every share of SPY, investors are entitled to $448 worth of S&P 500 stocks.

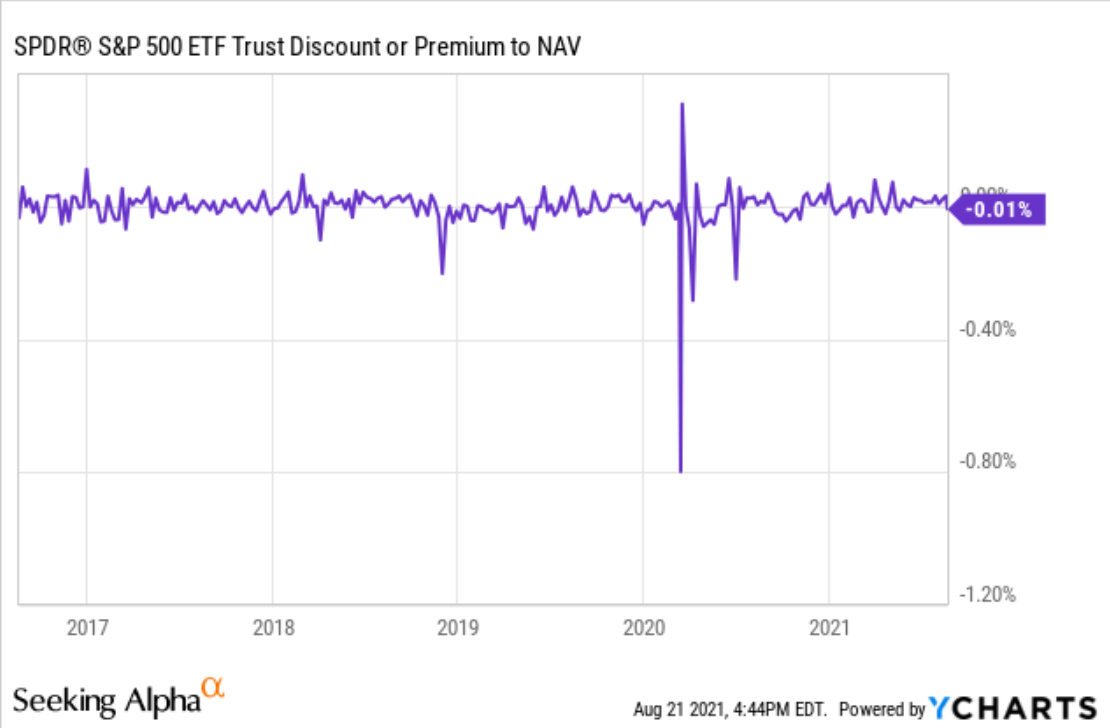
In the vast majority of cases, if an investor wants to invest in SPY, he simply puts a buy order on an exchange, and buys them from an investor who wishes to sell. In some cases, there are more buyers than sellers, in which case the ETF creation mechanism kicks in. Authorized participants, basically brokers and market makers, buy S&P 500 stocks, deliver these to SPY, receive SPY shares in return, and sell these shares in the open market. The end result is more SPY shares, created out of thin air by the fund itself, backed by more underlying S&P 500 stocks, delivered to the fund by the authorized participants.

The aim is to buy enough of the underlying/create sufficient shares to meet increased investor demand. Importantly, SPY itself does very little, outsourcing most of the operational and trading requirements to the authorized participants. There is a similar mechanism in place when there are more sellers than buys.

There are three key advantages to the ETF structure.

First, it ensures an ETF almost always trades very close to NAV. An ETF can't really trade at a premium to NAV, because if it did, authorized participants would buy fairly-valued underlying securities, receive overvalued fund shares, sell the shares, and profit from the spread (buying securities at NAV but selling fund shares at a premium means guaranteed profits). It would do so until the spread disappeared, which should happen as more and more shares are sold. Something similar would happen if the ETF traded at a discount.

SPY itself almost always trades at NAV. Discounts and premiums are incredibly rare, and always short-lived.



Data by YCharts

Second, as ETFs themselves do very little trading, operational expenses are extremely low. SPY itself sports a 0.09% expense ratio, and Vanguard index funds, the best of the best, usually sport even lower expense ratios. These are cheap products, and the structure is key.

Third, ETFs tend to be very tax-efficient, as the lack of trading means that gains are rarely realized, and that there are few taxable events.

These three advantages are large enough that ETFs are *almost* always the most appropriate fund structure, but there are exceptions. Actively-managed bond funds are one such exception, for one key reason: the creation/redemption mechanism works a little bit different, a little bit worse, for bond funds, especially *actively-managed* bond funds.

The way the creation mechanism should work for, say, BND, is that authorized participants buy and deliver 10,000 bonds to the fund when they want to receive shares.

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The issue is, buying *10,000 different bonds* is operationally quite difficult: too many bonds. At the same time, some bonds are very illiquid, and so there are no guarantees you could even buy some/each of these bonds if you wanted to do so.

So, the authorized participants might buy, say, a representative sample of 1,000 bonds, and deliver those to BND in exchange for shares. The sample might not include, say, literally every treasury ever issued, but it would include the most liquid treasuries, and with an equal maturity and duration to the index. The goal would be a sample which is very similar to the index, but with a lower, more manageable number of securities.

For an index fund like BND, receiving a representative sample of bonds works reasonably well. BND just has to make sure that the sample is indeed representative of the index, with similar characteristics, and there should not be any significant issues.

For an actively-managed bond fund like BHK, receiving a representative sample of bonds would not work. BHK is an actively-managed fund, it does not want to invest in a representative sample of bonds, it wants to invest in a select number of bonds which fund management believes will outperform. These are different, one might argue opposite, goals. BHK could tell its counterparties that it only wants to receive the specific bonds it has selected/invested in, but, remember, bonds are illiquid, and there are no guarantees that BHK's counterparties would be able to accommodate the fund's request.

Due to the above, many, perhaps most, actively-managed bond funds decide against being structured as ETFs. BHK itself is a CEF, and most of the strongest, best-performing BlackRock and PIMCO bond funds are CEFs too.