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Five Reasons To Be Active in Fixed Income

Active fixed-income approaches have historically outperformed their passive counterparts and may add value by aligning with an investor's objectives.

Insight from sub-adviser Wellington Management

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Many investors have moved from active to passive fixed-income strategies in recent years. Investors who make this switch believe fixed-income markets offer fewer idiosyncratic risks to exploit than equities and are too efficient for active managers to generate alpha.[1] Yet passive approaches have frequently underperformed active strategies across many segments of the fixed-income market and may expose investors to several forms of unintended risk. Active fixed-income management not only offers the potential for enhanced returns, but can also add value by aligning an investor's objectives with risks in several key areas—market structure, credit deterioration, dislocations, and divergence—where index-tracking approaches may fall short.[2]

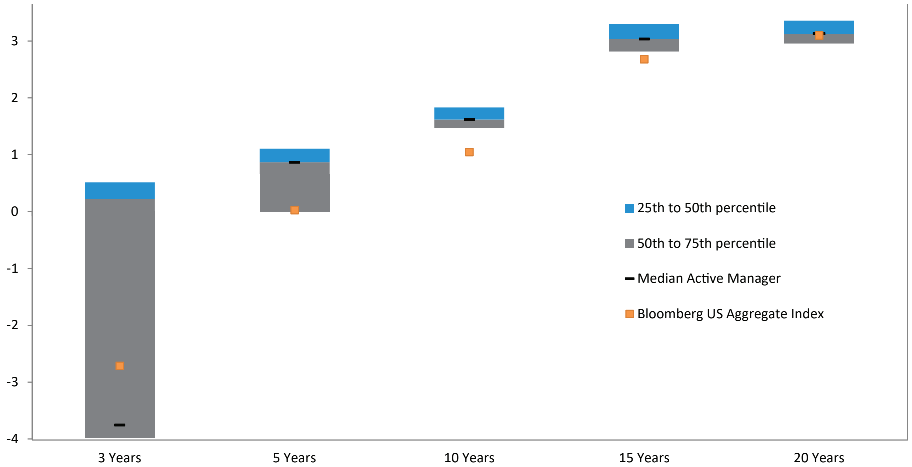
Key Points

- Active approaches have historically outperformed passive strategies across many segments of the fixed-income market.
- Active management can also add value by aligning an investor's objectives with risks in several other key areas in which index-tracking approaches may fall short.

Reason #1: Performance Potential

Advocates of index-replicating fixed-income strategies argue that active managers can't consistently outperform the Bloomberg US Aggregate Bond Index[3] (the "Agg") net of management fees. Yet active core-plus fixed-income approaches have historically fared well against the Agg over most time frames during the past 20 years, even after excluding a "survivorship bias" (**FIGURE 1**).

FIGURE 1
Active Managers Have Often Outperformed the Agg



Past performance does not guarantee future results. As of 6/30/23. Indices are unmanaged and not available for direct investment. Annualized total returns of US-based, active core-plus mutual funds, net of fees. Universe has been filtered to: 1) include those funds benchmarked to the Agg and exclude index funds; 2) mitigate survivorship bias, which occurs when the performance results of a group of managers are calculated using only the survivors at the end of the period and excluding those that no longer exist. Survivorship bias can result in the overestimation of historical performance by assuming that only funds currently in existence were available in the past. These results mitigate survivorship bias by including now-obsolete funds that were active historically but have since closed. Sources: Morningstar, Wellington Management.

Active outperformance over such a lengthy period, including turns in the credit cycle, suggests there are factors at play beyond an emphasis on credit. Indeed, active managers have many other levers for seeking to generate alpha, such as sector rotation, out-of-benchmark allocations, duration[4] positioning, security selection, and (in the case of global strategies) country and currency selection. These noncredit levers may also mitigate drawdowns during credit-adverse environments.

[1] The measure of the performance of a portfolio after adjusting for risk. Alpha is calculated by comparing the volatility of the portfolio and comparing it to some benchmark. The alpha is the excess return of the portfolio over the benchmark.

[2] We recognize that passive investing isn't exactly the same as index-tracking. Passive investing features low turnover of portfolio securities compared to active approaches, resulting in relatively lower transaction costs. A low-turnover approach may be perfectly consistent with an investor's objectives. However, to simplify terminology, this paper uses "passive" and "index-tracking" interchangeably.

[3] Bloomberg US Aggregate Bond Index is composed of securities from the Bloomberg Government/Credit Bond Index, Mortgage-Backed Securities Index, Asset-Backed Securities Index, and Commercial Mortgage-Backed Securities Index.

[4] Duration is a measure of the sensitivity of an investment's price to nominal interest-rate movement.

That said, credit overweights have clearly helped boost excess returns delivered by active managers over most periods—the great exceptions in the past 20 years being the GFC and COVID-19 pandemic. Narrowing spreads[5] emerging from these crises have compensated for active managers' shortfalls vs. index returns at their onsets.

While the median active manager's performance vs. the Agg has tended to be positively correlated to credit spreads—outpacing the Agg when spreads narrowed and lagging when spreads widened—periods of underperformance have often been short-lived and typically outweighed by longer stretches of outperformance.

Reason #2: Market Structure

Fixed-income markets tend to be fragmented, opaque, and prone to experiencing volatile liquidity. However, these features may benefit thoughtful investors by increasing the premia that can be earned through portfolio implementation and active management (**FIGURE 2**).

Fragmented: Unlike equity markets, there's no central fixed-income exchange. Instead, securities are still traded over-the-counter. This often requires a trading desk to strategically plan how it will either buy or sell a bond, allowing the implementation aspect of investing to potentially add value. Moreover, issuers may have different bonds in various parts of their capital structure or in varying currencies and maturities. A single corporate or government issuer may have numerous individual bonds, each with different terms and conditions. That can mean the risks and rewards differ as well. A passive exposure does very little to distinguish among those individual bonds.

Non-economic actors: Some key participants in fixed-income markets are looking to achieve objectives other than a rate of return. These include central banks and the US Treasury, along with banks and insurance companies that may be subject to investment constraints imposed by the regulatory framework. Hence, these counterparties are often not trading based on valuations, leaving room for active investors to purchase or sell bonds at opportune times.

Liquidity and balance sheet: Reductions in dealer balance sheets following the GFC have made liquidity more variable across fixed-income markets. Given that there's no central fixed-income venue, investors rely on dealers to serve as counterparties for trades and to hold inventories of bonds. The reduced ability of a dealer to intermediate or serve as a place to store inventory means bond prices can be influenced by the non-economic actors, providing the opportunity for an active investor to supply liquidity when traditional intermediaries cannot and to do so more effectively than passive investing.

Implementation: Fixed-income markets provide a number of ways for skilled practitioners to add value through implementation, many of which aren't replicable in passive terms. Issuer, CUSIP, and maturity are all important facets of a decision. In addition, active investors can decide whether the exposure looks better in cash (funded) format or through derivatives such as futures (unfunded) and can seek to exploit differentials between the two. Similar dynamics exist for currency markets, where lending dollars via the cross-currency basis market may deliver robust risk-adjusted returns. Over time, these and other tactics have often translated into superior results vs. passive exposure.

> Active outperformance over such a lengthy period, spanning turns in the credit cycle, suggests factors at play beyond an emphasis on credit.

Indices are designed to be market proxies, not investment strategies

The capitalization-weighted indices that passive fixed-income approaches typically seek to track, such as the Agg, are designed to be transparent, objective, and replicable sets of securities that represent opportunity sets and summarize market information. That said, the standard fixed-income market indices—or more precisely, the passive approaches that seek to closely mirror them—have several shortcomings as investment strategies, including:

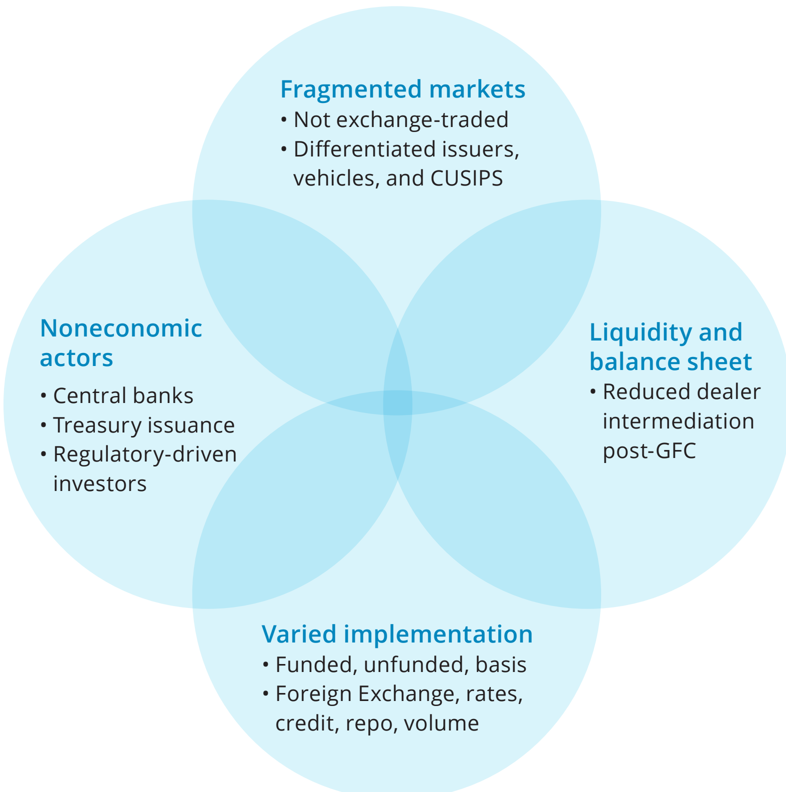
- **Performance**: By definition, generally cannot outperform the indices tracked
- **Duration**: Expose investors to substantial interest-rate risk
- **Downgrades**: Cost investors return due to mechanical rules on downgrades
- **Dislocations**: Cannot take advantage of pricing dislocations or inefficiencies
- **Divergence**: Can fail to accurately mirror the target index

We think investors' circumstances and goals should drive the composition of their portfolios, not an index provider's efforts to replicate a given market. Any weighting scheme that excludes consideration of a market's credit quality, duration, volatility, and liquidity exposure is too narrowly based, in our view.

[5] Spreads are the difference in yields between two fixed-income securities with the same maturity, but originating from different investment sectors.

FIGURE 2

The Structure of Fixed-Income Markets Can Work to Investors' Advantage



Source: Wellington Management

Reason #3: Credit Deterioration

An important feature of credit is its asymmetric risk profile: The market value of a bond can fall much more than it's likely to rise. (In other words, credit-yield spreads can widen much more than they can narrow.) An active portfolio manager can play an important role in anticipating turns in the credit cycle and seek to avoid downside risk. In particular, fundamental research can help managers identify deterioration or improvement in a credit before the rating agencies do—and even before the shift is priced in by markets.

A prominent concern among investors is that lower-rated credits now comprise a larger share of the investment-grade (IG) credit universe than in the past, while issuer leverage has been rising and interest coverage has been falling (**FIGURE 3**). However, in a recessionary environment, interest-coverage ratios could worsen, particularly for cyclical credits. Deeper analysis of a company's leverage ratios is essential to understanding whether or not the company's ability to service its debt is negatively impacted by higher debt levels. At the very least, higher leverage should be a clear warning sign for credit teams to investigate a company's earnings and free cash flow, its plans for asset sales and dividends, and how committed its senior management is to IG ratings. An experienced portfolio-management team that can go beyond the headlines may be able to identify opportunities and risks.

About the author

Amar Reganti works closely with the investment teams to help ensure the integrity of the investment approaches by overseeing portfolio positioning, performance, and risk exposures. He also communicates investment philosophy, strategy, positioning, and performance.

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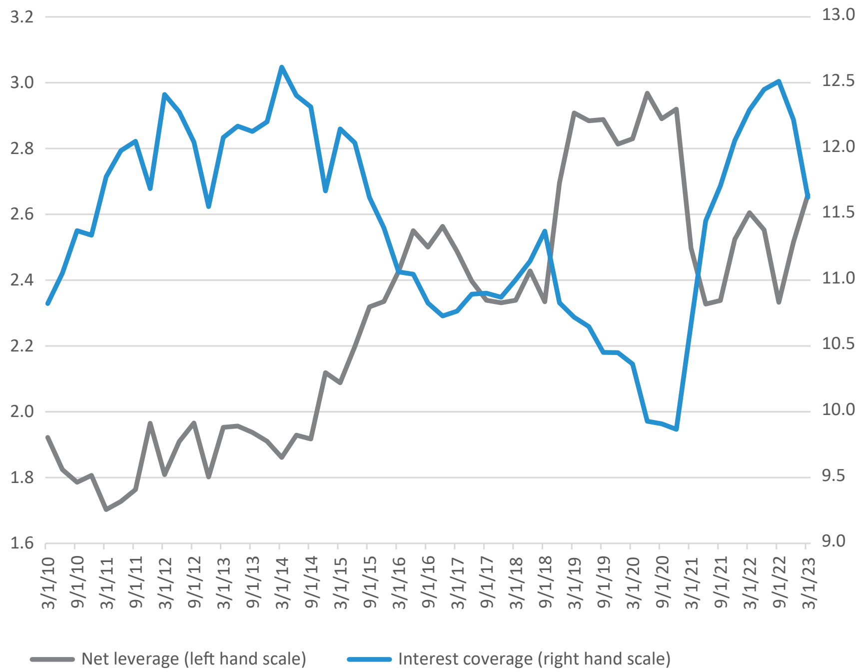
FIGURE 3

Investment-Grade Corporate Leverage Has Been Steadily Rising

US IG corporate credit metrics



As of 3/31/23. Net leverage is a measure of how much of a company's capital is in the form of debt and is used to evaluate the company's ability to meet its financial obligations. Interest coverage is a measure of a company's ability to meet its interest payments. Data Sources: Capital IQ and Wellington Management.

Index providers' rules for credit downgrades can also cause passive strategies to trail active ones.

Index providers' rules for credit downgrades can also cause passive strategies to trail active ones. In the Bloomberg US Corporate Investment-Grade Bond Index,[6] securities downgraded by at least two of the three main credit-rating agencies (Standard and Poor's, Moody's, and Fitch) must exit the Index by the end of the month in which they're downgraded. But deteriorating credits often sell off before they're downgraded as investors anticipate the downgrade. Consequently, the indices are often forced to sell such bonds after they've fallen in price.

Reason #4: Dislocations

Lack of liquidity, merger-and-acquisition (M&A) activity, and market segmentation can cause market dislocations and create opportunities for active managers, as can responses by government policymakers to such dislocations.

- Credit sectors, in particular, are where post-crisis regulations have made secondary bond markets less liquid. When spreads widen, the liquidity premium between new and older issues tends to widen, and vice versa. As noted earlier, active managers can seek to benefit from this by acting as liquidity providers, purchasing higher-yielding corporates at steep discounts when others wish to sell them.
- Periods of elevated M&A activity generate idiosyncratic risk that active managers can seek to exploit. Some combinations represent strategic transactions from which synergies may accrue, while others may be done to enhance shareholder value. Active managers can assess companies' deleveraging intentions and commitments to IG ratings. There may be opportunities for investors to profit from M&A, particularly if the announcement triggers indiscriminate spread widening. Conversely, some

[6] Bloomberg US Corporate Investment Grade Bond Index covers all publicly issued, fixed-rate, nonconvertible, investment-grade debt.

debt-funded M&A transactions have pushed the IG limit. If active managers are skeptical of management's commitment to bondholders, they may choose to avoid/underweight the issuer.

- Finally, active managers can exploit market inefficiencies caused by market segmentation. For example, BB-rated securities can't be included in mandates that require IG credits. Without a natural buyer, their spreads may be high relative to their credit risk, handing savvy active managers another potential path to outperformance.

M&A activity has accelerated in recent years, generating idiosyncratic risk that active managers can seek to exploit.

Reason #5: Divergence

Although many investors assume that an index fund will closely track its target index, this isn't always the case. The challenges of index replication are most evident among high-yield, index-tracking ETFs.

Two funds have had dominant market shares in the US ETF high-yield market since their launches in 2007. Almost since their inception, the funds have shown significant tracking risk[7] vs. the Bloomberg US Corporate High Yield Bond Index.[8] They've also meaningfully underperformed the Index, as reported by Morningstar (**FIGURE 4**). These funds may lag the Index because their benchmarks are more liquid than the Index; however, we think it's appropriate to measure their returns vs. the Bloomberg US Corporate High-Yield Bond Index because it's commonly used as a yardstick for the performance of high-yield portfolios.

FIGURE 4

Returns of Two Major High-Yield ETFs Vary Considerably From a Widely Used High-Yield Benchmark

12/31/07*–6/30/23

	Annualized return (%)	Annualized tracking error (%)
Bloomberg US High Yield Corporate Index	6.25	N/A
ETF 1	4.90	2.10
ETF 2	4.74	1.95

* Earliest date that monthly data is available for both ETFs. Returns are net of fees.
Data Sources: Morningstar and Bloomberg.

Conclusion

To summarize, we believe actively managed fixed-income portfolios have several distinct advantages over passive approaches:

- Active core-plus and IG corporate managers have demonstrated the ability to outperform their benchmarks across numerous time frames.
- Fixed-income markets tend to be fragmented and opaque with volatile liquidity—features that may benefit thoughtful investors.
- The fixed-income indices commonly used as portfolio benchmarks expose investors to potentially costly index rules that force-sell issues falling below IG. Active managers have more flexibility on the timing of such trades and can often stay ahead of these situations.
- Some so-called passive strategies can deviate meaningfully from the broad-market indices they purport to track in ways that cause them to underperform; high-yield ETFs are a prime example.
- Greater dispersion among sectors, issuers, and individual securities provides more opportunities for active managers to potentially add value.
- Finally, active managers are able to use market dislocations and inefficiencies to their advantage, whereas passive approaches must simply ride them out and endure the volatility.

Although many investors assume that an index fund will closely track its target index, this isn't always the case.

To learn more about the benefits of active management in fixed income, talk to your financial professional.

[7] Tracking risk is the difference between a portfolio's price behavior and its benchmark's price behavior

[8] Bloomberg US Corporate High-Yield Bond Index is an unmanaged broad-based market-value-weighted index that tracks the total-return performance of non-IG, fixed-rate, publicly placed, dollar-denominated and nonconvertible debt registered with the Securities and Exchange Commission.

Important Risks: Investing involves risk, including the possible loss of principal. • Fixed-income security risks include credit, liquidity, call, duration, and interest-rate risk. As interest rates rise, bond prices generally fall. • Investments in high-yield ("junk") bonds involve greater risk of price volatility, illiquidity, and default than higher-rated debt securities.