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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.

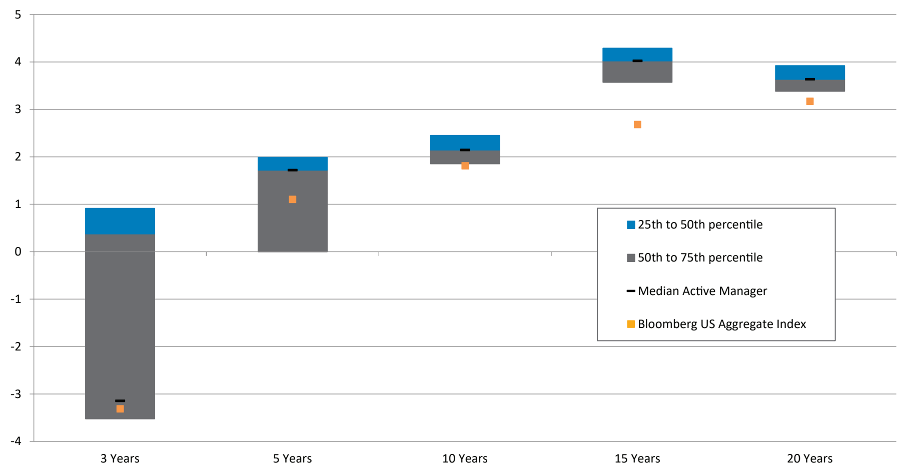
Over the past several years, many investors have moved from active to passive core fixed-income strategies, believing these markets offer fewer idiosyncratic risks to exploit than equities and are too efficient for active managers to generate alpha. Yet passive approaches have frequently underperformed active core plus fixed-income strategies and may expose investors to several forms of unintended risk. Active fixed-income management not only offers 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 dispersion—where index-tracking approaches may fall short.[1]

Reason #1: Performance Potential

Advocates of index-replicating fixed-income strategies argue that active managers cannot consistently outperform the Bloomberg US Aggregate Bond Index (the "Agg"), net of management fees. Yet active core plus fixed-income approaches have historically fared well against the Index over most time frames during the past 20 years (**FIGURE 1**).

FIGURE 1

Active Managers Have Often Outperformed the Agg



As of 12/31/23. **Past performance does not guarantee future results.** 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, spanning turns in the credit cycle, suggests 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 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.

Insight from sub-adviser Wellington Management

Amar Reganti
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Key Points

- Active approaches have frequently outperformed passive strategies across the core-plus fixed-income universe.
- Active management can also add value by aligning an investor's objectives with risks in several other key areas where index-tracking approaches may fall short.

[1] We recognize that passive investing is not 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.

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 global financial crisis (GFC) and COVID pandemic. Recouping of the spread widening emerging from these drawdown periods compensated for active managers' shortfalls vs. index returns in 2008 and early 2020.

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

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Reason #2: Market Structure

Fixed-income markets tend to be fragmented and opaque, 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 is no "central" fixed-income exchange. Instead, securities are still traded "over-the-counter" (OTC). 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.

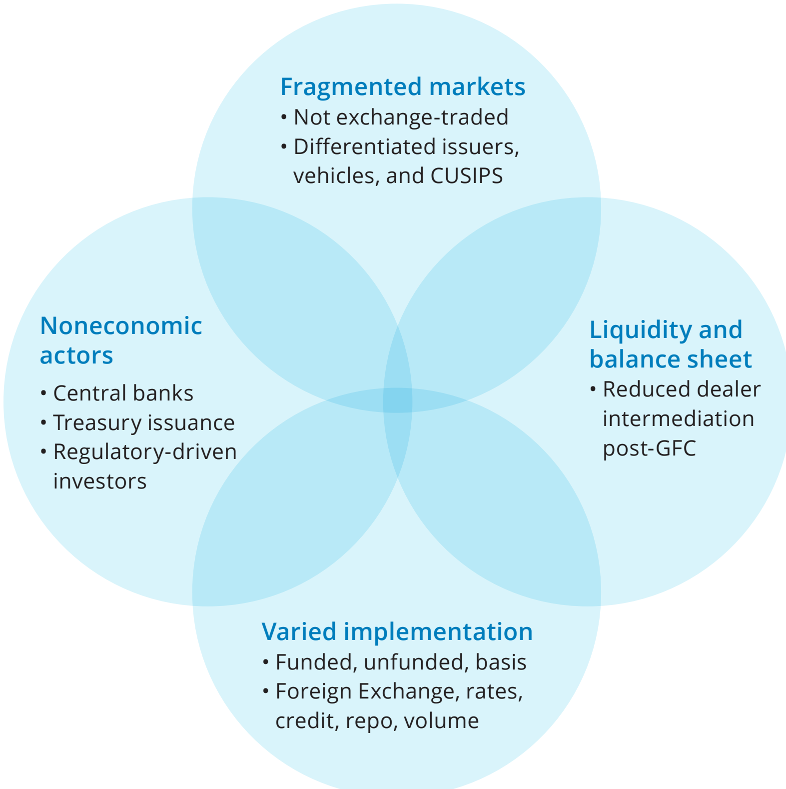
Noneconomic actors: Some key participants in fixed-income markets are looking to achieve objectives other than a rate of return. These include central banks and the US Treasury, along with commercial banks and insurance companies that may be subject to investment constraints imposed by the regulatory 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 is 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 noneconomic 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 are not 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.

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 is likely to rise. (In other words, credit 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 avoiding 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 credit universe than in the past (**FIGURE 3**). 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 investment-grade 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

Share of BBB-Rated Bonds in US Corporate Universe (%)

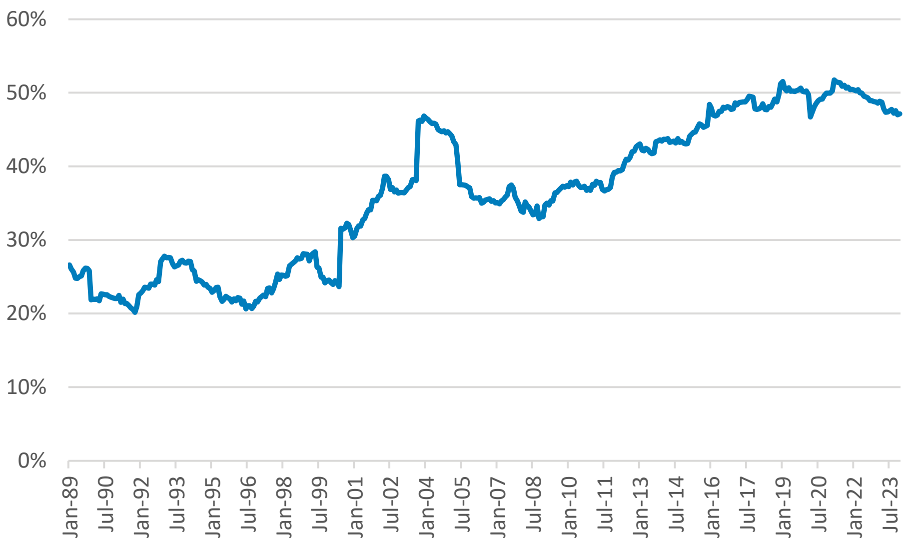

Chart data as of 1/89–12/23. Sources: Bloomberg and Wellington Management.

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, 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 are downgraded. But deteriorating credits often sell off before they are downgraded as investors anticipate the downgrade. Consequently, the indices are often forced to eliminate such bonds after they have fallen in price.

Reason #4: Dislocations

Dislocations can occur across all segments of fixed-income markets, driven by various structural imbalances (e.g., growth in debt stock vs. reduction in market-making activities) that leave securities across spread sectors vulnerable to bouts of illiquidity. These dislocations—and responses by policymakers to them—can create opportunities for active managers.

Dislocations are not a new phenomenon, and we believe they could be a pervasive feature of fixed-income markets. In the past decade, we've seen increasing frequency and volume of dislocations caused by a growing number of structural imbalances in fixed-income markets (**FIGURE 4**). These structural imbalances leave fixed-income assets highly vulnerable in periods of market stress, both at a macro and micro level. While they can represent a serious challenge for traditional fixed-income investing, these imbalances have created a dislocation seam for aptly resourced core-plus bond managers to identify and seek to exploit.

FIGURE 4

Post-GFC Structural Factors Can Lead to Ongoing Dislocations

Rapid growth of tradeable credit products		Regulatory changes limit liquidity	
High-yield bond issuance	↑	Gov't-sponsored enterprise balance sheet	↓
Leveraged loan, covenant-lite issuance	↑	Dealer corporate bond inventory	↓
Collateralized-loan-obligation issuance	↑	Money-market eligible assets	↓
BBB-rated size of investment-grade market	↑	Banks' willingness/ability to lend	↓
Volume of fallen angels	↑	Banks' proprietary trading activities	↓
Fixed-income index/ETF assets under management	↑	Consistency of cross-border securitized regulation	↓

Arrows are based on the views of the investment team. Views are based on available information and are subject to change without notice. Individual portfolio management teams may hold different views. Source: Wellington Management.

In our view, existing and growing structural market imbalances should lead to more frequent and severe disruptions on a go-forward basis. We believe that investors with patient and opportunistic capital may be able to take advantage of these market dislocations, creating the potential for attractive return outcomes. Active managers can seek to generate returns from the periodic bouts of volatility that we believe are now endemic in fixed-income markets.

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Reason #5: Divergence

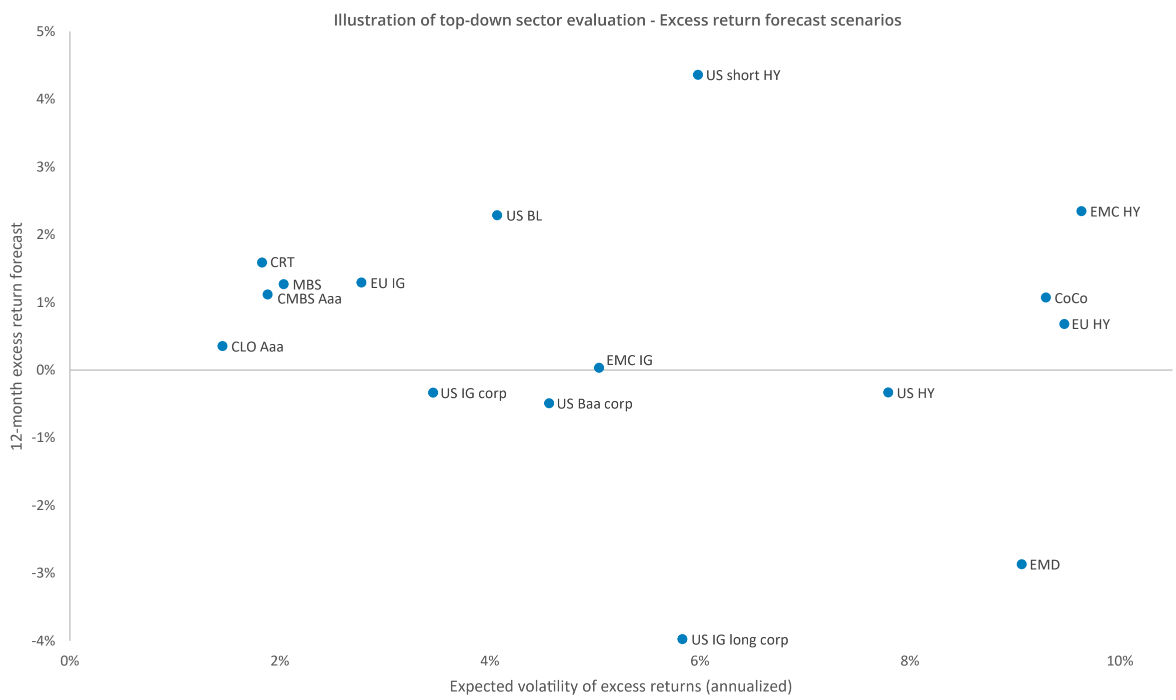
Opportunities shift over time, and risk postures should not remain static at different stages of the business cycle. Unsynchronized economic, interest-rate, and credit cycles lead to inefficiencies that often create these opportunities. The best way to identify and capture these inefficiencies is by using diversified independent sources of alpha.

Active managers may find more opportunities to add alpha when dispersion is elevated. At wider spread levels, indiscriminate investors may be rewarded simply by increasing portfolio beta, whereas when spreads are tight, a greater emphasis on discerning credit selection is prudent. This is especially true in today's environment as durations have extended over the last two decades, and spreads are at the tight end of their historical ranges. There is much less margin for error to cushion against moves up in rates/ spreads or credit-selection missteps.

But that's not to suggest opportunities aren't ripe. The recovery across spread sectors has been swift relative to past crises, but far from uniform. **FIGURE 5** illustrates our return forecasts across a core-bond plus opportunity set, which assumes spreads retrace 50% of the way toward their long-term average over the ensuing year.

FIGURE 5

Excess Return Forecast Scenario vs. Duration-Equivalent US Treasuries



As of 12/31/23. Asset classes represented by: CLO Aaa: JP Morgan CLOIE Aaa Index. CMBS Aaa: Bloomberg CMBS Aaa Index. CoCo: ICE BofA Contingent Capital Index. CRT: credit-risk transfer bonds, sourced from JP Morgan. EMC HY: ICE BofA Euro High Yield Constrained Index. EMC IG: JP Morgan CEMBI Broad Diversified Investment Grade Index. EMD:JP Morgan Emerging Markets Bond Index Global Diversified. EU HY: JP Morgan CEMBI Broad Diversified High Yield Index. EU IG: Bloomberg Pan European Aggregate Corporate Index. MBS: Bloomberg US MBS Index. USBL: Morningstar/LSTA Leveraged Loan Index. US HY: Bloomberg US High Yield Index. US Short HY: Bloomberg US High Yield 1-5 Year Index. US Baa Corp: Bloomberg US Corporate Index. US IG: Bloomberg US Baa Corporate Index. US IG Long Corp: Bloomberg US Long Corporate Index. Notes: Excess-return forecasts are vs. duration-equivalent US Treasuries. These are simulated forward-looking excess-return and volatility expectations based on analyses of historical return and volatility characteristics. The resulting forecasts are considered, along with other fundamental and technical data points, to determine which fixed-income sectors appear attractive at the time. Wellington Management determined the outlook above based on its own views and not necessarily based on objective market data. There can be no assurance that such information has been correctly determined, and nothing herein is intended to be a projection or assurance of performance of any portfolio, market, or asset class. The scenarios shown are hypothetical, for illustrative purposes only, and not representative of an actual investment. Investors cannot directly invest in indices. Data Sources: Bloomberg, BofA Merrill Lynch, Morningstar/LSTA, JPMorgan, and Wellington Management.

We observe a number of sectors whose fundamentals still appear underappreciated (notably select parts of the credit and structured-finance universes) that could potentially tighten further, though we also believe it's prudent to maintain a larger-than-typical reserve of high-quality, liquid assets so that we can exploit dislocations that could occur in the months ahead.

Conclusion

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

- Active core-plus 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 that fall below investment grade. Active managers have more flexibility on the timing of such trades and can often stay ahead of these situations.
- 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.
- Finally, greater dispersion among sectors, issuers, and individual securities provides more opportunities for active managers to potentially add value.

To learn more about the benefits of active management in fixed income, talk to your Hartford Funds representative.

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. • Mortgage-related and asset-backed securities' risks include credit, interest-rate, prepayment, and extension risk. • Foreign investments, including foreign government debt, may be more volatile and less liquid than U.S. investments and are subject to the risk of currency fluctuations and adverse political, economic and regulatory developments. These risks may be greater, and include additional risks, for investments in emerging markets.

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