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Active fixed-income management makes sense now more than ever

Passive strategies and fixed-income benchmarks exclude a significant portion of the investible market, hindering diversification and performance

By Jerry W. Miller

Cracks are beginning to appear in the case for passive investing, especially in the fixed-income world.

Morningstar data show that the majority of actively managed bond funds in the intermediate-term bond category outperformed their passive peers on average over the one-, three-, and five-year periods through the end of 2017. Contributing to this outperformance is the fact that investment-grade bond returns as measured by the Bloomberg Barclays U.S. Aggregate Bond Index, or the Agg — the most widely used benchmark for core fixed-income strategies — have declined steadily over the last five years. The Agg is down about 1.6% year to date, which is its second worst performance seven months into a year since 1999.

As the Federal Reserve continues to tighten monetary policy, exogenous risks such as trade wars and geopolitics become more evident and credit spreads widen from post-crisis tights, investors are questioning whether they are being adequately compensated for risk. This changing market backdrop mandates that investors reconsider the benefits of actively managed fixed income because of several structural flaws in the passive model.

First, passive strategies and fixed-income benchmarks exclude a significant portion of the investible market, which hinders diversification and performance. For example, the Agg represents less than half of the total fixed-income universe, excluding about $21 trillion of non-indexed securities.

Sectors under-represented or not represented in the Agg include non-agency commercial and residential mortgage-backed securities, asset-backed securities, collateralized loan obligations and any floating-rate bonds — securities that may offer attractive yields, limited duration risk and investment-grade ratings. And after a decade of deficit financing, fully 70% of the Agg now comprises low-yielding, long-duration government-related securities. Diversified institutional investors, which already have sizable U.S. debt exposure, face the prospect of lower returns if they are overly dependent on products that track such benchmarks.

In contrast, active fixed-income managers can be nimbler in exploiting under-researched and off-the-run areas. To put it simply: A bond or credit instrument excluded from an index is not necessarily unattractive. An index fund or exchange-traded fund benchmarked to the Agg may miss many of these potential diamonds in the rough.

Second, active managers have the ability to position accordingly as risks emerge and trading opportunities develop. For example, the negative impact of rate and yield curve changes on long-duration assets can be managed with active decisions around portfolio duration positioning.

Looking ahead at risks that a passive strategy may not be able to mitigate, we are concerned about the potential for meaningful downgrades in the next downturn. At the turn of a cycle, we typically see an acceleration of fallen angels — investment-grade corporate debt issuers downgraded to high yield. We have seen significant growth in this cycle in BBB corporate issuers, which are just on the cusp of investment grade and high yield. In the Agg, a record 13% of the index is BBB-rated, but in the Bloomberg Barclays U.S. Corporate Bond index, it is almost 50%.

BBB-rated corporate debt has grown by more than 200% over the past decade, which means there will likely be a record volume of fallen angels in the next wave of downgrades. When this starts to happen, passive vehicles that have investment-grade mandates would be forced sellers, while active managers with some latitude can identify downgrade risk with some diligence, and then take advantage of opportunities when forced selling reaches a consolidation period.

Lastly, active managers are better suited to analyze credit risks posed by lax underwriting standards that have prevailed in this extended bull market. At Guggenheim, we have observed a sharp increase in deals lacking covenant protection and overall aggressive deal structures — not to mention high levels of debt issued by lower-rated, first-time issuers. Rigorous credit analysis by active managers can mitigate these risks.

The benefits of an actively managed fixed-income portfolio are perhaps more pronounced than at any time since the Great Recession. Active managers have a greater ability to add value and manage risk than passive funds. Indeed, the pendulum has already started to swing back. Earlier this year, Natixis found that institutional investors have increased their allocations to active management by 6.25% since 2015.

That said, some insurance companies have been increasingly active in bond ETFs in recent years. But if those ETFs aren't truly diversified, have a liquidity mismatch and contain unanalyzed underlying credit risk, the insurer is taking significant risk by going passive. The same is true for a pension fund or any other institutional investor.

As we were reminded by turbulence at the start of 2018, nothing lasts forever in financial markets. Political uncertainty, decelerating growth prospects and further Fed tightening are just a few of the reasons to employ a different approach— one that offers investors the ability to evaluate and adjust to new risks and opportunities as they arise. Active managers are well-positioned to navigate these challenges in a continuously changing investment landscape.

Jerry W. Miller is president of Guggenheim Investments.

Important Notices and Disclosures