The reasons why active fixed income managers should continue to outperform

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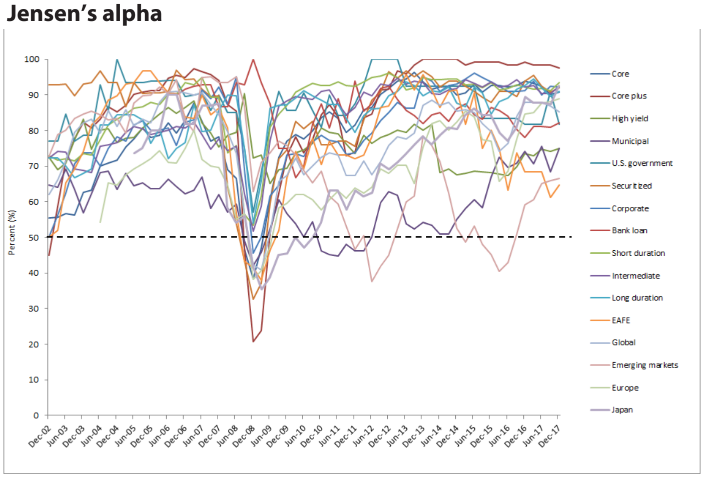
Skilled asset managers have successfully exploited inefficiencies in fixed-income markets and have demonstrated a consistent ability to add value for investors. Return data extracted from eVestment Alliance, LLC, are plotted in Figure 1, showing that a majority of active managers across several major bond categories have outperformed their benchmarks on a risk-adjusted basis over multiple 5-year investment horizons spanning a 20-year history.[1]

Figure 1: Percentage of universe producing a positive 5-year Jensen's alpha



Sources: eVestment Alliance, Wells Capital Management Inc.

The broad and persistent success of active bond managers seems to contradict the narrative that they ultimately will cede significant ground to passive alternatives, as has been witnessed recently in broad swaths of public equity markets. There is little doubt that relentless technological improvements in data reporting, transparency, computing power, and risk management techniques, which have paved the road for the passive equity revolution, also will benefit fixed-income market efficiency at the margin. But, as we outline in this summary, there are several unique structural characteristics of fixed-income markets that active investors can continue to exploit, perhaps indefinitely.

Below we identify nine discreet areas of inefficiency that we can group loosely under the headings of investor and market composition, benchmark construction, and practical complexity. Through various mechanisms, passive market participants give up value to active investors who, in the normal course of business, regularly exploit these market realities.

Areas of structural inefficiency

1. Investor and market composition

Market segmentation
The distinct, diverse, and heterogeneous nature of both debt market instruments and the market participants who trade them create preferred habitats that result in localized supply and demand dynamics. The inevitable differences in interpretation and/or reaction to news and events lead to temporary relative-value discrepancies among various segments. There is little to no mechanism for passive mandates to recognize and capture this dynamic.

Home bias
A specific and important form of segmentation is the tendency of investors to hold a higher proportion of assets in domestic bonds than that which would be prescribed by a representative global market exposure. Regional regulatory, economic, supply, sentiment, foreign exchange, simplicity, and familiarity factors may compel investors to favor local issues at the expense of the selection of securities suggested by a more open approach. This creates considerable relative-value opportunities for active managers who have a global mandate and the capabilities to exploit them.

Central bank intervention
Central banks are a major non-profit-seeking participant in many fixed-income markets. Their actions intentionally pursue macro-prudent objectives and affect yields and the price of risk in order to do so. Furthermore, their actions are not intended to surprise, meaning they often are telegraphed purposefully and thus provide a source of opportunity for forward-looking, predictive active managers.

2. Benchmark construction

Rating agencies
Traditional fixed-income indices most often mimicked by passive strategies include only rated securities. Not only do passive investors trust the accuracy of published ratings implicitly in portfolio construction, they also forgo any exposure to valid and potentially attractive unrated securities. Moreover, event studies have shown that rating agencies have been slower than the market to recognize downgrades and defaults—in other words, active managers have been able to add value by predicting them.

1. Presented gross of fees. All available historical return series in each universe over the 20-year period, including those that have terminated reporting prior to December 2017, are included in these calculations in an effort to mitigate survivorship bias in aggregate performance results.

Capitalization weighting

Traditional fixed-income indices are rooted in issuance-based methodologies whereby the bonds of relatively few large borrowers can dominate the majority of smaller issuers, often resulting in specific risks that are compensated insufficiently—that is, they do not offer additional yield. Passive strategies that track these seller-based indices automatically take on unrewarded concentration risks. In contrast, active managers assess specific risks and may pursue either appropriate yield compensation for them or improved portfolio diversification to mitigate them.

New issuance

In contrast to equities or other perpetual investments, fixed-income instruments almost always are dated; hence, the index churn created by redemption, reissue, or extension of term is a normal feature of the market. Yet, traditional fixed-income indices are refreshed monthly, making new issuance unavailable to passive investors until the end of the month they are issued. This delay would not be a material issue except that new issuance often comes with a yield advantage (called the new-issue concession) that delivers a source of outperformance to active managers.

3. Practical complexity

Heterogeneity

Fixed-income markets are complex and granular, more so than many other asset classes. The large and diverse universe of bonds, each with their individual covenants and characteristics, means that imperfect price discovery inevitably leads to pricing inefficiencies simply not found in other less complex and narrower asset classes. This provides active bond managers with a source of added value through price inefficiency and relative-value exploitation.

Economic and event risk

The primary risk to fixed-income investors is that the borrower fails to deliver some portion of coupon payments or principal—that is, the issuer defaults. The high probability of a modest positive return and low probability of a large negative return creates a negatively skewed expected return profile. Active credit risk assessment can monitor and predict credit migration, allowing active investors to avoid losers, particularly in poor systemic credit environments. Passive strategies have no mechanism to identify and avoid adverse credit events.

Liquidity and implementation challenges

All but the most liquid segments of bond markets are traded over the counter between counterparties. A substantial proportion of fixed-income markets are oriented toward smaller and/or less-credit-worthy bonds that trade with significantly less regularity and often have low liquidity in comparison to other assets classes, such as equities. This, coupled with challenges surrounding the issuance cycle, means that passive replication strategies that work well elsewhere simply are not viable in fixed income. Sampling approaches are used instead, which inevitably fail to mimic the risk profile of the underlying index—that is, there is some degree of implementation slippage inherent in passive strategies in fixed income.

What does this mean?

Given all of the inherent and, to some extent, unavoidable inefficiencies in fixed-income markets, we conclude that it is reasonable to expect active managers to be able to outperform passive managers.

Thinking through the different submarkets within fixed income, we believe the inefficiencies we have outlined above are more present in some mandates than others, and generally speaking, we view the broader, more global, more credit-intensive mandates to be the ones where the largest active management opportunity set is likely to be present. Figure 2 is indicative of where we might see these inefficiencies bear out at various instances across a sample of popular bond mandates.

On a go-forward basis, we believe there is a growing recognition of the inefficiencies we outline here, and work is underway by us and other managers to create better fixed-income portfolios. Part of this is centered on so-called smart-beta technologies that blend improved benchmark construction protocols with a richer understanding of rewarded risk factors that are present in fixed income. But these can go only so far to help generate better returns. At the end of the day, we believe most, if not all, of the inefficiencies outlined above will persist and thus can be seen as permanent. Therefore, active management in fixed income is likely to enjoy a strong future and continue to be able to show its added value in the form of notably higher net-of-fee returns and, in many cases, improved downside risk management versus the alternative of passive management.

A full version of the paper will be published that will discuss each of these inefficiencies in more detail.

Figure 2: Multiple inefficiencies affect common bond mandates

	Investor and Market Composition			Benchmark Construction			Practical Complexity		
	Market Segmentation	Home Bias	Central Bank Intervention	Ratings Agencies	Capitalization Weighting	New Issuance	Heterogeneity	Economic and Event Risk Mitigation	Liquidity and Implementation Challenges
Broad multi-sector (e.g. core-plus & unconstrained)	●	●	●	●	●	●	●	●	●
Emerging Market Debt (esp local)	●	●	●	●	●	○	●	●	◑
multi-sector (e.g. core)	●	●	●	●	●	●	●	●	◑
High Yield	●	●	●	●	●	●	●	●	●
Developed Market Sovereign	◑	●	●	◑	●	○	○	◑	○
Structured	●	●	●	●	●	●	●	●	◑
Municipal	●	●	●	●	●	●	●	●	●
Investment Grade Credit	●	●	●	●	●	●	●	◑	◑
Treasury	○	○	●	○	○	○	○	○	○

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