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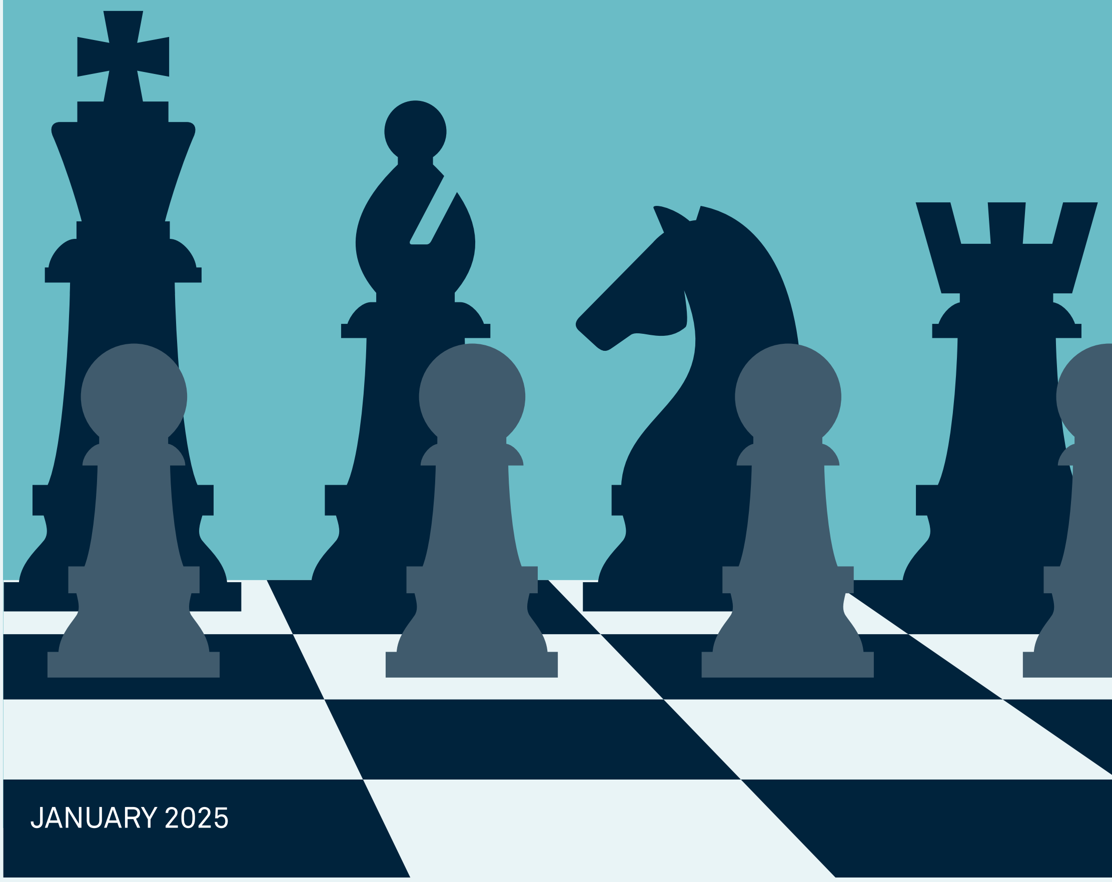
# THE CASE FOR ACTIVE FIXED INCOME



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# Executive summary

- **Active managers do generally add value in fixed income:** Contrary to popular belief, active managers often outperform benchmarks in fixed income markets, which are less efficient and transparent than equity markets. Data from MercerInsight shows that the median active managers in their customised global credit and global aggregate universes have outperformed traditional benchmarks over the past 10 years.
- **There are various strategies that can be used to enhance returns:**
  - Duration and yield curve: Positioning based on market yield outlooks or yield curve shape.
  - Security selection: Identifying undervalued securities with strong fundamentals.
  - New-issue premia: Capitalising on new debt being issued at above market yields.
  - Exploiting market fragmentation: Seeking opportunities that stem from the fragmented nature of bond markets.
  - Sector strategy: Seeking out those sectors that offer the best opportunity or avoiding those at risk.
  - Beta management: Adjusting credit risk exposures to take advantage of expected trends in credit markets.
  - Relative value: Exploiting value differences across markets.
- **The hidden risks of passive investing:** Investors in fixed income should be aware of the limitations of traditional fixed income indices when following a passive investment strategy. Unlike equity indices, which favour the largest and most successful companies, fixed income indices are skewed towards entities with the most debt. The dominance of BBB-rated corporates in investment grade indices further compounds the challenge, increasing the risk of downgrades during economic stress which may force passive investors to sell at inopportune times. When combined with fees, these factors leave many passive strategies doomed to structurally underperform.
- **Volatility is the friend of active managers:** Greater flexibility allows managers to exploit opportunities that arise from volatility, to avoid unrewarded risks, and shift to defensive assets when needed.
- **Winning by not losing:** Not all investors seek return maximisation – some just want safe, reliable cashflows. Active managers can improve returns by avoiding defaults and credit deterioration, focusing on strong fundamentals and diversified portfolios. We identify six ‘landmine‘ risks that can cause a sudden and unexpected deterioration in an issuer’s credit quality and which we believe are crucial for reducing default risk.

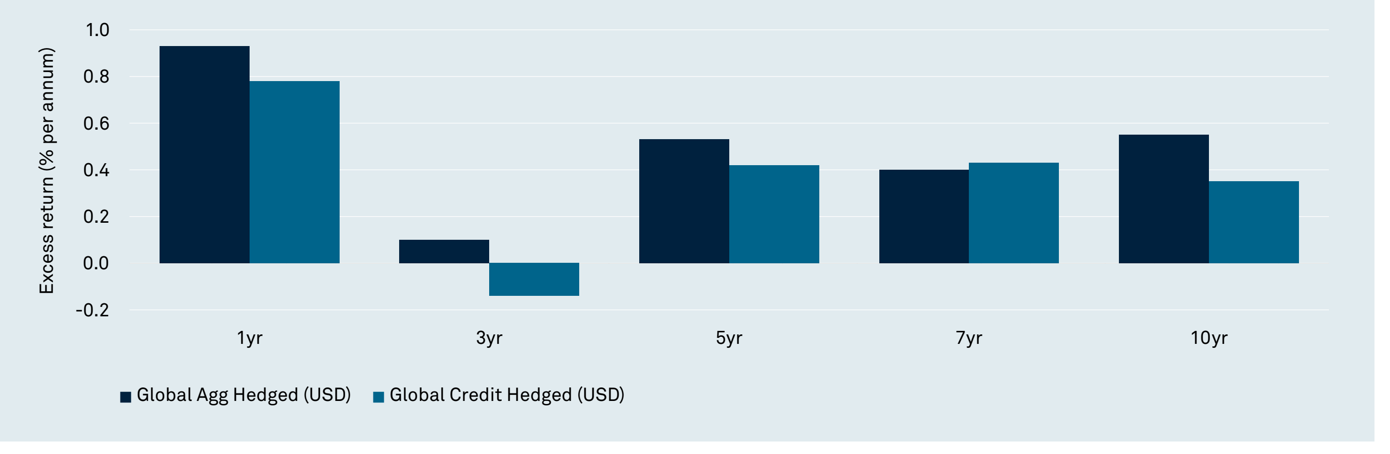
# Active fixed income managers do generally add value

Many investors believe that active managers struggle to outperform or even match their benchmarks and extrapolate this idea across all investment assets. Research, repeated over decades, suggests that this is certainly true of many active equity strategies. But this isn't generally true in fixed income. Bond markets can be less efficient and transparent than equity markets, presenting inefficiencies that can be exploited by active managers.

The rise of passive investment has, if anything, exacerbated these inefficiencies in bond markets. Data from MercerInsight shows that despite a short-term dip over a three-year period, the median active manager in their custom universes for both global credit and global aggregate strategies has generated returns well above traditional benchmarks over the past 10 years (see Figure 1).

The potential for active managers to enhance returns in fixed income means that it is important not to view an allocation to bonds via the lens of yield alone. Careful thought needs to be given to manager selection, with a focus on ensuring a robust investment process that provides comfort that excess returns are repeatable into the future.

**FIGURE 1: MEDIAN MANAGERS HAVE GENERALLY OUTPERFORMED TRADITIONAL INDICES IN FIXED INCOME MARKETS[1]**




> The potential for active managers to enhance returns in fixed income means that it is important not to view an allocation to bonds via the lens of yield alone.

[1] Source: MercerInsight data as at Q3 2024. This is a customised universe. Net of fees and hedged into US dollars. Traditional indices used for comparison are Bloomberg Global Aggregate Index (hedged into USD) and Bloomberg Global Credit Index (hedged into USD).

# Beating benchmarks and exploiting inefficiencies

## 7 WAYS ACTIVE INVESTORS CAN SEEK TO ENHANCE FIXED INCOME RETURNS

**There are a range of strategies that fixed income managers can use as they seek to add value in fixed income. These include:**

### 1 Duration and yield curve strategies:

Active managers can strategically position their portfolios based on their outlook for market yields. If they anticipate a decline in yields, they might add longer-maturity issues, which are expected to benefit the most from such a scenario. More sophisticated strategies may involve targeting specific segments of the yield curve or varying investments across different maturities. For instance, if credit spreads are relatively uniform across maturities, a manager might overweight credit exposure in shorter maturities while favouring government bonds in longer maturities. This enhances portfolio yield while minimising the impact of any future widening of spreads.

### 2 Security selection via fundamental analysis:

Fundamental credit analysis aims to identify securities whose valuations do not accurately reflect the company's current and future fundamental strength or weakness. When selecting an issuer's securities, it is crucial to choose those with robust balance sheets and easy access to money markets. Additionally, issuers may need to be stress tested for risks such as litigation, new regulations, environmental or social factors, and potential mergers or acquisitions.

### 3 Capturing new-issue premia:

Unlike equities, fixed income investments generally have a fixed maturity date. As they approach this date, the issuing sovereign or company often needs to return to the market to refinance the debt. They may also issue new debt for various reasons, such as funding growth or acquisitions. In the corporate world, issuers often offer new debt at slightly higher yields than the market to attract buyers – a phenomenon known as new issue premia. Active managers can capitalise on this by keeping a close eye on opportunities in primary issuance markets.

### 4 Exploiting market fragmentation:

When an investor buys an equity, the process is typically straightforward, with a single class of share to purchase. However, when an investor buys a bond, a single corporate issuer may have a range of debt issues across different maturities and currencies, each with different legal documentation, and even exposed to different parts of the capital structure. Each issue may be a different size, with variable levels of liquidity. This fragmentation introduces a range of options for an active manager to consider. For example, an investor might decide to target a higher yield by purchasing the lower-rated subordinated debt of a large corporate issuer. Although the risks are higher in the event of a default than if the investor bought a higher-rated issue, the investor may judge that the substantial size and strong market position of the corporation significantly mitigates this risk.

### 5 Sector strategy:

Whole industry sectors in fixed income markets can sometimes have valuations that do not reflect the current or future strength or weakness of their constituent companies. This is often due to the sector experiencing a slightly differentiated economic cycle than the broader market. Additionally, some industry sectors may become over-leveraged relative to others, making them less attractive to active managers. Importantly, active managers have the flexibility to avoid investing in sectors where they believe the outlook is concerning.

### 6 Beta management:

The constituents of a bond index represent a certain level of aggregate credit risk at any given time. Active managers have the flexibility to take on higher or lower credit risk compared to the index. This decision can be influenced by the stage of the credit cycle, average valuations, or a tactical market view. A prime example is the Bloomberg Aggregate Index, which includes both government and corporate bonds. Active managers can adjust their credit exposure by overweighting or underweighting these asset classes based on their relative attractiveness.

### 7 Relative value:

The value of fixed income instruments can fluctuate across markets or between segments of the fixed income universe at any given time. For instance, a large US company may issue bonds in US dollars, Japanese yen and euros, with the spread varying depending on the currency of issue. Active managers can capitalise on these variations by overweighting the credit in the market that offers the greatest value and underweighting the credit in the market that offers the least value.

Notably, these strategies can be used not just to outperform a specific benchmark or index. They can also be used by active fixed income managers seeking to generate an absolute, positive return through different market conditions.

## THE HIDDEN RISKS OF PASSIVE FIXED INCOME INVESTING

Investors in fixed income need to be aware of the shortcomings of many traditional fixed income indices, especially when pursuing a passive investment strategy. Unlike equity markets, where traditional indices are tilted towards the largest and most successful companies, fixed income indices are skewed towards governments or companies with the most debt. This can lead to poor diversification, as highly indebted countries or sectors become a larger part of the index. Passive investors have exacerbated this issue by eroding the traditional role of bond markets as 'bond vigilantes', where investors historically refused to extend further credit to governments or corporations pursuing unsustainable policies or business models.

Turnover in fixed income indices is also far higher than in equity indices. Bonds drop out of many indices as they approach maturity or are downgraded below a qualifying credit rating. This challenge for passive investors is further compounded by the fact that investment grade indices have become dominated by BBB-rated corporates over time as large corporates have come under pressure from shareholders to run higher levels of debt. As illustrated in Figure 2, BBB-rated issues now represent just under 50% of the Bloomberg US Investment Grade Corporate Index, while the best rated AAA and AA-rated issues represent under 10%.

This heightens the risk that even large corporates can be downgraded to below investment grade during times of economic stress, with passive investors forced to sell at the worst possible time. A combination of fees and the transaction costs needed to keep up with index changes mean many passive strategies are doomed to structurally underperform.

**FIGURE 2: THE SLOW UPWARD CREEP OF BBB-RATED WITHIN THE BLOOMBERG US INVESTMENT GRADE CORPORATE INDEX[2]**


> Most passive strategies due to their structural nature, tend to underperform.

Investment Managers are appointed by BNY Mellon Investment Management EMEA Limited (BNYMIM EMEA), BNY Mellon Fund Managers Limited (BNYMFM), BNY Mellon Fund Management (Luxembourg) S.A. (BNY MFML) or affiliated fund operating companies to undertake portfolio management activities in relation to contracts for products and services entered into by clients with BNYMIM EMEA, BNY MFML or the BNY Mellon funds.

[2] Source: Insight and Bloomberg. Data as at 31 December 2024.

# Volatility is the friend of active managers

## VOLATILITY CREATES INVESTMENT OPPORTUNITIES

Bonds are misvalued more frequently during periods of market volatility. Whether the market mood is fear or exuberance, any sharp market moves can become big opportunities for active managers with robust investment processes.

Bond market volatility has grown markedly in the past few years (see Figure 3). Between 2012 and 2020 low interest rates acted to supress market volatility for long stretches of time. The COVID pandemic and the rise in interest rates since 2022 has led to more regular volatility events. We expect volatility to remain elevated given the current macroeconomic backdrop. This is not just due to higher interest rates, but also geopolitical instability, deglobalisation and fiscal looseness.

**FIGURE 3: BOND MARKET VOLATILITY HAS BEEN ELEVATED OVER RECENT YEARS[3]**


[3] Source: Insight and Bloomberg. Data as at 31 December 2024. The MOVE Index (MOVE:GIF) uses an options-pricing model based on a weighted average of option probabilities to reflect collective expectations for future volatility in the fixed income market.

## THE MORE FLEXIBILITY, THE GREATER THE OPPORTUNITY

In our view, the greater the flexibility the active manager is given, the greater the number of opportunities they could exploit, while having the ability to invest with conviction when an opportunity is particularly compelling. It also provides the flexibility to avoid unrewarded risk, and to shift into more defensive assets or sectors if the outlook deteriorates.

When we look at the returns of some major segments of fixed income markets (see Figure 4), it is clear that both returns and volatility have diverged considerably over the 12 months to the end of December 2024. It is also a lesson that markets may not behave as you expect, with US high yield credit generating higher returns with lower volatility than the US Treasury index.

An active manager can work to pinpoint the underlying reasons for such trends and seek to take advantage of them. Ultimately, in fixed income, incremental returns from multiple sources are key to adding value over the long-term.

**FIGURE 4: DIVERGENT RETURNS[4]**

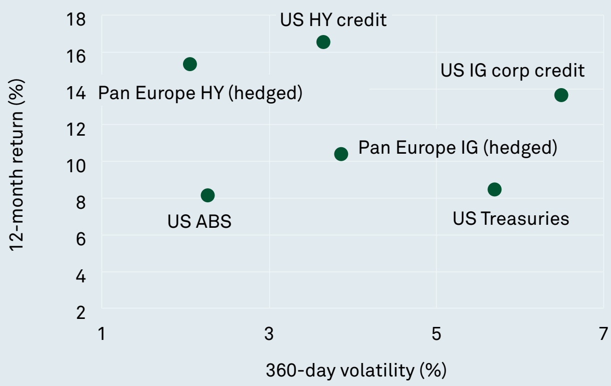
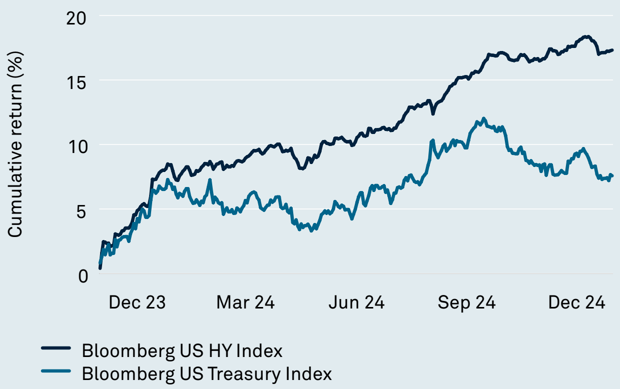



**FIGURE 5: US HIGH YIELD HAS BEEN LESS VOLATILE THAN TREASURIES[5]**




[4] Source: Insight and Bloomberg. Data as at 31 December 2024. Uses Bloomberg Index data in USD for all fixed income segments.
**US High Yield Credit** - Bloomberg US Corporate High Yield Total Return Index (USD).
**US Investment Grade Corporate Credit** – Bloomberg US Corporate Investment Grade Total Return Index (USD).
**US Treasuries** – Bloomberg US Treasury Total Return Index (USD).
**Pan Europe High Yield (Hedged)** - Bloomberg Pan-European High Yield Total Return Index Hedged (USD).
**Pan Europe Investment Grade (Hedged)** - Bloomberg Pan-European Investment Grade Total Return Index Hedged (USD).
**US Asset Backed Securities** – Bloomberg Agg ABS Total Return Index (USD).

[5] Source: Insight and Bloomberg. Bloomberg US Corporate High Yield Total Return Unhedged Index (USD). Bloomberg US Treasury Total Return Unhedged Index (USD). Data as at 31 December 2024.

# Winning by not losing

## SOME INVESTORS ARE FOCUSED ON CASHFLOWS RATHER THAN RETURN MAXIMISATION

Of course, not everyone invests in fixed income with the aim of maximising returns. Many do so as they require safe and predictable cashflows over time.

For this type of investor, finding undervalued securities is not the only way to improve on passive investing. Such an improvement can also be made by creating a portfolio that aims to avoid defaults and material loss from deteriorations in creditworthiness. This is the approach used for ‘buy and maintain’ portfolios, where securities are selected solely because of the manager’s confidence that they will provide a steady reliable income for their full term.

For buy and maintain strategies companies need to have strong stand-alone fundamentals. So, they must have sound reporting, strong risk credentials and a clear ability to repay, or hold sufficient assets to make good.

Diversification is also key to this type of strategy, with typical limits of 1% to 2% per name in a portfolio – a stark contrast to a market-weighted, index-tracking approaches that would allocate more to the most indebted firms.

## LANDMINE RISKS CAN RADICALLY AND UNEXPECTEDLY CHANGE CREDIT QUALITY

Reducing default risk is crucial when seeking to minimise the downside for fixed income investors. In our view there are six potential ‘landmines’ that can cause a sudden, unexpected deterioration in whether an issuer can repay its debt. Understanding these landmine risks also help to determine whether the spread available on a security is adequately compensating for its corporate risks or not.

**1 Liquidity risk:** How likely a company is to pay the coupons on outstanding credit, and to pay back capital on maturity, even if it is unable to refinance its debt for a period of time, such as two years.

**2 Regulation and litigation risk:** Regulatory risk is largely sector dependent. Sectors with a high level of regulatory oversight, such as the utility sector, can be subject to limits on profitability or have a minimum capital expenditure requirement. Similarly, banks face a higher level of regulation since the global financial crisis. This measure also looks at the potential for a company to be subject to litigation and the risk of any ongoing legal action against the company.

**3 Environmental Social and Governance Risk (ESG):** This is a measure of how ESG risk can hurt the financial viability of a corporate. This measure can include information taken from Insight’s proprietary Prime ESG ratings framework, which gives a corporate an ESG rating based on various data inputs in seeking to highlight its exposure to and management of ESG risks.

**4 Climate risk:** This measures a company’s exposure to physical climate risk or transition risk due to climate in either its location, product range or supply chain. This measure can include information taken from Insight’s Prime climate risk ratings framework, which gives a corporate a rating based on various data inputs in seeking to highlight its exposure to and management of climate risks.

**5 Event risk:** A key event risk is whether the company might buy another company or be bought out itself, which could significantly affect its debt burden or repayments. A late equity-market cycle with low financing costs will typically result in higher M&A activity; companies that have poor relative equity performance over one, three and five years may be at risk.

**6 Leveraged buyout risk:** This seeks to reflect a company’s risk of facing a bid from a leveraged buy-out by private equity. Such a buyout can put more debt on a corporate’s balance sheet such that it is less able to repay its debt in a high-interest rate environment.

# Conclusion

Active investors have a multitude of strategies at their disposal to enhance fixed income returns. By utilising duration and yield curve strategies, engaging in meticulous security selection, capturing new issue premia, exploiting market fragmentation, and employing sector strategies, they can navigate the complexities of fixed income markets and seek to add incremental return. Managing credit beta and identifying relative-value opportunities provide further opportunities to optimise portfolios.

At Insight, we believe that when executed with precision, these approaches can significantly enhance performance in fixed income investments, whether the goal is to maximise returns or ensure steady cashflows. When choosing an active manager, we urge investors to check on how consistent managers are in beating the benchmark. We believe if a manager can show a higher level of consistency to others, this is likely to be a sign of a more robust investment process and one with a judicious approach to risk-taking.

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