Market and Economic Insights

Spotlight: Opportunities in active fixed income

In our May 2020 spotlight on active management, we discussed the shortcomings of issuance-based indexes such as the Bloomberg Barclays U.S. Aggregate Index and noted our expectations for increased dispersion among sectors and individual credits. We believed that these circumstances created favorable conditions for active managers in fixed income. The market now appears to have adopted this view as well. Within taxable bonds, nearly two-thirds of October's $62 billion net inflows went to active managers. This followed two consecutive quarters of sizable net inflows to active fixed income strategies ($124 billion in the third quarter of 2020 and $101 billion in the second quarter).

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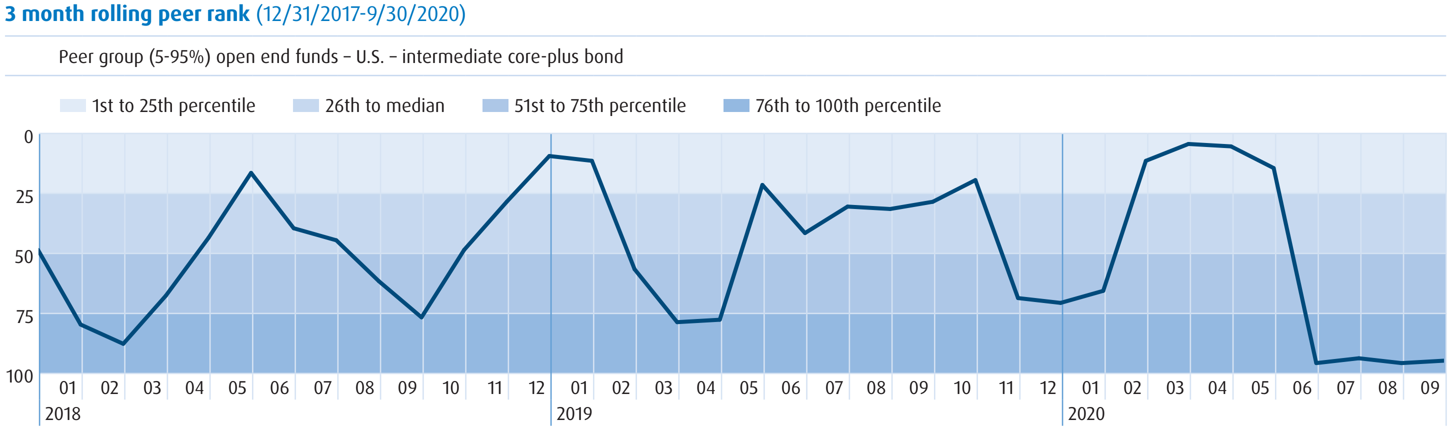
Since late spring, active fixed income managers' performance has been unprecedented. The three-month rolling peer rank for the Bloomberg Barclays U.S. Aggregate Index has been near the bottom of Morningstar's intermediate core-plus bond category during the period. In other words, nearly all active managers have outperformed passive strategies.

Bloomberg Barclays U.S. Aggregate Bond TR USD
3 month rolling peer rank (12/31/2017-9/30/2020)



Source: Morningstar Direct

Why has active management outperformed?

Since March, the federal funds rate's upper bound of 0.25% has kept Treasury returns nearly nonexistent. An overweight to any other part of the fixed income market would have been additive to relative performance for the eight months ending November 30. The average active manager had a material underweight (-23%) to Treasurys as of the third quarter of 2020. This has boosted performance, with the Bloomberg Barclays U.S. Aggregate Bond Index returning 4.08% while Treasurys returned 0.05% during this period.

The "plus" sectors have also been additive to returns since the initial shocks of the pandemic in March. The high-yield market was driven by the prospects for an improving economy, with the crisis paralleling a natural disaster rather than a traditional recession. Unprecedented fiscal and monetary support, including the Federal Reserve's (Fed's) first foray into buying corporate bonds, contributed to these returns. Spreads on high-yield bonds started this period at 880 basis points and ended at 412 basis points — a contraction of 468 basis points. Emerging-market debt experienced a similar rally. Significant fiscal stimulus and the monetary policy response from global central banks, including the International Monetary Fund, supported the contraction of spreads, as did the broad economic re-opening during the summer months.

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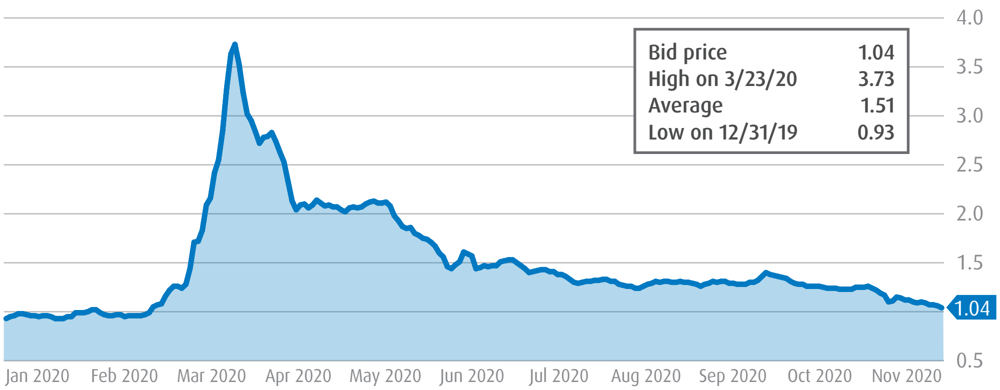
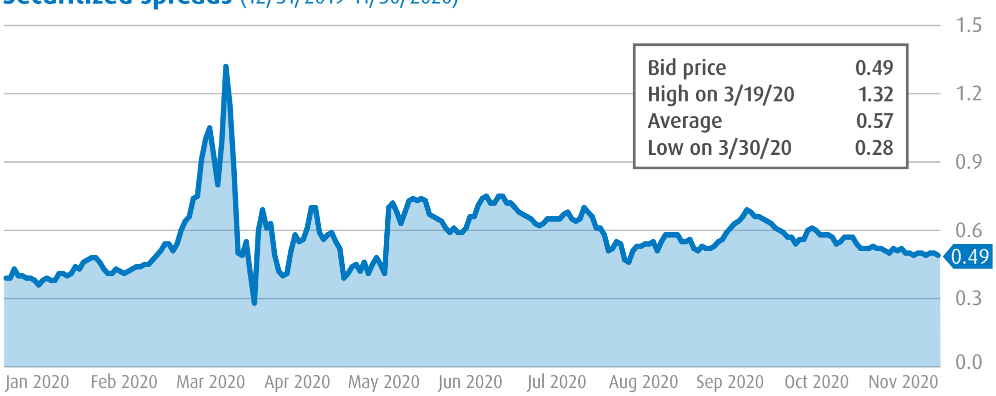
Corporate spreads (12/31/2019-11/30/2020)



Source: Bloomberg

> Spreads on the corporate and securitized sectors have now compressed to near pre-COVID-19 levels.

Securitized spreads (12/31/2019-11/30/2020)



Source: Bloomberg

This compression led to meaningful returns for these areas. A recovering economy and the Fed's role as an indiscriminate buyer helped drive the relative outperformance of mortgage-backed securities and investment-grade corporates. For the eight-month period ending November 30, mortgage-backed securities outperformed Treasurys by 76 basis points while investment-grade corporates outperformed Treasurys by 1,349 basis points.

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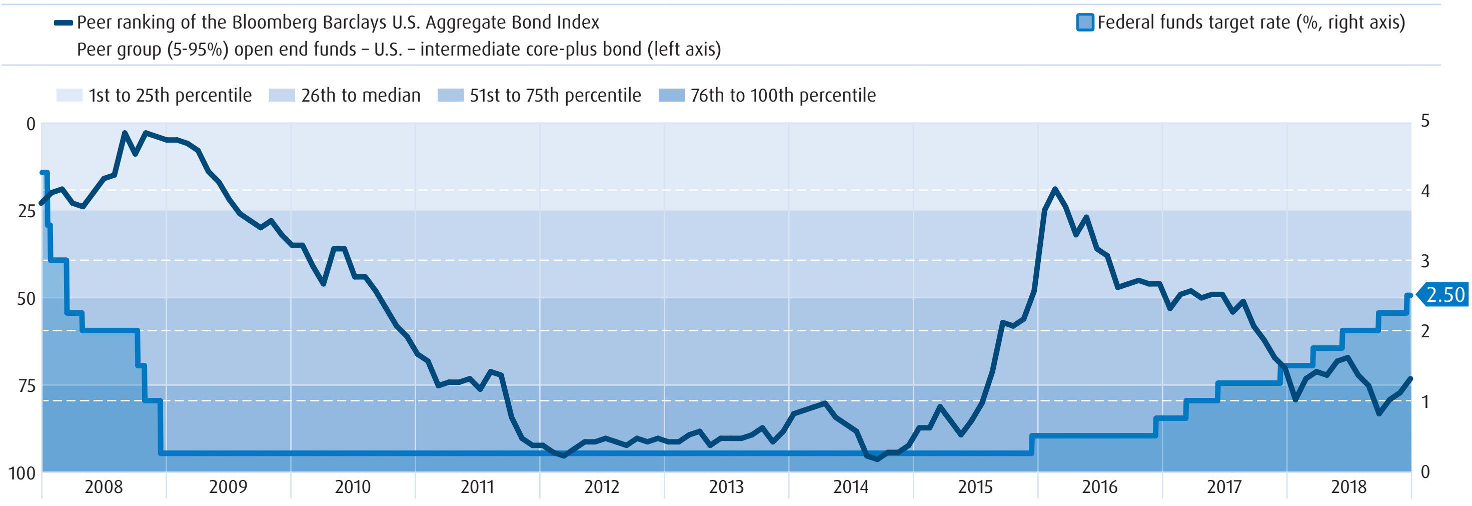
Conditions remain favorable for active management

With the Fed's commitment to an average inflation target of 2%, we believe rates will remain low for an extended period. The last time the Fed pushed rates to this low level, passive fixed income strategies significantly underperformed. On a rolling three-year basis, passive was a bottom-quartile performer from 2012 to 2015.

Passive underperformance



Source: Bloomberg, Morningstar Direct

Active managers have a number of levers to pull to help outpace a passive benchmark, including sector/quality allocation, security selection and yield curve/duration management. By increasing allocations to agency mortgage-backed securities, a portfolio can achieve a higher yield without taking on too much additional risk. Dispersion within sectors and among individual credits is likely to remain high as the economy works its way through the end of the pandemic to a normal environment. Skilled credit analysts and portfolio managers can adjust their investments to take advantage of these relative-value opportunities.

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In addition, we believe there may be room for further spread compression in parts of corporate credits. Good active managers can pivot away from defensive, stay-at-home issuers to more cyclical names as the business cycle enters the expansion stage.

We prefer active managers who selectively invest in plus sectors, such as high yield and emerging-market debt. These out-of-benchmark areas can offer alpha opportunities to managers who are selective in picking off credit.

Finally, while we see an increased opportunity set for active management, we focus on the most efficient allocation of our fee budget for client portfolios and allocate to active managers that we believe can add significant value on a net-of-fees basis.

Risks in the post-pandemic environment

This isn't to say the outperformance of active management in fixed income is guaranteed. An economic downturn or negative credit environment would propel passive investments over active management. However, with vaccines imminent and economies re-opening, we believe these risks are low, at least for the time being.

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Bloomberg Barclays U.S. Aggregate Bond Index is an unmanaged index that covers the U.S. investment-grade fixed-rate bond market, including government and credit securities, agency mortgage pass-through securities, asset-backed securities and commercial mortgage-based securities. Investments cannot be made in an index.

Intermediate-term core-plus bond portfolios invest primarily in investment-grade U.S. fixed income securities including government, corporate and securitized debt, but generally have greater flexibility than core offerings to hold non-core sectors such as corporate high yield, bank loan, emerging-market debt and non-U.S. currency exposures.

Basis points (bps) represent 1/100th of a percent (for example: 50 bps equals 0.50%).