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The Case for Active Management: What May Work for Equities, Doesn't Work for Fixed Income

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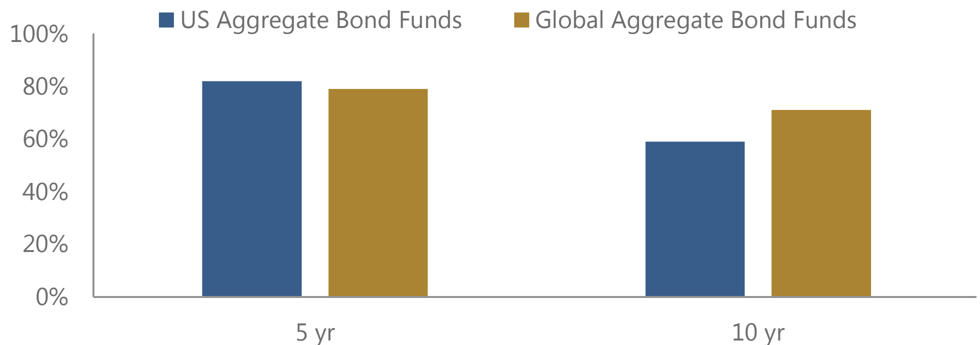
Raman Srivastava, CFA
Deputy Chief Investment Officer

The increasing popularity of passive strategies for equity investment raises the question of whether similar approaches can and should also be applied to fixed income markets. While passive strategies' promises of reduced costs may seem attractive in the current low-interest rate environment, we believe that the size, variegated nature and inefficiency of the $46 trillion global bond market offers opportunities that astute active managers are uniquely able to capture on behalf of their clients.

The ability of fixed income managers to deliver alpha over time shows up clearly in performance data. As the chart below indicates, active managers of US aggregate and global aggregate portfolios have outperformed their benchmarks on a net-of-fees basis over the 5 and 10-year periods up to September 30, 2016.

Percentage of Funds Outperforming Their Benchmarks (net of fees)



Source: Morningstar as of September 30, 2016

Active fixed income managers especially stand out in the corners of the market which are more niche, and hence less followed. In fragmented and inefficient categories—such as US municipal bonds, securitized bonds and emerging market debt—the rigorous research and skillful security selection practiced by active managers are indispensable in achieving return while managing risk. In markets such as these, where the quality and quantity of information about issuers' creditworthiness varies widely, active investment managers have a clear advantage over index-based strategies that may overlook entire sectors of the investible universe. The Bloomberg Barclays U.S. Aggregate Bond Index, for example, doesn't include high-yield bonds, inflation-linked securities or floating rate debt.

Instead of the precise security selection practiced by active managers, passive investment offers the opposite. Like trawler nets scooping up debris as well as fish, index investing in fixed income pulls in all sorts of things an investor might prefer to avoid. This includes large quantities of sovereign bonds whose prices have been inflated by central banks' policies of buying up large swathes of debt without concern for price. This problem is an especially serious one for passive strategies investing in global bonds. Consider the makeup of a passive exchange-traded fund (ETF) based on the Bloomberg Barclays Global Aggregate Index. At present, 25% of its holdings are bonds with negative interest rates and nearly 40% are securities with yields of fewer than 50 basis points. Even when rates increase, this "bycatch" will remain in the portfolio, placing a drag on overall return.

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While index-based strategies expose investors to securities they might prefer to avoid, they can also deny them opportunities for exposure to securities they might otherwise consider. For instance, a passive strategy may have index rules that prevent exposure to so-called "fallen angels"; on the other hand, the manager of an active strategy may thoroughly research the fundamentals of these issuers and identify value. Index-based investing will include or exclude securities based on the judgment of ratings agencies, which alone can be inefficient.

It may be worth considering that the rise of passive equity investment has not been driven by passive strategies' track record of success at generating alpha. Rather, it reflects a lowering of expectations on the part of investors who have lost confidence that active management can deliver consistent outperformance.

While this lower-cost, lower-expectation passive approach may make sense in today's highly-efficient equity market, adopting a similar approach to the far larger and more diverse fixed income universe would mean trading away time-tested tools for generating alpha and managing risk in favor of a false economy and diminished expectations.

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