FIXED INCOME

10 reasons for active management
in fixed income

CONTENTS

Introduction

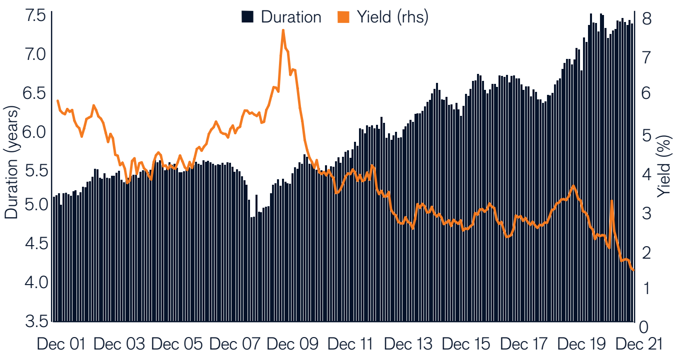
Active management seeks higher returns over time than a specific benchmark, typically through discretionary security selection. By contrast, passive management seeks to track index returns, typically by holding securities in line with their constituent weight in an index. There is ongoing debate about the implications of passive investment on securities markets in terms of correlation of returns and the potential for a reduction in security specific information contained in prices. The purpose of this document, however, is to set out ten reasons why we believe active management is desirable within fixed income funds. It is split into two sections:

- The first five reasons explore some of the inherent drawbacks that can exist within indices and by extension portfolios that passively track an index.
- The second five reasons look at some of the distinct alpha opportunities that can exist within fixed income markets.

1. Time mismatch – duration risk in indices

Borrowers and lenders (investors) often have conflicting desires in terms of the yield paid on bonds. Investors would like a high yield, yet borrowers want to minimise their cost of capital so they tend to issue long-dated bonds when rates (yields) are low and short-dated bonds when yields are high. This contributes to higher duration (sensitivity to changes in interest rates) when yields are low.

Figure 1: Duration exposure increases when yields are least attractive



Source: Refinitiv Datasteam, ICE BofA Merrill Lynch Global Corporate Index, effective duration and effective yield, 31 December 2001 to 31 December 2021.

Indices, therefore, tend to exhibit duration risk that suits the borrowing issuer better than it does the lending investor. Blindly investing in the index, with little thought of its constituent characteristics may have its disadvantages. Duration risk is likely to be of increasing importance as central banks move away from highly accommodative monetary policy.

- Active management allows duration to be managed rather than beholden to an index construction, so that any interest risk taken in an active portfolio is intended.

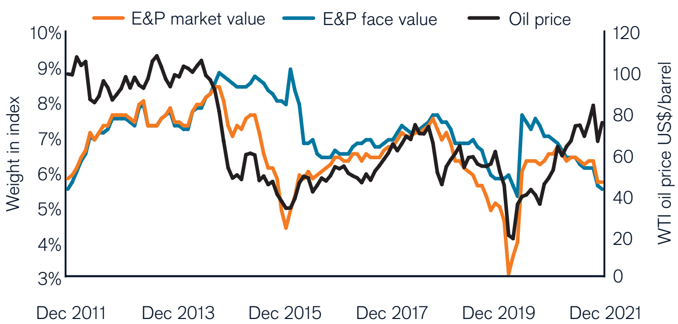
2. Indices are biased towards indebtedness

It is an irony of indices that while equity indices display survivorship bias and reflect successful companies, corporate bond indices are populated by those companies that carry the most debt.

Of itself, this need not be a concern. Debt is generally tax efficient (interest charges are often tax deductible) and a useful source of capital. Most companies can service the debt, although the lower down the credit spectrum the more questionable this capacity. It does, however, mean investors need to be aware of the creditworthiness of an issuer and potential concentration risks as heavier borrowers constitute a larger share of the index.

A rising oil price early in the last decade encouraged Energy explorers and producers (E&P) to borrow to drill, with debt issuance lifting the sector's weight in high yield. When the oil price collapsed in 2014-15, the face value of Energy E&P debt within the index had reached a high, although falling bond prices pulled down the market value sector weight. Leisure in 2020 faced a similar crisis as revenues collapsed and borrowings rose with debt issuance and downgrades from investment grade lifting the weight of this sector.

Figure 2: Debt levels affect sector weights



Source: Bloomberg ICE BofA US High Yield Index, WTI spot crude oil price, 31 December 2011 to 31 December 2021.

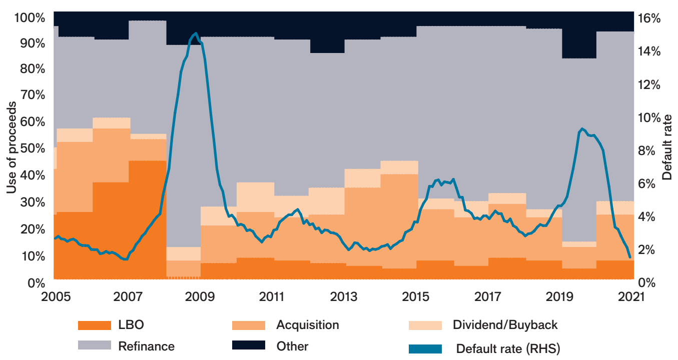
- Indices by their nature reflect the past rather than the future. An active approach can take pre-emptive action to avoid downside risk, although poor decision-making could lead to worse performance.

3. Time mismatch – credit risk in indices

There exists a time mismatch between issuer's borrowing desires and the economic cycle. Companies tend to borrow for acquisition or shareholder-friendly activities at the peak of an economic cycle, i.e. right before a downturn. Moreover, following periods of prolonged economic expansion, market participants tend to become complacent so lending standards typically relax and investors become less risk averse. This sows the seeds of future defaults as weak borrowers are able to receive funding but go on to default as the economy sours. This is visible in the chart below where bondholder-unfriendly activities such as leverage buy-outs and share buy-backs (highlighted by the warm colours) increase during economic late cycle expansion and contribute to subsequent defaults.

The pick-up in the default rate in 2020 was unusual in that it was sparked by an exogenous factor, the coronavirus pandemic. Moreover, emergency support from central banks and governments enabled – indeed encouraged – viable corporate borrowers to refinance, while abrupt loss of revenues sent some less viable companies into default. This distorted the typical pattern of the credit cycle.

Figure 3: US high yield bonds - use of proceeds and default rate (%)



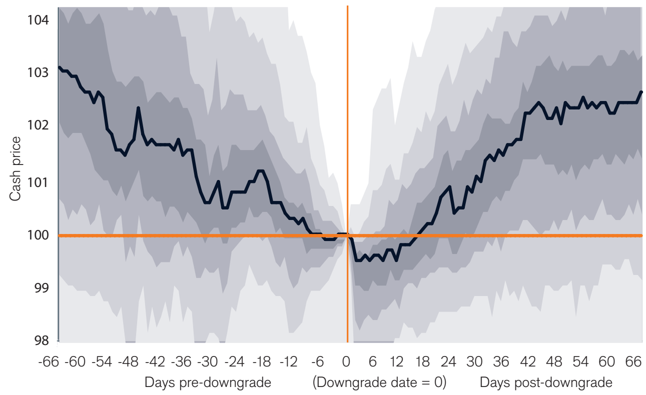
Source: Morgan Stanley, S&P LCB, US high yield issuance use of proceeds, Moody's US speculative grade (high yield) default rate, December 2005 to December 2021.

- An active management approach offers the potential to detect problems early in an issuer since there is often a lag between deteriorating fundamentals and this being picked up by the wider market.

4. Index changes create crowded trades

Passive approaches that replicate the index are likely to suffer from the effect of crowded trades. This is because when bonds move in or out of the index there will be a rush of investors seeking to engage in the same trade. For example, when an investment grade rated bond is downgraded to sub-investment grade, i.e. it becomes a fallen angel, it may fall out of an investment grade index, obliging index replicators to sell the bond. Historical data suggests that immediately post-downgrade is often the worst time to sell, as reflected in the chart below.

Figure 4: Price performance of bonds following a downgrade (2003-2016)



Source: Morgan Stanley Research, Bloomberg, Markit, February 2016. Note: Each colour band represents one decile; dark line represents sample median. Based on a universe of 89 fallen angel issuers going back to 2003.

Past performance does not predict future returns.

In contrast, active portfolio managers can anticipate such movements and sell ahead of the event (before a bond is rated sub-investment grade) or recognise positive trends and invest ahead of a bond being upgraded.

- Active managers can use pre-emptive action ahead of ratings changes with a view to profiting from ratings changes or avoiding losses associated with downgrades.

5. Performance divergence within passive funds

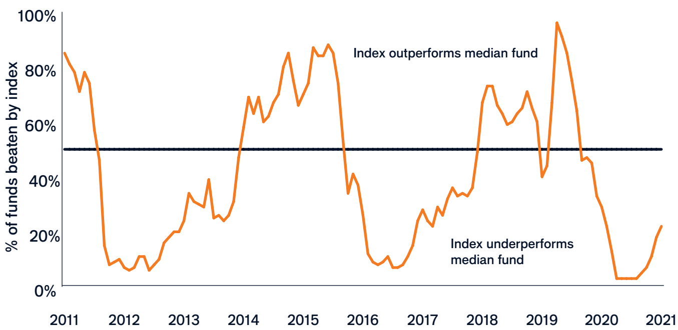
The fees associated with tracking the index make it almost a mathematical impossibility that an investor in a passive index-tracking fund can match the index. Over time, the performance divergence between the tracker and the index is likely to grow as the cumulative costs mount. Factors that will cause the passive fund to diverge from the index include:

- Transaction costs related to buying and selling the underlying securities
- Accrual of ongoing charges by the passive manager
- Efficiency of managing cash flows into and out of the passive vehicle

Semi-passive approaches that incorporate active management elements might be able to beat the benchmark.

The bigger question is whether it is desirable to track the benchmark. The chart below compares the Bloomberg US Aggregate Total Return Index with a peer group comprising actively managed Intermediate Core Bond and Core Bond Plus funds, using rolling 12 month returns. Index-tracking funds are excluded. The orange line shows the percentage of active funds beaten by the index. Over the past ten years the median active fund has beaten the index 59% of the time.

Figure 5: Percentage of funds beaten by index in Intermediate Core Bond & Core Bond Plus peer group



Source: Morningstar, Janus Henderson Investors; peer group is Intermediate Core Bond & Core Bond Plus Morningstar Categories, institutional share class, index funds filtered out; Index is Bloomberg US Aggregate Total Return Index; monthly datapoints, based on rolling 12-month total returns, USD, 31 December 2011 to 31 December 2021.

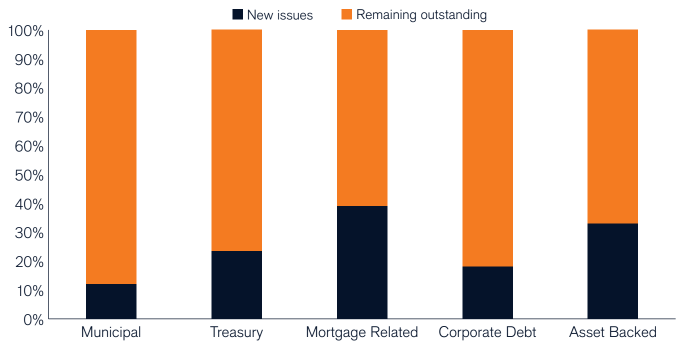
Past performance does not predict future returns.

▶ An active management approach offers an opportunity to match or beat the index. An active approach does carry greater risk, however, as poor investment decisions could lead to underperformance

6. New issues are an integral part of fixed income investing

The bond market is heavily influenced by new issues, a function of the fact that many bonds have finite maturities and so regularly need replacing. Taking the US market as an example, the chart below shows that it is not uncommon for new issues to make up a fifth of the market.

Figure 6: New issues typically represent a high proportion of the total US debt market (12 months to Q3 2021)



12 months to Q3 2021	Municipal	Treasury	Mortgage Related	Corporate Debt	Asset Backed
Outstanding	4,036	21,873	11,906	10,010	1,476
New Issues	492	5,072	4,756	1,904	498

Source: SIFMA data, Janus Henderson chart construction, grey represents new issues while orange represents total amount outstanding at Q3 2021 less the new issuance amount in four quarters to Q3 2021 (inclusive). Treasury represents long-term debt only. Data at 28 February 2022.

New bonds are typically issued at a slight discount (ie with a higher credit spread) to existing issues to attract investors and allocations are achieved through negotiation. Knowing when to participate and at what levels can give an active investor a potential advantage over a passive manager.

▶ Active managers' credit analysis and their relationships with issuing intermediaries can help maximise value from new issues.

7. OTC market and variety create relative value opportunities

Unlike the equity market where trading is largely conducted on exchanges, a large proportion of fixed income investing, particularly in the corporate space, takes place over-the-counter (OTC), with prices often reflecting some negotiation between buyer and seller. This reflects three key reasons: the large size of deals (which are typically institutional in size); the lower frequency of trading; and the sheer variety and number of bonds. Consider a company such as Vodafone. It has one primary-listed ordinary stock (albeit trading on multiple venues) but 64 different bonds. Banks are even more complicated. HSBC, for example, has more than 1,300 bonds in issue (data sourced from Bloomberg at 28 February 2022).

The variety of bonds reflects the capital requirements and market environment at the time of issue, and this typically leads to different coupons and maturities and decisions on whether to make the bonds senior or subordinate in the capital structure. Issuers often issue bonds in different currencies as well in order to access liquidity in other markets or to align liabilities with the currencies in which revenues are earned.

This often creates relative value within the capital structure of an individual issuer so that bonds of different seniority or maturity may outperform at any one time.

Figure 7: Example of corporate capital structure

Source: Janus Henderson Investors, at 28 February 2022. For illustrative purposes only.

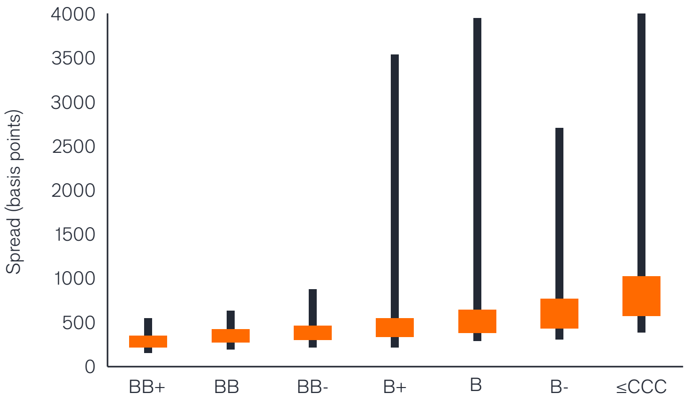
- The nature of the market means an active investor may be better placed to exploit relative value in the capital structure.

8. Asymmetry of returns and idiosyncratic risk

Unlike equity markets where a key aspect of investing is capital gain, fixed income markets tend to be more heavily focused on sustainability of income and capital protection. Avoiding defaults is a key objective of fixed income managers given the limited upside when investing in a bond but the risk of complete capital loss should it default and offer no recovery value.

Idiosyncratic risk is particularly prevalent in corporate debt, even more so among high yield corporate bonds. Strong credit analysis can help penetrate these idiosyncrasies and seek to sort out the winners from the losers. Due to the asymmetry of returns, an active portfolio can sometimes benefit more from not owning a struggling issuer than it can from owning bonds issued by a company that is generating strong cash flow. The wide differences between issuers that share the same credit rating is indicated by the range in spreads in the chart below. The unusually high percentile range for B+ and B rated bonds can be partly explained by rapid spread widening among bonds issued by several Chinese real estate companies.

Figure 8: Range in spreads offers opportunities



Source: Bloomberg, as of 28 February 2022. Note: ICE BofA Global High Yield Index. Chart shows the interquartile range (tangerine box) and 5th/95th percentiles by rating category (grey line).

- An active approach allows selectivity, which, if applied successfully, should help to reduce downside risk and capture returns.

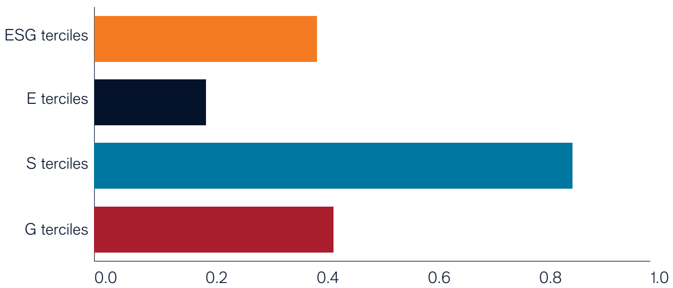
9. Environmental, social and governance (ESG)

Sustainable and ethical investing is becoming increasingly important for investors when they select asset managers. We would argue that ESG sits quite comfortably with bond investing for two reasons. First, many of the sustainability and governance factors that would score a bond issuer highly in terms of ESG are factors that would contribute to a strong rating in credit analysis, although ESG and credit factor effects are themselves distinct. Second, the emphasis that an ESG approach often places on identifying and isolating downside risks echoes the importance of default avoidance when investing in bonds.

Passive ESG investing typically involves negative screening, ie filtering out securities that fail ESG criteria. We believe that active management has an advantage in that it can be more dynamic and forward looking by identifying bond issuers that are on an improving ESG trajectory.

Research by MSCI in 2020 highlighted how ESG factors had contributed to positive excess returns between higher and lower rated ESG terciles. The terciles were composed of corporate bonds from the MSCI Investment Grade and High Yield Corporate Bond Indexes for USD and EUR. The upper tercile (T3) reflects the top third of issuers with relatively high MSCI ESG Ratings, while the lower tercile (T1) reflects the lowest ratings.

Figure 9: Excess return spread (% annualised) between high (T3) and low (T1) ESG terciles



Source: MSCI, "What ESG Ratings tell us about corporate bonds", R Mendriatta, H Varseni, G Giese, November 2020. Average equal-weighted excess return between the high-rated (T3) and low-rated (T1) E-, S- and G-pillar-score terciles and industry-adjusted ESG score terciles, over the period from January 2014 to July 2020.

Past performance does not predict future returns.

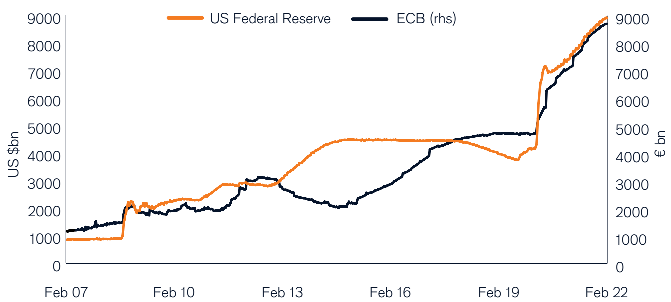
- Active managers can integrate ESG factors into their credit analysis when selecting individual investments for portfolios, with a potentially greater emphasis on forward-looking and qualitative factors.

10. Caveat emptor – end of an era?

Investors in bonds have been used to more than three decades of falling interest rates, coupled in recent history with central banks expanding their balance sheets through purchases of bonds. This has led to an extended period of strong returns from bonds.

Having large price-insensitive buyers supporting the bond market has been useful in dampening volatility. Central banks and others will continue buying and selling in bond markets for reasons other than maximising total return but a winding down of quantitative easing, together with rises in interest rates and a move towards quantitative tightening, is likely to lead to more volatility in future. Elevated inflation is further adding to uncertainty around central bank action, supporting the case for a nimble approach to investing.

Figure 10: Central bank total assets on balance sheet



Source: Refinitiv Datastream, US Federal Reserve, ECB, at 28 February 2022.

- Active managers' capacity to be pro-active allows them to potentially exploit volatility and reposition a portfolio if structural change is evident. This assumes active managers make good decisions – poor decisions could lead to worse performance than the index.

ESG or sustainable investing considers factors beyond traditional financial analysis. This may limit available investments and cause performance and exposures to differ from, and potentially be more concentrated in certain areas than, the broader market.

Summary – what do we expect in the future?

While we believe there will always be a place for active management, we recognise that passive approaches have a role to play. For investors seeking to replicate an index and who are less concerned about beating it, a passive approach can provide cost-effective exposure. The launch of style-led and actively-managed fixed income exchange traded funds (ETFs) is also opening up additional asset allocation avenues for investors. The presence of passive approaches, however, creates opportunities for the active manager and we anticipate investors continuing to see value in employing managers who can generate alpha and shape beta exposure through active management.

The value of an investment and the income from it can fall as well as rise and an investor may not get back the amount originally invested.

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