Batter Up! Should Bond Managers Swing for the Fences?

Batting average may be outdated in baseball, but with bond investing, it can drive performance that's consistently good rather than occasionally great. Guess which one investors prefer?

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Key takeaways

- Unlike with baseball hits, fixed income excess returns resemble a normal distribution, but **as volatility increases, there's a greater chance of underperforming.**
- Bonds should provide stability, not volatility. **An overly aggressive approach at the plate can lead to strikeouts, a lower batting average and an unpredictable return profile.**
- At Voya, rather than trying to tear the cover off the ball, we believe **consistently good results that come from a high batting average** lead to better investor outcomes.

Ever wonder why you rarely see batting averages above .300 these days? While greats of the past—players like Ty Cobb, Ted Williams and Tony Gwynn—consistently hit over .300, good luck finding recent players on the list of top lifetime batting averages. Some say the falloff stems from a shift away from focusing on batting average and playing small-ball toward slugging percentage and extra-base hits.

It often makes sense for today's ballplayers to swing for the fences rather than hit into the gap or drop down a bunt. Big swings can yield an immediate and impactful result: the "occasionally great" performance, which hopefully makes up for the higher likelihood of a strikeout. Situational hitting and quality at-bats require persistence and patience—the "consistently good" feat.

We too ponder the tradeoffs of being too aggressive when building fixed income portfolios. But there's a key difference between bond managers and ball-players—a swing and miss in investing has bigger consequences. Not only can you squander the opportunity for positive performance, but you can also lose what was already gained.

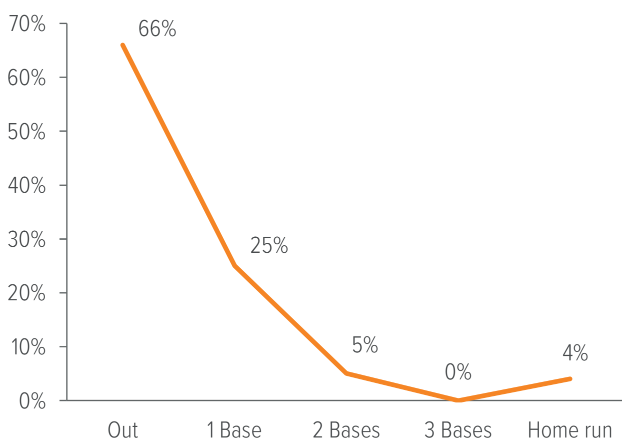
The consequence of a strikeout is greater in investing

What makes a successful at-bat? Other than driving home a run, baseball looks at on-base percentage, batting average (BA) and more recent sabermetrics such as slugging percentage (SLG). Whereas BA treats all hits equally, SLG weighs extra-base hits higher than singles. Modern analytics have shown that going 1-for-4 with a home run adds more team value than going 3-for-4 with three singles.

In a game where two-thirds of at-bats result in an out, a critical factor to batting strategy is that teams can't lose runs they've already scored. That means batters are encouraged to reap the rewards for slugging a home run, despite the low odds, giving rise to asymmetrical outcomes. **In other words, there is no left-tail risk** (Exhibit 1, left side).

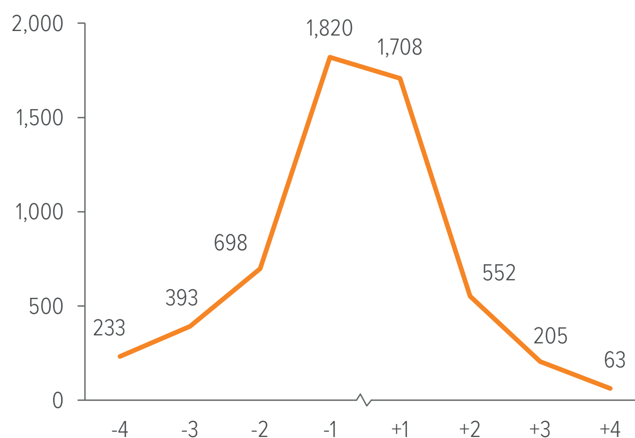
If only investing were similarly a matter of degrees of upside. But alas, fund managers must factor in the risk of loss. Whereas at-bats have no downside, bond fund returns are distributed to both the upside

Exhibit 1. At-bats have a one-sided distribution...



As of end of 2023 MLB regular season. Source: baseball-reference.com

...but bond excess returns are two-sided—they can be negative or positive



As of 09/30/23. Source: Morningstar Direct, Voya IM. The x-axis shows the number of standard deviations away from the mean. The y-axis shows Number of observations.

and downside. Looking at quarterly returns over the past 10 years within Morningstar's Intermediate Core Plus bond category, managers with plate discipline—excess returns within one standard deviation of the mean—had a 59% chance of outperforming the benchmark. But when they tried for the moonshot—reaching for excess returns beyond one standard deviation—the chance of underperforming increased exponentially (the so-called left-tail risk).[1] **This negative skewedness means the potential loss with a swing and miss is often greater than the possible gain** (Exhibit 1, right side).

The Mendoza Line for adequate management

No investor wants to hand over their money to an inadequate portfolio manager, just like no club wants to have unskilled hitters in its lineup. But how do you know what "adequate" looks like?

Baseball's line of adequacy—infamously known as the Mendoza Line—falls at a .200 batting average.

We believe the threshold of investing adequacy needs to be higher—let's say better than average. To establish that midline, our previously cited data show that 57% of quarterly observations outperformed the benchmark over the past 10 years.[1] So, the line of adequacy for core plus bond fund managers sits at a .570 batting average.

Is your manager above the Mendoza Line?

Hitting leadoff, not cleanup, offers better results in investing

In 2023, the top three home run hitters rounded the bases one out of every three base hits—impressive for sure! But that only equated to slugging a home run in 8% of their total at-bats, and they struck out 30% of the time. Their prowess for home runs and slugging percentage masked the strikeouts and their paltry .233 combined batting average.

For investors, strikeouts show up as underperformance. Swing-for-the-fences portfolio managers can (and do) strike out, and this **often leads to a volatile excess return profile**—the opposite of what investors want from their bond allocation.

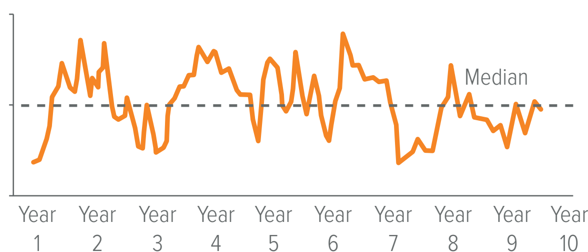
To see our two statistics—batting average and slugging percentage—play out in investment performance, take a look at rolling excess return rankings. A fund that hits for average is going to spend more time above median, unlike a proverbial slugger, whose excess return rankings will swing wildly above and below median.

In our hypothetical example, Fund A spends more than half the time below the median, while Fund B spends about two-thirds of the time above median (Exhibit 2).

Hitting a home run in bond markets is hard, whereas striking out is easy. And striking out can produce actual dollar losses, which may impact an individual's wealth plan or potentially delay retirement or other goals.

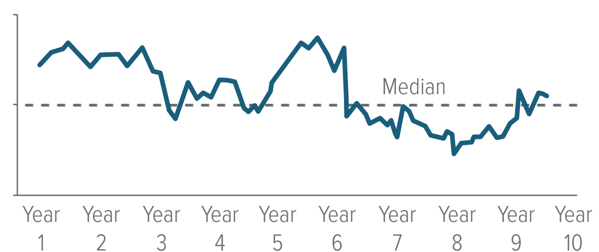
Exhibit 2. A low batting average plays itself out in volatile rolling 1-year excess return rankings

Fund A



Source: Voya IM. For illustrative purposes only.

Fund B



Source: Voya IM. For illustrative purposes only.

[1] Data based on quarterly excess returns of all funds in the Morningstar Intermediate Core Plus bond category vs. the Bloomberg U.S. Aggregate Total Return Index for the 10 years ending 09/30/23. Total number of observations = 24,847. An excess return observation at least one, two, three and four standard deviations from the mean had a 52%, 56%, 66% and 79% chance of underperforming the benchmark, respectively.

At Voya Investment Management, we think more like a leadoff hitter. We aim to get on base every time—a mindset of "consistently good"—so that we can deliver strong long-term returns and less volatile short-term performance. Because for bond investors, especially those near or in retirement, a fund that tries to smash the ball out of the park each time it steps up to the plate simply adds unnecessary risk. Who do you want batting in your lineup?

A note about risk

The principal risks are generally those attributable to bond investing. All investments in bonds are subject to market risks as well as issuer, credit, prepayment, extension, and other risks. The value of an investment is not guaranteed and will fluctuate. Market risk is the risk that securities may decline in value due to factors affecting the securities markets or particular industries. Bonds have fixed principal and return if held to maturity but may fluctuate in the interim. Generally, when interest rates rise, bond prices fall. Bonds with longer maturities tend to be more sensitive to changes in interest rates. Issuer risk is the risk that the value of a security may decline for reasons specific to the issuer, such as changes in its financial condition.

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