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Structural Advantages of Active Management in Core Fixed Income Strategies

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Experienced active managers can capitalize on opportunities that fall outside their benchmarks and can manage unwanted concentrations. This has historically resulted in relatively high success rates in generating alpha.

Executive summary

Given the appeal of passive equity index strategies in providing market access at a low cost, it's understandable that investors might also look to passive strategies for fixed income, often the primary source of equity diversification. Active core and core-plus bond managers, however, have demonstrated more consistent outperformance than active equity managers.

We believe this success rate arises partly from structural advantages for fixed income managers, including:

- **More latitude in security selection:** Bond index construction rules exclude securities such as below-investment-grade credits, floating-rate securities and smaller issues. Active managers can unlock opportunities from non-index sectors to enhance potential for generating alpha and managing risk.
- **Greater flexibility in sector allocation:** Stock market indexes are cap weighted; top-performing constituents tend to be the biggest drivers of return. By contrast, bond indexes are debt weighted, exposing investors to concentrations in more leveraged issuers and inopportune sector allocations. Active managers potentially can manage these risks through off-index sector allocations.
- **Active fixed income enjoys a cost advantage:** Fees for active bond managers generally are lower than fees for active equity managers. This reduces the cost advantage of passive fixed income strategies relative to passive equity strategies.

Historical performance advantage of active fixed income

More than half of core and core-plus bond funds beat their benchmark net of fees over the trailing 10 years, while among core-plus I-share funds, 88% outperformed.

As of 12/31/22. Source: Morningstar Direct. Benchmark = Bloomberg U.S. Aggregate Index. Investors cannot invest directly in an index. **Past performance is no guarantee of future returns.**

For years, investors have been challenged to find equity managers who consistently beat their benchmarks, and this has resulted in massive flows into passive equity index strategies. That's a stark contrast with the situation among active fixed income managers.

The idea behind passive strategies is that they attempt to deliver "average" performance at a low cost by tracking the performance of a market index. While this may work for certain equity strategies, a look at the performance record of a major bond index such as the Bloomberg U.S. Aggregate Index — a proxy for passive core fixed income strategies — undermines the notion of what "average" might mean for investors.

Exhibit 1 compares the performance of the U.S. Aggregate to funds in the Morningstar intermediate core and core-plus categories using three-year rolling periods over the past ten years — a total of 85 observations. During that period, the index return exceeded the universe median in 22 of 85 observations, or 26% of the time; it fell below the median 74% of the time.

Exhibit 1. Strategies that mirror fixed income indexes are likely to disappoint investors

Bloomberg U.S. Aggregate Index, rolling three-year percentile rank within Morningstar universes

As of 12/31/22. Source: Morningstar. Investors cannot invest directly in an index. **Past performance is no guarantee of future returns.**

The index never reached the top quartile, i.e., above the 25th percentile. If this trend were to continue, **passive core fixed income strategies potentially could deliver below-median performance about three-quarters of the time.** Is this a shortcoming of the index, or is it a measure of success for active bond managers? We believe a bit of both.

Bond index construction rules restrict opportunity set

Like equity indexes, fixed income indexes apply rules for inclusion of securities that help define the investible universe in a methodical manner. Yet those rules can exclude a meaningful portion of the bond market, which still may be available to active investment strategies.

For example, the Bloomberg U.S. Aggregate Index is composed of U.S. Treasury, government-related, corporate, and securitized sectors that are of investment-grade quality or better, have at least one year to maturity, and have various minimum outstanding par values for different types of instruments.[1]

That definition sounds like a broad range of choices, but it excludes floating-rate securities, below-investment-grade bonds, non-U.S. dollar securities, privately issued debt, shorter-term issues and smaller, nominal-value issues — all of which offer the potential to improve risk-adjusted returns and enhance diversification. A passive indexing strategy is unable to use non-benchmark instruments without straying from its mandate, whereas active bond managers have these additional investment options at their disposal.

Debt weighting disadvantages passive bond strategies

Stocks that represent the largest weightings of an equity index are usually among the best performers in that index. A stock's market capitalization is the total value of all shares outstanding; if the company's stock price increases, its market capitalization also increases, and so does its index weighting. Thus, passive equity strategies enjoy the benefits of larger allocations to those stocks that have delivered the best historical performance.

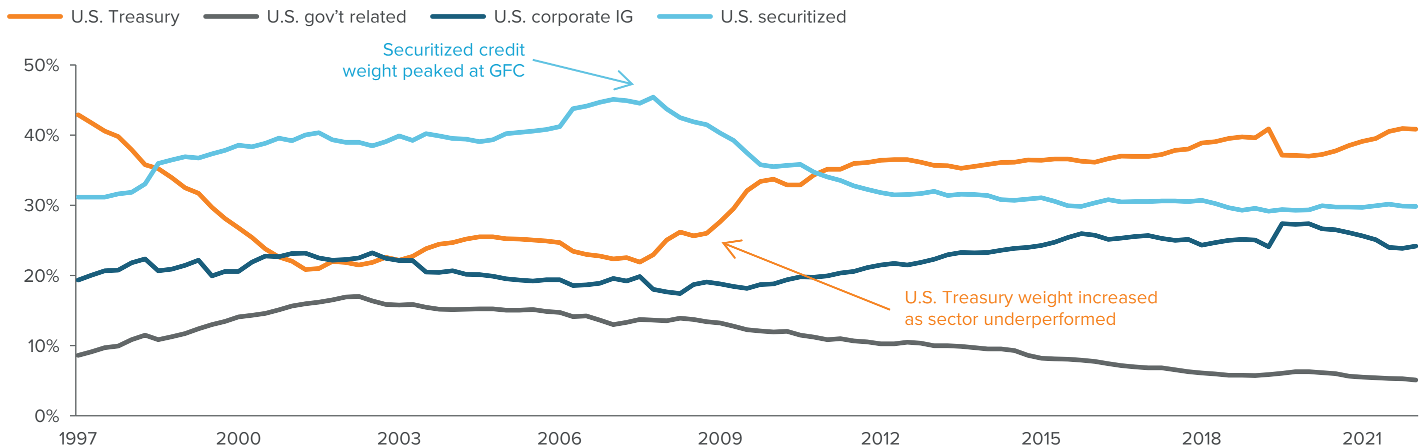
Fixed income is different. Fixed income benchmarks are debt weighted; the most heavily weighted positions stem from borrowers that have issued the most debt. While they may enjoy investment-grade status, the bonds of such issuers are not necessarily the most promising investments. As a result, the largest positions in the bond index may not be the strongest performers over time. Investors in passive, indexed strategies are thus more heavily exposed to debt-laden issuers with greater potential risk of underperforming and adding volatility. Active managers, on the other hand, can mitigate these risks by avoiding large concentrations in such positions.

[1] For details, see disclosures at end of insight.

The same holds true at the sector level. Exhibit 2 shows that the Bloomberg U.S. Aggregate Index's weighting to U.S. securitized bonds, such as mortgage-backed securities, peaked around the great financial crisis, just before mortgage values plunged. It also shows that the index's weighting to U.S. Treasury securities generally has been low in times of turmoil (GFC and dot-com bubble), corresponding to periods when Treasury securities were outperforming. The index's Treasury weighting then dramatically increased, via quantitative easing, in times when Treasury securities underperformed, i.e., as credit spreads were generally rallying post-GFC and post-Covid.

Exhibit 2. Aggregate sector allocations can lead to untimely exposures for indexed strategies

Bloomberg U.S. Aggregate Index, monthly allocations, percent of total index value



As of 12/31/22. Source: Bloomberg, Voya Investment Management. Investors cannot invest directly in an index. **Past performance is no guarantee of future returns.**

Active fixed income enjoys a cost advantage

Advocates of passive investing often point to lower fees as an advantage. In an information-rich age, where finding alpha can be challenging, total expense ratios can become a key factor in relative portfolio performance. Active fixed income strategies historically have outperformed their benchmarks more often than active equity strategies. An important reason for this is that active fixed income strategies enjoy a cost advantage over equity. Using the Morningstar universes as gauges, the median prospectus net expense ratio for the large-blend equity category was significantly higher than the median prospectus net expense ratio for the combined core and core-plus categories (Exhibit 3).

Exhibit 3. Active bond management has a cost advantage over equity

Total expense ratio	Large blend	Core/core+
Category median	0.79%	0.60%
I-share median	0.65%	0.47%

As of 12/31/22. Source: Morningstar Direct, Voya Investment Management. Category medians represent the median prospectus net expense ratio for the full equity and fixed income universes; I-share medians represent the median prospectus net expense ratio for the subsets of class I shares within each universe. **Past performance does not guarantee future returns.**

The cost advantage of passive strategies is reduced in fixed income because actively managed bond funds tend to be lower cost than actively managed stock funds.

Advantage: Active fixed income

We believe investors need to understand the differences between equity and fixed income index composition, and how those differences affect portfolio construction — especially in an environment of heightened uncertainty and volatility. It is particularly important to note that fixed income index construction may not represent the full investment universe, imposing opportunity costs on indexed portfolios. Furthermore, the lack of allocation flexibility potentially exposes passive portfolios to greater risk of underperformance. The comparatively modest fees of active bond portfolios also play a role in reducing the cost advantages of passive strategies.

In our view, the historical consistency of active fixed income's outperformance versus passive counterparts supports the notion that active fixed income management offers investors greater potential than passive investing.

Disclosures

The **Bloomberg U.S. Aggregate Index** is composed of U.S. fixed income securities in U.S. Treasury, government-related, corporate and securitized sectors that are of investment-grade quality or better and have at least one year to maturity. Minimum required par amounts outstanding vary by instrument: for U.S. Treasury, government-related and corporate securities, $U.S. 300 million; for pass-through mortgage-backed securities (MBS) pool aggregates, $1 billion; for asset-backed securities (ABS), $500 million minimum deal size and $25 million minimum tranche size; for commercial mortgage-backed securities (CMBS), $500 million minimum deal size with at least $300 million remaining in the deal and $25 million minimum tranche size. U.S. Treasury securities held in the Federal Reserve SOMA account (both purchases at issuance and net secondary market transactions) are deducted from the total amount outstanding. New issuance bought at auction by the Federal Reserve does not enter the index. **Investors cannot invest directly in an index.**

Principal risks. All investing involves risks of fluctuating prices and the uncertainties of rates of return and yield inherent in investing. **Past performance is no guarantee of future results.**

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