Actively Adding Alpha to Fixed-Income Strategies

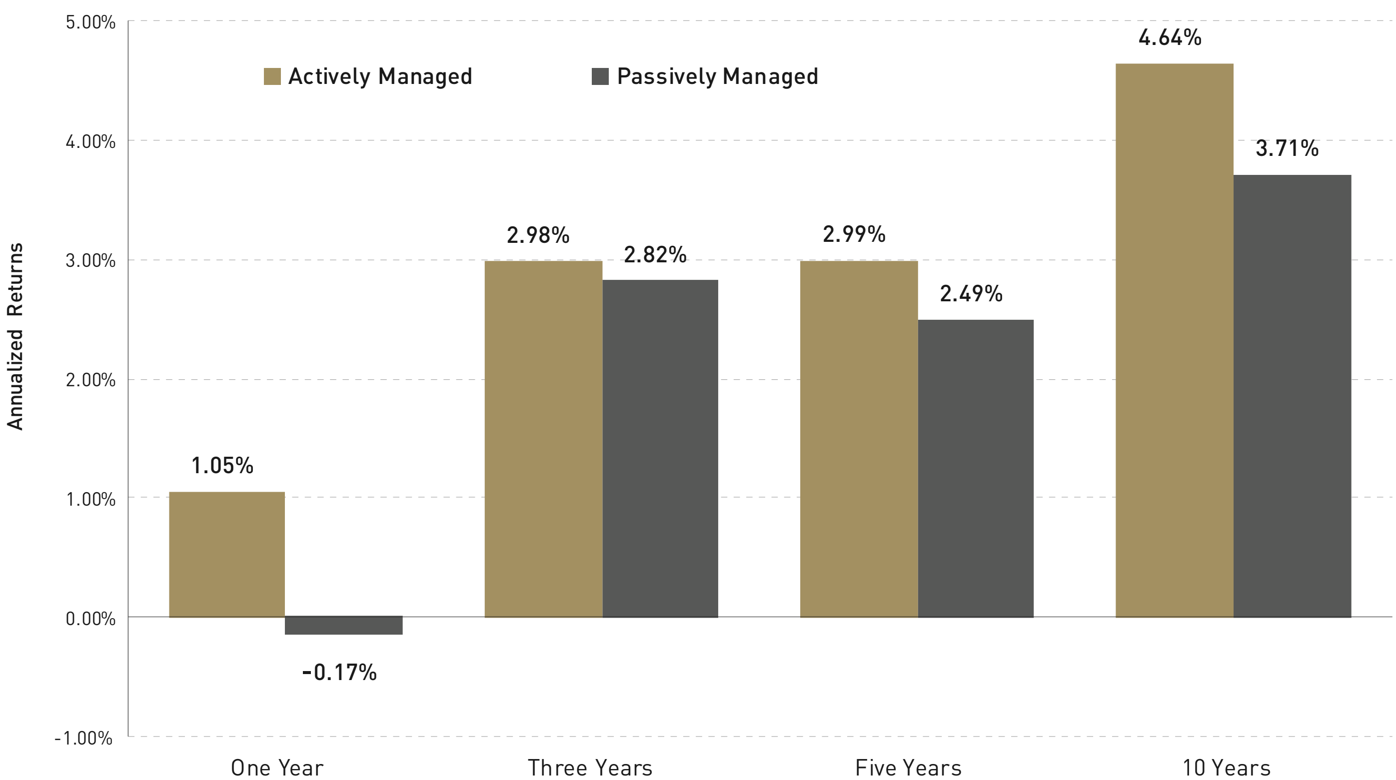
When it comes to fixed-income portfolios, the strategies of active bond managers frequently have outperformed passive approaches.

Contributor

Tim Paulson
Investment Strategist

Chart 1. What's the Historical Track Record of Actively Managed Fixed-Income Funds?

Annualized returns for the indicated periods (ended December 31, 2018)



Source: Morningstar's Active/Passive Barometer, December 2018.

See Footnote 1 for methods of calculation. The information shown is for illustrative purposes only and does not represent any specific portfolio managed by Lord Abbett or any particular investment. Statements concerning financial market trends are based on current market conditions, which will fluctuate. There is no guarantee that markets will perform in a similar manner under similar conditions in the future.

Past performance is not a reliable indicator or a guarantee of future results.

In Brief

- With the current volatility in the equity market, investors may want to consider actively managed bond strategies as a diversifier and a potential source of income.
- A recent Morningstar study[1] found that actively managed bond funds (as measured by their respective Morningstar categories) outperformed passive strategies during the one-, three-, five-, and 10-year periods through December 31, 2018.
- Active management may help protect investors against overly hasty responses to dramatic market moves.

Fixed

As an active investment manager, we are frequently asked about the potential effectiveness of active management in various investment categories. One common question concerns the fixed-income category: How has active performed relative to popular passive offerings in recent years?

A recent Morningstar report[1] offers some insight. The report showed that actively managed fixed-income mutual funds generated superior annualized returns compared with passive funds during the one-, three-, five-, and 10-year periods through December 31, 2018.

In short, when it comes to fixed-income portfolios, passive approaches frequently have underperformed the strategies of active bond managers, often substantially underperforming the index they are attempting to track.

What might lie behind this trend? We see five important potential advantages that can potentially contribute to outperformance by active managers in the fixed-income markets:

1. Capturing Opportunities

Unlike equity markets, where we would argue most investors are striving for total return, we observe that participants in fixed-income markets often have different objectives, valuing securities differently or buying for reasons that have little to do with expected returns, thereby creating opportunities for active managers.

Central banks, for instance, buy and sell securities in their execution of monetary policy. Their objective is to provide or withdraw funds or, in the case of quantitative easing, affect the level of interest rates, all without regard to profitability. Central bank activity creates distortions that astute active managers can potentially exploit. Additional opportunities may be created by the bond investments made by insurance companies and pension funds, which may be driven more often by the need to position their portfolios to meet future liabilities than by the valuation of the securities.

2. Conscious Risk Control

Passively managed funds are designed to track various benchmark fixed-income indexes (representing sectors such as high yield, floating rate, and others). This can result in undesirable changes in volatility as well as concentrations in specific sectors or credits. Passive portfolio exposures can increase because the fund must adjust its holdings as issuers borrow more, not because they represent better value. The resulting portfolio may mirror excessive optimism or "frothiness," such as when oil prices spike, for example, just at a time when prudence might dictate the opposite approach.

Unlike many passively managed approaches, active managers are not required to reflect changes in the market's composition but can instead seek to control risk by avoiding overexposure to questionable credits or troubled industries, and intentionally selecting securities that may fit portfolio objectives and investor needs.

3. Thoughtful Credit Selection

Beyond controlling overexposure to less-desirable sectors, active credit analysis can inform individual security selection through identifying credits with weak management or deteriorating financial conditions. In contrast with stocks, bond investments typically have limited upside, so avoiding downside risks is critical for investment success; passive strategies are required to own these credits or even increase exposure as they borrow more and more. Credit analysis also can capture relative opportunities created by external factors, such as shifts in government fiscal priorities, tax policy, and spending programs that affect companies differently.

4. Opportunistic Sector Rotation

The analytical approach used by active managers when evaluating individual credits can be expanded and applied to sectors. Rotation among sectors allows changes in portfolio weightings that might capture deviations from historical norms. Active management can take advantage of temporary price anomalies due to excess supply or owing to short-term investor overreaction to sudden market events. Similarly, intermediate-term opportunities can be driven by such events as a gradual change in the price of oil, the impact of rising rates, or the expectation of a shift in the U.S. Federal Reserve's portfolio of U.S. Treasury and mortgage-backed securities.

5. Alignment with Client Interest

Actively managed portfolios also may offer a better fit with a client's objectives and risk tolerances than a passive approach can accomplish. Within credit and duration parameters, active managers seek to deliver a different risk and return profile than might be offered by available indexes. Moreover, active managers have the ability to assess and manage risks such as unwanted portfolio concentrations that may accrue in passive portfolios as a result of large debt issuances.

Moreover, active management may help protect investors against overly hasty responses to dramatic market moves. Where ETFs can be forced to sell attractive assets at disadvantageous prices, active managers can add these assets when those opportunities become available.

Summing Up

Active decision making allows for a wide range of styles and outcomes. Of course, not all active management is equally successful, nor is every investment style appropriate for every investor. However, because the bond market includes hundreds of thousands of securities, and because of the diversity of objectives among market participants, investors can find a risk / return profile among active options that is most suitable for them, instead of having to invest in a one-size-fits-all passive replication of an index.

And while there are many ways for managers to take advantage of the many investment opportunities available in the fixed income markets, we have found that resources, experience, and investment discipline are important factors in a manager's ability to deliver those opportunities to investors in a way that most consistently aligns with an investor's own interests and objectives.

[1]The *Morningstar Active/Passive Barometer* is a semiannual report that measures the performance of actively versus passively managed funds within their respective Morningstar Categories. The barometer measures active managers' success relative to the actual, net-of-fee performance of passive funds rather than an index, which isn't investable. And it measures actively managed funds' success relative to investable passive alternatives in the same category. For example, an active manager in the U.S. large-blend Morningstar Category is measured against a composite of the performance of its index mutual fund and exchange-traded fund peers Vanguard Total Stock Market Index (VTSMX), SPDR S&P 500 ETF (SPY), and so on. Specifi¬cally, it calculates the equal- and asset-weighted performance of the cohort of index-tracking ("passive") options in each category examined, and that figure is used as the hurdle that defines success or failure for the active funds in the same category.

A Note about Risk: The value of investments in fixed-income securities will change as interest rates fluctuate and in response to market movements. Generally, when interest rates rise, the prices of debt securities fall, and when interest rates fall, prices generally rise. Bonds may also be subject to other types of risk, such as call, credit, liquidity, interest-rate, and general market risks. High-yield securities, sometimes called junk bonds, carry increased risks of price volatility, illiquidity, and the possibility of default in the timely payment of interest and principal. Moreover, the specific collateral used to secure a loan may decline in value or become illiquid, which would adversely affect the loan's value. Longer-term debt securities are usually more sensitive to interest-rate changes; the longer the maturity of a security, the greater the effect a change in interest rates is likely to have on its price. Lower-rated bonds may be subject to greater risk than higher-rated bonds. No investing strategy can overcome all market volatility or guarantee future results.

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MV-09-09-19