Five Key Advantages of Active Bond Management

Investors focused on lower-fee strategies may wish to take a fresh look at the ways that active managers can add value to fixed-income portfolios.

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IN BRIEF

- With the publicity surrounding the use of passive strategies in equity investing, investors may be wondering about how such an approach has worked in the fixed-income market.
- A recent study noted in a Morningstar article found that nearly two-thirds of actively managed bond funds did better than a matching best fit portfolio of bond exchange-traded funds.
- An analysis of the bond market and the strategies that active managers can employ suggests five important advantages that can contribute to outperformance:
  1. The idiosyncratic nature of the bond market offers active managers a better chance to exploit opportunities.
  2. Active managers have the potential to control risk by avoiding overexposure to questionable credits.
  3. They also are better positioned to steer clear of credits with weak management or deteriorating financial conditions
  4. An active approach provides the flexibility to rotate among sectors and allows for optimal changes in portfolio weightings
  5. Actively managed portfolios also may offer a better fit with client objectives and risk tolerances than a passive approach.
- ***The key takeaway:*** The resources, experience, and culture of an active bond manager may enable strategies to capture opportunities in fixed income that passive investment vehicles cannot match.

Investor preference for passive management strategies, such as exchange-traded funds (ETFs), often seems entirely focused on the notion that ETFs' low costs will contribute to superior performance versus actively managed strategies. Indeed, that belief has helped spark the robust growth of equity ETFs in recent years. However, when it comes to fixed-income portfolios, passive approaches frequently underperform the strategies of active bond managers.

A recent Morningstar article compares the five-year returns of 791 bond funds to that of their ETF counterparts (by asset class).[1] Morningstar's conclusion: "Nearly two-thirds of bond funds did better than a matching best fit portfolio … of bond ETFs." In this study, the mean actively managed bond fund outperformed its ETF counterpart by a cumulative 2.92%, suggesting that the effects of compounding the excess returns of a consistent top-quartile manager could be even more substantial.

But how, exactly, can active managers add alpha to fixed-income strategies? An analysis of the bond market and the strategies that successful active managers can employ suggests five important advantages that can contribute to outperformance.

1. CAPTURING OPPORTUNITIES

The unique nature of the U.S. bond market creates opportunities that active management can capture. Unlike equity markets, where most investors are striving for total return, the many participants in fixed-income markets often have different objectives, creating opportunities for active managers that seek them.

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 capture. The bond investments made by insurance companies and pension funds often are driven by the need to position their portfolios to meet future liabilities; securities valuation may not be a primary focus. The investment styles of such institutions may create more situational opportunities that active managers can take advantage of. For example, risk-adjusted investment requirements for banks and insurance companies often push prices higher for securities in key fixed-income categories with narrowly defined quality and maturity characteristics, while securities with differing credit and maturity profiles languish. Further, ETFs focus on specific securities in order to replicate an index, while largely ignoring comparable issues of credit quality and maturity.

The diverse array of debt securities available in U.S. markets, worth trillions of dollars, combined with the broad range of objectives from so many different participants, provides experienced active managers with abundant opportunities to add value and manage risk relative to that of a manager with a passive approach.

2. CONSCIOUS RISK CONTROL

Passively managed ETFs 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 ETF must adjust its holdings as issuers increase their leverage, 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 control risk by avoiding overexposure to questionable credits and intentionally selecting securities that fit portfolio objectives.

3. THOUGHTFUL CREDIT SELECTION

Beyond controlling overexposure to less-desirable sectors, active credit analysis can inform individual security selection through avoidance of credits with weak management or deteriorating financial conditions. Credit analysis also can capture opportunities created by external factors, such as shifts in government fiscal priorities, tax policy, and spending programs that affect companies differently. Such changes, including those in regulations or trade policies, can produce appropriate shifts in actively managed portfolios that would not be considered in most passive portfolio structures. Credit analysis can differentiate active portfolio management performance, especially when it comes to lower-quality credits.

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 to 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. As different bond market participants react to political, economic, and supply factors, various sectors re-price accordingly, giving an active bond manager an opportunity to rotate out from a sector that has become overvalued and into one that, in the manager's analysis, is undervalued.

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 capture a variety of opportunities that a passive approach ignores. Active managers have the ability to assess, and take steps to help manage risks, such as unwanted portfolio concentrations that may accrue in passive portfolios as a result of large debt issuance.

Another potential edge for active managers lies in managing call protection on portfolio bonds. This is an active strategy that can help maintain income; a passive strategy likely will ignore the premium on a high coupon bond and watch it be called and replaced with a lower-coupon issue, resulting in reduced income for the investor. In addition, as investors would expect, an actively managed bond portfolio trades at net asset value (NAV). Unfortunately, ETFs are not obligated to trade at NAV, and actually may trade below NAV, especially when sellers dominate the market.

Finally, active management may help protect investors against their own worst instincts, especially if they are prone to act emotionally in response to dramatic market moves. Active management may enable investors to avoid impulsive buying and selling decisions, following the herd, or remaining too cautious when opportunities become available. From a structural standpoint, actively managed portfolios seem to align much more closely with investor interest than passive portfolios whose primary selling point seems to be low fees.

THE ACTIVE ADVANTAGE

It is interesting to note that within the fixed-income market, active managers may have inherent opportunities to outperform passive strategies. These opportunities exist as a result of the diverse goals and priorities of market participants, often with objectives other than total return. The resources, experience, and culture of an active bond manager can, as we said, enable numerous strategies to capture those opportunities that often are not even possible via a passive approach. We believe investors should bear this in mind as they consider which approach to portfolio management best aligns with their own interests.

[1]"Active Bond Funds Holding Their Own," Morningstar.com, March 21, 2017.

IMPORTANT INFORMATION

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