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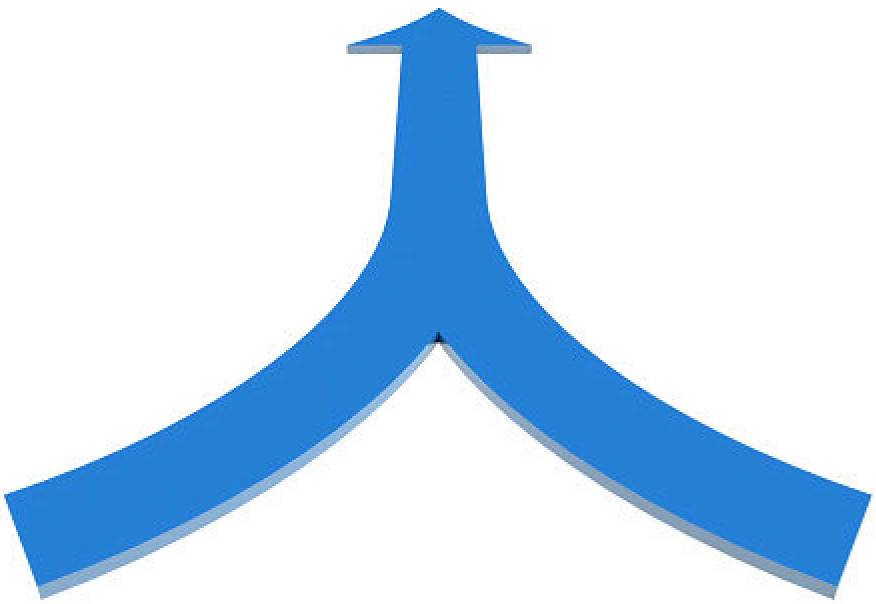
Active vs. passive: Should you use both in fixed income?



The active versus passive management debate has always been an intriguing one in fixed income. On the one hand, the allure of cheap market exposure to a low-volatility asset class is tempting. On the other hand, history suggests that the median bond manager rather consistently beats the standard benchmark[1] and does so far more frequently than in, say, large-cap U.S. equities—not to mention the fact that market-cap-weighted indexes use a very undesirable methodology for weighting securities from a lender's perspective[2]. In reality, the decision isn't, nor has it ever been, so stark as an *either-or*.

The dirty little secret

Based on our 40 years of manager research at Russell Investments, we have observed that active fixed income managers have almost universally emphasized the importance of security selection in their investment process, and as one of the key drivers of why they have typically been able to outperform passive alternatives over time. But when we analyze the performance of individual bonds across investment-grade portfolios, the bulk of that performance can be explained by systematic factors rather than security-specific risk[2]. In such a low-volatility asset class, that doesn't leave a whole lot of room to generate high excess returns through security selection alone. In fact, overcoming active management fees through security selection only would imply a rather implausibly high batting average on security picks for an investment-grade portfolio. **In truth, the historical success of the median active bond manager[1] versus indexes in this s pace rests heavily on strategic factor tailwinds that they have built into their portfolios, whether by design or not.**

Strategic factor exposures

In analyzing active management's periods of greatest success against indexes, much of that success can be attributed to a single strategic factor bias shared across the active management bond community: **credit**. We believe most managers tilt toward lower-rated, higher-yielding credit securities than the benchmark, and over time that added credit risk is usually rewarded with higher returns almost irrespective of the underlying security selection. To be sure, there is added return to be had from positive security selection within that credit exposure, but those idiosyncratic risks rarely outweigh the importance of the generic factor risk to credit.

Some active managers are more than just a one-trick pony with respect to their factor exposure in fixed income. The other crucial factor in fixed income is **interest rate risk**, or **duration**. That investors will get paid to take interest rate risk over time is the basic premise of the fixed-income asset class. Yet, it is perplexing that so few managers strategically take advantage of this factor**.** A select few do bias their portfolios toward a long duration position. They do so in recognition of the additional long-term return as well as the diversification benefits, when used in conjunction with a credit bias. Overall, however, active managers actually tend to tie one hand behind their backs by either remaining strategically neutral or even biased toward a short duration stance, out of fear that Godot might actually arrive one day—and clients will be proven right in their perpetual fear of rapidly rising rates.

Duration and credit exposure may be the most well-known factors influencing fixed income, but they are not the only ones. We believe there are **value** and **momentum** factors at work within interest rate markets that investors can tilt toward to systematically generate returns. Within credit markets, we also believe in a value factor at an individual security level. This belief can take strategic factor investing in credit beyond just the generic overweight to the factor so common in the active universe.

Tactical opportunity

Of course, strategically allocating to a factor is not the only way to add value with passive factor exposures. We believe tactically tilting on these factors offers an opportunity for adding additional returns. On this front, we believe the record of active managers is more mixed. While tactically tilting on credit based on mean reversion seems like a simple enough strategy, it requires a great deal of discipline to not chase yield at the top of the market.

On the duration front, active managers have proven even less adept at tactical timing with any semblance of consistency. It all brings to mind the old adage of ***just because you could, doesn't mean you should***. We do believe that some active strategies for tactical tilting, such as mean reversion in credit spreads, work over time. But investors should rightly consider how much risk they really want to be allocating to such tactical strategies relative to the greater certainty we see in strategic exposures to such factors.

The bottom line

We believe investors should bring together fully active and factor-based bond management, with the goal of enhancing returns and managing risk on multiple levels. We believe strategic factor exposures in the portfolio construction phase of the process can help. Active security selection in appropriate sectors and tactical factor rotation in measured size may further enhance returns. In other words, we believe a hybrid of fully active and more passive factor investing may lead investors to better return outcomes with their fixed-income allocations.

Disclosures:

[1] Claim based on eVestment Active Core universe performance versus the Bloomberg-Barclays U.S. Aggregate Bond Index as of 3/31/2017.

[2] The most commonly used indexes weight securities based on market capitalization. This forces true passive investors to hold more exposure of companies that have more debt outstanding, which is not necessarily an advisable static strategy in most lenders' opinion.

[3] Fama, Eugene and Kenneth French, "Common Risk Factors in the Returns on Stocks and Bonds", *Journal of Financial Economics*, Vol. 33 (1), February 1993, pp 3-56.

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