White Paper
Fixed Income

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Combining Active and Indexed Fixed Income

Create Better Outcomes in Multi-Asset Portfolios

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Executive Summary

Although the polarizing active versus passive management debate persists, more sophisticated investors have found that the real question is not whether to choose active or passive strategies, but how to combine the best of both approaches in a holistic way to construct the most beneficial portfolios. In this paper, we look at where active managers have and have not performed, what may be driving performance, and consider how a blend of active and indexed fixed income strategies can be incorporated into a portfolio.

We find that the performance of fixed income active managers has historically been mixed and inconsistent. Active managers in multi-sector strategies (Global Aggregate, Global Government and Global Credit) have generated healthy outperformance versus the benchmark (alpha), while single-sector active strategies (Global High Yield, Emerging Market Debt) have struggled. However, most active managers have failed to produce alpha in consecutive years, suggesting that asset owners could struggle to achieve median returns from their active managers.

Our analysis suggests that fixed income active managers, particularly multi-sector ones, are exposed to credit beta which is an important driver of their alphas. As a result, alphas tend to turn negative during equity sell-offs, implying poor diversification when it is needed the most. This is not ideal for asset owners looking to their fixed income portfolios for risk mitigation, liquidity or rebalancing purposes, as they can end up locking in losses at potentially the worst possible time.

We are seeing a shift towards fixed income indexing as institutional investors change the way they are constructing their portfolios. They are starting to take a core-satellite approach by combining strategies of different sectors/durations to give them more allocation flexibility and to improve portfolio efficiency. By incorporating some indexing elements in both FI core and satellite programs and utilizing indexing to rebalance a portfolio, we demonstrate that we can improve the portfolio's return/risk ratio by lowering the portfolio risk without sacrificing the portfolio return.

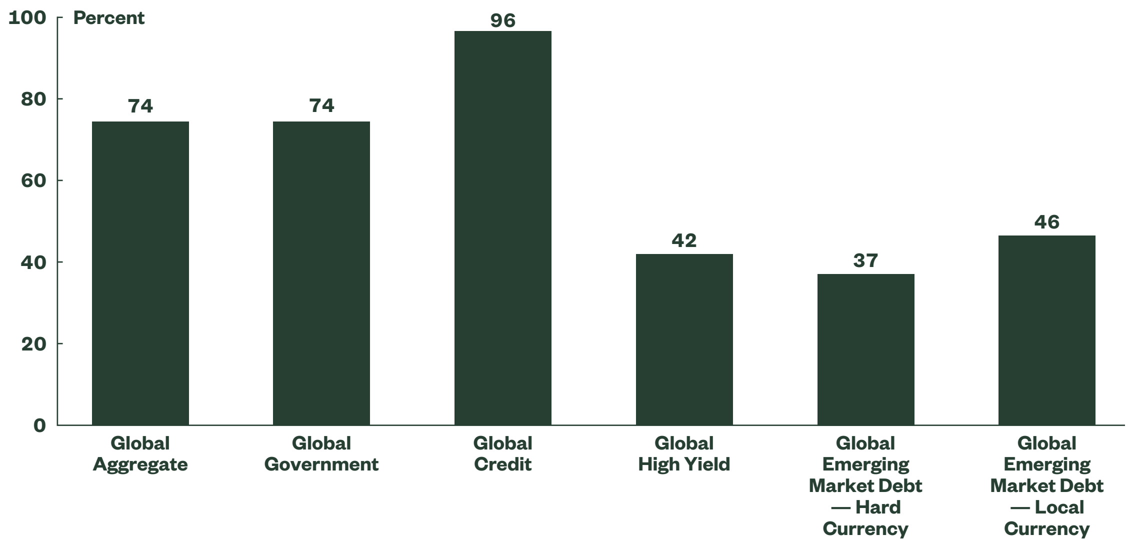
Active Fixed Income: Mixed Performance with a Lack of Alpha Persistence

- **Active managers in multi-sector active strategies (Global Aggregate, Global Government and Global Credit) have generated solid excess returns (alphas) over the last ten years, while single-sector active strategies have struggled**
- **Across most fixed income segments, many active managers fail to persistently generate alpha. This suggests that asset owners could struggle to achieve median returns from their active managers**
- **An important driver of alpha for multi-sector active strategies appears to come from their out-of-benchmark exposure to credit**

Multi-sector Active Strategies Had Better Performance

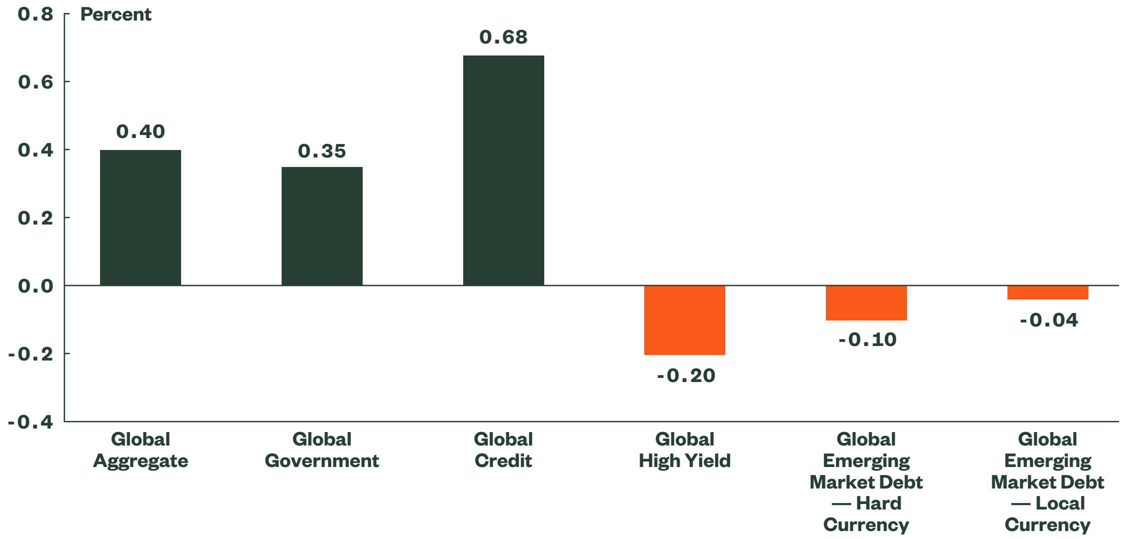
The performance of active fixed income strategies has been mixed over the past ten years. In general, active managers of multi-sector active strategies, including Global Aggregate, Global Government and Global Credit produced better excess returns than those in single-sector strategies such as high yield bonds and emerging market debt (see Figure 1 and Figure 2).

Figure 1
% of Active FI Strategies Outperforming the Benchmark
(Net of Fee, Jan 2012–Dec 2021)



Source: State Street Global Advisors, eVestment, as of December 31, 2021. Active managers with at least 10 years of track record are included in the universe. The manager preferred benchmark and the sliding fee level at 250 million are used in the calculation. If the manager preferred benchmark or the sliding fee level is not available, the default benchmark and the average manager fee are used in the calculation. Default benchmark index: Bloomberg Global Aggregate for Global Aggregate, FTSE WGBI for Global Government, Bloomberg Global Aggregate — Credit for Global Credit, Bloomberg Global High Yield for Global High Yield, JPM EMBI Global Diversified for Global EMD — Hard Currency, JPM GBI-EM Global Diversified for Global EMD — Local Currency. Fee assumptions: Global Aggregate Active Strategy 25bps; Global Aggregate Index 10bps; Global High Yield Active 45bps; Global High Yield Index 15bps; EMD Hard Currency Active 45bps; EMD Hard Currency Index 20bps; EMD Local Currency Active 45bps; EMD Local Currency Index 20bps. Past performance is not a reliable indicator of future performance. The information contained above is for illustrative purposes only.

Figure 2
Median Annualized Excess Return
(Net of Fee,
Jan 2012–Dec 2021)



Source: State Street Global Advisors, eVestment, as of December 31, 2021. Active managers with at least 10 years of track record are included in the universe. The manager preferred benchmark and the sliding fee level at 250 million are used in the calculation. If the manager preferred benchmark or the sliding fee level is not available, the default benchmark and the average manager fee are used in the calculation. Default benchmark index: Bloomberg Global Aggregate for Global Aggregate, FTSE WGBI for Global Government, Bloomberg Global Aggregate — Credit for Global Credit, Bloomberg Global High Yield for Global High Yield, JPM EMBI Global Diversified for Global EMD — Hard Currency, JPM GBI-EM Global Diversified for Global EMD — Local Currency. Fee assumptions: Global Aggregate Active Strategy 25bps; Global Aggregate Index 10bps; Global High Yield Active 45bps; Global High Yield Index 15bps; EMD Hard Currency Active 45bps; EMD Hard Currency Index 20bps; EMD Local Currency Active 45bps; EMD Local Currency Index 20bps. Past performance is not a reliable indicator of future performance. The information contained above is for illustrative purposes only.

It seems intuitive that certain markets, such as high yield and emerging market debt, are less efficient and thus should provide opportunities for active managers to generate alpha. However, investing in these fixed income markets presents additional challenges and complexities. In fact, as Figure 2 illustrates, over half of the Global High Yield and Emerging Market Debt active strategies failed to beat or match their benchmark indices on a net of fee basis over the past 10 years.

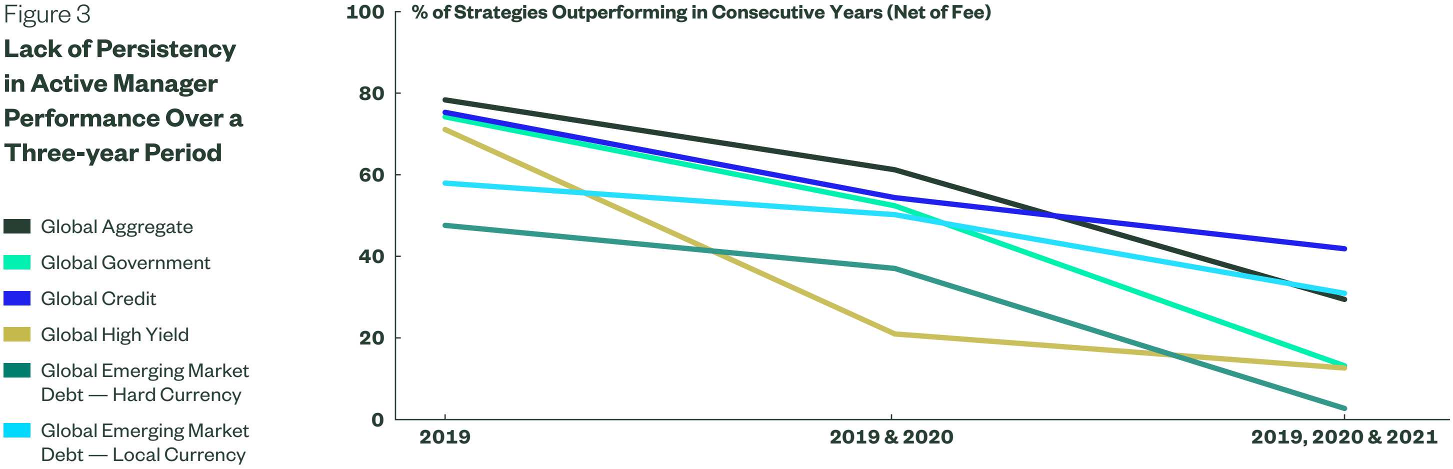
Most high yield active managers tend to position defensively due to idiosyncratic default risks and high transaction costs. Consequently, they generally fail to capture the full return potential of the market, particularly during cyclical recoveries that are typically the strongest periods for high yield returns. This is a cause of active managers' underperformance in the long run.[1]

The performance of EM hard currency debt active managers is often driven by their positioning in distressed issuers as the investment grade names are typically fairly priced and provide fewer opportunities for alpha generation. Hence, hard currency active managers often face binary choices, such as Argentina's litigation with holdout creditors and Ukraine's restructuring in recent years. Meanwhile, EM local currency debt active managers face challenges to make a call on the currency component which accounts for approximately 70% of the volatility. Not surprisingly, active managers generally don't get these calls right on a consistent basis.[2]

Finding an Active Manager With Persistent Performance is not Easy

One of the challenges facing asset owners today is to not only find an active manager who generates alpha, but to find one who does so consistently. In Figure 3, we calculated the percentage of active managers who outperformed their respective benchmarks for each of the past three calendar years.

Figure 3
Lack of Persistency in Active Manager Performance Over a Three-year Period



Source: State Street Global Advisors, eVestment, as of December 31, 2021. Active managers with at least 10 years of track record are included in the universe. The manager preferred benchmark and the sliding fee level at 250 million are used in the calculation. If the manager preferred benchmark or the sliding fee level is not available, the default benchmark and the average manager fee are used in the calculation. Default benchmark index: Bloomberg Global Aggregate for Global Aggregate, FTSE WGBI for Global Government, Bloomberg Global Aggregate — Credit for Global Credit, Bloomberg Global High Yield for Global High Yield, JPM EMBI Global Diversified for Global EMD — Hard Currency, JPM GBI-EM Global Diversified for Global EMD — Local Currency. Fee assumptions: Global Aggregate Active Strategy 25bps; Global Aggregate Index 10bps; Global High Yield Active 45bps; Global High Yield Index 15bps; EMD Hard Currency Active 45bps; EMD Hard Currency Index 20bps; EMD Local Currency Active 45bps; EMD Local Currency Index 20bps. Past performance is not a reliable indicator of future performance. The information contained above is for illustrative purposes only.

While over 70% of Global Aggregate/Global Government/Global Credit active strategies outperformed in 2019, only 13%–42% were able to outperform consecutively over the last three years. Similarly, it has been difficult for Global High Yield/EMD active strategies to maintain their strong performance, with only 3%–31% managing to outperform for three years in a row. While median active multi-sector strategies tend to outperform their benchmarks, asset owners may not actually get those median returns in light of the low performance persistency amongst active managers.

Credit an Important Driver of Active Multi-sector Manager Returns

As shown earlier, there has been better performance in multi-sector fixed income active strategies, with a majority of Global Aggregate, Global Government and Global Credit active strategies outperforming their respective benchmarks over the past 10 years. One reason behind the outperformance is that many of these active managers take out-of-benchmark credit exposures in order to generate alpha.

As shown in Figure 4, a majority of Global Aggregate active strategies had the ability to take out-of-benchmark exposures to high yield. These strategies typically produced higher alphas than those with no high yield exposures, which on average did not generate any alpha (net of fees).

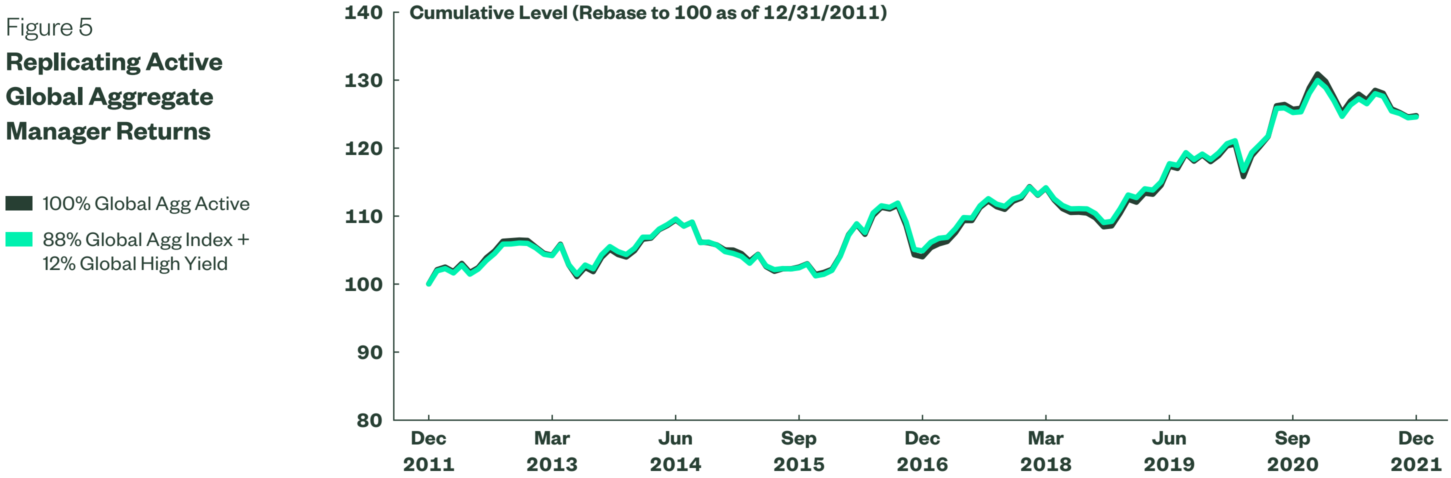
Figure 4
Multi-Sector Active Strategies With Out-of-benchmark Credit Exposures Generated Higher Alphas

	No. of Strategies	% of Active Strategies Outperforming the Benchmark (Net of Fee)	Median Annualized Excess Return (Net of Fee) (%)
Global Aggregate Strategy with High Yield Exposure	25	80	0.56
Global Aggregate Strategy with No High Yield Exposure	8	50	0.00
Global Government Strategy with IG Corporate or High Yield Exposure	8	75	0.42
Global Government Strategy with No IG Corporate or High Yield Exposure	9	56	0.01

Source: State Street Global Advisors, eVestment, as of December 31, 2021. Active managers with at least 10 years of track record are included in the universe. The manager preferred benchmark and the sliding fee level at 250 million are used in the calculation. If the manager preferred benchmark or the sliding fee level is not available, the default benchmark and the average manager fee are used in the calculation. Default benchmark index: Bloomberg Global Aggregate for Global Aggregate, FTSE WGBI for Global Government. Fee assumptions: Global Aggregate Active Strategy 25bps; Global Aggregate Index 10bps; Global High Yield Active 45bps; Global High Yield Index 15bps; EMD Hard Currency Active 45bps; EMD Hard Currency Index 20bps; EMD Local Currency Active 45bps; EMD Local Currency Index 20bps. Past performance is not a reliable indicator of future performance. The information contained above is for illustrative purposes only.

We can replicate active global aggregate manager returns using index strategies. We found that a simple 88% Global Aggregate/12% Global High Yield mix would have tracked closely the returns of a medium active global aggregate manager over the last 10 years, as shown in Figure 5.

Figure 5
Replicating Active Global Aggregate Manager Returns



Source: State Street Global Advisors, eVestment, as of December 31, 2021. Active managers with at least 10 years of track record are included in the universe. The manager preferred benchmark and the sliding fee level at 250 million are used in the calculation. If the manager preferred benchmark or the sliding fee level is not available, the default benchmark and the average manager fee are used in the calculation. Default benchmark index: Bloomberg Global Aggregate for Global Aggregate. Global Aggregate Index = Bloomberg Global Aggregate total return USD index; Global High Yield Index = Bloomberg Global High Yield total return USD index. Fee assumptions: Global Aggregate Active Strategy 25bps; Global Aggregate Index 10bps; Global High Yield Index 15bps. Past performance is not a reliable indicator of future performance. The information contained above is for illustrative purposes only.

In the global government bond space, about half of the active strategies invested in out-of-benchmark investment grade corporate bonds or even high yield bonds. Similar to the case for Global Aggregate active managers, the global government bond strategies with credit exposure generated better alphas than those without, which failed to produce meaningful alpha on average (net of fees).

Although not shown here due to the limited number of managers, close to 90% of Global Credit active strategies in our manager sample have out-of-benchmark exposures to high yield to boost alphas. Only a small number of active global credit managers in the sample do not have some kind of exposure to high yield.

Active Fixed Income: Alpha Patterns Indicate Less Diversification for Asset Owners

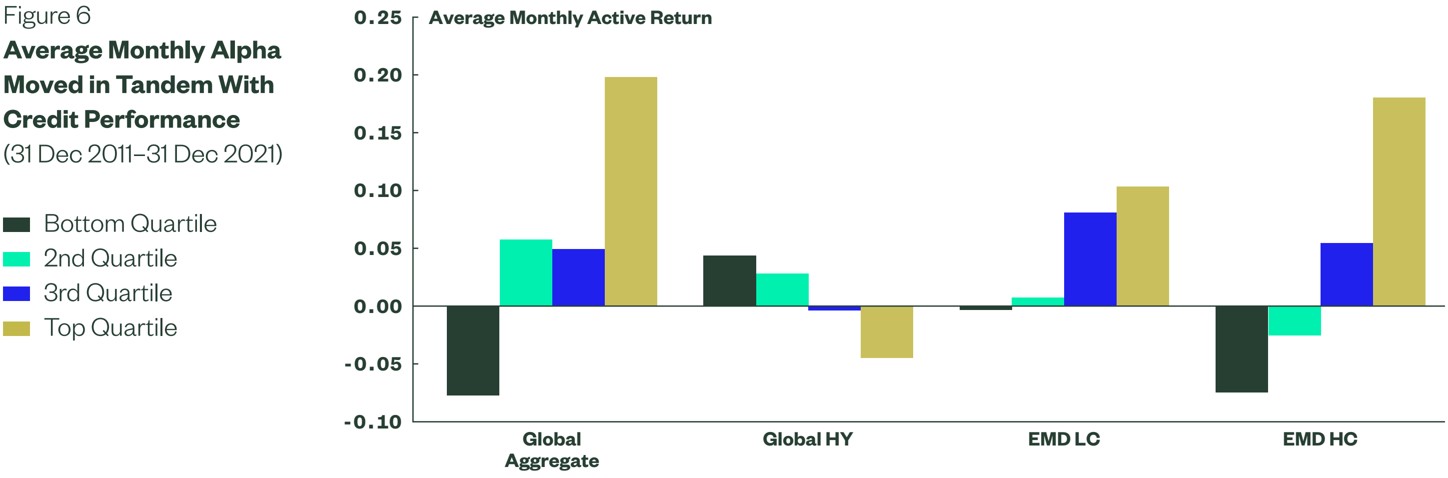
- **Excess returns, particularly those generated by multi-sector active strategies, tend to move in tandem with credit performance, suggesting managers are exposed to credit beta**
- **Active managers' excess returns (alphas) have been strongly correlated with equities and credit spreads, while their correlations with macro factors were not meaningful**
- **Alphas tend to turn negative during equity sell-offs, implying poor diversification when it is needed the most. This means locking in losses to active managers at the worst time**

Struggling to Navigate Credit Underperformance

As discussed earlier, one of the reasons behind active manager outperformance, particularly in multi-sector strategies, is that many take out-of-benchmark credit exposures to generate alpha. The question is, are these excess returns coming from a structural over-exposure to credit or are they coming from the timing or selection ability of the active managers?

We conducted a simple test where we compared FI alpha against four different credit performance quartiles. As shown in Figure 6, active manager alphas tended to move in lock-step with the credit performance quartiles, i.e. their alphas were mostly negative during the bottom quartile credit performance periods and increased as the credit returns improved. The one exception was the global high yield active manager universe where active managers tended to position defensively due to the idiosyncratic default risks and high transaction costs in the market. However, this positioning comes at the cost of performance which, as we showed earlier, has been challenged.

Figure 6
Average Monthly Alpha Moved in Tandem With Credit Performance
(31 Dec 2011–31 Dec 2021)



Source: State Street Global Advisors, eVestment, Bloomberg as of December 31, 2021. Bloomberg Global Agg Credit Total Return Index monthly returns from 31 Dec 2011 to 31 Dec 2022 were divided into quartiles by performance. Monthly active returns were calculated using the median of active managers' gross of fee excess returns with at least 10 years of track record. The manager preferred benchmark and the sliding fee level at 250 million are used in the calculation. If the manager preferred benchmark is not available, the default benchmark is used in the calculation. Default benchmark index: Bloomberg Global Aggregate for Global Aggregate, FTSE WGBI for Global Government, Bloomberg Global Aggregate — Credit for Global Credit, Bloomberg Global High Yield for Global High Yield, JPM EMBI Global Diversified for Global EMD — Hard Currency, JPM GBI-EM Global Diversified for Global EMD — Local Currency. Fee assumptions: Global Aggregate Active Strategy 25bps; Global Aggregate Index 10bps; Global High Yield Active 45bps; Global High Yield Index 15bps; EMD Hard Currency Active 45bps; EMD Hard Currency Index 20bps; EMD Local Currency Active 45bps; EMD Local Currency Index 20bps. Past performance is not a reliable indicator of future performance. The information contained above is for illustrative purposes only.

Alpha Patterns Show High Correlation With Equities

To further assess the alpha patterns of fixed income active managers, particularly multi-sector ones who have generated outperformance on average, we looked at the correlations of active manager excess returns (alphas) with global equity returns, credit spreads, and other commonly used macro variables. (See Figure 7).

We found that active manager excess returns were not particularly correlated with US inflation, the Fed Funds Rate or 10-year US Treasuries. This is perhaps not that surprising as these indicators in themselves (individually) do not necessarily drive markets. However, we did find that active manager alphas, especially in the Global Aggregate sector, were strongly correlated with both equity performance and credit spreads. In fact, the correlation to equities and credit has increased over the course of the last 10 years. This is not particularly surprising given the out-of-benchmark credit exposure that many of the multi-sector active managers have been taking. However, this can be problematic for asset owners who may be expecting their fixed income exposures to provide portfolio diversification.

Figure 7
Active Manager Excess Returns are Strongly Correlated With Equity Returns and Credit Spreads

	Correlations (Dec 2011–Dec 2021)				
	Global Equity	**IG Spread**	**US Inflation**	**Fed Funds Rate**	**UST 10yr Yield**
Global Agg	0.75	-0.83	0.02	-0.10	-0.08
Global HY	0.26	-0.26	0.06	-0.05	0.06
EMD LC	0.39	-0.57	0.07	-0.10	-0.11
EMD HC	0.64	-0.74	0.11	-0.06	-0.15

Source: State Street Global Advisors, eVestment, Bloomberg as of December 31, 2021. Monthly median excess returns were used to calculated correlation data. MSCI AC World Equity Total Return Index was used for Global Equity. CSI BBB Index was used for IG spread. Active managers with at least 10 years of track record are included in the universe. The manager preferred benchmark and the sliding fee level at 250 million are used in the calculation. If the manager preferred benchmark is not available, the default benchmark is used in the calculation. Default benchmark index: Bloomberg Global Aggregate for Global Aggregate, FTSE WGBI for Global Government, Bloomberg Global Aggregate — Credit for Global Credit, Bloomberg Global High Yield for Global High Yield, JPM EMBI Global Diversified for Global EMD — Hard Currency, JPM GBI-EM Global Diversified for Global EMD — Local Currency. Fee assumptions: Global Aggregate Active Strategy 25bps; Global Aggregate Index 10bps; Global High Yield Active 45bps; Global High Yield Index 15bps; EMD Hard Currency Active 45bps; EMD Hard Currency Index 20bps; EMD Local Currency Active 45bps; EMD Local Currency Index 20bps. Past performance is not a reliable indicator of future performance. The information contained above is for illustrative purposes only.

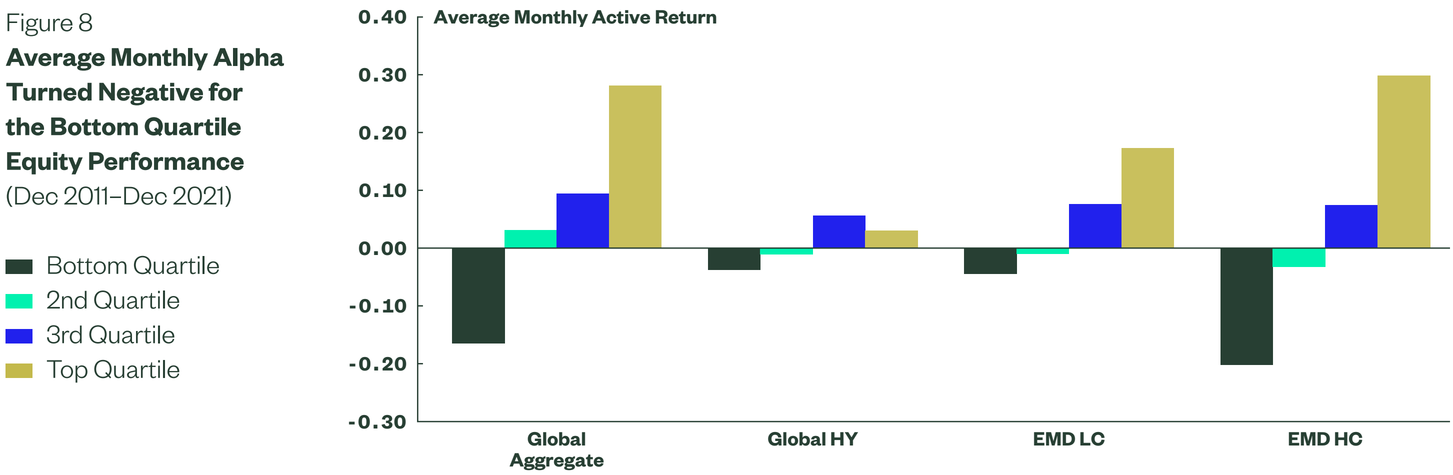
High Correlation With Equity Returns Means Less Diversification in Portfolios

From an asset owner's perspective, it would be ideal to have fixed income active manager returns which are uncorrelated with equities. In this scenario, the fixed income portion of the portfolio would provide diversification compared to equities, with the manager helping to increase that diversification. However, historical results show this is not the case.

To illustrate this, we compared average monthly active manager excess returns against equity performance by quartile (see Figure 8). This analysis shows that when equity performance was the poorest, so was manager alpha.

In the absence of any other liquid assets in the portfolio, investors would be locking in losses (by selling underperforming active strategies) in order to generate liquidity or to facilitate rebalancing to equity markets.

Figure 8
Average Monthly Alpha Turned Negative for the Bottom Quartile Equity Performance
(Dec 2011–Dec 2021)



Source: State Street Global Advisors, eVestment, Bloomberg as of December 31, 2021. MSCI AC World Equity Total Return Index monthly returns were divided into four quartiles by performance. Monthly active returns were calculated using the median of active managers' gross of fee excess returns with at least 10 years of track record. The manager preferred benchmark and the sliding fee level at 250 million are used in the calculation. If the manager preferred benchmark is not available, the default benchmark is used in the calculation. Default benchmark index: Bloomberg Global Aggregate for Global Aggregate, FTSE WGBI for Global Government, Bloomberg Global Aggregate — Credit for Global Credit, Bloomberg Global High Yield for Global High Yield, JPM EMBI Global Diversified for Global EMD — Hard Currency, JPM GBI-EM Global Diversified for Global EMD — Local Currency. Fee assumptions: Global Aggregate Active Strategy 25bps; Global Aggregate Index 10bps; Global High Yield Active 45bps; Global High Yield Index 15bps; EMD Hard Currency Active 45bps; EMD Hard Currency Index 20bps; EMD Local Currency Active 45bps; EMD Local Currency Index 20bps. Past performance is not a reliable indicator of future performance. The information contained above is for illustrative purposes only.

A Mix of Fixed Income Indexing and Active Can Deliver Better Portfolio Efficiency

- **Active management in fixed income still dominates but there has been a move towards indexing to reduce costs and improve portfolio efficiency**
- **A mix of index and active in a Global Aggregate core to rebalance a multi-asset portfolio can deliver similar annualized returns to holding an active core while improving the return/risk ratio**
- **Adding indexing in Global High Yield and EMD satellites can further improve the portfolio's return/risk ratio by lowering the portfolio risk without sacrificing the portfolio return**

Increased Use of Indexing by Investors to Improve Portfolio Efficiency

Active management of fixed income strategies still dominate in institutional investors' portfolios, based on a survey we conducted in association with Longitude in 2021. However, there has been a move towards indexing — over 60% of the survey respondents indicated that they are prioritizing increased use of indexing for core and/or satellite FI exposures over the next three years. "Lowering costs/improved efficiency" is the primary motivation for these institutional investors to make the change. In addition, one-third of respondents plan to increase their indexed allocations in areas where they believe it has become more difficult for active managers to add value (see Figure 9).

Figure 9
Survey Responses to the Question "What are the Key Drivers of Increased Indexed FI Adoption?"

Lowering costs/improved efficiency	39%
Index strategies can maximize the impact of our asset allocation decisions because of their efficient and reliable delivery of benchmark returns	38%
Believe the opportunity for active managers to add alpha has become more difficult in these segments	33%
Enhanced liquidity and pricing transparency	32%
Index strategies are increasingly demonstrating more reliable performance, even in more specific and less liquid fixed income sectors	30%
Risks in this segment are too unpredictable for high conviction, active managers to reliably protect against	29%
Index strategies can complement existing active allocations in these segments	27%

Source: Fixed Income: Preparing for the Big Shift, State Street Global Advisors, July 2021. Respondents asked to select up to three choices. n = 321. The information contained above is for illustrative purposes only.

What is Driving the Shift to Indexing?

Institutional investors are changing the way they construct their fixed income portfolios. Historically, many institutions relied on their Core or Core Plus Aggregate bond allocations. However, there has been an increasing ability and willingness among institutional investors to construct their fixed income portfolios in a Core-Satellite model. This is done by combining strategies of different sectors and/or targeted durations and tactically allocating among them to suit their return/risk objectives and cashflow needs. Over the past 10 years, flows into building block segments such as sovereign bonds, investment grade and high yield credit bonds, and emerging market debt have grown much faster than those into the core fixed income segments. Moreover, passive fixed income managers have recorded better flows than their active counterparts.

Replacing Some Active Core With Indexing: Similar Returns for Lowers Risk

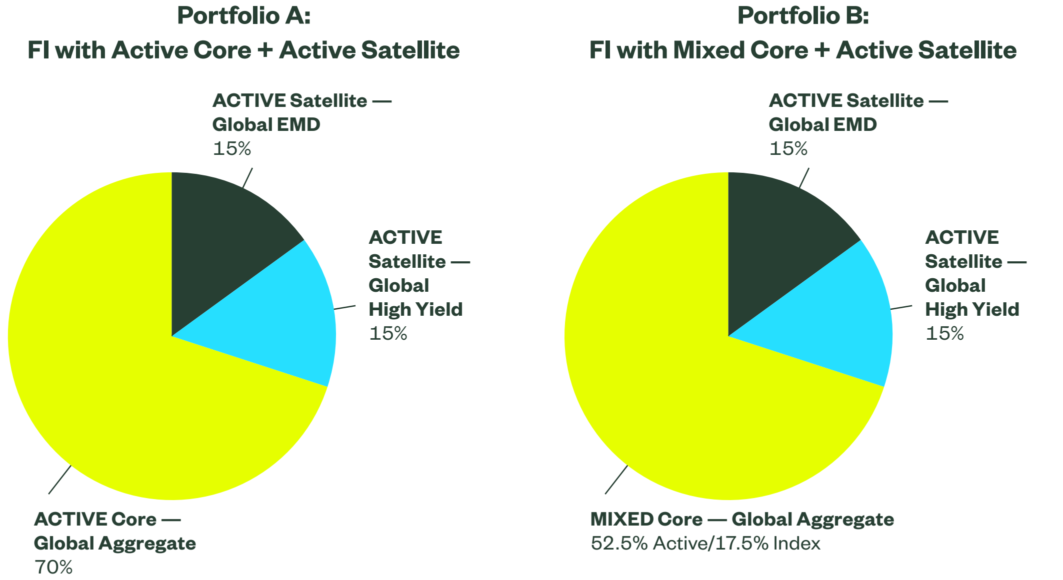
To show the benefits of holding some index exposure, we can look at some simple comparisons using a 60% ACWI/40% Fixed Income portfolio. The core-satellite fixed income portfolio is comprised of 70% Global Aggregate Bonds and 30% Global High Yield Bonds and Global Emerging Market Debt.

First, we compare a core-satellite portfolio with only active fixed income (Portfolio A) with one which replaces some of the active core FI strategy with an indexed exposure (Portfolio B), as shown in Figure 10. Considering the historical strong performance of active core managers, we replace only a quarter of active core exposures with indexing to provide liquidity to meet portfolio rebalancing needs. For the mixed FI core assets in Portfolio B, we utilize indexing for rebalancing — in this example, our rebalancing rule takes from the indexed assets first with a band of 0–15% on the total portfolio level; if the band is exceeded, only then would actively managed core assets be used for rebalancing.

As highlighted earlier, active fixed income managers tend to underperform during large equity sell-offs, and so we rebalance the portfolio using indexed assets instead. This allows the active manager allocation to remain undisturbed, thus positioning them to take advantage of the market rebound to generate alpha.

Over a long period, adding indexing to the core and then using it for rebalancing purposes can result in similar annualized returns to that achieved by holding only active fixed income (on a net of fee basis), but with a lower overall portfolio risk and a more contained drawdown (see Figure 10). The portfolio's return/risk ratio also improves. This demonstrates that investors don't need to give up returns to reduce overall portfolio risk.

Figure 10
Rebalancing with Indexing Core:
Supportive of Portfolio Risk-Return



12/31/2005–12/31/2021	Portfolio A: 60% ACWI + 40% Fixed Income with Active Core Plus Active Satellite	Portfolio B: 60% ACWI + 40% Fixed Income with Mixed Core Plus Active Satellite
Annualized Return (Net of Fee) (%)	7.13	7.12
Annualized Risk (%)	11.44	11.38
Return/Risk Ratio	0.62	0.63
Max Drawdown (%)	-39.21	-39.04

Source: State Street Global Advisors, eVestment, as of December 31, 2021. Active managers with at least 10 years of track record are included in the universe. Active manager returns are calculated based on the median active manager excess return plus the index return. ACWI = MSCI All Country World net total return index. Global Aggregate Index = Bloomberg Global Aggregate USD unhedged index. Fee assumptions: Global Aggregate Active Strategy 25bps; Global Aggregate Index 10bps; Global High Yield Active Strategy 45bps; Global EMD Hard Currency Active Strategy 45bps; Global EMD Local Currency Active Strategy 45bps; ACWI 5bps. Our rebalancing rule uses the Global Aggregate Index first to rebalance with a band of 0–15% on the total portfolio level. If the band is exceeded, then active Global Aggregate strategies will be used for rebalancing. Fee assumptions: ACWI 5bps; Global Aggregate Active Strategy 25bps; Global Aggregate Index 10bps; Global High Yield Active 45bps; Global High Yield Index 15bps; EMD Hard Currency Active 45bps; EMD Hard Currency Index 20bps; EMD Local Currency Active 45bps; EMD Local Currency Index 20bps. Past performance is not a reliable indicator of future performance. The information contained above is for illustrative purposes only.

Mixing Index and Active in the Core and Satellite: Highest Portfolio Return/Risk Ratio

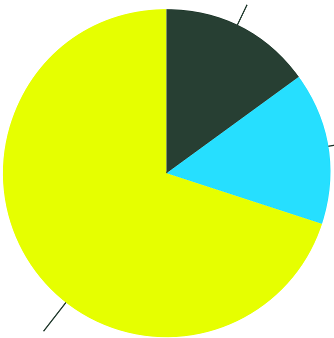
In Figure 11, we add indexing to the FI satellite portfolio (Portfolio C). Given the poor historical performance of active global high yield strategies, we replace all of the active exposures with indexing for illustrative purpose. As active manager performance in EMD has been more mixed, we apply a 50%/50% split between active and indexing while utilizing indexing for portfolio rebalancing.

Over a long period, adding indexing to both FI core and satellite portfolios can further improve the portfolio's return/risk ratio. Of the three portfolios that we analyzed, Portfolio C — with a mix of indexing and active in both FI core and satellite portfolios — achieved the highest return/risk ratio as portfolio risk was reduced without sacrificing portfolio return.

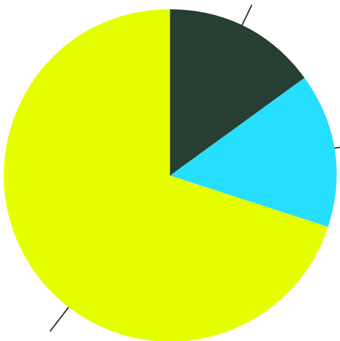
Figure 11

Adding Indexing in the Satellite Further Improved the Portfolio Risk-Return

Portfolio B: FI with Active Core + Mixed Satellite



Portfolio C: FI with Mixed Core + Mixed Satellite



12/31/2005–12/31/2021	Portfolio A: 60% ACWI + 40% Fixed Income with Active Core Plus Active Satellite	Portfolio B: 60% ACWI + 40% Fixed Income with Mixed Core Plus Active Satellite	Portfolio C: 60% ACWI + 40% Fixed Income with Mixed Core Plus Mixed Satellite
Annualized Return (Net of Fee) (%)	7.13	7.12	7.13
Annualized Risk (%)	11.44	11.38	11.35
Return/Risk Ratio	0.62	0.63	0.63
Max Drawdown (%)	-39.21	-39.04	-38.93

Source: State Street Global Advisors, eVestment, as of December 31, 2021. Active managers with at least 10 years of track record are included in the universe. Active manager returns are calculated based on the median active manager excess return plus the index return. ACWI = MSCI All Country World net total return index; Global Aggregate Index = Bloomberg Global Aggregate USD unhedged index; Global High Yield Index = Bloomberg Global High Yield USD unhedged index; Global EMD Index is a 50%/50% mix of the JP Morgan EMBI Global Diversified USD unhedged index and the JP Morgan GBI-EM Global Diversified USD unhedged index. Fee assumptions: Global Aggregate Active Strategy 25bps; Global Aggregate Index 10bps; Global High Yield Active Strategy 45bps; Global High Yield Index 15bps; Global EMD Hard Currency Active Strategy 45bps; Global EMD Hard Currency Index 20bps; Global EMD Local Currency Active Strategy 45bps; Global EMD Local Currency Index 20bps; ACWI 5bps. Our rebalancing rule uses the Global Aggregate Index/Global EMD Hard Currency/Global EMD Local Currency Index first to rebalance with a band of 0–15%/0–3%/0–3% on the total portfolio level. If the band is exceeded, then active Global Aggregate/Global EMD Hard Currency/Global EMD Local Currency strategies will be used for rebalancing. Fee assumptions: ACWI 5bps; Global Aggregate Active Strategy 25bps; Global Aggregate Index 10bps; Global High Yield Active 45bps; Global High Yield Index 15bps; EMD Hard Currency Active 45bps; EMD Hard Currency Index 20bps; EMD Local Currency Active 45bps; EMD Local Currency Index 20bps. Past performance is not a reliable indicator of future performance. The information contained above is for illustrative purposes only.

Conclusion

As our analysis in this paper has demonstrated, there are merits of incorporating indexed strategies into fixed income portfolios. The lack of consistency in the performance of actively managed strategies, where most managers have typically failed to beat their benchmark in consecutive years, underpins the argument for diversifying into indexed strategies. But, as is abundantly clear, it is not a case of either/or.

Because an important element of active manager alpha has historically been exposure to credit, these strategies tend to struggle for outperformance when equities sell off, implying poor diversification when it is needed the most. This can be problematic and costly for asset owners who depend on their fixed income portfolios for risk mitigation, liquidity or rebalancing purposes.

We are seeing a shift towards fixed income indexing as institutional investors change the way they are constructing their portfolios. They are starting to take a core-satellite approach by combining strategies of different sectors/durations to give them more allocation flexibility and to improve portfolio efficiency. By incorporating some indexing elements in both FI core and satellite programs and utilizing indexing to rebalance a portfolio, we demonstrate that we can improve the portfolio's return/risk ratio by lowering the portfolio risk without sacrificing the portfolio return.

Endnotes

1 Case For Global High Yield Why Now, Why Indexing, State Street Global Advisors, 2021.

2 Emerging Market Debt — Indexing on the Rise, State Street Global Advisors, September 2021.

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* Pensions & Investments Research Center, as of December 31, 2020.
† This figure is presented as of March 31, 2022 and includes approximately $73.35 billion USD of assets with respect to SPDR products for which State Street Global Advisors Funds Distributors, LLC (SSGA FD) acts solely as the marketing agent. SSGA FD and State Street Global Advisors are affiliated.

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