Insights
Fixed Income

November 2022

Diversifying Outcomes in Core Fixed Income

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While top-performing active core fixed income managers have received accolades for decades, the difficulty in selecting a top-performing manager across market cycles, and pairing this manager with other active options, has proven difficult for plan sponsors, manager selectors, and professional asset allocators alike. We believe that pairing a high conviction active core manager with an indexed approach satisfies allocators' goals of diversification, income, and capital preservation most effectively across full market cycles from both performance and portfolio construction perspectives.

Diversification, income, and capital preservation are often cited as the primary reasons for investing in fixed income among asset allocators. Using core fixed income as the anchor of an investment model allows investors to add or subtract allocations to growth asset classes in meeting investor risk levels, time horizons, and income appetites. Particularly in times of market turbulence, the diversification and capital preservation pillars remain the primary reasons for an investor to hold fixed income in a multi-asset portfolio.

Over the past 15 years, data shows that top-performing active core fixed income managers, placing in the top quartile among peers' performance,[1] have beaten the Bloomberg U.S. Aggregate Bond Index. An accommodative Federal Reserve, tepid inflation, and favorable fundamentals supported a "risk-on" investing environment for much of the period, providing a tailwind to many managers in the asset class. Within the Core manager universe, exposures within and outside of benchmark sector and quality weightings vary, as many Aggregate-bond-benchmarked managers have held a larger allocation of risky securities to achieve excess returns. In 2019, Morningstar sought to ease some of the relative imbalance within its intermediate-bond universe by separating funds into Core and Core-Plus universes. Grouping portfolios that take similar levels of risk seems like an appropriate exercise during the post-Great Financial Crisis (GFC) period. However, imbalances in risk-taking within peer groups still exist, impacting performance versus the Index. What may be more nuanced are the implications of the timing and the correlations of excess returns during the period, as the engines driving outperformance may also drive correlations between peers.

For manager selection teams, consultants, or plan sponsors, picking those high-performing, top quartile managers over the next 5, 10, or 15 years is a very difficult and resource-consuming proposition. Additionally, balancing individual manager performance expectations with the goal of diversification in the portfolio construction architecture becomes a more nuanced proposition. Rather than wrestle with choosing and overseeing multiple core managers, we believe that combining a single, high conviction active core manager with an indexed approach will best satisfy allocators' goals of diversification, income, and capital preservation throughout a market cycle. Furthermore, adding an indexed core option will introduce or augment a level of liquidity in the overall portfolio that would otherwise only be achieved with policy-level decisions, likely damaging to returns over time.

Why an Active Fixed Income Component Makes Sense

Over time, data suggests that top-performing, higher yielding active core managers have a good chance of outperforming the common benchmark — the Bloomberg U.S. Aggregate Bond Index (the "Index") — over full market cycles, after fees. At the same time, the Core fixed income peer group's median (and worse) managers, have struggled to outperform the Index net-of-fees (Figure 1).

Acknowledging the difficulty in selecting managers based on forecasts, top-performing funds in the Core peer group hold strong track records, largely attributed to skill in macroeconomic forecasting, sector allocation, and risk management. Despite the resources large asset managers afford these teams, the additional performance delta is not completely free to investors. Much of this performance is oftentimes attributed to risk-taking, whether through overweights to riskier sectors of the benchmark or taking small out-of-benchmark positions (staying within the constraints of Morningstar's 2019 universe changes). While exhibiting a distinct yield advantage, the higher volatility, larger drawdown risk, and in some cases, less liquidity relative to the Index, illustrates some of the drawbacks to seeking higher performance in Core fixed income (Figure 1).

Beyond the top quartile of peer group performers, the yields and volatility of managers vary, though on average are only slightly higher than the benchmark (Figure 1). Without the tailwinds of higher-yielding exposures, after-fee performance is typically in line with, if not below, benchmark returns. Given the relative performance and volatility across the peer group, this will complement our case to invest in a more conservative, indexed Core fixed income option as a pairing with a top quartile manager, to best achieve the overall goals of core fixed income over a market cycle.

Figure 1
Comparison of Yield, Volatility, and Outperformance Across Active Managers

	Yield (08/31)	Volatility			Relative Performance (bps)		
		5yr	10yr	15yr	5yr	10yr	15yr
Bloomberg U.S. Aggregate Bond Index	3.96	3.97	3.44	3.54	—	—	—
Top Quartile Peers	4.75	4.31	3.68	4.08	21	33	57
Category Avg for 2/3/4 Quartiles	4.11	4.08	3.48	3.81	-2	7	-19

Source: Performance figures are net of fees (total return), as shown by the averages of the first quartile performers of the Morningstar Core Bond (Open-End and Separate Account) universes and the averages of the non-top quartile portfolios, or those in the second third and fourth quartile. Quartile defined by total returns for 15-year trailing period as of May 31, 2022. Volatility and outperformance data from Morningstar Direct as of May 31, 2022 data. Yield data from Bloomberg and Morningstar Direct, as of August 31, 2022.

Paradox of Higher Correlations and Diminishing Returns

While highly performing, active Core approaches can hold a place in a model portfolio, a paradox arises: more active managers may, in reality, yield less diversification. This is especially true among the top quartile performers, when analyzing the correlations of their excess returns versus the Index. While these managers individually may not invest extensively in the same sectors or have similar out-of-benchmark positions, these risk-on allocations can perform in concert, especially in risk-off markets. Many Core fixed income managers will diversify their risk-on bets across commercial mortgage-backed securities (CMBS), BBB- credit, and small high yield or emerging markets allocations in an effort to outyield the benchmark and increase performance. From an asset allocator standpoint, diversifying across Core fixed income exposures can become much more difficult when factoring intra-peer group excess return correlations, and portfolio similarities from a risk or beta standpoint.

As illustrated below (Figure 2), over the trailing 15-year period as of May 2022, the full active Core peer group's excess returns, on average, have a positive correlation (0.32) with each other. However, the excess returns of the top performance quartile managers (typically exhibiting higher volatility and allocations to risk sectors, whether in benchmark or out-of-benchmark asset classes) have even higher correlations (0.43) with each other. Positive correlations at this level may be expected by asset allocators, and would not generally be an issue in portfolio construction. What is more problematic for a true portfolio-anchoring fixed income allocation is how these intra-peer group correlations rise sharply during periods of stress and market uncertainty. This rise in correlations can occur dramatically, thereby reducing the diversification effect, even among top performing managers. In the three examples of market stress below, we see the averages of excess return correlation increase to over 0.60 between top quartile managers. Median excess return correlations of top quartile performers' climb even higher, reflecting how the bulk of these high performers provide weaker diversification with each other during periods of stress.

Figure 2
Average Correlations of Excess Returns Between Core Bond Managers

Average Correlations of Excess Returns Between Core Bond Managers
June 2007–May 2022

Complete Core Bond Peer Group	0.32
Top Quartile Peers	0.43

Average Correlations of Excess Returns Between Top Quartile Core Bond Managers
Periods of Stress

	Average	Median
Great Financial Crisis	0.58	0.76
European Sovereign Debt Crisis	0.67	0.79
Covid 19 Crisis	0.56	0.97

Source: Morningstar Direct, State Street Global Advisors.

With diversification between managers less a factor than once thought, and in an asset class where capital preservation is of utmost importance, we believe there are strong arguments using a more conservative, liquid option which may serve as a stronger ballast during drawdowns. Correlations show the factors that are truly driving performance point to similar risks across beta bets rather than a sizable impact from security selection, which would be somewhat uncorrelated. Despite its difficulty, if allocators can pick multiple high performers, the benefits from diversification would be diluted.

Case for Combining Active and Index Strategies for Core Fixed Income Exposure

Our belief is that combining a high-conviction active Core fixed income manager with an indexed option helps best accomplish the goals of fixed income within a multi-asset or platform structure. The process to identify and select a top-performing manager for the next 10 or 15 years is not easy. Choosing a second or third manager includes decisions on not only whom, but how they mix with a first option. Choosing an indexed approach to act as a true diversifier, especially when markets sell off, better complements high conviction active managers and allows investors to more effectively achieve the goals of core fixed income - diversification, capital preservation, and income.

As shown by the data below, combining a high conviction, active core bond manager with an indexed solution, rather than a singular (or multiple) lower-conviction portfolio, nets a favorable Sharpe ratio through lower volatility- especially in times where it is of utmost importance. By outperforming on a risk-adjusted and overall basis during market selloffs, longer-term performance will benefit from a capital preservation and diversification standpoint. Figure 3 illustrates this trend, with long-term absolute and risk-adjusted performance benefitting from the index/top-quartile performer pairing versus a top-quartile performer/median performer combination.

Figure 3
Risk-adjusted Performance of Index/Top Quartile Portfolio Combination Advantageous in Stressed Periods

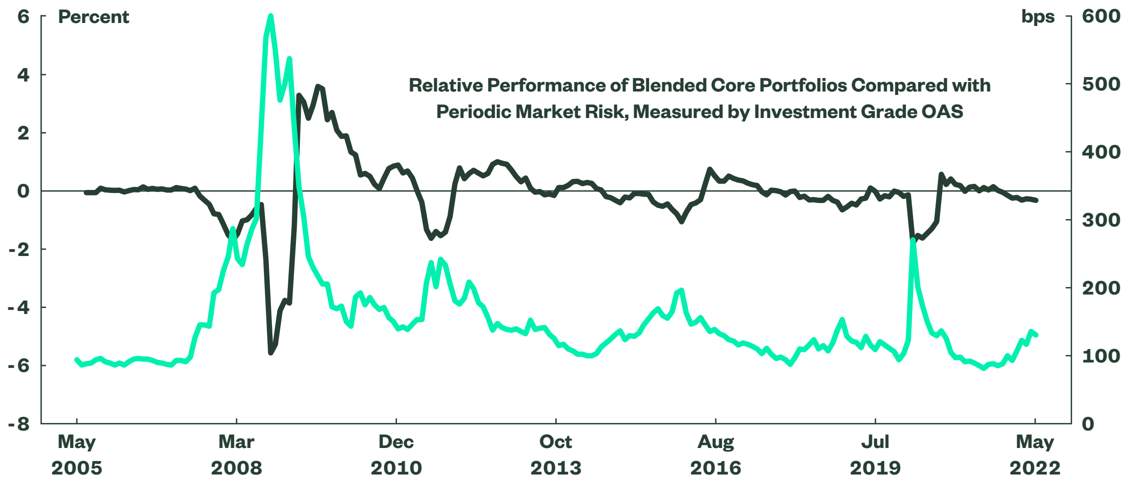
				Return (%)		Volatility (%)		Sharpe Ratio	
	Start	End	# Mo.	Index/ Top Quartile	Median/ Top Quartile	Index/ Top Quartile	Median/ Top Quartile	Index/ Top Quartile	Median/ Top Quartile
Trailing 15 Years	06/01/07	05/31/22	180	3.62	3.51	3.79	4.21	0.96	0.83
Global Financial Crisis (GFC)	09/01/08	02/28/09	6	-1.61	-5.37	9.07	10.86	-0.18	-0.49
Euro Debt Crisis	06/01/11	05/31/12	12	6.39	5.48	2.67	3.09	2.39	1.77
Covid-19	01/01/20	05/31/20	5	4.68	3.11	5.81	8.00	0.81	0.39

Source: Morningstar Direct. Study uses median top quartile performer for trailing 15-year period. For this study, two funds are used to calculate the median: one is the top quartile active performer combined with the median active performer; the other is the top quartile active performer with the indexed approach. Data as of May 31, 2022.

Figure 4 shows the relative performance of the two blended portfolios (Index/top-quartile performer blend and top-quartile/median performer blend) and how they correspond to investment grade spread (OAS) movements, especially during market selloffs. In the chart below, the blue lows reflect periods when the "Index/top-quartile blend" outperforms the two combined active funds. Further, the exhibit shows how relatively protective the Index/top-quartile blend is within a risk-off environment (as shown by the OAS in orange expanding). For the most part, during normal times performance between the two is similar. However, during these periods of market selloff, we see the "Index blend" model outperforming. Importantly, a combination of an indexed solution with an active manager will improve risk/reward by providing ballast, while allowing for risk-taking by an active pair during most markets.

Figure 4
Rolling Relative Performance: Index vs. Median Performer

Relative Return: Median/ Top Quartile — Index/ Top Quartile (LHS)
US IG Corp OAS (RHS)



Source: Bloomberg and Morningstar Direct as of May 31, 2022. Rolling 6-month returns used for relative performance comparison. For this study, two funds are used to calculate the median: one is the top quartile active performer combined with the median active performer; the other is the top quartile active performer with the indexed approach.

The Bottom Line

While State Street Global Advisors' index products can certainly provide that singular diversifier option in the Core fixed income space, we can also provide the building blocks and insights to dial risk up or down to more effectively match the goals of investors' fixed income exposure. Whether adding a Core fixed income allocation, or other sources of portfolio beta, we can tailor a portfolio to satisfy investors' goals of diversification, capital preservation, and income. We strive to design allocations that complement an investor's full range of investments, while importantly meeting both short-term and long-term goals within stated risk tolerance levels.

Endnote

1 Using Morningstar's Core fixed income open-end and separate account universes, trailing net returns through May 31, 2022.

About State Street Global Advisors

Our clients are the world's governments, institutions and financial advisors. To help them achieve their financial goals we live our guiding principles each and every day:

- Start with rigor
- Build from breadth
- Invest as stewards
- Invent the future

For four decades, these principles have helped us be the quiet power in a tumultuous investing world. Helping millions of people secure their financial futures. This takes each of our employees in 29 offices around the world, and a firm-wide conviction that we can always do it better. As a result, we are the world's fourth-largest asset manager* with US $3.26 trillion† under our care.

* Pensions & Investments Research Center, as of December 31, 2021.
† This figure is presented as of September 30, 2022 and includes approximately $55.12 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. Please note all AUM is unaudited.