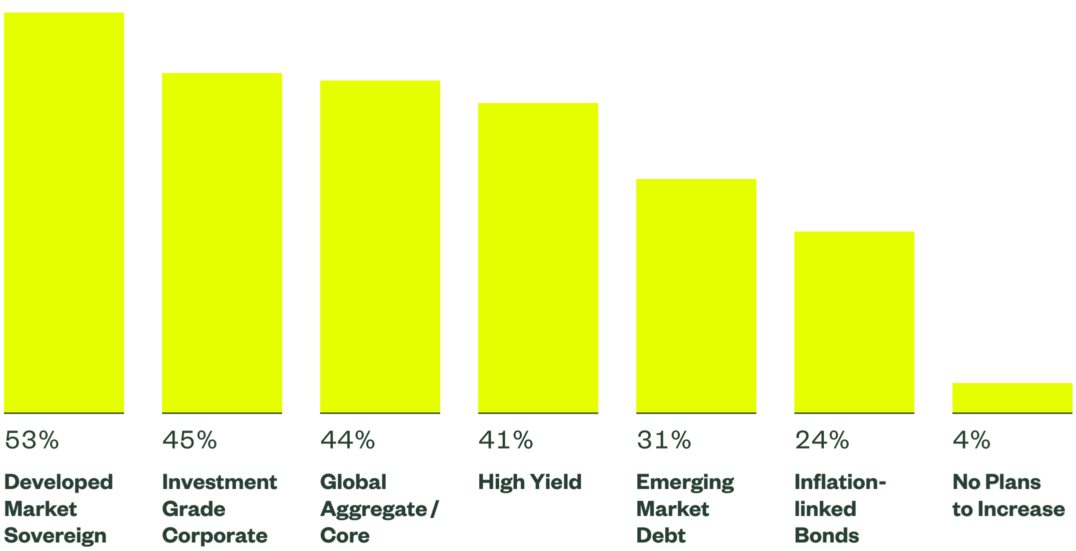
The Rise of Indexing in Fixed Income

Earlier this year, State Street Global Advisors conducted a survey of over 350 institutional investors. Our respondents came from pension funds, wealth managers, asset managers, and sovereign wealth funds. Their responses confirmed that there is a substantial shift underway in fixed income investing. This paper is the first in a series that focuses on what the key findings are likely to mean for fixed income investors.

Our survey found that while active fixed income portfolio management still predominates, the gap between active and index outcomes is narrowing in just about all segments.

Globally, over the next three years more than one-third of institutional investors plan to increase their allocation to fixed income index strategies. And for certain segments in North America, those figures are even higher: 53% for Developed Market Sovereign, 45% Investment Grade Corporate, 44% Global Aggregate/Core and 41% High Yield. In fact, in Europe, a mere 4% had no plans to increase their allocations to index strategies for their fixed income portfolios.

Figure 1
Planned Future Index Fixed Income Allocations
By Strategy



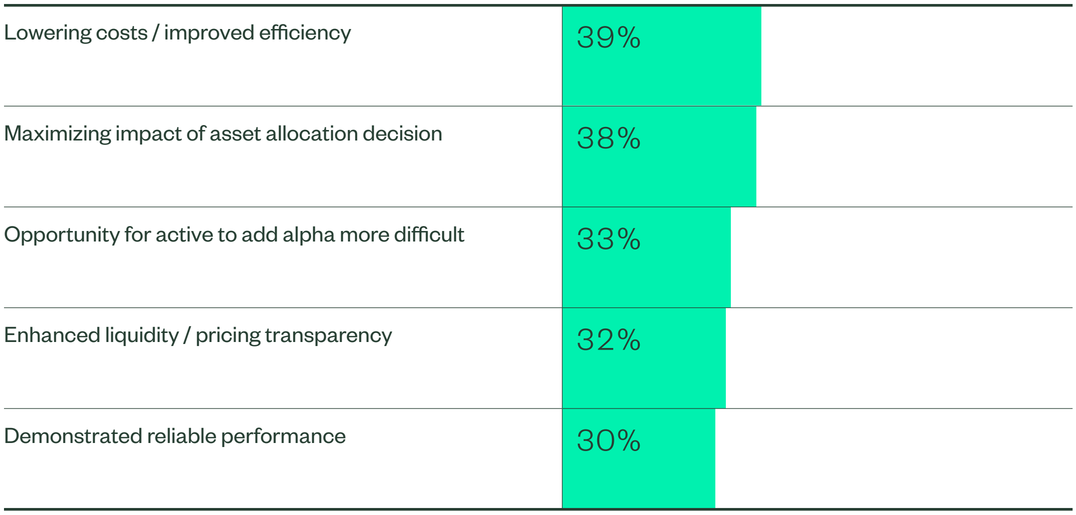
Source: State Street Global Advisors. North America n=119. Q: Does your institution plan to increase its allocation to index strategies for any of the following fixed income segments over the next three years? Respondents asked to select all that apply.

What Is Driving This Move?

Indexing's well-known cost benefits and improved efficiency (39%) inevitably lead the motivation globally, but maximizing the impact of asset allocation decisions (38%) and an understanding that the opportunities for active to add alpha is becoming more limited (33%) followed very closely behind.

Indexing's enhanced liquidity and pricing transparency (32%) and demonstrated reliable performance (30%) rounded out the set of powerful motivating factors.

Figure 2
Leading Motivating Factors



Source: State Street Global Advisors. Global n = 321. What are your institution's main motivations for increasing the use of index strategies in the fixed income segments that you cited previously. All who have plans to increase use of index strategies.

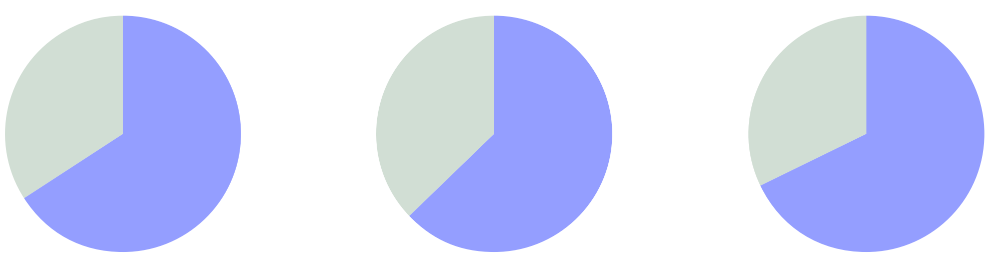
Drilling down on institutions' priorities over the short term revealed a nuanced picture but with one very clear direction: indexed approaches are being increasingly adopted. Over the next three years the following were all stated to be high or very high priorities for institutions globally:

Figure 3
Intend to Increase Use of Indexing Over Next Three Years

Broad or Liquid, Core FI Exposures
66%

Less Liquid, Non-core / Satellite FI Exposures
63%

Exchange-Traded Funds for FI Portfolio Construction
68%



Source: State Street Global Advisors. Global n = 358. To what extent is your institution prioritizing each of the following strategies for its fixed income portfolio over the next three years?

Our Take

These figures were not surprising to us. In fact, they mirror conversations that we have with investors on an almost daily basis. Indexed fixed income just makes more sense for investors today and not just in the areas where it traditionally featured.

We believe that this can be attributed to the liquidity benefits of indexing, as well as some general disappointment with returns from active managers, particularly within the more complex fixed income segments such as high-yield strategies and emerging market debt.

From these conversations and the results of this survey, we see 6 key factors at play:

Performance Transparency and Reliability	Transparency and reliability of performance have become a key focus for fixed income investors in recent years and the sources of alpha are also increasingly better understood, leading investors to question whether they should be paying active fees for what may simply be asset allocation decisions.
Efficiency and Cost-Effectiveness	Efficiency, cost and ultimately value for money are other important factors, especially given how low bond yields and risk premia are today. With experienced index managers able to deliver benchmark returns efficiently and reliably, net-of-fee performance can be comparable against many active managers.
Reduction in Alpha Opportunities	Central bank operations have reduced the alpha potential that is available from security selection, in turn making asset allocation decisions more of a factor. Efficient exposure to market beta via indexing can therefore maximise the impact of these asset allocation decisions.
Diversification and Liquidity	Index portfolios, by their nature are broader and have more diversified exposures than active portfolios, since they do not seek to exploit security selection in a significant way. Such portfolios are therefore typically less concentrated and arguably more liquid and easy to trade in aggregate.
Ability to Deliver Even Complex Betas	With structural changes in the markets and new portfolio management techniques, everything from emerging market debt, high yield and convertibles can now be delivered reliably and efficiently via index strategies.
Emerging Market Debt Now Mastered	The trading cost for EM hard currency bonds is now comparable to investment grade corporate bonds, and the cost for local currency denominated securities is a fraction of that. With the right techniques and expertise EMD is now eminently deliverable in indexed form, in a reliable, cost-effective way.

We cover these factors in more depth in a related whitepaper, The Move to Indexing, but in short, the continuing lower-yield environment, new advanced indexing capabilities, and structural changes in the space are driving a move towards indexing right across the whole fixed income spectrum.

The Takeaway

Indexing's increasing ability to capture the full performance potential of even the most complex fixed income exposures, in a highly cost-effective and reliable way, means that active management is no longer the default choice for fixed income investors.

Furthermore, investors now appreciate the benefits of both active and index approaches and how they can complement each other to achieve their investment objectives.

There are clear reasons and evidence that investors across the globe are increasingly turning to indexing to achieve their fixed income objectives. Traditional approaches to fixed income investing are clearly changing as investors seek to get more cost-effective and reliable outcomes across their whole fixed income program. It can therefore only make sense to ensure that your fixed income portfolio is properly designed and aligned to this new reality.

For the full survey, please visit ssga.com/insights/fixed-income-research.

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

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* Pensions & Investments Research Center, as of December 31, 2020.
† This figure is presented as of June 30, 2021 and includes approximately $63.59 billion 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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