Insights
Fixed Income

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Fixed Income Investing — Shift to Indexing Accelerates

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The volatility experienced on global fixed income markets in the first quarter, amid massive uncertainty emanating from the COVID-19 outbreak, has resulted in a changed landscape. Return-seeking investors are increasingly challenging the approaches they've used in the past. With sovereign bond yields on the floor, the potential opportunity in credit is drawing attention. And the momentum behind gaining fixed income exposures through indexing shows few signs of letting up.

Challenging Return Expectations

A key feature of the period since the global financial crisis (GFC) has been aggressive monetary policy, both conventional in terms of policy rates, and unconventional in terms of quantitative easing (QE).

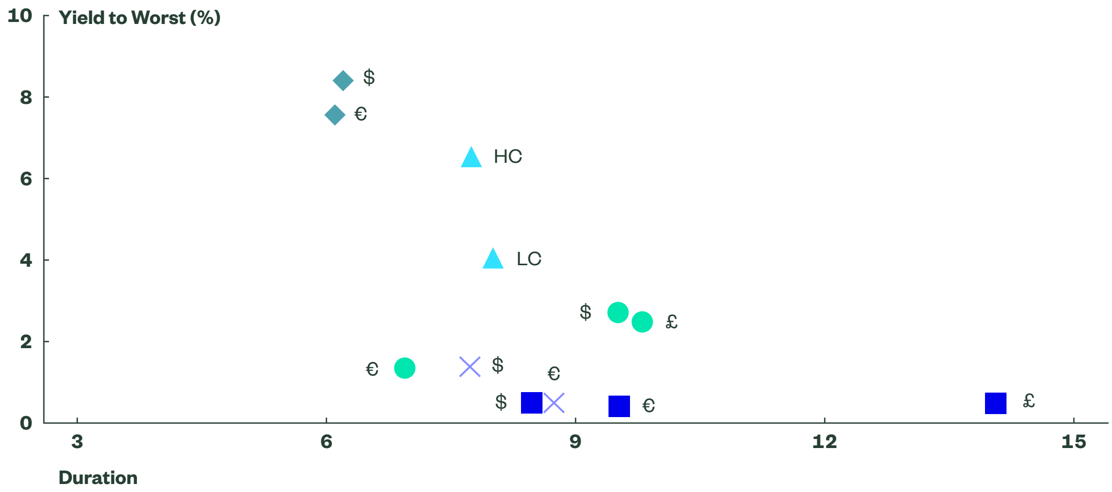
Major central banks across developed markets are now aligned in pursuit of strong policy responses — rate cuts, QE, liquidity programs — to the COVID-19 pandemic. This collective action, in conjunction with the supply and demand shocks that we're still seeing as a consequence of the pandemic, suggests that rates are likely to remain close to, or below, zero for the foreseeable future, with yield curves remaining flat. This will continue to have profound implications for fixed income (FI) investments going forward.

Fixed Income Allocations Since GFC

Against the backdrop of caving interest rates and collapsing yield curves since the GFC, Mario Draghi's "whatever it takes" declaration marked a key moment in how European investors viewed FI markets. Shortly after that, we saw a trend among our clients to move money from government to spread products in search of return.

More recently, the impact of COVID-19 and central banks' responses has been felt across bond markets. In Figure 1, we can see how the return outlook for developed market government bonds across currencies looks particularly challenged. Investment grade corporates offer relatively better return/risk prospects by comparison, while prospects for high yield are even more attractive.

Figure 1
Credit Offers Attractive Potential Entry Point

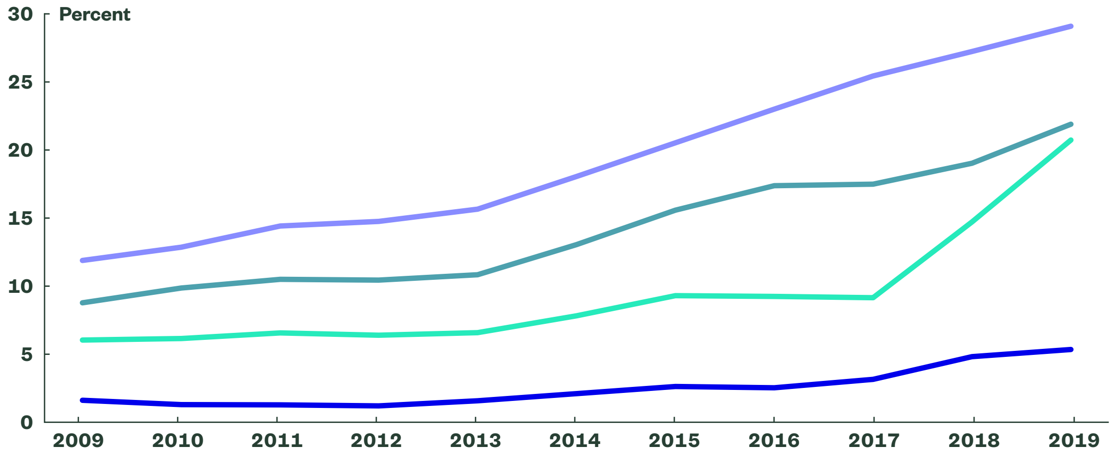


Source: State Street Global Markets as at 31 March 2020.

Making the Shift to Indexing

Investors are increasingly changing how they invest in FI markets, including how they gain exposure to spread products. In short, they are allocating to spread products in a similar fashion to how equity investors sought exposure after the GFC — via indexing. As is evident in Figure 2, indexing now accounts for between 20% and 30% of the whole market in the US and Europe and the trend has shown a rapid acceleration since 2017. It is worth noting that overall allocations to FI have increased for both active and index, but indexing is growing at a faster pace and we believe this will continue.

Figure 2
Percentage of AUM in Passive Fixed Income Inflected Upwards Post-2017



Source: Morningstar Direct, State Street Global Markets as at 31 December 2019.

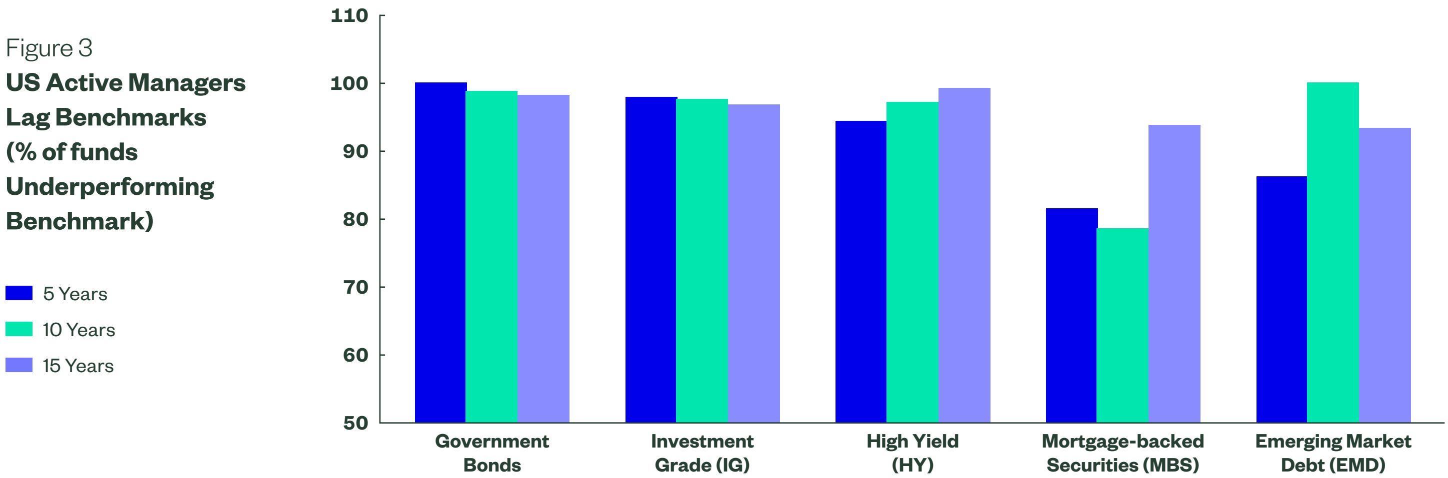
Active Funds Struggle for Performance

A key factor in the shift towards indexed equity investment (which now accounts for 40% of the market) is also a feature in the move to fixed income indexing: active manager underperformance.

After the GFC, many investors sought yield replacement strategies as rates looked set to stay lower for longer. And the incremental Alpha that had historically been available from active FI managers, even net of fees, appeared attractive.

But, as Figure 3 shows, the performance of U.S. active FI managers over the medium to long term ultimately disappointed. All the sectors saw underperformance over 15 years by more than 90% of managers, and 10-year numbers (except Mortgages) look equally dire. Of note is the underperformance in emerging market debt and high yield, where inefficiency in these markets is supposed to suit active managers. And yet the manager underperformance was like that seen in the more efficient sectors, such as government bonds.

Figure 3
US Active Managers Lag Benchmarks (% of funds Underperforming Benchmark)



Source: S&P Dow Jones Indices LLC. State Street Global Markets. Data as of 31 December 2019. Underperformance is based upon equal weighted fund counts. Fund percentages are Net of Fees. All index returns used are total returns. Charts and tables are provided for illustrative purposes. Past performance is no guarantee of future results.

COVID-19 Period Highlights Challenge

And it's not just the long term. Active manager underperformance is also apparent over the short term. As the table in Figure 4 demonstrates, median active managers in the US and Europe across all categories failed to beat the benchmark in Q1 2020. One might argue these managers are "bull market bullies", outperforming when markets are up, but underperforming when markets are on the way down.

Figure 4
Q1 2020 Excess Returns for FI Active Managers

US	IG (%)	HY (%)	EM LC (%)	EM HC (%)	Core (%)	Core Plus (%)
5th %ile	2.7	4.2	-1.5	3.1	1.6	-0.7
25th %ile	-1.2	0.8	-1.7	-0.6	-1.2	-3.0
Median	-1.8	-0.5	-2.2	-2.0	-2.3	-4.7
75th %ile	-3.6	-2.1	-3.7	-3.8	-3.6	-6.2
95th %ile	-10.8	-10.8	-5.5	-6.8	-5.9	-9.5

Europe	IG (%)	HY (%)	EM LC (%)	EM HC (%)	Diversified (%)	Flexible (%)
5th %ile	1.3	4.9	4.0	3.4	0.7	-1.2
25th %ile	0.1	2.0	0.1	-0.8	-0.4	-3.4
Median	-0.6	0.5	-1.0	-3.0	-1.5	-5.5
75th %ile	-1.6	-1.6	-1.7	-4.8	-3.7	-9.0
95th %ile	-5.0	-8.8	-6.2	-10.8	-7.6	-15.7

Source: Morningstar Direct, State Street Global Advisors as of 31 March 2020 — All excess returns gross of fees.
Past performance is no guarantee of future results.

We expect the trend towards fixed income indexing to accelerate and broaden across sectors in the coming years, in large part because active managers have failed to prove their worth in both good times and bad.

Opportunities in Credit

During periods of market dislocation, spreads over Treasuries for US investment grade and high yield corporate issues typically widen, as has been the case in the COVID-19 period. It is during such times of distress that investors may find attractive investment opportunities, benefitting from the ensuing narrowing of spreads as conditions return to normal. Events such as the Iraq invasion of Kuwait, 9/11, and the Great Financial Crisis have all set the stage for investors to handsomely profit depending on when they chose to enter the market. However, there are invariably risks and investors need to be prudent and informed of potential outcomes when investing during times of turbulence.

There is also a potentially attractive entry point into Europe as well. However, because spreads did not widen to the same extreme levels seen in the US, the potential upside is likely more limited.

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- 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 27 offices around the world, and a firm-wide conviction that we can always do it better. As a result, we are the world's third-largest asset manager with US $2.69 trillion* under our care.

* AUM reflects approximately $50.01 billion USD (as of March 31, 2020), with respect to which State Street Global Advisors Funds Distributors, LLC (SSGA FD) serves as marketing agent; SSGA FD and State Street Global Advisors are affiliated.