Insights
Fixed Income

October 2020

The Role of Active and Indexing in Fixed Income Portfolios: A Focus on Crisis Periods

Nate Earle, CFA®, FRM®
Portfolio Strategist, Global Fixed Income

Tom Coleman
Managing Director, Global Head of Fixed Income Portfolio Strategists

Active management of fixed income investments offers the potential for investors to realize portfolio outperformance (alpha) relative to a benchmark over a full market cycle. In aggregate, active managers have succeeded in delivering alpha; however, during historic periods of heightened risk-asset volatility, our research suggests that outperformance can quickly shift to underperformance. While rapid market drawdowns often reverse quickly, many investors turn to fixed income for liquidity amidst such volatility – effectively locking in their losses before any recovery begins.

In this paper, we study fixed-income return data to understand the behavior of both asset owners and active managers in crisis periods (i.e., periods characterized by a sharp correction in risk assets). Based on this analysis, we believe that an investment strategy which combines active and indexed fixed income exposure offers the benefit of flexibility to investors, by preserving the long-term outperformance potential of active management, while providing the risk mitigation and predictability afforded by index management.

Background

For fixed income investors, risk-off crises magnify the impact of many investment decisions, as returns reach unusual extremes in what is generally considered a "safer" asset class. Amid this volatility, distinct trends emerge, with implications for portfolio construction.

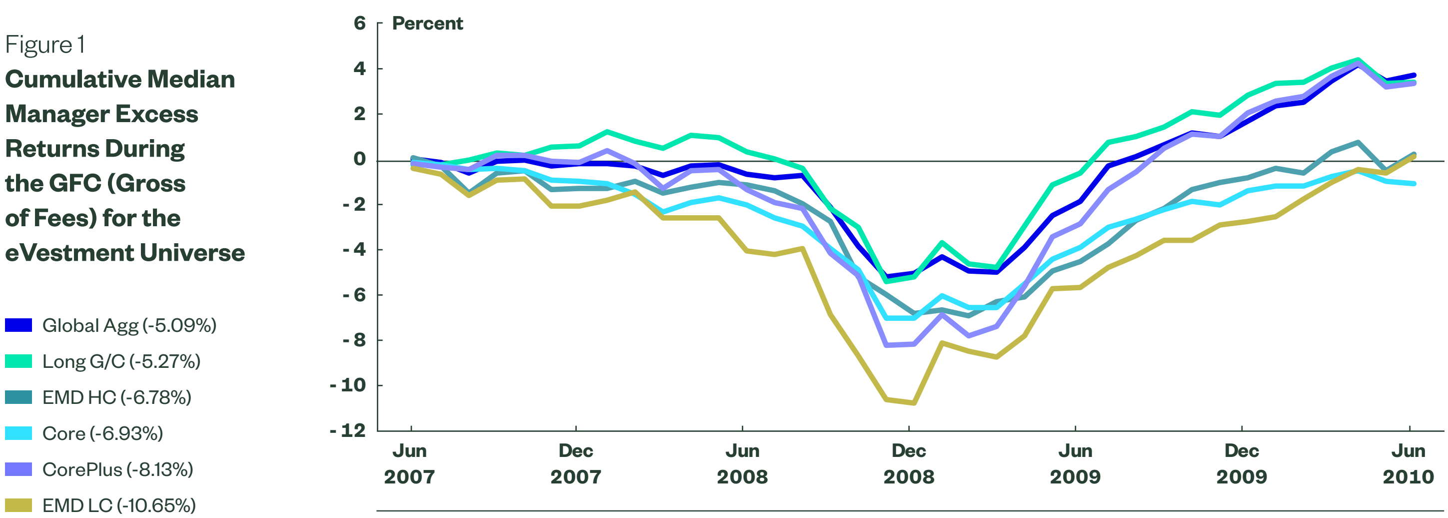
We examined data on active and indexed returns across common fixed income strategies, which yielded the following observations:

- **A balance of both index and active allocations offers benefits** — Paring the long-term outperformance of active alongside the stability of indexing enables optionality
- **Credit beta, a major driver of active manager excess returns, tends to be volatile** — While many active fixed income managers add value over market cycles, credit beta volatility tends to influence active manager outcomes in the short term

Historical data tells us that, while over the long run the median active fixed income managers have added value, in periods of market crisis those managers have tended to substantially underperform their benchmarks. Further, we found that client-driven allocations away from fixed income tend to coincide with periods where active manager excess returns are down. To demonstrate these points, we extracted manager performance data from eVestment for a number of common fixed income strategies: US Core, US Core Plus, US Long Government/Credit, Emerging Market Debt (Hard Currency and Local Currency), and Global Aggregate. Below, we graphically demonstrate how these strategies have performed in terms of cumulative excess returns relative to their benchmarks, focusing on two crisis periods: the Global Financial Crisis (GFC) and the COVID-19 pandemic. Recognizing that universe medians do not necessarily capture the true investor experience as AUM is typically concentrated in a few products, we therefore present asset-weighted excess returns (identified as "excess returns"). All returns described and presented in charts and tables are shown gross of fees.

The GFC unfolded over a period spanning three years, starting in mid-2007 and peaking in the fourth quarter of 2008, with a market recovery extending well beyond that point. Active manager alpha began to erode at the start of the crisis with maximum drawdowns of excess return in each

Figure 1
Cumulative Median Manager Excess Returns During the GFC (Gross of Fees) for the eVestment Universe



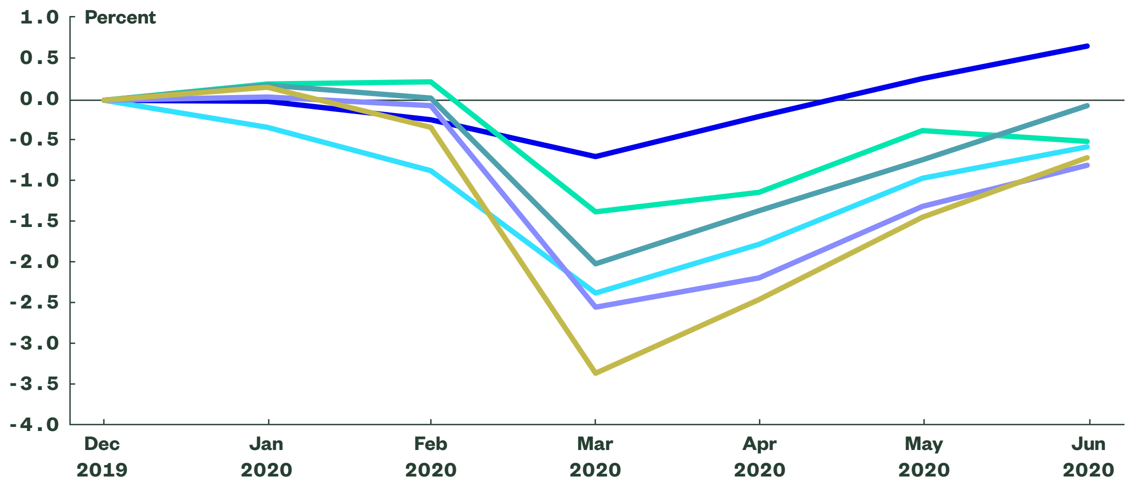
Source: eVestment as of 06/30/2020.

universe occurring as markets bottomed (see Figure 1).

The COVID-19 crisis is still unfolding, but it bears a close resemblance to the GFC in terms of the magnitude of drawdowns in excess returns (see Figure 2).[1] As in the case of the GFC, a strong recovery in median manager active alpha is underway reinforcing the point that sharp alpha drawdown periods tend to be followed by strong recoveries. While time may cure these alpha drawdowns, the pressing needs for liquidity or rebalancing purposes calls for immediate action.

Figure 2
Cumulative Median Manager Excess Returns During the COVID-19 Crisis (Gross of Fees) for the eVestment Universe

- Long G/C (-0.68%)
- EMD LC (-1.37%)
- Core (-2.00%)
- Global Agg (-2.36%)
- EMD HC (-2.53%)
- CorePlus (-3.35%)



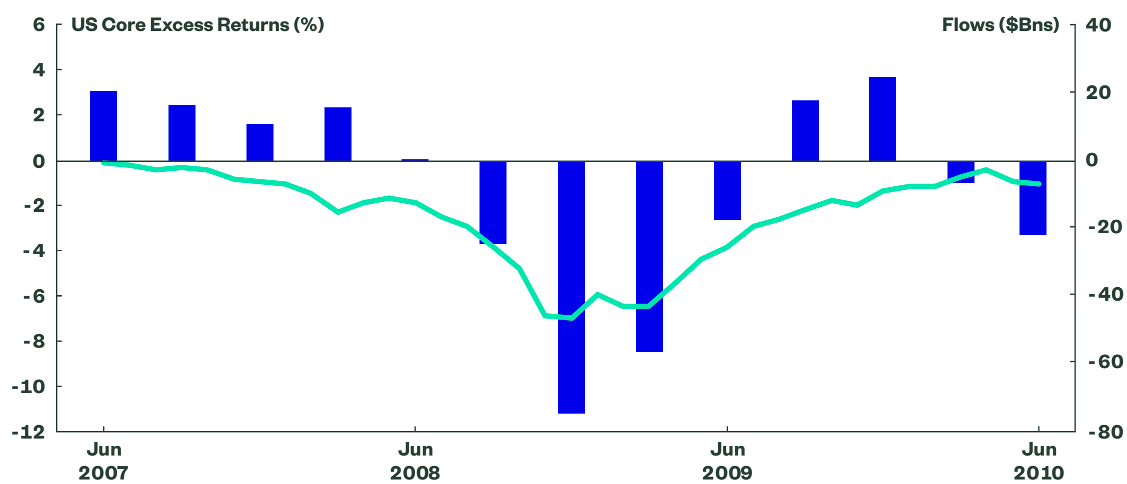
Source: eVestment as of 6/30/2020.

Pairing Active with Indexed Preserves Value, Offers Flexibility

Pairing actively managed exposure with indexed would provide a investors the flexibility to realize the recovery in active manager returns while also sourcing liquidity from their indexed allocation. Similarly, to the extent liquidity requirements arise in periods of active manager outperformance investors could choose to lock in those gains by sourcing liquidity from their active allocation. To illustrate this point, we looked at various drawdown events over the past 13 years and client cash flow activity during those periods. The drawdown of median manager excess returns in the eVestment US Core universe during the GFC along with net institutional cash (out)flows during that period appears in Figure 3, where net cash flows are represented by the sum of US Core, US Core Plus, US Long Government/Credit and Global Aggregate universes. As risk assets underperformed, investors repeatedly tapped their fixed income managers for liquidity, all while Core fixed income managers experienced significant drawdowns. From Q3 2007 to Q2 2010,

Figure 3
Manager Excess Returns (Gross of Fees) and Flow Activity During the GFC

- Net Quarterly Institutional Flows: US Core, Core Plus, Long G/C, Global Agg (RHS)
- US Core Excess Returns

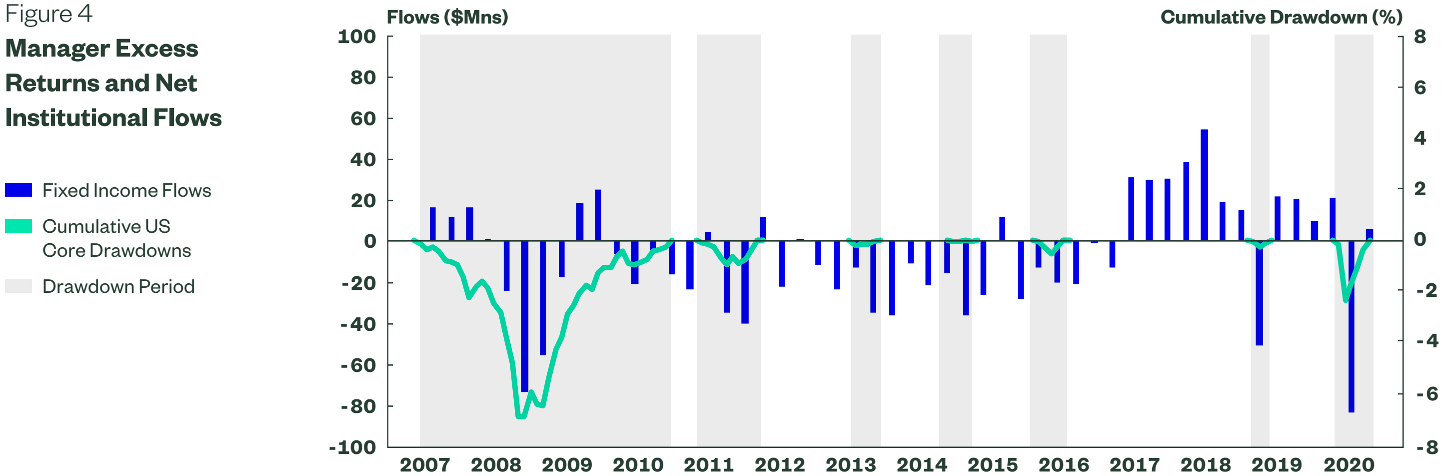


Source: eVestment as of 06/30/2020.

there was $113 billion of outflows from the four investment grade universes.

The GFC was not an isolated incident in this respect. During periods in which US Core manager excess return drawdowns lasted three months or more, these same four strategies consistently experienced large cash outflows. (see Figure 4). Granted, fixed income will experience trends of both inflows and outflows, but outflows in late 2018 and early 2020 each interrupted an extended period of contributions to these strategies.

Figure 4
Manager Excess Returns and Net Institutional Flows



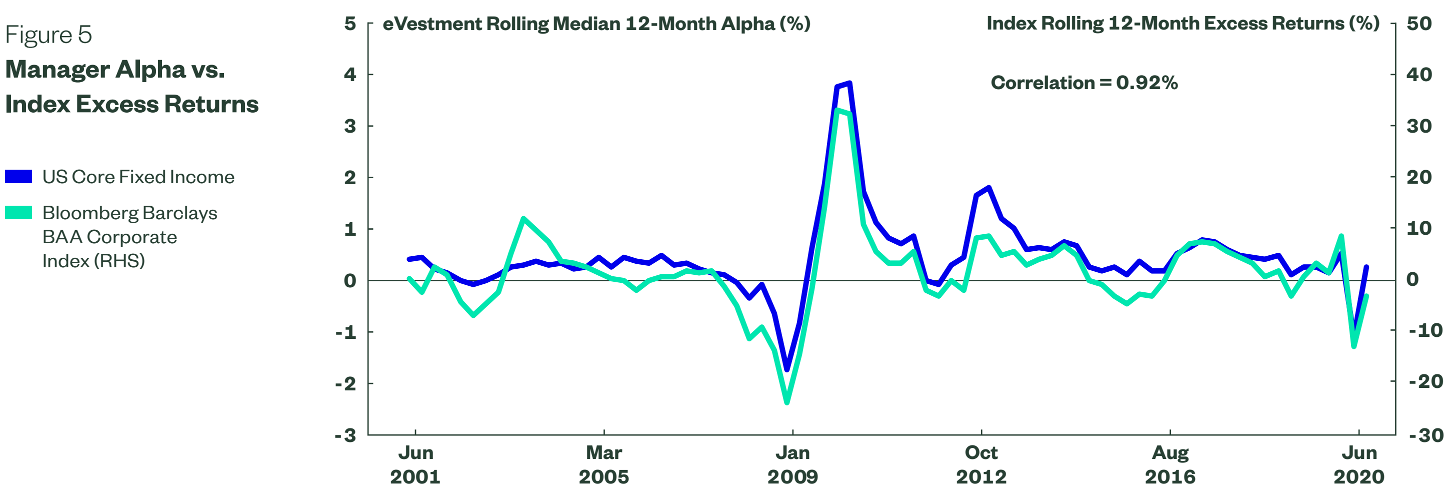
Source: eVestment as of 06/30/2020.

Employing both skilled indexed and active fixed income managers may provide the optimal outcome for investors: long-term outperformance potential, smoothed volatility and preservation of assets when they are needed most.

Credit Beta Volatility Can Influence Outcomes

The propensity for active fixed income managers to underperform in crisis periods stems from managers' strong tendency to overweight credit risk assets relative to US Governments to capture the yield benefit of these investments over time. While this strategy does work when looking at returns over a cycle, it may not be working when liquidity is most needed. Over time, US Core alpha has been highly correlated with lower quality beta returns. As per Figure 5, after adjusting the scaling, the historical US Core universe rolling alpha maps almost exactly on top of

Figure 5
Manager Alpha vs. Index Excess Returns



Source: Bloomberg Barclays and eVestment as of 06/30/2020.

BBB-rated Corporate excess returns over Treasuries.

Recently, we commented on the various levers that active managers employ when sourcing alpha. Some of these levers include structurally overweighting lower quality assets and/or selecting upgrade candidates in credit. Both positions tend to exhibit lower ratings. Lower-rated issuers have historically provided attractive upgrade potential, so it makes sense for managers to have an outsized position in these segments. Higher quality credits, on the other hand, have almost nowhere to go but down the quality spectrum. There is also a longer term strategic impetus to invest in lower quality credits, as the additional carry will incrementally add to returns over time. All in all, these decisions tend to result in portfolios that have a higher credit beta than their benchmarks across each of these common fixed income strategies. Demonstrating this trend across other strategies, Figure 6 displays a correlation matrix of monthly median manager alpha with index excess returns for both US BBB-rated Corporates and US Corporate High Yield.

Figure 6
Correlations of eVestment Universe Alpha with Index Excess Returns over like-duration Treasuries

	US Core Fixed Income	US Core Plus Fixed Income	Global Aggregate Fixed Income	US Long Duration-Gov/Credit Fixed Income	Global Emerking Mkts Fixed Income-Hard Currency	Global Emerking Mkts Fixed Income-Local Currency
Bloomberg Barclays U.S. BAA Corporate Index	0.91	0.95	0.89	0.64	0.78	0.65
Bloomberg Barclays US Corporate High Yield Index	0.84	0.94	0.85	0.69	0.80	0.61

Source: eVestment universe median monthly exces returns vs manager benchmark, and Bloomberg Barclays Indices monthly excess returns vs. Treasuries, from July 2010 to June 2020.

Conclusion

This relationship between credit excess returns and alpha helps explain the propensity of active managers to outperform over the long run as well as why they will tend to experience drawdowns in periods of stress. Pairing them with a risk-neutral index allocation will dampen volatility and can help preserve plan assets.

Endnote

1 There are, of course, notable differences between the COVID-19 crisis and the GFC. For example, the timeline for the COVID-19-related drawdown was much shorter compared with the GFC, with the maximum drawdown of excess returns occurring within a few months of the start of the crisis and markets well on their way to recovery at the end of the Q2 2020.

About State Street Global Advisors

For four decades, State Street Global Advisors has served the world's governments, institutions and financial advisors. With a rigorous, risk-aware approach built on research, analysis and market-tested experience, we build from a breadth of active and index strategies to create cost-effective solutions. As stewards, we help portfolio companies see that what is fair for people and sustainable for the planet can deliver long-term performance. And, as pioneers in index, ETF, and ESG investing, we are always inventing new ways to invest. As a result, we have become the world's third-largest asset manager with US $3.05 trillion* under our care.

* This figure is presented as of June 30, 2020 and includes approximately $69.52 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.

ssga.com

Marketing Communication

State Street Global Advisors Worldwide Entities

Abu Dhabi: State Street Global Advisors Limited, ADGM Branch, Al Khatem Tower, Suite 42801, Level 28, ADGM Square, Al Maryah Island, P.O Box 76404, Abu Dhabi, United Arab Emirates. Regulated by the ADGM Financial Services Regulatory Authority. T: +971 2 245 9000. **Australia:** State Street Global Advisors, Australia, Limited (ABN 42 003 914 225) is the holder of an Australian Financial Services License (AFSL Number 238276). Registered office: Level 14, 420 George Street, Sydney, NSW 2000, Australia. T: +612 9240-7600. F: +612 9240-7611. **Belgium:** State Street Global Advisors Belgium, Chaussée de La Hulpe 120, 1000 Brussels, Belgium. T: 32 2 663 2036. F: 32 2 672 2077. SSGA Belgium is a branch office of State Street Global Advisors Ireland Limited. State Street Global Advisors Ireland Limited, registered in Ireland with company number 145221, authorised and regulated by the Central Bank of Ireland, and whose registered office is at 78 Sir John Rogerson's Quay, Dublin 2. **Canada:** State Street Global Advisors, Ltd., 1981 McGill College Avenue, Suite 500 , Montreal, Qc, H3A 3A8, T: +514 282 2400 and 30 Adelaide Street East Suite 800, Toronto, Ontario M5C 3G6. T: +647 775 5900. **France:** State Street Global Advisors Ireland Limited, Paris branch is a branch of State Street Global Advisors Ireland Limited, registered in Ireland with company number 145221, authorised and regulated by the Central Bank of Ireland, and whose registered office is at 78 Sir John Rogerson's Quay, Dublin 2. State Street Global Advisors Ireland Limited, Paris Branch, is registered in France with company number RCS Nanterre 832 734 602 and whose office is at Immeuble Défense Plaza, 23-25 rue Delarivière-Lefoullon, 92064 Paris La Défense Cedex, France. T: (+33) 1 44 45 40 00. F: (+33) 1 44 45 41 92. **Germany:** State Street Global Advisors GmbH, Brienner Strasse 59, D-80333 Munich. Authorised and regulated by the Bundesanstalt für Finanzdienstleistungsaufsicht ("BaFin"). Registered with the Register of Commerce Munich HRB 121381. T: +49 (0)89-55878-400. F: +49 (0)89-55878-440. **Hong Kong:** State Street Global Advisors Asia Limited, 68/F, Two International Finance Centre, 8 Finance Street, Central, Hong Kong. T: +852 2103-0288. F: +852 2103-0200. **Ireland:** State Street Global Advisors Ireland Limited is regulated by the Central Bank of Ireland. Registered office address 78 Sir John Rogerson's Quay, Dublin 2. Registered Number: 145221. T: +353 (0)1 776 3000. F: +353 (0)1 776 3300. **Italy:** State Street Global Advisors Ireland Limited, Milan Branch (Sede Secondaria di Milano) is a branch of State Street Global Advisors Ireland Limited, registered in Ireland with company number 145221, authorised and regulated by the Central Bank of Ireland, and whose registered office is at 78 Sir John Rogerson's Quay, Dublin 2. State Street Global Advisors Ireland Limited, Milan Branch (Sede Secondaria di Milano), is registered in Italy with company number 10495250960 - R.E.A. 2535585 and VAT number 10495250960 and whose office is at Via Ferrante Aporti, 10 - 20125 Milano, Italy. T: +39 02 32066 100. F: +39 02 32066 155. **Japan:** State Street Global Advisors (Japan) Co., Ltd., Toranomon Hills Mori Tower 25F 1-23-1 Toranomon, Minato-ku, Tokyo 105-6325 Japan. T: +81-3-4530-7380. Financial Instruments Business Operator, Kanto Local Financial Bureau (Kinsho #345), Membership: Japan Investment Advisers Association, The Investment Trust Association, Japan, Japan Securities Dealers' Association. **Netherlands:** State Street Global Advisors Netherlands, Apollo Building, 7th floor Herikerbergweg 29 1101 CN Amsterdam, Netherlands. Telephone: 31 20 7181701. SSGA Netherlands is a branch office of State Street Global Advisors Ireland Limited, registered in Ireland with company number 145221, authorised and regulated by the Central Bank of Ireland, and whose registered office is at 78 Sir John Rogerson's Quay, Dublin 2. **Singapore:** State Street Global Advisors Singapore Limited, 168, Robinson Road, #33-01 Capital Tower, Singapore 068912 (Company Reg. No: 200002719D, regulated by the Monetary Authority of Singapore). T: +65 6826-7555. F: +65 6826-7501. **Switzerland:** State Street Global Advisors AG, Beethovenstr. 19, CH-8027 Zurich. Authorised and regulated by the Eidgenössische Finanzmarktaufsicht ("FINMA"). Registered with the Register of Commerce Zurich CHE-105.078.458. T: +41 (0)44 245 70 00. F: +41 (0)44 245 70 16. **United Kingdom:** State Street Global Advisors Limited. Authorised and regulated by the Financial Conduct Authority. Registered in England. Registered No. 2509928. VAT No. 5776591 81. Registered office: 20 Churchill Place, Canary Wharf, London, E14 5HJ. T: 020 3395 6000. F: 020 3395 6350. **United States:** State Street Global Advisors, One Iron Street, Boston, MA 02210-1641. T: +1 617 786 3000.