White Paper
Fixed Income

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The Move to Indexing
Why Indexing Makes Sense in Fixed Income

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- Fixed income indexing has developed tremendously in sophistication, scope and delivery over the past few years.
- Indexing's ability to capture the full performance potential of even the most complex fixed income exposures, in a highly cost effective way, means that active management is no longer the default choice for fixed income investors.
- Pandemic-related market disruption shone a spotlight into the myriad risks embedded in active strategies, arguably only resolved by the large-scale interventions by policy-makers. This has accelerated the case for incorporating indexing approaches alongside active ones.

Once, all investing was active but over time, as index strategies and products were refined, the value and efficiency of indexing has persuaded more and more investors to switch.

This has been strongly the case for equity at least. For fixed income, though, things were different because of market structure and liquidity differences, and the choice was perhaps not such an obvious one initially. The fixed income market was different and deemed too diverse, too complex for indexing to deliver.

For example, large parts of the bond market were illiquid and difficult to access. Without the transparency of the exchange-traded equity markets, fixed income had traditionally been regarded as the domain of active management.

Fast forward to today, times have changed and indexing techniques have evolved sufficiently that investors are increasingly moving to index strategies within their fixed income allocations. Active is still very much there and dominant but it is no longer the automatic default choice for fixed income investors.

Interestingly, the greatest inroads are being made in the more complex parts of the market where active approaches were once understood to be a necessity. As investors appreciate the reliability, transparency and efficiency of index strategies this is now changing.

Why Indexing Makes Sense Now

Like seemingly so many of the trends in the world today, the main factors that have contributed to the rise in indexed fixed income over recent years, have arguably been reinforced and accelerated as a result of the COVID-19 pandemic.

1 Performance Transparency and Reliability

Performance transparency and reliability have become a key focus for fixed income investors in recent years. These issues came to the fore once again, given the speed and severity of the market disruption caused by the COVID-19 pandemic.

As the markets shuddered in the first quarter of 2020 further evidence of this became clear for many investors. Because the market movements were so large and fast, it was difficult for managers to make any meaningful changes; as a result, investors could immediately see the risks that they had been exposed to in their portfolios. This also helped investors better understand the investment style of their active fixed income manager.

For some investors, what they learned may have been concerning and prompted some to question the prudence of relying solely on an active manager.

The sources of alpha are also increasingly better understood today, leading investors to question whether they should be paying active fees for what may simply be asset allocation decisions, such as structural overweighting of credit to outperform their benchmarks.

2 Efficiency and Cost-Effectiveness

Efficiency, cost and ultimately value for money are other important factors, 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.

The techniques used by sophisticated index managers are very effective in reducing the drag from indexing and in many cases result in returns that can be marginally ahead of benchmark. Index mangers can also exploit fixed income market inefficiencies just like active managers do, but obviously within very tight risk constraints. The new-issue premium in credit markets is a good example of a very reliable source of excess return which index managers can also exploit effectively to benefit performance.

3 Diversification and Liquidity

Index portfolios, by their nature are **broader and 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.

We expect this characteristic to further advance the trend towards indexing, even in areas of the market that were previously considered not to be conducive for indexing, such as emerging market debt and high yield. Furthermore, as investors increasingly use active asset allocation into these higher return potential sectors of the fixed income market to meet their return objectives, a reliable and efficient index exposure has renewed appeal.

The trend towards indexing fixed income exposures has picked up pace. Part of the momentum behind this has been the increased transparency available to investors in determining where performance is coming from. Investors now have much better insight on what is driving return and how much of that is attributable to beta, factor exposure or true alpha.

4 Reduction in Alpha Opportunities

As central banks are currently so dominant in fixed income markets with their quantitative easing programs, there's been a crowding-out effect on fixed income investors, supressing risk premia and in turn reducing the usual alpha potential that is available from security selection.

Security selection opportunities are not only reduced, but the importance of asset allocation as a more potent driver of overall fixed income returns is also increased. And, when asset allocation becomes the dominant factor, why not **do it more cost-effectively** via indexing without the high cost of active management?

5 Ability to Deliver Even Complex Betas

Through market structure changes and new portfolio management techniques, an experienced index manager can continue to push the boundaries of what is possible in indexing. Everything from emerging market debt, high yield and convertibles are all exposures which can now be **delivered reliably and efficiently** via index strategies.

6 Emerging Market Debt Now Mastered

In the past, the high cost of replication, market volatility and inefficiency were the main obstacles to the use of index strategies in the emerging markets. Although these concerns may appear valid, indexing techniques have **moved a long way from replicating the index constituents**; today there are multiple ways that experienced investment managers can minimise and offset these negative effects.

These days, the cost of indexing is no longer as prohibitive as many might expect. 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.

Employing portfolio management techniques such as minimising turnover, tax-lot planning as well as controlling all FX trades (even in controlled currencies) indexers are able to keep indexing costs very low in EMD. Value can also be added by exploiting market inefficiencies, gaining exposure through the primary markets while also pro-actively anticipating index changes. Indexers can also manage exposure effectively through the forward or non-deliverable forward markets to ultimately deliver benchmark returns through a thoughtful but tightly risk-controlled investment process. This reliable and efficient delivery of EMD returns contrasts with the variability and higher costs associated with active managers in EMD. These techniques and results are what lie behind State Street Global Advisor's success in growing to be one of the largest managers of EMD indexed assets globally.

Moving to Indexing: The Game Plan

For investors who are interested in indexing's ability to cost-effectively harness the main drivers of return and deliver even complex sources of beta in a reliable way, the next steps are to consider the whys and hows of moving from active.

Given the nature of fixed income as primarily a solutions or problem-solving asset, it is only natural that active management still has a central role to play in investor portfolios, so indexing may not be the right choice in some situations. But for many it will.

Also key is the choice of manager. A good manager brings to the table experience and insights learned over multiple market cycles, crises and liquidity conditions. The strength of the index process and risk management is tested during bouts of volatility and not during calm markets.

We are increasingly seeing investors employ both active and index approaches to their fixed income strategies. Index strategies can complement active strategies and provide investors with greater flexibility to tactically allocate and fine-tune exposures to target allocations.

We recommend analysing current approaches and questioning whether they can be improved. In many instances a switch to indexing can bring greater cost-effectiveness and performance transparency as well as diversification and liquidity benefits.

1 Evaluate

What are the costs and complexity of the existing approach?

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2 Determine

Are objectives being met? Consistently and efficiently?

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3 Analyse

If employing multiple managers, are there offsets to their styles?

Is that impacting overall outcome?

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4 Act

Consider replacing the weaker manager(s) with an index strategy.

Reducing costs, improving performance reliability and facilitating tactical allocations.

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 rigour
- 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 over US $3.47 trillion* under our care.

* This figure is presented as of 31 December 2020 and includes approximately $75.17 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.