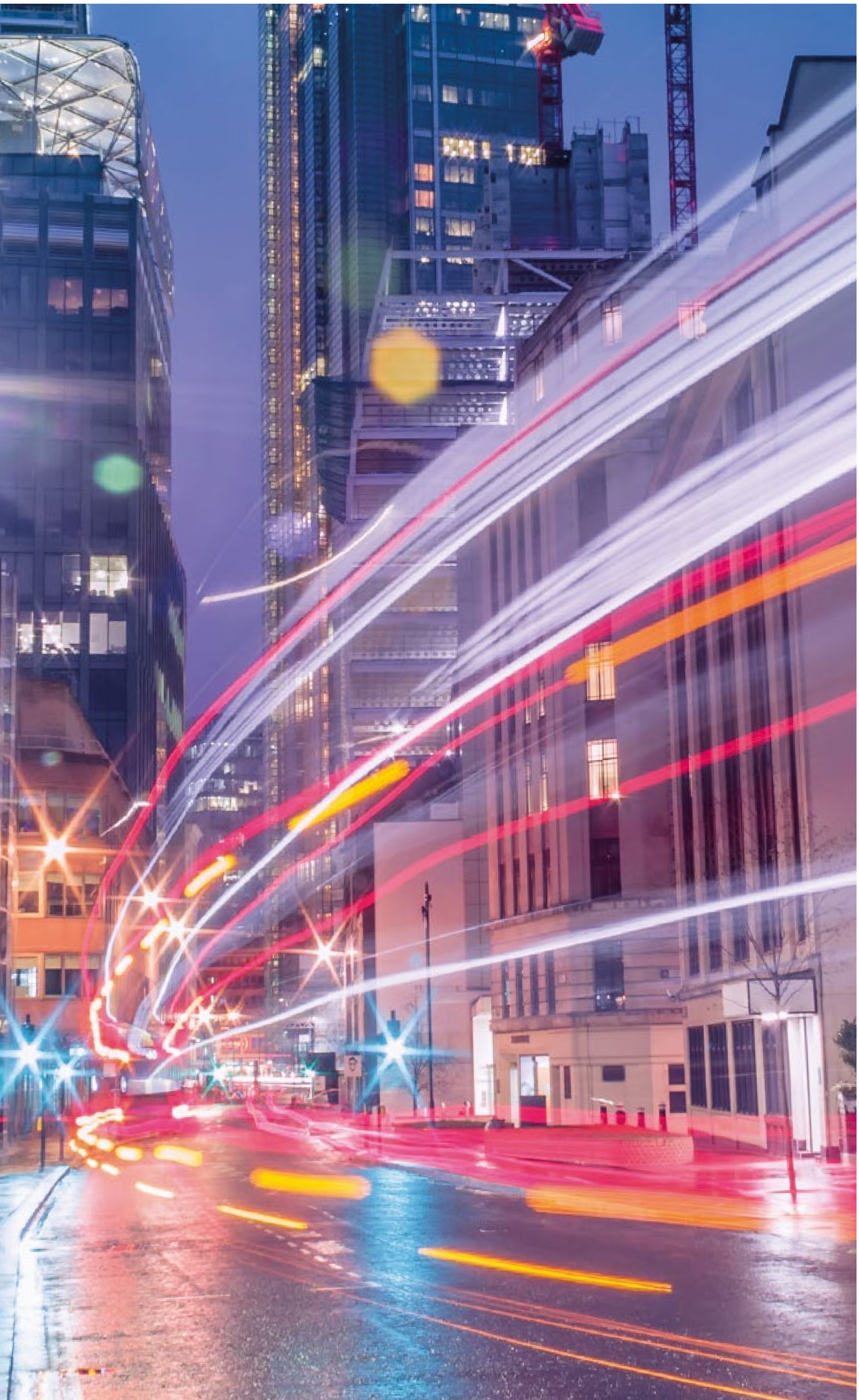
For Investment Professionals only

The case for active management in fixed income



Examining the case for active management in fixed income

The value of a fund's assets will go down as well as up. This will cause the value of your investment to fall as well as rise and you may get back less than you originally invested.

While passive investments have seen rapid growth in recent years, we believe there are several crucial advantages for choosing active management when investing in fixed income. This is especially true in the current climate, as uncertainty over the future path of interest rates and inflation continues to drive heightened volatility across the asset class.

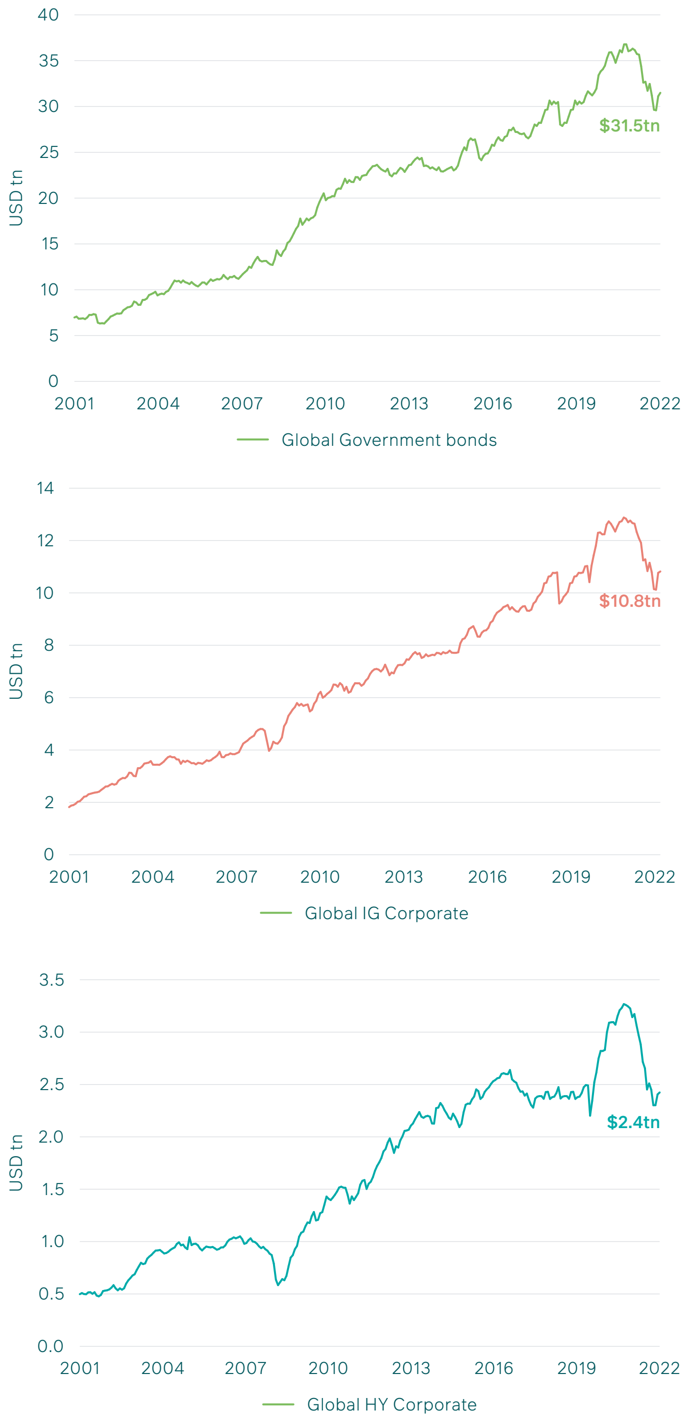
A deep, diverse and growing investable universe

The added value – or alpha – that fund managers can generate depends on both their skill and the breadth of the opportunity set available to them. The greater the number of market inefficiencies, the greater the opportunity for skilled managers to generate returns over and above those of an index, or a passive instrument that seeks to track such an index.

It is therefore encouraging to report that the global bond market continues to see strong growth and is today valued at around $127 trillion[1]. To put this into context, this is more than three times the size of the global equity market. The bond market has been a hive of innovation in the past 40 years, with many new asset classes being developed, such as inflation-protected securities, asset-backed securities (ABS) and high yield bonds, to name just a few. These advances are likely to continue, creating ever more opportunity for active fund managers to generate alpha by utilising the broadest set of tools ever seen.

Past performance is not a guide to future performance.

Figure 1. Credit markets: a deep, diverse and growing investable universe



Source: M&G, Bloomberg, 22 December 2022.

[1] https://www.sifma.org/resources/research/research-quarterly-fixed-income-outstanding/

While the current environment of rising inflation and interest rates undoubtedly presents challenges for fixed income investors, we believe it has also created a significant number of opportunities for well-resourced active managers. Volatility tends to create dislocation in market pricing, and we are currently seeing significant spread dispersion across global credit markets. This is true both within individual names, as well as across different sectors of the economy.

At the same time, the uncertain economic backdrop and higher cost of borrowing means that parts of the credit market are likely to experience an increase in defaults over the next couple of years. This could be exacerbated by the tighter lending conditions that have been witnessed following the recent turmoil in the US banking sector, which in the past few months has seen the failure of a string of mid-tier US banks.

For all these reasons, we believe the need for skilled investment decision-making in fixed income has never been greater. As we move into the later stages of the economic cycle, it will be more important than ever to ensure a thorough assessment of credit risk – it is only through this process that investors can determine how much they need to be paid as compensation.

A better starting point for fixed income valuations

The past couple of years have clearly been a difficult time for bond investors, with surging inflation and a rapid series of interest rate hikes putting pressure on nearly all areas of the fixed income market. Double-digit losses have not been uncommon in 2022, with many longer-dated government and inflation-linked bonds seeing losses in excess of 20%. This volatility has continued throughout the first half of 2023 as markets react to the latest inflation figures and the pronouncements of central bankers.

While this adjustment has been painful, the good news is that fixed income valuations have been reset to much more attractive levels. For perhaps the first time in a decade, investors are being well paid to take both interest rate and credit risk. This is the case almost everywhere you look – from emerging market bonds to European corporate bonds we are now seeing compelling value across the board. While further volatility is likely in the short-term, longer-term returns are largely a function of current yields. On this basis, we believe bond investors have entered the second half of 2023 on a much better starting point.

This shift in valuations presents active investors with a wealth of opportunities to lock in yields at what we consider to be very attractive levels. From a fundamental perspective, we think the majority of companies are still in good shape, with many having taken the opportunity to refinance their debt for an extended period back in 2020 and 2021, when borrowing costs had fallen to near record lows. With limited refinancing requirements over the next few years, we believe investors are being well-compensated for any reasonable expectation of default, especially in the investment grade space.

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Figure 2. A better starting point for bonds – 30y UST real yield over time

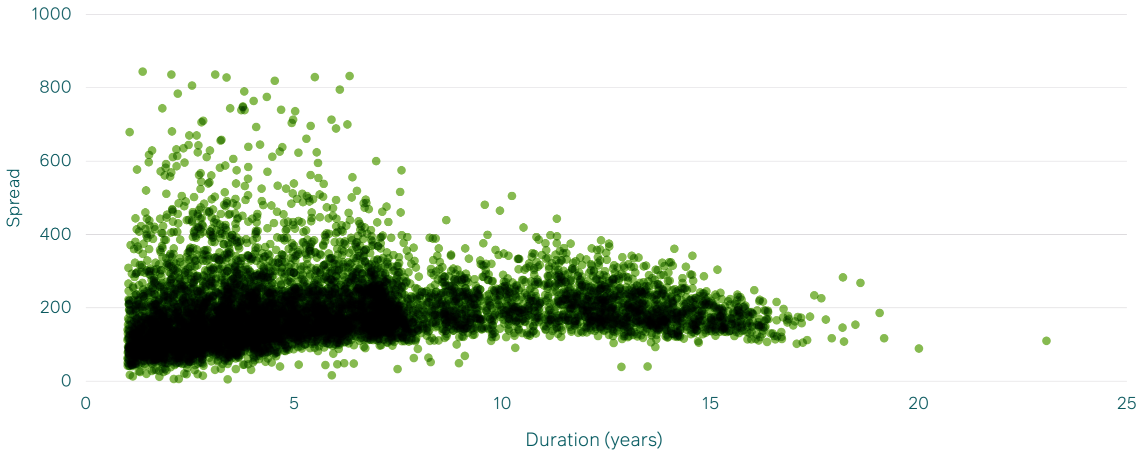
Source: Bloomberg, 2 June 2023.

Spread dispersion creates opportunities for active managers

We continue to find significant dispersion across corporate bond markets – this is where bonds with the same credit rating trade at different credit spreads over government bond markets. High levels of dispersion are often found during periods of market volatility; this type of environment should provide a rich source of opportunities for active managers to identify mispriced securities through in-depth credit analysis.

The chart below shows the level of dispersion within BBB rated bonds. Even though these bonds all have the same credit rating, they offer very different levels of credit spread to investors. Through a careful assessment of risks, we believe it is possible to uncover value opportunities within specific market sectors and to attain a higher credit spread while running the same level of credit risk. Furthermore, an active bond fund can offer further value due to its broker relationships and the scale at which they operate, which can potentially lead to more favourable pricing when trades are executed.

Figure 3. Credit spread dispersion remains elevated – global BBB corporate bonds



Source: Bloomberg, 2 June 2023.

How active bond managers can add value

In our view, a well-resourced active bond manager offers several important advantages over passive bond strategies, especially during periods of heightened market volatility and significant credit spread dispersion as described above.

Fundamental credit analysis

We believe that fundamental credit analysis is a key driver of relative performance, as it is only through this process that investors are able to gain a thorough understanding of a company's financial situation and business model. With one of the largest teams of credit analysts in Europe, we believe M&G is particularly well placed to identify the companies and sectors that should be in the strongest position to perform in a variety of economic scenarios, including a prolonged economic downturn.

As part of their assessment, our credit analysts consider all factors that could have an impact on a company's financial performance, covering areas such as business risk (management, market position and product strategy, for example), financial risk (such as cashflow, debt and profit margins) and bond structure and covenants. In addition, our analysts carry out a detailed assessment of environmental, social and governance (ESG) factors.

A flexible approach

Active managers also typically benefit from greater flexibility, giving them the freedom to adjust portfolio positioning in accordance with the economic environment. The ability to adjust sector and company exposure, benefit from careful bottom-up security selection and position portfolios to seek to minimise the impact of rising interest rates provides active managers with crucial levers to take advantage of the investment opportunities – something not afforded to passively manged funds.

Relative value trades

Active managers have the flexibility to capture a broad range of relative value opportunities that can often exist across fixed income markets. One of the ways in which we seek to do this is by comparing different bonds from the same issuer (such as those issued in different currencies or maturities) in order to take advantage of pricing mismatches, which can often occur during periods of market volatility. We may also be able to identify instances when similar companies (those in the same sector and with similar credit metrics) trade at different valuations. Another example is where the spreads offered by physical corporate bonds can sometimes differ from what is available through the credit default swap ('CDS') market.

Capturing new issue premiums

Active managers are also well-placed to capitalise on the additional yield pick-up that issuers typically offer when pricing new issues versus their existing debt. We believe this is a key area where active managers can add value versus their passive counterparts. For example, in the post-COVID period in 2020, we saw a host of highly-rated companies issuing new debt at highly attractive premiums compared to their existing debt. As active managers, we were placed to participate in many of these new deals.

The shortcomings of passive fixed income

Passive bond funds have seen steady growth in recent years, but we believe there are a number of reasons why fixed income may not always be suitable for a passive approach.

Tilted towards most indebted companies

While an equity index tracker will typically be weighted towards a market's biggest and arguably most profitable corporations, a bond index by contrast gives exposure to the most indebted governments or companies – so-called 'sinners, not winners'. For example, the largest constituents of a typical corporate bond index will usually be those with the largest outstanding amounts of debt – far from the type of issuer to which investors may choose to have a sizeable exposure.

Poor diversification

It is also a common misconception that credit indices are, by definition, well diversified. The ICE BofAML Global High Yield Index, for example, has an exposure of around 80% to US dollar denominated assets, making it very reliant on the US economy and highly exposed to oil prices. In another example, the ICE BofAML European Investment Grade Credit Index has some 40% exposure to financials. This highlights why investors must be careful to look through to the underlying assets to make sure that they are gaining an exposure that corresponds with their appetite for risk – as well as providing them with sufficient diversification.

Exposed to market volatility

Recent market volatility has again highlighted the dislocations that can occur between fixed income ETF prices and their underlying net asset values (NAVs). During sharp market sell-offs, there have been instances where ETFs have lagged their underlying benchmarks as the market is unable to absorb large amounts of selling. During severe sell-offs, there have even been cases when ETF prices have fallen below their NAVs. Furthermore, unlike active managers, index funds are fully invested and therefore cannot hold cash and other liquid instruments to act as a buffer against market falls.

Lack of flexibility

To varying degrees, active bond managers have the ability to adjust portfolio positioning depending on their macro outlook and their assessment of valuations. For instance, they may choose to reduce interest rate risk to mitigate the risk of rising interest rates, or to move into higher quality credits where they have concerns over the economic backdrop. Passive bond strategies do not have the ability adjust exposure in this way; instead, they will seek to match the interest rate and credit risk of a specific bond index.

Limited ability to capture value opportunities

As noted above, market volatility has created significant spread dispersion across credit markets. This type of environment can create an abundance of opportunities for active managers to capture value, but this is not something passive bond vehicles are able to exploit. Similarly, passive managers would not usually have the flexibility to sell a position, whether due to a deterioration in its credit profile or simply on valuations grounds.

This is by no means an exhaustive list of the differences between active and passive investments in bond markets. However, we believe that the areas that we have highlighted – index construction, duration exposure and significant market inefficiencies – are particularly relevant in today's shifting economic climate. In our opinion, the opportunity is made especially attractive now by the fact that investors in credit could be significantly overcompensated for the risk they are taking given the recent repricing in bond yields.

Investment grade credit – the sweet spot in fixed income

As well as having the ability to focus on the most compelling individual credits, active managers will typically also have some flexibility (which can vary depending on the strategy) to adjust asset allocation towards the areas they consider to offer the best risk-adjusted returns. While we currently see value across many parts of the fixed income markets, we think investment grade corporate bonds occupy the sweet spot from a risk/reward perspective.

Given the increasingly uncertain economic outlook, we think investment grade corporate bonds should be well-placed to withstand a more protracted economic slowdown. As well as offering robust credit fundamentals, investment grade bonds also provide natural diversification qualities due to their separate interest rate and credit spread components.

While 2022 was an exception, credit spreads and interest rates typically move in opposite directions to one another, and we believe this inverse correlation can offer a valuable cushion against adverse market movements. For instance, while credit spreads may be expected to widen during a recessionary period as corporate fundamentals deteriorate, we would normally expect this to be offset by a fall in government bond yields as markets anticipate a cut in interest rates to boost growth. We believe these separate interest rate and spread components can provide a more diversified source of returns throughout the economic cycle.

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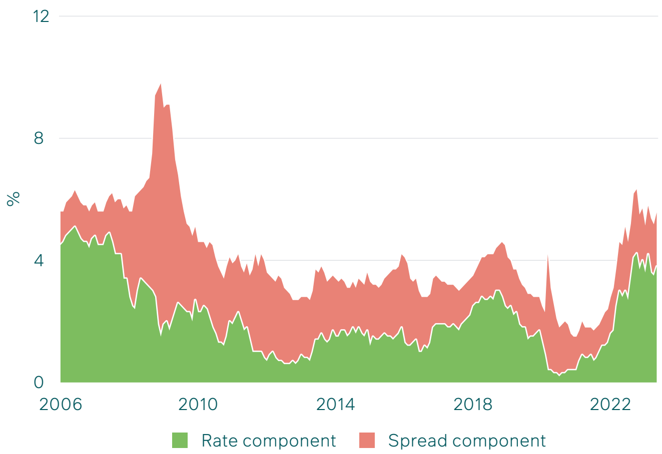
Figure 4. Natural diversification – rate and spread components provide separate drivers through the economic cycle



Source: Bloomberg, 31 May 2023.

Conclusion

For the second half of 2023, we maintain a positive outlook for fixed income markets. With inflation expected to gradually come down, and with the end of the interest rate hiking cycle now in sight, we think fixed income continues to offer an attractive entry point for investors. That said, the macro backdrop remains uncertain and we think a flexible approach to asset allocation will be increasingly important in order to capitalise on the most compelling risk/return opportunities across global bond markets.

The movement in bond markets during the past couple of years has been unprecedented. Having the flexibility to adjust interest rate and credit exposure in response to rapidly changing macro conditions has been the key to mitigating losses in a rising yield environment. We believe this underlines the importance of the role active managers play in protecting investors' capital during market weakness and in picking up attractively valued bonds that could outperform in an eventual recovery.

Investments in bonds are affected by interest rates, inflation and credit ratings. It is possible that bond issuers will not pay interest or return the capital. All of these events can reduce the value of bonds held by the portfolio. High yield bonds usually carry greater risk that the bond issuers may not be able to pay interest or return the capital.

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