Active and passive fixed-income: Lessons from the COVID-19 pandemic

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- The COVID-19 pandemic provided investors with two important reminders: first, core bonds provide critical diversification in a downturn, and second, not all bond funds are created equal.
- Passively managed bond funds thrived during 1Q20's extreme volatility, a result of high allocations to U.S. Treasury and agency-backed mortgage securities.
- But actively managed funds re-asserted their lead during 2Q20's powerful recovery, at least in part because of out-of-benchmark exposure to credit risk.
- We believe the post-COVID-19 environment may favor active fixed-income funds in the near term, but index funds can (and should) play a role in fixed-income allocations as well.

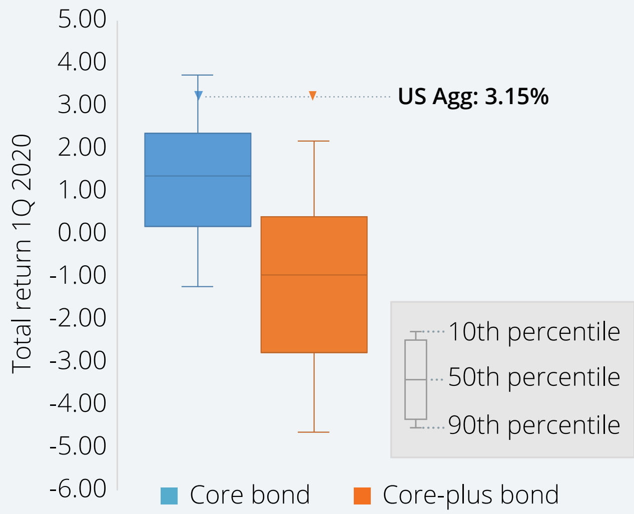
It took a pandemic to remind us why core and core-plus bonds play a key role in a diversified portfolio: As equity investors rushed for the exits, they naturally sought the safety and liquidity of relatively safe-haven assets like government bonds and agency-backed mortgages as a way to weather the crisis. These securities provided an all-important ballast to those who held at least a portion of their assets in core and core-plus bond strategies.

But the market's reaction to the COVID-19 crisis provided another reminder as well — namely, that not all bond portfolios are created equal. Passive core bond funds, many of which are benchmarked to the Bloomberg-Barclays U.S. Aggregate Index, performed exceptionally well during the first quarter of 2020 when volatility was at its peak. That was due in no small part to the composition of the index itself, two-thirds of which is invested in U.S. Treasuries and agency securities.

Meanwhile, many actively managed fixed-income funds entered the crisis with out-of-benchmark exposures such as low duration and an overweight to so-called "plus sectors" — an entirely reasonable response to a pre-pandemic environment characterized by low yields and worries that the secular decline in rates was nearing its end. These strategies had worked well for years prior to the pandemic, but these same exposures caused many of these same funds to

Not created equal

Active bond funds underperformed passive during 1Q20 sell-off



Data: Bloomberg Best, GWI calculations, June 2020.

struggle as credit-sensitive portions of their portfolios declined in tandem with stocks when the COVID-19 crisis arrived full force: The median core U.S. bond fund returned just over 1.3% during the first quarter of 2020 — far better than stocks, but nonetheless disappointing compared to the 3.15% return of the U.S. Aggregate Index. (In fact, the benchmark's return would have been enough to place the index in the top 15% of actively managed core U.S. bond funds).

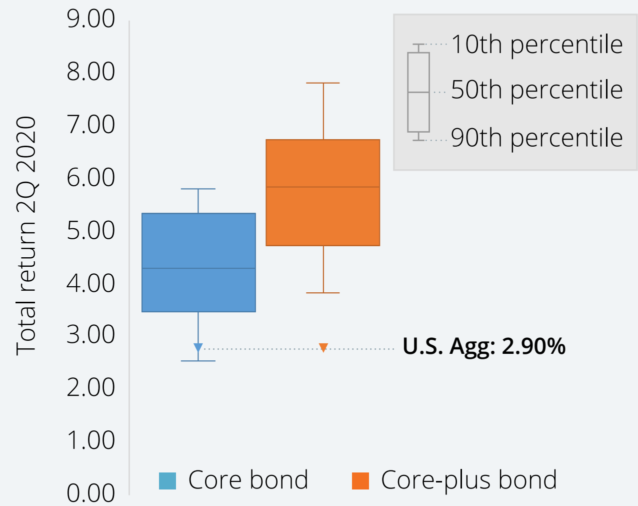
This dynamic was even more pronounced among core-plus bond managers, who place even greater emphasis on credit-sensitive sectors than core managers when building their portfolios. There, the Index's 3.15% return would have bested nearly the entire peer group of active managers by a wide margin.

In some ways, this merely represented a reckoning that was somewhat overdue. Since the Global Financial Crisis in 2008, many active bond funds took on more credit risk in a reach for yield, taking larger-than-benchmark positions in investment-grade and speculative-grade corporate credit while also dabbling in sectors such as non-agency mortgages and asset-backed securities collateralized by credit card receivables and auto loans. Some also made tweaks to the interest rate sensitivity of their portfolios, using portfolio duration as yet another way to try and "beat the Agg." These strategies paid off handsomely during the long post-crisis recovery, and on a three-year rolling basis, a significant portion of active core and core-plus bond managers outperformed the U.S. Aggregate Index easily.

But then the pandemic arrived, and the wheels came off the bus.

Back in style

With a zero interest rate policy (ZIRP) and explicit support from the Fed, credit is once again fashionable.



Data: Bloomberg Best, GWI calculations, June 2020.

Second quarter recovery: Active shines again

Fast forward to the second quarter of 2020, when efforts by the Federal Reserve made it clear that the central bank would use every tool at its disposal — including near-zero policy rates and explicit support for both investment-grade and high-yield corporate bonds — to support the U.S. economy. By late spring, the pandemic had shown signs of stabilizing, the global economy had begun the slow process of re-opening, and the credit exposure that had helped active management shine prior to the pandemic was once again en vogue.

That allowed active fixed-income managers and their out-of-benchmark bets to regain the spotlight: During the second quarter's market recovery, more than eight in 10 core U.S. bond managers beat the benchmark (and, by extension, the passively managed funds that are tied to it). In core plus, that outperformance relative to the U.S. Aggregate Index was nearly unanimous.

Looking ahead: A role for both active and passive

One thing is certain: The post-pandemic environment will be unlike any before it. The Federal Reserve has essentially promised markets that it will keep rates lower for longer, making it even more difficult for safe-haven securities like U.S. Treasuries and agency-backed mortgages to provide a competitive return. But even if the secular tailwind of declining interest rates has all but stopped, continued economic uncertainty has made it even more likely than ever that "spread product" (that is, bonds with risk characteristics that require a higher rate of interest than U.S. Treasuries of the same maturity), will provide a more competitive total return than safer sectors such as U.S. government debt and agency mortgages. The ability of active fixed-income managers to identify and take measured risks — in terms of credit, duration and perhaps even a few esoteric, out-of-benchmark sector bets — may therefore prove to be the key to success in the post-COVID-19 environment. But that success will come at a cost: Only those managers with the skill and resources to navigate a still-uncertain environment are likely to thrive.

We therefore believe that active fixed-income managers who have proven themselves able to manage in uncertain times may enjoy an advantage over passively managed funds, at least in the near term. That said, we continue to believe that passively managed fixed-income funds can (and should) continue to play a role in an investor's fixed-income allocation due in part to their extremely low cost — something that becomes even more important when expected returns are low. Moreover, as the steep market decline we saw during the first quarter of this year illustrates, market reversals can be swift and sudden, making the relative safety of sectors like U.S. Treasuries and agency-backed mortgages attractive as a hedge against a sudden relapse.

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