Passive credit can mean missing out

Introduction

RLAM believes that active management of credit bond portfolios adds long-term value significantly in excess of costs compared with lower-cost passive approaches that add no value; the adoption of a passive approach will mean that clients miss out on individual sources of value and that their funds will consequently deliver lower returns.

Asymmetry of credit bonds – why this favours the active manager

Fundamentally, the risk and return characteristics of bonds are very different from equities and this in turn enables an active bond manager to improve the risk and return characteristics of a portfolio compared to its benchmark. Bond returns are asymmetric – upside is generally getting your stream of coupons and the repayment of principal at maturity. If the company does really well, a bondholder still just gets their coupons and principal, rather than any additional return due to that stronger performance. On the downside, if the company goes under, you lose everything. The nature of bonds, and the fact that on the whole, these will not see widespread large capital gains, means that there are relatively few benchmark constituents that a bond manager must hold to manage tracking error risk.

This position is very different from an equity fund manager where positioning relative to benchmark in the largest constituents can make or break performance. Furthermore, as there are unlikely to be individual 'winners' to offset laggards, managing the 'downside risk' of individual holding is a critical aspect of bond fund management and flexibility from benchmark positioning facilitates this aspect of fund management.

Bond indices are different

In contrast to active managers, passive managers buy the universe of stocks (or a representative subset) that comprises the chosen benchmark. Unlike an equity index, which broadly reflects the economic contribution a company makes (companies with higher weightings will have a record of growth that has pushed their market capitalisation higher), a bond index just reflects the amount of debt a company has issued i.e. the more debt a company issues, the heavier their weighting in the index. A passive manager may therefore hold low quality debt with poor risk/return characteristics just because it is included in the benchmark index.

Inefficiencies in credit markets

Our belief that active credit management produces better results than passive management is reinforced by the narrower selection base available to passive managers. By definition the passive manager is restricted to index constituents, thereby excluding many bonds that are not eligible for index inclusion. The main UK credit indices apply the same criteria for benchmark eligibility, namely constraints around issue size and rating. In our view, the reliance on these two factors 'hard wire' inefficiencies into the market and create investment opportunities for value orientated active credit bond managers.

Issue size

New bonds have to have a minimum issue size of £250m for inclusion in benchmarks. Therefore, a bond with a size of below £250m is excluded, no matter how high quality or attractively priced it is, and with no reference to the size or financial strength of the issuing company. The active manager is not constrained and may, indeed, benefit because this bond will be overlooked by a subset of investors i.e. the passive managers and closet tracker funds.

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Credit rating

There is a common fallacy in bond markets: that ratings are a quality stamp and that the absence of a rating therefore means a bond is low quality, high risk and should be avoided. This is not the case.

A rating awarded to a bond by a credit ratings agency, such as Standard and Poor's, Moody's or Fitch, is an expression of the creditworthiness of the issuer in relation to that debt or, in other words, the probability of default of that bond. However, a lack of rating does not mean that the bond 'failed' to get one – just that the company has not paid for a rating agency to issue one. Most bonds without a credit rating are not junk bonds (i.e. sub investment grade). In fact, many unrated bonds have inherently attractive risk/return characteristics, in many instances because they are backed by specific commercial property or financial assets, thereby making the bonds more robust against adverse change. In our experience the losses arising from a rated bond getting into trouble are much higher than those losses incurred for unrated (but secured) debt.

This highlights aspects of how corporate bond markets have developed over time, with an emphasis on credit rating and market liquidity, in preference to inherent security and value. Specifically, rating agencies are focused on a 'point in time' assessment of the prospects of an issuer fulfilling its obligations to make timely payment of interest and capital payments. There is little focus on any protection of the investor's interests should the company's financial fortunes deteriorate, which is critically important to an appropriate assessment of value from an investor's perspective. When bonds 'go wrong', passive managers only sell when the credit rating downgrade (below BBB-) triggers expulsion from the benchmark index. This is likely to be at a depressed price level given the market's ability to price credit events ahead of actions by credit rating agencies.

Concentration risk

In terms of sector concentration there is a bias towards supranational and financial bonds in credit indices. For example, in the iBoxx Non-Gilt Sterling index, the two largest issuers – the European Investment Bank and KfW, formerly known as Kreditanstalt für Wiederaufbau (literally the Credit Institute for Reconstruction), both of which are banks backed by the European Union and German Federal state respectively – account for around 10% of the index, while there are five banks/financial service companies in the next ten largest issuers. The active manager has the advantage of not mechanically exposing clients to concentrated sector/issuer risk.

Active funds need active decision making

Superficially, passive management may appear less risky than active management. Trust the market, not the manager, is the underlying thought process. However, we firmly believe that active management can give rise to better medium to long-term performance in bond portfolios; we have the track records to demonstrate this, and that those higher portfolio returns can also be less volatile than those of the relevant benchmark index to which a passive investor would be exposed. This may seem like the entrenched position of an active bond manager but is based on the specific characteristics of the asset class and in particular, its benchmarks, as well as our success. Understanding the evidence supporting active management does mean more work for the adviser, for example in assessing how RLAM actively exploits identified market inefficiencies, but we believe that this is preferable to making an investment using a flawed approach.

Contact us

For more information about our range of products and services, please contact us.

Royal London Asset Management

55 Gracechurch Street, London EC3V 0RL

020 327 25950
institutional@rlam.co.uk
www.rlam.co.uk

67429 02 2020