

Is a passive approach to corporate bond management sensible?



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Introduction

From Royal London Asset Management's viewpoint we strongly believe that active bond management, particularly credit bond management, adds significant long-term value. This view challenges the consensus that active managers do not add value after fees are considered. Our view is that the adoption of a passive approach to bond management will mean that clients miss out on opportunities which enhance bond returns and that their portfolios will consequently deliver lower returns.

In this article we look at the structural credit market inefficiencies that underpin our sterling credit investment philosophy and assess how the volatile conditions of recent years have impacted relative performance.

How do active managers take advantage of these inefficiencies?

Superficially passive management may appear less risky than active management. However, we believe that

active management can give rise to better medium-term performance in bond portfolios. This is not just the entrenched position of an active bond manager but is based on particular aspects of the asset class and benchmarks.

Asymmetry of credit bonds

Fundamentally, the risk and return characteristics of bonds are very different to equities and this in turn provides an active bond manager with opportunities to improve the risk and return characteristics of a portfolio compared to its benchmark. Specifically, unlike equities, bond managers do not have a normal distribution of individual holding returns within their portfolios.

Bond managers are unlikely to have any stellar single asset performances within portfolios, or within benchmark constituents, and therefore there are relatively few or no benchmark constituents a bond manager must hold in order to manage tracking error compared to benchmark. This position is very different from an equity fund manager where positioning relative to benchmark in the largest constituents can make or break relative performance.

As a result, given there are unlikely to be individual 'winners' to offset laggards, managing the downside risk of individual holdings is a critical aspect of bond fund management — and flexibility from benchmark positioning facilitates this aspect of fund management. 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 (through profits), a bond index simply 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.

At Royal London Asset Management we only hold bonds which offer the prospects of attractive returns within the context of our clients' performance objectives and risk tolerances. If we don't like the risk and return characteristics of a bond, then we don't hold it. This may sound like we are introducing high tracking error into the portfolio (deviation from benchmark) — but this is not the case. This may feel counter-intuitive at first, but it is because of the asymmetric risk profile of corporate bonds — with downside risk generally higher than upside potential. Therefore, not holding a bond that is a large part of an index (because we do not like its risk profile), does not introduce much tracking error — because even if we are incorrect in our assessment, and the company performs well, the upside impact on the bond price will not be significant. Conversely, if we are correct, the price impact could be dramatic and may involve a significant loss of value for the holder of that bond, meaning we add outperformance for our clients by not holding it.

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 sterling credit indices apply common criteria for benchmark eligibility, of which the most constraining relate to issue size and rating:

- **Issue size:** New bonds have to have a minimum issue size of £250m for inclusion in benchmarks – so a bond with a size of below £250m is excluded, no matter how high quality or attractively priced it is. 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 the benchmark ‘huggers’ (those managers who say they are active but really follow benchmark weightings).
- **Credit rating:** For inclusion in investment grade benchmarks a bond has to be rated BBB- or better. Again, a fund that is restricting stock selection to only rated bonds excludes many unrated debt issues that may be undervalued. Contrary to common belief, most bonds that do not have 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.
- **Security:** In lending to the likes of GlaxoSmithKline, IBM, Marks & Spencer, Apple and so on, we primarily do so on an unsecured basis. Hence if the company defaults we rank alongside other unsecured creditors (and usually behind banks who have protected their positions). In the past, the market would have focused on collateral (a ring-fenced pool of assets for the benefit of bond holders) as a key characteristic, but this has been replaced by an emphasis on credit rating and market liquidity. Investors have gone along with this switch, preferring the stamp of approval from a rating agency to hard assets.

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, but 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. There are numerous examples of highly rated companies going bust, not quickly but over time, as their business model is overtaken by more nimble competitors. How does this affect the passive manager? In such cases bonds are only sold 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.

In our view, over-reliance upon issue size and credit ratings by many investors are two of the key factors that create investment opportunities for value orientated active credit bond managers.

Managing interest rates

Another factor to consider is duration i.e. the sensitivity of the fixed interest assets to the movement in long-term interest rates. The passive manager is, in effect, indifferent whether interest rates move up or down. The active

manager will use judgment to shape portfolios that reflect the expectation of movement in long term interest rates. Whilst there is no guarantee that the active manager will get the direction of interest rates correct, they have the flexibility to change the characteristics of the portfolio when markets appear very cheap or expensive – an option not open to the passive manager.

Sector concentration

In terms of sectors there is a bias towards supranational and financial bonds in credit indices. For example, the two largest issuers (EIB and KfW) account for around 8.5% of non-gilt indices, while there are six banks in the next ten largest issuers. The active manager has the advantage of not automatically exposing clients to concentrated sector/issuer risk.

How have active credit funds performed?

As stated earlier, we believe that skilled active credit bond managers have some clear advantages due to the characteristics of credit bonds and the unattractive features of benchmark orientated investment strategies. However, we would like to go a bit deeper and look at the performance of the Royal London Corporate Bond Fund, one of our flagship pooled funds – looking at the



last three years, covering some extreme volatility, and a 10-year period which should give a clear picture of whether strategies add long-term value.

The fund reflects our key investment principles: issuer diversification, sector selection biased towards bonds with strong covenants, a willingness to use bonds that fall outside the narrow parameters of credit benchmarks and a high exposure to secured bonds (where recovery rates in the event of default are likely to be significantly higher than those for unsecured bonds). Over the last ten years the Fund has had at least 40% invested in collateralised and secured bonds (e.g. social housing,

real estate, infrastructure, commercial mortgage backed, investment trusts and covered bonds) – more than double that of passive strategies.

Over a long period of time we have been very successful in choosing the ‘right’ bonds, embedding greater secured debt into portfolios and producing a clear yield advantage over benchmark indices / passive strategies. Whilst no one can guarantee that this continues we believe that we have the philosophy, process and team that are capable of producing excellent results in the future. After management fees this means that an investor, over the last 10-year period, would have been materially better off.

What does a passive approach imply?

In addition to the paradox of buying bonds just because they form part of a benchmark index there are some practical problems that need to be addressed in any discussion on passive investment strategies for credit markets.

Let’s take a step back and consider the role of capital markets. At a broad level we think there are two conceptions of equity investment. In the first, ‘traditional’ view, an equity share conveys ownership of a business; the equity owner can be called upon to provide additional capital (rights issue) if required by the business. In the second an equity share is just a tradeable commodity which can be bought, sold or shorted as required by the investor. It appears to be that the latter is now dominant. As a consequence, credit bond markets are increasingly the route by which companies access capital markets to raise funding for the business.

Changing role of credit markets

We can see the broadening role of credit markets in recent years, as banks retreat from lending activity. We have participated in a range of bond issues covering a wide variety of projects e.g. social housing, universities, infrastructure investment, student accommodation and hospital developments. From our perspective the move to passive investment strategies helps larger, global companies and limits the supply to newer areas where issue size will be lower (and therefore not qualifying for inclusion in indices)

	Fund (%)	Benchmark (%)	Relative (%)
Q4 2022	6.16	5.74	0.42
1 year	-15.74	-17.72	1.98
3 years p.a.	-2.47	-4.92	2.45
5 years p.a.	0.35	-1.55	1.90
10 years p.a.	3.88	1.96	1.92
Since inception p.a. 01.03.1999	5.00	3.60	1.40

As at 31 December 2022. Past performance is not a guide to future performance. The value of investments and the income from them is not guaranteed and may go down as well as up and investors may not get back the amount originally invested.

All performance figures stated gross of fees and tax unless otherwise stated. The impact of fees or other charges including tax, where applicable, can be material on the performance of your investment. The impact of fees reduces your return.

Source: Royal London Asset Management, based on the Z share class, RL Corporate Bond Fund. Benchmark: iBoxx Sterling Non-Gilt All Maturities Index.



or where the issue characteristics do not conform to credit rating agency models (and are therefore not rated). A move to passive investment will further increase the role of credit rating agencies in markets with all the potential pitfalls that we saw during the Great Financial Crisis.

Overall we think that the UK economy suffers from a lack of business investment and the availability of capital is one reason often cited. As a participant in debt markets for a long time, we have seen how the investment opportunity set has widened and how important debt markets have become for the development of our society and economy. We believe moves towards passive management are detrimental and makes more innovative approaches more difficult to sustain.

Environmental, Social and Governance risks

Active investors are better aligned to managing Environmental, Social and Governance (ESG) issues. Put bluntly, active investors are more incentivised in holding companies to account for their actions. Our credit analysts and fund managers work closely with our Responsible Investment team to address ESG concerns, reflecting the growing recognition that credit bond managers have a vital role to play in undertaking dialogue, exerting influence where improvements are necessary and ultimately withholding finance.

Why Royal London Asset Management

We believe that our distinctive approach to credit offers a way to take advantage of structural market inefficiencies. As investment strategies become more homogenous, relying on credit ratings and issue size, there is a clear opportunity for the active manager to be different and better. Success should be measured over the long term and assessed against the robustness of the investment approach. We are very happy to be evaluated on this basis.

RL Corporate Bond Fund performance to 31 December 2022.

	Cumulative (%)					Annualised (%)	
	3M	6M	1Y	3Y	5Y	3Y	5Y7
Fund (gross)	6.16	-3.86	-15.74	-7.22	1.78	-2.47	0.35
Fund (net)	6.05	-4.06	-16.08	-8.35	-0.13	-2.87	-0.03

	Year on year performance (%)				
	Q4 2021 to Q4 2022	Q4 2020 to Q4 2021	Q4 2019 to Q4 2020	Q4 2018 to Q4 2019	Q4 2017 to Q4 2018
Fund (gross)	-15.74	1.43	8.55	11.39	-1.51
Fund (net)	-16.08	1.01	8.11	10.98	-1.81

Past performance is not a guide to future performance. The impact of fees or other charges including tax, where applicable, can be material on the performance of your investment.

Source: Royal London Asset Management as at 31 December 2022. All figures are mid-price to mid-price in GBP for the Z Inc share class.



Risk Warnings

- **Investment Risk:** The value of investments and any income from them may go down as well as up and is not guaranteed. Investors may not get back the amount invested.
- **Credit Risk:** Should the issuer of a fixed income security become unable to make income or capital payments, or their rating is downgraded, the value of that investment will fall. Fixed income securities that have a lower credit rating can pay a higher level of income and have an increased risk of default.
- **EPM Techniques:** The Fund may engage in EPM techniques including holdings of derivative instruments. Whilst intended to reduce risk, the use of these instruments may expose the Fund to increased price volatility.
- **Exchange Rate Risk:** Changes in currency exchange rates may affect the value of your investment.
- **Interest Rate Risk:** Fixed interest securities are particularly affected by trends in interest rates and inflation. If interest rates go up, the value of capital may fall, and vice versa. Inflation will also decrease the real value of capital.
- **Liquidity Risk:** In difficult market conditions the value of certain fund investments may be difficult to value and harder to sell, or sell at a fair price, resulting in unpredictable falls in the value of your holding.
- **Counterparty Risk:** The insolvency of any institutions providing services such as safekeeping of assets or acting as counterparty to derivatives or other instruments, may expose the Fund to financial loss.
- **Charges from Capital Risk:** Charges are taken from the capital of the Fund. Whilst this increases the yield, it also has the effect of reducing the potential for capital growth.



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