RBC BlueBay Asset Management

The case for active in global fixed income

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"There are structural and tactical arguments to support an active fixed income approach."

We believe that there are many compelling structural reasons why investors should take an active approach in fixed income markets.

Below we highlight five areas, covering how fixed income markets are more complex and exhibit greater pricing anomalies than equity markets, providing a systematic return advantage for skilled active managers.

Fixed income benchmarks are difficult to replicate

Unlike equity indices that may comprise several hundred securities which do not vary greatly over time, fixed income benchmarks such as the Bloomberg Barclays Global Aggregate Index comprise close to 30,000 securities. The sheer size and near constant issuance of new securities makes benchmark replication significantly more challenging than for equities.

An opportunity from opacity

Information inefficiencies also exist in the global fixed income asset class. As bonds don't routinely trade on formal exchanges, price discovery can be opaque. Many securities also comprise complex features, such as callability, subordination or covenant protection, which are difficult to value. This market structure may be seen to lead to pricing anomalies that can potentially be exploited through active management.

Specifically, studies have shown fixed income to be an inefficient asset class by means of the identification of observed premia attached to term structure, credit, volatility and liquidity. In our view, investors can theoretical be compensated by exploiting these premia.

Gaining an advantage from anticipating benchmark changes

Fixed income benchmarks are governed by rigid rules with respect to issue inclusion, which may often rely on assessments from third-party credit rating agencies. However, rules around inclusion and exclusion can often be exploited by anticipating moves from these agencies, which will flag their intentions to the market in advance of making formal rating adjustments.

Arguably, the greater the volume of assets passively tracking such benchmarks, the greater the distortions around such index-rebalancing events will occur, creating market inefficiencies for active investors to exploit.

Reduced exposure to credit risk events

In contrast to equities where benchmarks are constructed to reward the stocks whose prices increase over time, bond benchmarks are constructed based on those entities that issues the largest volume of debt. This could intrinsically favour the most indebted institutions rather than success stories, making risk management more important.

When investing in any credit, one is hoping to earn an attractive yield and to receive capital paid back at par at the point of maturity. The principal risk an investor bears is that the issuer can't or won't meet this repayment, meaning that returns are subject to a left-tailed risk in the event of default. In this context, there may be robust arguments to suggest that credit analysis can be undertaken by active investors to avoid those issuers whose credit metrics are on a deteriorating trajectory and are most likely to experience such 'credit events'.

The breadth of the global fixed income universe offers compelling prospects

The fundamental law of investing dictates that the broader this opportunity set, the higher the alpha, when manager skill is positive. We think that this is particularly true in global fixed income markets, which have low correlation to each other. Smaller markets in the global investment grade universe, such as Mexico or Hungary, tend to have very different volatility patterns to each other, and can have low correlation to core markets in the US or Europe.

There are structural and tactical arguments to support an active fixed income approach. With elevated yields now on offer across the fixed income landscape, the return prospects are favourable, especially for those willing to take an actively managed approach.

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