NORTHERN TRUST
ASSET MANAGEMENT

POINT OF VIEW

INDEX INVESTING AS AN ACTIVE DECISION: IMPLICATIONS FOR FIXED INCOME INVESTORS

Increased Complexity Brings Greater Flexibility — and Opportunity

Passive investing in the fixed income space has undergone a significant evolution in the past decade. Not only has the number of passive product choices and investor adoption increased, but there's also an increasing demand for customization and precision to achieve intended risk exposures in fixed income.

Looking back, 2022 was one of the worst years on record for bond returns, largely due to central banks raising interest rates in response to rising inflation uncertainty. This has forced asset owners to take a hard look at their fixed income allocations from a risk exposure perspective. "We know our institutional investors spend a lot of time doing their analysis, many partnering with their consultants, to create policy benchmarks that become their neutral point of risk. We continue to see that passive approaches are utilized to fulfill policy benchmarks to achieve pure asset allocation goals — all done so in a risk and cost-efficient manner," says Thomas Wackerlin, CFA and client portfolio manager with Northern Trust Asset Management. Across the industry, adoption is growing for passive approaches according to Morningstar research, which shows that every year from 2013 through 2023, passive bond funds have pulled in more dollars on a net basis than their active counterparts.[1]

Additionally, from a risk exposure perspective, Wackerlin adds, "Asset owners are distilling their active fixed income allocations to understand if managers are providing excess returns through static market risk, such as term and credit beta, or providing true alpha beyond these market risks. Variation in excess returns may be explained from beta-like risk factor sources, and those may be accessed using passive strategies, which may be more cost efficient."

The demand for passive bond investing continues to grow, which may be attributed to the evolution of the asset class and the investment style approach, which now offers far more for investors of all risk tolerances compared to a decade ago. However, it is important to understand the complexities and decisions that entail what it means to be passive in fixed income.

What it is

We explore how passive fixed income index investing has evolved, now offering investors active choices and customizable strategies to help manage risk exposures.

Why it matters

Investors who understand the variables and nuances in index investing are likely better prepared to customize their portfolios with active decisions.

Where it's going

Passive investing in fixed income is moving toward greater customization with systematic approaches, enabling more tailored portfolio management.

[1] https://www.morningstar.com/funds/recovery-us-fund-flows-was-weak-2023.

A DECADE OF PROGRESS IN FIXED INCOME

"One of the biggest evolutions in fixed income over the last decade has been the notable improvement in price discovery mechanisms," says Manan Mehta, head of quantitative fixed income research, also with Northern Trust Asset Management.

A key driver behind this improvement in price transparency has been the acceleration of the ETF ecosystem, with fixed income ETFs now making up close to $2 trillion in assets globally, per Bloomberg. Moreover, there are now richer data sets available, which ultimately help power better research efforts.

"Access to better data enables us to identify new opportunities utilizing systematic investing techniques. For example, now we can better understand the performance of style factors such as value and quality across a variety of market regimes. We can understand intended vs. unintended risks and exposures that are embedded within an integrated fixed income portfolio. Ultimately, we can offer more precision when it comes to gaining risk exposures and aligning those exposures with client objectives," says Mehta.

Other aspects of this evolution include increased requirements for transparency and a focus on exposures and risk, as well as investors taking greater control over their passive investment decisions.

"We've also seen bond issuance patterns shift, and those shifts have altered the composition of broad bond indexes. They've resulted in potential unintended exposures, unintended concentrations, or unexpected duration and interest rate profiles," says David Alongi, CFA and director of fixed income index management, also with Northern Trust Asset Management.

He refers to a progression away from market-cap weighting approaches and a migration to strategies that separate rates from spread exposures or have systematic overlays in the form of factors, stating as an example the application of quality and value metrics. "These are terms we've borrowed from the equity world and used in ways that are relevant for fixed income securities to target certain portfolio exposures — or even build what are arguably better benchmarks," Alongi adds.

OPPORTUNITIES AND CHALLENGES

The advancements in passive investing over the last decade have made way for sophisticated techniques not often widely recognized. There are benefits to exposures that tightly match a chosen benchmark, like low-cost beta exposure, but increasingly so, investors are able to choose passive strategies that reflect their outlooks with cost-controlled exposure across a range of market segments.

“There have been advances in optimization and trading techniques that have enabled improvements in indexing approaches beyond the most liquid segments into a broader set of market segments,” says Alongi. “Investors can use traditional passive funds as building blocks in the form of a component approach to achieve either a narrow- or broad-based exposure,” he adds.

“So, while it’s obvious that huge numbers of investors hold portfolios that follow the Bloomberg U.S. Aggregate Index at relative market-cap weights, there are some investors who want exposure to the components of the Bloomberg U.S. Aggregate Index, but in a different weighting scheme depending on their risk view or preference,” Alongi says.

One such example is the U.S. government sector, which increased meaningfully as a percentage of the market value of the U.S. Aggregate Index in the period following the global financial crisis in 2008, and at the expense of the mortgage-backed sector. This resulted in relative sector weights that were not desirable for every U.S. Aggregate investor.

“Rather than passively accepting that shift, an investor might decide to overweight credit and securitized sectors relative to government bonds. We employ a disaggregated, or re-weighted component approach like this for investors who want such a strategy using either commingled funds or separate accounts,” Alongi adds.

As with most new opportunity sets, challenges arise as well. Replication and liquidity concerns come with the territory of passive indexes. “Liquidity isn’t uniform across all corners of the universe, so full replication is generally impossible except in the narrow segments and one needs to employ approaches like stratified sampling or optimization techniques to get representative liquid exposure,” says Alongi.

Diversification and how to properly identify it within the passive portfolio is also key.

“I think this notion of sufficient diversification and understanding what represents a sufficiently diversified portfolio in the context of passive fixed income investing is paramount. Sufficient diversification also varies depending on the risk regime, and sampling rates need to be calibrated to stress period variance. It is imperative to precisely understand the tradeoffs between sampling rates, trading costs, and tracking error coming from systematic versus idiosyncratic sources,” noted Mehta.

Alongi adds that “along with these complexities comes flexibility and an opportunity to manage exposures more precisely with either isolation of risk characteristics or combinations of them. The complexities become evident when you look at performance dispersion and tracking error across managers, so it’s important for an investor to select a manager with a disciplined process.”

THE NEXT 10 MONTHS AND THE NEXT 10 YEARS

As passive investing has developed to include better data quality and systematic approaches have become more integrated, investors will ultimately be left with more opportunities for alpha.

“We are seeing that systematic fixed income strategies and models have been developed over the last decade with the improvement in data quality and coverage, along with trading efficiencies. Models are almost exclusively used with systematic approaches as the model output stays true to the original research and design parameters and these models can be passively implemented,” says Wackerlin. “Overall, we see very exciting opportunities in the area that sits in between traditional indexing approaches and those that target outperformance opportunities,” he adds.

Interestingly, the evolution of passive indexing has also led to an ongoing collaboration between index portfolio managers and quantitative research groups, and some technological advances have succeeded in enabling precision investing within fixed income.

“We’re seeing standard benchmark allocations combined in non-standard ways, and this really goes back to the notion that there is an active design that comes into play before you select an index,” says Mehta. “Customization in passive indexing is going to grow, just as vanilla, traditional fixed income indexing is likely to persist as well,” Wackerlin adds.

As for the current macro environment and the short-term outlook, investors seem to be altering their view but not collectively landing in one spot. “Some investors are extending duration, reflecting an expectation that rates have peaked for this cycle and are headed lower. The degree to which they have lengthened their exposure varies by investor. Others are shortening up existing exposures, again to varying degrees. We do see that this macro environment is prompting some investors to evaluate their inflation-linked exposure, and some are looking at the front-end, which is more sensitive, while others are further out on the curve, which introduces much greater interest rate sensitivity,” Alongi says.

Despite where an institutional investor will fall, one enduring benefit to modern passive indexing will be its nimbleness — a trait that will be necessary for managers to exercise in the latter half of 2024 and in the face of uncertain interest rate adjustments. Alongi adds that “The overall point is that a passive approach offers a range of options to implement your risk requirements and your views within any particular rate environment.”

ABOUT NORTHERN TRUST ASSET MANAGEMENT

Northern Trust Asset Management is a global investment manager that helps investors navigate changing market environments in efforts to realize their long-term objectives.

Entrusted with nearly $1.2 trillion in assets,* we understand that investing ultimately serves a greater purpose and believe investors should be compensated for the risks they take — in all market environments and any investment strategy. That's why we combine robust capital markets research, expert portfolio construction and comprehensive risk management in an effort to craft innovative and efficient solutions that seek to deliver targeted investment outcomes.

As engaged contributors to our communities, we consider it a great privilege to serve our investors and our communities with integrity, respect, and transparency.

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* Assets under management as of March 31, 2024.

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