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Exploring the full spectrum of fixed income strategies

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Investors have traditionally thought of there being two primary investment styles, namely Active and Passive (or Indexing). But this binary view oversimplifies the new reality. Instead, it is better to think of investment styles as sitting along a continuum, where they become progressively more "active," from index replication to unconstrained.

In addition, investors today are increasingly evaluating what their strategic fixed income benchmarks should be, and not always accepting capitalization-weighted indices as their only options. This change in mindset is challenging the simplicity of traditional active/passive thinking and giving rise to more custom exposure design and management.

With more than 1000 institutional clients across 50 countries, and $1.2 trillion USD under management in total fixed income, cash, and currency, State Street Global Advisors is at the forefront of developing innovative, efficient solutions that expand the possibilities of what investors can achieve in their fixed income portfolios.

The Evolution of the Fixed Income Market

The structure of the bond market has been evolving, partly in response to an expansion in electronic trading and the rapid growth of fixed-income ETFs. As a result, improved liquidity and lower transaction costs are paving the way for a broader set of approaches available to fixed income investors. This much more diverse array of strategies progresses from a no-alpha/replication approach through stratified sampling, enhanced indexing, active (both fundamental and now systematic), and finally to, essentially, unconstrained. We believe it's important for investors to appreciate the full spectrum of investment styles, and the pros and cons associated with each, so as to better choose which are most appropriate for them to deliver on their own specific fixed income objectives. In Figure 1 we outline how each of these styles is positioned along the continuum and where they fall on the active risk and return spectrum.

Indexing – Full Replication

On one end of the continuum are the purely passive approaches, also known as full replication, because they seek to replicate an index as closely as possible. This approach is generally only feasible in the most liquid of exposures, such as government bonds, as market liquidity is a large determiner of the price paid for a bond. Consistently high liquidity at the individual bond level in government bond exposures facilitates full replication at a very low cost, ensuring extremely tight risk alignment and performance tracking. In these exposures there is high confidence that the beta can be delivered efficiently and reliably, which is the overarching goal of a replication approach. However, increased liquidity and price transparency also makes it more difficult to add additional alpha or beat the benchmark. The choice of a fully replicated approach is therefore best suited for very liquid sectors, and in cases where additional alpha is not the investment goal.

Indexing – Stratified Sampling

As we move beyond liquid government bonds, a more pragmatic and increasingly sophisticated approach to portfolio construction is required. Sectors with more variable liquidity profiles such as investment grade credit can introduce higher transaction costs, effectively resulting in a performance drag versus the benchmark. A sampling approach solves the liquidity problem by allowing for flexibility around individual holdings, while still keeping the portfolio aligned to the benchmark along its key risk dimensions, such as maturity, sector, issuer etc. Moreover, advances in electronic trading technology and protocols (i.e. portfolio trading) have unlocked less liquid parts of the market thereby enabling more efficient implementation. Sampling also allows for the use of additional value-add techniques such as participation in new issues, relative-value security selection, and a considered approach to rebalancing. These techniques can often result in what we at State Street Global Advisors call "implementation alpha", and are vital tools in reducing the performance drag inherent to trading in more complex exposures.

Indexing Plus/Enhanced Indexing

Next along the continuum is Index Plus, also referred to as enhanced indexing, which expands on the value-add techniques used in stratified sampling in order to deliver a higher level of implementation alpha. While this approach seeks to add alpha, it does so while still operating within the constraints of a more traditional indexed portfolio, unlike a fully active strategy which gives managers discretion around security selection. Alpha is instead generated through the aforementioned implementation alpha techniques and by utilizing out-of-index proxy exposures.

Active – Fundamental

Traditional active managers seek to outperform a benchmark index within a set risk budget, typically 100-200bps of tracking error volatility per annum. As such, they have the discretion to express their convictions or views through active exposures to a number of risk factors such as duration targets, sector rotations, plus sector allocations and individual security selection. Fundamental active strategies are most effective in sectors that are viewed as having greater inefficiencies (such as credit, high yield, and emerging markets debt), thus having a greater opportunity to generate alpha.

Active – Systematic

Systematic active strategies seek to outperform a benchmark index through a rules-based, data-driven approach to security selection. Individual bonds are scored based on a number of quantitative signals, and security selection is dictated by the highest scoring bonds. A systematic approach reduces biases in decision making, ensuring a disciplined adherence to a predefined strategy. Systematic investing can be advantageous in managing large complex portfolios where scalability and efficiency are paramount, allowing for precision risk management and cost control. Systematic strategies are perhaps most widely utilized in credit sectors, where there is an abundance of historical data, data coverage of the investment universe is extensive, and the alpha signals have demonstrated consistency and efficacy over different time periods and market environments. Given the data-driven approach to investing, systematic strategies often perform more consistently than a more traditional active strategy, and will generally have lower risk budgets and alpha targets.

Active – Unconstrained:

Unconstrained strategies can invest in a broad range of fixed income sectors, ratings, currencies, and geographies without being tied to a specific benchmark. As a result, unconstrained investing is very flexible and can offer uncorrelated outcomes and a high degree of customization. However, an unconstrained approach also carries a higher level of risk due to the human decision-making and oversight involved.

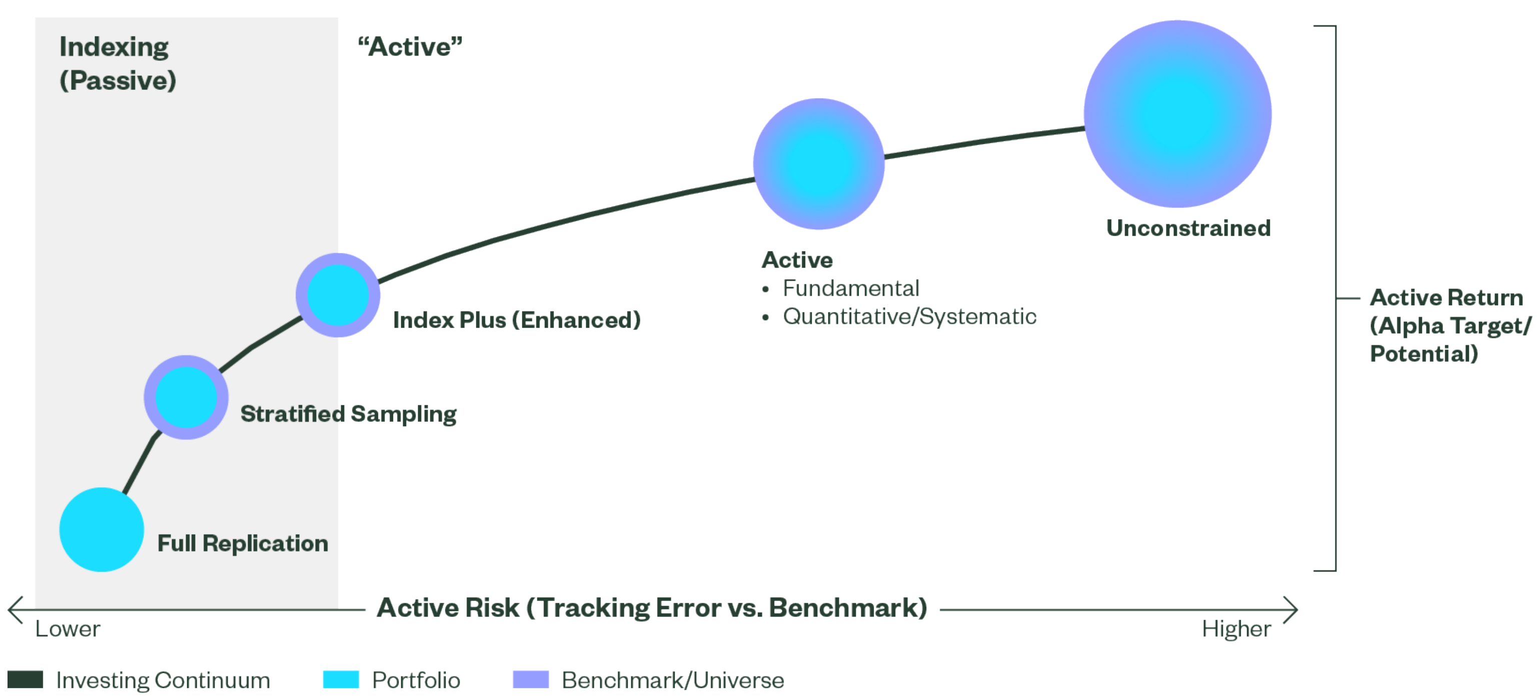
The Bottom Line

Institutional investors require flexibility and a range of options within their asset allocations. The evolution of fixed income markets now allows for customized solutions and strategies that can help deliver target returns and, as we discussed in Optimizing a Global Credit Portfolio (ssga.com), a combination of multiple investment styles is often the best solution to optimize investors' portfolios at specific risk budgets.

Whether it be risk-controlled indexing, unconstrained managers, custom benchmarks, or utilizing active strategies, the tool set has grown, and investors would benefit from choosing a manager that has a wide breadth of investment style capabilities as fixed income evolves further into a solutions asset class.

State Street Global Advisors provides a straightforward and balanced response to investors' fixed income requirements, having served our clients' index and active investment needs and objectives for over 40 years. Our broad suite of fixed income, cash management, and currency solutions continues to evolve, underpinned by the depth of talent in our investment management, trading, and research teams – continuing to support our clients and the people they serve.

Figure 1: Think of Fixed Income as a Continuum



Source: State Street Global Advisors. The information contained above is for illustrative purposes only.