RBC Global Asset Management

Why take an active approach to fixed income investing?

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"Active management can be used to provide smoother returns in an uncertain world, through capital preservation techniques."

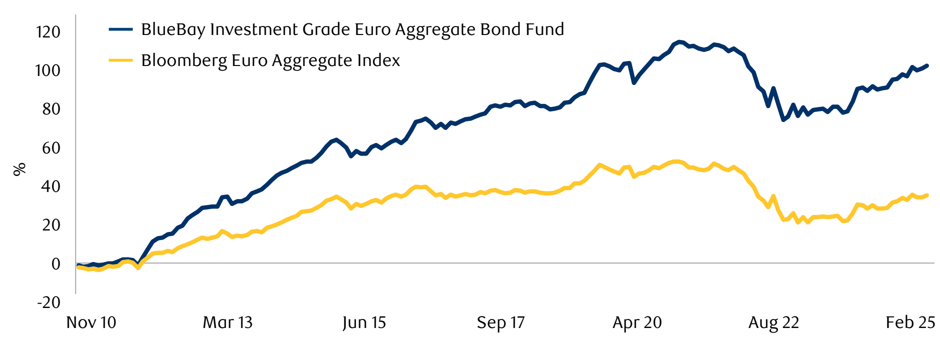
Mark Dowding, CIO of BlueBay fixed income, explains why the asset class is best invested in using an active rather than passive approach.

While the market backdrop in fixed income has shifted meaningfully over recent years, the overarching argument to invest in active funds over passive remains ever present. Yields have risen, resulting in a much brighter total returns outlook, increasing demand for fixed income funds.

With Trump's White House comeback dominating the start of 2025, the uncertain macro backdrop shows no signs of abating this year. Ongoing noise and policy announcements from the administration are now a key feature of everyday life and a driver of market volatility, while investor uncertainties around the paths of growth and inflation continue.

Active management can be used to provide smoother returns in an uncertain world, through capital preservation techniques. We believe that active fixed income managers are well placed to outperform the benchmark over the medium term. The performance of our BlueBay Investment Grade Euro Aggregate Bond Fund versus the Bloomberg Euro Aggregate Index illustrates the tangible benefits of investing in an actively managed fund (Figure 1).

Figure 1: BlueBay Investment Grade Euro Aggregate Bond Fund versus Bloomberg Euro Aggregate Index



Source: RBC GAM, as at 28 February 2025. Returns are shown gross of fees, in EUR terms. **Past performance is not indicative of future results.** The return on your investment may increase or decrease as a result of currency fluctuations if your investment is made in a currency other than that used in the past performance calculation. Fees and other expenses will have a negative effect on investment returns. Fund inception date: 2 November 2010.

Transaction costs and fees mean passive funds will always lag benchmark returns, especially in volatile periods when costs are higher and passive fund flows tend to be larger.

We discuss below why we believe that an active rather than passive approach is best suited to fixed income investing:

Structure of fixed income benchmarks: index methodologies mean that those issuers with the most debt are the largest constituents in benchmarks. In other words, the most indebted, potentially most vulnerable issuers, are also the most impactful on index performance. Therefore, passive investors need to be aware of concentration risks from both an issuer and sector perspective.

In contrast, active managers can focus on investing into compelling opportunities which potentially offer the most alpha (outperformance), rather than those issuers with the most debt. Our BlueBay fixed income team achieves this through rigorous proprietary credit analysis of issuer fundamentals, technicals and valuations, incorporating politics and macro analysis to give a top-down element to a fundamentally bottom-up driven decision-making process.

Responsible investing: the rise of responsible investing is also strengthening the case for active fixed income approaches. We believe that investors who pursue a passive approach in fixed income could find themselves at the mercy of rules that benchmark providers articulate and bond issuers may seek to exploit. Through active management, we can integrate responsible investment analysis into our credit evaluations when selecting investments, with an emphasis on forward-looking and qualitative factors.

Fixed income – structurally inefficient: inefficient markets typically mean more opportunities in the active management space. As a mostly 'over the counter' (OTC) market, the bond market is generally less efficient than the equity market and is more prone to the mispricing of risk. This can create opportunities for active managers, who through their analysis, are able to better understand these risks and how they should be priced.

Information inefficiencies also exist, as price discovery can be opaque. Many securities comprise complex features such as callability, subordination or covenant protection, which are difficult to value. This market structure can lead to pricing anomalies that can be exploited through active management.

The deep knowledge of our investment professionals within the Investment Grade team, with an average of 20 years of industry experience, ensures that we are well equipped to see opportunities when these pricing discrepancies occur.

New issue market: the new issue market is the most liquid way to add exposure to issuers. Since issuers can't afford the reputational risk of their new issues not being fully subscribed, they will often provide what is known as a new issue premium (extra spread) and offer investors a discount for participating in the primary market. This gives managers the opportunity to take active long positions in order to take advantage of this premium.

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The broader the universe, the higher the alpha...when manager skill is positive: the investment grade universe is broad, with the Bloomberg Barclays Global Aggregate universe containing 30,000 issues from over 3,000 issuers and multiple sources of alpha built in, while in the Bloomberg Global Aggregate Corporate Bond universe alone there are over 2,000 issuers[1].

[1] Bloomberg as at July 2024.

These markets give access to a variety of investment opportunities including active sector rotation, bottom-up security selection and curve positioning. Furthermore, active management allows for investing off-benchmark, broadening the universe of opportunities even further into areas such as the subordinated debt of banks and non-financials.

As a result, investors who take an active approach can take advantage of opportunities across a vast and diverse global universe, in contrast to passive investors who are limited to benchmark-driven strategies.

Volatility: generating alpha requires both volatility and positive manager skill. With uncertainties surrounding the path of central bank easing, growth, inflation, politics and geopolitics, volatility has been a key feature of markets for some time and looks set to continue in the near term (Figure 2). An active approach suits this environment, as managers can be proactive in portfolio positioning to take advantage of dispersion in security performance and deliver excess returns to investors. In particular, our team's tactical and nimble approach allows us to limit the drawdown from underperforming positions and to reduce risk when needed.

Asymmetry of returns: an inherent feature of fixed income is the asymmetric risk profile, in which there is the potential for more downside than upside in bonds. As a result, an active portfolio can benefit more from not owning a deteriorating issuer than holding bonds from a company that is generating strong cashflows. Hence, risk management is crucial in managing bond portfolios. Passive strategies must replicate the benchmark, and this can therefore mean holding deteriorating securities until a formal downgrade takes place.

However, in active management, managers are able to adjust their portfolios to focus more on fundamentally strong issuers and exclude less creditworthy issuers. Furthermore, they can favour sectors with more attractive risk/reward profiles and avoid more uncertain sectors.

Another point worth considering is the ability of active managers to engage in index trading and take advantage of the known momentum that will be created, as issuers enter or leave a particular index.

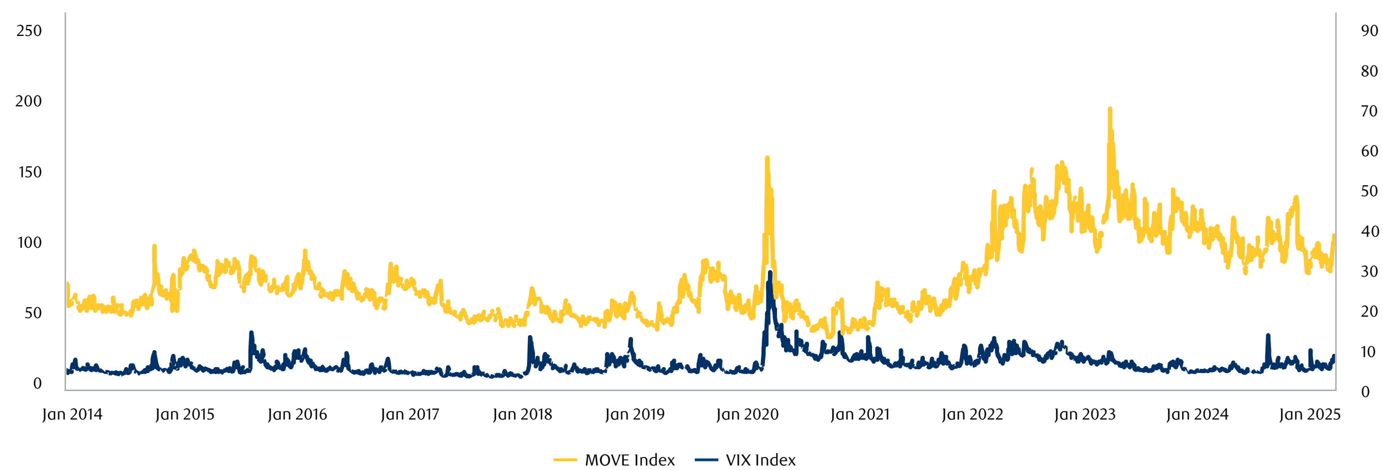
Price distortion: along with index trading, the development of momentum trading can also lead to further opportunities resulting from disruptions to the market price. Within momentum trading, price movements build on existing trends and can therefore diverge from the fundamental value of the assets. If we believe certain assets are mean-reverting, or will eventually converge to reflect their true value, we are able to take a contrarian view and position ourselves in direct opposition to ongoing market trends.

Looking ahead

Elevated yields have increased demand for fixed income assets, particularly as the market has grown in confidence that rate hikes are in the rearview mirror.

However, as we have seen, bond markets still face many economic, political, and geopolitical uncertainties, which likely means further volatility ahead. In this environment, we believe that active management is best placed to reduce the impact of this volatility on returns and exploit the mispricings that are created.

Figure 2: Market volatility shows no signs of abating



Source: Bloomberg, as at 5 March 2025.

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