Market Insight

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New Risks Emerge for Aging Plan Participants:
Revisiting active versus passive in fixed income

Executive Summary

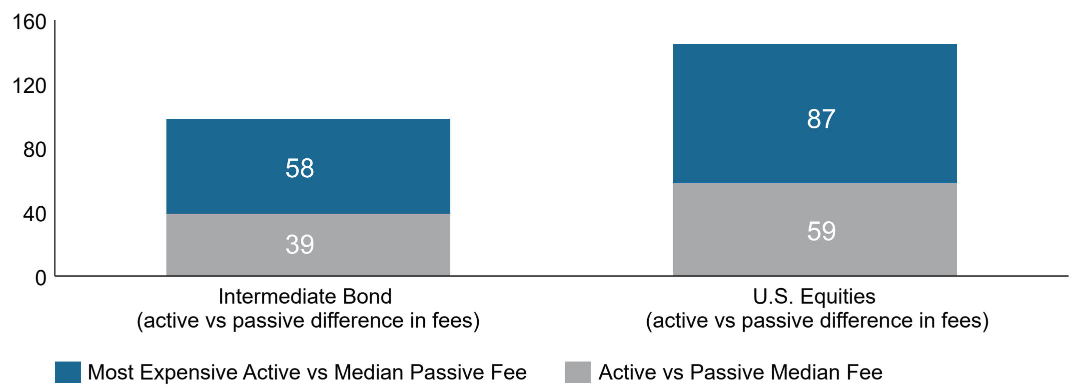
- "Active versus passive" is one of the most significant decisions facing DC retirement plan sponsors today.
- The debate has no shortage of opinions and passive investing has clearly gained favor over the last decade, especially in core allocations like large-cap equity.
- However, it is important to realize that arguments making the case for passive equity strategies are generally not applicable to fixed income.
- In fact, most active fixed income managers have a proven track record of outperforming market indices and the difference in fees between active and passive strategies is significantly smaller.
- Plan participants are aging, which means the demand for fixed income will continue to increase as these plan participants seek to mitigate risk into retirement. This demographic shift is coinciding with a significant change in the fixed income market, as interest rates have finally started to rise, reversing a nearly 40-year trend of declining rates.
- As this changing environment presents new risks for plan participants, our analysis highlights the key differences between equity and fixed income market indices to help DC plan sponsors evaluate passive and active strategies' ability to deliver optimal retirement outcomes.

Argument #1 for passive investing: Lower fees

Advocates of passive investing often point to the strategies' relatively low fees. And for good reason—an analysis of active and passive equity strategies shows that the median fee for active U.S. equity strategies is 59 basis points (bps) higher than passive strategies. Narrowing this universe to the most expensive active equity managers reveals an even wider gap. The median fee for the most expensive active U.S. equity strategies is almost 90 bps higher than the median fee for passive equity strategies (Figure 1).

Figure 1. The difference in fees between active and passive fixed income is significantly lower than equities

Fixed Income vs Equity: Fee Analysis of Active and Passive Strategies



As of 06/30/2018. Source: Morningstar and Voya Investment Management. The Intermediate Bond universe is represented by Morningstar's U.S. Fund Intermediate-Term Bond category. The U.S. Equities universe is represented by Morningstar's U.S. Fund Large Blend category. The passive sleeve of each universe comprise strategies identified by Morningstar as index funds. The equity universe was screened to remove index funds that include numerous short positions, track a proprietary, non-standard index and include high levels of emerging markets and preferred securities.

However, as Figure 1 also highlights, the fee gap between active and passive strategies looks much different in fixed income. Generally, fees for active fixed income strategies are much more in line with the fees for passive strategies. This is true even when you consider the most expensive strategies in the fixed income category.

Argument #2 for passive investing: It's hard to identify active managers that consistently outperform

In addition to lower fees, advocates of passive investing also point to performance, or more specifically active managers' lack of ability to outperform with any semblance of consistency. Although historically, active equity managers have added value in certain market conditions, the data largely supports this view when it comes to large-cap equity. An analysis of rolling 5-year returns over the ten years ending June 30, 2018 shows that only 1 out of 4 active equity funds in the Morningstar Large Cap Blend category outperformed the Russell 1000 Index. Accordingly, advocates for passive equity strategies believe the likelihood of overpaying for underperformance in the large-cap equity space is high, making passive investment strategies a more attractive option.

However, similar to fees, an analysis of the core fixed income market paints a much different picture. Figure 2 shows that active fixed income managers compete very well against their benchmarks and the passive fixed income fund strategies that track them. The likelihood of choosing an outperforming active manager has been much higher in the fixed income space—an analysis of the last ten years shows that roughly 3 out of 4 active fixed income funds outperformed the Bloomberg Barclays U.S. Aggregate Index.

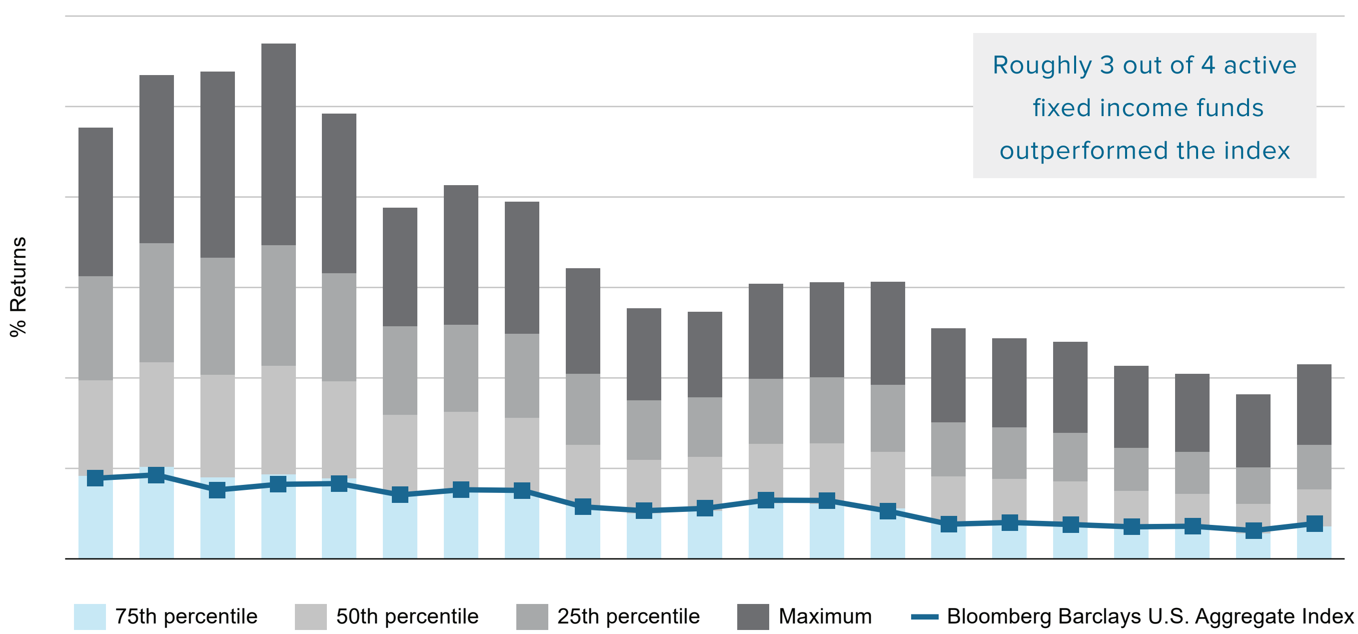
Analyzing the differences between the two asset classes will help DC plan sponsors understand why this trend is likely to persist and why active fixed income management is even more critical in the current market environment.

Fixed income is different: Why broad market indices have historically lagged active strategies

There are three significant differences between fixed income and equity market indices that help explain why active fixed income management has delivered superior historical relative performance:

1. The capitalization-weighted structure of fixed income indices has negative implications for performance.
2. Turnover in fixed income indices is significantly higher than equity indices, which increases trading costs for strategies replicating fixed income indices.
3. Replicating a fixed income index is difficult; the Bloomberg Barclays U.S. Aggregate Index contains roughly 10,000 securities.

Figure 2. Active fixed income's proven track record of outperformance
Bloomberg Barclays U.S. Aggregate Index, Rolling 5-Year Return Quartile Rankings within the Morningstar Intermediate-Term Bond Category 07/2008–06/2018



Source: Morningstar and Voya Investment Management. Net returns based on Morningstar Intermediate-Term Bond category; rolling 5-year time periods on a quarterly basis (21 total time periods).

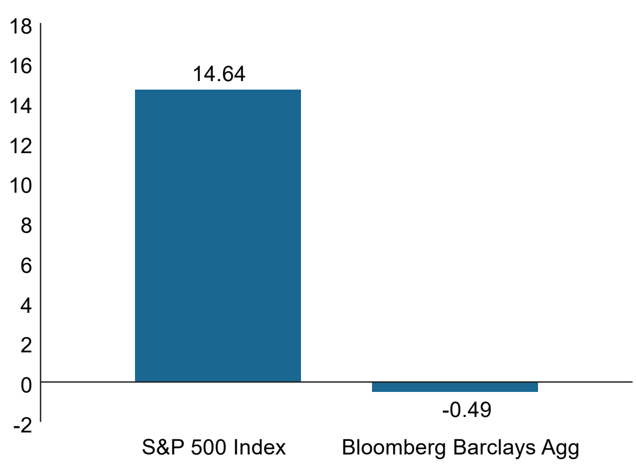
The weighting methodology of fixed income indices can negatively affect passive investors

In the equity market, stocks that represent the largest percentage holdings of an index are usually among the best performing stocks in that index. The reason is the market capitalization of a stock equals the total value of all shares outstanding and reflects the value of the issuing company. This means a stock's market capitalization increases when the stock's price increases, so stocks that have higher market capitalization have delivered high share price appreciation. By default, passive equity strategies enjoy the benefits of relatively large allocations to the stocks that have delivered the best historical performance.

Fixed income is different. For strategies that track a market cap weighted fixed income index, the most heavily weighted positions are those from companies that have issued the most debt. This presents a problem for the buyer of a cap weighted fixed income index, as they are heavily exposed to the most debt-laden (and not necessarily the most creditworthy) of issuers. Accordingly, the bonds held in the largest positions may not necessarily be the strongest performers over time. Figure 3 illustrates this point, comparing the 2017 performance of the top ten holdings by market capitalization in the S&P 500 and Bloomberg Barclays U.S. Aggregate indices. While the top ten equity holdings significantly outperformed the broad index return, the top ten fixed income holdings actually underperformed the index.

Figure 3. The largest holdings in fixed income indices have underperformed

2017 Relative Performance: Top 10 index holdings versus index



January 1, 2017 – December 31, 2017. Source: Bloomberg Barclays, Factset and Voya Investment Management. Returns shown represent the average returns of the top ten holdings by market capitalization in the Bloomberg Barclays U.S. Aggregate Index and the S&P 500 Index minus the full returns for each respective index.

Higher turnover: The hidden costs of passive fixed income investing

Annual turnover in the Bloomberg Barclays U.S. Aggregate index has been about 35% over the past three years, versus the turnover in the S&P 500 index turnover of 5%. Bonds have maturity dates and stocks do not, which contributes to higher turnover in bond indices. This difference is also driven by how companies raise capital in the equity and bond markets. Issuing corporations frequently refinance, which creates turnover as new bonds are issued and existing bonds are called. This activity results in trading activity in the indices and strategies that replicate a fixed income index are forced to make those trades as well, which creates an expense for investors.

Investors that buy and hold passive fixed income products, mutual funds or ETFs, may be unaware of the cost associated with trading happening underneath the product wrapper.

Harder to replicate: Fixed income indices contain significantly more securities than equity indices

Consider AT&T as an example. When it comes to equities, you have one stock to choose from. However, in fixed income, there are close to 50 AT&T bonds in the Bloomberg Barclays U.S. Aggregate Index. In total, the Bloomberg Barclays U.S. Aggregate Index contains roughly 10,000 securities, making index replication a more challenging undertaking given the sheer size of the market.

Passive fixed income strategies cannot protect against changing market risks

As work forces age and approach retirement, DC plan participants are beginning to increase their fixed income allocations. Accordingly, demand for fixed income in DC plans is rapidly increasing. At the same time, the market environment is changing. After a downward trend that lasted close to 40 years, interest rates are finally beginning to increase, presenting new risk for plan participants.

As participants approach retirement, the goal of a fixed income allocation is to preserve capital. Several elements of passive fixed income design hinder these strategies' ability to deliver on this goal. In addition to challenges surrounding market-capitalization and turnover, passive core fixed income strategies are also highly tethered to rate-sensitive fixed income benchmarks. The performance of such benchmarks are almost entirely dependent on the directionality of prevailing market rates, leaving passive investors overly exposed in rising rate environments. This potential volatility is especially problematic for participants nearing the end of their accumulation phase, as they cannot tolerate as much volatility as they could earlier on: there is not enough time left to recover from a significant loss. According to the U.S. Census Bureau, the average length of retirement is about 18 years; a late-stage loss could significantly jeopardize savers' long-term goals.

In this challenging new market environment, active fixed income management can play an important role for retirement savers by providing risk-management benefits that are not available with passive strategies.

Conclusion

An aging workforce, with less appetite for equity risk, coupled with rising domestic interest rates is causing some DC plan sponsors to reevaluate the role of actively managed fixed income in their plan's investment menus.

Importantly, not all active fixed income strategies are the same. For DC plans to reap the benefits of active management, we believe there are three attributes to look for in a fixed income manager:

1. Uses the flexibility afforded to them to avoid risk and minimize losses, not always look for the highest return potential
2. Aims to create a steady stream of moderate consistent returns
3. Provides a portfolio that looks, feels, and acts like fixed income

In the current market environment, we believe a comprehensive understanding of the differences between equity and fixed income market indices is crucial as DC plan sponsors help participants navigate the challenges ahead.

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