Passive Equity Arguments Fail in Fixed Income

"Consistency matters: Roughly three out of four active fixed income funds outperformed the index since 2009."

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Executive summary

- **Apples to Oranges:** while the active versus passive investment approach has only grown stronger over the years – with many pointing to the successes in passive equity products – it's important to remember that what works in one core investment sector may not be as successful in another.
- **Active fixed income's consistency of outperformance:** active bond managers have broadly outperformed the index, especially among higher ranked managers.
- **Fixed income is harder to replicate in an index:** the weighting methodology of bond indexes can negatively impact passive fixed income investors.
- **In bond indexing, size is a problem:** the greater an issuer's share of a market-cap-weighted fixed income index, the greater its level of outstanding debt, i.e. *leverage*.

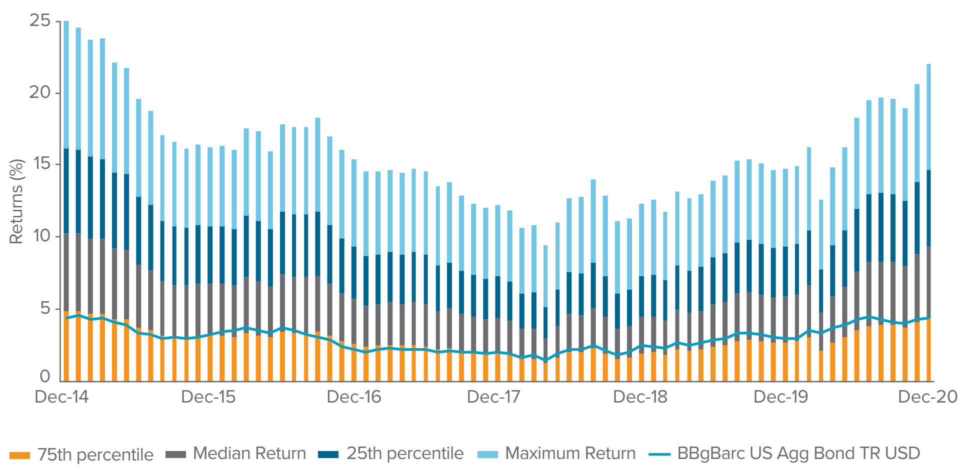
Active fixed income's consistency of outperformance

While some active equity strategies have undoubtedly added value during periods of market turmoil, few if any have been able to outperform their passive counterparts consistently, or across multiple market cycles. As the reasons for this are hotly debated, it is one key area where active fixed income and equity managers differ starkly.

While passive fixed income may have some advantages, such as lower fees, over the past decade *most* active funds in Morningstar's Intermediate Term Bond universe outperformed the Bloomberg Barclays Aggregate Index and the passive strategies that track them, per Figure 1.

Figure 1. Active Fixed Income's Proven Track Record of Outperformance

Bloomberg Barclays U.S. Aggregate Index, Rolling five-year Return Quartile Rankings within the Morningstar Intermediate-Term Bond Category 1/2010–12/2020



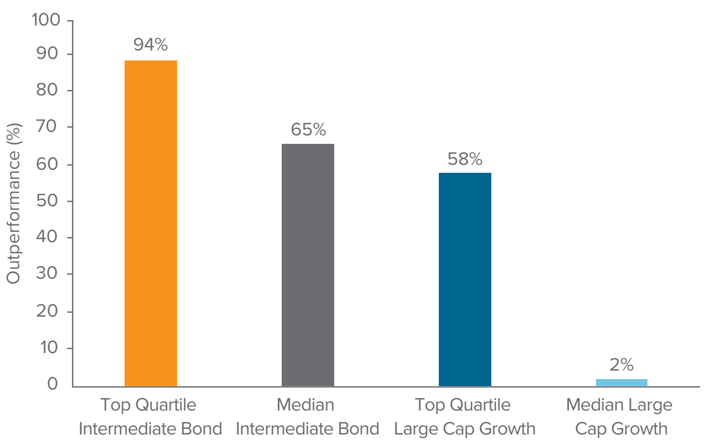
Source: Voya Investment Management and Bloomberg Barclays.

As any investor knows, choosing the right manager can be a daunting task in any investment sector. But the likelihood of choosing an outperforming active fixed income manager has historically been much higher than in equity; an analysis of the last 10 years shows that roughly three out of four active fixed income funds outperformed the Bloomberg Barclays U.S. Aggregate Index.

Per Figure 2, when looking at three-year rolling periods since 2006, top quartile active fixed income funds outperformed the index 94% of the time, compared to top quartile active large-cap growth funds, which outperformed the index just 58% of the time during. Furthermore, during the same time period, median active fixed income funds outperformed the index 67% of the time, versus only 2% of median active equity funds.

Figure 2. Top and Median Active Traditional Fixed Income Managers Outshine Their Equity Counterparts

Rolling three-year periods 1/2007 to 12/2020



Source: Voya Investment Management, Morningstar and Standard & Poor's.

Fixed income is harder to replicate in an index

Replicating a fixed income index is difficult, not only due to the sheer size of the index, but also because the make-up can be more fluid. Consider that the Bloomberg Barclays U.S. Aggregate Index contains almost 12,000 securities, versus the namesake amount in the S&P 500. However, annual turnover in the Bloomberg Barclays U.S. Aggregate index has been about 35% over the past three years, versus turnover in the S&P 500 of 5%.

Drilling down a bit deeper, bonds have maturity dates, whereas 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 is not so for equites. Consider AT&T, which represents just one stock in an equity index but has over 50 bonds in the Bloomberg Barclays US Aggregate Index.

Figure 3. Bond Indices are Larger More Diverse, Defying Easy Replication

	# of securities	% of securities in ETF
S&P 500	500	100
S&P 1500	1,506	100
Russell 3000	2,861	100
Barclays US Aggregate	11,984	25 – 75

	# Issues	Market Value $ (MM)	Market Value %
Treasury	262	$9,300,816,831	37%
Govt-Related	1,243	$1,573,032,234	6%
Corporate	6,647	$6,877,227,605	27%
Securitized	3,832	$7,374,746,973	29%
Total	11,984	$25,125,823,643	100%

Source: Voya Investment Management, Morningstar and Standard & Poor's. As of 3/31/21.

Additionally, like equity indices, there are rules for fixed income indices that help define the investment universe in a methodological manner. However, these same rules can also exclude a meaningful portion of bonds that may still be eligible for investing per a given strategy or product guidelines. For example, the Bloomberg Barclays U.S. Aggregate Index does not include any securities that are floating rate or certain securitized credit assets, among others.

Active bond managers can access these different instruments, which may not only provide additional alpha, but could offer greater risk-management capacity from prevailing market risks. For example, because the Agg is dominated by low-yielding government-related debt – the performance of which is almost entirely dependent on the directionality of interest rates – passive fixed income strategies that replicate the Agg are highly exposed to rate volatility. Thus, actively managed core bond and core-plus bond strategies' ability to engage off benchmark securities and methods helps to mitigate such risks as they arise.

In bond indexing, size is a problem

In the equity market, stocks that represent the largest percentage holdings of an index are usually among the best performers, i.e. a stock's market capitalization is the total value of all shares outstanding, therefore reflecting the value of the issuing company. Since a stock's market capitalization increases when the stock's price increases, by default, passive equity strategies enjoy the benefits of relatively large allocations to the those 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. Active managers can avoid large concentrations in these positions but passive investors in fixed income are heavily exposed to the most debt-laden (and not necessarily the most creditworthy) of issuers.

Conclusion: While active fixed income has advantages, manager selection is key

Given the overall success of passive equity products over the years, it is understandable that investors would look to replicate that approach within their primary source of equity diversification. However, as we illustrated above, what works in one core investment sector may not be as successful in another, especially considering the structural differences inherent with the two asset classes. Indeed, active fixed income's consistency of outperformance versus its passive counterparts alone lends strong support to this notion. But even as the much larger, complex, and more fluid pools of securities that bond market indexes are constructed from make replication more difficult, the indexes themselves are still not fully representative of the entire investment universe they're comprised from. Thus, confining a portfolio to a fixed income index could carry unnecessary opportunity costs, as well as hinder its flexibility in managing prevailing market conditions, including interest rate volatility.

That said, while we certainly believe that an actively managed bond strategy is a more effective way to gain core fixed income exposure, it's important to remember that not all active fixed income strategies are the same. For investors to reap the benefits of active management, we believe there are three key manager principles to look for. The manager should:

1. Primarily use the flexibility afforded to them to manage risks and minimize losses, instead of always looking for the highest return potential
2. Aim to create a steady stream of moderate consistent returns
3. Maintain 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 investors build portfolios designed to navigate the challenges ahead.

All investing involves risks of fluctuating prices and the uncertainties of rates of return and yield inherent in investing. High-Yield Securities, or "junk bonds," are rated lower than investment-grade bonds because there is a greater possibility that the issuer may be unable to make interest and principal payments on those securities. To the extent that the Fund invests in Mortgage-Related Securities, its exposure to prepayment and extension risks may be greater than investments in other fixed-income securities. The Fund may use Derivatives, such as options and futures, which can be illiquid, may disproportionately increase losses and have a potentially large impact on Fund performance. Foreign Investing does pose special risks including currency fluctuation, economic and political risks not found in investments that are solely domestic. As **Interest Rates** rise, bond prices fall, reducing the value of the Fund's share price. Other risks of the Fund include but are not limited to: **Bank Instruments; Company; Credit; Credit Default Swaps; Currency; Floating Rate Loans; Interest in Loans; Interest Rate; Investment Models; Liquidity; Market; Market Capitalization; Municipal Securities; Other Investment Companies; Prepayment and Extension; Price Volatility; U.S. Government Securities and Obligations; Portfolio Turnover; and Securities Lending Risks. Investors should consult the Fund's Prospectus and Statement of Additional Information for a more detailed discussion of the Fund's risks.**

Index Disclosures

The **S&P 500** Index is a gauge of the U.S. stock market, which includes 500 leading companies in major industries of the U.S. economy. The **Bloomberg Barclays U.S. Aggregate Bond Index** is composed of U.S. securities in Treasury, Government-Related, Corporate and Securitized sectors that are of investment-grade quality or better, have at least one year to maturity, and have an outstanding par value of at least $250 million.

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