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Active fixed income strategies: balancing risk and return

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Active fixed income strategies may offer investors numerous advantages over passive index strategies, including the potential for alpha and enhanced risk-adjusted performance. Investors are still seeking risk-managed returns in the current higher-for-longer rate environment, and we believe active management for fixed income can better help investors pursue their goals. These advantages become more significant as we consider the flawed nature of issuance-based fixed income indexes and the long-standing segmentation of indexed markets.

KEY TAKEAWAYS

Active managers:

- Exhibited a better risk/return trade-off over the past 10 years
- Can expand the investment universe to broaden diversification across high grade sectors and incorporate higher yielding sectors to potentially enhance income and total return
- May reduce credit risk through fundamental and quantitative research; sector and security selection; and tactical trading
- Manage interest rate sensitivity through active duration and yield curve positioning

> Actively managed portfolios have historically provided higher total returns and improved risk-adjusted returns than passive portfolios.

ACTIVE MANAGEMENT CAN BE USED IN ANY ENVIRONMENT

We believe actively managed bond strategies can help manage portfolio risk while enhancing returns, particularly in today's environment of volatile interest rates and historically tight credit spreads. Active sector rotation, bottom-up security selection and interest rate management (duration and yield curve) may create opportunities for investors to add value that are simply not available in passively managed strategies.

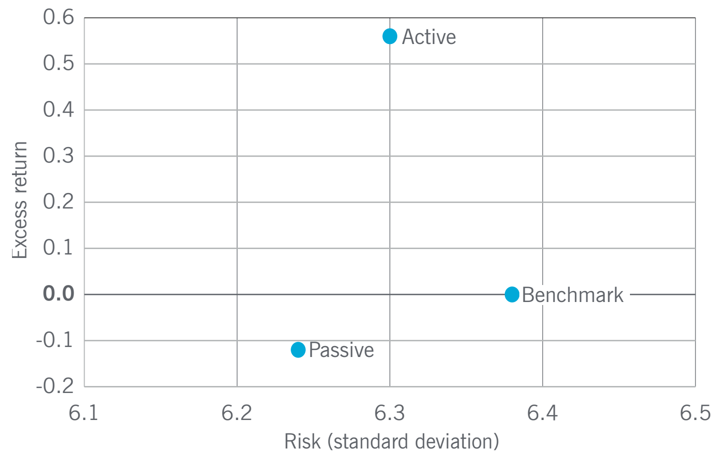
Actively managed global bond portfolios outperformed passively managed portfolios, on average, over the 10 years ending 31 Dec 2024 (Figure 1, top). Within the eVestment Global Aggregate Fixed Income peer universe, we used the gross of fees excess returns of active and passive strategies. Using excess returns controls for currency hedging policies and the currency in which returns are reported.

Fixed income investors also tend to be concerned with volatility. Return per unit of risk is represented by the Sharpe ratio (higher numbers indicate more return per unit of risk). Excess returns per unit of active risk can be measured by the information ratio, which divides excess return by the tracking error.

The volatility (standard deviation) of the median passive and active strategies was slightly lower than the benchmark, while the tracking error for the median active strategy was only slightly higher than for passive. However, excess and risk-adjusted returns were highest for active strategies (Figure 1, bottom). Negative Sharpe ratios occur when yield curves are inverted, meaning rates at the very front end of the curve are higher than rates further out.

Figure 1: Actively managed core bond strategies have offered better risk-adjusted returns

10 years ending 31 Dec 2024



	Sharpe ratio	Information ratio
Passive	-0.28	-0.12
Active	-0.17	0.49
Benchmark	-0.26	NA

Data source: eVestment, 31 Dec 2024. **Performance data shown represents past performance and does not predict or guarantee future results.** Risk is measured by 10-year annualized standard deviation and return by 10-year annualized excess return. **Representative universes or indexes: passive:** Global Passive Aggregate Fixed Income; **active:** Global Aggregate Fixed Income; **benchmark:** manager indicated benchmark or Bloomberg Global Aggregate Index if none were indicated.

WHY IS IT DIFFICULT FOR INDEX STRATEGIES TO KEEP UP?

Fixed income index strategies may often have difficulty matching their benchmarks' performance due to the complexities of bond indexes. The U.S. listed equity market spans roughly 3,300 public companies.[1] In contrast, the most widely quoted U.S. bond index, the Bloomberg U.S. Aggregate Index, contains more than 13,600 securities.[2] Similarly, the MSCI Europe Equity Index included 414 companies at the end of 2024,[2] while the Bloomberg Pan-European Aggregate Index counted 9,420 constituents.[3]

It is virtually impossible to buy all of those bonds given supply constraints, so an index manager must attempt to replicate the characteristics and performance of the benchmark using fewer securities.

HOW CAN ACTIVE MANAGERS ADD VALUE?

Commonly used broad market benchmarks like the Bloomberg Global Aggregate Index suffer from many drawbacks that offer active managers opportunities to generate excess returns and manage risk. These shortfalls include limited sector exposure, magnified credit risk due to market value weighting, fluctuating duration and a construction methodology bias that favors large, frequently traded instruments to ease index data publication. Active managers may add value to fixed income portfolios by taking advantage of these limitations. Let's look at each in turn:

Expanding the investment universe

By their very nature, bond indexes are exclusionary, meaning they limit themselves in terms of the opportunity set. For example, the Global Aggregate Index contains over 30,000 holdings with a market value of nearly $67 trillion.[2] But the index excludes bonds with less than $300 million outstanding in USD, euro, and AUD, and there are minimum deal size thresholds for all currencies. The index eliminates bonds with maturities of less than one year.

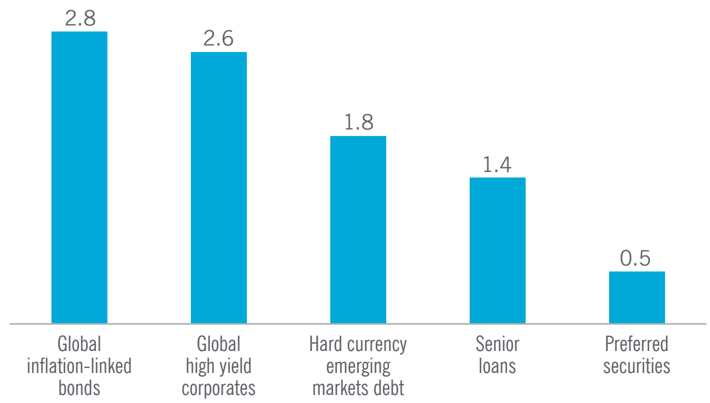
The index also excludes major market segments like below investment grade corporate bonds and senior loans, as well as specialized markets like inflation-linked bonds, floating rate instruments and preferred securities (Figure 2). While not all active strategies include these extended sectors, we believe opportunistic and judicious use may help to improve a strategy's return profile without meaningfully changing its risk level or correlation to the Global Aggregate Index.

Active global managers have flexibility to alternate between currencies and local yield curves to improve return potential and increase diversification because global interest rates often follow different paths. These securities are subject to additional risks, including political risk and exchange rate volatility. But active managers carefully consider these risks when choosing how and when to adjust allocations. Passive index strategies simply pass through the local market risks on a cap-weighted basis that ebbs and flows with cyclical issuance patterns.

Active managers also may strategically allocate away from potentially lower yielding government bonds. They could supplement index-eligible bonds with off-benchmark investments that may offer higher yield and greater diversification, while providing more opportunities to manage interest rate risk (Figure 3).

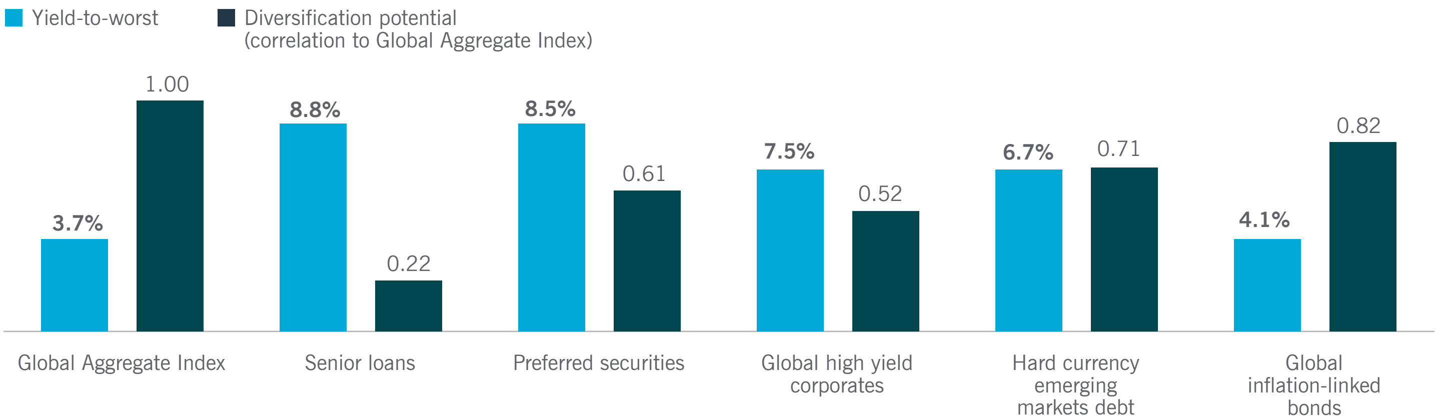
Figure 2: The Global Aggregate Index misses out on many sectors

Index market value ($ trillions)



Data source: Bloomberg, L.P., JPMorgan, Standard & Poor's, 31 Dec 2024. **Performance data shown represents past performance and does not predict or guarantee future results.** Chart shows market value of various market indexes only and does not include the entire universe of outstanding securities. Certain securities may be represented in more than one index. **Representative indexes: global inflation-linked bonds:** Bloomberg Global Inflation-Linked Total Return Index Value Unhedged USD; **global high yield corporates:** Bloomberg Global High Yield Index; **hard currency emerging markets debt:** JPMorgan Emerging Markets Bond Index Global, JPMorgan Corporate Emerging Markets Bond Index; **senior loans:** S&P UBS Leveraged Loan Index; **preferred securities:** ICE BofA US All Capital Securities Index, ICE USD Contingent Capital Index.

Figure 3: Off-benchmark sectors have offered potential for higher yield and greater diversification



Data sources: Bloomberg, L.P., JPMorgan, Standard & Poor's, 31 Dec 2024. **Performance data shown represents past performance and does not predict or guarantee future results. Representative indexes: Global Aggregate Index:** Bloomberg Global Aggregate ex USD Index; **senior loans:** S&P UBS Leveraged Loan Index; **preferred securities:** ICE BofA U.S. All Capital Securities Index; **global high yield corporates:** Bloomberg Global High Yield Index; **hard currency emerging markets debt:** Bloomberg Emerging Markets USD Aggregate Index; **global inflation-linked bonds:** Bloomberg Global Inflation Linked Bond Index.

Enhancing risk-adjusted returns

In fixed income indexes, securities are weighted by the market value of the outstanding debt, so the most indebted issuers make up more of the index. That means passive investors are, by the nature of the index, investing in issuers that have the most debt.

This is certainly true of developed market sovereigns, which represent an increasing share of aggregate indexes globally. For example, U.S. Treasury exposure in the Global Aggregate Index grew from 8.7% at the end of 2007 (before the Global Financial Crisis) to 18.5% at year-end 2024.

Chinese government bonds denominated in CNY were included in the Global Aggregate Index beginning in 2019, and CNY Treasury exposure surged from 1.3% at year-end 2019 to 5.4% in 2024. Local market government securities have substantial interest rate risk, with no credit spread to cushion prices from rate volatility.

The same is true for credit instruments. Passive investing may increase exposure to issuers with higher leverage (because they have issued more debt). Active managers, using rigorous credit research processes, can focus on the most compelling opportunities, rather than those companies that issue the most debt.

Managing downside risk is critical. Bonds have an asymmetric pay off profile; a default can take price all the way to zero, while repayment of principal at maturity caps potential upside price appreciation. Equities, on the other hand, can theoretically appreciate without a limit, countering the risk of going to zero.

Therefore, fixed income portfolio returns can be hurt more by a bond not repaying its principal than they are helped by a bond repaying principal plus interest. Using in-depth research, active managers can seek to avoid issuers they believe may not repay their debt or may experience financial hardship that could cause bonds to decline in price before maturity.

To be sure, avoiding or selling index-eligible securities before they are downgraded from investment grade to below investment grade may give active managers an edge. Passive portfolios are forced to experience price declines on a downgraded bond before it exits the benchmark at the end of the month (or subsequent rebalancing period).

Figure 4: The Global Aggregate Index has a high concentration of lower-yielding bonds

	Market value (%)	Yield-to-worst (%)	Option-adjusted duration (years)
Global Treasuries	53	3.2	7.2
Government-related	15	3.1	5.7
Investment grade corporates	18	4.8	5.9
Securitized	14	4.8	5.7

Data source: Bloomberg, L.P., 31 Dec 2024. **Performance data shown represents past performance and does not predict or guarantee future results.** Yield represents yield-to-worst.

Actively managing interest rate risk

The typical bond index is limited in its sector composition, and sector weights tend to change over time. This makes it important for investors to know what they own, as the risk factors are not constant (sector, duration, default and prepayment), even for an index strategy.

The Global Aggregate Index sector composition highlights how index strategies concentrate risk in a lower yielding, longer duration market segment (Figure 4).

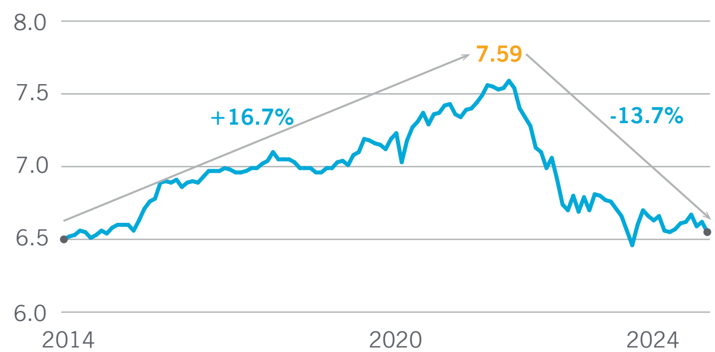
Bond market participants may have investment objectives outside of maximizing income or earning risk-adjusted returns. Central banks focus on controlling inflation and stabilizing markets, while financial institutions often manage against book yield or regulatory constraints.

These entities make up more than half of the participants in the bond market and their activities can sometimes suppress yields for certain sectors. They also can represent a bid for securities that might not otherwise come to market, yet issuance volumes will drive compositional changes of benchmarks. All of this leads to inefficiencies that may be exploited by active managers, while index investors are left holding whatever the market bears.

For instance, the index's duration fluctuates over time (Figure 5). Longer duration means the bonds tend to be more sensitive to rising interest rates.

Figure 5: Benchmark interest rate risk has not been static

Bloomberg Global Aggregate Index option-adjusted duration (years)



Data source: Barclays Live, Bloomberg, L.P., 31 Dec 2014 – 31 Dec 2024. **Performance data shown represents past performance and does not predict or guarantee future results.** Duration is expressed in years and measures the sensitivity of the price (value of the principal) of a fixed income investment to change in interest rates.

Investors in passive fixed income strategies are, in essence, forced to accept these risks. Active managers may reduce duration risk by favoring credit-sensitive securities to mitigate rate volatility, selecting mortgage pools with more stable duration profiles, and focusing on yield curve segments that are less affected by rate fluctuations, monetary policy and inflation.

ACTIVE FIXED INCOME MANAGEMENT OFFERS OPPORTUNITY

Investors have been increasingly drawn to passive strategies due to their low cost. However, the fee differential between active and passive strategies is wider in equities than fixed income.

At the same time, shifting from active to passive fixed income investing forfeits potential alpha and risk management opportunities while exposing investors to construction methodologies biased toward borrowers that issue the most debt.

Active managers can adjust their sector allocation, benefit from bottom-up security selection and position portfolios in an effort to minimize the impact from rising rates, while enhancing alpha potential, income and diversification with a broader opportunity set.

Actively managed portfolios have historically provided higher total returns and improved risk-adjusted returns than passive portfolios and we believe actively managed fixed income strategies should continue to add value.

For more information, please visit nuveen.com.

Endnotes

Sources

1 Data source: Wilshire Indexes, 31 Dec 2024.

2 Data source: Bloomberg, L.P., 31 Dec 2024. The Bloomberg U.S. Aggregate Index contained 13,630 securities with a market capitalization of $28.19 trillion.

3 Data source: Barclays Live, 31 Dec 2024.

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