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In-depth analysis and insights to inform your decision-making.

Active Fixed Income Management
ADDING VALUE WITH ACTIVELY MANAGED BOND PORTFOLIOS

EXECUTIVE SUMMARY

- Although actively managed bond strategies remain much larger in terms of total assets, passive bond strategies have grown in popularity.
- Amid broad strength in bond performance in recent years, investors may have overlooked the potential benefits of active fixed income management.
- There are risks associated with trying to replicate the performance of bond indexes, where issuers with the heaviest debt loads typically garner the largest weightings. In addition to credit risk, investors tracking passive benchmarks may also be exposing themselves to greater interest rate risk and limiting the opportunity set.
- In our view, actively managed bond strategies hold distinct advantages versus a passive approach to fixed income portfolio construction.
- Active bond strategies that emphasize fundamental credit research can help mitigate downside risk and enhance returns—especially if market volatility increases as global central banks withdraw support and the credit cycle enters its late stages.

Fixed income allocations remain a core component of investors' asset allocations as a source of income and portfolio diversification. Amid robust inflows into fixed income assets since the global financial crisis, passive fixed income portfolios have gained appeal, seen by some as a simple, low-cost means of gaining exposure to the asset class. While actively managed bond strategies still hold far more assets, passive bond strategies have been gaining market share.

Amid broad strength in bond performance in recent years, thanks to abundant central bank monetary support, investors may have overlooked the benefits of active management, as well as the risks and opportunity costs that can come with indexed investing. Of course, actively managed strategies can underperform their benchmarks when managers' allocation and security selection decisions fail to pay off, particularly over shorter time periods and when bond prices are broadly moving in the same direction. However, we believe that actively managed bond strategies possess inherent advantages that can help mitigate downside risk and enhance returns, and our portfolios are designed to address this dynamic. This is especially true in more volatile market conditions where bond performance is more varied. With the potential for rising interest rates and increased turbulence in richly valued credit markets, prudent security selection and interest rate management will likely become even more important drivers of performance.

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BOND INDEX STRUCTURES CAN LEAD TO UNDUE CREDIT RISK

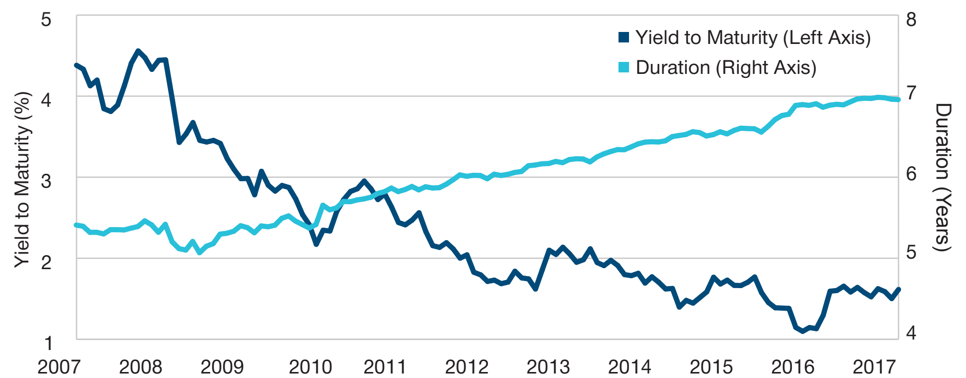
Bond and equity indexes possess a key difference. With equity indexes, market capitalization usually determines individual stock weightings. If a company's earnings potential increases—in turn, raising its share price—its stock garners a larger weighting in the index. By contrast, weightings in most fixed income indexes are based on the market value of an issuer's outstanding bonds. The result is that companies and governments with the most outstanding debt have the largest weightings in bond benchmarks.

Issuers possessing large debt loads—often some of the leading companies in the world—can be good investments if they are capable of meeting their obligations to bondholders and are working to strengthen their finances. But it is important to remember that fixed income investments have what is known as an asymmetrical risk/reward profile: Upside is limited to the promised stream of interest and principal payments, but downside can be substantial if an issuer defaults. Credit rating downgrades triggered by deteriorating fundamentals likewise can hurt performance as default risk rises. Therefore, indiscriminately buying highly leveraged issuers simply because they are large index positions is a dubious investment approach—particularly at times of rising rates, when it becomes more expensive to refinance outstanding bonds.

We believe employing in-depth credit analysis to identify bond issuers with stable or improving fundamentals and attractive valuations is the most prudent means of generating reliable income streams and possibly some capital appreciation if the market has mispriced credit risk. Diligent fundamental research also helps to avoid or minimize exposure to issuers and sectors with deteriorating credit profiles in an effort to mitigate the negative impact of downgrades and defaults.

FIGURE 1: **Yields Lower, Interest Rate Risk Higher Since the Global Financial Crisis**

September 2007 to September 2017



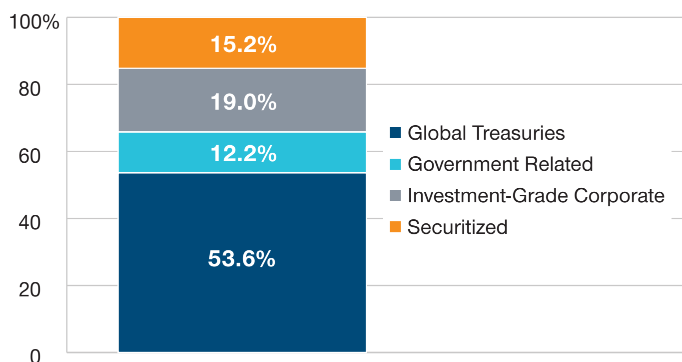
Lines represent yield and duration of the Bloomberg Barclays Global Aggregate Bond Index.
Sources: Bloomberg Barclays and T. Rowe Price.
Source for Bloomberg Barclays index data: Bloomberg Index Services Ltd. Copyright© 2017, Bloomberg Index Services Ltd. Used with permission.

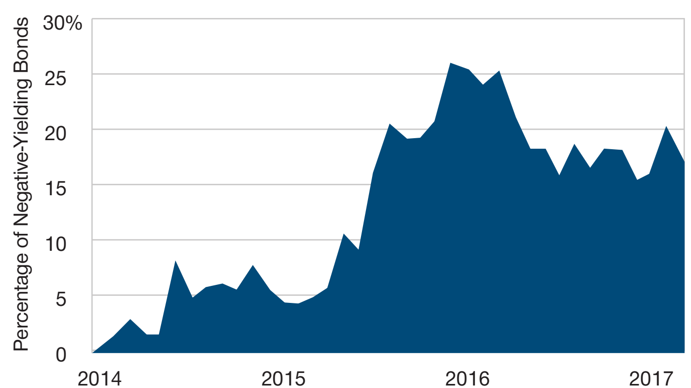
ACTIVE BOND STRATEGIES ARE BETTER EQUIPPED TO DEFEND AGAINST INTEREST RATE RISK

A sustained period of historically low interest costs has prompted corporations and governments to issue large quantities of new bonds and extend maturities. Lower yields and longer maturities have led to increased duration, a measure of how sensitive bond prices are to interest rate changes (see Figure 1). While longer durations benefit bond performance in a declining interest rate environment, there is now greater risk that bond prices will fall if inflation picks up and pressures interest rates higher.

FIGURE 2: **Negative-Yielding Government Debt Makes Up a Meaningful Portion of Major Global Index**

As of 29 September 2017





Allocation percentages for the Bloomberg Barclays Global Aggregate Bond Index and percent of index market value with negative yields.
Sources: Bloomberg Barclays and T. Rowe Price.

Unlike indexed products that attempt to mirror the duration profile of their benchmark as closely as possible, active fixed income strategies typically have some latitude to modify duration and yield curve exposures. This can range from modest flexibility, in the case of more traditional "core" bond strategies that adhere more closely to benchmarks, to significant leeway for less traditional, benchmark-agnostic bond strategies that can reduce duration to zero or below.

Although correctly predicting the precise timing and magnitude of interest rate moves is extremely difficult, the ability to shorten duration when rates appear likely to rise may provide some downside protection against price declines. Likewise, the ability to lengthen duration in markets where yields are prone to fall and curves are steep can augment return potential.

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3 Key Advantages of Active Bond Investing

We believe actively managed bond strategies possess advantages that can help mitigate downside risk and enhance returns

Fixed income investments typically possess more downside risk than upside potential

ACTIVE ADVANTAGE

In-depth credit analysis can identify bond issuers with stable or improving fundamentals and avoid issuers that will be challenged to meet debt obligations

PASSIVE RISK

In most fixed income indexes, issuers with the most outstanding debt have the largest weightings, which increases credit risk

CREDIT RISK

GLOBAL OPPORTUNITY

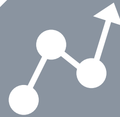
The fixed income investment universe is extremely large and expanding globally

ACTIVE ADVANTAGE

Active managers can potentially generate better returns by utilizing a broader opportunity set and selecting bonds offering attractive relative value and risk profiles

PASSIVE RISK

Investments are confined to those meeting specific benchmark criteria without regard to valuations, risks, and return potential



INTEREST RATE RISK

In the current low interest rate environment, there is greater risk that bond prices will fall if inflation picks up and pressures interest rates higher

ACTIVE ADVANTAGE

Active bond strategies typically have some flexibility to manage interest rate exposures, making them better equipped to defend against and exploit rate fluctuations

PASSIVE RISK

Indexed products attempt to replicate the performance and duration profile of their benchmark, which increases risk from rising interest rates

ACTIVE PORTFOLIOS CAN MORE FULLY EXPLOIT THE BROAD GLOBAL FIXED INCOME OPPORTUNITY SET

The fixed income opportunity set is vast and not fully captured by even the broadest fixed income benchmarks. For example, the AUD 62.6 trillion (USD 49.1 trillion) Bloomberg Barclays Global Aggregate Bond Index is dominated by the U.S., Japan, and major European economies that have issued copious amounts of debt. More than three-quarters of the index consists of government bonds, government-related debt, and U.S. agency mortgage-backed securities—sectors that tend to offer lower yields and greater interest rate sensitivity. Although down from its peak, about 17% of the index offered negative yields as of 29 September 2017 thanks to ongoing unconventional monetary stimulus programs in Europe and Japan (see Figure 2, page 2).

Despite its large size, the Bloomberg Barclays Global Aggregate Bond Index excludes multiple sectors and securities that can offer attractive yields and compelling risk-adjusted return opportunities. High yield bonds, floating rate bank loans, and inflation-linked securities are among the sectors not represented. The index also has relatively low exposure to higher-yielding emerging markets bonds as well as securitized credit sectors, such as asset-backed and commercial mortgage-backed securities. It also omits trillions of dollars' worth of bond issues that do not meet prescribed index eligibility requirements.

Active managers whose portfolios are measured against broad market indexes can potentially generate better returns versus their benchmarks by strategically allocating less to lower-yielding government bonds and increasing their exposure to sectors with higher yields and lower interest rate risk. Active managers can often supplement index-eligible bonds with some out-of-benchmark securities, such as high yield bonds and bank loans, which offer larger coupons and are less sensitive to rate increases. Managers of active global bond portfolios can compare countries and currencies to improve return potential and manage risk as interest rates follow different paths and exchange rates fluctuate. These securities are subject to additional risks, such as default risk and the risks of international investing.

> ...we believe our active approach to fixed income investing holds distinct advantages over a highly constrained, passive approach to fixed income portfolio construction—particularly in a more challenging environment with elevated interest rate risk and areas of credit concern.

Active multi-sector bond managers can add further value by adjusting sector allocations as relative valuations and market risks change. Sector performance can vary widely from year to year, and some sectors historically have fared better than others in different interest rate and credit environments. For example, noninvestment-grade securities, or those with higher default risk, have tended to outperform in market environments where corporate revenues are rising due to an improving economy; conversely, high-quality bonds typically perform best in environments where economic growth and inflation are weak, putting downward pressure on interest rates, due to their higher-duration profile.

WITH MANY FIXED INCOME OPTIONS AVAILABLE, ACTIVELY MANAGED PORTFOLIOS OFFER A CHOICE

Bonds serve important roles in portfolios, helping to diversify equity risk, generate income, dampen volatility, and preserve capital. Investors can select from a multitude of fixed income options, depending on their specific objectives and risk tolerances, with strategies ranging from the benchmark aligned to the benchmark agnostic.

Regardless of the route taken, we believe that investors can benefit from skilled fixed income managers, supported by robust global research and trading platforms, who are able to make judicious sector allocation, security selection, and duration decisions. As such, we believe our active approach to fixed income investing holds distinct advantages over a highly constrained, passive approach to fixed income portfolio construction—particularly in a more challenging environment with elevated interest rate risk and areas of credit concern. Even in highly benchmark-aligned portfolios, there is room to add incremental value and increase risk-adjusted returns with modest active overlays. Our disciplined fixed income investment process, with an emphasis on independent research and risk management, seeks to help our clients meet their long-term investment objectives.

Of course, if the investments selected and strategies employed by a portfolio fail to produce the intended results, the portfolio could underperform in comparison to other portfolios with similar objectives and investment strategies.

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T. Rowe Price focuses on delivering investment management excellence that investors can rely on—now and over the long term.

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