Why passive investing may not work for fixed income — and what does | Gene Tannuzzo, Deputy Global Head of Fixed Income

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In the fixed income market, I think passive investing actually poses a tremendous risk.

There has been a shift from active to passive investing across asset markets. So over the last year we've seen over $70 billion move into passive strategies that track the Bloomberg Barclays U.S. Aggregate Index.

I think it's important for investors to understand what that index is. Often it's tempting to think about that as “the S&P 500 of bonds,” but I think investors need to understand that bond indices are built a bit differently than equity indices. You get the largest exposure to the most indebted issuers.

So let's think about what that means for the U.S. Aggregate Index. For example, the U.S. Treasury had $9 trillion of public debt outstanding before the financial crisis. Today it has $19 trillion. So that has more than doubled, and that exposure is directly reflected in the exposure in passive fixed income indices like the U.S. Aggregate. So, for example, the U.S. Aggregate Index is very concentrated in interest-rate risk. Most of its returns are explained by changes in government bond yields. It's not really a diversified or “aggregate” exposure really at all.

Traditional fixed income benchmarks were never meant to be portfolios.

I think a strategic beta approach makes a lot of sense in fixed income, particularly relative to traditional passive strategies. A few elements that really benefit a strategic beta, fixed income approach are the ability to widen the opportunity set and apply a more constructive, smarter filtering to that process than you would see in a traditional benchmark

You want to start with income, and you want to really filter and sort by yield, but then you realize that that can, on its own, push you pretty far out the risk spectrum. So after you sort by yield, you really want to filter then by quality. Quality filters allow you to remove tail risk from the market and from the portfolio so you're not buying the riskiest issuers or the riskiest companies. And then after that, I think it's very important to have a liquidity screen, and really focusing on liquidity allows the process to be repeatable. Because if bonds are liquid, it means that we know we'll be able to find bonds, and be able to put them in a portfolio, and repeat that process over again.

The Bloomberg Barclays US Aggregate Bond Index (U.S. Aggregate) is a broad-based benchmark that measures the investment grade, U.S. dollar-denominated, fixed-rate taxable bond market. The index includes Treasuries, government-related and corporate securities, MBS (agency fixed-rate and hybrid ARM pass-throughs), ABS and CMBS (agency and non-agency).

The Standard & Poor's (S&P) 500 Index tracks the performance of 500 widely held, large-capitalization U.S. stocks.

It is not possible to invest directly in an index.

Market risk may affect a single issuer, sector of the economy, industry or the market as a whole. Fixed-income securities present **issuer default** risk. A rise in **interest rates** may result in a price decline of fixed-income instruments held by the fund, negatively impacting its performance and NAV. Falling rates may result in the fund investing in lower yielding debt instruments, lowering the fund's income and yield. These risks may be heightened for longer maturity and duration securities. **Non-investment-grade** (high-yield or junk) securities present greater price volatility and more risk to principal and income than higher rated securities. **Prepayment and extension** risk exists because the timing of payments on a loan, bond or other investment may accelerate when interest rates fall or decelerate when interest rates rise which may reduce investment opportunities and potential returns.

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