Elston

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Elston Insights

Building a bond portfolio: active, passive, or both?

- A dynamic approach is key
- Active allocation across exposures
- Implementation options

A dynamic approach is key

The last few years have seen seismic changes both in the interest rate environment (Bank of England Bank Rate (or "base rate") has risen from a floor of 0.10% to 5.25% in short order), and in the inflation environment (UK CPI peaked at over 5x times its target rate of 2%).

Buy and hold bond or "passive-allocation" invested were severely penalised for a "do nothing" approach in 2022, and will not fully make up the capital losses they experienced unless (crudely) interest rates were to return from 5.25% to 0.10%. Bluntly, bonds don't bounce the same way as equities can – their valuation is a closed form function of coupon, interest rates, credit risk and term.

Strategic or "active-allocation" bond funds had potential to protect capital as best they can by shortening duration, and switching into exposures positively correlated with rising interest rates, such as money market funds and floating rate notes. We wrote about this at the time (see Managing interest rate risk with floating rate notes (26th November 2021)).

Given the key variables to bonds – interest rates, inflation expectations, and credit risk – are constantly changing, it makes sense to have a dynamic approach to navigating these risks.

Active allocation across exposures

Whereas the performance of individual equities is a function of their (potentially unlimited) earnings growth, the performance of individual bonds can be grouped together into "exposures" based on their shared characteristics – yield, duration, credit quality, issuer-type, currency and term.

Indeed there are plenty of indices (and index-tracking funds) representing these exposures at a very granular level. Whether looking at Gilts (short-term or all), UK Corporate Bonds (short-term or all), Global Corporate Bonds (unhedged or GBP hedged), Global High Yield, Emerging Market (local currency or USD based). The performance impact of exposure selection will outweigh the potential performance impact for security selection within a particular exposure for bonds from different issuers with similar characteristics.

Furthermore, if using bond index funds or index-tracking ETFs, the bond exposures included in the index are typically more liquid and in the case of ETFs, there is a secondary layer of liquidity. This reduces the risk of being caught holding run-off, illiquid bonds that can't be sold by a fund. Indeed for investors who are concerned about liquidity, it's better to stick to bond ETFs (25th April 2019).

Implementation options

Whilst we would not advocate a "set and forget" "do nothing" bond portfolio approach (i.e. passive allocation), but we do believe that a bond portfolio can be effectively and actively managed using index-tracking "passive" bond funds. This active allocation/passive implementation approach is common in the equity markets, so why not in the bond space too. Considerations for choosing between active and passive bond funds is set out in the Case Study below.

Finally combining a core allocation of low cost index-tracking bond funds to reflect a strategic asset allocation with a managed (or "strategic") bond fund that is actively risk-managed could provide an optimum approach from a dynamism and value-for money perspective.

Whose strategy is it anyway?

Some allocators may choose to have a number of strategic bond funds to delegate the decision-making around bond portfolio management.

However there is a genuine risk of "di-worsification" here. Say you have two strategic bond funds that start similarly positioned. If one strategic bond manager goes bullish on rates and moves their portfolio aggressively into long-duration bonds, and the other strategic bond manager goes bearish on rates and moves their portfolio aggressively into short-duration bonds, the net effect could be that the average duration of the bond portfolio remains unchanged, but frictional costs are incurred.

So ensuring a managed bond fund's strategy is and remains aligned to your investment outlook is key.

We present some additional considerations for managers and advisers in the Case Study below

Case Study: Using Bond funds within a model portfolio

Choosing between active and passive bond funds

For bond allocation strategy in discretionary models, the portfolio manager can (or should) allocate actively across bond exposures based on the outlook for interest rates, inflation and credit spreads. However many DFM's adherence to a "set and forget" approach that comes with using relatively static third-party risk-profiled allocations meant a lot of them got caught out by the bond meltdown in 2022.

For bond allocation strategy in advisory models, where fund switches are harder to implement in a timely fashion, using actively-managed strategic bond funds makes more sense in a fast-moving interest rate environment. Strategic bond funds thereby provide a delegated approach. But the manager needs to have an unconstrained mandate to have maximum flexibility with duration risk and/or credit risk. And needs to do a good job.

For implementation, Bond index fund exposure makes more sense for core exposures. That said there's no shortage of sub-index exposures (split out by maturity, credit quality and currency hedging policy) to actively choose from.

Active bond exposure makes more sense for specialist exposures such as high yield and emerging markets, where indices can introduce unwanted biases.

What are the strengths and weaknesses of an active or passive approach?

The strength of an actively managed approach is the ability to move quickly to take advantage of market opportunities. Its weaknesses are the higher cost and the risk that the manager makes the wrong decisions, or the right decisions at the wrong time.

The strength of an index-based approach is transparency and cost efficiency. For asset allocators like us, we can target the specific exposures we need and can have the assurance the nature exposure won't change over time. It does what it says on the tin. The transparency of the index and underlying holdings means you know everything you hold, unlike an active fund where you might only see the top 10 holdings. It is also worth noting that bond ETFs – the exchange-traded version of bond index funds – provide an additional layer of liquidity that helped, rather than hindered, markets function in liquidity droughts like in March 2020 with Covid. So for investors who are concerned about liquidity, it's better to stick to bond ETFs.

The weakness of a passive or index-based approach is that bond index funds are "just" building blocks, rather than a managed approach so they cannot *per se* take advantage of dynamic markets.

When and where do active or passive make more sense?

Active works better for some exposures for two reasons: firstly in less efficient markets such as high yield and emerging markets, where active research pays off. Secondly in markets where the respective index introduces unwanted biases. For example high yield bond indices are skewed towards more heavily indebted companies. So a selective, actively managed approach makes more sense.

Passive or index-based approach works best in vanilla, standardised exposures, such as government bonds. However there's a huge amount of granularity and choice when it comes to index design selection.

What key metrics should DFMs or Advisers consider when evaluating a bond fund?

For active bond funds, it's important to look at how broad a mandate the manager has. A narrow mandate severely restricts active management and the fund ends up looking like a "closet tracker".

For passive you need to look at the inherent biases of the index exposure and methodology, tracking error, tracking difference and other efficiency metrics for index funds

What is the best way of blending active and passive bond funds?

It makes sense to blend both active and index bond funds for the reasons outlined above. At present we prefer investment grade and government bonds with low to medium duration. This exposure can be readily implemented using index funds, but there will be a time to look again at high yield and that's when we will dip into the active universe.

For adviser firms we consult to that run advisory models, we have some actively managed strategic bond funds that we monitor to enable a delegated and adaptive approach.

What about currency considerations?

We take an active allocation approach to bond portfolio management and consider only bond duration, credit quality but also currency. Some managers typically hedge all currency exposure back to sterling. We are not afraid to tilt away from sterling when its outlook is weak.

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