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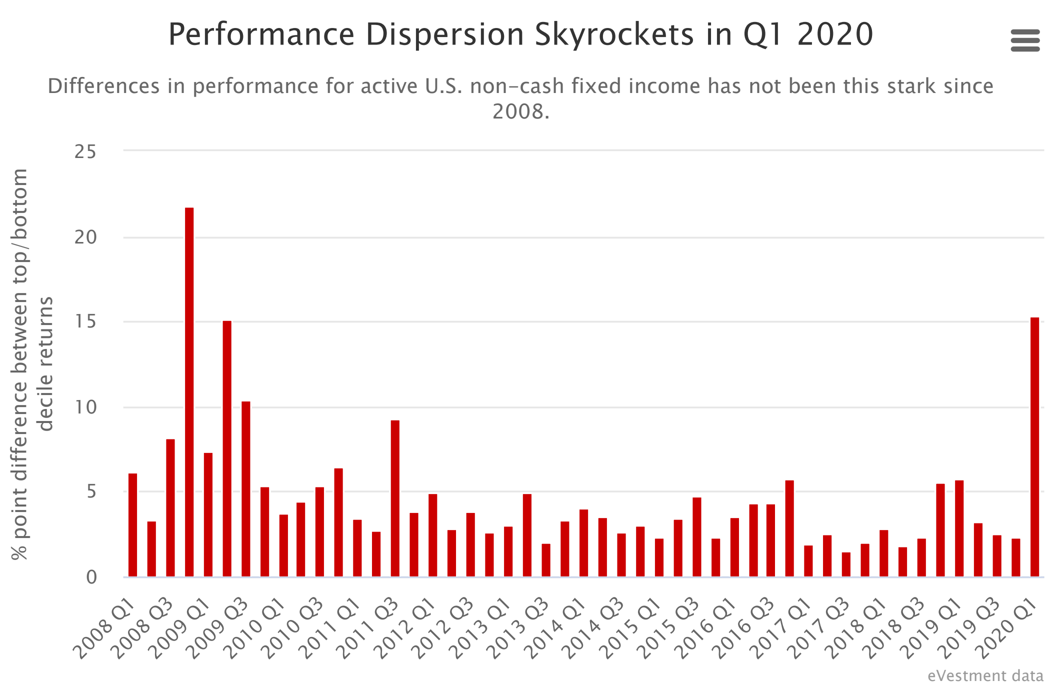
# COVID-19 Volatility Puts Active Fixed Income to the Test

By Lisa Fu   July 13, 2020

Flows into active fixed income strategies face headwinds as the COVID-19 market shock produces large performance dispersions, and long-term trends like the low-yield environment and a shift to passive continues.

Whether in U.S. core fixed income or within all active non-cash U.S. fixed income strategies, the periods of elevated market volatility revealed varying performance differentials between the best and worst performing strategies, says eVestment global head of research **Peter Laurelli**.

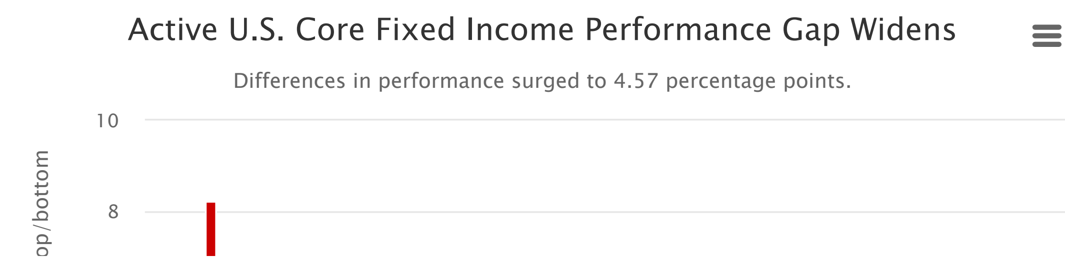
Indeed, the percentage point difference between top- and bottom-decile returns for active non-cash U.S. fixed income jumped to 15.29 percentage points in this year's first quarter from 2.35 percentage points in Q4 2019, according to eVestment data. Such a large differential had not been seen since the second quarter of 2009, which posted a 15.09 difference, and Q4 2008, which had a 21.82 gap.




The trend was also felt in U.S. core fixed income strategies, where there was a 4.57 percentage point gap between the worst- and best-performing deciles in the first quarter of 2020. This is the largest difference in performance since 2009, when there was a 5.25 percentage point deviation between the top and bottom deciles in the second quarter.

The performance gap could make some investors uneasy, says **Ashish Shah**, Goldman Sachs Asset Management's fixed income co-CIO and head of corporate credit.

"A lot of money is held in core, [and] it's supposed to be nice and stable," he says. "[Clients] want to make sure their




core is core.”

The COVID-19 shock came “out-of-the-blue” compared to prior economic cycles, and that led to some challenges, Shah says. In a typical late cycle, investors usually observe companies behaving more aggressively toward bond holders and the Federal Reserve tightening rates, he explains. This latest downturn came at a time when the Fed was already easing and companies had become more conservative, he says.

The lower interest rate environment, which is likely to continue as the pandemic persists, and the lack of yield as a result, creates a problem, Shah says. Institutional investors are looking to maintain the yield they used to receive by investing in lower-risk securities like Treasurys and moving further out into the risk curve, he says.

“The need for stability, need for yield, but safe yield, and need to immunize liabilities are three major themes” weighing on fixed income managers, Shah says.

The challenges facing the asset class may affect sales, says **Amanda Tepper**, founder and CEO of Chestnut Advisory Group.

“Core fixed income is a brutal space,” she says. “In many ways it’s even more competitive than [active] long-only U.S. equities.”

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Passive fixed income options are “super cheap” and have led to fee compression in the fixed income industry, Tepper says. In addition, differentiating one’s firm from the pack is a challenge because historically, most managers tend to outperform the fixed income index, she says.

“[Managers] outperform the index, but most managers that are active will also tell you that the fixed income index is fatally flawed,” Tepper adds.

Traditional passive fixed income indices weight securities by size, so as debt grows it earns greater weight in the index, she says. The more debt a segment of the market issues, the more leveraged it becomes, and greater leverage indicates greater risk, she adds.

Over the last few months, several institutional investors have terminated fixed income mandates. The Employees’ Retirement System of the City of Baltimore (BCERS) redeemed approximately $63 million from PIMCO’s core-plus fixed income strategy after the strategy underperformed its benchmark, sister publication *MandateWire* reported. **The El Paso City Employees’ Retirement Trust** terminated a mandate with Franklin Templeton**,** liquidating $200 million, *MandateWire* reported. Meanwhile, the Teachers’ Retirement System of the State of Illinois terminated a $250 million fixed income mandate with **Ramirez Asset Management** in June**.**

Wilshire Associates became more defensive in its tactical views and reduced credit exposure going into the year, the firm’s senior v.p. **William Beck** says. As investors became cautious on credit, the relative value trade has shifted more into Treasurys and government-related securities, he says.

However, active fixed income investments continue to command strong interest from Wilshire clients — if there have been terminations, it is likely due to style drift rather than underperformance alone, he says.

“We understand that there are going to be periods of underperformance, but we are really looking to build a long-term asset allocation plan with some tactical tilts,” he says.

Some institutional investors are decreasing their overall allocation to fixed income, and the ongoing trend of shifting from investing in active to passive persists, observes **Dan Sondhelm**, CEO of **Sondhelm Partners**. However, fixed income is not being eliminated altogether from institutional investor portfolios, he says.

“There’s still a role for fixed income in a portfolio, and I think they’re going to weather the storm,” Sondhelm says. “Investors know they need some fixed income to complement the equity.”

To maintain clients, portfolio managers need to be vocal during this challenging time, Sondhelm adds. Managers need to show they are sticking to a disciplined, repeatable process by highlighting their firm, process and managers in commentaries, videos, social media, news coverage and webinars, he says.

“If your story is not good, you are going to lose assets,” Sondhelm says. “You’ve got to have that story. I think investors will forgive you over the short-term for a little bit of underperformance.”

Investors recognize that active fixed income can have an edge, particularly in niche strategies like private credit or emerging market debt, Sondhelm says. Traditional classes like government bonds can be tougher, but focusing on how the firm adds value can create opportunities among the investors that are still searching for active fixed income exposure, he explains.

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