Fixed income benchmarks
Time to think again?

There are a number of drawbacks to the use of traditional fixed income benchmarks. As a consequence, some fixed income managers are reappraising their performance targets and in some cases moving away from traditional benchmarks altogether, in favour of a more unconstrained investment style.

In this paper we discuss some of the weaknesses of traditional fixed income benchmarks and also touch on some alternative approaches. In particular we find:

— The composition of a fixed income index is partly determined by the volume of debt issuance. This can expose investors to higher than desired concentrations in certain markets (for example sovereign debt in a time of uncertainty about some governments’ creditworthiness)

— Following a traditional credit benchmark can also lead an investor to hold riskier securities than they would otherwise

— Not all the bonds in a fixed income index are investible, leading to a performance mismatch that may not be due to decisions taken by the manager

— Fixed income benchmarks are not stable over time, and so tracking them can incur significant transaction costs.

The above issues will be most significant for an investor heavily constrained by the construction of an index. Active fixed income managers can begin to mitigate these factors by investing away from the benchmark. Some active managers and pension funds are also exploring alternatives to measuring performance against a single traditional fixed income benchmark. These alternatives include creating a bespoke index that is a composite of other indices, or using a ‘cash plus,’ or even a ‘liabilities plus,’ benchmark.

1. The composition of a fixed income index is partly determined by who issues the most debt

The majority of fixed income indices are weighted according to the price of the included bonds and the size of the issues. This means that companies and/or countries with a large amount of debt in issuance will form a substantial part of the index. Therefore, when a company/country suddenly issues a sizeable quantity of debt, a fund manager tracking the index would have to increase their holding of that entity’s bonds. However, there are a variety of reasons why a company or government may issue bonds, many of which are not necessarily an indication of a good investment.
As shown in Figure 1, the amount of government debt in the Bank of America Merrill Lynch Global Broad Market Index has increased substantially over the past five years - from 59% in 2007 to 66% in 2012 - in line with the amount of government issuance. Therefore, at a time when there are significant concerns surrounding sovereign debt, index-constrained managers are obliged to increase the proportion of government bonds in their funds.

The same effect can be seen in the corporate bond market. For example, in the year 2000 companies in the European Telecoms sector faced extremely high costs for the licenses required for third-generation mobile technology. Many of these companies issued bonds to finance this, which led to the telecoms sector becoming a larger proportion of corporate bond indices.

Source: Bank of America Merrill Lynch Global Broad Market Index, December 2012

Source: Bank of America Merrill Lynch Euro Corporate Index, December 2012
As a consequence, a benchmark-constrained corporate bond manager may well have increased their holdings of corporate bonds in the European Telecoms market, at a time when the industry faced considerable uncertainty.

Debt issuance is not necessarily a sign of weakness. However, weighting a portfolio based on the size of debt under issue does not represent an objective investment decision. This issue will be most significant for investors that are heavily index constrained, as these investors are more likely to invest in bonds from larger issuers as a consequence of the formulaic way the index is rebalanced.

2. Following a traditional credit benchmark can constrain an investor to hold riskier companies than they otherwise would

Corporate bond returns are asymmetric: when a company is solvent investors earn a steady income (albeit with fluctuations in price), however losses are very substantial if the company defaults. As shown in Figure 3, default rates vary considerably throughout the economic cycle, particularly for less highly rated companies.

Figure 3: Global default rates over time

A fixed income investor constrained by an index may hold companies with significant downside risk, whereas with more freedom they might have excluded these companies from their portfolio. This is particularly true during times of market stress, when default risks grow substantially for less secure companies. This is clearly illustrated in Figure 3. During the credit crunch in 2008-2009 and the dot-com bubble in 1999-2000 the default rate for less highly rated securities increased dramatically.

Moreover, as shown in Figure 4, the credit ratings and therefore risk profile within an index can vary dramatically over time (even within an investment grade index).

Investors less constrained by an index are able to adjust their portfolios towards companies which are viewed as safer in times of economic uncertainty.
3. Not all bonds in a fixed income index are investible

The investibility of a benchmark is a measure of how easily the index can be replicated by an investor - that is, whether each individual constituent can actually be bought.

Investibility was once a major issue in equity markets, but is now taken into consideration by index providers through the free float adjustment. Equity indices were traditionally weighted by market capitalisation, a measure which included shares owned by governments, company insiders, or other companies. Free float adjustments address this issue by adjusting market capitalisation for the percentage of total shares that are publicly available and can be invested in. However, with fixed income indices investibility is still an issue, as indices tend to be constructed based on the total amount of debt in issuance, rather than the total amount of *investible* debt. For example, in recent years the UK government has bailed out a number of financial institutions by buying their bonds in open market operations. Corporate bond indices which calculate sector weightings based on total debt issuance will therefore overweight the financial sector relative to the ‘investible’ debt in this industry.

Measuring against such an index potentially introduces a substantial degree of performance mismatch that is not attributable to decisions made by the fund manager.

4. Fixed income benchmarks are not stable over time

A key difference between equity and fixed income indices lies in the nature of their constituents. While an equity index tracks the path of a relatively constant collection of securities over time, the bond universe is constantly changing as new bonds are issued and others are redeemed.

A bond’s maturity decreases over its lifetime. This means that a long maturity bond will only fall into a long maturity index for a short period of time, until it is eventually reclassified as a shorter maturity bond. Unlike an equity index, which shows the changing prices of a relatively fixed set of securities, a bond index is a snapshot of the prices of all bonds of a certain maturity at a given point in time. One year down the line, the same index will consist of different bonds.
A recent example is the FTSE Over 5 Year Index-Linked Gilt Index. On 22 November 2012 its duration (broadly the weighted average time to payment of its constituents’ coupon and redemption payments) was 20.4 years. However the following day the duration had increased by a whole year. This was due to the 2017 index-linked gilt falling out of the index. An investor using this benchmark would potentially have had to sell this bond from their portfolio (and incur transaction costs) or else accept a fairly significant performance mismatch as a result of being short duration.

**Alternatives to traditional fixed income benchmarks**

Active fixed income managers can begin to mitigate some of the factors described in this paper by investing away from the benchmark. Some active managers and pension funds are also exploring alternatives to measuring performance against a single traditional fixed income benchmark.

Alternative approaches that pension fund trustees may wish to consider include:

— Investing in a fund that uses a bespoke, composite index that is more reflective of the pension scheme’s desired investment portfolio. For example, for an aggregate bond mandate the fund manager may choose to use a bespoke index split 50/50 between a sovereign debt index and corporate bond index. This would overcome the current bias in a broad market index towards sovereign debt.

— Targeting outperformance relative to cash (or LIBOR). This is likely to lead to a much less constrained portfolio, enabling the fund manager to exploit more fully the range of fixed income opportunities available. For example, the portfolio might contain domestic, global and emerging market debt, as well as high yield debt and some currency positions. The manager may offer a suite of fixed income portfolios, each targeting cash plus a different target (e.g. +1.5%, +3%, etc.). This gives greater flexibility to investors, enabling them to fine-tune the risk and return characteristics of their fixed income strategy by combining different funds. Funds with cash plus targets sit well alongside liability driven investment strategies, where there may be the need to generate at least a LIBOR return over the long-term to fund the strategy.

— Using a ‘liabilities plus’ benchmark. For an underfunded pension scheme, the ultimate investment objective is for the assets to grow faster than the scheme’s liabilities in order to close a funding deficit. For pension schemes with larger governance budgets the present value of the scheme’s own projected cashflows can serve as the benchmark. This closely aligns the fund manager with the objectives of the trustees, whilst providing the freedom and flexibility of a ‘cash plus’ target.

**Conclusion**

Traditional fixed income indices have a number of shortcomings. Funds that are heavily constrained by these indices potentially expose investors to higher than desired concentrations in certain companies or markets and can also lead the fund manager to hold riskier companies than they would do otherwise.

Furthermore, fixed income benchmarks are not stable over time, and also lack investibility – both of which can lead to a performance mismatch that is not a result of decisions made by the manager.

Trustees and active fixed income fund managers are beginning to look at a number of alternatives to traditional benchmarks, including creating bespoke benchmarks or using cash plus or even liability plus targets.

*If you would like to discuss any of the topics raised in this paper please contact your Client Director or a member of the UK Strategic Solutions team.*
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