Eaton Vance

Active Bond Managers Show Their Worth in a Turbulent Decade

TOPIC PAPER | FIXED INCOME | May 2024

Key Takeaways

- A new Eaton Vance study found that actively managed funds in nine major Morningstar fixed-income sectors collectively beat passive funds over the 3-, 5- and 10-year investment horizons studied.
- Active managers also showed consistency in their outperformance: They prevailed over passive funds in 84 rolling three-year periods ended within the past 10 years, representing a winning batting average of 87%.
- The greatest outperformance by active managers occurred over the most recent three-year period, which included the massive bond market selloff of 2022. This highlighted the ability of active managers to mitigate downside risk.
- Explanations for the underperformance by passive funds may include their lack of flexibility to adapt to changing market conditions, and self-limiting opportunity sets.

The growth of passive investing fundamentally re-shaped the market for equity mutual funds. Since passive funds were introduced in the 1970s, their assets under management have grown to $13.3 trillion, according to Morningstar, as of December 31, 2023. Last year was notable in that passive fund assets for the first time eclipsed the $12.2 trillion in active funds. For the larger equity sectors, investors have mostly been rewarded for choosing passive. For example, in the six largest Morningstar equity categories[1], active funds underperformed their passive counterparts for the 10 years ended December 31, 2023 on an equal-weighted basis.

AUTHORS

CHRISTOPHER REMINGTON
Managing Director Product & Portfolio Strategy

KATIE HERR
Managing Director Fixed Income

JUN LI, CFA
Executive Director Performance & Risk Management

[1] Large-cap growth, large-cap value, large-cap blend, mid-cap growth, mid-cap value, mid-cap blend.

Past performance is no guarantee of future results.

Unsurprisingly, passive fixed-income investing has also surged in popularity in recent years. But a new study by Eaton Vance of fixed-income mutual funds paints a different picture. It shows that fixed-income active managers have handily outpaced the passive ones, based on analysis of 327 funds with $2.2 trillion in AUM in nine major fixed-income Morningstar categories.[2]

As shown in Display 1, we found that actively managed fixed-income funds collectively beat the passive ones over the 3-, 5- and 10-year investment horizons studied. Active managers also prevailed in our analysis of 84 rolling three-year periods ended within the past ten years. In other words, active outperformance has been a consistent theme through time, not one just buoyed by recent outperformance.

In this report, we outline the study's key findings, and explore some of the potential reasons why active fixed income has consistently delivered superior results.

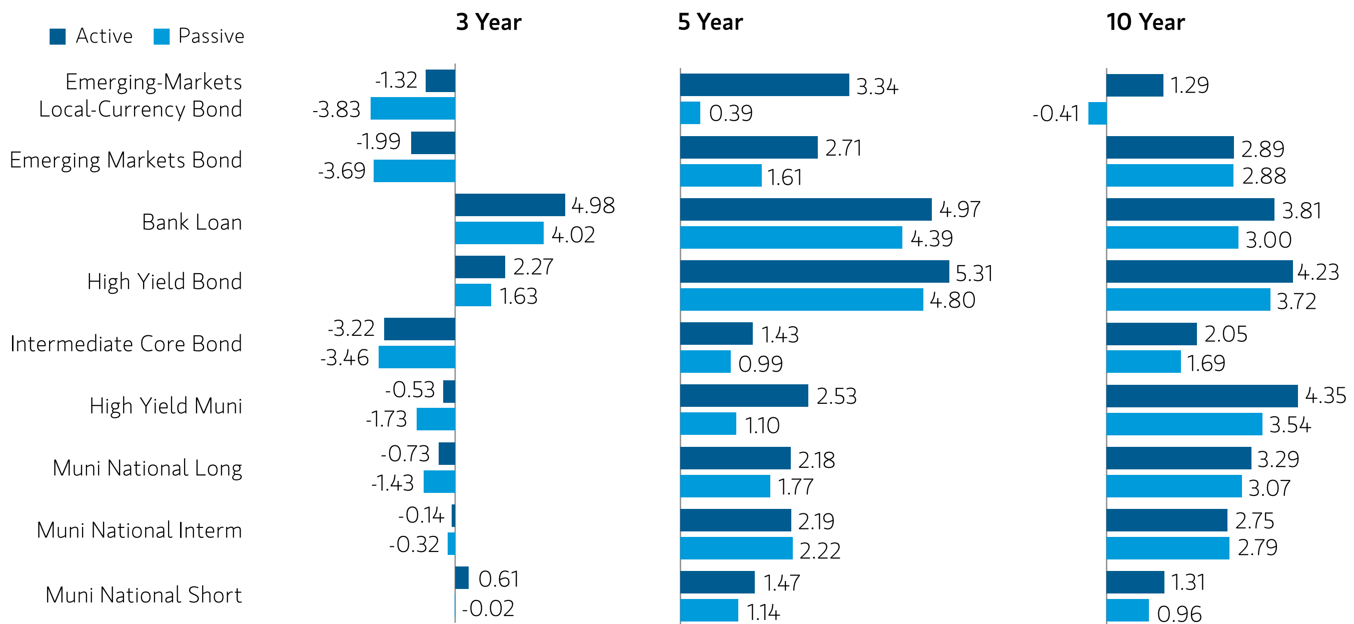
A record of active outperformance

As shown in Display 2, actively managed fixed-income funds collectively beat the passive ones over the three investment horizons studied. For the taxable universe, the active advantage was an annual average of 121 bps over three years; by 112 bps over five years; and by 68 bps for 10-years, ending on December 31, 2023. For the municipal universe, the active advantage was an annual average of 68 bps over three years; by 53 bps over five years; and by 33 bps for 10-years. Over that full 10-year period, active funds outperformed in eight of the nine major Morningstar fixed-income categories.

DISPLAY 1

Active fund managers outperformed over 10 years, but especially in the volatile past 3 years.

Average Annual Total Return (%) for periods ended 12/31/23.



Source: Eaton Vance research based on Morningstar U.S. fund data and categories, as of December 31, 2023. See footnote 2 for description of methodology. **Past performance is no guarantee of future results.**

[2] Eaton Vance research based on Morningstar U.S. fund data, comparing actively managed fund net returns with passive funds, based on the lowest expense ratio share class performance on an equal weighted basis, as of December 31, 2023.

The study considered a Morningstar universe comprising 793 active funds with $1,438 billion in assets under management (AUM) and 137 passive funds, with $1,097 billion AUM, including both open end funds and ETFs, in nine well-defined and relatively homogeneous fixed income categories. (See Display 1 for list.)

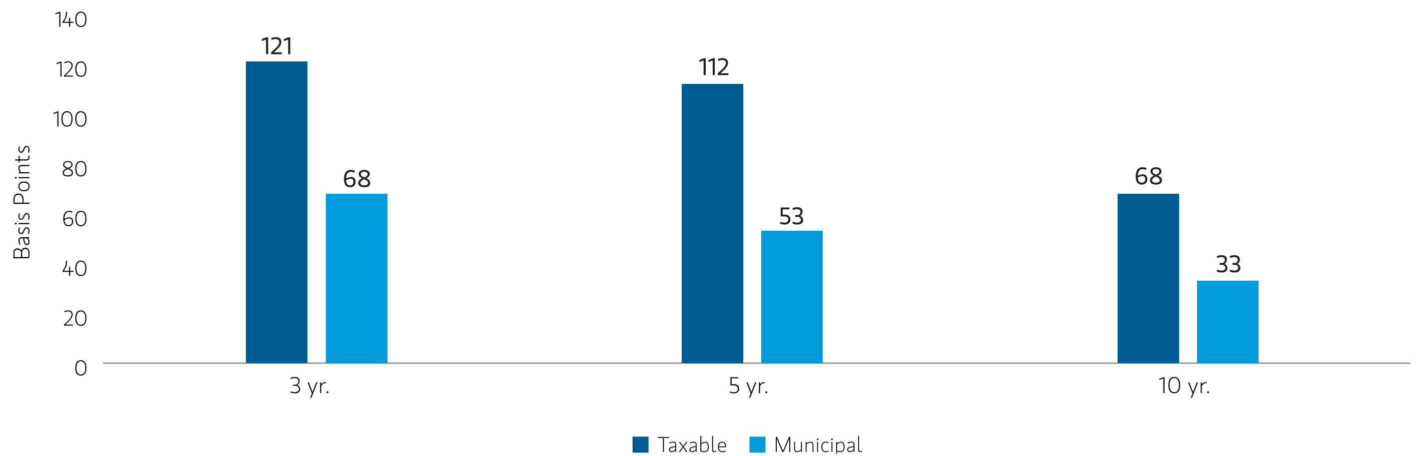
We made several adjustments to ensure balanced and fair comparisons, starting with analysis of the benchmarks used by all funds – active and passive – within a certain category. We then excluded funds benchmarked to indexes that don't represent the general characteristics of the category. This included indexes that generally did not match the category's overall characteristics based on criteria such as credit, duration, geographic or asset class. We further applied an AUM floor of $500M (as of 1/31/2024).

After applying the benchmark and AUM filters, the study's universe included 289 active funds with $1,226 billion AUM, or 85% of the original, and 38 passive funds with $982 billion AUM, or 90% of the original. Past performance is no guarantee of future results.

DISPLAY 2

Active outperformed by a meaningful margin in both taxable and municipal categories, over all periods.

Margin of outperformance by active managers in avg. annual return over period.



Source: Eaton Vance research based on Morningstar U.S. fund data and categories, as of December 31, 2023. See footnote 2 for description of methodology. Past performance is no guarantee of future results.

The recent three-year period highlights an important consideration in any discussion of active versus passive: the flexibility of active managers to seek avoidance of downside risk. Recall that those three years encompassed one of the most traumatic episodes in modern bond market history.

In March 2022, the U.S. Federal Reserve began raising interest rates, and did so 10 more times through July 2023, boosting the Federal Funds rate to 5.50% from 0.50%. So, too, did other major central banks join the global fight of inflation, including the ECB, BOE and many others. Widespread carnage in the bond market resulted, as major fixed-income indexes like the Bloomberg Aggregate lost 13.0% in 2022.

Over the past three years, active outperformed passive in all nine fixed-income sectors, with margins ranging from 251 bps to 18 bps. This analysis did not include data to determine attribution of these excess returns with precision. But there are clearly structural differences worth considering, and it's reasonable to assume it simply wasn't luck.

It's worth noting that three sectors produced positive returns during the three years ended December 31, 2023, led by bank loans, which have rates that adjust with changes in short-term rates. The return of active bank loan managers was 4.98%—96 bps higher than passive funds. The other two sectors in the black over the most recent three years were High Yield and Muni National Short (but in the Muni National Short sector, only active managers had positive returns; passive lost 2 bps).

A better batting average for active

Our second broad analysis – often referred to as a "batting average" – highlights the consistency of outperformance by active managers. Display 3 shows how often actively managed returns exceeded passive funds in 84 rolling 3-year periods that ended over the course of the 10-year investment horizon.

DISPLAY 3

Active fund managers consistently outperformed passive over a long period.

Percentage of 84 rolling 3-year periods ended 12/31/23 in which active outperformed passive.

	10-YEAR BATTING AVG.
Emerging-Markets Local-Currency Bond	100%
Emerging Markets Bond	73%
Bank Loan	93%
High Yield Bond	95%
Intermediate Core Bond	96%
High Yield Muni	98%
Muni National Long	76%
Muni National Interm	60%
Muni National Short	91%
Overall:	**87%**

Source: Eaton Vance research based on Morningstar U.S. fund data and categories, as of December 31, 2023. See footnote 2 for description of methodology. The batting average is a statistical measure of a manager's ability to consistently beat the market or competitive fund universe. In this study, it is calculated by dividing the number of rolling 3-year periods in which the manager beat or matched passive funds by 84 -- the total number of 3-year periods ended 12/31/23.

On average, active funds in all nine sectors outperformed in 87% of the rolling periods, ranging from 100% for Emerging Markets Local Currency to 60% for Muni National Intermediate. The results suggest that the advantages active managers displayed to the greatest extent during a distressed market also were effective in more-normal environments.

Flexibility can be key to active fund alpha

As noted above, analysis of the numerous strategies employed by active managers is beyond the scope of this study. Thus, we can't definitively point to the factors leading to their consistent outperformance versus passive funds. However, active funds – by definition – have flexibility to proactively take advantage of opportunities that arise as markets fluctuate. Passive funds make no attempt.

For example, a typical active emerging markets debt fund may seek to generate alpha through country and security selection, currency management, trading and execution, and duration management. The first two may be the principal focus, but the others give managers significant leeway to seek other sources of return or manage risk as market conditions change.

Management of currency and duration exposure, along with cost-effective trading and execution, are important considerations in emerging markets, but they are absent by design in passive funds.

In stressed markets, active managers can manage credit quality exposures, shorten or lengthen duration, or emphasize defensive or opportunistic sectors. They also have a broader investment universe, which can be advantageous in any environment. For example, in the emerging markets example, fund managers have the ability to hold U.S. Treasury debt. Or, managers of bank loan funds can allocate to high yield bonds and CLOs (collateralized loan obligations) when they see value in those sectors.

In short, active managers have discretion to take action that seeks to improve returns, enhance yield or lower risk, and this study suggests that, on balance, they have used that discretion effectively.

The drag of passive inflexibility

A closer look at the indexes mirrored by passive funds suggests that they may have an ongoing structural disadvantage in competing with active funds, both in terms of higher transaction costs and lower income potential.

When indexes change their composition, so must passive funds, which effectively become forced buyers or sellers – something that is not optimal in bond investing, as it creates friction that can erode returns. As Morningstar noted in a study of high-yield passive funds, "Index fund managers can face particularly high transaction costs when they mechanically trade to match index changes."[3] As such, many indexes have minimum liquidity requirements for their component bond issues to ensure the funds will be able to buy or sell when needed.

Bond portfolios limited to issues with greater liquidity may sound benign or even preferred, but that constraint imposes a cost. Less-liquid bonds generally offer higher yields – the so-called "liquidity premium" that active managers can capture but many passive funds must forgo, potentially reducing their income stream.

To implement their liquidity requirements, most passive funds indexes are constructed to emphasize the most highly indebted issuers in the sector – the more debt a company has on its books, the greater the index weighting. While this may work to boost liquidity, portfolios that feature companies with the highest debt loads may not be what the average investor bargained for. This is especially true for sectors like high yield bonds and bank loans, which, by definition, are below investment grade.

Looking forward to the active advantage

The key takeaway for us is that the structure of passive funds in fixed-income investing robs them of the flexibility to adapt to changing markets. For the decade considered by our study – including one of the worst bond market environments in recent memory – active managers have shown their ability to use that flexibility to benefit their investors.

Going forward, we suggest investors interested in the potential of fixed-income sectors look beyond only the superficial appeal of passive funds and consider where the superior returns have actually been delivered.

[3] Morningstar, "Are High-Yield ETFs Junk?" May 8, 2017.

IMPORTANT INFORMATION

Risk Considerations:

In general, equity securities' values also fluctuate in response to activities specific to a company. Investments in foreign markets entail special risks such as currency, political, economic, and market risks. The risks of investing in emerging market countries are greater than risks associated with investments in foreign developed countries. Fixed income securities are subject to the ability of an issuer to make timely principal and interest payments (credit risk), changes in interest rates (interest-rate risk), the creditworthiness of the issuer and general market liquidity (market risk). In a rising interest-rate environment, bond prices may fall and may result in periods of volatility and increased portfolio redemptions. In a declining interest-rate environment, the portfolio may generate less income. Longer-term securities may be more sensitive to interest rate changes. Alpha refers to the excess return generated by a fund manager relative to an appropriate benchmark.

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AD 3595788 Exp. 5/31/2025 JOB# 24Q20110 LTR