Insights
Fixed Income

April 2024

Implementation Alpha: Adding Value in Indexed Fixed Income

David Furey
Global Head of Fixed Income Portfolio Strategists

Matthew Coolidge, CFA
Portfolio Strategist, Fixed Income

Index investing in fixed income markets is different than in equity markets. By their nature, bond markets are more fragmented and not as well structured as their equity market counterparts, resulting in them being relatively less efficient. For fixed income index managers with the skillset and experience to navigate through such challenges, there are ample opportunities to add value throughout the investment process.

The Alpha Opportunity for Fixed Income Index Investors

In fixed income markets, the same issuer can have multiple bonds, with each of them having their own characteristics (e.g. coupon, maturity, price). This gives rise to a very different market structure and liquidity profile than in equity markets. Furthermore, the decentralised OTC (over-the-counter) nature of fixed income market trading causes a variable liquidity profile to exist through time at the individual security level.

This presents challenges and opportunities for fixed income investors — from both portfolio construction and exposure management perspectives — and these are as relevant to index managers as they are to active managers, despite their different objectives and constraints. When properly understood and controlled, these can be exploited very effectively by index managers to deliver highly reliable sources of incremental excess returns, or what we at State Street Global Advisors call our 'implementation alpha'.

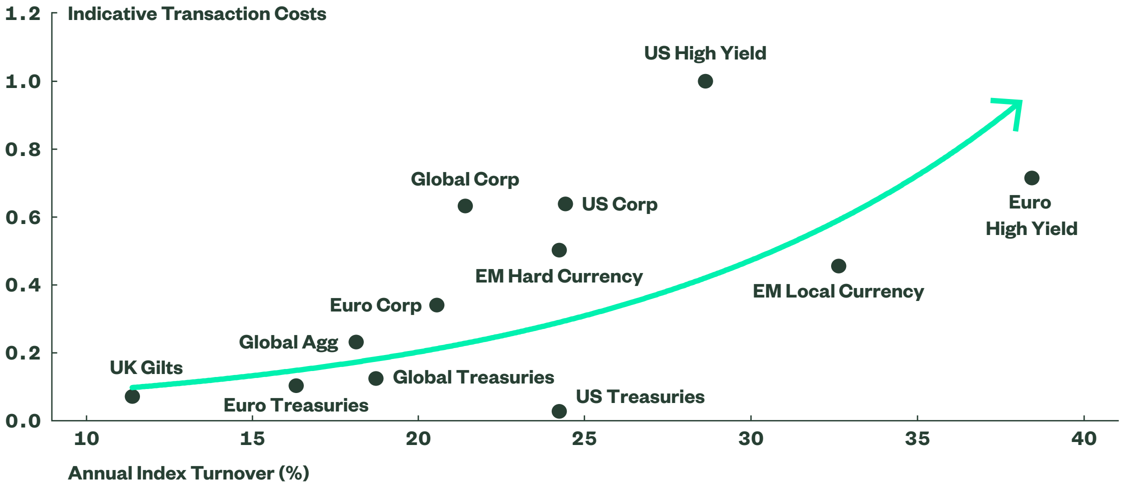
For fixed income index strategies that seek to closely track the performance of the reference benchmark, both the approach taken on portfolio construction and the techniques employed within that are important. Essentially, the variable liquidity dynamics of the fixed income market make full index replication, in most exposures, either impossible or just so expensive that they essentially guarantee a performance shortfall over the long run. The question for index managers is how can they overcome these difficulties.

Adding Incremental Value via Implementation Alpha

To mitigate the challenges around replication, sophisticated fixed income index managers such as State Street have traditionally employed a top-down portfolio construction technique known as stratified sampling. However, at some stage in the portfolio construction process, the index manager, just like an active manager, has to make a bottom-up security selection decision. While the degrees of freedom afforded to the index manager around such decisions are very low, it does still provide sufficient latitude and opportunity for an experienced index manager to add incremental value via implementation alpha and in this way offset the inherent cost of managing the relevant exposure.

Interestingly, it is in the more complex and liquidity-challenged fixed income exposures where the opportunities to add incremental value are greatest. Markets such as credit or emerging markets have higher idiosyncratic risks and higher turnover, while liquidity is not as abundant as in more 'vanilla' exposures such as developed market government bonds. This translates into higher trading costs as is clearly illustrated in the chart in Figure 1. Therefore, any highly-replicated approach in these exposures is guaranteed to deliver a performance shortfall versus the benchmark that will compound itself over the long run. To avoid this, and as already highlighted, at State Street Global Advisors we have developed a more pragmatic approach that employs sophisticated techniques to deliver the performance of fixed income benchmarks more effectively.

Figure 1
Full Replication Not Always Feasible in Fixed Income



Source: State Street Global Advisors, Bloomberg Finance P.L., Barclays as of December 31, 2023. The information contained above is for illustrative purposes only.

Employing an Active Mindset in Portfolio Construction

Given the fragmented nature of the fixed income market and its variable liquidity dynamics, an active mindset is necessary throughout the portfolio construction process — whether you are an active or an index (or "passive") manager. Because of the higher inherent costs and turnover associated with the more complex exposures, in particular, some investors question whether index managers can closely track the performance of their reference benchmarks. The reality is that index managers need to adopt a pragmatic approach to achieve benchmark returns, given the aforementioned difficulties around full index replication.

At State Street Global Advisors, we like to think of ourselves as an active manager operating within very tight risk constraints or, alternatively, as an active manager with a very low risk budget. As a highly experienced index manager that is comfortable operating within tight constraints along each risk dimension, we seek to exploit some of the inefficiencies that persist in fixed income markets for the ultimate benefit of our client portfolios. All while delivering on our first priority — maintaining tight tracking error and delivering the desired beta.

Leveraging Innovative Techniques

To achieve our goals requires a sophisticated investment process alongside advanced quantitative techniques and technological platforms, something we have worked diligently to develop and refine over nearly 30 years.[1] Supported by advanced investment management systems that integrate proprietary analytical tools we have been able to identify, harvest, and scale these micro inefficiencies in a very effective way. Additionally, our ongoing drive to innovate has resulted in the launch of our internal investment platform that further enhances and systematizes portfolio construction decisions while helping our portfolio managers to evaluate multiple factors simultaneously. This underpins the application and effectiveness of these techniques.

Delivering Implementation Alpha

The techniques that we employ are highly effective in exploiting the liquidity and structural inefficiencies of fixed income markets that give rise to a highly reliable source of added value. We lay out below how those techniques are utilized. When this is done well, it results in what we call implementation alpha.

Reducing Drag From Transaction Costs

We seek to minimise turnover by being thoughtful about when, whether, and how we trade. We typically achieve significantly lower turnover than the reference indices by holding on to bonds that may have fallen out of the index but still offer value. For example, in our flagship US Corporate Bond Strategy, turnover was 20.5% in 2023 compared to 41.9% for the benchmark Bloomberg US Corporate Index.[2] Knowing when not to trade can be as important as knowing when to trade, as it reduces overall transaction costs and can also add incremental value from the bonds we retain.

When we decide to trade, strong trading execution is essential in controlling and minimizing transaction costs. Unlike some firms that utilize only one trading location for all their trades, our trading operation is decentralized — we have three regional fixed income trading desks in North America, Europe and Asia. Each is responsible for trades within its geographic region and is staffed by specialist trading professionals with deep knowledge of local markets and sectors and interact directly with local counterparties.

Our dedicated traders leverage their large counterparty panel of relationships as well as buy-side to buy-side electronic trading platforms and venues in order to minimise portfolio transaction costs. In addition, our large ETF business allows us valuable insights into bond market liquidity dynamics and positioning through the management of intraday flows (in-kind baskets). Furthermore, being a manager of predominantly indexing strategies our flows are therefore broad, diversified and highly granular. This makes us a desirable counterparty to trade with and because of this we are also better able to execute inside the full market bid/offer as these small ticket sizes are more easily managed in the market.

Exploiting Fixed Income Market Inefficiencies

As already noted, inefficiencies still exist in fixed income markets today despite tremendous improvements in liquidity from electronic trading. A skilled index manager can take advantage of the multitude of micro inefficiencies at the bond level, rather than the broad and less reliable macro inefficiencies at the sector or country level. We will always aim to keep risk alignment very tight at the broader levels, but we find that opportunities arise constantly at the issuer and security level.

New Issue Premia We know that the new issue premium represents a key source of potential excess return. In our experience, we estimate that on average over the last few years, each new issue in the Euro Investment Grade Corporate bond market has delivered price benefits of 0.30–0.80% from launch date to index inclusion date.[3] The contribution to portfolio performance is a function of our degree of participation and allocation in new issues, as well as the volume of new issues. We participate in the majority of new issues that are due to enter the benchmark, and the value-add to portfolio returns has ranged from mid-single digits up to over 30bps in certain years.

Unlike unconstrained/active managers that can inflate their orders far above what they ultimately receive, we have typically achieved allocations in line with our application — this is largely due to the consistency of our orders and the nature of our business in providing almost permanent funding as a predominantly index manager. This new issue premium is therefore a highly reliable and low-risk source of excess returns that we also seek to exploit prudently and consistently within our tight risk constraints for the benefit of our client portfolios.

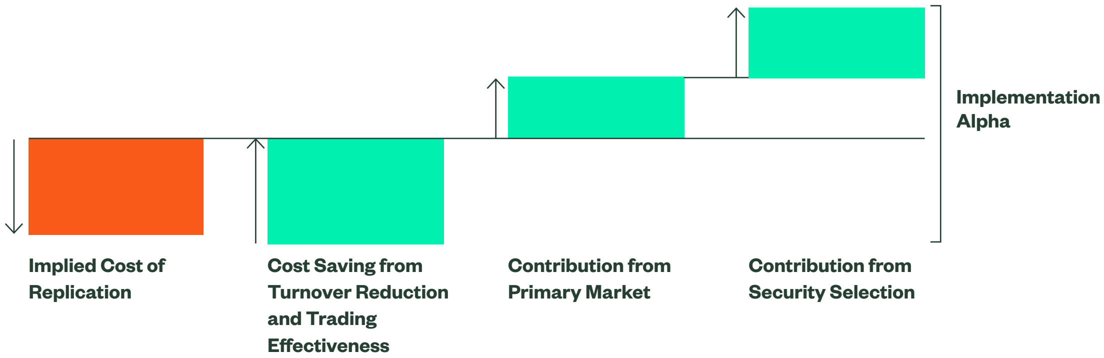
Security Selection This process seeks to continuously match the portfolio exposures to the index as efficiently as possible. As index investors, we hold most bonds in the index and have long intended holding periods. Therefore, as market conditions change and existing holdings become rich, we are generally well positioned to exploit these persistently-occurring micro opportunities. We can execute relative value trades to improve portfolio yield and exploit pockets of richness in our portfolios across the securities of the issuer. We estimate that we can reliably add a few basis points to our portfolios' performance through a variety of security selection relative value strategies.

Proactive Management of Index Events Proactively managing index changes such as upgrades/downgrades or corporate actions enables us to achieve more optimal outcomes for our clients' portfolios. For example, we will monitor and manage downgraded issuers' exposures and market liquidity very carefully to assess when downgraded bonds should be sold in relation to when they are dropped from the index.

Delivering Returns Efficiently

While our investment approach is highly process-driven to ensure tight risk alignment, human judgement is ultimately behind every investment decision. We deliberately allow small degrees of latitude to our investment team and traders to add incremental value throughout the process — but all within the objective of delivering the index returns as efficiently as possible. Figure 2 illustrates the key sources of our value add techniques and how they can lead to a positive outcome. Implied cost of replication reflects the transaction costs associated with buying and selling replicated positions blindly at the stated bid (selling) and ask (buying) marks, respectively.

Figure 2
Actively Adding Value in Indexed FI
We Exploit Opportunities to Reduce Costs and Add Value



Source: State Street Global Advisors, Bloomberg, Barclays Live. The information contained above is for illustrative purposes only.

The Bottom Line

Delivering benchmark returns in fixed income exposures requires far more that a 'passive' mindset. As we have illustrated, it requires a more pragmatic approach and active mindset in order to overcome the implementation challenges and costs that arise in the more fragmented and less efficient fixed income market.

At State Street Global Advisors, our experience of managing fixed income indexing strategies through multiple market cycles, crises, and conditions have enabled us to continuously refine and enhance our indexing investment process. This approach, and the advanced portfolio construction techniques employed within it, recognize both the challenges of fixed income implementation and the highly reliable opportunities that exist to also add incremental value. We achieve this within very tight risk constraints, even in the more complex exposures like credit and emerging market debt. We therefore like to approach fixed income indexing pragmatically and with an active mindset, but of course within the very tight risk constraints of an index approach.

Endnotes

1 State Street Global Advisors began managing fixed income index assets in 1995.

2 Source: State Street Global Advisors, Bloomberg as of December 31, 2023.

3 Source: State Street Global Advisors, Bloomberg Finance LP as of December 31, 2023.

ssga.com

Marketing communication.

State Street Global Advisors Worldwide Entities

Abu Dhabi: State Street Global Advisors Limited, ADGM branch is regulated by the Financial Services Regulatory Authority (FSRA). This document is intended for Professional Clients or Market Counterparties only as defined by the FSRA and no other person should act upon it. State Street Global Advisors Limited, ADGM Branch, Al Khatem Tower, Suite 42801, Level 28, ADGM Square, Al Maryah Island, P.O. Box 76404, Abu Dhabi, United Arab Emirates. Regulated by the ADGM Financial Services Regulatory Authority. T: +971 2 245 9000. **Australia:** State Street Global Advisors, Australia, Limited (ABN 42 003 914 225) is the holder of an Australian Financial Services License (AFSL Number 238276). Registered office: Level 14, 420 George Street, Sydney, NSW 2000, Australia. T: +612 9240-7600. F: +612 9240-7611. **Belgium:** State Street Global Advisors Belgium, Chaussée de La Hulpe 185, 1170 Brussels, Belgium. T: +32 2 663 2036. State Street Global Advisors Belgium is a branch office of State Street Global Advisors Europe Limited, registered in Ireland with company number 49934, authorised and regulated by the Central Bank of Ireland, and whose registered office is at 78 Sir John Rogerson's Quay, Dublin 2. **Canada:** State Street Global Advisors, Ltd., 1981 McGill College Avenue, Suite 500, Montreal, Qc, H3A 3A8, T: +514 282 2400 and 30 Adelaide Street East Suite 800, Toronto, Ontario M5C 3G6. T: +647 775 5900. **France:** State Street Global Advisors Europe Limited, France Branch ("State Street Global Advisors France") is a branch of State Street Global Advisors Europe Limited, registered in Ireland with company number 49934, authorised and regulated by the Central Bank of Ireland, and whose registered office is at 78 Sir John Rogerson's Quay, Dublin 2. State Street Global Advisors France is registered in France with company number RCS Nanterre 899 183 289, and its office is located at Coeur Défense — Tour A — La Défense 4, 33e étage, 100, Esplanade du Général de Gaulle, 92 931 Paris La Défense Cedex, France. T: +33 1 44 45 40 00. F: +33 1 44 45 41 92. **Germany:** State Street Global Advisors Europe Limited, Branch in Germany, Brienner Strasse 59, D-80333 Munich, Germany ("State Street Global Advisors Germany"). T: +49 (0)89 55878 400. State Street Global Advisors Germany is a branch of State Street Global Advisors Europe Limited, registered in Ireland with company number 49934, authorised and regulated by the Central Bank of Ireland, and whose registered office is at 78 Sir John Rogerson's Quay, Dublin 2. **Hong Kong:** State Street Global Advisors Asia Limited, 68/F, Two International Finance Centre, 8 Finance Street, Central, Hong Kong. T: +852 2103-0288. F: +852 2103-0200. **Ireland:** State Street Global Advisors Europe Limited is regulated by the Central Bank of Ireland. Registered office address 78 Sir John Rogerson's Quay, Dublin 2. Registered Number: 49934. T: +353 (0)1 776 3000. F: +353 (0)1 776 3300. **Italy:** State Street Global Advisors Europe Limited, Italy Branch ("State Street Global Advisors Italy") is a branch of State Street Global Advisors Europe Limited, registered in Ireland with company number 49934, authorised and regulated by the Central Bank of Ireland, and whose registered office is at 78 Sir John Rogerson's Quay, Dublin 2. State Street Global Advisors Italy is registered in Italy with company number 11871450968 — REA: 2628603 and VAT number 11871450968, and its office is located at Via Ferrante Aporti, 10 - 20125 Milan, Italy. T: +39 02 32066 100. F: +39 02 32066 155. **Japan:** State Street Global Advisors (Japan) Co., Ltd., Toranomon Hills Mori Tower 25F 1-23-1 Toranomon, Minato-ku, Tokyo 105-6325 Japan. T: +81-3-4530-7380. Financial Instruments Business Operator, Kanto Local Financial Bureau (Kinsho #345), Membership: Japan Investment Advisers Association, The Investment Trust Association, Japan, Japan Securities Dealers' Association. **Netherlands:** State Street Global Advisors Netherlands, Apollo Building 7th floor, Herikerbergweg 29, 1101 CN Amsterdam, Netherlands. T: +31 20 7181 000. State Street Global Advisors Netherlands is a branch office of State Street Global Advisors Europe Limited, registered in Ireland with company number 49934, authorised and regulated by the Central Bank of Ireland, and whose registered office is at 78 Sir John Rogerson's Quay, Dublin 2. **Singapore:** State Street Global Advisors Singapore Limited, 168, Robinson Road, #33-01 Capital Tower, Singapore 068912 (Company Reg. No: 200002719D, regulated by the Monetary Authority of Singapore). T: +65 6826-7555. F: +65 6826-7501. **South Africa:** State Street Global Advisors Limited is regulated by the Financial Sector Conduct Authority in South Africa under license number 42670. **Switzerland:** State Street Global Advisors AG, Beethovenstr. 19, CH-8027 Zurich. Registered with the Register of Commerce Zurich CHE-105.078.458. T: +41 (0)44 245 70 00. F: +41 (0)44 245 70 16. **United Kingdom:** State Street Global Advisors Limited. Authorised and regulated by the Financial Conduct Authority. Registered in England. Registered No. 2509928. VAT No. 5776591 81. Registered office: 20 Churchill Place, Canary Wharf, London, E14 5HJ. T: 020 3395 6000. F: 020 3395 6350. **United States:** State Street Global Advisors, 1 Iron Street, Boston, MA 02210-1641. T: +1 617 786 3000.