PIMCO

# Bonds are Different: The Advantages of Active Bond Management

Investors often have to weigh the pros and cons of allocating to an active or passive strategy. There are, of course, many differences between active and passive, but both approaches offer potential benefits, costs and risks.

## WHAT YOU NEED TO KNOW

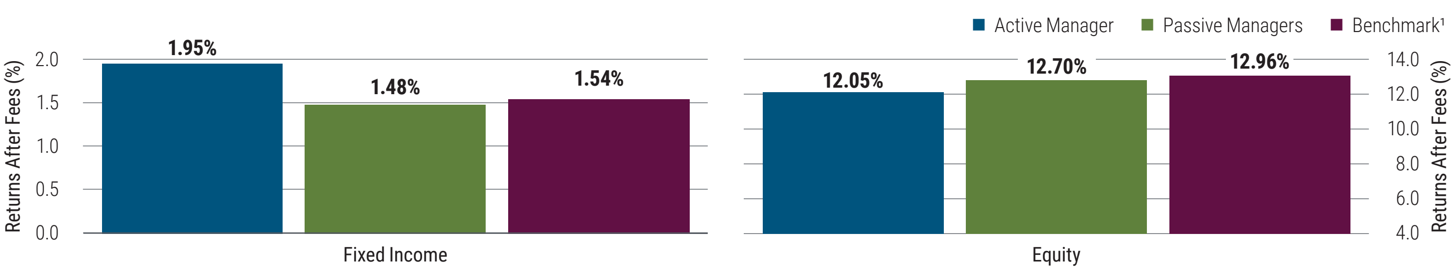
**Why active for bonds?** We compared performance of the U.S. equity and fixed income markets over the past 10 years. Unlike the median active equity manager, which has underperformed its passive counterpart, the median active bond manager has outperformed the median passive manager over the last 10 years.

**Why are bonds different?** We believe the reason why active bond strategies have been more successful than active equity approaches for this period lies in the bond market's unique structure. Consider:

- **Noneconomic investors make up almost half of the global bond market.** Central banks, insurance companies and other noneconomic investors typically have objectives other than generating alpha. Central banks, for instance, may buy bonds to weaken their currency or boost inflation and asset prices. Commercial banks and insurance companies may care more about book yield or credit ratings than total return. The result: noneconomic investors leave alpha potential on the table for active bond managers.
- **The composition of bond indexes changes frequently.** When fixed income securities join or leave an index, their prices tend to rise or fall as passive investors rush to buy or sell. Active investors seek to anticipate and profit from these changes.
- **Bonds, unlike stocks, mature after a number of years, leading to more turnover in the bond market.** New securities make up about 15% of bond market capitalization annually, compared with about 0.4% in equity markets.[2] Importantly, they typically are offered at concessional pricing to drive demand. Yet these discounts are generally not available to passive managers, who tend to buy new securities when they join an index, often a couple of weeks after they've been issued.
- **Structural tilts can be an important source of durable added value.** Active managers, for instance, can target factors such as duration and exposures to high yield credit, mortgages, high yielding currencies and other sources of potential alpha.

In short, informational efficiencies make beating equity markets difficult. But, we believe that's not the case with fixed income, where noneconomic and passive investors pursue agendas that are not exclusively about total return. Put simply, bonds are different.

### 10-Year returns of U.S. Median active and passive managers




Source: Morningstar. As of 30 June 2023.

Based on Morningstar U.S. Fund Intermediate Core and Intermediate Core-Plus categories for fixed income and Morningstar U.S. Fund Large Cap Blend Category for equities. Institutional share class.

[1] Fixed Income: Bloomberg U.S. Aggregate Index; Equity: S&P 500 Index. "Return after fees" does not apply to index returns where no fees are applicable.

**Past performance is not a guarantee or a reliable indicator of future results**. Figure is provided for illustrative purposes and is not indicative of the past or future performance of any PIMCO product.

[2] Source: SIFMA 2023 Capital Market Factbook

## WHAT IT MEANS FOR INVESTORS

- The median active bond manager in the U.S. has outperformed the median passive manager over the last 10 years. While the gains may not seem large, they compound over time and, if sustained, could represent meaningful total return potential.
- Active managers can pick and choose what they buy in an effort to gain the best returns for investors. Even though most new bonds come to market with a concession, active managers don't necessarily buy them. Active bond managers with deep credit research teams regularly pass on new deals they view as overpriced. Passive managers, by contrast, have an incentive to buy all bonds that enter the index or replicate these exposures to maintain consistency with the index regardless of price.
- While U.S. median active bond funds have largely outperformed their passive peers over the past 10 years, this does not necessarily mean that all active funds outperformed passive. Active fund managers invest in different ways, so investors may want to compare a range of funds to assess differences including investment philosophy and performance.



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