Passive Investing in Fixed Income – The Way Ahead

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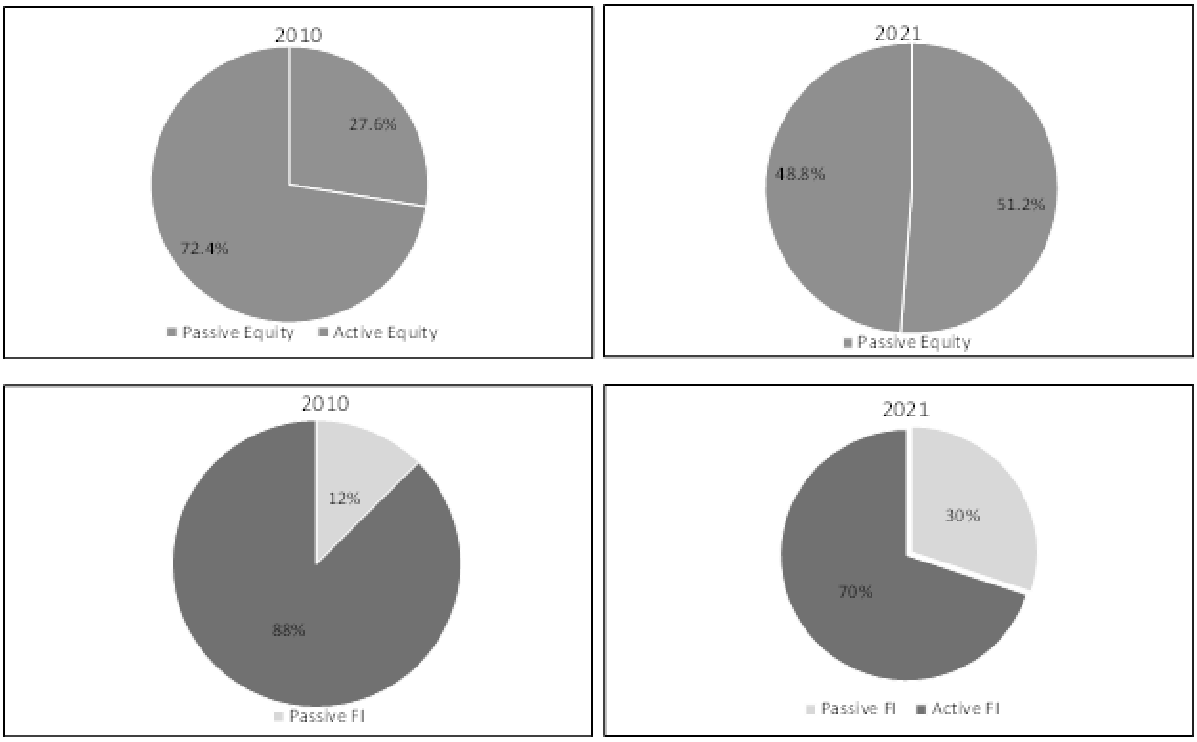
Passive Investing – Global experience

Over the last decade, the shift in investor allocation towards passive investing stands out as one of the key developments in the asset management industry in recent years. As can be seen from the charts below, in just 11 years, passive funds have grown exponentially. Passive equity mutual funds are almost same size as actives in the US while share of passive fixed income funds have grown more than 2.5 times since 2010. Many investors see passives as a lower-cost option in a lower return environment while some prefer them as predictable vehicles for constructing their portfolios according to their risk profile.

Split between active/passive MFs in the US 2010/2021



Source: Bloomberg

Two of the four worst bear markets over the last 100 years have occurred in the last decade (1929,1987,2008,2020). Expected patterns on risk premia and diversification have not worked. First, risk did not generate returns, as bonds outperformed equities over extended periods helped by central bank purchases (Bloomberg High yield Total return index delivered annualized return of 20% vs 6% for S&P 500 between 2008-2010, Source Bloomberg). Second, realized returns sometimes have diverged markedly from expected returns & diversification hasn't worked as expected (Both Treasuries & equities fell in early March 2020 to recover together after unconventional policies). As a result, some of the active strategies built from traditional economic models have failed to live upto investor's expectations.

While active strategies give portfolio managers discretion to select securities with the objective of outperforming a pre-agreed benchmark, passive strategies, including indexing, use rule-based investing, often to track an index by holding all or a representative of those assets. Hence passive funds are typically built at a much lower cost than active funds due to lower involvement of fund manager. In fixed income, a passive strategy could even be a target maturity fund which aims to build a portfolio around a maturity bucket & then let it run down over the course of its life-cycle.

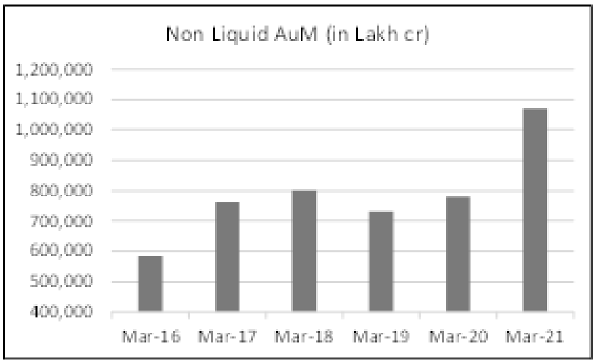
Capital markets during Covid-19

The preceding 15 months have witnessed a paradoxical manifestation of incomprehensible human misery on one hand with over 4 million Covid related fatalities, widespread hardship to communities across the world & a boisterous capital market on the other hand as investors initially numbed by the pandemic responded favorably to record fiscal & monetary stimulus packages. Governments and central banks across the globe unleashed conventional and unconventional policy support amounting to nearly $9.9 trillion (excluding off balance sheet support) or 9.2% of 2020 world GDP (Source: IMF) while interest rates across the world were slashed to record lows & are still at those record low levels for most of the countries. The NSE NIFTY index has risen by 106% in July 2021 from its lows in March 2020 while bond yields, especially at shorter end fell to their record lows driven by exceptionally high liquidity (3 year Government bond yield fell to its all-time low of 4.4% in June 2020 & is currently trading at 5.2% compared to its 10 year average of 6.85% (source Bloomberg))

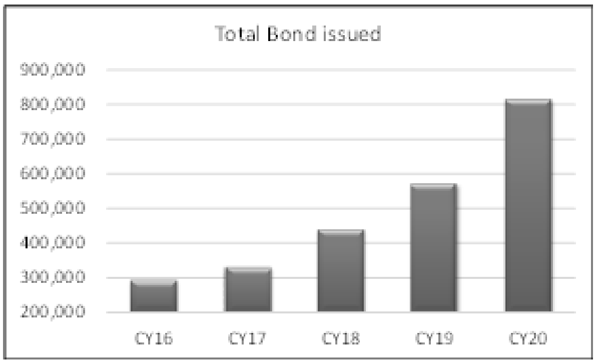
The mobility restrictions also led to a reset of some sorts with corporates & households in the organized sector forced into savings while the unorganized businesses lost significant part of their income/savings. As organized sector corporates & households saved more, flows into Indian capital markets including mutual funds meaningfully rose with Average AuM for fixed income mutual funds rising by Rs. 2.4 trillion from 2020 to Rs. 13.9 trillion as on 31 March 2021 (Source AMFI).

Fixed income mutual funds in India

The Indian fixed income asset management space has seen a stellar as well as somewhat a roller coaster ride in the last 5 years. The industry has been a beneficiary of low deposit rates especially after demonetization, slow credit growth due to lower capex spend by Indian corporates & general preference of savers shifting from traditional instruments towards capital markets. As can be seen from the charts below, the non-liquid/overnight fund fixed income AuM has grown from Rs. 5.85 lakh crs in FY16 to Rs. 10.7 lakh crs in FY21 at a CAGR of 16.6% (Source: ICRA Online). The spectacular growth in mutual funds has fortified the bond market as well with corporate bond issuance rising 3 times from Rs. 2.9 lakh crs in CY16 to Rs. 8.2 lakh crs in CY20.



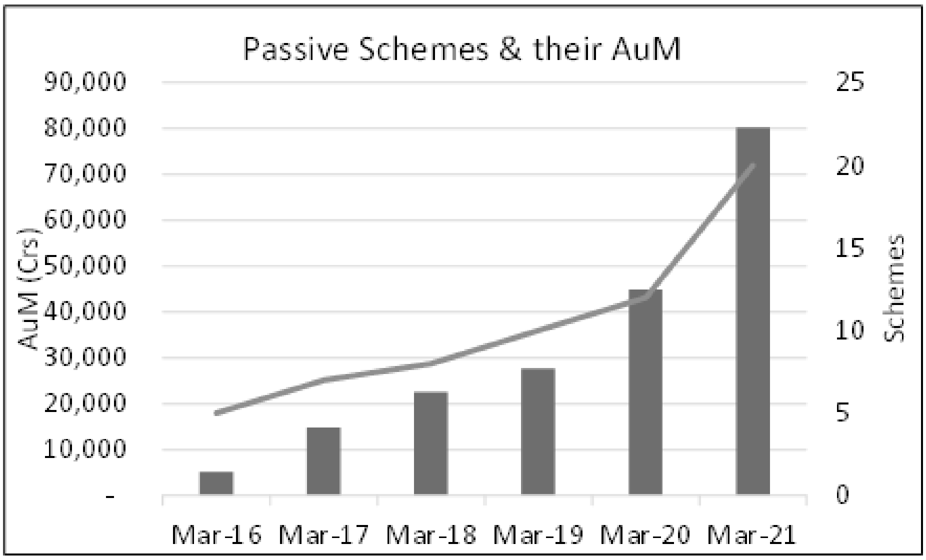
Source: AMFI



Source: Bloomberg, put/call bonds not considered due to inadequate disclosures on put/call dates

The fixed income space has also seen improving awareness in the last 5 years with investors more appropriately aligning their risk-reward expectations. A certain section of investors had begun to aggressively pursue high yield or credit strategies especially during 2016-2018. This resulted in disproportionate share of lower credit quality papers in some strategies followed by downgrades, defaults & write offs when the credit cycle turned. Unfortunately, this caught many investors unprepared for the accompanied risks these strategies sometimes entail.

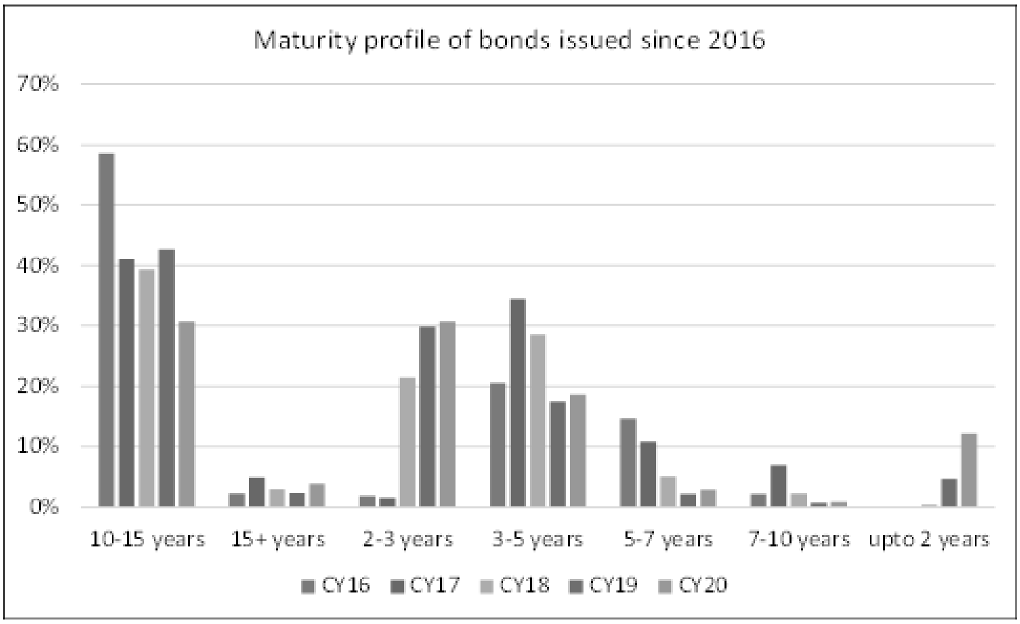
While one investor segment was preferring credit-oriented strategies, the need for passive funds, interestingly, came from a large section of investors who had experienced the volatility of 2013 & were looking for high credit quality, liquid & more predictable investment avenues. The stars got further aligned for passive debt as India implemented the inflation targeting framework in 2016 which lengthened interest rates cycles, gave better policy predictability & helped build a steeper than historical yield curve due to the new liquidity & rate framework. As a result, many funds were able to offer passive roll down strategies which can relatively isolate investors from interest rate volatility as long as they hold their investments till maturity. As can be seen from the chart below, passive fixed income strategies have seen an exponential growth since 2016 – from just over Rs. 5,000crs in FY16 to Rs. 80,000 in FY2021 (Source Icra online, roll down funds have been considered as passives) reflecting shifting investor's preferences. The number of investors transacting in ETFs (all asset classes) went up by 96% from 20.4 lakhs in FY20 to 40.1 lakhs in FY21 while the first 3 months of FY22 has already seen transactions?by more than 22 lakh investors. (Source: Financial express). Although the current share of passive funds is still moderate of overall fixed income AuM share, the shift is quite prominent & as we have learnt from global precedents, the next growth phase in passives could be much faster as investors continue to seek predictable low-cost strategies.



Source: MFI ; Explicitly stated Roll down strategies of open ended funds have been included in calculation of Schemes & AuM

Implications for passive funds for corporate bond market

The growth of passive funds also has an important implication for the bond markets. The below chart represents the corporate bond issuance under various tenors since calendar year 2016. As can be seen, the share of 10-15-year bond issuance in overall supply has almost halved (30.8% in CY20 from 58% in CY16) in favor of upto 3-year bonds which have grown from 1.9% of total supply in CY16 to 43% in CY20. This period has also coincided with the growth in fixed income mutual funds' assets with funds preferring the 3-year segment as their investors largely consider debt funds from a 3-year perspective given the tax implications. This goes to show how a seemingly innocuous preference based on a tax policy can change the landscape of corporate debt structures. Interestingly, some of the new passive funds which have been launched in last couple of years including GOI endorsed Bharat bond ETFs are spread across at various points of the yield curve. However, as we can see from previous historical issuance profiles, while there is reasonable sized issuance on the short (0-3 year) & long end (10+ year) of the curve, there are not too many issuances on the intermediate part of the curve. These opportunities provide a win-win situation for both issuers as well as investors. Bond issuers who want to optimize their debt structure & diversify their maturity profile can closely track these passive strategies & consider issuing in these buckets while investors can seek to benefit from a diversified pool of issues & hopefully better bond spreads & liquidity once the market becomes wider.



Source: Bloomberg, put/call bonds not considered due to inadequate disclosures on put/call dates

The asset management industry has remained largely unaffected by the pandemic, but the people, the processes, and the technology used by the AMCs has changed. While there will always be a certain set of investors who don't mind higher uncertainty but have the appetite to seek "alpha" in their investments, Investor preferences in an era of record high global liquidity, low real rates & unconventional policies could continue to gravitate towards low cost, low intervention & more predictable passive products.

The rise of passives not only presents a good opportunity for investors but also for bond issuers who by aligning themselves with these products can generate regular demand for their fund-raising needs.