BlackRock

Challenging the top myths

About fixed income indexing
Introduction

After yields surged to multi-year highs in 2022\(^1\) and kept that trend into 2023, fixed income finally offers “income” again. As we adapt to a new macro regime, investors are re-evaluating the role of fixed income in portfolios, re-embracing the asset class for the first time in years, while re-thinking the composition of fixed income sleeves\(^2\). At the same time, greater macro and market volatility has increased the value of flexibility in portfolios. Against this backdrop, we see continued adoption of fixed income indexing. However, while most investors are inherently familiar with index investing in equities, views questioning the practice in fixed income still abound. We have long believed that the active/index choice was a false dichotomy, and we see investors increasingly recognizing the advantages of blending index with actively managed strategies in fixed income. Here, we address the most common misconceptions or “myths” we hear about fixed income indices and index investing.

Four myths about fixed income indices

**Myth**
Fixed income is too broad of an asset class and therefore indices are unable to help investors build efficient portfolios, while being nimble.

**Fact**
Indices transform the fragmented bond market into standardized exposures that can simplify portfolio construction and act as reference tools to understand the drivers of risk and return, as well as helping to quantify true alpha.\(^3\)

**Myth**
Indices are slow to respond to sudden changes in market conditions and extreme volatility.

**Fact**
Over the past three years indices have proven to be resilient and dynamic in their responses to several idiosyncratic market events.\(^4\)

**Myth**
Indices are not investable and therefore do not consider the realities of trading in the underlying markets.

**Fact**
Indices incorporate diversification and liquidity rules which help portfolio managers effectively replicate the risk and return characteristics of their benchmarks across a diverse set of fixed income markets.

**Myth**
Indices cannot add value through sustainability analysis and scoring systems in the way active managers can.

**Fact**
BlackRock has worked with index and sustainability data providers to develop sustainable fixed income indices which seek to meet investors’ needs and satisfy regulatory requirements, in addition to promoting standardization across the industry.

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01. Myth

Fixed income is too broad of an asset class and therefore indices are unable to help investors build efficient portfolios, while being nimble.

Over time, even more granular indices are being developed, providing access to exposures across credit sectors, duration, factors, as well as defined outcomes, such as sustainable or hedged exposures.

The increasing granularity of indices allows investors to redefine their desired market exposure. For example, an investor can pull apart a broad-based market exposure such as the Bloomberg US Aggregate Bond Index and insert an inflation protection component by replacing US Treasury bond exposure with Treasury Inflation-Protected Securities (TIPS) exposure. The proliferation of indices in fixed income is also helping investors to blend more index and active strategies together, leading to better portfolio outcomes.

Fact

Indices transform the fragmented bond market into standardized exposures that can simplify portfolio construction and act as reference tools to understand the drivers of risk and return, as well as helping to quantify true alpha.

BlackRock’s modular fund design leverages scale and facilitates crossing opportunities.

Source: BlackRock utilizing Bloomberg data as of June 30, 2023. Funds are BlackRock CTFs. For illustrative purposes only.
Index providers responded quickly in a coordinated, timely fashion during the COVID-19 selloff in March 2020 and again in March 2023 following the US Regional Bank stress and collapses of Silicon Valley Bank and Signature Bank.

In March 2020 at the height of the market selloff, most major fixed income index providers came together to partially delay index rebalancing actions for the majority of their indices. We estimate that around 40% of BlackRock’s global fixed income index platform rebalancing at March month-end was delayed following this coordinated effort. While the April month-end rebalance saw significant changes across fixed income indices, BlackRock’s experience trading these changes was orderly.

Most major fixed income index providers came together again in March 2023, deciding to remove SVB Financial Group (SIVB) and Signature Bank (SBNY) bonds at March month-end. On March 10th, Silicon Valley Bank collapsed, followed by the collapse over the weekend of Signature Bank. There was an immediate erosion of bond prices and contagion impacts were observed across US Regional Banks. With a collapse instead of a downgrade, SIVB and SBNY bonds would not enter the High Yield benchmarks which added complexity to the index change.

In both instances, we believe the coordinated and dynamic response of index providers helped to promote market stability and better outcomes for end clients than if no action had been taken.

Index rules such as caps, floors and minimum issue sizes help ensure appropriate diversification and investability of an index. Caps prevent any large issuer from dominating the index, while floors ensure that small issuers whose bonds may be illiquid and hard to get hold of are excluded. Caps and floors are often found in credit and emerging market debt indices. In addition, many indices across US fixed income markets incorporate rules on minimum issue sizes to ensure that only bonds which are likely to be relatively freely traded are included.

**Myth**

Indices are not investable and therefore do not consider the realities of trading in the underlying markets.

**Fact**

Indices incorporate diversification and liquidity rules which help portfolio managers effectively replicate the risk and return characteristics of their benchmarks across a diverse set of fixed income markets.
Sustainable fixed income indices offer a transparent, rules-based approach to sustainable investing. They usually incorporate business involvement screens, while targeting specific sustainable objectives through minimum sustainability ratings and controversy scores. BlackRock offers one of the widest ranges of sustainable fixed income index funds globally, spanning credit, government bonds and emerging market debt, having worked closely with index providers to develop indices that meet investors’ needs for products that incorporate an increasing degree of complexity. As of June 30th 2023, BlackRock manages US $705 billion in our dedicated sustainable investment platform, including Uplift, Thematic and Impact funds, and also Baseline Screened portfolios across equities, fixed income, multi-asset, liquidity and alternative investments. In the US, BlackRock has been managing client assets versus the Bloomberg MSCI US Aggregate ESG Focus Index (USD) since 2018, offering exposure to investment grade bonds from issuers with favorable environmental, social and governance practices while seeking stability and income in a sustainable portfolio with similar risk and return to the Bloomberg US Aggregate Bond Index.

Five myths about fixed income index investing

**01**

**Myth**
Index managers incur the highest turnover during month end, suffering from information slippage and high transaction costs.

**Fact**
BlackRock’s Fixed Income Index portfolio managers trade flexibly through the month to proactively rebalance towards the forward-looking benchmark as they seek to deliver on investment objectives for investors. We take advantage of new issue markets, primary flows and internal crossing opportunities to limit excessive turnover and the market impact of rebalancing activities.

**02**

**Myth**
Index portfolio managers are forced buyers and sellers during credit events.

**Fact**
BlackRock’s Index Fixed Income portfolio managers are never forced buyers or sellers during credit events. We have flexibility on when to trade bonds which are exiting/entering the indices and can take advantage of internal crossing opportunities to aim to deliver the best outcome for clients.
Myth
Index managers cannot benefit from new issue premia.

Fact
Portfolio managers can participate in new issues to benefit from liquidity, new issue premia and the absence of transaction costs.

Myth
Active managers are better able to navigate illiquid markets.

Fact
As index portfolios tend to be highly diversified, index portfolio managers are able to navigate illiquid markets while still maintaining close tracking to their benchmark.

Myth
It is not possible to index "plus" sectors like Emerging Markets and High Yield as liquidity can be low and transaction costs are high.

Fact
Portfolio managers have been managing index high yield and emerging markets mandates against a variety of benchmarks.
At BlackRock, index investing is anything but ‘passive’. Rather than being strictly bound by the monthly rebalance cycle, BlackRock’s Index Fixed Income portfolio managers follow a stratified sampled approach using data, technology and a long history of index investing expertise to navigate fixed income index rebalances. This approach seeks to deliver the risk and return characteristics of the index by holding a subset of the index’s securities. To do this, we divide each index into groups of bonds with specific risk factors (such as sector, maturity, credit rating, seniority, country and currency), then select bonds from each subset to build a portfolio that reflects the characteristics of its underlying index, including yield and duration, to replicate the index returns as closely as possible.

Under this approach, BlackRock’s Index Fixed Income portfolio managers are not required to hold every single bond in the index. The investment process balances tracking error, liquidity and transaction costs when selecting securities. For example, the Bloomberg US Aggregate Bond Index includes over 13,000 bonds, our flagship collective trust fund benchmarked to the US Aggregate Index holds just around 11,000 bonds. This fund has consistently delivered tight annualized tracking difference of +7bps gross of fees since inception (source: BlackRock, as of 30 June 2023).

**Figure 2: Balancing tracking error and cost.**

For illustrative purposes only and subject to change. Source: BlackRock. As of 30 June 2023.
While there is still a need for better quality and standardized index analytics, we leverage proprietary and third-party data in Aladdin, BlackRock’s risk management system, to improve transparency around upcoming benchmark changes and performance drivers*. Importantly, because we methodically sample bond indices as opposed to fully replicating them, we have the flexibility to adjust portfolios in a pragmatic and dynamic fashion. We may also hold bonds to maturity if deemed beneficial, even if the index does not.

Rebalancing trades are executed with our investors in mind. For our large funds, such as our flagship collective trust fund managed to the Bloomberg Intermediate Credit Index (AUM: US $16B as at 26 June 2023) most rebalancing activity takes place dynamically through the month with an eye on the forward index, with very little adjustments made at month-end.

* While proprietary technology platforms may help manage risk, risk cannot be eliminated.
BlackRock’s Fixed Income Index portfolio managers have flexibility on when to trade any issuers entering and exiting indices, allowing us to avoid trading at the same time as others who may be forced buyers or sellers. In the case of fallen angels, BlackRock may end up being a net buyer during credit downgrades, given the size of the High Yield market and the scale of our High Yield funds across the firm. In emerging market debt, the indices tracked by Emerging Market index funds keep restructuring credits within the index. This provides investors the potential opportunity to benefit from any potential upside post credit event while also enabling us to act on our mission as a fiduciary, engaging with sovereign issuers during restructuring phases, to maximize value for clients while promoting a healthy market. For example, BlackRock engaged with the Argentinian government and more recently, the Ukrainian government in their debt restructuring. Over the years, we have also shared insights and feedback with index providers to evolve index rules in a pragmatic manner. For example, we collaborated with one index provider in 2020 to align the timing between downgraded bonds exiting certain USD Investment Grade indices with when they enter USD High Yield indices. This rule change aligned natural sellers of downgraded bonds (Investment Grade funds) with natural buyers of the bonds (High Yield funds), improving liquidity and reducing transaction costs of trading such events.
Portfolio managers will weigh up the benefits of improved liquidity, the new issue concession, and the absence of transaction costs of a new bond issue versus the potential tracking error created by owning it prior to its official inclusion in the index at the next rebalance. The process works because index funds generally have some flexibility to hold up to a certain percentage of non-index bonds.

In some asset classes, such as Emerging Market Debt, where the universe can be concentrated and sometimes illiquid, using the new issue market to access liquidity can be very beneficial to investors. With this in mind, BlackRock advocated with one index provider to include newly issued bonds more promptly within Emerging Market Debt indices from January 2021. By lowering the average time lag between the date of issuance of an index-eligible bond and its inclusion into the index, the breadth of the universe covered by the index increased, with the resulting index a better reflection of the evolution of the underlying market.
Index portfolios typically track highly diversified benchmarks and contain hundreds, if not thousands, of bonds. The Bloomberg US Aggregate Index, for example, holds over 13,000 bonds as of 30 June 2023. As a result, any individual position is unlikely to impact their ability to maintain tight tracking through the stratified sampling process. At BlackRock, managing index portfolios is never “passive” and we incorporate active insights such as single name news, market conditions and liquidity considerations in managing index portfolios to reduce portfolio turnover and unnecessary trading costs, thus enhancing overall tracking quality.

Myth

Active managers are better able to navigate illiquid markets.

Fact

As index portfolios tend to be highly diversified, BlackRock index portfolio managers are able to navigate illiquid markets while still maintaining close tracking to their benchmark.

In the US, our portfolio managers have been managing index high yield mandates since 2003 and index emerging markets mandates since 2007. These mandates are run against a variety of benchmarks, including those provided by Barclays, ICE BofAML, J.P. Morgan and iBoxx. The depth and breadth of our high yield and emerging market knowledge on the index side is also enhanced by the access that our index portfolio managers have to active teams on the BlackRock platform. This gives our portfolio managers additional insight into understanding issuer capital structures, event risk that could impact market volatility, and insights regarding corporate actions.

Myth
It is not possible to index “plus” sectors like Emerging Markets and High Yield as liquidity can be low and transaction costs are high.

Fact
Portfolio managers have been managing index high yield and emerging markets mandates against a variety of benchmarks.
Conclusion

As investors re-examine the role of fixed income in portfolios in a new macro regime, we see the adoption of fixed income indexing continuing. While the highly fragmented and discontinuously liquid nature of the bond market has led to claims that index investing cannot work in fixed income and that active management is the only solution, we argue that it is the very nature of fixed income that makes indexing valuable for all styles of investing. Indexing transforms the fragmented bond market into standardized, predictable and efficient exposures that greatly simplify portfolio construction. The broadening range of fixed income indices, index funds, and ETFs afford investors an increasing degree of precision and flexibility in creating highly customized and nimble portfolios, that can be adjusted efficiently to capture opportunities in changing market environments. Index funds can be used to rapidly and cost effectively scale portfolios, enabling portfolio managers to focus on higher conviction trades. For these reasons, we believe that not only does fixed income indexing work, but that it is becoming indispensable for more and more portfolio managers.
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