

- Enhanced Indexing addresses limitations of passive credit strategies
- Passive strategies face challenges like high turnover and transaction costs
- Enhanced Indexing improves returns and integrates sustainability

In recent years, passive investing has gained significant traction due to its predictable returns, broad market exposure, transparency, and low costs. These qualities have made passive strategies a staple in core allocations. However, while passive strategies offer several benefits, they also come with inherent limitations, particularly in the realm of credit investments.

Firstly, passive credit strategies structurally lag their benchmark index returns and exhibit substantial tracking errors versus their benchmark. Secondly, passive strategies by definition do not integrate sustainability. We outline in this article how our Enhanced Indexing approach provides a smarter alternative to passive in credits.

Passive in credits is challenging

Passive managers strive to produce index returns, but investment grade credit indices are diverse and their composition changes over time. They consist of thousands of bonds that are redeemed on or before the maturity date, pay coupons (at the time of writing circa 4% per annum) that are re-invested in the index, and can be downgraded to or upgraded from high yield. These dynamics cause investment grade credit indices to have an average annual turnover of almost 40% – almost ten times higher than the average turnover of the S&P 500 index.

Passive credit strategies lag their index with considerable tracking error

To keep up with the index composition, passive managers must buy and sell bonds at market prices, incurring transaction costs that are not reflected in the index return. These costs include bid-offer spreads and costs related to holding cash and hedging currency risk. Unlike equity indices, full replication is not possible with corporate bond indices due to their illiquidity, making it difficult for passive managers to buy all index constituents in the desired quantities within a short period of time. Therefore, passive managers apply a partial replication approach that inevitably introduces tracking error risk versus the benchmark, as the chosen subset of bonds will not perfectly track the full set of index constituents.

To keep their portfolios aligned with credit indices, passive managers perform significant trading which comes at a cost: the average roundtrip trade in credits costs circa 30 bps in normal markets, but this figure can double in volatile periods like 2008/2009 and 2020. Understandably, producing index returns is a daunting task for passive credit managers.

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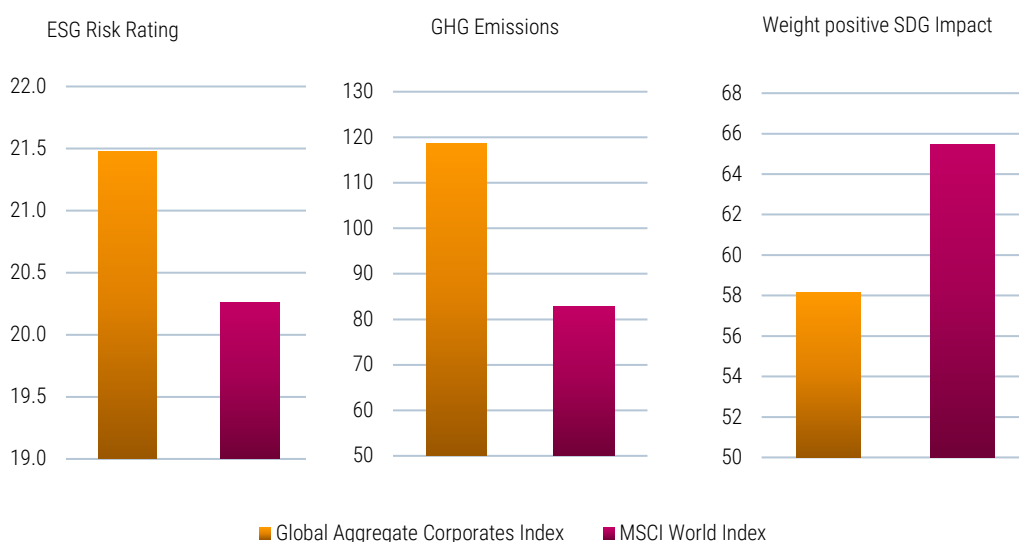
Passive strategies are typically offered via Exchange Traded Funds (ETFs). A salient point is that most ETFs in credits follow a so-called liquid index that consists of the most liquid bonds, for instance by imposing more stringent demands regarding minimum bond size. Such a liquid index should be easier to follow than a broader index that also contains less liquid bonds. Nevertheless, the two largest investment grade ETFs underperformed their own index in the July 2015 – June 2024 period by an annual average of 7 bps (see Figure 2), note that this is before management fees. Moreover, the ETFs tracked their index with an annual average tracking error of 51 bps, which demonstrates that passive strategies have considerable difficulty with closely tracking their benchmark index.

Passive credit strategies are less sustainable

Due to their sector composition, credit indices are typically much more pollutive than their equity counterparts, increasing the importance of sustainability considerations in managing the portfolio. The carbon footprint ownership of the Bloomberg Global Aggregate Corporates Index was 118.7 tons of CO₂-equivalent emissions per USD 1 mln invested, while the MSCI World Index was 82.9 tons as of July 2024. Additionally, the ESG Risk Rating of the credit index (higher is riskier) was 21.5 while that of the equity index was 20.2. Lastly, the credit index contains fewer companies with a positive contribution to the United Nations Sustainable Development Goals (SDGs). These statistics show that across three key sustainability dimensions – carbon emissions, ESG risks, and SDG contributions – credit indices score worse than equity indices.

However, by definition, passive credit strategies do not integrate sustainability criteria, nor do they favor more sustainable companies. Although there are passive credit strategies that follow ESG-tilted indices, the risk profile of these indices can significantly deviate from their mainstream parent indices due to differences in duration, rating, sector, or country exposures. This exposes investors to the kinds of active risk they aim to avoid by choosing a passive strategy.

Figure 1 - Sustainability of credit and equity benchmarks



Source: Robeco, Trucust, Sustainalytics. "GHG Emissions" is the index weighted average tCO₂e emissions per 1m USD invested, based on Trucust scope 1, 2 and 3 upstream data. "Weight positive SDG Impact" refers to the percentage weight of companies with a positive contribution to the UN SDGs as determined in Robeco's SDG Framework. "ESG Risk Rating" refers to Sustainalytics ESG Risk Rating. Data as of end July 2024.

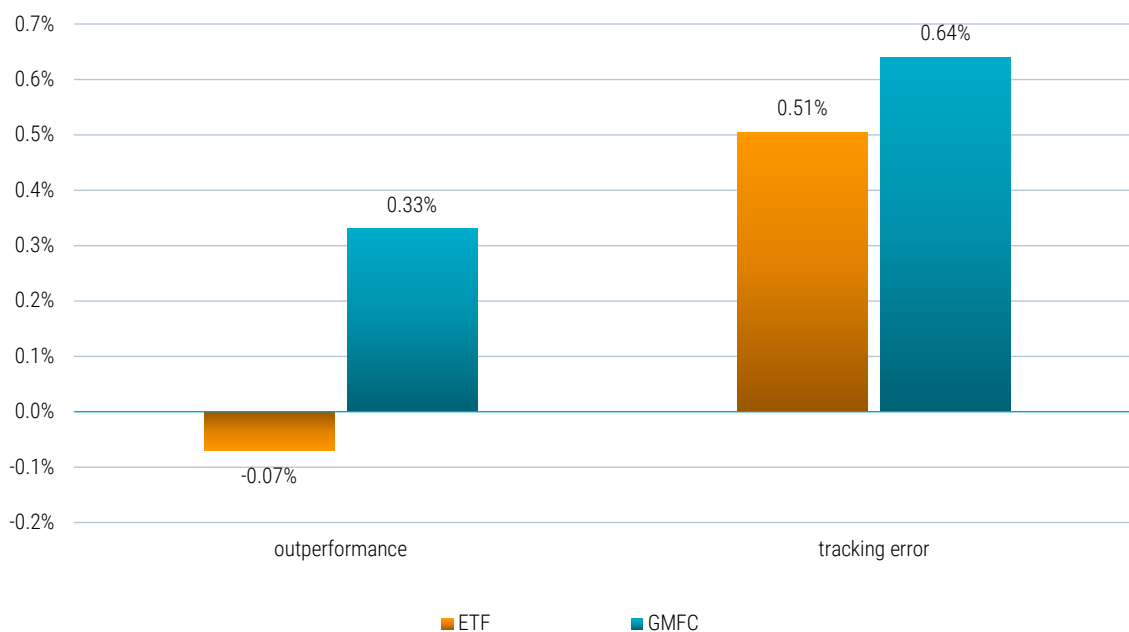
Enhanced Indexing credits: a smarter alternative

The objective of Robeco’s enhanced indexing strategies is to deliver improved returns at market-like risk with better sustainability integration than passive strategies. The strategies are managed in a rules-based manner and offer transparent and consistent returns. In credits, we manage our Global Multi-Factor Credits strategy as an enhanced indexing strategy by ensuring that the portfolio’s risk profile remains aligned with that of the credit index. In the selection of individual issuers and bonds, the strategy prefers bonds from financially healthier companies over bonds from weaker ones. Also, it prefers bonds with more attractive relative valuations. This is based on our long-standing multi-factor credit selection model. Furthermore, it prefers more sustainable companies over less sustainable ones. This approach has led to a relatively low tracking error while having delivered above-index returns with improved sustainability.

Improved returns and comparable tracking error

The success of this approach is evidenced by the strategy’s average relative return of 0.33% per annum (gross of management fees) after trading and implementation costs, compared to the Bloomberg Global Aggregate Corporates Index, since inception in July 2015 (see Figure 2). As a result of its risk-controlled portfolio construction, the strategy was able to track its index almost as closely as passive alternatives (tracking error of 0.64% versus 0.51%). However, instead of underperforming its benchmark, like passive strategies did over this period, it successfully outperformed its benchmark in nine out of ten calendar years, including the second half of 2015 and the first half of 2024.

Figure 2 – Annualized outperformance and tracking error of credit ETFs and Global Multi-Factor Credits, July 2015 – June 2024



Source: Robeco, Bloomberg, July 2015 - June 2024. Performance figures for Robeco QI Global Multi-Factor Credits IH EUR (GMFC), iShares iBoxx \$ Investment Grade Corporate Bond ETF (LQD) and iShares Broad USD Investment Grade Corporate Bond ETF (USIG). The performance figures for LQD and USIG are averaged to show the aggregate ETF performance. To determine gross of fees returns, we add the total expense ratios of the ETFs to their net returns. This ensures a like-for-like comparison with the gross-of-fees returns of our Multi-Factor Credits strategy. To calculate the tracking error, we use NAV-returns, again to ensure a like-for-like comparison with Robeco QI Global Multi-Factor Credits strategy.

Improved sustainability

Enhanced Indexing strategies do not only prefer financially healthier companies, they also prefer more sustainable companies. By definition, passive strategies do not select on alpha or sustainability considerations, as they aim to track their benchmark index as closely as possible. For enhanced indexing in credits, the Multi-Factor Credits strategy applies exclusion criteria related to products and business practices that Robeco believes are detrimental to society. Examples include manufacturers of tobacco or controversial weapons and companies involved in thermal coal, oil sands, or arctic drilling. And if a company in the portfolio is in breach of international standards, such as the OECD Guidelines for Multinational Enterprises, it will become part of Robeco's enhanced engagement program and the reported shortfalls will be addressed.

Moving beyond exclusions and enhanced engagement, the strategy is committed to providing investors with a lower environmental footprint than its benchmark in terms of carbon emissions, water use, and waste generation. In addition, the strategy commits to being exposed to less ESG risk than the benchmark and to being invested more than the benchmark in companies that positively contribute to the SDGs. In mandates, enhanced indexing strategies can even be customized to the exact sustainability preferences of the investor.

Table 1 – Improved sustainability across various dimensions as of end July 2024

	Credit index	Global Multi-Factor Credits
ESG risk rating	21.5	19.8
Carbon footprint	118.7	108.4
Water use	10,383	5,152
Waste generation	18.9	6.1
Weight in positive SDG scores	58.1%	68.0%

Source: Robeco, July 2024.

How the strategy works

To ensure an index-like risk profile, the Multi-Factor Credits strategy takes as a starting point the credit, duration and FX risk of the credit benchmark and ensures the portfolio remains in line with the index on these key risk dimensions. Subsequently, in the bottom-up selection of individual issuers and bonds, the strategy prefers bonds from financially healthier companies over bonds from weaker ones. Also, it prefers bonds with more attractive relative valuations. This is based on our long-standing multi-factor credit selection model. This model uses scientifically proven characteristics of companies and bonds (so-called factors like low-risk, quality, value and momentum) to assess the financial health of companies and the relative attractiveness of their bonds. In the portfolio construction, it explicitly controls identified systematic risk dimensions, such as exposures to sectors, currency denominations, seniority types, and size groups. The strategy ensures sufficient diversification over companies to avoid large single-name impact on returns. The above-index returns are thus generated by the selection of healthier companies and more attractively valued bonds while taking index-like risk.

Conclusion

Passive credit strategies face several challenges, including high turnover, transaction costs, and difficulty in fully replicating credit indices. These challenges result in structural underperformance, considerable tracking error, and limited possibilities for alpha generation or sustainability integration. Enhanced Indexing, as exemplified by Robeco's Global Multi-Factor Credits strategy, offers a smarter alternative by delivering improved returns at market-like risk, with better sustainability integration. Enhanced Indexing strategies prefer healthier and more sustainable companies while keeping the portfolio's risk profile in line with the index. This offers investors a more attractive and responsible option for their core allocations to credits.

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