Breckinridge
CAPITAL ADVISORS

INSIGHTS

A CLOSER EXAMINATION OF PASSIVE FIXED INCOME INDEXING

KEY TAKEAWAYS

- Now, more than ever, investors must assiduously evaluate each company for both financial and extra-financial risks, and thoughtfully position portfolios to get the most out of today's markets.
- With equity indices, a company's weighting increases as the value of its business grows. In contrast, fixed income indices increase a company's weighting as its indebtedness grows.
- History has often illustrated the unfortunate effects of indexing during changing market cycles.
- Bond indices reflect an erosion in credit quality, with BBB rated corporate credits accounting for nearly 48% of the Barclays U.S. Corporate Credit Index today versus 39% in 2012.

In this landscape for fixed income markets, risk avoidance reigns supreme. Leverage is rising, margins are compressing and balance sheets are stretched, all while the U.S. Federal Reserve has lifted rates for the first time in seven years and the commodities rout has created volatility. Companies not built with adequate financial armor may add risks that will be exacerbated in volatile markets. Now, more than ever, investors must assiduously evaluate each company for both financial and extra-financial risks, and thoughtfully position portfolios to get the most out of today's markets.

We don't believe this is the time to invest passively without doing in-depth research on individual bonds. Much has been written about the distinction between active and passive index management and whether the tactical decision-making of a skilled manager is worth paying for; however, most of this commentary focuses on equities. We tackle this question through the lens of today's fixed-income environment, where investors face an unprecedented set of issues, to which we think an index strategy may add unwelcome exposure. We will also address the matter of management fees. While it may come as a surprise to some, at Breckinridge we welcome the opportunity to compare our fees to those of most passive index funds.

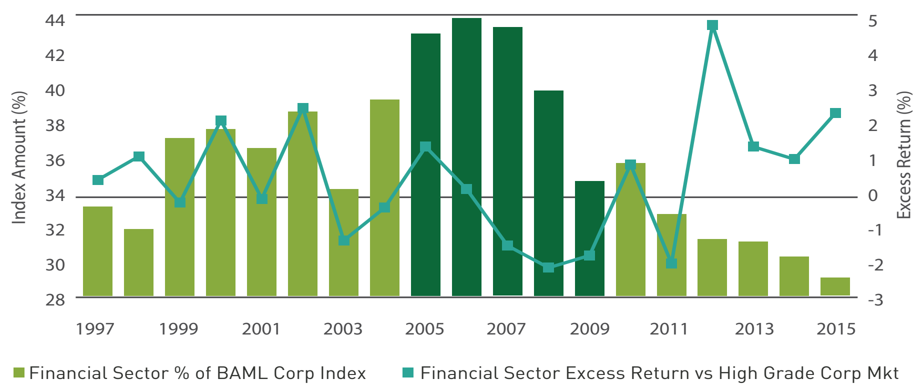
UNDERSTANDING THE MECHANICS OF FIXED INCOME INVESTING

In fixed income, indices are not market cap weighted like equity indices. With equity indices, a company's weighting increases as the value of its business grows. In contrast, fixed income indices increase a company's weighting as its *indebtedness* grows. The corporate bond weightings of fixed income indices are based on the amount of a company's outstanding public debt. The more a company issues debt, the greater its weighting in an index. By indexing, fixed income investors will tend to take on more exposure to companies as they *increase* debt and reduce exposure as companies *lower* debt. This is precisely the opposite of what fundamental credit analysis usually dictates.

History has often illustrated the unfortunate effects of indexing during changing market cycles.

- *Financials.* In the early- to mid-2000s, as the mortgage sector ballooned, financial companies rapidly took on debt and climbed from 39% of the Bank of America Merrill Lynch (BAML) Corporate Index in 2004 to 43% in 2007 (Figure 1). As a result, indexers' exposure to financials rose during a period that just preceded significant underperformance of the sector (2007 through 2009). The index trimmed exposure to financials in 2008 and 2009. But during this period, the difference in option-adjusted spread between financials and the rest of the corporate market ratcheted higher to a record 235 basis points in March 2009, per Barclays—exactly the most expensive time to unwind the sector. The index continued to trim exposure from 2010 to 2015, when financials *outperformed* in five out of those six years.

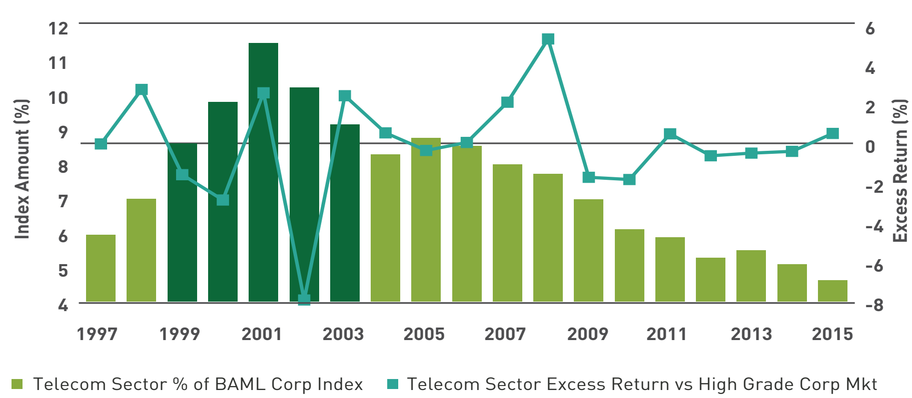
Figure 1: Index Holdings of Financials Grew in the Mid-2000s as Sector Performance Worsened



Source: Bank of America Merrill Lynch, as of December 31, 2015.

- *Telecom.* In the late 1990s, telecom companies expanded their balance sheets partly due to regulatory changes and the Internet upsurge. The index boosted telecom holdings from 6% in 1997 to 10% in 2002, during a period when telecoms underperformed. In 2003, the index pared back holdings just when the sector saw a rebound that helped to stabilize the index overall.

Figure 2: The Index Trimmed Telecom Holdings in 2003 as the Sector Rebounded

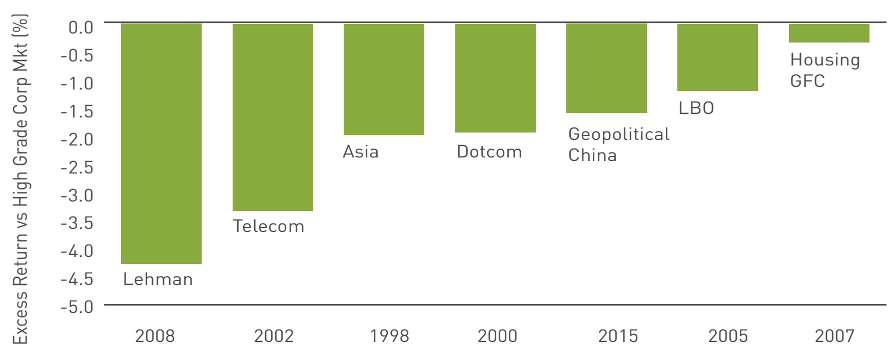


Source: Bank of America Merrill Lynch, as of December 31, 2015.

As we enter a new fixed income landscape in 2016 when strong and weak credits could see greater bifurcation, it is not a time to invest passively.

- *BBB Rated Companies.* In recent years there has been tremendous growth in corporate bond issuance, much of which has funded share buybacks, dividends and M&A. Not surprisingly, the resulting increase in corporate leverage has reduced credit quality across most industrial sectors; and this, in turn, has produced a broad migration of corporate credit ratings from mid investment grade (A and AA) to lower investment grade (BBB). Bond indices reflect this erosion in credit quality, with BBB rated corporate credits accounting for nearly 48% of the Barclays U.S. Corporate Credit Index today versus 39% in 2012. A passive index fund would have to reflect this move to lower credit quality as well. As a result, exposure to companies of lower credit quality would be increasing at a time when widening spreads in the bond market clearly anticipate the credit cycle turning lower.

Figure 3: BBB Corporate Bonds Have Underperformed during Challenging Markets



Source: Bank of America Merrill Lynch, as of December 31, 2015.

Year	Key
2008	Lehman Brothers Bankruptcy, Center of the Global Financial Crisis
2002	Telecom Meltdowns
1998	Asian Financial Crisis
2000	Dotcom Bubble Burst
2015	Geopolitical Volatility, China Slowdown Concerns
2005	LBO Wave, Aggressive Leveraging
2007	Stretched U.S. Housing Debt, Opening Months of GFC

Source: Bank of America Merrill Lynch, as of December 31, 2015.

NOW, MORE THAN EVER, RESEARCH MATTERS

The whipsaws in performance of these sectors show that passive fixed-income investing could put you on the wrong side of sector trends simply due to the mechanics of indices. Companies that have loaded on debt as part of an M&A transaction or shareholder-friendly action will actually then take bigger roles in fixed income indices, an important consideration with the rise of shareholder activism. In our view, just because corporate America is taking more risk doesn't mean you have to.

In markets like these, we believe active management is even more valuable for fixed income clients seeking a counterbalance to the higher-risk parts of their portfolios. Rigorous company research is a necessity for mitigating today's risks, as companies are grappling with higher leverage and a volatile global economy.

DO YOUR FEE DUE DILIGENCE

We agree that fees are very important, as some active managers charge high fees that substantially erode returns. What is more, these active managers are often incentivized to take outsized, riskier bets to justify their fees. However, investors may be overlooking active managers with fees just as low as—*or even lower than*—some passive index managers.

Again, at Breckinridge, we welcome comparisons of our fees to index products. Moreover, we invite investors to examine our investment approach relative to an index fund approach. Our investment teams carefully scrutinize companies as their indebtedness grows—rather than automatically boost exposure to match a higher index weighting. We remain grounded in our mandate to preserve capital and continuously strive to strike the right balance between managing risk and pursuing returns. At a time when corporate credit quality appears more vulnerable, we believe this approach is especially appropriate.

SOURCES:
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BofA Merrill Lynch U.S. Financial Index, Excess Return (%) versus Governments, Annual, as of December 31, 2015.
BoA Merrill Lynch U.S. Telecommunications Index, Excess Return (%) versus Governments, Annual, as of December 31, 2015.
BofA Merrill Lynch BBB U.S. Corporate Index, Excess Return (%) versus Governments, as of December 31, 2015.