



THE PROBLEM WITH FIXED INCOME INDEXATION

The factors that affect the bond markets and interest rates are very complex. Economics, monetary and fiscal policy, business conditions, international trade, currency movements, and capital flows all affect market interest rates. These factors are very fickle and, above all, they are very human. Where equity managers can evaluate a business and "buy and hold" a good stock, the task of the bond manager is considerably more difficult.

Bond managers make important choices on term, yield curve positioning, sector and issuers on a continuous basis. A manager can make a fabulous call, only to be wrong a few months later. This makes bond indexing a very attractive option. If the factors affecting the bond market are so complex, why not let the market make the important decisions?

Bond Indexing Makes For Poor Issuer Choices

The complexity of forecasting market interest rates perhaps limits the potential for consistent value-added by a bond manager, which might make fixed income indexing a reasonable choice. In our view, the major weakness of bond indexation is issuer choice.

Unlike equity indexation, bond indexation is inherently slanted towards making the wrong issuer choices. Successful companies with increasing equity prices see their equity weightings increase as a percentage of the market indices. This does not follow for bond issuers. Issuer weightings increase in debt indices as their debt issuance increases.

The amount of an issuer's debt represented in a bond index is not very dependent on the market's pricing of its debt. The interest rate differential or "credit spread", unique to a corporate issuer, forms only a small part of a bond's interest rate. Changes in the interest rate on outstanding debt, other than market changes on government reference securities, are not usually substantial, unless default is a serious concern. This really means that bond issuers weightings increase primarily as they issue more debt!

Large Debt Issuers are not Necessarily Successful

Very successful companies can rely on internal cash flows for investment and usually have willing bankers. Companies with large public debt issuance are not necessarily those at the vanguard of corporate performance. Heavy debt issuance can come from companies with grandiose expansion plans or large cash flow deficits.

Large issuance came from real estate companies in the late 1980s, the failed consolidators in the funeral home sector in the 1990s and the booming telecom industry of the late 1990s. The serially restructuring airline industry has sucked in tremendous amounts of debt capital, never earning sufficient cash to ever repay its debt. At the peak of the equity markets in 1999 and 2000, stock buybacks, popular with shareholders, increased many public companies' debt issuance for little economic reason.

The de facto indexing principle that one should increase exposure to heavy bond issuers gives pause to an experienced credit analyst. The examples of Enron and WorldCom come to mind. There is a good reason why Banks and other sophisticated credit organizations have specific issuer limits and independent credit departments. This controls their exposure to the credit risk of specific issuers.

Consider the situation of an increasingly risky issuer, one that bankers and other direct lenders wish to reduce

their exposure to. As the issuer requires higher amounts of credit, the lenders become more skittish, as their professional risk management areas require more caution. These organizations might seek to limit their exposure by selling loans, using credit derivatives or actually requiring the borrower to pay back outstanding loan balances.

Public Issues Replace Risky Bank Debt

Thinking this example through, a risky issuer would look to the public bond market as a method of refinancing. Indeed, this is the time-tested way for banks, with insider credit information, to reduce exposure by requiring repayment of bank debt out of public bond financings. The skill of the credit analyst is to avoid overvalued bonds, where the default risk of an issuer far exceeds the additional yield reward. Indexed bond management turns this on its head, rewarding a profligate borrower with increasing investment in its securities.

This is true, at least until downgrade, when downgraded issues are precipitously removed from the investment grade indices. Unlike equity indices, which remove issuers when default and delisting actually arrive, the bond indices have their bad bets removed when downgrade occurs, not necessarily at default. This occurs because bond indices usually separate investment grade bonds from the “junk” or below investment grade bonds. This causes huge discontinuity in the debt markets with actual and closet indexers selling on downgrade since they are unable to hold bonds rated below investment grade. Where an issuer is downgraded but avoids default, indexed managers have been forced to sell at a substantial discount to distressed buyers.

Indexers Reward Government Deficits

Even away from the corporate side, governments who are heavily increasing their debt issuance are not usually the best investments. Witness Japan, which has seen its share of the world government bond indices increase substantially as it has run up its government deficits and bond issuance to pump prime its economy. Japan has gone from 20% of world government bond indices in its heady “economic miracle” days of the late 1980s to 24% in its current “basket case” and deficit financing incarnation (Merrill Lynch Indices).

Perhaps there is some evidence that, given equity manager behaviour, a passive strategy might work for large equity portfolios. Our strict investment disciplines and strong beliefs argue viscerally against this position, even given the sensible rationale that financial markets will reward growing and successful companies with higher weights over time in equity indices. On the other hand, as we explain above, the prescriptions of fixed income indexing are suspect when applied to bond issuers, especially in the minefield of corporate bonds!