Portfolio Perspectives

Returns of Active Bond Funds Stand Above Active Equity Funds

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This year's results of Morningstar's Active/Passive Barometer study presented some interesting but not-too-well-recognized facts. Actively managed bond funds proved their worth as 65% of actively managed fixed income funds were able to outperform their comparable ETF benchmark. The study also revealed that over 80% of actively managed equity funds were unable to outperform a comparable ETF benchmark.

Clark Capital itself manages five different individual equity portfolios, and these results certainly don't convince us that actively managing equity has no merits. The bar is perhaps higher for active equity managers but we believe the bar can be met. However, the results certainly indicate that, on average, actively managed equity funds can be replaced by ETFs if they are the right fit for the end investor. Studies such as Morningstar's have been around for a number of years and, as a result, Clark Capital does use low cost index and Smart Beta ETFs. However, on the fixed income side, we continue to use actively managed fixed income funds even for core positions. In this article we will review Morningstar's study and discuss some reasons behind actively managed fixed income's perhaps surprisingly strong showing.

Morningstar's Active/Passive Study

Morningstar's study looked at a large universe of actively managed stock and bond funds with five years of weekly returns, and then selected from a universe of ETFs to construct a passive ETF portfolio that closely replicates each fund's return stream. The results showed that 65.5% of active fixed income managers outperformed their ETF replication portfolios but only 17.9% of active equity managers did so. Such a startling difference between bonds and equity deserves explanation. Morningstar provides numerous reasons behind fixed income's success in its article, but we'd like to expand upon some of their points and add a few more.

The Markets — Size and Structure

One big difference between the stock and bond markets is their size and structure. The bond market is many times the size of the stock market, with a wider variety of issuances, including municipalities, governments, and issues all across the corporate capital structure. The market has such size that it remains fragmented to a greater degree than the equity market; it is thus easier to find a take on a segment of the market and materially differ from the benchmark. One recent example of this was the distortion (and opportunities) that presented themselves at the short end of the yield curve immediately after money market reform was finalized. When only Treasury money market funds became insured, a wide

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swath of high-quality corporate short-term debt immediately gapped down and offered substantial extra yield at relatively low risk.

Perhaps the most important difference between bonds and stocks is the difference in spreads and underlying liquidity. While stock spreads are measured in pennies and are often under 10 basis points, bond spreads vary widely and are often 75 to 100 basis points in the high yield space. Trading in the bond space often occurs directly, and thus bond managers with strong trading relationships can potentially gain an advantage.

In our opinion, the scale and fragmentation of the bond market makes individual credit research (and effective trading, as mentioned above) more impactful. As a result, when we screen for fixed income managers we tend to prefer larger firms that have deep credit benches and strong trading operations.

The Role of Liquidity

As we have already alluded to, liquidity is substantially lower in fixed income markets, and this can manifest itself as opportunities for nimble managers. Smaller, illiquid issues that cannot be held by ETFs due to their very nature can earn extra yield for an active manager. If their credit research is sound, this can be a lasting source of added return. As an example, Nuveen, one of the largest and most respected fixed income managers, often owns smaller issues in its portfolios — issues that are so small that they might not be eligible as an ETF holding. They are able to do so effectively because though these issues are illiquid, a mutual fund's structure means they can dedicate a sizeable chunk of the portfolio to this area and yet not be forced to liquidate. Newly issued bonds are also an area rich with potential alpha. This particularly is true for issues that are large and destined to go into ETF portfolios. Our investment team often sees investment grade bonds bid up by up to 50 basis points from their original issue price as they enter ETF eligibility. Within the high yield space, this premium can be up to 75 to 100 basis points.

Benefits of Fixed Income ETFs

While actively managed fixed income has some structural advantages, we want to be clear that fixed income ETFs themselves offer considerable benefits. In our opinion, bond ETFs offer low cost, broad, consistent, and transparent exposure within their segment. Of particular note is fixed income ETF liquidity. Large high yield ETFs such as HYG and JNK offer the ability to transact within high yield at a spread that is much cheaper than that of the underlying cash market. We must also, of course, never forget that ETFs offer intra-day liquidity, while mutual funds do not. With fixed income ETFs offering a liquid way to achieve broad segment exposure, we find them to be an ideal vehicle to use in our Fixed Income Total Return separately managed account program, which allocates tactically within the high yield, Treasury, and cash market segments.

Finally, we'd like to note that the same arguments that support actively managed fixed income also support actively managed alternative investing. Alternatives by their very definition offer unique and innovative strategies in newer financial markets that are less heavily researched and less liquid. Nimble and efficient trading, a lack of transparency — which enables managers to hide their trades somewhat — and the ability to harvest liquidity premia are strong arguments for the mutual fund structure within alternatives.

Alternative ETFs are much less able to harvest these sources of return, as they must be transparent and liquid enough to liquidate at any time due to their structure.

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Mason Wev joined Clark Capital Management Group, Inc. in 2005 as a Portfolio Manager. He is a member of the Clark Capital Investment Committee, contributing to asset allocation policy and security selection. Mason has more than a decade of experience in the investment industry. He is responsible for quantitative investment analysis, security selection, and communicating the firm's investment policy to wealth advisors and consultants. He participates in the research and product development efforts of the Portfolio Team. A graduate of Dickinson College, Mason earned an M.B.A. in International Management from the Garvin School of Management at Thunderbird (the American Graduate School of International Management). He is a CFA® charter holder and a Chartered Market Technician.

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CCM-910