Breckinridge CAPITAL ADVISORS

Harnessing Choice in Fixed Income Investing

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In the same way that some equity investors object to owning or profiting from companies deemed at odds with their moral compass, we have seen a number of bond investors who want to tie their capital to issuers that share their values.

Bond investors must consider how to accomplish this alignment in a meaningful way. In this blog post, we focus on the shortfalls of passive bond index funds with regards to their inability to customize in ways that align with investor values.[1]

In short, since passive bond index funds track specified indices, fund investors will unavoidably hold the constituents of the tracked index, even when those issuers are out of line with their values. On top of this, passive investors can face a tough road in determining just how out of line with their values an index fund is. For example, the Bloomberg Barclays Aggregate Index, which many passive funds track, is composed of more than 12,500 as of May 31, 2022, complicating visibility into precisely how it is exposed—directly or indirectly—to certain products, industries, locations or other criteria.[2] For investors attentive to concepts like water conservation, diversity or workplace safety, the task of discerning exposure to poor performers in these areas could also present challenges, even with access to top-shelf tools and data. Given this lack of transparency, passive index fund investors could unwittingly experience a wide chasm between their values and their investments. We note that some of the same values-based criteria of which investors are conscious, such as natural resource consumption and depletion, independent board member representation or other factors, can have credit impacts, beyond values concerns. For example, in 2010, BP's oil spill in the Gulf of Mexico resulted in credit downgrades and billions of dollars in legal fines over several years. In 2015 and early 2016, Energy bonds materially underperformed other industrials as the price of fossil fuels declined sharply, prompting credit rating downgrades and bond spread widening. Finally, poor governance policies and procedures among large U.S. banks contributed to weak underwriting standards prior to the financial crisis in 2008 and 2009, which also led to credit downgrades. These events illustrate how material environmental, social and governance (ESG) factors, when poorly managed, can negatively impact corporate credit quality.

We continue to believe that the current market landscape calls for active bond management with in-depth, fundamental credit research. We remind investors that within fixed income indices, a bond issuer's weighting is determined by the market value of its debt outstanding; that is, a company's index weighting increases as its indebtedness grows (See: *The Case for Active Management*).

With that in mind, index funds could lead investors into a difficult vise of unintentional or obligatory misalignment with certain values, and high exposure to companies with elevated debt. As we move through a period of elevated economic uncertainty and market volatility, issuers could experience deterioration of debt metrics with the potential for changes to the value of their bonds.

Active managers are not bound to index holdings and can invest thoughtfully and strategically without being overly tactical (See: *When To Bench the Municipal Bond Benchmark* and *Taking the Measure of Bond Ladders*). For investors interested in emphasizing certain values in their investments, a customized strategy may be appropriate, as it empowers the investor to choose which values to reflect in their portfolio and how strongly to consider those criteria. That said, not all customized strategies are alike. At Breckinridge, our ability to customize separate accounts is a core competence of the firm, and we have invested significantly in technology that allows us to construct and manage portfolios that hew to client directives such as values-based customizations, meaningfully and systematically.

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As Robert Monks wrote, "Passive index funds, algorithm trading, the incessant churn of financial markets around the world have all served to weaken the bonds of ownership and divorce shareholders from any compelling sense of responsibility for the corporations in which they have invested."[3] We know it's not our job to define our clients' values, but we do think investing should be done responsibly and thoughtfully. We look forward to continuing to provide opportunities for our clients to do so, and we invite further discussion on fixed income strategies for a changing world.

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FOOTNOTES:

1. There are differences between active and passive investing. Active portfolio management employs a professional portfolio manager, or team of managers, to decide which underlying investments to choose. Typically, the goal of an active manager is to achieve better total return performance as measured against an appropriate market index, or benchmark, based on its stated investment strategy by choosing investments believed to be top-performing selections. Passive portfolio management seeks to parallel the performance of a particular market or benchmark index as closely as possible. Benchmark indexes are unmanaged, and an investor cannot invest directly in an index. However, passive strategies are branded as passively managed rather than unmanaged because a portfolio manager oversees replicating the index. Some passive strategies invest in all of the securities included in a benchmark index, while others invest in only a sample of the securities included in a market index. There is no guarantee that either passive or active strategies will achieve their performance objectives. Active investing generally involves more risk than passive investing because active managers may take on greater market risk to outperform the index. Active strategies also tend to have higher management fees and operating costs than passive strategies. Investors should consider all the differences and risks before making any investment decisions.
2. Reshma Kapadia, "We're All Gun Owners, and Here's Why." Barron's. February 24, 2018. Eric Roston, "New York City, Albany Part Ways on Divesting Fossil-Fuel Stocks," Bloomberg, February 27, 2018.
3. Robert A.G. Monks, Citizens DisUnited: Passive Investors, Drone CEOs and the Corporate Capture of the American Dream (Miniver Press, 2013).

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All investments involve risk, including loss of principal. Diversification cannot assure a profit or protect against loss. Fixed income investments have varying degrees of credit risk, interest rate risk, default risk, and prepayment and extension risk. In general, bond prices rise when interest rates fall and vice versa. This effect is usually more pronounced for longer-term securities. Income from municipal bonds can be declared taxable because of unfavorable changes in tax laws, adverse interpretations by the IRS or state tax authorities, or noncompliant conduct of a bond issuer.

Breckinridge believes that the assessment of ESG risks, including those associated with climate change, can improve overall risk analysis. When integrating ESG analysis with traditional financial analysis, Breckinridge's investment team will consider ESG factors but may conclude that other attributes outweigh the ESG considerations when making investment decisions.

There is no guarantee that integrating ESG analysis will improve risk-adjusted returns, lower portfolio volatility over any specific time period, or outperform the broader market or other strategies that do not utilize ESG analysis when selecting investments. The consideration of ESG factors may limit investment opportunities available to a portfolio. In addition, ESG data often lacks standardization, consistency and transparency and for certain companies such data may not be available, complete or accurate.

Breckinridge's ESG analysis is based on third party data and Breckinridge analysts' internal analysis. Analysts will review a variety of sources such as corporate sustainability reports, data subscriptions, and research reports to obtain available metrics for internally developed ESG frameworks. Qualitative ESG information is obtained from corporate sustainability reports, engagement discussion with corporate management teams, among others. A high sustainability rating does not mean it will be included in a portfolio, nor does it mean that a bond will provide profits or avoid losses.

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