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.

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.[1] 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."[2] 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. 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.
2. Robert A.G. Monks, Citizens DisUnited: Passive Investors, Drone CEOs and the Corporate Capture of the American Dream (Miniver Press, 2013).