Active management: The optimal approach to sterling spread assets.

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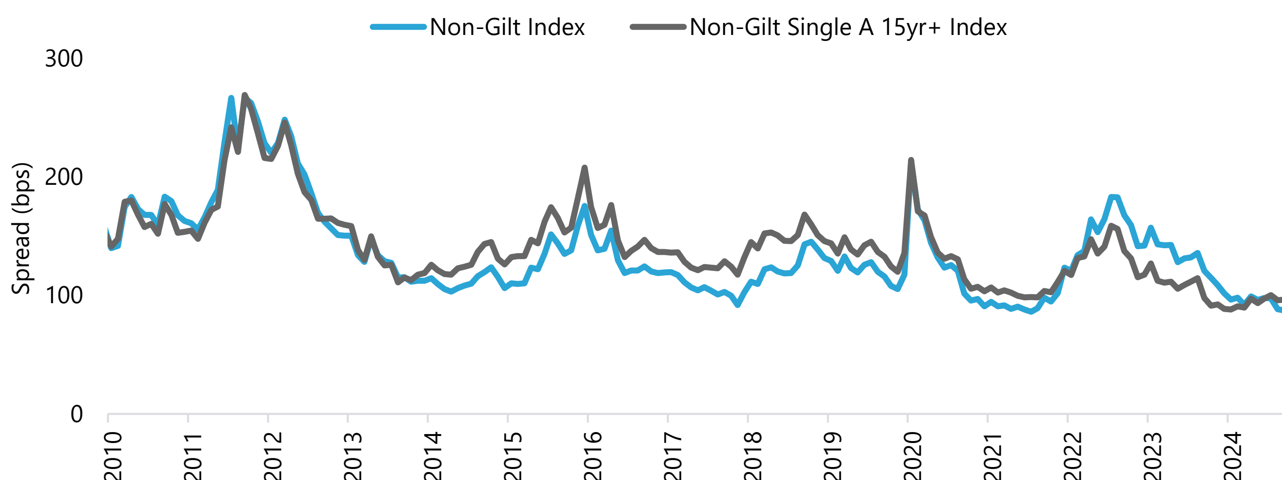
Amid attractive yields and historically tight spreads, today's sterling credit market offers limited compensation for credit risk. Passive and buy-and-maintain strategies lack the flexibility to navigate such a nuanced environment. Given its ability to exploit inefficiencies, pursue incremental returns, and manage risk dynamically, active management presents a superior alternative for investors in sterling spread assets.

The rise of passive strategies (and their limitations)

From 2008 to 2022, a combination of ultra-low interest rates and central banks' quantitative easing compressed credit spreads, leading to more than a decade of muted fixed-income returns, despite an initial boost. This environment drove many fixed-income investors into passive strategies for their simplicity, cost efficiency, and transparency. As a result, inflows into European (including U.K.) passive funds have consistently outpaced those of their active counterparts every year for the past decade[1]. Technological developments further fuelled this trend, as easy access to exchange-traded funds (ETFs) provided an entry point for many investors.

Exhibit 1: U.K. credit and U.K. long-duration credit benchmark spreads



Source: Bloomberg. As of 31/12/2024.

[1] https://www.morningstar.com/business/insights/blog/funds/active-vs-passive-investing (Accessed: 14 January 2025)

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Investors may have had their reasons to flock to passive over the period described above, but we believe, as we did then, that active management has the potential to deliver superior results. Today's sterling credit market, which is characterized by elevated yields, strong demand for credit securities, and spreads hovering just below 100 basis points (bps), only strengthens the case for active management.

Buy-and-maintain strategies (and their limitations)

Buy-and-maintain strategies are popular among institutional investors that manage liability-driven investment (LDI) strategies (e.g., pension funds and insurance companies). These strategies build portfolios of high-quality bonds that can be held to maturity, thereby minimising turnover, and reducing the need for frequent trading. By holding bonds over the long term, buy-and-maintain strategies ensure stability in their returns. The consistent cash flows and predictable duration make them ideal for liability matching, where active strategies' dynamic duration adjustments can disrupt a liability hedge.

Liability-Driven Investment (LDI) is an investment strategy designed to ensure that a portfolio's assets align with and meet future liabilities, commonly used by pension funds to match cash flows and duration with their payment obligations.

Despite their advantages, buy-and-maintain strategies also face notable limitations in an environment of tight credit spreads. While some customisation is possible within liability-matching mandates, like passive vehicles, these strategies also lack the flexibility to fully capitalise on short-term opportunities (e.g., temporary price suppression caused by sentiment shifts or credit events). Given the current market environment, this dynamism gives active management an advantage over both passive and buy-and-maintain strategies; where opportunities arise, only active managers have the flexibility to fully exploit them.

Active management’s advantage

When spreads are tight, active management thrives by capitalising on inefficiencies in the market. Active managers conduct detailed credit analyses, assessing both quantitative and qualitative factors to identify undervalued securities. For example, bonds trading at a discount due to sentiment or regulatory concerns present active-management opportunities; should sentiment improve, a portfolio holding these discounted bonds would benefit when prices rebound. While active management typically carries higher fees, the performance data below demonstrates that historically it has outperformed on a net-of-fees basis, meaning that active’s superior returns more than offset its higher cost.

Active managers can respond to market volatility opportunistically, purchasing high-quality bonds at discounts to enhance returns as spreads normalise. Unlike passive vehicles, which must maintain strict index weightings regardless of valuation and are often forced to buy overvalued bonds during rebalancing periods, active managers can reallocate their portfolios to capture value strategically around issuer-specific events, such as rating changes, defaults, or restructurings. Investors that prefer gilts can also benefit from active management, as active managers can adjust duration and curve positioning dynamically, responding to interest-rate changes to identify mispriced gilts, and capturing value that passive strategies overlook. Even in a gilt-focused portfolio, active management can still deliver superior investment outcomes, highlighting that the benefits of active go beyond credit.

The table below underscores active management’s advantages: the 12-month success rate for active sterling corporate-bond managers, measured in terms of outperformance over their passive counterparts, was over 70%, largely due to their strategic positioning ahead of anticipated interest-rate cuts. Notably, this outperformance has been consistent over longer time horizons as well, with success rates remaining above 66% across 3- and 5-year periods. This highlights the persistent value that active managers can deliver by navigating market dynamics and capturing opportunities that are inaccessible to more passive strategies. However, it is worth noting that while the majority of active managers outperformed over these periods, selecting the right manager is also critical, as the range of performance outcomes can vary substantially.

Exhibit 2: Active funds’ success rates over time

	No. of active funds at beginning of period	No. of passive funds at beginning of period	Active success rate (%)
1-year trailing total return	105	22	72.4
3-year trailing total return	107	22	66.4
5-year trailing total return	108	16	67.6

Source: Morningstar (2024) European Active/Passive Barometer. Active success rate refers to the percentage of active funds that started the sample period which went on to survive and generate a return more than the simple average of the passive funds’ return over the same period. All performance numbers are net of fees.

Enhanced risk management through active management

In markets with narrow margins for error, active management has another crucial advantage in terms of risk management. When economic indicators signal potential trouble on the horizon, active managers can adjust their credit exposure, prioritising high-quality issuers. This selective approach preserves capital more effectively than passive strategies, which, as mentioned earlier, are largely bound to their underlying indices.

In addition to controlling credit risk, active strategies also allow for efficient duration management. Interest-rate fluctuations can erode bond returns, but active managers can adjust their duration in anticipation of or in response to rate changes. In these situations, active strategies can reduce their interest-rate sensitivity by shortening their duration. Passive portfolios, tied to the duration of their underlying indices, cannot adjust their compositions in this manner. Moreover, active managers can adopt defensive positioning in weakening markets, reducing exposure to high-risk segments or increasing their cash positions. By actively managing duration and credit risk, active portfolios can mitigate their downside and protect returns in ways that other approaches cannot.

Conclusion

In today’s high-yield, tight-spread sterling credit market, passive strategies—despite their cost efficiency and broad exposure—struggle to adapt to nuanced market conditions. While buy-and-maintain strategies’ level of customisation may make them better suited than passive strategies to navigate the current environment, it takes the flexibility of active management to fully capture specific opportunities, optimise risk, and make tactical adjustments that the alternatives cannot. Using today’s elevated yields as a buffer, active managers can focus on quality credit selection, duration management, and sector-specific positioning to enhance returns and mitigate risk dynamically. This adaptability allows active managers to uncover value that is inaccessible to passive investors, making active management the optimal approach for navigating the current sterling credit environment.

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