Research Report
Fixed Income

July 2021

Fixed Income: Preparing for the Big Shift

STATE STREET GLOBAL ADVISORS

The fixed income (FI) portfolios of institutional investors are evolving rapidly. Investment strategists around the globe are noting that, in the search for yield, many investors are:

- Shifting their fixed income portfolios to incorporate index strategies alongside active strategies, typically in search of performance at a lower cost
- Rebalancing the ways in which they access FI assets, focusing on yield, liquidity, and transparency
- Considering higher-yielding FI assets; creating standalone country/sector FI allocations to take advantage of market opportunities
- Incorporating ESG approaches to add a quality lens to their FI portfolios

In sum, we believe the fixed income market reflects four key trends.

Four Trends Transforming Institutional Portfolios

1 **The Move to Indexed Fixed Income**
Increasing the range of FI approaches deployed to meet investor needs, in particular the increased use of indexing

2 **ETFs in the Fixed Income Toolkit**
Changing the mix of investment vehicles that are used for executing FI strategies, especially the expansion of ETFs

3 **ESG Moves Mainstream for Fixed Income**
Expanding the ways in which core investor concerns are addressed, including the growing role of ESG

4 **China, EM Come Online**
Bringing additional focus to regions that are opening up to FI investing and offering attractive yields

To test these four hypotheses, State Street Global Advisors conducted an online survey of 358 institutional investors in May of 2021.[1] The global survey respondents came from pension funds, wealth managers, asset managers, and sovereign wealth funds.[2] Their responses confirmed that the evolution in fixed income investing is very real and, in fact, that institutional FI investing could be reaching the point where "evolution" will become "revolution." The survey also identified a few surprises in the ways in which investors think about, and employ, indexed fixed income strategies.

1 In partnership with Longitude Research, a *Financial Times* company. The research also included in-depth telephone interviews with two institutional portfolio managers (one in North America and one in Europe).

2 Detailed demographics are included at the end of this report.

The Move to Indexed Fixed Income

There are a variety of reasons why investors are moving to fixed income indexing.

- While active FI portfolio management still predominates and is seen as valuable by most institutional investors, the gaps between active and index outcomes are narrowing in many areas of FI.
- Price transparency has led to more efficient markets, which means alpha has become more difficult to achieve.
- The growth in core/beta FI strategies confirms that investors are looking to "focus" their portfolios in search of yield.
- Institutional investors seeking alternatives to sovereign-heavy broad market exposures are constructing portfolios comprising sector exposures that are aligned with specific objectives.
- Index allocations provide a cost-effective and highly transparent tool to access the assets beta investors desire in a multi-sector portfolio.

Key Findings on the Increased Use of Indexing

Survey respondents confirm that active management of fixed income strategies still predominates, which translates to both a challenge and an opportunity for indexing in an evolving FI market. More than three-quarters (76%) of respondents have less than 30% of their fixed income portfolio allocated to index strategies.

Despite this relatively low base of indexed fixed income adoption, survey respondents indicate that they are preparing for substantial change — because indexed FI is now a clear future priority.

66%

of global respondents are prioritizing increased use of indexing for **broad or liquid, core FI exposures** over the next three years (in Australia the percentage was 82%; in North America it was 71%).

63%

of global respondents are prioritizing increased use of indexing for **less liquid, non-core/satellite FI exposures** over the next three years.

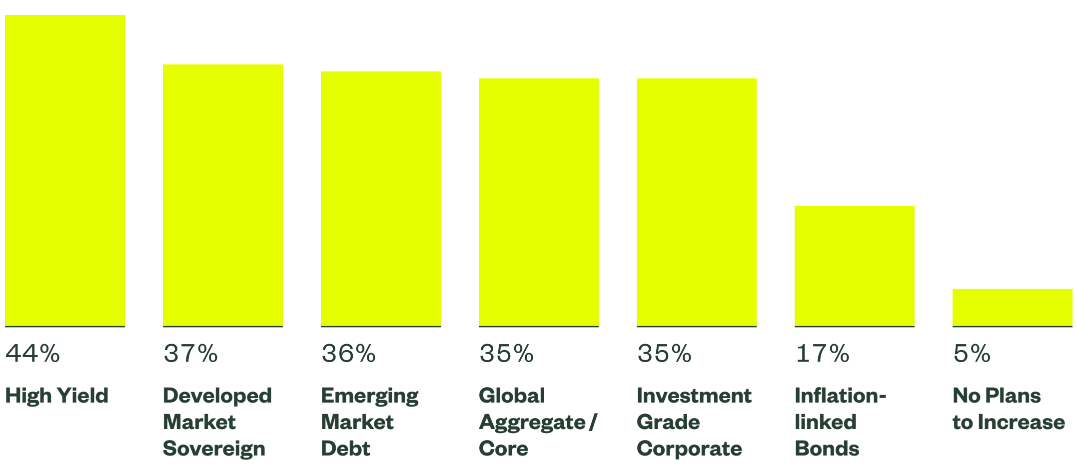
The combination of low current adoption rates and very high expectations for near-term future adoption suggests that FI indexing may indeed be approaching an inflection point. The core/satellite approach in fixed income may also be helping to drive this forward-looking level of acceptance.

Planned Future Index Fixed Income Allocations

By Strategy

Figure 1

Does your institution plan to increase its allocation to index strategies for any of the following fixed income segments over the next three years?



Source: State Street Global Advisors. Respondents asked to select all that apply. n=339.

Figure 1 breaks out the fixed income strategies for which respondents plan an increased allocation. More than one-third of respondents plan to increase their allocation to each of five index strategies. It is notable that both core and satellite FI strategies are well represented on this list, representing quite disparate risk and return characteristics as well.

Efficiency and reliability are key drivers of indexed fixed income adoption. When asked to consider the fixed-income areas where they plan to increase their allocations to indexed approaches, respondents most often cited “lowering costs/improved efficiency” as a primary motivation for making the change. This was closely followed by the desire to use efficient and reliable indexed exposures to maximize the impact of asset-allocation decisions (38%). In addition, one-third of respondents believe that, in the areas where they plan to increase their indexed allocations, it has become more difficult for active managers to add value (see Figure 2). These findings confirm that institutional investors recognize the potential for indexed fixed income to contribute to their objectives in this low-yield environment.

Key Drivers of Increased Indexed FI Adoption

Figure 2

What are your institution’s main motivations for increasing the use of index strategies in the fixed income segments for which an increased allocation is planned?

Lowering costs / improved efficiency	39%
Index strategies can maximize the impact of our asset allocation decisions because of their efficient and reliable delivery of benchmark returns	38%
Believe the opportunity for active managers to add alpha has become more difficult in these segments	33%
Enhanced liquidity and pricing transparency	32%
Index strategies are increasingly demonstrating more reliable performance, even in more specific and less liquid fixed income sectors	30%
Risks in this segment are too unpredictable for high conviction, active managers to reliably protect against	29%
Index strategies can complement existing active allocations in these segments	27%

Source: State Street Global Advisors. Respondents asked to select up to three choices. n=321.

The move to include indexing as part of a fixed income portfolio is also supported by investors' lack of complete satisfaction with their current active FI strategies. Less than half of survey respondents say that they are "Somewhat Satisfied" or "Extremely Satisfied" that their actively managed strategies, in aggregate, have delivered the investment performance (net of fees) that they were hoping for over the last three years. The percentage of respondents reporting that they are either "Somewhat Satisfied" or "Extremely Satisfied" with specific active strategies were: IG Corporate (52%), EMD (46%), HY (44%), Global Agg/Core (44%), DM Sovereign, (43%), and Inflation-Linked Bonds (40%).

Lastly, one other way in which the search for yield is manifesting itself is the breadth of the field of strategies from which active managers are choosing their fixed income investments. Respondents whose active portfolio managers are running a Core/Core Plus FI portfolio report that many of those active managers do have the flexibility to allocate to non-core FI segments, specifically: HY (55%), EMD (47%), Bank Loans (37%), and Public Equities (24%).

ETFs in the Fixed Income Toolkit

ETFs first gained institutional credibility in the world of equities, but they are now a popular and proven vehicle with which to access the fixed income market. ETFs offer institutional investors capabilities that are highly complementary to other types of FI allocations, and there are multiple use cases for FI ETFs, including:

- As building blocks for asset allocation purposes
- To modify specific duration or credit targets relative to a core index
- As a liquidity sleeve
- For interim beta exposure
- As a transition management tool

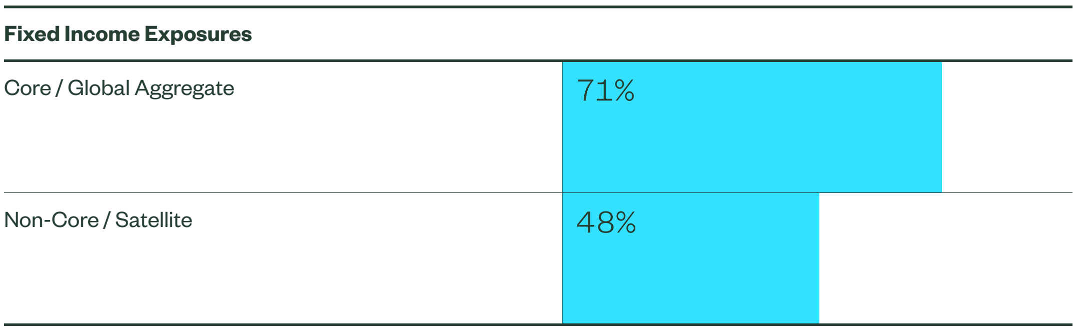
An increasingly transparent and efficient indexed fixed income market is well served by ETF strategies' transparent and efficient properties. ETFs are particularly well suited to helping execute a "core (index) and satellite (active)" FI strategy as well as other structural positionings. Currently a great deal of FI ETF demand comes from model portfolios, asset allocation strategies, and tactical opportunities — each of which increasingly includes an indexed FI component. State Street Global Advisors is both an indexing and ETF leader; this positions us well to deliver value to institutional investors in the indexed FI space.

Key Findings on ETF Use and Trends

Investors have plans to increase ETF use within their larger fixed income portfolios. Figure 3 shows that seven in ten (71%) survey respondents have a strong appetite to increase the use of ETFs within their global aggregate/core FI portfolios over the next three years. Nearly half (48%) of respondents have a strong appetite to increase the use of ETFs within their non-core/satellite FI exposures over the next three years. In addition, more than two-thirds (68%) of respondents say they are prioritizing increased use of ETFs for fixed income portfolio construction over the next three years.

Figure 3
How strong is your institution's appetite to increase the use of ETFs within its core and satellite fixed income portfolios?

Appetite for Increasing ETF Use in FI Portfolios, Core and Non-Core



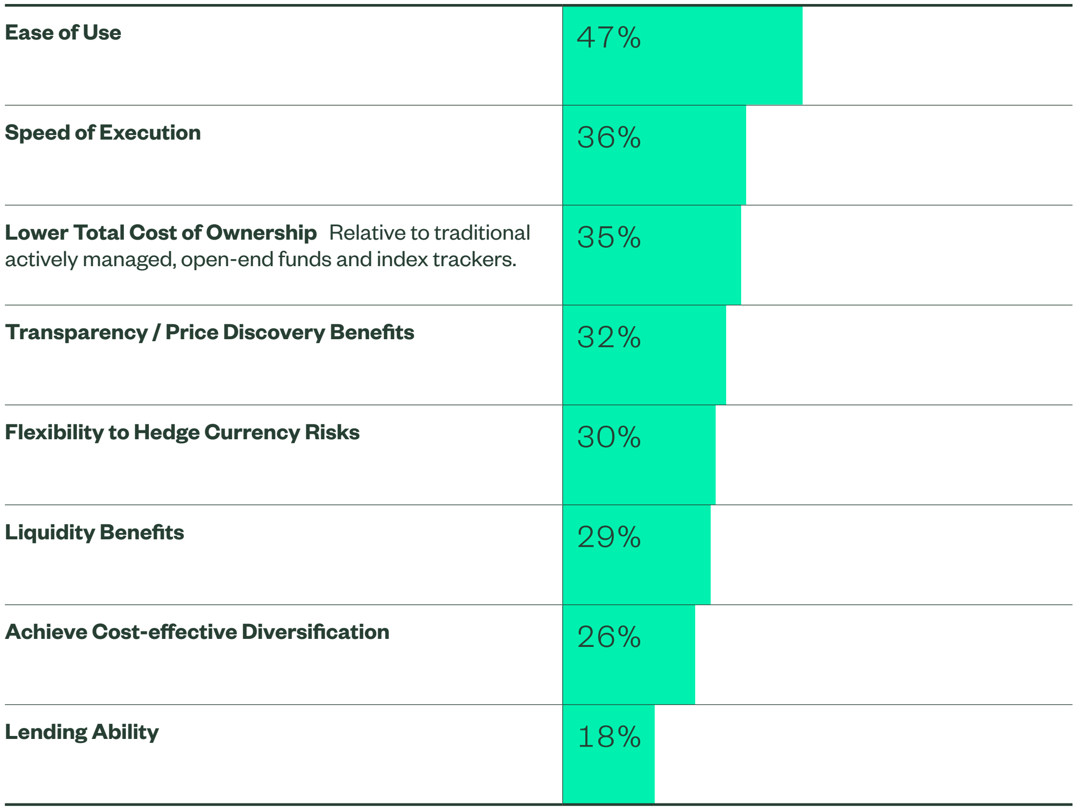
Source: State Street Global Advisors. Percentage responding either "Strong Appetite" or "Very Strong Appetite". n=358.

Ease of use, speed of execution, and lower total cost were the top factors driving survey respondents' appetite to increase allocations to fixed income ETFs over the next three years (see Figure 4). Most options on the list of possible choices (respondents could choose up to three) received substantial support — the survey respondents confirmed the value of a broad set of positive FI ETF characteristics.

> **"There was no liquidity in underlying cash bonds, so the market price of ETFs was the true price where market risk was transferring. We actually had to override our models to show what the yield to worst on the high yield ETF was because there was such a disconnect. When stress hits, that's the price we'll reference instead of an index value or a paper mark on a basket of bonds."**
>
> —Portfolio Manager, Pension Fund

Figure 4
What are the main factors driving your appetite to increase allocations to fixed income ETFs over the next three years?

Factors Driving Increased Future FI ETF Allocations



Source: State Street Global Advisors. Respondents asked to select up to three choices. Does not include respondents who selected "No appetite to increase use of ETFs." n=348.

Volatility tested all aspects of the fixed income market during 2020, and the survey found that FI ETFs validated their strengths during that market stress.

51%

of survey respondents agree that the **liquidity and price discovery benefits** of FI ETFs became more attractive as a result of the Covid-19-driven market turbulence in Q1 2020 (in North America the percentage was 70%).

53%

of respondents agree that the **overall performance** of FI ETFs during the Covid-19-driven market turbulence in Q1 2020 made their institution more comfortable with allocating to these vehicles in the future (in North America the percentage was 77%).

ESG Moves Mainstream for Fixed Income

ESG integration has been well-established in investors' approach to equity investing, and as ESG has become a mainstream, key concern for investors, it is now seen as a key consideration in fixed income investing as well.

- ESG is seen by FI investors as a way to provide a "quality" lens through which to view potential FI investment strategies.
- ESG is an important component in index manager selection checklists; managers that are not prepared to discuss ESG for FI fully should prepare themselves for rejection.

Key Findings on the Growing Role of ESG

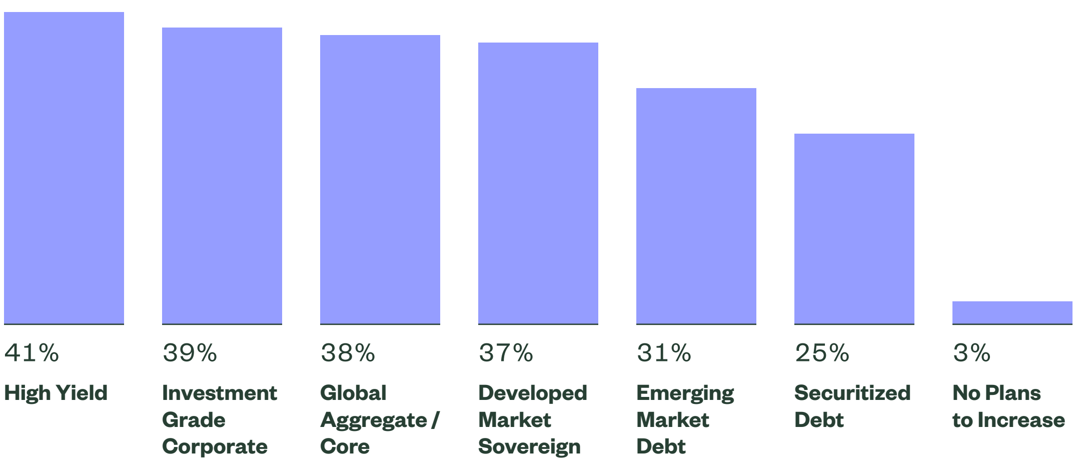
The survey confirmed that ESG has become a clear priority for fixed income investors. Many segments of respondents' fixed income portfolios will be prioritized for deeper/more comprehensive ESG integration over the next three years, led by HY and IG Corporate (see Figure 5). Among North American respondents, DM Sovereign was most likely to be prioritized. Among European respondents, High Yield was most likely to be prioritized. Interestingly, more than half (58%) of all respondents noted that they are most likely to use ETFs as their preferred fund vehicle for increasing allocations to FI ESG strategies over the next three years.

61% of respondents say that they are prioritizing integration of ESG factors within their fixed income portfolio over the next three years. The breakdown by region was Australia 80%, Europe 61%, and North America 57%.

Planned Future ESG Integration in FI Portfolio

By Strategy

Figure 5
Which segments of your fixed income portfolio will you prioritize for deeper/ more comprehensive ESG integration?



Source: State Street Global Advisors. Respondents asked to select all that apply. n=358.

Survey respondents currently use a variety of approaches to incorporating ESG issues into their fixed income portfolios, with the "best-in-class" and "impact" approaches being most frequently employed (see Figure 6). The breadth of support across multiple approaches reflects both the high level of engagement on ESG issues for FI as well as the variety of valid approaches that exist to implement ESG strategies.

Current Approaches to Incorporating ESG Issues Into FI Portfolios

Figure 6
What approaches does your institution — or the external asset managers you employ — currently take to incorporating ESG issues into its fixed income portfolio?

Best-in-class Investment in issuers selected for stronger ESG scores relative to industry peers.	49%
Impact Targeting a measurable positive social and/or environmental impact. Investments typically align to the UN Sustainable Development Goals and are generally project-specific.	39%
Thematic Investment in themes or assets specifically aimed at solving social or environmental problems e.g. clean energy and green technology.	31%
Norms-based Screening of investments against minimum standard of business practice, based on international norms.	30%
ESG Tilt The inclusion of ESG risks and opportunities into traditional financial analysis using a weighting scheme or optimizer with constraints.	27%
ESG Tail-risk Monitoring ESG scores through time and imposing constraints when there is a deterioration in ESG performance.	24%
Negative Screening The removal of certain sectors or companies based on specific ESG criteria.	16%
No ESG Issues Incorporated	3%

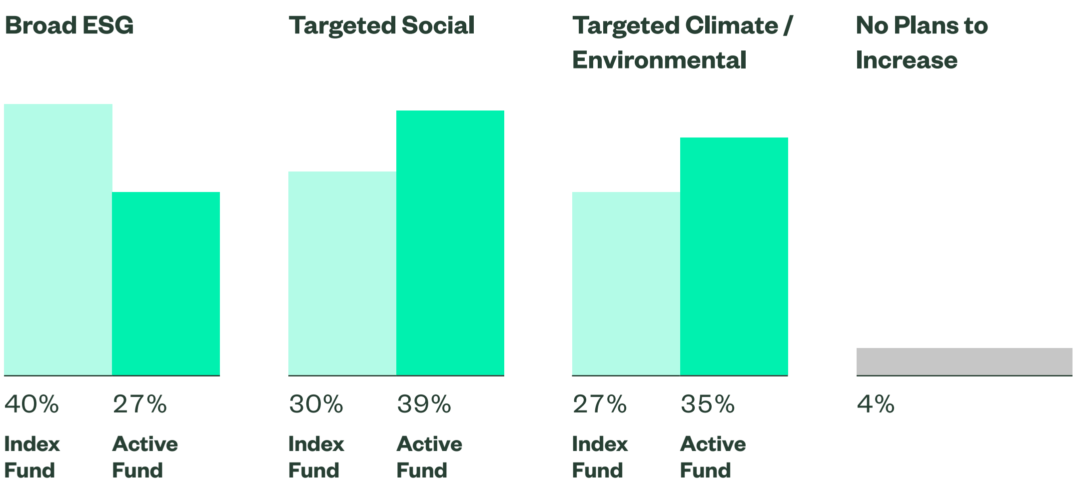
Source: State Street Global Advisors. Respondents asked to select all that apply. n=358.

Substantial numbers of respondents say they are likely to increase their allocation to three types of fixed income ESG strategies over the next three years: broad ESG tilt/theme, targeted social tilt/theme, and targeted climate/environmental tilt/theme (see Figure 7). Survey findings indicate that active and index strategies are equally likely to see such an increased allocation.

Future Fixed Income ESG Strategy Allocations

By Tilt/Theme

Figure 7
What type(s) of fixed income ESG strategy is your institution likely to increase allocation to over the next three years?



Source: State Street Global Advisors. Respondents asked to select all that apply. n=358.

China, EM Come Online

In October of 2021 Chinese sovereign bonds will be added to the FTSE WGBI, thus opening a major new section of the FI market to institutional investors.

- China has already been added to the Bloomberg Barclays Global Aggregate Index.
- China's inclusion in the FTSE WGBI points to a normalization of investment and operations, as well as a normalization of liquidity and hedging requirements.
- In addition, the broader EMD market remains of clear interest to investors, representing more than $6 trillion in investments.[3]

3 As of May 31, 2021. Source: JP Morgan.

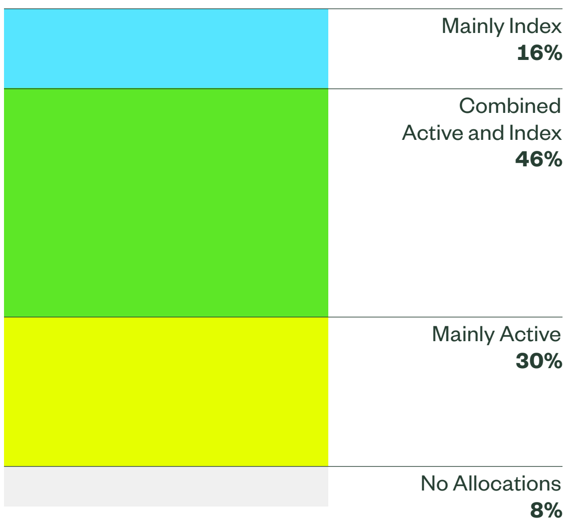
Key Findings on Emerging Markets / China

More than a quarter (27%) of survey respondents are already prioritizing development of a dedicated/standalone fixed income exposure for China over the next three years. Not surprisingly, respondents from firms with the highest AUM are more likely to be developing a dedicated China exposure than firms with the lowest AUM.

In the broader EMD space, survey respondents are most likely to use a combined active/index strategy for the EMD segment of their fixed income portfolio (see Figure 8). And overall, 42% of survey respondents indicate that they plan to increase their allocation to EMD over the next three years.

Emerging Market Debt FI Strategies: Active, Index, or Combination

Figure 8
What type of strategy does your institution use in the EMD segment of its fixed income portfolio?



Source: State Street Global Advisors. n=336.

> **“We’re comfortable making country bets and thinking about longer-term trends. Standard China sovereign bonds could be interesting. Within equity, there are more China-focused strategies, so there is more of an opportunity to specifically play different themes in China, but there’s a lot more room to grow in those products in fixed income.”**
>
> —Portfolio Manager, Pension Fund

Closing Thoughts

Institutional investors responding to our survey validated four major trends in FI investing:

- The indexed FI trend and growth trajectory are clear.
- Investors have plans to increase ETF use within their FI portfolios.
- ESG has become an essential priority for FI investors.
- China and emerging markets expect strong FI investment growth.

State Street Global Advisors is a proven market leader that can help investors capitalize on these trends with our insights and expertise. For more information, visit ssga.com/insights/fixed-income-research.

Survey Methodology

This survey was conducted in May of 2021 via an online survey instrument (n=358) and telephone interviews (n=2). Respondents were limited to senior leaders and senior portfolio managers who are directly involved in fixed income portfolio construction and investment decisions at pension funds, wealth managers, asset managers, and sovereign wealth funds.

Figure 9
Financial Services Business Types

Pension Fund	82%
Traditional Asset Management Firm	8%
Wealth Manager	6%
Sovereign Wealth Fund	4%

Figure 10
Total Assets Under Management
USD

Figure 11
Regions

Europe	59%
North America	34%
Australia	7%

Source (Figures 9–11): State Steet Global Advisors. n=358.

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- Start with rigor
- Build from breadth
- Invest as stewards
- Invent the future

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* Pensions & Investments Research Center, as of December 31, 2020.
† This figure is presented as of June 30, 2021 and includes approximately $63.59 billion of assets with respect to SPDR products for which State Street Global Advisors Funds Distributors, LLC (SSGA FD) acts solely as the marketing agent. SSGA FD and State Street Global Advisors are affiliated.

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