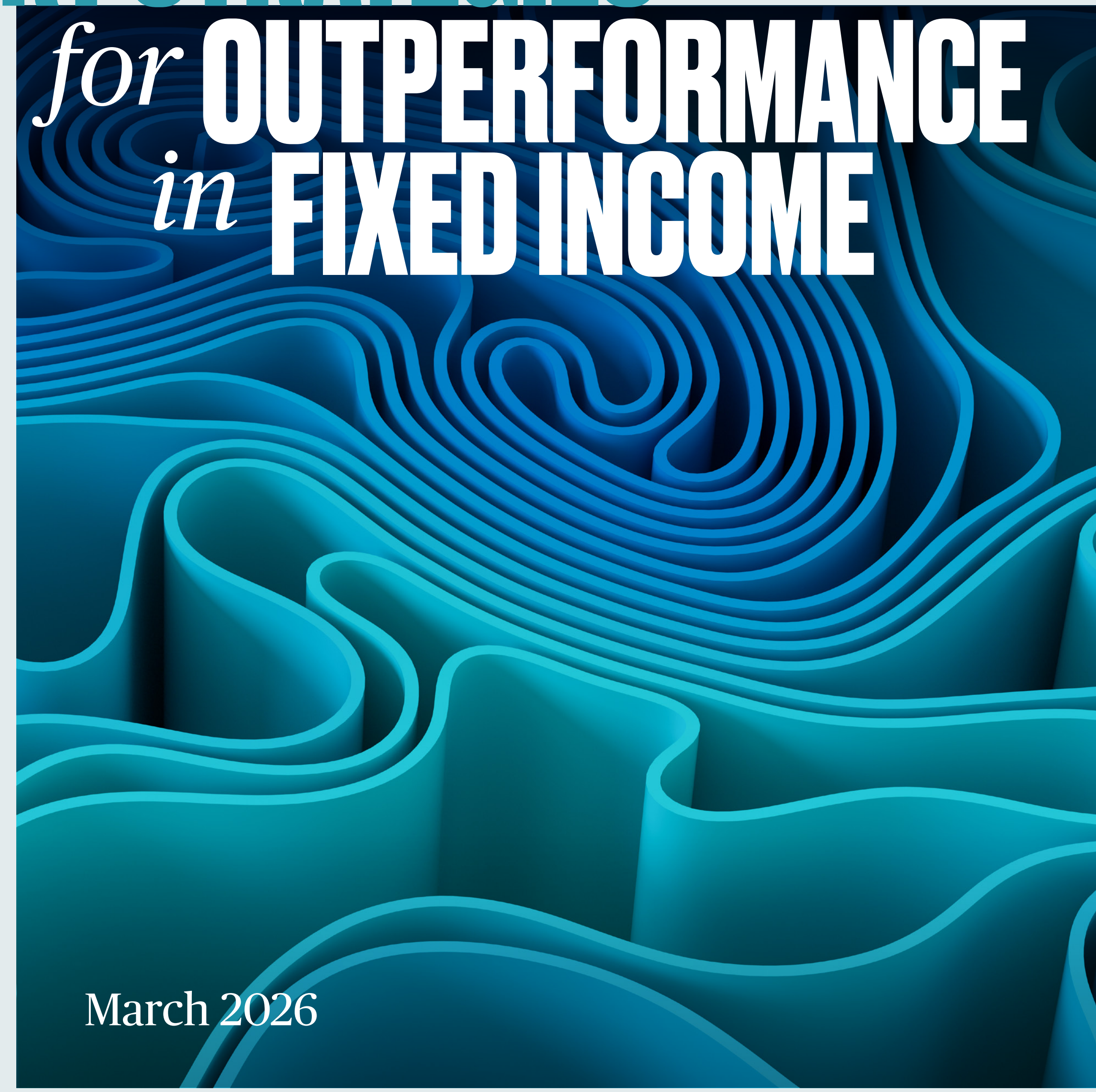
FOR INSTITUTIONAL, PROFESSIONAL, QUALIFIED INVESTORS AND QUALIFIED CLIENTS.

SMART STRATEGIES *for* OUTPERFORMANCE *in* FIXED INCOME



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BNY | INVESTMENTS

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Executive summary

- **Bond markets can provide greater scope for active management:** Fixed income markets are less efficient and transparent than equity markets. Data from Morningstar shows that active corporate bond managers have meaningfully outperformed their passive counterparts over the medium term.
- **Seven strategies skilled active managers can use when seeking to generate excess returns relative to benchmarks:**
  - → **Duration and yield curve:** Positioning based on yield outlook or yield curve shape
  - → **Security selection:** Identifying undervalued securities with strong fundamentals
  - → **New-issue premia:** Capitalising on new debt being issued at above market yields
  - → **Exploiting market fragmentation:** Seeking opportunities that stem from the fragmented nature of bond issuance
  - → **Sector strategy:** Seeking out those sectors that offer the best opportunity or avoiding those at risk
  - → **Beta management:** Adjusting credit risk exposures to take advantage of expected trends in credit markets
  - → **Relative value:** Exploiting value differences across markets
- **The hidden risks of passive investing:** Investors in fixed income should be aware of the limitations of traditional fixed income indices when following a passive investment strategy. Unlike equity indices, which favour the largest and most successful companies, fixed income indices are skewed towards entities with the most debt. The dominance of BBB-rated corporates in investment grade indices further compounds the challenge, increasing the risk of downgrades during economic stress which may force passive investors to sell at inopportune times. When combined with fees and transaction costs, we believe these factors leave many passive strategies doomed to structurally underperform.
- **Volatility is the friend of active managers:** Greater flexibility allows managers to exploit opportunities that arise from volatility, to avoid unrewarded risks, and shift to defensive assets when needed.
- **Winning by not losing:** Not all investors seek return maximisation – some just want safe, reliable cashflows. Active managers can improve returns by avoiding defaults and credit deterioration, focusing on strong fundamentals and diversified portfolios. We identify six key risks that can cause a sudden and unexpected deterioration in an issuer's credit quality and which we believe are crucial for reducing default risk.

> "Data from Morningstar shows that active corporate bond managers have meaningfully outperformed their passive counterparts over the medium term."

Active fixed income managers have greater scope to add value

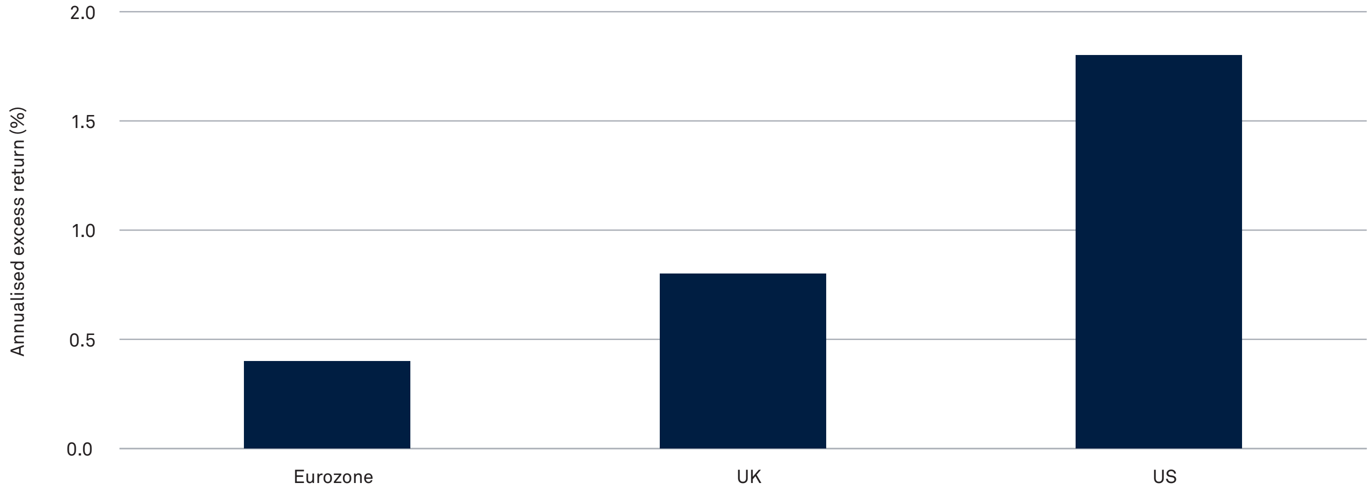
Many investors assume that active managers rarely outperform their benchmarks and often extend this belief across all asset classes. Decades of research support this view in equities, where market efficiency and transparency make it harder for active strategies to add value. But fixed income is different. Bond markets are structurally less efficient, less transparent, and far more fragmented – creating opportunities that skilled active managers can exploit.

The growth of passive investing has only amplified these inefficiencies, as index-tracking flows can distort pricing and reduce the market discipline once imposed by active investors. For example, data from Morningstar shows that European active fixed income managers have delivered meaningful annualised outperformance of their passive counterparts over the five years to June 2025 across major corporate credit markets (see Figure 1).

This ability to generate benchmark-beating returns underscores that fixed income should not be approached solely through the narrow lens of benchmark yields. Instead, manager selection becomes critical. Choosing an active manager with a robust, repeatable investment process can provide confidence that excess returns are sustainable over time.

"This ability to generate benchmark-beating returns underscores that fixed income should not be approached solely through the narrow lens of benchmark yields."

FIGURE 1: ACTIVE MANAGERS HAVE ADDED MEANINGFUL VALUE IN MAJOR CORPORATE CREDIT MARKETS



Source: Morningstar Active/Passive Barometer Mid-year 2025, published August 2025. Shows annualised performance of asset weighted active managers relative to passive managers. **Past performance is not indicative of future results. Investment in any strategy involves a risk of loss which may partly be due to exchange rate fluctuations.**

Beating benchmarks and exploiting inefficiencies

Seven strategies active managers can use to beat their benchmarks[1]

There are a range of strategies that fixed income managers can use as they seek to add value in fixed income. These include:

1. **Duration and yield curve strategies:** Active managers can strategically adjust their portfolios based on their outlook for future market interest rates and yields. If they anticipate that yields will fall, they might add longer-maturity issues, which typically benefit the most from such a scenario. More advanced approaches involve targeting specific segments of the yield curve or varying investments across different maturities. For instance, if credit spreads are relatively uniform across maturities, a manager might overweight credit exposure in shorter maturities while favouring government bonds in longer maturities. This enhances portfolio yield while minimising the impact of any future credit underperformance.

2. **Security selection via fundamental analysis:** Fundamental credit analysis aims to identify securities where the manager feels the valuations don't accurately reflect the company's current and future outlook. Issuers may be stress tested for risks such as litigation, new regulations, environmental or social factors, and potential mergers or acquisitions.

3. **Capturing new-issue premia:** Unlike equities, fixed income investments generally have a fixed maturity date. As they approach this date, the issuing sovereign or company typically needs to return to the market to refinance the debt. They may also issue new debt for various reasons, such as funding growth or acquisitions. In the corporate world, issuers often offer new debt at slightly higher yields than the market to attract buyers – a phenomenon known as new-issue premia. Active managers can capitalise on this by keeping a close eye on opportunities in primary issuance markets.

4. **Exploiting market fragmentation:** Buying an equity is usually straightforward – there is typically a single class of share to purchase. In contrast, investing in a corporate bond is far more complex. A single issuer may have numerous bonds outstanding, each with different maturities, currencies, legal terms, covenant protections, positions in the capital structure, and levels of liquidity. This fragmentation creates a wide spectrum of choices for investors and a rich opportunity set for active managers. For example, an investor seeking higher income might choose to buy a subordinated, lower-rated bond from a large, financially robust issuer. While this part of the capital structure carries greater risk of loss than senior bonds, the investor may judge that the issuer's scale, cash-generation and market position materially reduce the likelihood of a default – making the additional yield an attractive trade-off.

> "Active managers can strategically adjust their portfolios based on their outlook for future market interest rates and yields."

1 The strategies described are illustrative only. They may not be suitable for all portfolios and may not always result in positive outcomes.

5. **Sector strategy:** Entire sectors within fixed income can at times trade at valuations that bear little resemblance to the underlying strength, or weakness, of their constituent companies. This often reflects the fact that sectors move through their own economic and credit cycles, which may differ from the broader market. Some sectors may also become structurally over-leveraged, making them fundamentally less attractive from both a credit-quality and valuation standpoint. Active managers are not forced to own these weaker areas. They can step back from sectors where fundamentals are deteriorating or leverage is rising, and focus instead on those where balance sheets are strengthening or valuations more accurately reflect the risks.

6. **Beta management:** Bond indices reflect a mix of issuers and therefore a specific level of aggregate credit risk at any given moment. Active managers, by contrast, are not constrained by this risk profile. They can deliberately increase or reduce credit exposure in response to where we are in the credit cycle, prevailing valuations, or shorter-term tactical considerations. A clear illustration is the Bloomberg Aggregate Index, which blends government and corporate bonds. Active managers can tilt portfolios toward corporates when credit spreads offer attractive compensation for risk, or shift toward government bonds when economic conditions call for greater defensiveness.

7. **Relative value:** The value of fixed income instruments can vary meaningfully across regions and market segments at any point in time. For example, a large US issuer might sell bonds in US dollars, euros, and Japanese yen, with each market pricing the same credit risk differently depending on local demand, currency dynamics, and market conditions. Active managers can exploit these discrepancies by allocating more to the market where the issuer's bonds offer the most attractive relative value, and reducing exposure where pricing is less favourable – turning cross-market inefficiencies into a potential source of alpha.

Notably, these strategies can be used not just to outperform a specific benchmark or index. They can also be used by active fixed income managers seeking to generate an absolute, positive return through different market conditions.

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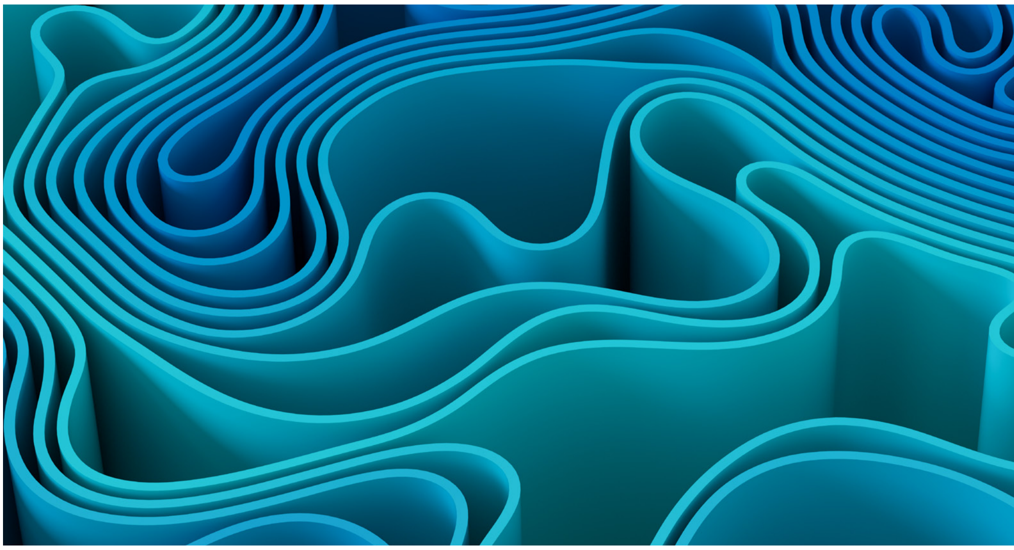


The hidden risks of passive fixed income investing

Investors in fixed income need to understand the limitations of traditional bond indices – particularly when adopting a passive approach. Unlike equity indices, which naturally tilt toward the largest and most successful companies, fixed income indices are weighted toward the biggest issuers of debt, whether governments or corporations. This means that the most indebted borrowers command the greatest importance within an index, often resulting in poor diversification and unintended concentrations in highly leveraged issuers.

Compounding the problem, the rise of passive investing has weakened the traditional function of bond markets as bond vigilantes – the market discipline once imposed when investors refused to lend to governments or companies pursuing unsustainable fiscal policies or business models. With passive funds required to hold bonds in proportion to their index weight, even heavily indebted issuers may continue to receive capital, diminishing a key source of market accountability.

Turnover in fixed income indices is significantly higher than in equity indices. Bonds routinely drop out as they near maturity or fall below the credit-rating thresholds required for inclusion, creating a structural challenge for passive investors. This issue is amplified by the growing dominance of BBB-rated corporates within investment-grade indices – a consequence of large issuers being incentivised by shareholders to operate with higher leverage. As Figure 2 shows, BBB-rated bonds now make up just under half of the Bloomberg US Investment Grade Corporate Index, while the highest-quality AAA and AA-rated bonds represent less than 10%.

This heightens the risk that even large corporates can be downgraded to below investment grade during times of economic stress, with passive investors forced to sell at the worst possible time. A combination of fees and the transaction costs needed to keep up with index changes can, in some cases, contribute to underperformance of passive funds versus their reference index.

> “The most indebted borrowers command the greatest importance within an index, often resulting in poor diversification and unintended concentrations in highly leveraged issuers.”

FIGURE 2: BBB-RATED DEBT DOMINATES THE BLOOMBERG US INVESTMENT GRADE CORPORATE INDEX

Source: Insight and Bloomberg. Data as at 31 December 2025.

Volatility is the friend of active managers

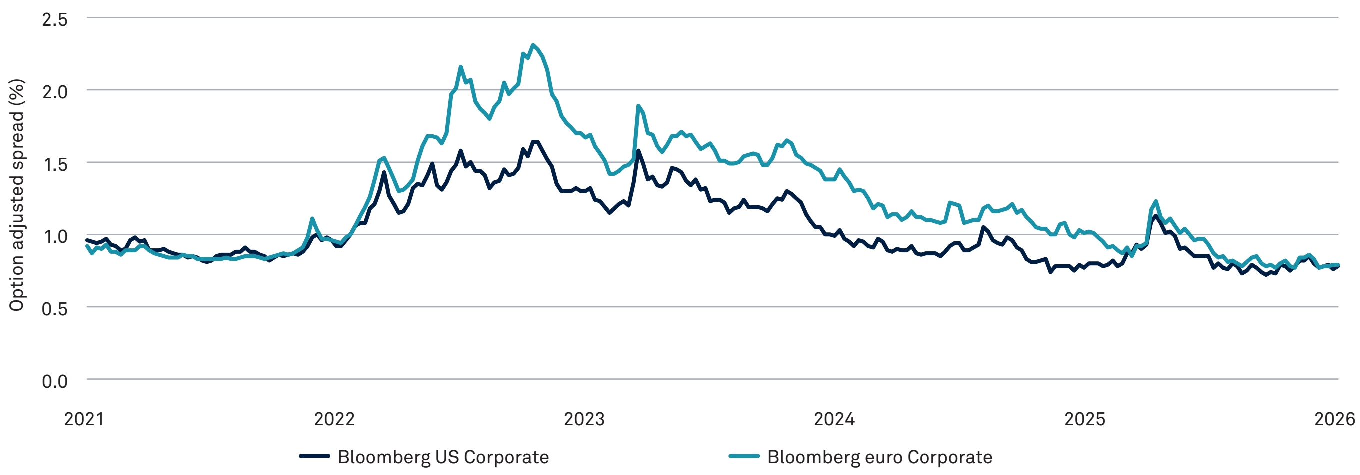
Volatility creates investment opportunities

For years after the global financial crisis, ultra-low interest rates kept market volatility in check. But as rates normalised post-pandemic, bouts of sharp volatility have returned. With today's geopolitical tensions and policy uncertainty, we expect this pattern to persist.

When market volatility rises, bonds more frequently become misvalued. Whether the market mood is fear or exuberance, any sharp market moves can become big opportunities for active managers that can take advantage of market dislocations.

Market dislocations can persist for years, creating long opportunities for patient global investors to harvest them. For example, euro-denominated corporate spreads widened versus US spreads in 2022 and took three years to realign (see Figure 3). Because many major corporates issue in both currencies, investors could overweight euro debt relative to US dollar debt – even for the same underlying issuer.

FIGURE 3: THE GAP BETWEEN US DOLLAR AND EURO SPREADS TOOK YEARS TO NORMALISE



Source: Insight and Bloomberg. Data as at 31 December 2025. Uses Bloomberg Index data in USD for all fixed income segments. **Past performance is not indicative of future results. Investment in any strategy involves a risk of loss which may partly be due to exchange rate fluctuations.**

The more flexibility, the greater the opportunity

In our view, the more flexibility an active manager has, the broader the range of opportunities they can exploit – and the greater their ability to invest with conviction when conditions are especially favourable. Flexibility also allows managers to sidestep unrewarded risks and rotate into more defensive assets or sectors when the outlook deteriorates.

Recent performance across major fixed income segments (see Figure 4) highlights just how differently markets can behave. Over 2025 returns and volatility varied markedly – illustrated by the surprising outcome that US high-yield credit delivered higher returns with lower volatility than the US Treasury Index.

An active manager can analyse the underlying drivers of these dynamics and position accordingly, seeking to capitalise on dislocations while managing downside risks. Ultimately, in fixed income, long-term outperformance is rarely the product of a single big call; rather, it comes from accumulating incremental gains across multiple sources of return.

FIGURE 4: RETURNS AND VOLATILITY VARIED ACROSS BOND MARKETS IN 2025

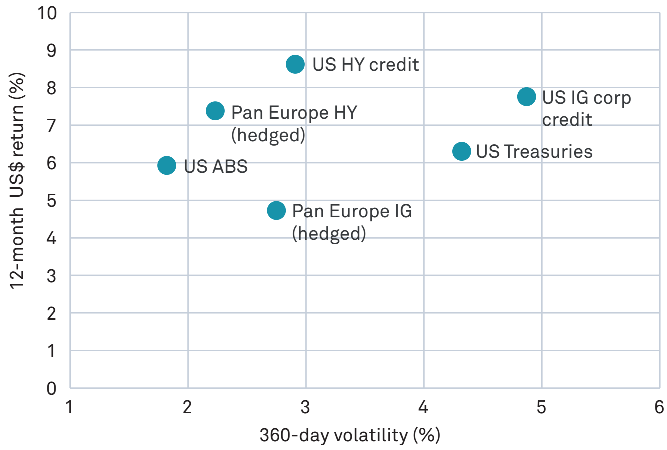
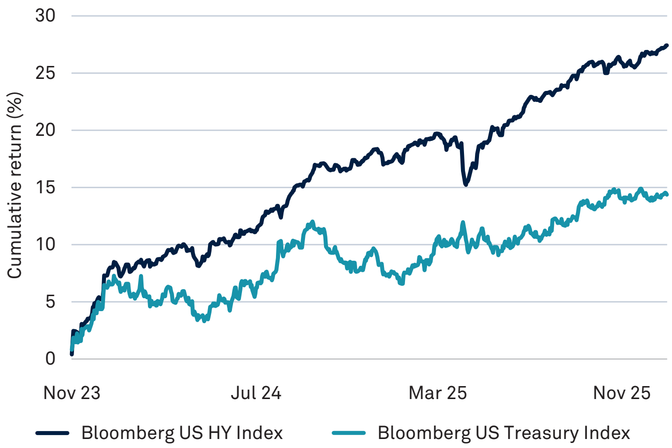


FIGURE 5: US HIGH YIELD HAS BEEN LESS VOLATILE THAN TREASURIES



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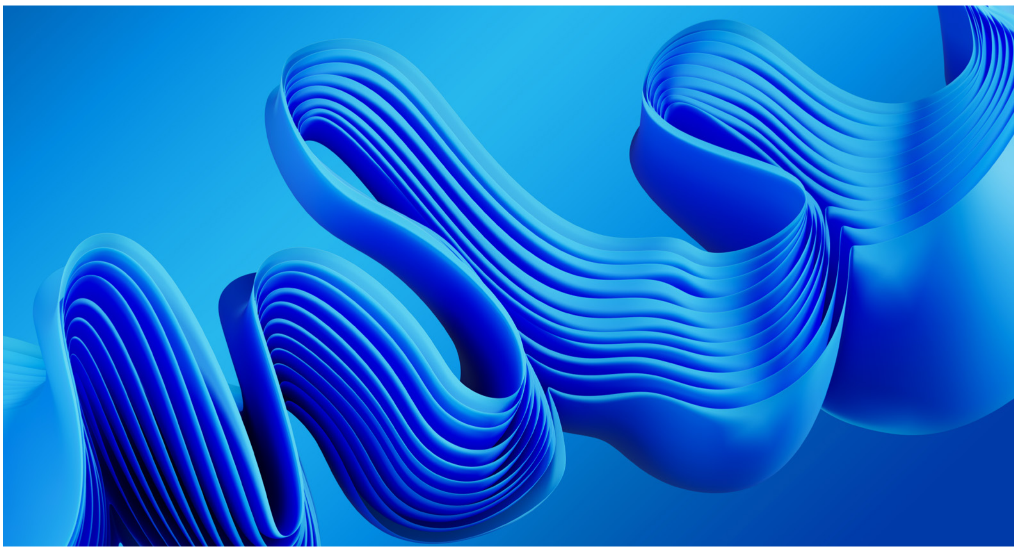

Winning by not losing

Some investors focus on cashflows rather than return maximisation

Of course, not everyone invests in fixed income with the aim of maximising returns. Many do so as they require safe and predictable cashflows over time.

For this type of investor, finding undervalued securities is not the only way to improve on passive investing. Such an improvement can also be made by creating a portfolio that aims to avoid defaults and material loss from deteriorations in creditworthiness. This is the approach used for 'buy and maintain' portfolios, where securities are selected solely because of the manager's confidence that they will provide a steady reliable income for their full term.

For buy and maintain strategies companies need to have strong stand-alone fundamentals. So, they must have sound reporting, strong risk credentials and a clear ability to repay, or hold sufficient assets to make good.

Diversification is also key to this type of strategy, with typical limits of 1% to 2% per name in a portfolio – a stark contrast to a market-weighted, index-tracking approach that would allocate more to the most indebted firms.

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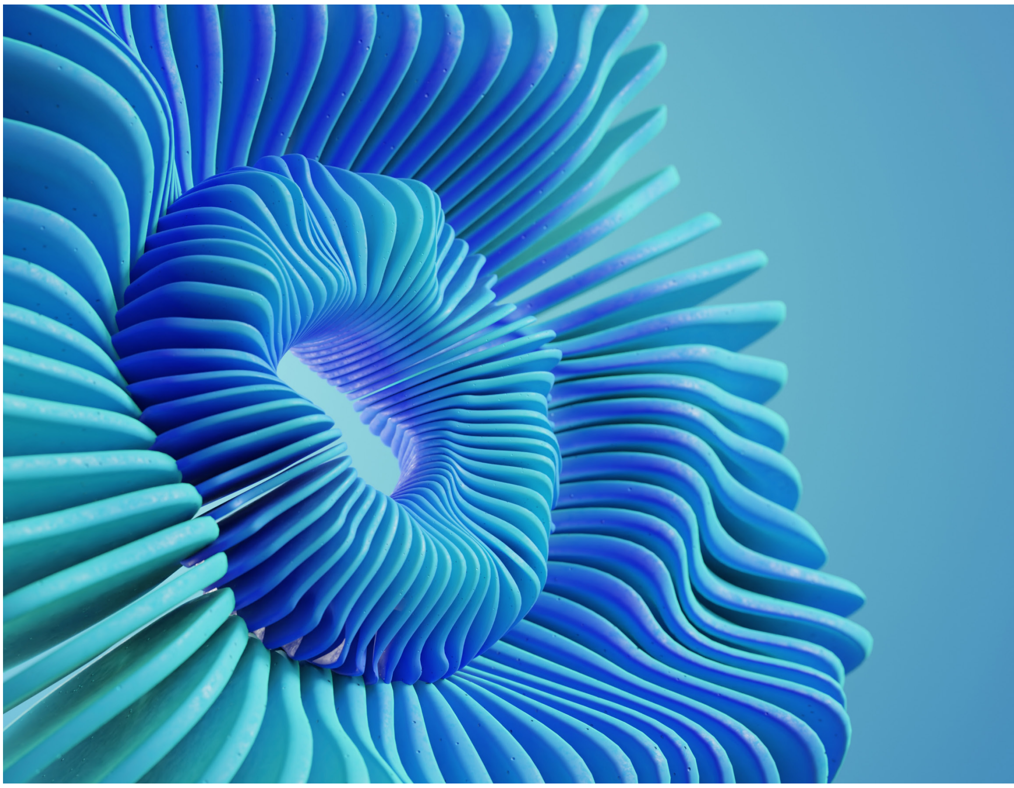

Some risks can radically and unexpectedly change credit quality

Reducing default risk is crucial when seeking to minimise the downside for fixed income investors. In our view there are six key risks that can cause a sudden, unexpected deterioration in whether an issuer can repay its debt. Understanding these risks also helps to determine whether the spread available on a security is adequately compensating for its corporate risks or not.

1. **Liquidity risk:** How likely a company is to pay the coupons on outstanding credit, and to pay back capital on maturity, even if it is unable to refinance its debt for a period of time, such as two years.
2. **Regulation and litigation risk:** Regulatory risk is largely sector dependent. Sectors with a high level of regulatory oversight, such as the utility sector, can be subject to limits on profitability or have a minimum capital expenditure requirement. Similarly, banks face a higher level of regulation since the global financial crisis. This measure also looks at the potential for a company to be subject to litigation and the risk of any ongoing legal action against the company.
3. **Environmental, social and governance (ESG) risk:** Some ESG risks can be financially material, with the potential to hurt the viability of a corporate. Where appropriate, we include information taken from Insight's proprietary Prime ESG ratings framework, which seeks to highlight financially material ESG risks and how they are being managed.
4. **Climate risk:** This measures a company's exposure to physical climate risk or transition risk due to climate in either its location, product range or supply chain. This measure can include information taken from Insight's Prime climate risk ratings framework, which gives a corporate a rating based on various data inputs in seeking to highlight its exposure to and management of climate risks.
5. **Event risk:** A key event risk is whether the company might buy another company or be bought out itself, which could significantly affect its debt burden or repayments. A late equity-market cycle with low financing costs will typically result in higher M&A activity; companies that have poor relative equity performance over one, three and five years may be at risk.
6. **Leveraged buyout risk:** This seeks to reflect a company's risk of facing a bid from a leveraged buy-out by private equity. Such a buyout can put more debt on a corporate's balance sheet such that it is less able to repay its debt in a high-interest rate environment.

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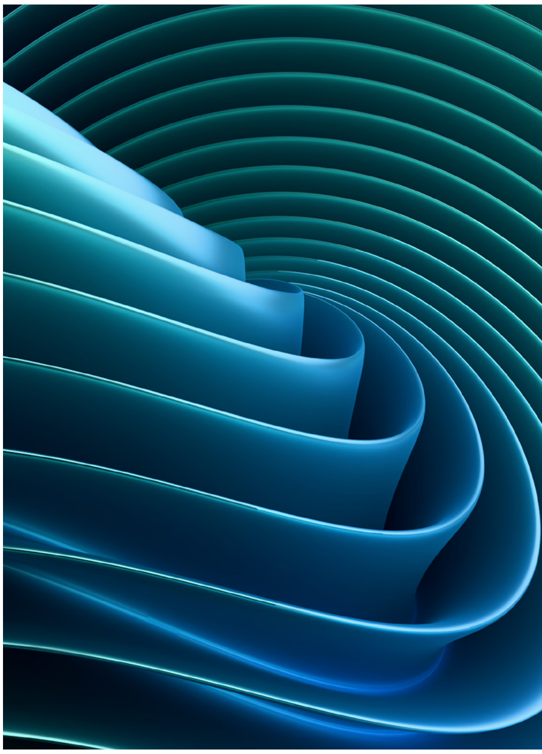

Key considerations when investing in fixed income

More broadly, there are several important considerations that can help investors form realistic expectations about the returns available from fixed income markets:

- Credit spreads are poor predictors of future returns – they provide little insight into future total returns; starting yield is what matters most, with active managers seeking to add value beyond that.
- Moderate economic growth is sufficient for credit markets; very strong growth often encourages excessive risk-taking (high capex, questionable M&A, rising leverage), which can be negative for bondholders. This stands in contrast to equity markets, which typically require stronger economic growth to drive earnings expansion and support higher valuations.
- Recession is a danger for all risk assets including credit, not because higher borrowing costs kill companies, but because liquidity can dry up, preventing refinancing. However, recession can be positive for government bond investors as falling interest rates and yields can boost returns.
- Fundamental analysis is key to avoiding defaults; aggregate defaults are not a useful indictor in determining total returns from lower grade credit, as careful analysis can help managers avoid deteriorating credits.
- Market liquidity is a key macro factor to monitor – including bank lending conditions, money supply, trading volumes, new issuance activity, deal reception, and bid–offer spreads – because liquidity determines whether companies can access cash when they need it.

Strategies that endure

Active investors have a multitude of strategies at their disposal to enhance fixed income returns. By utilising duration and yield curve strategies, engaging in meticulous security selection, capturing new issue premia, exploiting market fragmentation, and employing sector strategies, they can navigate the complexities of fixed income markets and seek to add incremental return. Managing credit beta and identifying relative-value opportunities provide further opportunities to optimise portfolios.

At Insight, we believe that when executed with precision, these approaches can significantly enhance performance in fixed income investments, whether the goal is to maximise returns or ensure steady cashflows.

When selecting an active manager, investors should focus on the manager's ability to outperform the benchmark consistently, not just occasionally. A manager who demonstrates repeated success across different market environments is more likely to have a disciplined, repeatable investment process and a thoughtful approach to risk-taking.

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