RPIA

Corporate Bond Markets

An Inefficient Asset Class

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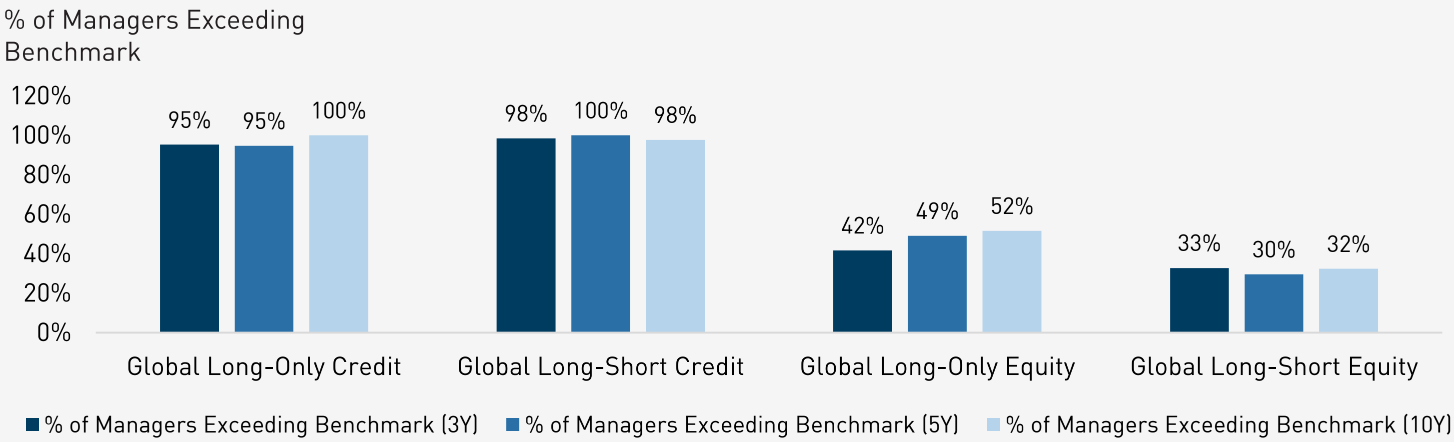
Executive Summary

- There are characteristics of corporate bond markets that make the asset class out as being as unique – and certainly unlike the equity market.
- In this white paper, we discuss some of the ways in which "bonds are different" and the opportunities that exist for active, flexible managers.
- While it may make sense for investors to invest passively in efficient and transparent markets such as equities, we believe that there is a strong case for active management in corporate bonds.

Why Corporate Bond Markets?

Corporate bonds can be attractive investments – offering investors the safety of fixed income with additional yield versus government or provincial bonds. In an environment of low government bond yields, the value proposition of corporate bonds can be particularly enticing. In what follows we will argue that corporate bond markets are inefficient in four key respects – they are opaque, there is an abundance of differentiated securities that can trade at quite different valuations, non-economic investors are abundant, and the corporate bond indices have very high turnover. We believe that these inefficiencies make the asset class even more attractive as they provide profitable trading opportunities for active managers.

Unlike Equity Managers, Fixed Income Managers Have a Strong Track Record of Beating the Passive Benchmark



Source: eVestment. Data as of February 28, 2025.
Benchmark: Fixed Income = Bloomberg Barclays Global Aggregate Corporate Bond Index; Equities = MSCI World Index.

The Corporate Bond Market is Opaque

The best way to think of this is by considering how equities are bought and sold versus corporate bonds. Let us take Canadian pipeline company Enbridge Inc. as an example. The common stock of Enbridge Inc. trades on the Toronto Stock Exchange each day between the hours of 9:30am and 4:00pm. There is a transparent price quote for the stock whether the investor is a retail investor, high net worth individual or an institution. After each trade in the stock, the information is disseminated broadly to all interested parties via platforms such as Bloomberg, Reuters or Google Finance.

The way that corporate bonds trade is quite different. There is not a centralized exchange for corporate bonds – these securities change hands following bilateral negotiations between involved parties. In practice, these negotiations happen either via telephone or increasingly via an online chatroom. The only market participants that know what has traded and at what price are the buyer and the seller involved in the trade. Different investor types can be presented with different prices as market makers use full discretion to set prices. In practice there is the strong possibility that institutional investors will be able to obtain better execution than other types of investor owing to their size and the importance of the relationship they have with the bank / liquidity-provider.

There is some transparency after a trade is executed, but the transparency is partial at best. In the US, the Financial Industry Regulatory Authority ("FINRA") requires all corporate bond trades to be reported within fifteen minutes of execution. Selected but incomplete information is then disseminated on Bloomberg which can be seen by all market participants.[1] There is less transparency elsewhere. In Canada, there is delayed reporting of all trades that clear through the Canadian Depository for Securities ("CDS"). This reporting is shared only with subscribers. Where a corporate bond trades more than once during the day, the trades are reported the following day to subscribers. Where a corporate bond trades only once that day, the trade is reported two weeks later. Again, even when reporting occurs on the following day, the information shared is incomplete.

Characteristics of Equity Markets Versus Corporate Bond Markets Benchmark

	Equities	Fixed Income
Centralized Market	✓	X
Transparent Pricing	✓	X
Post-Trade Reporting	✓	X
Equal Pricing	✓	X

The nature of the way corporate bonds change hands favors investors that have an expertise in corporate bonds, that are well-connected with long-standing relationships. These investors will likely have better access to information, pricing and liquidity. In turn, this will ensure best execution and give advantages when it comes to managing risk through adjusting the portfolio.

[1]There is limited disclosure on the size of the trade that has taken place, but the price and credit spread is shared.

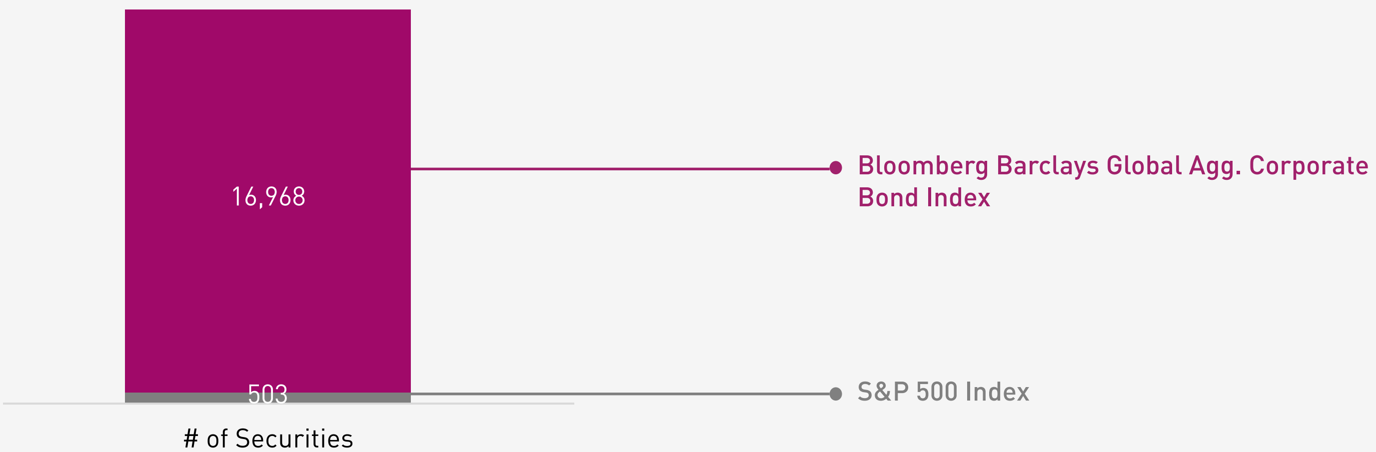
In Corporate Bonds, Security Selection Matters

Generally speaking, public companies – no matter how large – will be capitalized with a single stock. Sometimes, a company may have a listing on two exchanges, but the decision is often moot when it comes to security selection in equities. If you want exposure to the company, you have one security to buy. However, in the realm of corporate bonds, a given company can have dozens of individual securities with different characteristics.

For example, Toronto Dominion Bank ("TD") has 161 bonds with an issue size greater than 100mm across 9 currencies. This selection of securities encompasses covered bonds (securities backed by prime mortgages), senior obligations, and subordinated debt. In addition, there are 8 preferred shares, which are "bond-like" in some respects. So when choosing which security to invest in, you need to consider where you are comfortable sitting in the capital structure, what coupon you are getting paid for assuming that credit risk, and what protections you have in the event of financial difficulty. You also need to consider the liquidity of the instrument you hold, along with other features such as currency of issue and coupon type (fixed or variable).

From an investment point of view, this wider choice can bring opportunity. There may be securities in a company's debt stack that are attractively priced for the risk and others that are expensive for the risk. The job of the active manager is to sift through the debt stack and identify the right securities to buy and the ones to avoid. This is what we mean when we say security selection matters in corporate bonds in a way that it doesn't in the public equity market.

Security Selection is Relevant for Corporate Bonds in a Way it isn't for Equities



Source: Bloomberg. Data as of March 21, 2025.

Owing to the sheer abundance of securities for many issuers, at any given time there are often certain bonds that are relatively cheap and bonds that are relatively expensive. However, for a number of reasons most bond investors can't take advantage of this value. Some of these reasons are as follows:

- Investors are typically restricted to their "home" currency
- Investors often can only be "long" – so can't benefit from selling short expensive securities
- Because most managers don't have the tools to manager interest rate risk, they can only invest in select bonds circumscribed by a maturity range determined by their tolerance for interest rate risk

Non-Economic Bond Investors are Plentiful in Fixed Income

By some estimates, almost half of the stock of bonds globally are owned by "non-economic investors" – that is to say investors who are motivated by some criteria other than value.[2]

For example, central banks have always bought bonds with the goal of managing economic outcomes - whether it be currency, inflation or growth. In recent years, several central banks have gone further and have bought corporate bonds. Under the Corporate Sector Purchasing Program ("CSPP"), the European Central Bank ("ECB") spent more than 175bn from 2016-2018 buying corporate bonds with the goal of reducing borrowing costs for European companies as a way to promote economic growth. The ECB participated in every deal that met a simple set of rules,[3] without considering coverage ratios, debt to equity ratios, use of proceeds or management plans. This has led to some notably bad investments – for example being the ECB's investment in Steinhoff whose bonds dropped from $100 to $50 within six months of being issued.

Insurance companies generally find predictable income generation to be an important characteristic in the context of liability-driven investing. This is driven in large part by accounting considerations. As such, many insurance companies focus on portfolio yield as the most important thing to target, rather than total return. That is to say, these investors might be buying the highest coupon bonds, rather than the corporate bonds that offer the best value.

The reality is that even for the bond investors that aren't "non-economic investors" – the majority of the balance of investors will likely be highly constrained by a restrictive investment mandate. Most bond investors have strict rules restricting the securities they can and can't invest in – often being constrained by ratings and restricted to securities that are in the broad index. This lack of flexibility can lead to suboptimal investment decisions. The truth is, when it comes to corporate bond investing, it is actually quite rare to find a manager that invests using a value lens. It means that flexible, unconstrained managers can seek out value where they see it – as a way to benefit from the constrained actions of others.

[2]Estimate from PIMCO "Bonds are Different: Active versus Passive Management in 12 Points", April 2017.
[3]To qualify, corporate bonds had to be (1) incorporated in the Eurozone and denominated in Euros (2) Non-financial (3) investment grade with a maturity between 6 months and 31 years (4) no asset-backed or structured securities.

Benchmark Rebalancing Presents Trading Opportunities

There is constant stream of new issuance of corporate bonds – as corporations refinance existing deals that are coming due, or as corporations issue debt to make acquisitions or fund their operations. This issuance activity (the "primary market") can represent up to ~20% of the bond market's capitalization every year. As a result, a strong presence in the new issue market for an active manager can add meaningfully to return, if that manager is able to accurately identify the new issues with attractive concessions.

Furthermore, as old bonds mature and new bonds are issued, the composition of the index changes. Bond managers whose job is to match or closely track the index are forced to rebalance their portfolios on an ongoing basis to ensure they are still following the index. Their job is not to find value investments but merely to replicate a basket of the overall universe. This can be another opportunity for active managers to add value by providing liquidity to these investors.

	Equity Market	Bond Market
New Issuance Per Year	0.9%	17.5%
Index Turnover Per Year	4.4%	40.0%
Rebalance Frequency	Quarterly/Annually	Daily

Conclusion

Although global corporate bond markets are mature and liquid in nature, they are characterized by significant inefficiencies. Some of these inefficiencies derive from the nature of the underlying securities themselves, and some from the constraints placed on the vast majority of bond investors globally. These inefficiencies represent opportunity for active, expert bond investors with the skill and flexibility to capitalize. Indicative of this point is the fact that active bond managers have consistently been able to outperform passive benchmarks net of fees – something that is not the case in the equity market.

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