GAMA Fixed Income Focus – Quarterly

Bond Benchmarks: Good Servants but Bad Masters – Rethinking and Optimizing Fixed Income Strategic Allocation

Bond benchmarks provide true advantages to measure risk, compare performance, and control costs. Yet their debt-weighted construction creates structural biases. Are bond benchmarks truly the right way to invest in fixed income? And if not, what are the alternatives? What are their advantages and limitations?

- Bond benchmarks provide an indispensable framework to measure risk, compare performance, and control costs. Yet their debt-weighted construction creates structural biases that need to be properly understood.
- At GAMA, we use indices as strategic anchors with weight revisited on an annual basis but rely on active, selective management to generate alpha, enhance risk-adjusted returns, and build more resilient portfolios.

The Benchmark Question

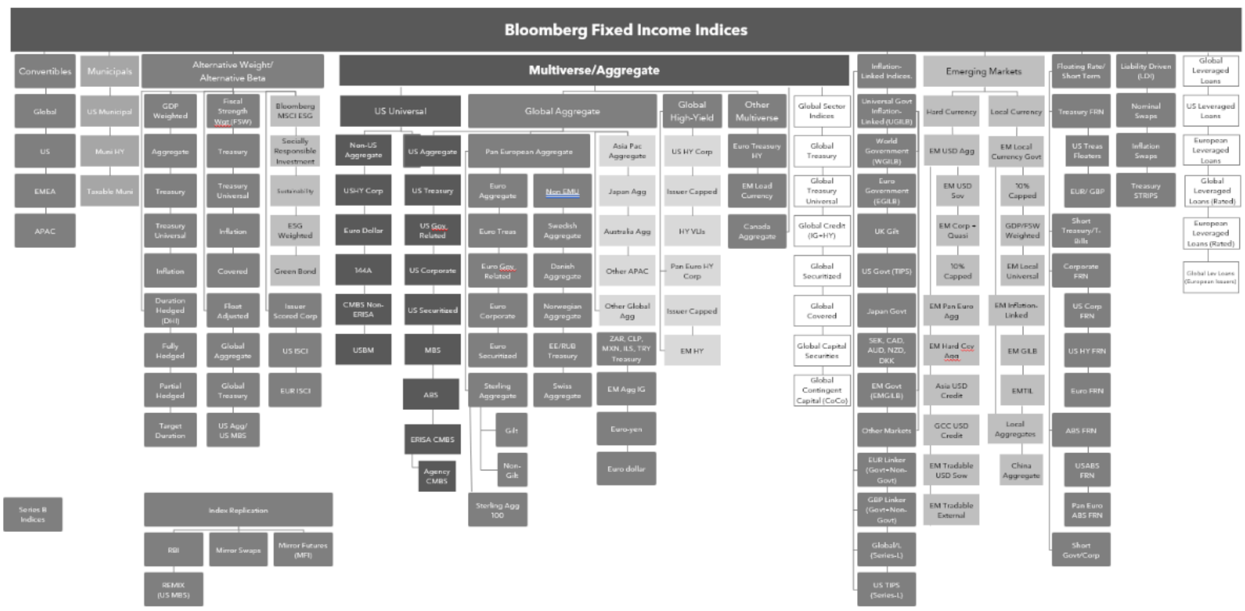
The question of benchmark choice remains central for both asset managers and asset owners, particularly as passive investing continues to gain market share. In equities, reference indices are clear and rarely challenged: S&P 500, MSCI World, EuroStoxx 50. In fixed income, by contrast, the universe is vastly more complex and fragmented. The use of benchmarks as an anchor for portfolio construction is far more controversial. With a multiplicity of issuers, maturities, ratings, currencies, and structures, bond indices can be either a valuable guide—or a restrictive straitjacket. As the debate between active and passive management intensifies, a critical question arises: are bond benchmarks truly the right way to invest in fixed income? And if not, what alternatives do investors have?

Why Benchmarks Matter ?

Benchmarks were originally designed to serve two essential purposes: risk control and performance measurement. By comparing a manager's duration, maturity structure, or credit beta against a reference index, allocators can determine the manager's true value-add.

They also provide a common language. Without an index, it would be nearly impossible to compare portfolio characteristics, returns, or fees in a standardized way. The rise of bond ETFs—transparent, low-cost, and index-linked—has democratized access to benchmarks and lowered entry costs. Finally, benchmarks are replicable: market-cap weighted indices such as the Bloomberg US Aggregate or ICE BofA Global High Yield can be readily tracked through liquid, investable ETFs.

Bloomberg Fixed Income Indices Family



Source: Bloomberg

The Limits of Debt-Weighted Benchmarks

Despite their utility, the majority of bond indices are weighted by outstanding debt. In other words, the more indebted an issuer, the greater its representation in the index. Intuitively, this is neither an objective measure of performance nor risk, and it is hardly an optimal way to allocate capital. It introduces well-known and well-documented biases.

In equities, stronger companies naturally grow their weight; in bonds, it is the largest borrowers that dominate. As a result, bond indices systematically overweight the most indebted sovereigns and corporates, regardless of fundamentals. In the Global Aggregate, France carries more weight than Germany, and Japan more than South Korea—simply because they issue more debt. The share of sovereign debt in global indices has risen to nearly two-thirds in recent years, crowding out corporates as governments ran record deficits. But is that really a sound reason to increase allocation to these segments?

The issuance effect compounds the problem: when an issuer raises more debt, its index weight rises mechanically, forcing passive investors to buy more—even if credit quality deteriorates. Heavy reliance on indices by large institutions and ETF managers amplifies global liquidity cycles and magnifies stress in crises, reinforcing macroeconomic procyclicality.

Moreover, a global bond index aggregates over 30,000 securities, compared with fewer than 1,500 stocks in the MSCI World. Constant inflows of new issues and redemptions make them difficult to replicate, particularly for smaller mandates. Some indices even exclude bonds with maturities below one year, compelling passive investors to sell prematurely and incur unnecessary costs.

Beyond Debt Weighting: Alternative Approaches

To address these shortcomings, academics and asset managers have proposed alternative approaches:

- Fundamental or “smart beta” indices: weighting by GDP, fiscal strength, or balance sheet quality rather than debt issuance. This mitigates debt bias, but quality does not always equal performance. In fact, some of the best opportunities have come from deleveraging stories, such as Greek debt post-2012 restructuring. Excluding Greece or Italy in recent years would have been costly; excluding France or Japan would have been beneficial this year.
- Risk-balanced indices: distributing risk more evenly across duration, credit, and sectors, or applying a “risk parity” framework to bonds.
- Factor indices: systematically capturing value, carry, and momentum factors in bonds—well documented and increasingly applied.

Yet these new indices remain niche. They are complex, harder to follow, and difficult to replicate at scale.

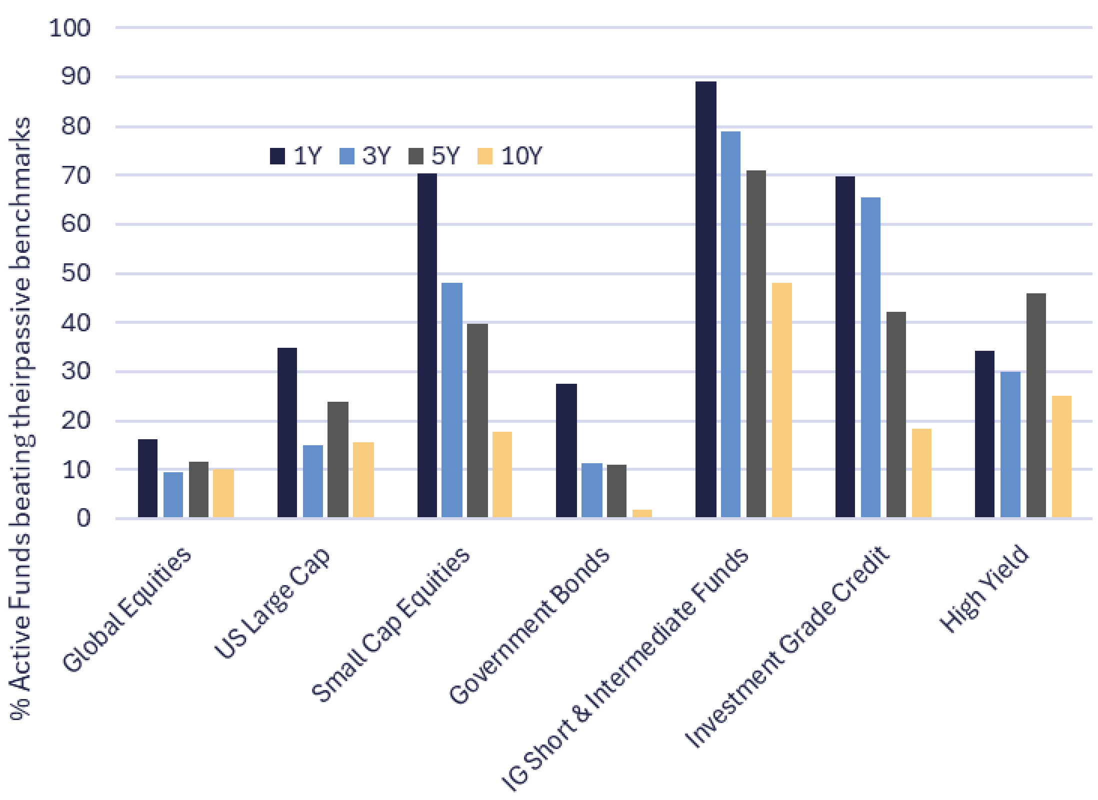
Active vs. Passive: What the Evidence Shows

The debate is particularly acute in fixed income. Unlike equities, where passive strategies dominate, bond markets remain fertile ground for active management: more than two-thirds of bond funds are actively managed. Studies confirm that, on average, bond managers are more likely to outperform after fees than equity managers.

The evidence, however, is nuanced. Outperformance is more likely when dispersion is high and defaults are rare (BB/BBB bonds, emerging markets). Conversely, the likelihood of outperformance shrinks in homogeneous segments (sovereigns) or in high-yield areas with elevated default risk. As we detailed in a previous GAMA Quarterly (A Case for Active Bond Management), structural inefficiencies in fixed income create more opportunity for skill to shine than in equities.

Still, the momentum behind passive strategies is undeniable. ETFs and index funds continue to capture flows at the expense of active managers.

Active Management Outperformance Rate vs. Passive (Post-Fees, Survivor Bias Adjusted)



Sources: GAMA, S&P Global, data as of 31.12.2024

When Benchmarks Help – and When They Don't

Benchmarks remain indispensable for governance, transparency, and cost control. They work well for:

- tracking broad market characteristics,
- offering a representative view of a market segment,
- replicating systematic exposures.

But they are less relevant when:

- structural biases distort exposures (overweighting indebted borrowers),
- investor goals are liability-driven or cash-flow specific,
- markets are inefficient (high yield, EM, structured credit) where skilled managers can add value.

GAMA's Approach: Strategic Anchor, Selectivity, and Agility

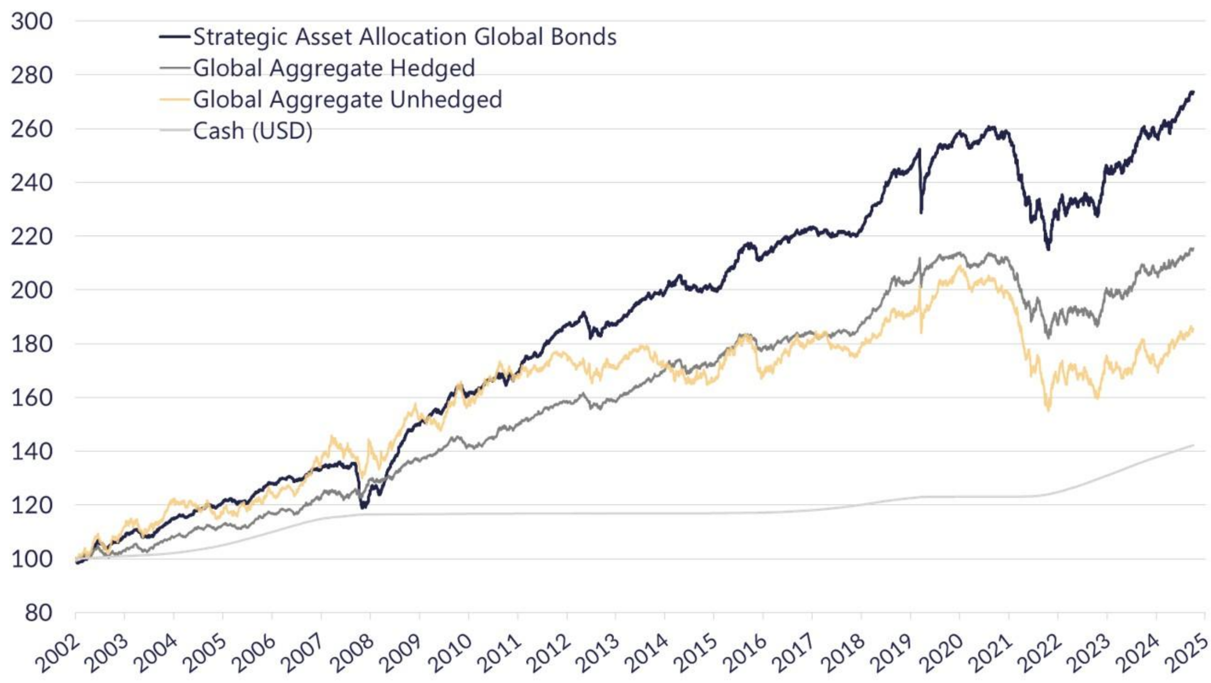
At GAMA, we regard benchmarks as useful references, but not as portfolio blueprints. They define our long-term risk budgets and provide strategic anchors, but they do not dictate portfolio construction.

Our objective is to design portfolios with the same risk profile as leading global indices, but with superior expected risk-adjusted returns. We seek to add value where alpha opportunities are proven: selective crossover credit (BB–BBB), EM sovereigns, or targeted high yield pockets.

Unlike equities, where missing the top 5% of winners ensures underperformance, in credit markets a disciplined manager focused on fundamentals can simply avoid the weakest 5% and generate superior results.

Agility is key: trimming exposures where valuations are stretched, reallocating capital where risk premia are attractive, and integrating both fundamental and systematic approaches to enhance resilience. For example, in 2023 we exited Japanese sovereigns, given their enormous debt load (>200% of GDP) and unattractive yields relative to OECD peers. We also favor indices with caps on EM local-currency debt, to improve diversification and robustness.

GAMA Strategic Asset Allocation and traditional industry benchmarks ("Global Aggregates")



Sources: GAMA, Bloomberg

Conclusion: A Good Servant, a Bad Master

Bond indices are unavoidable but far from efficient. They provide discipline and comparability, but their debt-weighted design systematically favors the most indebted issuers and amplifies cycles. Using them wisely is more art than science, requiring a solid fundamental framework.

At GAMA, we advocate a flexible, active approach built around an annually reviewed strategic allocation. Where alpha is scarce, passive exposure has its place. But where dispersion and inefficiencies abound, disciplined active management remains essential.

The ultimate goal is not merely to outperform an index, but to ensure investors allocate capital optimally: delivering superior risk-adjusted returns, building more resilient portfolios, and allocating resources more efficiently.

In that sense, a bond index is much like money itself: an excellent servant—but a very poor master.

Manuel Streiff – Founding Partner, Portfolio Manager, GAMA Asset Management

About GAMA

GAMA, an asset management company based in Geneva and founded in 2019, specializes in global bond management. GAMA is majority-owned by its investment team. In addition to striving for excellence in performance, as is typical for any asset manager, GAMA also offers strategy and bond management services for institutional and professional investors. GAMA stands out for its independence and high level of transparency in management, processes, and tools made available to its partners. In an increasingly challenging and complex low-yielding environment, GAMA provides best-in-class asset management solutions as well as bespoke investment services tailored to meet clients' expectations. GAMA is regulated by the FINMA.

About the author

Manuel Streiff, CFA, FRM

Prior to co-founding GAMA in 2019, Manuel spent 18 years at Banque Lombard Odier & Cie, where he headed the fixed income franchise of the private bank. The solid unconstrained investment framework he established led to successful performance and asset growth. He was also a member of the Bank's investment committee. Manuel began his career at Synthesis Bank, where he launched and managed a global bond fund.

Manuel holds a Master in International Relations from the Graduate Institute of International and Development Studies (IHEID) in Geneva. He has been a CFA charterholder since 2003 and an FRM charterholder since 2007.

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