portfolio construction forum

Market cap-weighted bond indices - always tough to beat

Michael Furey | Delta Research and Advisory | 28 July 2014

The common criticism of market-cap weighted bond indices is that they are inefficient because they are obviously weighted towards those entities with the most debt - thus, indicating that the index potentially carries more risk than necessary or than we may want in a portfolio, because those entities with the most debt carry greater default risk than those with very little debt.

Although there is definitely logic to this argument, it misses one essential ingredient - price. If those entities with the most debt are priced appropriately such that the price reflects all risks, then an argument of inefficiency is irrelevant.

On the other hand, if there is mispricing, it doesn't mean a bond index fund is a bad place to invest - or that it is easily outperformed. Generally speaking, aside from lower fees, if the mispricing favours an overweight position to higher market cap securities, then the index will be very hard to outperform given the high weighting towards cheap assets. Active management has its best opportunity to outperform the index if the mis-pricing is such that the higher market cap securities are over-priced and, given those securities are typically the most traded and therefore (in theory) most efficient, it still becomes a difficult task for the active manager to outperform the index.

So it is not surprising that bond managers have significant difficulty in outperforming a market cap-weighted benchmark - despite the more frequent agreement among investment professionals that bond indices are more flawed than equity indices (see Figure 1).

Figure 1: Percentage of funds outperformed by the Index

Fund Category	Comparison Index	1 Yr (%)	3 Yr (%)	5 Yr (%)
Australian Equity General	S&P/ASX 200 Accumulation Index	32.21	62.83	69.67
Australian Equity Small-Cap	S&P/ASX Small Ordinaries Index	5.41	10.58	17.12
International Equity General	S&P Developed Ex-Australia LargeMidCap Index	77.63	84.31	75.69
Australian Bonds	S&P/ASX Australian Fixed Interest Index	44.62	83.64	54.55
Australian Equity A-REIT	S&P/ASX 200 A-REIT	59.60	73.68	59.05

The safety cushion represents how many basis points in yield rise would trigger a price decline that would wipe out one year's worth of yield.

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