Weitz | INVESTMENT MANAGEMENT

# ACTIVE FIXED INCOME: Unlocking Diversification, Flexibility, and Results

SEPTEMBER 2025

## Executive Summary

Passive investing has transformed capital markets over the past several decades, offering investors a low-cost, rules-based approach to broad market exposure. Nowhere has this been more disruptive than in equities. But as passive strategies have migrated into the complex and fragmented fixed income market, they face significant structural limitations.

This piece examines the inherent constraints of passive fixed income investing—most notably through the lens of the Bloomberg U.S. Aggregate Bond Index ("the Agg")—and contrasts them with the structural advantages of active bond management. We explore how active managers are better equipped to navigate volatility, adjust for changing credit and interest rate environments, and tap into a broader, more diverse set of opportunities.

Importantly, we also present compelling historical performance data demonstrating that active fixed income strategies have prevalently delivered higher risk-adjusted returns over time. In an increasingly dynamic bond market, flexibility is not just an advantage—it's a requirement. Active managers bring both the tools and the flexibility to navigate what's next.

## The Rise of Passive Investing - And its limits in fixed Income

The modern passive investing movement began in earnest with the 1976 launch of what is now the Vanguard 500 Index Fund. John Bogle's idea—to offer investors a low-cost way to track the performance of the S&P 500—was transformational. Over time, indexing expanded across asset classes and vehicles, fueling a massive shift in investor behavior.

In equities, this shift has been especially pronounced. Passive strategies have become dominant, thanks in large part to the liquidity, transparency, and replicability of major stock indices. Fixed income markets, however, are fundamentally different.

Despite their growth, passive bond vehicles face distinct challenges when it comes to replicating broad fixed income exposure. Bond indices are far more complex than their equity counterparts—featuring tens of thousands of individual securities, many of which may be illiquid or infrequently traded. As a result, index replication typically relies on statistical sampling, introducing the potential for mismatch, tracking error, and distortion.

Passive fixed income strategies have become increasingly popular—mirroring the growth of passive equity investing. But this expanding adoption masks a critical issue: passive bond investors are locked into the index—regardless of its composition, sector risks, or embedded inefficiencies. They cannot avoid troubled sectors or pursue undervalued opportunities. Most importantly, they cannot reposition dynamically in response to changing market conditions.

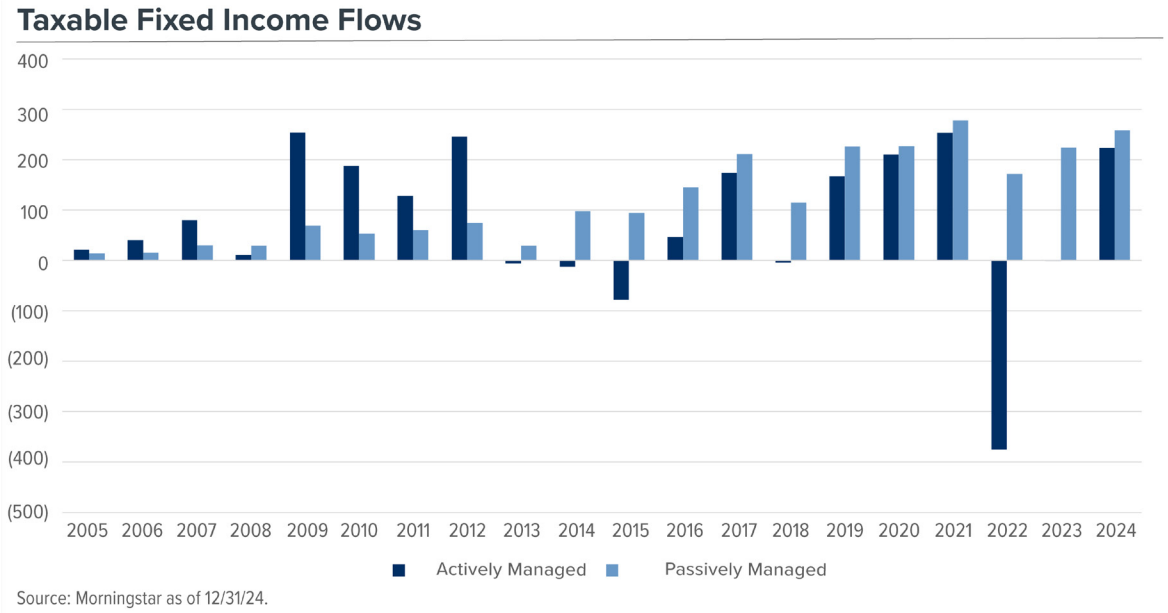
These limitations matter. And in a market as dynamic and nuanced as fixed income, they can materially affect outcomes.

## The Bloomberg U.S. Aggregate Bond Index (AGG): A Closer Look

### Origins and Dominance

Long before the passive equity revolution, the seeds of bond indexing were planted by Kuhn, Loeb & Co., which developed three U.S. bond indices in the early 1970s. Lehman Brothers later acquired the firm, ultimately laying the foundation for the Lehman Aggregate Index in 1986. Bloomberg assumed responsibility for the index in subsequent years and retroactively extended its history to 1976, renaming it the Bloomberg U.S. Aggregate Bond Index (the "Agg").[1]

Today, the Agg stands as the most widely tracked bond benchmark in U.S. financial markets. As of December 31, 2024, total assets invested in passively managed taxable bond funds—including both ETFs and mutual funds—reached nearly $2.5 trillion. Of that total, more than $938 billion specifically tracked the Agg. Passive fixed income strategies continued to grow in 2024 with $258 billion in net inflows, while active strategies made a stark reversal from previous years, attracting $224 billion.[2]




Source: Morningstar as of 12/31/24.

But beneath this popularity lies a benchmark with critical design flaws—flaws that create both limitations for passive investors and opportunities for active managers.

## How the Index Is Constructed

The U.S. bond market is comparable in size to—and at times larger than—the U.S. equity market, with a far more fragmented structure. [3,4] To capture that complexity, the Agg includes pricing for more than 10,000 securities.

This scale makes replication nearly impossible. While an equity index fund tracking the S&P 500 can hold every stock in the index with exact or near-exact weights, no bond index fund manager can reasonably purchase and manage 10,000 unique securities. Instead, passive bond funds must use statistical sampling to approximate the index's performance—introducing a higher potential for tracking error than is typical in passive equity investing.

Additionally, the Agg assigns weight to individual securities based on the amount of debt outstanding—meaning securities issued in larger sizes represent a greater share of the index. This structure results in heavier exposure to issuers that borrow more frequently or in greater amounts, regardless of their financial condition, credit quality, or balance sheet strength.

Inclusion thresholds also skew exposures: the Agg requires at least $300 million outstanding for government or corporate bonds and $500 million for asset-backed or mortgage-backed securities.[5] This concentration bias may result in unintended exposure to highly leveraged entities or sectors with deteriorating fundamentals.

## The Agg's Blind Spots: What It Misses

As of year-end 2024, the Agg included more than 10,000 securities but still covered only a portion of the U.S. bond market:

- It represented approximately $31 trillion in market value, compared to $59 trillion for the total U.S. bond market.[4,6]
- It excludes all high yield debt, a market valued at over $1.4 trillion.[6]
- It omitted floating-rate debt—such as bank loans—representing another $1.4 trillion in assets.[7]

This narrow composition limits the index's effectiveness as a proxy for the full bond universe. The absence or underweighting of key areas, such as high yield, municipals, floating-rate and asset-backed securities (ABS), reduces the Agg's ability to diversify across different interest rate and credit environments. These underrepresented segments

| | Investment-grade Debt | Mortgage Debt | Government Debt | Agency Debt | Asset-backed Debt | Municipal Debt | High Yield Debt |
|---|---|---|---|---|---|---|---|
| **Bloomberg Agg** | 24.3% | 26.7% | 46.5% | 1.3% | 0.5% | 0.8% | 0.0% |
| **Total U.S. Market** | 16.6% | 20.5% | 47.5% | 3.4% | 2.7% | 7.0% | 2.3% |

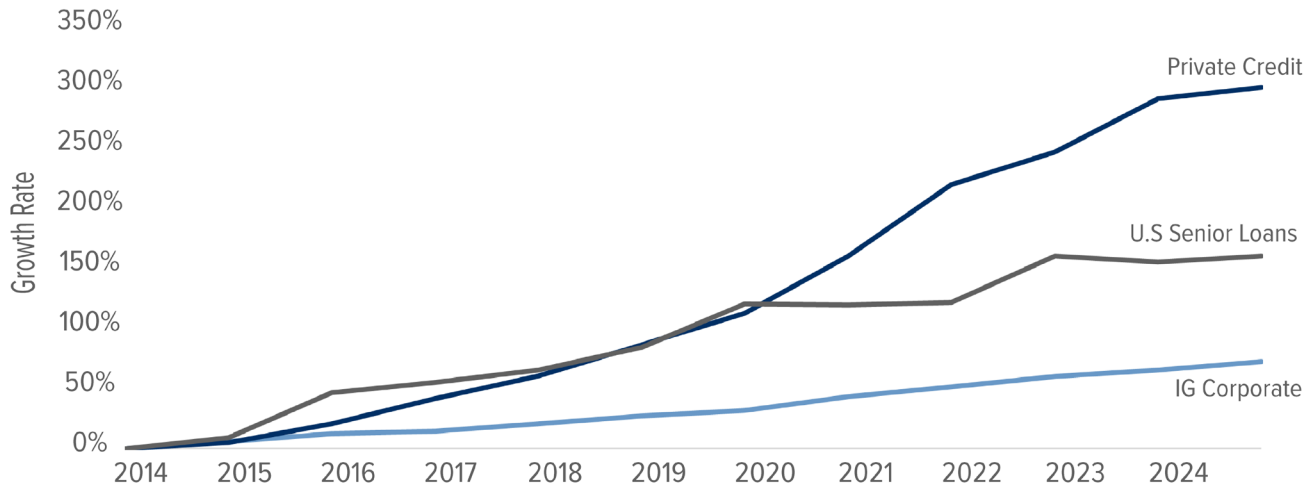
Source: SIFMA, Bloomberg as of 12/31/24. Market value of U.S. bond market excludes cash, money market instruments and high yield securities. Numbers may not add to 100 due to rounding.

comprise meaningful slices of the total market that offer important sources of diversification and return potential.

At the same time, the Agg does not reflect the growing importance of private credit and senior loans in the market. As shown in the chart below, private credit and senior loans have dramatically outpaced investment-grade corporates in growth over the past decade.

Institutional and retail demand for yield, diversification, and credit exposure has driven expansion in these sectors. Yet passive strategies tied to the Agg remain structurally constrained from accessing them. As investment banks play a smaller role in dominating new issuance, the case for moving beyond traditional investment-grade corporates has only strengthened.

**Private Credit & Loans Outpacing IG Corporate Debt**




Source: Data as of 12/31/2024. Private Credit is represented by the sum of all private debt sponsors in the Preqin data base, U.S. Senior Loans are represented by the Morningstar/LSTA Leveraged Loan Index, IG Corporate is represented by Bloomberg US IG Corporate Index.

## The Agg's Structural Limitations: Inflexibility and Inefficiency

The fixed income market is structurally different from equities. It is vast, fragmented, and at times opaque—many bonds don't trade daily, and in many cases pricing relies heavily on models rather than observable transactions. This makes the market inherently inefficient.

For active managers, this inefficiency presents opportunity: to identify mispricings, avoid overpriced or illiquid securities, and uncover relative value across sectors, issuers, and structures.

Passive strategies, however, are not equipped to respond. Indexes like the Agg must incorporate models into pricing for illiquid securities—potentially introducing valuation inaccuracies across the portfolio. And because passive funds must adhere strictly to their benchmark's composition and weights, they lack the flexibility to respond when conditions change such as credit quality deteriorates, interest rates shift, or volatility spikes.

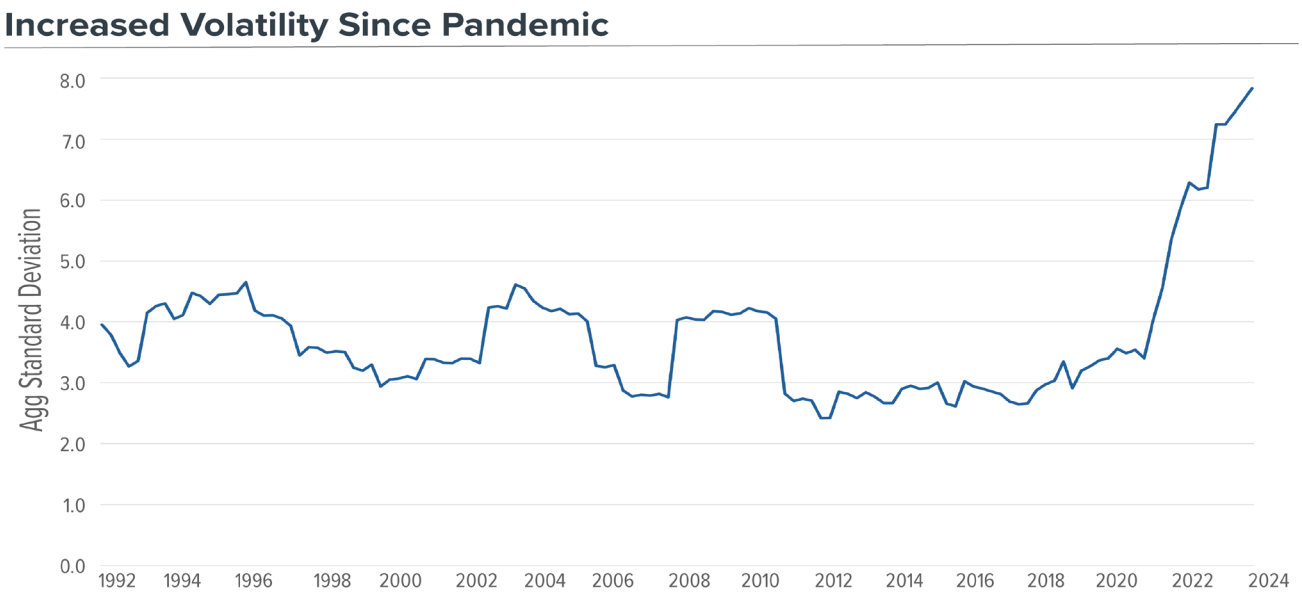
In contrast, active managers can:

- Adjust security selection and sector exposures
- Manage duration and yield curve positioning
- Reallocate based on macro or credit trends
- Hold cash tactically or employ derivatives
- Invest beyond the index in floating-rate, high yield, or private credit

This flexibility is not just a source of potential return—it's a critical tool for managing risk and aligning portfolios with the realities of today's bond market. Passive strategies, by design, lack this adaptability.

## Volatility: Another Challenge for Passive Bond Investors

Volatility in fixed income markets has increased significantly in recent years, and the Agg has not been immune. Historically seen as a relatively stable benchmark, the Agg has exhibited notably higher levels of volatility since the COVID-19 pandemic.




Source: Bloomberg as of 12/31/2024.

Several structural shifts contributed to this change:

- Unprecedented government stimulus and deficit spending
- Persistent inflation pressures
- A rapid sequence of Federal Reserve rate hikes beginning in 2022

These forces collectively drove bond yields higher and created instability across interest rate-sensitive sectors. The Agg—weighted heavily toward Treasuries, mortgages, and investment-grade corporates—absorbed much of that volatility.

Even after inflation began to moderate and the Fed signaled the end of its hiking cycle, volatility persisted. Over the course of 2024, the 10-year U.S. Treasury yield climbed approximately 70 basis points, rising from about 3.88% at the start of the year to around 4.58% at year-end.[8] Such pronounced movement—within what was once a relatively stable asset class—can significantly affect portfolio duration, price sensitivity, and risk profiles.

Active managers are not immune to volatility, but they have tools to respond. By adjusting sector exposure, managing duration, reallocating across the curve, and investing in floating-rate or non-core segments, active managers can help smooth the ride and potentially reduce the impact of rate-driven swings.

Passive investors, however, must ride out the volatility embedded in the index—with no option to sidestep duration risk, de-risk certain exposures, or seek alternative income streams.

## Actived Fixed Income Investing: Exploring the Benefits

The inherent flexibility of active fixed income investing is more than a theoretical advantage—it's a practical one. In contrast to passive strategies tied to the Agg, active managers have the discretion to adjust exposures, mitigate risk, and pursue value across a wider set of opportunities.

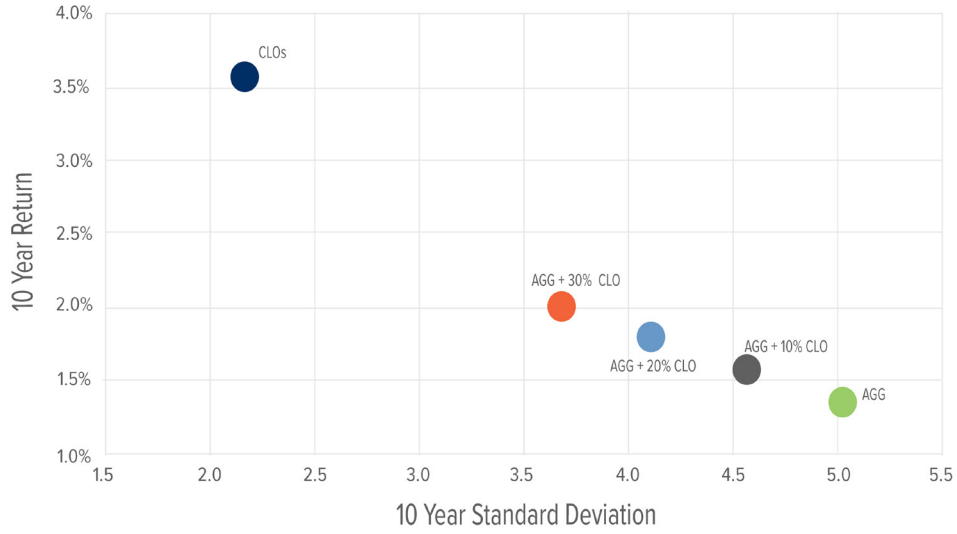
### Risk Mitigation

Passive investing may feel inherently less risky—eliminating manager discretion and following established benchmarks. But in fixed income, that intuition can be misleading.

The Agg's volatility has structurally increased in recent years, and its limited diversification can leave investors more exposed to concentrated risk in Treasuries, mortgages, and investment-grade corporates. Active managers, by contrast, have the ability to proactively shift out of vulnerable sectors and invest in securities outside the Agg—such as floating-rate debt or collateralized loan obligations (CLOs)— offering additional levers for managing risk and stabilizing returns.

For example, as illustrated below, adding investment-grade CLOs to a portfolio tracking the Agg could have lowered overall volatility and improved returns over the past decade.

**Adding CLOs Provided Better Outcomes and Yields**




Source: Bloomberg as of 12/31/2024.
CLOs are represented by Palmer Square CLO Senior Debt Index

Similarly, floating-rate securities have historically offered reduced interest rate sensitivity and provided a valuable counterweight during periods of rising yields. When thoughtfully combined with fixed-rate exposure, these instruments can improve a portfolio's risk-return profile without sacrificing income potential.

| | 10 Year | |
|---|---|---|
| **Index** | **Return** | **Standard Deviation** |
| ICE BofA Fixed & Floating Rate ABS | 2.31% | 2.01 |
| Bloomberg US Aggregate Bond | 1.35% | 5.03 |
| Bloomberg MBS Conventional 30 Year | 0.90% | 5.33 |
| ICE Bof A US Corporate | 2.52% | 6.77 |
| ICE BofA US High Yield | 5.08% | 7.65 |

Source: Morningstar as of 12/31/24.

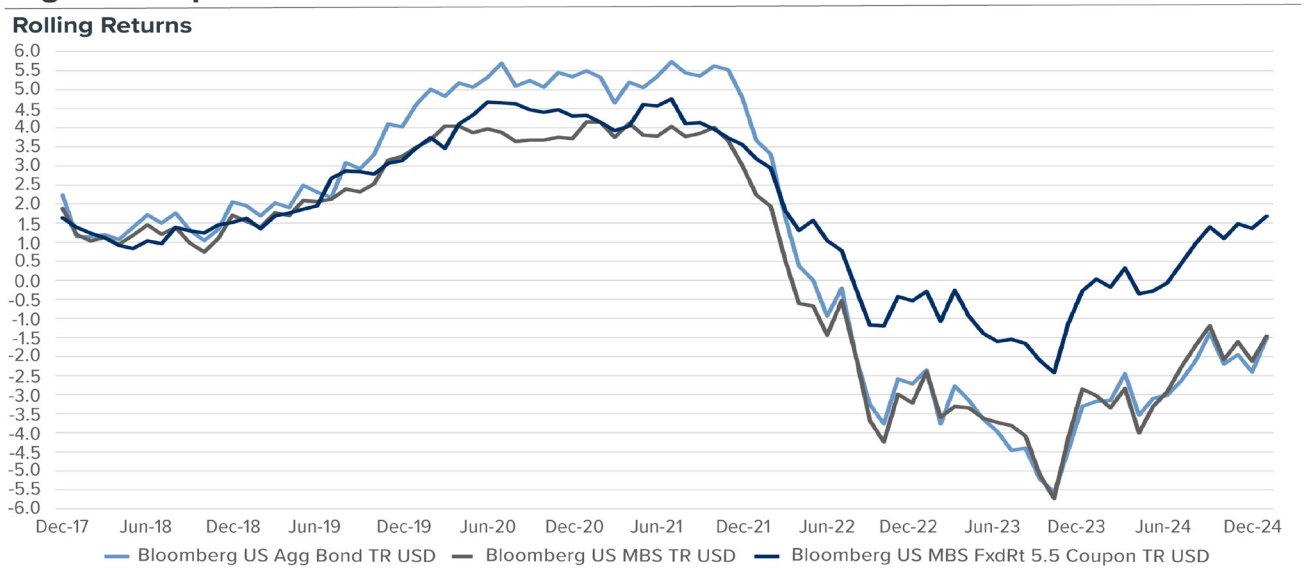
## Alpha Opportunities from Casting a Wider Net

Passive strategies are bound to index holdings—regardless of valuations or risk. Active managers, by contrast, are unconstrained.

By deviating from the Agg's sector weights, adjusting security selection, and incorporating non-index holdings, active managers can generate excess return—or alpha—across a wide range of market environments.

The mortgage-backed securities (MBS) market offers a timely illustration. From 2018 through early 2022, higher coupon MBS generally underperformed their lower coupon counterparts. However, as the Fed began raising rates in March 2022, that relationship reversed. Higher coupon MBS—less sensitive to prepayment and extension risk—began to outperform both the Agg overall and the MBS portion of the Agg. An active manager who shifted MBS exposure to higher coupon securities over the past two years likely outperformed not only the Agg's MBS exposure but the entire index as well.

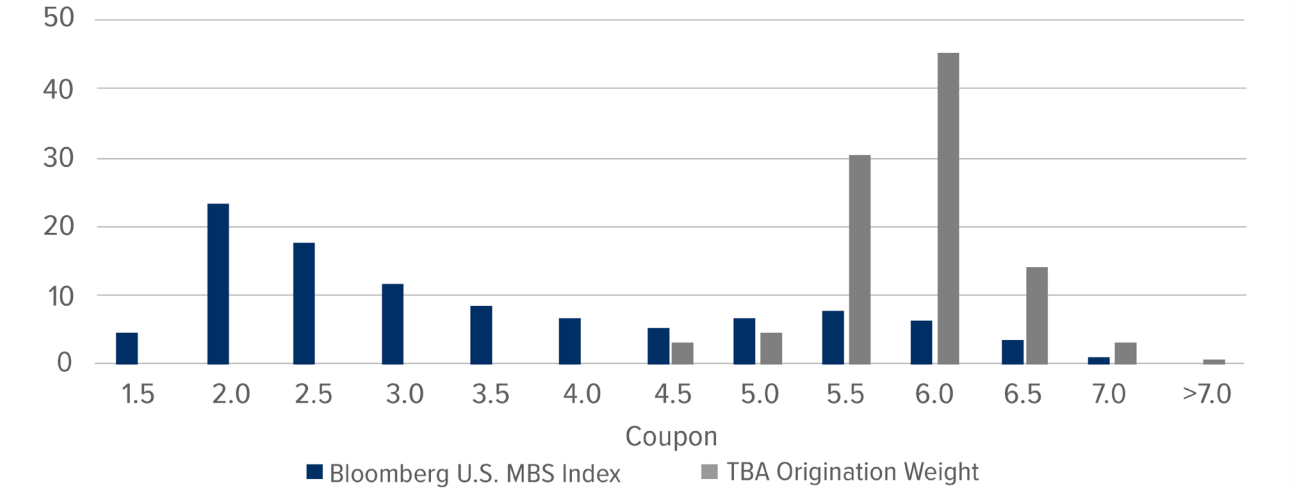
### Higher Coupon MBS: Resilience Amid Fed Rate Hike




Source: Bloomberg as of 12/31/24.

Rising interest rates in 2022-2023 led to a sharp decline in mortgage origination, leaving the Agg heavily weighted toward lower coupon MBS. Meanwhile, as illustrated in the chart below, MBS originated at the end of 2024, represented by the "to-be-announced" (TBA) market have significantly higher coupon rates, making them an increasingly attractive and dominant segment of the fixed income market.

### Coupon Distribution of MBS Index vs. Originations



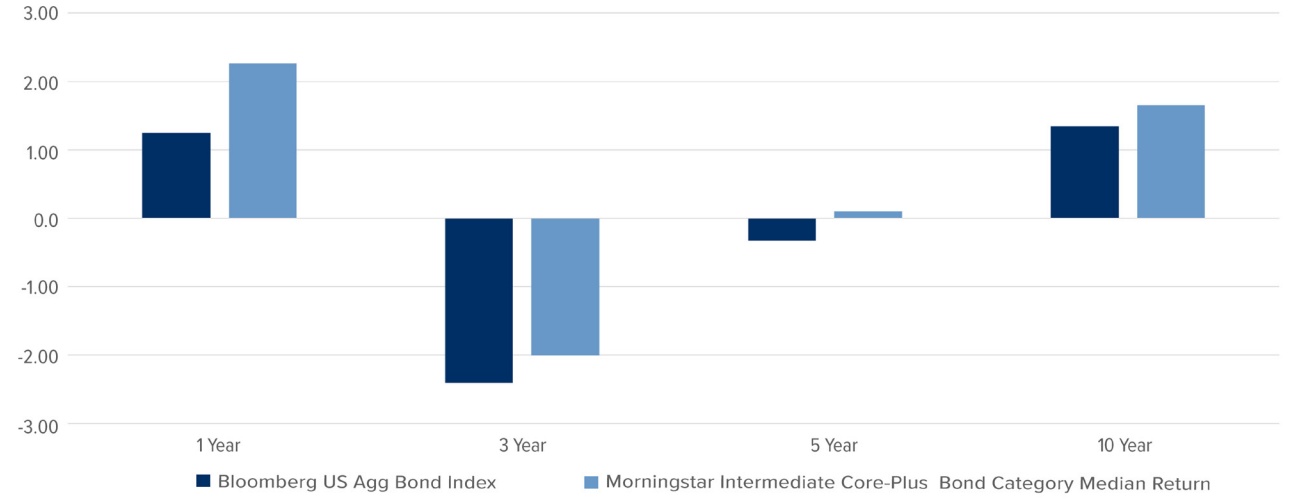

Source: Bloomberg, Morgan Stanley and Yield Book as of 12/31/24.

## Boosting Long-Term Returns

The most compelling argument for active fixed income management? Results. Looking back over the past decade, active strategies—especially in the Core Plus space—have delivered stronger performance.

Approximately 70% of active U.S. intermediate core-plus bond funds have outperformed the Agg.[2] The median return for this Morningstar category has exceeded the Agg's average annual return over 1-, 3-, 5-, and 10-year periods.

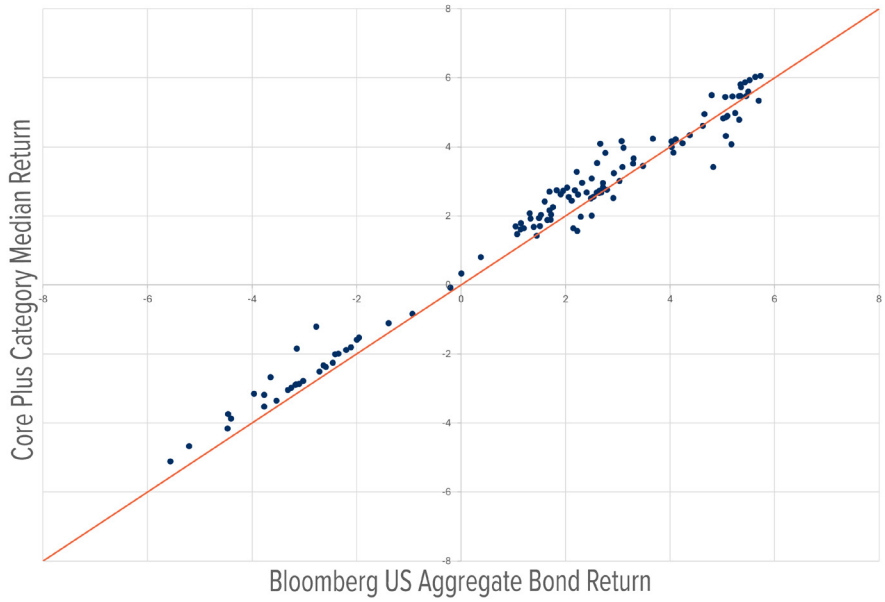
### Core Plus Funds Outperformance Over Time




Source: Morningstar as of 12/31/24.

That outperformance has also been prevalent over time. In 120 monthly rolling 3-year periods beginning in 2012, the Core Plus category median outperformed the Agg in 89 instances—nearly 75% of the time.[2]

### Prevalent Outperformance Over Time




Source: Morningstar as of 12/31/24.

Looking even further back, the 20-year information ratio of the median Core Plus manager vs. the Agg is +0.13—indicating excess return relative to risk.

These results suggest that active fixed income managers have not only helped investors protect capital and manage risk, but have also delivered enhanced return potential relative to the most widely used benchmark.

## Conclusion: Active Fixed Income's Enduring Edge

The appeal of passive investing is clear: low costs, simplicity, and broad exposure. In equities, these benefits have helped transform investor behavior. But in fixed income, the limitations of passive strategies are far more pronounced.

The Bloomberg U.S. Aggregate Bond Index—while widely used—is constrained by its design. It omits large portions of the investable bond universe, relies on models for pricing, and cannot adapt to changing market dynamics. Investors in Agg-tracking strategies are exposed to increased volatility, limited diversification, and an inability to respond to shifts in credit or interest rate environments.

Active fixed income managers, by contrast, have the tools and flexibility to manage risk, uncover value, and enhance return potential. They are not bound by benchmark rules—and that freedom can translate into better outcomes.

Historical data confirms this: active managers, particularly those in the Core Plus category, have delivered higher risk-adjusted returns during a range of market environments over the past decade.

There is no guarantee that active management will always outperform. In today's bond market—defined by structural distortions and rapid shifts—the case for active management isn't just persuasive, it's proven.

[1]Flagel, S. (2009, April 20). Single- vs. multidealer fixed-income indexes. ETF.com

[2]Morningstar. (2024, December 31)

[3]Siblis Research. (2025, April 4). US stock market total market value 2025

[4]Citi, Bloomberg, & SIFMA. (2024, Q4)

[5]Bloomberg Index Services Limited. (2024, June 12). Bloomberg Fixed Income Indices

[6]Bloomberg. (2024, December 31)

[7]Morgan Stanley Investment Management. (2025, January 10). Floating-rate loan market monitor: Q4 2024

[8]Federal Reserve Economic Data, Federal Reserve Bank of St. Louis (2024, December 31)

## IMPORTANT DISCLOSURES

The opinions expressed are those of Weitz Investment Management and are not meant as investment advice or to predict or project the future performance of any investment product. The opinions are current through 8/25/2025, are subject to change at any time based on market and other current conditions, and no forecasts can be guaranteed. This commentary is being provided as a general source of information and is not intended as a recommendation to purchase, sell, or hold any specific security or to engage in any investment strategy. Investment decisions should always be made based on an investor's specific objectives, financial needs, risk tolerance and time horizon.

**Bloomberg U.S. IG Corporate Index** an unmanaged index that measures the performance of investment-grade corporate securities within the Bloomberg U.S. Aggregate Index. **Bloomberg U.S. Aggregate Bond** a broad-based benchmark that measures the investment grade, U.S. dollar-denominated, fixed-rate taxable bond market. **ICE BofA U.S. Corporate Index** tracks the performance of US dollar denominated investment grade corporate debt publicly issued in the US domestic market. **ICE BofA U.S. High Yield Index** tracks the performance of US dollar denominated below investment grade corporate debt publicly issued in the US domestic market. **Bloomberg U.S. Mortgage Backed Securities (MBS) Index** measures agency mortgage-backed pass-through securities issued by GNMA, FNMA, and FHLMC. **Morningstar Intermediate Core-Plus Bond Category Median Return** is the middle-performing return of all funds within the Morningstar Intermediate Core-Plus Bond category, calculated as the equal-weighted average of the returns of all constituent funds in that category at the end of a given period. **Morningstar/LSTA Leveraged Loan Index** an unmanaged index of the institutional leveraged loan market. **Palmer Square CLO Senior Debt Index** a rules-based observable pricing and total return index for CLO debt for sale in the United States, rated at the time of issuance as AAA or AA (or an equivalent rating). **Morningstar Intermediate Core-Plus Category** portfolios invest primarily in investment-grade U.S. fixed-income issues including government, corporate, and securitized debt, but generally have greater flexibility than core offerings to hold non-core sectors such as corporate high yield, bank loan, emerging-markets debt, and non-U.S. currency exposures. Their durations (a measure of interest-rate sensitivity) typically range between 75% and 125% of the three-year average of the effective duration of the Morningstar Core Bond Index. **ICE BofA U.S. Fixed & Floating Rate Asset Backed Securities Index** tracks the performance of USD-denominated investment-grade asset backed securities publicly issued in the US domestic market. **Bloomberg U.S. MBS Fixed 5.5 Coupon Index** is a specific component of the broader Bloomberg U.S. MBS Index, which tracks fixed-rate agency mortgage backed pass-through securities guaranteed by Ginnie Mae (GNMA), Fannie Mae (FNMA), and Freddie Mac (FHLMC). **Bloomberg MBS Conventional 30 Year Index** is a sub-index of the broader Bloomberg U.S. MBS Index. It tracks the performance of fixed-rate, 30-year mortgage-backed securities (MBS) that are conventional (non-government guaranteed), meaning they are issued or guaranteed by Fannie Mae (FNMA) or Freddie Mac (FHLMC), but not Ginnie Mae (GNMA).