



Actively Managed TIPS?

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When PIMCO talks, the market listens. Bill Gross, Mohammed El-Erian, and Paul McCulley provide consistently insightful, thought-provoking and entertaining market commentaries. As evidence of the power of their words, PIMCO's forecast of a *New Normal* has become a paradigm for market analysis.

But we mustn't forget that the bulk of PIMCO's revenue comes from actively managing bond portfolios. So when PIMCO claims (as they did in a recently published paper, [*Approaching TIPS Allocations in the World of the "New Normal"*](#)) that alpha can be earned by actively managing Treasury Inflation Protected Securities (TIPS), a healthy dose of scrutiny is warranted.

That scrutiny should cause investors to avoid such a product, if it is ever offered.

PIMCO's paper, written by John Cavalieri, Gang Hu, and Mihir Worah, points to four areas of inefficiency in the TIPS market.

Due to the TIPS market's small size (approximately 8% of the nominal Treasury bond market), the authors argue passive investors incur larger transaction fees than active investors, like hedge funds. Passive investors, such as the ETFs (e.g., the iShare TIP fund), typically transact at the end of the day, and the authors contend that active investors can time their transactions during the day to take advantage of market imbalances that might occur at the end of the day.

Second, indices that track the TIPS market (such as the index used by the TIP ETF) are rebalanced periodically. By anticipating which securities will be bought and sold when passive investors rebalance, or by purchasing securities at what might be artificially depressed prices after rebalancing, active investors can capture alpha.

The authors also cite evidence that TIPS auctions create market inefficiencies. Historically, TIPS prices have cheapened before those auctions, which the Treasury conducts eight times per year, and richened post-auction, offering another source of potential alpha.

Lastly, the authors point to seasonal patterns in TIPS pricing. They contend that prices richen and cheapen corresponding to seasonal patterns in the underlying inflation (CPI-U) index issued by the government.



In addition to these four “structural inefficiencies,” the authors claim they can gain a performance advantage by positioning their portfolio on specific durations or by taking advantage of changes in the shape in the yield curve.

I am not persuaded. I doubt that active managers can outperform a passive fund, such as TIP, net of fees.

Fees generally dictate the ultimate fate of bond investors. TIP’s fees are a modest 20 basis points, but PIMCO’s fees for active management are generally between 75 and 100 basis points, setting a high hurdle for successful active management – and giving portfolio managers an incentive to take excessive risks.

Don’t forget that 10-year TIPS currently yield just under 2%. Passive investors already sacrifice 10% of their returns in management fees; fees for active management could consume nearly half of that yield.

PIMCO’s first two arguments – that inefficiencies exist in transaction costs and rebalancing – could be applied to virtually any fixed income ETF. But the TIPS market is far more liquid and efficient than virtually any other fixed income market, with the exception of the highly liquid nominal Treasury market.

The efficiency of the TIPS market is evident in the low tracking error for the TIP ETF. Until late last year, its average tracking error was between 0.04 and 0.06. In 2008, that figure rose to 0.53 because of liquidity issues stemming from the Lehman bankruptcy (see our article [here](#) for a further explanation of the volatility in the 2008 TIPS market), and the average tracking error this year has been 0.42. But these averages are still approximately half of the values for the LQD ETF, which tracks an index of the most liquid investment-grade bonds.

Perhaps the size of PIMCO’s portfolio, the experience of its trading staff, and the sophistication of its technology will allow them to capture a few basis points through these inefficiencies, but that’s all. The remaining alpha must generated through the auction and seasonality inefficiencies, which may be unique to the TIPS market.

As with the first two inefficiencies, I am willing to assume that PIMCO’s size and sophistication will enable it to capture some amount of alpha from these factors as well. But, unlike the first two efficiencies, any alpha these generate is unlikely to persist. If seasonal or auction factors create a large enough inefficiency for institutional investors to exploit, then PIMCO will quickly face competition and their advantage will be arbitrated away.

The authors acknowledge that passive management is best suited for markets with “an absence of active managers with records of long-term outperformance.” Vanguard is



the only fund company to attempt a TIPS active fund, the Vanguard Inflation-Protected Securities – VIPSX.

That fund has failed to achieve long-term outperformance. It's three-year and five-year returns trail those of TIP:

Fund	3-year Return	5-year Return
VIPSX	4.50	3.86
TIP	4.84	4.04

Kenneth Volpert, head of Vanguard's taxable bond group, told the [Wall Street Journal](#) last week, "We feel that in the TIPS space active is a better way to go." His fund's performance, however, offers no support for his statement.

In fairness, VIPSX is permitted to hold up to 20% of its assets in non-TIPS securities. According to Morningstar, as of its last quarterly report it held 14% in nominal Treasuries. Therefore, we cannot say whether a lack of opportunities in the TIPS market or a bad bet in the nominal market is the source of VIPSX's underperformance.

The authors contend that, because the TIPS market has proportionately more passive investors, there are more opportunities for active managers. I believe the opposite may be the case: The smaller universe of actively managed TIPS means there are proportionately fewer opportunities to find mis-priced securities.

In fact, the authors make this point explicitly in the beginning of their paper, when they state that passive management is justified when there is "an absence of recurring structural risk premiums (a tightly arbitrated market)." Investors betting on a successful actively managed TIPS strategy are betting that the TIPS market contains exploitable risk premia.

TIPS may be volatile, but the TIPS market is well-understood easily modeled. Credit analysis is unnecessary and quantitative analysis should rapidly identify any inefficiency. Active management may succeed in the equity or corporate bond markets, where individual securities are highly differentiated and require shrewd analysis, experience, and judgment. Such is not the case with the TIPS market, where active management is doomed to fail.

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