



The case for active multisector fixed income

Key points

- **An expanded opportunity set:** Active fixed income managers can pursue return opportunities in spread sectors and areas such as high yield, bank loans, structured credit and non-U.S. debt — exposures that are absent or only modestly represented in the benchmark index.
- **A more exploitable benchmark:** The Bloomberg U.S. Aggregate Bond Index (Agg) represents approximately one-half of the investable U.S. fixed income market. As of December 31, 2025, the index maintained a 45.9% weight to USTs, which suggests that investors have greater exposure to lower-yielding government debt and less exposure to higher-yielding spread sectors.
- **Additional levers:** Active managers have the ability to adjust portfolio duration, yield-curve positioning and sector weights in response to evolving economic cycles and monetary policy regimes, while passive investors remain tethered to benchmark-like characteristics.
- **A favorable backdrop:** Rolling-return and peer-ranking analysis suggests that the post-2009 environment has been more favorable for active core and core plus strategies than the pre-2008 financial crisis period.
- **Security selection is key:** Within corporates and mortgages, active managers are able to seek out: relative value opportunities, earlier exits in “fallen angels” and opportunities to mitigate downgrade risk and improve collateral/pool selection in ways index-tracking vehicles cannot.
- **A role for passive:** We view the use of passive strategies primarily as a targeted portfolio tool, such as to provide UST ballast or low-cost rebalancing. Over full market cycles, the thoughtful selection of active core and core plus managers may offer investors the opportunity to outperform.

Go deeper

This paper highlights the investment merits and opportunities of active fixed income, while also acknowledging the role passive strategies may play within an investment portfolio.



The big picture

Nowadays, investors can benefit from actively managed core and core plus bond strategies' expanded investment opportunity set.

Why it matters

A passive core bond allocation may provide index exposure, but it can also deliver greater U.S. Treasury (UST) concentration, reduced flexibility and fewer opportunities to capture excess return through sector allocation, yield-curve positioning, duration management and security selection.



How did we get here?

It has been nearly two decades since the Global Financial Crisis (GFC) reshaped markets. At the time, risk asset markets buckled amid the shock, which shifted leverage from consumer and corporate balance sheets to the public ledger and thus triggered a substantial reset for active multisector fixed income managers.

Since then, active core and core plus fixed income managers have gained a greater opportunity set with which to outperform passive funds that track the Agg — with encouraging results. Expanding global bond markets, particularly the growth of corporate, securitized and non-U.S. bond sectors, have enabled enhanced diversification, broader relative value opportunities and the opportunity for more adept fixed income managers to outperform the largely static Agg.

Notably, the UST market has also expanded. Following the successive shocks of the GFC and the COVID-19 pandemic, persistent U.S. government deficits to remedy the effects of these crises drove a marked increase in UST issuance and thus, materially altered the composition of the investment grade (IG) bond universe, and by extension, passive funds. These structural shifts have proven constructive for active strategies.



“As valuation regimes shift, active managers benefit from the freedom to rotate exposure across sectors, seeking higher yields or superior relative value...”

As UST issuance has ballooned, the Agg has become increasingly concentrated in lower-yielding sovereign debt, rendering it a more exploitable benchmark for active management. The majority of active core and core plus bond managers typically choose to underweight USTs and instead, seek out excess return in credit-oriented spread sectors.

Active managers' capacity to adjust portfolio duration in anticipation of evolving macroeconomic conditions and monetary policy, rather than remaining bound to the Agg's fixed duration profile, is also valuable. Beyond duration management, active managers can also express views along the yield curve — selecting bonds with different maturities depending on where the best value can be found — in response to changing growth and inflation dynamics.

Passive investors, by contrast, are constrained to the index's static maturity weightings and must largely accept the interest rate risk embedded in the Agg.

As valuation regimes shift, active bond managers benefit from the freedom to rotate exposure across sectors — including government, securitized, corporate and non-U.S. markets — seeking either higher yields or superior relative value as conditions warrant. Passive strategies lack this flexibility and may remain structurally anchored to lower-yielding segments of the market, often with disproportionately high allocations to the most heavily indebted issuers — whether sovereign or corporate.

This distinction becomes even more pronounced when viewed through the lens of credit quality management. Active managers can proactively allocate to issuers with strengthening fundamentals ahead of bond rating agency upgrades, reduce exposure prior to downgrades or exit positions entirely when credit trajectories deteriorate. By contrast, downgraded issuers may persist within the Agg and, in some cases, increase in their index weighting, introducing a growing headwind for passive strategies.

Moreover, active managers are not compelled to hold securities through adverse credit events. In situations involving prospective fallen angels, the ability to sell positions between the downgrade announcement and the issuer's eventual removal from the Agg represents a meaningful advantage, in our view. This flexibility allows active portfolios to sidestep potential credit and liquidity events — further underscoring how benchmark elasticity, sector mobility and credit discretion collectively enhance the long-term return potential of active fixed income strategies relative to passive alternatives.

While these developments should theoretically favor active management, bond market sectors are replete with complexities and nuances. As such, manager skill and often, scale enable advantages in alpha generation, for example, through increased trading efficiency or a broader investable universe. We do, however, subscribe to the belief that all active core and core plus managers benefit from the structural challenges to passive management including the influence of non-economic buyers.

This paper highlights four key merits of active management that allow those within the core and core plus fixed income universe the flexibility to outperform in a variety of market environments. Additionally, we note certain transitory, but complementary, roles that passive management may serve in a portfolio and the implications for fund selection.

1. The opportunity to generate above-benchmark yield

When active managers assess the sector landscape in an effort to out-yield passive investment options, allocating to sectors absent or very modestly represented in the Agg has historically provided a yield/return advantage in many environments over the past 40 years (Figure 1).

Those most-trafficked yield frontiers beyond the reach of passive core bond investors include:

High yield and bank loans — provide skilled managers with spread opportunities by virtue of moving down the credit spectrum. Given this advantage, coupled with the reality that passive vehicles may be restricted by their focus on liquidity and issuer size rather than creditworthiness and market inefficiencies, active managers can also maintain an edge in below-IG investing.

The four structured credit sectors — commercial mortgage-backed securities (CMBS), asset-backed securities (ABS), non-agency residential MBS and collateralized loan obligations (CLOs) offer many potential investment opportunities to skilled managers. CMBS and ABS are both modestly weighted benchmark sectors, while non-agency residential MBS and CLOs are not part of the Agg. Managers with acumen in navigating structured credit niches or sub-markets and their cash flow structures, can successfully generate excess returns through the “complexity premium” often priced into spreads.

Non-U.S. markets — non-U.S. markets are very modestly weighted in the Agg, including both developed non-U.S. and emerging market debt (EMD). Global inflationary pressures since the early 2020s have given way to increased yield opportunities in developed non-U.S. markets. Within EMD, investors tend to appreciate the blended orientation of IG and below-IG opportunities, with yield levels typically offering a relevant comparison to domestic high yield fixed income.

Figure 1. 5-Year Trailing Annualized Sector Performance for the Bloomberg U.S. Aggregate Bond Index

| 1990 | 1995 | 2000 | 2005 | 2010 | 2015 | 2020 | 2025 |
|-------------------------|-------------------------|-------------------------|-------------------------|-------------------------|-------------------------|-------------------------|--------------------------|
| Agency MBS 10.44 | High Yield 18.51 | EM Debt 12.44 | EM Debt 12.67 | High Yield 8.91 | EM Debt 5.12 | High Yield 8.59 | Bank Loans 6.42 |
| Aggregate Index 9.78 | Non-US Dev 11.72 | Agency MBS 6.91 | High Yield 8.85 | EM Debt 8.34 | High Yield 5.04 | EM Debt 6.91 | High Yield 4.51 |
| Inv Grade Corp 9.78 | Inv Grade Corp 11.15 | ABS 6.53 | Non-US Dev 7.65 | Non-US Dev 7.19 | Inv Grade Corp 4.53 | Inv Grade Corp 6.74 | ABS 2.29 |
| Treasuries 9.39 | Treasuries 9.36 | Treasuries 6.49 | Inv Grade Corp 7.10 | Agency MBS 6.34 | CMBS 4.31 | Bank Loans 5.24 | EM Debt 1.49 |
| High Yield 4.81 | Aggregate Index 9.48 | Aggregate Index 6.46 | CMBS 7.05 | Inv Grade Corp 6.05 | Bank Loans 3.41 | Non-US Dev 4.89 | CMBS 1.00 |
| | Agency MBS 8.73 | Inv Grade Corp 5.74 | Aggregate Index 5.87 | Aggregate Index 5.80 | Aggregate Index 3.25 | CMBS 4.75 | Agency MBS 0.15 |
| | | High Yield 4.28 | ABS 5.45 | CMBS 5.59 | Agency MBS 2.96 | Aggregate Index 4.44 | Inv Grade Corp -0.09 |
| | | Non-US Dev 1.23 | Agency MBS 5.44 | Treasuries 5.47 | Treasuries 2.91 | Treasuries 3.77 | Aggregate Index -0.36 |
| | | | Treasuries 5.36 | Bank Loans 5.22 | ABS 2.31 | Agency MBS 3.05 | Treasuries -0.99 |
| | | | Bank Loans 5.24 | ABS 4.28 | Non-US Dev -0.83 | ABS 2.87 | Non-US Dev -3.59 |

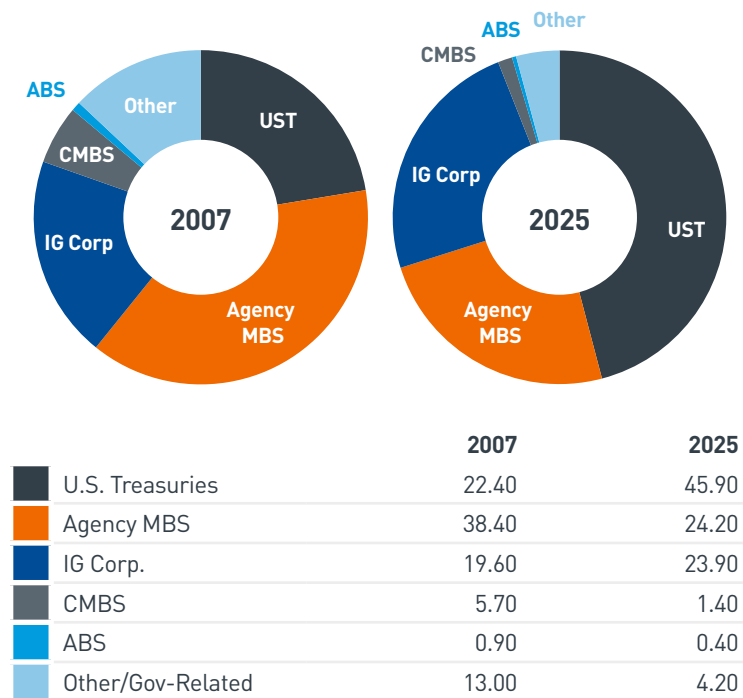
As of 12/31/2025. Source: Morningstar

2. Targeted UST exposure

Representing approximately one-half of the U.S. fixed income market, the Agg is heavily concentrated in lower-yielding USTs, which comprised 45.9% of the index as of year-end 2025 (Figure 2). Fiscal responses to two recessions, rising entitlement spending and large-scale tax cuts have increased USTs' benchmark weight. Given political constraints and federal spending projections, this sizable weight is unlikely to decline meaningfully and may even continue to grow, in our view.

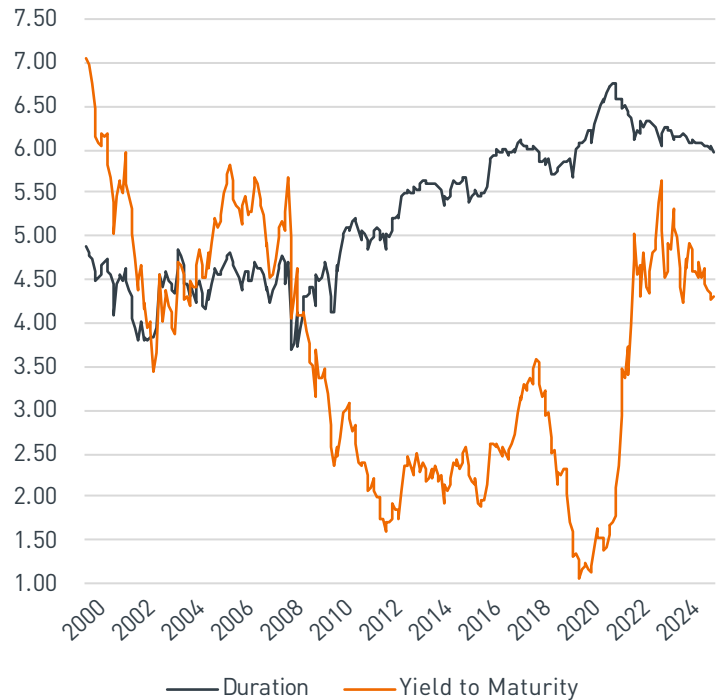
The post-GFC structural shift in bond market composition has crowded out other sectors and created a performance headwind for the Agg that is favorable for the active core/core plus universe. Additionally, an index characterized by greater Treasury duration and less carry has allowed active managers to generate excess returns through, at times, only modest positioning differences in duration, yield-curve positioning and sector allocation (Figure 3). To this effect, a comparative analysis of rolling five-year returns shows a stronger relative performance trend for active management in the post-2009 period compared to the period leading up to 2008. (Figure 4).

Figure 2. Bloomberg U.S. Aggregate Index Sector Composition (%)



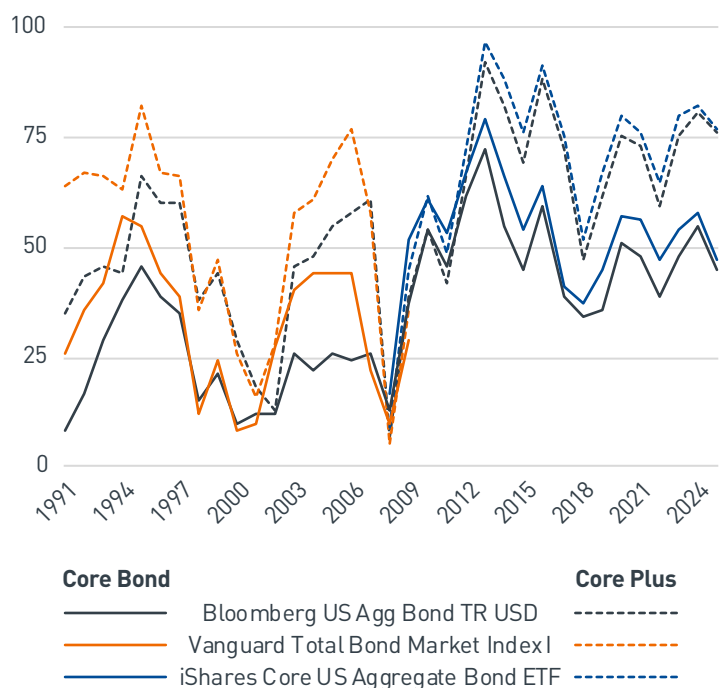
As of 12/31/2025. Source: Barclays

Figure 3. Bloomberg U.S. Aggregate Bond Index Yield to Maturity (%) and Duration (Years)



As of 12/31/2025. Source: Bloomberg L.P.

Figure 4. Trailing 5-Year Percentile Ranks for Passive Funds vs. Core Bond & Core Plus Universes*



*A higher percentile correlates with a worse outcome
As of 12/31/2025. Source: Morningstar**

3. Targeted sub-sector, security and industry allocations

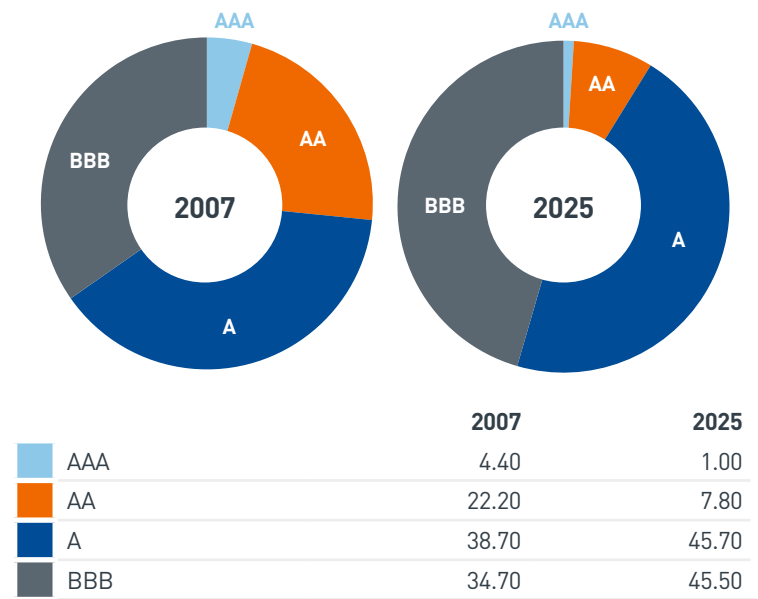
While active managers have the potential to generate excess returns in many environments, by moving off-benchmark and underweighting USTs, adherence to a core or core plus mandate remains essential, in our view. Accordingly, investors expect foundational exposure to the three major IG bond market segments — USTs, agency MBS and IG credit. Nevertheless, adeptly navigating these sectors entails more than basic exposure — it requires skill and resources to identify structural inefficiencies and mispricing within sectors and securities.

Within IG corporate bonds, an active manager can capitalize on the opportunity set by identifying relative value opportunities and mitigating risk through security selection and industry allocation. Conversely, passive exposure within IG corporates may prompt a higher weighting toward downgrade candidates, given the structural bias common across fixed income indices that skews towards issuers with higher debt. Additionally, given that issuers within the same industry tend to exhibit similar trends in spread performance, active managers may also take active positions in industries in which spread levels are misaligned with fundamentals.

In fixed income — an asset class known for asymmetric downside return vs. upside return potential — investment teams can enhance relative performance by avoiding or underweighting these credits. Likewise, active managers can purchase an off-index, non-IG bond that is expected to be updated to IG (and thus can be included in the Agg), thereby positioning the portfolio to benefit from potential spread compression. With lower-quality credit profiles and a tight spread environment, rigorous credit selection is imperative, in our view (**Figure 5**).

Although an underweight may be the most accretive course from a sector allocation standpoint, USTs can also serve as an “alpha lever.” For example, active bond managers can distinguish themselves from a passive approach by making disciplined, tactical adjustments to duration and/or yield curve positioning, based on market developments such as an anticipated change in monetary policy. The easing cycle that began in 2019 and the tightening cycles in 2018 and 2022 are examples of environments in which preemptive and measured duration and yield-curve management could have proved additive for active managers.

Figure 5. IG Corporate Credit Quality Composition (%)



As of 12/31/2025. Source: Barclays

Moreover, active managers can capitalize on “kinks” in the yield curve, which indicate less liquidity and higher yield with minimal credit risk, such as in the reintroduction of the 20-year UST issue in May 2020. Furthermore, we believe that today’s macro environment, characterized by continued shifts in global trade, prolonged geopolitical conflicts and megatrends related to artificial intelligence, may continue to be associated with rate volatility, and ultimately favor tactical defensive approaches and active implementations utilizing USTs and/or UST futures.

Active management can further enhance return potential within agency MBS. The Agg’s exposure is focused on the largest, most liquid “current coupon” pools, whereas active managers can exploit mispricing across coupons. Specifically, the active advantage stems from selecting and rotating between higher and lower coupons based on the interest rate environment, and in consideration of factors such as prepayment speeds.

Finally, while the Agg is comprised of generic mortgage pools that may possess less-desirable characteristics, active management has the ability to target specific attributes, such as loan balance profile, borrower credit score or specific geographies. These active measures can offer a mortgage allocation with better protection against various forms of reinvestment (prepay) risk, which is notoriously high in the sector.

4. Tailored trading activity

Beyond the scope of traditional research around assessing fundamentals and valuations within the fixed income market, active bond managers can also address structural market inefficiencies arising from bond market segmentation. In particular, non-economic, or “natural,” buyers of fixed income and fixed income passive funds, who are not guided by a total return mandate, can facilitate market dislocations that active managers can exploit. Examples of such buyers include central banks, which have growth and inflation targets; insurance companies, which undertake liability management measures and commercial banks, which navigate book yield and regulatory constraints. All are significant buyers of fixed income securities, yet none specifically target return maximization.

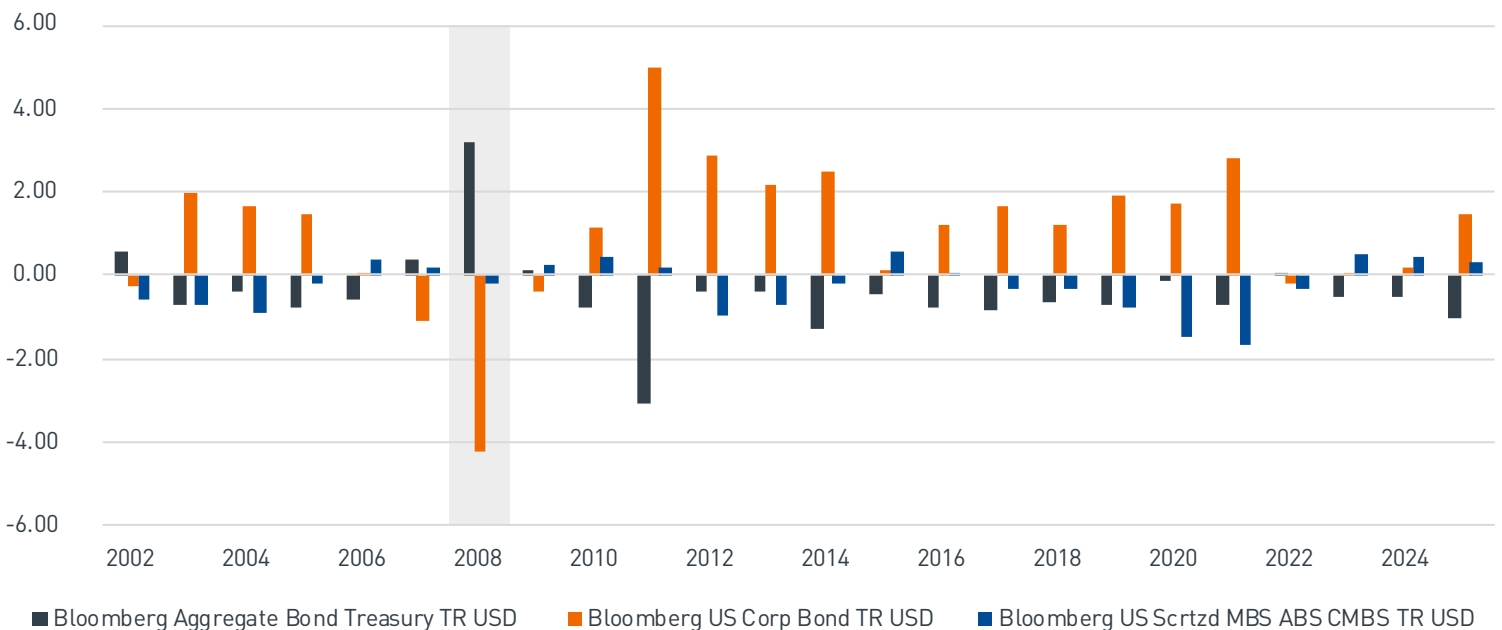
Also, the Agg adds and removes various securities monthly, and Bloomberg publishes the list of affected issues. Passive vehicles cannot adjust their portfolios in alignment with the removal until index changes are complete. Conversely, active managers can tailor trading activity to capitalize on these potential spread compression opportunities or to circumvent selling pressure in response to these various non-economic practices and index-based rules.

The role of passive management in fixed income portfolios

While we have outlined the many rationales that favor taking an active approach in core and core plus, we believe passive management can serve a key role in specific scenarios, including as a defensive portfolio position during certain market environments. Despite the alpha that can be generated by core and core plus managers in benign credit markets, economic downturns are inevitable and growth tail risks remain. When these cycle-ending disruptions materialize, the liquidity and safe-haven status of USTs have historically bolstered the performance of passive funds, effectively penalizing an active preference for higher-yielding credit sectors.

This dynamic was evident during the past two recessions, when spreads widened across nearly all credit markets and triggered losses in these sectors. During the same period of broad market stress, U.S. government sectors provided ballast with positive returns. However, it should be noted that market cycles that favor USTs tend to be fleeting relative to those that favor spread sectors, which typically persist for several years (Figure 6).

Figure 6. Rolling 3-Year Excess Returns vs. Bloomberg U.S. Aggregate Bond Index (%)



As of 12/31/2025. Source: Morningstar

Overall, we believe passive management may serve a targeted purpose within an asset allocation. An Agg-tracking fund or exchange-traded fund (ETF) may help balance a large collective underweight to government sectors and help to buffer credit risks when conditions warrant. Such an allocation can also enable cost-efficient rebalancing, which becomes particularly advantageous when active managers expect a favorable credit environment.

The importance of astute manager due diligence

Evidence suggests that disciplined fund selection can enable an investor to capitalize on core and core plus strategies with the potential to outperform. A thorough manager evaluation framework is key, in our view, and should address nuances such as discerning the manager's ability to uncover opportunities in more complex IG exposures and vetting its adherence to the mandate's stated government sector allocation.

Just as taking credit risk is often rewarded more than credit risk aversion, selection among core plus funds has tended to favor managers with the ability to exploit a wider breadth of sector exposures — particularly in below-IG. Through most market environments, a large swath of core plus funds have outperformed based on longer-lasting, credit-favoring regimes; and we have seen that phenomenon persist, despite the current tight spread environment. In our view, fund evaluation in the core plus space should focus on many factors, particularly a manager's attention to investable breadth, balanced with rigorous oversight of various risks, such as credit, duration, currency, etc. In summary, we believe that the thoughtful selection of actively managed core and core plus fixed income strategies offers the opportunity for investors to outperform passive alternatives.

***As of 1/1/2010, the Vanguard Total Bond Market Index Fund began tracking the Bloomberg US Aggregate Float-Adjusted Index. Thus, its history beyond the reference of the Bloomberg US Aggregate Bond Index has been excluded from the above exhibits. The iShares Core US Aggregate Bond ETF (AGG) was launched on September 22, 2003. The results account for all share classes of Morningstar's Intermediate Core Bond and Core Plus category constituents.*

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