

Passive by default

FOR PROFESSIONAL INVESTORS ONLY
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Is euro credit sleepwalking through a shifting landscape?

Euro credit is often treated as the quiet corner of institutional portfolios – stable, low-maintenance, and easy to overlook. But that assumption is under pressure. Structural biases and shifting market dynamics are making passive exposure harder to justify.

The illusion of stability

Fixed income indices are typically seen as neutral. In reality they carry structural biases. The most indebted issuers dominate index weightings, which can leave passive investors overexposed to leverage risk. Unlike equity benchmarks, credit indices rebalance monthly to reflect new issuance and rating changes. This churn creates inefficiencies that active managers can try to exploit, while passive strategies must accept them.

These issues have always existed, but today's market dynamics make them harder to ignore.

What is changing beneath the surface

Issuer dispersion is rising. Credit quality is diverging, and the share of BBB-rated names has grown in recent years, increasing sensitivity to downgrades in late cycle conditions. The euro investment grade universe is also expanding, which adds selection complexity. Passive portfolios remain exposed to deteriorating credits until they fall out of the index, often after spreads have widened.

ESG expectations are evolving. Investors are moving beyond exclusions. They want deeper integration, proprietary analysis and engagement. Concerns about the influence of US-based ESG data providers are growing, which encourages independent views that reflect European priorities. Passive approaches find this harder to achieve.

These shifts amplify structural weaknesses that have always existed in passive credit strategies.

Structural challenges for passive credit

Passive credit strategies face several built-in limitations, grouped into three areas:

1

Index construction and turnover

- **Negative selection bias:** index weightings favour the most indebted issuers
- **Frequent monthly rebalancing:** creates inefficiencies and transaction costs

2

Risk and credit quality

- **Delayed response to credit deterioration:** exposure persists until removal from the index
- **Rising downgrade risk:** driven by the growing share of BBB-rated issuers

3

ESG and implementation

- **Limited ESG integration:** often restricted to exclusions, with little engagement
- **Independent of external ESG providers**

Against this backdrop, the question is whether passive approaches can adapt – or whether active management offers tools that matter more in today's market.

Where active can add value

Active managers are not immune to market stress, but they have tools that passive strategies lack. The new issue market is a good example. New bonds often come with pricing concessions that can provide attractive entry points. Passive strategies, tied to month-end rebalance schedules, usually miss them. The over-the-counter nature of bond trading also creates pricing inefficiencies that can be addressed through research and nimble execution. Active teams can exit deteriorating credits earlier, helping to manage the downside, while passive portfolios remain exposed until index removal.

Historical perspective: active versus index

The figures below illustrate how active euro credit managers have performed relative to an index-fund proxy over three and five years. To ensure a fair comparison, the index fund returns were adjusted by 10 basis points to reflect the typical cost advantage of passive strategies. Historically, around three in four active euro credit funds outperformed an index-fund proxy over three- and five-year periods after a 10bps fee adjustment, on a gross-of-fees basis.

Figure 1: Distribution of excess returns for active euro credit funds vs index fund proxy

Based on Morningstar data to June 2025, approximately 76% of active euro credit funds delivered positive excess returns over three- and five-year periods after a 10bps adjustment. Past performance is not indicative of future results.

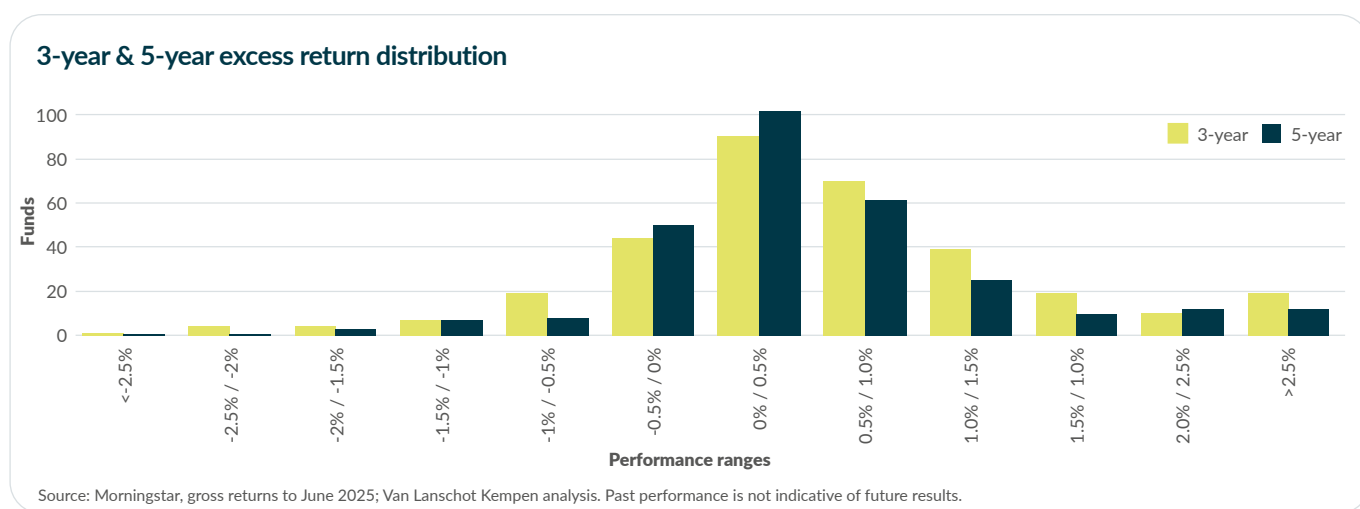


Figure 2: Performance snapshot – active euro credit vs index-fund proxy

This table highlights how active strategies have historically delivered higher average and median excess returns compared to passive over three- and five-year periods.

Metric	3 years	5 years
Average excess return (after 10bps)	+0.59%	+0.52%
Median excess return	+0.47%	+0.40%

Source: Morningstar, gross returns to June 2025; Van Lanschot Kempen analysis.

Note: Past performance is not indicative of future results. Figures are gross of fees unless stated otherwise.

Additional insights

- Peer group size: ~326 funds (3 years), ~291 funds (5 years)
- Persistence: 11% of funds (33 funds) were top quartile across 1, 3 and 5 years

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Methodology note:

Peer group returns are gross to June 2025. The index fund proxy is the iShares Euro Corporate Bond ESG SRI Index Fund. The proxy's own gross 3 and 5-year relative returns versus the ICE index were +0.09% and +0.15%, respectively, before applying the 10bps cost adjustment.

Comparing strategy characteristics

The table below compares passive, semi-active, and active strategies across ESG integration, responsiveness, and risk control, highlighting where flexibility and depth differ.

Feature	Passive	Semi active	Active with ESG and risk control
ESG integration	Basic exclusions	Third party scoring	Proprietary analysis and engagement
Benchmark personalisation	None	Limited	Tailored to client needs
Responsiveness to market shifts	Low	Moderate	High, both top down and bottom up
Risk framework	Benchmark tracking	Loose guidelines	Strict, defensive framework

What to watch next

ESG regulation continues to evolve. Investors are likely to face greater scrutiny over how sustainability is integrated into fixed income portfolios. These dynamics suggest that the assumptions behind passive credit allocations warrant a closer look.

A quiet rethink

This is not about abandoning passive credit altogether. It is about recognising that the landscape has changed – and asking whether long-held assumptions still hold. As dispersion widens, refinancing risk intensifies and ESG demands grow more complex, investors may need to revisit how euro credit fits into their long-term strategy.

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Author:

Joost de Graaf
Co Head of Credit



**VAN LANSCHOT
KEMPEN**

Van Lanschot Kempen Investment Management NV
Beethovenstraat 300, 1088 WZ Amsterdam, The Netherlands.

