US fixed income

Beyond benchmark fixed income investing

- The path towards a normalized growth and interest rate environment will produce headwinds for fixed income investors over a medium to longer-term period. Higher rates will exert pressure on principal values and low starting yields will lead to greater bond price sensitivity. Future returns are likely to be modest with starting yield levels being a strong indicator of future annualized returns.
- Diversifying bond portfolios away from traditional taxable fixed income benchmarks that are heavily government weighted (i.e., Barclays Aggregate Index) and incorporating other types of fixed income asset classes into portfolios should lead to superior risk/adjusted returns.
- We believe the flexibility provided by extending beyond a traditional benchmark should prove to be value added more often than not over longer cycles. This can be achieved through multiple approaches that incorporate active fixed income portfolio management.

Not giving up on "normalization"
Fixed income investors are well aware of the challenges that the aftermath of the Global Financial Crisis (GFC) and unprecedented global monetary stimulus have created. For savers, it’s created near-zero rates in short maturity instruments that were the often go-to choice for excess cash during the pre-crisis years. It’s also created a drawn-out normalization cycle that could be characterized as two steps forward, one-and-a-half steps back over recent years. Since the GFC, the US economy has struggled to find solid footing on account of factors such as the Eurozone debt crisis, fiscal headwinds, government shutdowns, and geopolitical events.

Despite the prolonged waiting game, CIO does believe that we are on track towards a normalized macro environment. Consider that growth should revert to trend with the US economy leading the way on solid footing and aggressive monetary policy actions still being implemented by other major global central banks. The Federal Reserve will likely begin to raise rates later this year, which has direct implications for shorter term Treasury yields that tend to price off

**Fig. 1: Long-term trend has been towards lower yields**

Yield, in %

Source: Bloomberg, UBS CIO WMR, as of 11 March 2015

**Fig. 2: Fed participant’s long-term outlook for the Fed funds rate**

Number of participants

Source: Federal Reserve, UBS CIO WMR, as of December 2014
of monetary policy expectations. Once the economy gains firmer footing, the broken link between inflation and the monetary base is likely to start functioning again and produce more trend-like rates of inflation. This should nudge longer rates higher as the term premium in the Treasury curve begins to reappear.

**But differences exist this cycle**

There are important differences that the current normalization cycle will have for fixed income investors. The terminal value, or natural fed funds rate, is expected to be lower this time. The Fed central tendency points to a rate of 3.75% over the longer term (see Fig. 2). This compares to terminal values of 6.5% and 5.25% during the 2000 and 2004 tightening cycles, respectively. The degree to which current market coupon levels rise will be lower than many investors might expect for many fixed income instruments. A second difference is that the pace of monetary policy tightening will likely be more protracted and could occur in a less predictable fashion than the lock-step pace that occurred from 2004 to 2006. Third, central banks globally are not moving in unison as the growth and inflation outlook outside the US varies considerably. All of these factors point towards a slower path towards normalization, characterized by more rapid bouts of resetting market expectations. This will likely translate into frequent pockets of volatility on the path towards a new, lower rate equilibrium.

**Don’t expect fixed income investing to get easier**

Challenging times lie ahead for fixed income investors against the backdrop of normalizing macro conditions. Future returns are likely to be modest with starting yield levels being a strong indicator of future annualized returns (see Fig. 3). An environment where rates are biased higher would exert pressure on principal values and will be a detractor to total returns. Investors’ starting position is disadvantaged by the fact that duration exposure rises as market yields decline, which results in greater price sensitivity to changes in yields (see Fig.4). The flattening of the curve also takes away the additive return opportunity stemming from “roll down” that is available in steeper yield curve environments. Put simply, fixed income investors will likely have to accept mediocre returns, potentially for several years ahead. It won’t be until yield levels reset to higher points, or we encounter a risk case scenario of economic decline, that high quality fixed income would produce more attractive returns.

**The traditional benchmark has flaws**

The Barclays Aggregate bond index is the most widely used benchmark for the US taxable fixed income market. Unlike the S&P 500 equity index that offers exposure to a diverse group of industry sectors with multinational exposure, the primary composition of the Barclays Agg come from government and government-related segments of the bond market, which gives the index a very high AA rating. US Treasuries have been the fastest growing segment of the index over the past few years, which stems proportionally from their market value outstanding. Treasuries comprise 35% of the index today, compared to 29% five years ago and 25% ten years ago (see Fig. 7). This growth has taken place even when considering that Treasuries held in custody by the Fed are excluded from the index.

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**Fig. 3: Starting yields reflect future returns**

<table>
<thead>
<tr>
<th>In %</th>
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<tbody>
<tr>
<td>25</td>
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<tr>
<td>20</td>
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<tr>
<td>15</td>
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<td>10</td>
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<tr>
<td>5</td>
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<td>0</td>
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</table>

Source: Bloomberg, UBS CIO WMR, as of 31 December 2014

**Fig. 4: Barclays Aggregate Index modified duration**

<table>
<thead>
<tr>
<th>In years</th>
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<tbody>
<tr>
<td>6.00</td>
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<tr>
<td>5.50</td>
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<tr>
<td>5.00</td>
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<tr>
<td>4.50</td>
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<tr>
<td>4.00</td>
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<tr>
<td>3.50</td>
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<td>3.00</td>
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</table>

Source: Bloomberg, UBS CIO WMR, as of 27 February 2015

**Fig. 5: Amount outstanding per segment**

<table>
<thead>
<tr>
<th>In trillion</th>
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<tbody>
<tr>
<td>7.00</td>
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<td>6.00</td>
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<tr>
<td>5.00</td>
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<tr>
<td>4.00</td>
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<td>3.00</td>
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<tr>
<td>2.00</td>
</tr>
</tbody>
</table>

Source: Barclays, UBS CIO WMR, as of 11 March 2015
Investment grade corporate (IG) bonds are represented in the index but high yield (HY) corporate bonds are not. USD EM is represented, but only by a small margin. TIPS, municipals, and non-Agency MBS are also excluded from the Agg. Agency MBS have been influenced by the Fed’s three rounds of QE policies. The Agg does not adjust for the Fed’s MBS purchases, which has taken a substantial amount of supply out of the market but are nonetheless represented in the benchmark.

As yield levels for these segments of the market have declined, the overall yield level for the Agg sits at 2.2%, near an all-time low.

Price returns contribute less to total return
Although many investors may be worried about negative price reactions of bond prices prior to Fed rate hikes, we believe that coupon return is more important from a total return perspective. This is especially true in today’s environment where the Fed’s quantitative easing programs have led to expensive valuations for many fixed income products. When analyzing the total return contributions of the Barclays Aggregate Index over the last 15 years, the coupon return with reinvestments accounted for roughly 90% of the total return. In the broader Barclays Universal Index, coupon return with reinvestment contributed to 92% of the total return over the past 15 years. We believe this suggests that investors should consider fixed income investments that have higher coupons instead of chasing investments that may have capital gain potential when investing over the long term. However, higher coupons and yields often coincide with lower credit quality. Investors should always keep their individual risk tolerance in mind when allocating his/her portfolio.

Add diversification to fixed income portfolios
We believe diversifying bond portfolios and incorporating different types of fixed income asset classes that are not just concentrated in government segments should lead to superior risk-adjusted returns over time. While this investment philosophy has merit during all market cycles, we believe the market backdrop is conducive for diversification given the unique position that fixed income investors find themselves, as well as the aforementioned flaws in the benchmark. Investors can circumvent benchmark shortcomings by increasing exposure to credit spread sectors, where the additional risk premium can help cushion the effect of higher rates. The often unrelated behavior that credit sensitive fixed income exhibits compared to government bonds can help in the construction of more efficient portfolios that offer greater return potential for a given level of risk.

To illustrate this point, we compare the broader based Barclays Universal Index to the Aggregate Index. The Universal takes the Agg as the starting point, which comprises 84% of the index, but then adds a mix of high yield bonds (6%), Eurodollar and EM bonds (4%), and private placement 144a bonds (6%). Having exposure to these segments increases the credit sensitivity of the index, but also allows for incrementally greater total returns for similar levels of risk (see Figs 8 and 9). The credit quality of the overall index drops only marginally to single-A when these additional segments are added, while the Universal index yield level rises to 2.7%.

**Fig. 6: Coupon return contributed the most to total return**

<table>
<thead>
<tr>
<th></th>
<th>Barclays Aggregate</th>
<th>Barclays Universal</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total Return</td>
<td>128.04%</td>
<td>134.48%</td>
</tr>
<tr>
<td>Price Return</td>
<td>16.82%</td>
<td>14.55%</td>
</tr>
<tr>
<td>Coupon Return (with reinvestment)</td>
<td>115.84%</td>
<td>123.93%</td>
</tr>
<tr>
<td>Other Return</td>
<td>-4.62%</td>
<td>-4.00%</td>
</tr>
</tbody>
</table>

Source: Barclays, UBS CIO WMR, as of 16 March 2015

**Fig. 7: Barclays Agg composition shifts**

<table>
<thead>
<tr>
<th></th>
<th>2015</th>
<th>2010</th>
<th>2005</th>
</tr>
</thead>
<tbody>
<tr>
<td>U.S. Treasury</td>
<td>35%</td>
<td>29%</td>
<td>25%</td>
</tr>
<tr>
<td>Government-Related</td>
<td>10%</td>
<td>13%</td>
<td>15%</td>
</tr>
<tr>
<td>IG Corporate</td>
<td>24%</td>
<td>18%</td>
<td>20%</td>
</tr>
<tr>
<td>CMBS/ABS</td>
<td>2%</td>
<td>4%</td>
<td>5%</td>
</tr>
<tr>
<td>U.S. MBS</td>
<td>29%</td>
<td>36%</td>
<td>35%</td>
</tr>
</tbody>
</table>

Source: Barclays, UBS CIO WMR, as of 1 March 2015

**Fig. 8: Universal Index outperforms the Agg when credit spreads tighten**

Relative return, left, and HY spread, right (inverted)

Source: Barclays, UBS CIO WMR, as of 11 March 2015

**Fig. 9: Universal Index adds incremental return for similar risk**

Source: Barclays, UBS CIO WMR, as of 11 March 2015
Fixed income diversified strategic asset allocation

The diversified strategic asset allocation depicted in Fig. 10 represents an illustrative diversified allocation among taxable fixed income segments in the thematic spirit of this report. It is valid for an investor with a moderate risk profile.

It was derived based on the strategic asset allocations included in the CIO flagship publication UBS House View (HV), with the following adjustments. The existing moderate risk allocations in the HV are depicted for multi-asset class portfolios with stocks and bonds. In a first step, the US taxable fixed income allocations were extracted from the models for nontaxable accounts and were proportionally scaled up to create a 100% portfolio. In a second step, broad asset classes such as government bonds were split into related subcategories (e.g. Treasuries, TIPS, Agency debt, Mortgage-backed securities etc.). Third, asset classes that exhibit a hybrid nature were sourced from multiple asset classes (e.g. preferreds from investment grade and high yield corporates). Finally, some additional asset classes were carved out from close counterparts (e.g. bank loans from high yield corporates).

Flexibility is key

We believe the flexibility provided by extending beyond a traditional benchmark should prove to be valuable more often than not over longer market cycles. This flexibility stems from the broad investment opportunity set that extends beyond traditional fixed income benchmarks. This can be achieved through multiple approaches that incorporate active fixed income portfolio management. Investors also have flexibility depending on how their fixed income portfolio fits within their overall investment strategy. For example, investors who deploy high quality fixed income as a buffer for their equity positions may still consider dialing up the credit exposure a tad to increase the efficiency of the fixed income holdings. Other investors that are open to taking an even greater degree of credit risk and wish to fully participate in a broad variety of fixed income segments may want to utilize a disciplined asset allocation approach for their fixed income holdings that incorporates strategic and tactical tilts.

Conclusion

Although the Fed will likely commence the monetary tightening cycle later this year, fixed income investors face challenges ahead. Higher, or even range-bound rates, and low starting yield levels portend mediocre returns to come. Against this backdrop, we believe venturing beyond the benchmark in fixed income should be value added over a multi-year horizon. Investors have flexibility in this approach when considering how their fixed income holdings fit within their overall portfolio goals and objectives.
Appendix

Sources of strategic asset allocations and investor risk profiles
Strategic asset allocations represent the longer-term allocation of assets that is deemed suitable for a particular investor. The strategic asset allocation models discussed in this publication, and the capital market assumptions used for the strategic asset allocations, are based on those developed and approved by the Wealth Management Americas Asset Allocation Committee (WMA AAC).

The strategic asset allocations are provided for illustrative purposes only and are based on those designed by the WMA AAC for hypothetical US investors with a non-taxable, moderate risk profile. In general, strategic asset allocations will differ among investors according to their individual circumstances, risk tolerance, return objectives and time horizon. Therefore, the strategic asset allocations in this publication may not be suitable for all investors or investment goals and should not be used as the sole basis of any investment decision. Minimum net worth requirements may apply to allocations to non-traditional assets. As always, please consult your UBS Financial Advisor to see how these weightings should be applied or modified according to your individual profile and investment goals.
Appendix: Investment Committee

Global Investment Process and Committee Description
The UBS investment process is designed to achieve replicable, high quality results through applying intellectual rigor, strong process governance, clear responsibility and a culture of challenge.

Based on the analyses and assessments conducted and vetted throughout the investment process, the Chief Investment Officer (CIO) formulates the UBS Wealth Management Investment House View (e.g., overweight, neutral, underweight stance for asset classes and market segments relative to their benchmark allocation) at the Global Investment Committee (GIC). Senior investment professionals from across UBS, complemented by selected external experts, debate and rigorously challenge the investment strategy to ensure consistency and risk control.

Global Investment Committee Composition
The GIC is comprised of 13 members, representing top market and investment expertise from across all divisions of UBS:

- Mark Haefele (Chair)
- Mark Andersen
- Andreas Høfert
- Jorge Mariscal
- Mads Pedersen
- Mike Ryan
- Simon Smiles
- Tan Min Lan
- Themis Themistocleus
- Larry Hatheway (*)
- Bruno Marxer (*)
- Curt Custard (*)
- Andreas Koester (*)

(*) Business areas distinct from Chief Investment Office/Wealth Management Research

WMA Asset Allocation Committee Description
We recognize that a globally derived house view is most effective when complemented by local perspective and application. As such, UBS has formed a Wealth Management Americas Asset Allocation Committee (WMA AAC). WMA AAC is responsible for the development and monitoring of UBS WMA’s strategic asset allocation models and capital market assumptions. The WMA AAC sets parameters for the CIO WMR Americas Investment Strategy Group to follow during the translation process of the GIC's House Views and the incorporation of US-specific asset class views into the US-specific tactical asset allocation models.

WMA Asset Allocation Committee Composition
The WMA Asset Allocation Committee is comprised of six members:

- Mike Ryan
- Michael Crook
- Stephen Freedman
- Richard Hollmann (*)
- Brian Nick
- Jeremy Zirin

(*) Business areas distinct from Chief Investment Office/Wealth Management Research
Appendix

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