US fixed income

Beyond benchmark fixed income investing - update | 24 May 2016

CIO WM Research
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- US taxable fixed income investors find themselves in a challenging market environment characterized by low starting yield levels, bouts of volatility, and a longer, drawn-out normalization cycle.
- Diversifying bond portfolios away from traditional taxable fixed income benchmarks that are heavily government weighted (i.e., Barclays Aggregate Index) and incorporating multiple types of credit instruments into portfolios should lead to superior risk-adjusted returns over time.
- Year-to-date, the exposure that the recommended theme allocation has to high yield bonds, securitized products, and TIPS has benefited its performance. Its shorter duration has been a performance drag vs. the Barclays Aggregate Index.

"Beyond benchmark fixed income investing" recommends that investors diversify bond portfolios away from traditional taxable fixed income benchmarks that are heavily government-weighted, such as the Barclays Aggregate Index. In addition to investment grade corporates, which are represented in the Barclays Aggregate, the theme incorporates other types of credit-related asset classes such as high yield bonds, securitized products such as CMBS, preferred securities, and senior loans. Within the government allocation, it also has exposure to Treasury Inflation Protected Securities (TIPS), which are absent from the traditional benchmark. We believe that having exposure to these additional asset classes should lead to superior risk-adjusted returns over the longer term.

Performance tracking
Since we first launched this theme on 26 March 2015, the Barclays Aggregate index has produced a 2.6% total return, while our House View taxable fixed income strategic allocation has a 2.4% return. Year-to-date, the Barclays Aggregate has a 3.3% total return, while the strategic theme allocation has a 3.5% return. The beyond-benchmark theme’s exposure to high yield corporate bonds (+7.2%), TIPS (+4.1%), and securitized products (+3.2%) is the primary source of the theme’s outperformance this year. Its shorter duration has been a performance drag vs. the Barclays Aggregate.

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Our House View taxable portfolio has a duration of 4.8 years vs. 5.5 years for the Barclays Aggregate Index. The longer duration has been a benefit to the Agg this year, as Treasury yields moved lower and the rates curve flattened. The average yield for the beyond benchmark portfolio is 2.7% vs. 2.2% for the Barclays Aggregate. This stems from the inclusion of credit-sensitive asset classes that contain greater coupon income.

**Venture beyond the benchmark**

Ten-year Treasury yields fell throughout the early part of the year, as turbulent global financial markets and less-than-encouraging economic data decreased the likelihood of a rate increase in March. While we have seen increased expectations of rate hikes following the release of the April FOMC minutes, 10-year Treasury yields remain below 2%. We expect yields to slowly and modestly rise throughout the course of the year, and we expect further bouts of volatility due to uncertainty around Fed policy.

The Fed’s “dot plot” shows us that policymakers look for the tightening cycle to be more gradual and finish at a lower level than in past history. Gradually rising rates help limit the immediate price risk to fixed income holdings, but they don’t bode well for future total returns. 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. Given that the normalized level of coupon rates (i.e., market yields) are likely to be lower in this cycle, bonds are poised to produce more mediocre returns over the next several years. We believe the composition of our recommended theme allocation has superior qualities relative to the Barclays Aggregate Index. This includes the lower exposure to government bonds and increased allocation to spread sectors that provide an added element of risk asset exposure, and potential for greater returns.

**Summary**

US taxable fixed income investors find themselves in a challenging market environment characterized by low starting yield levels, bouts of volatility, and a longer, drawn-out normalization cycle. The most widely used benchmark is the Barclays Aggregate Index, which suffers from several flaws, in our view. We believe that investors can circumvent benchmark shortcomings by diversifying bond portfolios beyond a traditional benchmark and adopting a more flexible approach to active fixed income management.
Appendix

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