UBS

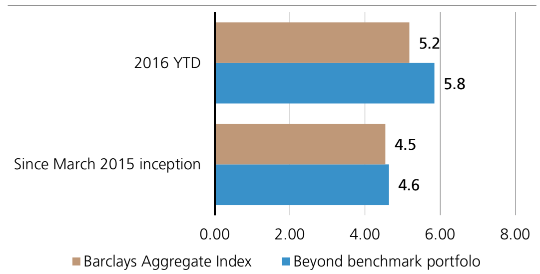
US fixed income

Beyond benchmark fixed income investing - update | 19 September 2016

CIO WM Research
Barry McAlinden, CFA, Fixed Income Strategist, barry.mcalinden@ubs.com; Leslie Falconio, Senior Fixed Income Strategist, leslie.falconio@ubs.com

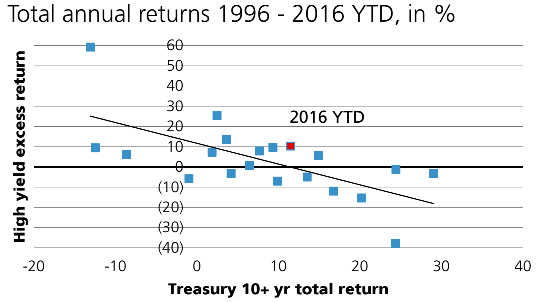
- Despite it's shorter duration (4.7yrs vs 5.6yrs), the beyond the benchmark theme portfolio has outperformed the Barclays Agg this year, even with the sharp decline in Treasury yields. Strong performance in high yield (HY) corporates has made up for the theme's lower duration. In addition, off-benchmark TIPS have provided added return.
- Surprisingly, both high quality long duration and riskier credit segments have simultaneously shined. This comes as global central bank policies have pushed down sovereign yields, and a recovery in commodity sectors and investor reach for yield has benefited credit.
- Amidst the uncertain backdrop, keeping balance in a fixed income portfolio will remain important. We believe having a dispersion of sectors gives investors the ability to obtain extra yield in a risk controlled way.

Fig. 1: Theme performance
In %



Source: Bloomberg, UBS, as of 16 Sept. 2016

Fig. 2: Long Treasuries vs. HY annual returns
Total annual returns 1996 - 2016 YTD, in %



Source: BAML, UBS, as of 16 Sept. 2016

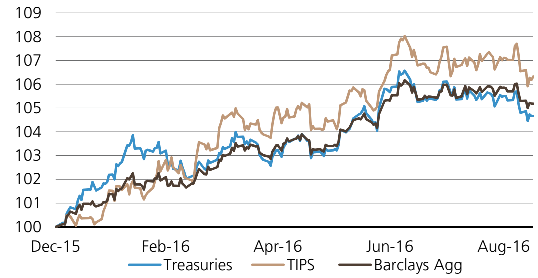
Theme overview

"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.

What's been working for the theme?

Given how well both long duration and credit spread products have performed this year is surprising. Long-term government bond yields declined by over 50bps and HY credit spreads narrow by 170bps over the same period. Normally such a plunge in benchmark rates would signal a poor economic environment or central bank mistake. Instead, this dichotomy stems from the impact that accommodative global central banks have had in pushing non-US sovereign yields lower and the influence this has on US government yields. At the same time that Treasury yields have declined and the yield curve has flattened, credit spreads have sharply narrowed. High yield bonds have been the best performing US fixed income segment, which has been the largest contributor to the theme's relative performance. High yield benefited from the recovery in oil prices that provided an opportunity for energy companies to raise capital in the debt and equity markets following oil's plunge earlier this year. HY energy has had a 29% total return YTD but even outside of energy, significant returns of 12% have been realized. Accommodative policies by global central banks and alleviating growth scares have helped to compress risk premiums more broadly.

Fig. 3: TIPS outperforming Treasuries
YTD total return, 31 Dec. 2015 = 100

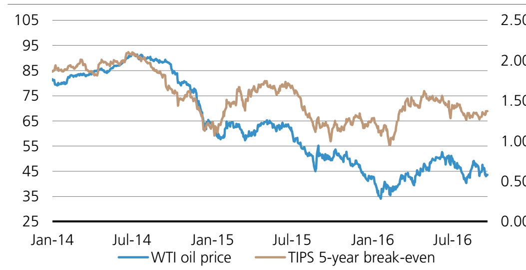


Source: BAML, Bloomberg, UBS, as of 16 Sept. 2016

Treasury Inflation Protected Securities (TIPS)

Another non-index allocation which has provided additional total rate of return to the beyond benchmark strategy has been TIPS. The year-to-date return on the TIPS index is currently 5.9%. Our view on TIPS, and particularly 5-year TIPS this year, has moved from an overweight to a neutral stance. The break-even inflation rates on the majority of TIPS assets are higher than the beginning of the year given the recovery in oil. We maintain a hold in the asset class for a non-index type of strategy. We believe that when interest rates rise on the back of growth and inflation, TIPS will outperform nominal US Treasury securities.

Fig.4: Oil prices influencing break-even rates
WTI oil (LHS) in USD and TIPS 5-yr break-even (RHS) , in %

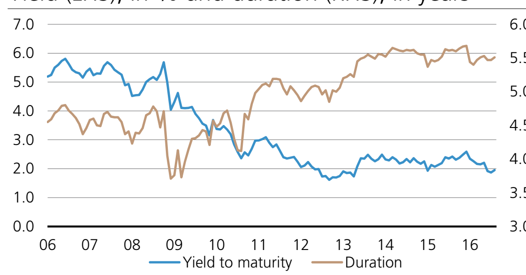


Source: Bloomberg, UBS, as of 16 Sept. 2016

Amidst the uncertainty, maintain balance

We continue to see yield developments outside the US as having strong influence on the shape of the US yield curve, which should make for a more gradual rise in longer term yields. History shows when the Fed tightens, the yield curve flattens. This time, the curve is currently very flat and may be leading the Fed's actions. Within high yield credit, we see spreads as slightly expensive at 530bps and we recommend investors maintain a neutral allocation. Normally HY bonds can do well if the Fed is hiking rates on the back of stronger growth. At this time, however, we see potential for some spread widening given how far spreads have already compressed.

Fig.5: Barclays Agg: low yield and high duration
Yield (LHS), in % and duration (RHS), in years



Source: Bloomberg, UBS, as of 16 Sept. 2016

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 fed tightening 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. Keeping balance in the portfolio will remain important and having a dispersion of sectors gives investors the ability to obtain extra yield in a risk controlled way.

Appendix

Statement of Risk

Municipal bonds - Although historical default rates are very low, all municipal bonds carry credit risk, with the degree of risk largely following the particular bond's sector. Additionally, all municipal bonds feature valuation, return, and liquidity risk. Valuation tends to follow internal and external factors, including the level of interest rates, bond ratings, supply factors, and media reporting. These can be difficult or impossible to project accurately. Also, most municipal bonds are callable and/or subject to earlier than expected redemption, which can reduce an investor's total return. Because of the large number of municipal issuers and credit structures, not all bonds can be easily or quickly sold on the open market.

	Rating Agencies			Credit Ratings
	S&P	Moody's	Fitch/IBCA	Definition
Investment Grade	AAA	Aaa	AAA	Issuers have exceptionally strong credit quality. AAA is the best credit quality.
	AA+	Aa1	AA+	Issuers have very strong credit quality.
	AA	Aa2	AA	
	AA-	Aa3	AA-	
	A+	A1	A+	Issuers have high credit quality.
	A	A2	A	
	A-	A3	A-	
	BBB+	Baa1	BBB+	Issuers have adequate credit quality. This is the lowest Investment Grade category.
	BBB	Baa2	BBB	
	BBB-	Baa3	BBB-	
Non-Investment Grade	BB+	Ba1	BB+	Issuers have weak credit quality. This is the highest Speculative Grade category.
	BB	Ba2	BB	
	BB-	Ba3	BB-	
	B+	B1	B+	Issuers have very weak credit quality.
	B	B2	B	
	B-	B3	B-	
	CCC+	Caa1	CCC+	Issuers have extremely weak credit quality.
	CCC	Caa2	CCC	
	CCC-	Caa3	CCC-	
	CC	Ca	CC+	Issuers have very high risk of default.
	C		CC	
			CC-	
	D	C	DDD	Obligor failed to make payment on one or more of its financial commitments. this is the lowest quality of the Speculative Grade category.

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Appendix

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