Portfolio Construction and Strategy

PORTFOLIO DIAGNOSTICS REPORT

Income Investing Simplified

Reorienting Portfolio Yield for Today's Markets

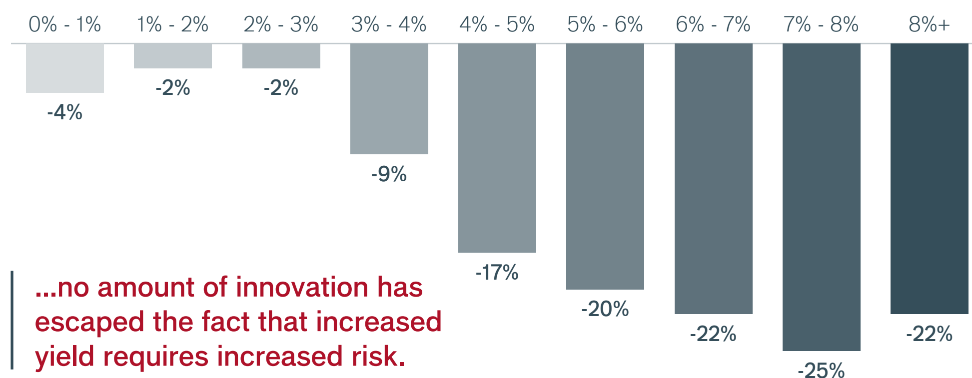
In a world starved of yield for nearly a decade, there has been a proliferation of new income investment solutions spanning public and private markets, equities and fixed income. Income innovation in the face of low global interest rates has been welcome, but many of these new solutions are stretching the risk boundaries of traditional income asset classes by utilizing increasingly complex and esoteric instruments. We believe investors have opportunities to take advantage of some of these new capabilities, but at the same time, they need to be more mindful than ever of potential hidden risks.

The Global Financial Crisis and the Hidden Risk of Yield

Considering that many current income solutions didn't exist in 2008, the Global Financial Crisis (GFC) is a good starting point for advisors to study the hidden risk of yield in some portfolios. One lens through which we can study this risk is the GFC drawdown over the period September 2008 to March 2009 and how it affected fixed income strategies grouped by current yield.[1]

When Yield isn't Safety

Drawdowns during the Global Financial Crisis by current portfolio yield (9/08 – 3/09)



...no amount of innovation has escaped the fact that increased yield requires increased risk.

A couple of necessary caveats to this exercise: 1) this analysis is based on each fund's current yield (as of 2/28/19), not its 2008 yield, and 2) we don't expect the GFC to repeat. However, this is a useful way to gain risk-based insight on income portfolios: no amount of innovation has escaped the fact that increased yield requires increased risk.

Throughout our thousands of consultations with financial advisors, the Janus Henderson Portfolio Construction and Strategy (PCS) team helps our clients navigate portfolio income and other challenges. Based on our experience throughout these consultations, we have identified three primary areas of focus for investors looking to enhance their portfolio's risk-adjusted yield:

1. Opportunities in an "Uncurved" Yield Curve
2. Dynamic Credit: Lowering Risk in High Yield
3. The Equity Income Blind Spot

[1] Source: Morningstar. "Fixed income strategies" includes funds in the following Morningstar categories: Bank Loan, Corporate Bond, Emerging-Markets Local-Currency Bond, Inflation Protected Bond, Long Government, Long-Term Bond, Multisector Bond, Preferred Stock, Short Government and Ultrashort Bond

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① Opportunities in an "Uncurved" Yield Curve

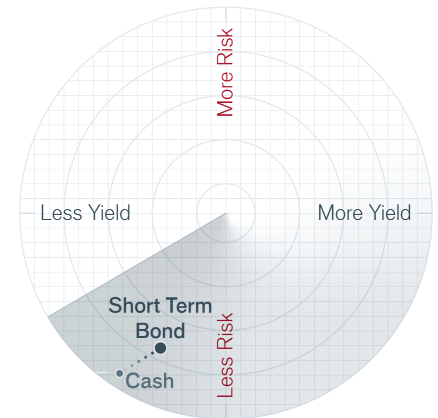
The flattening yield curve dominated economic headlines in the first half of 2019. Between January 2017 and April 2019, two-year Treasury yields rose slightly over 1% to 2.3%, while the 10-year Treasury rose only about 0.1% to 2.5%.

Despite the extensive media attention, common-sense explanations of this phenomenon's investment implications have been hard to come by. Simply put, when investing in U.S. Treasuries, today's flattening curve means short-term bonds and long-term bonds may generate similar yields, but they carry different levels of interest rate risk. Consequently, relative to shorter maturity Treasuries, investors are being paid less yield to venture into longer-maturity, higher-risk Treasuries compared to two years ago.

The implications of this are twofold: put cash to work, and derisk traditional core bonds.

1a Put Cash to Work

The aforementioned increase in short-term rates hasn't filtered through to clients' cash savings accounts. According to the FDIC, as of April 2019, the national average checking account interest rate is 0.06%, and the savings account rate is 0.10%. Adjust for inflation, and it's not surprising that the average real return on cash since the Global Financial Crisis has been -1.4%.



Since the GFC, Holding Cash has Eroded Wealth

0.06%
National Average Checking Account Interest Rate

0.10%
National Average Savings Account Interest Rate

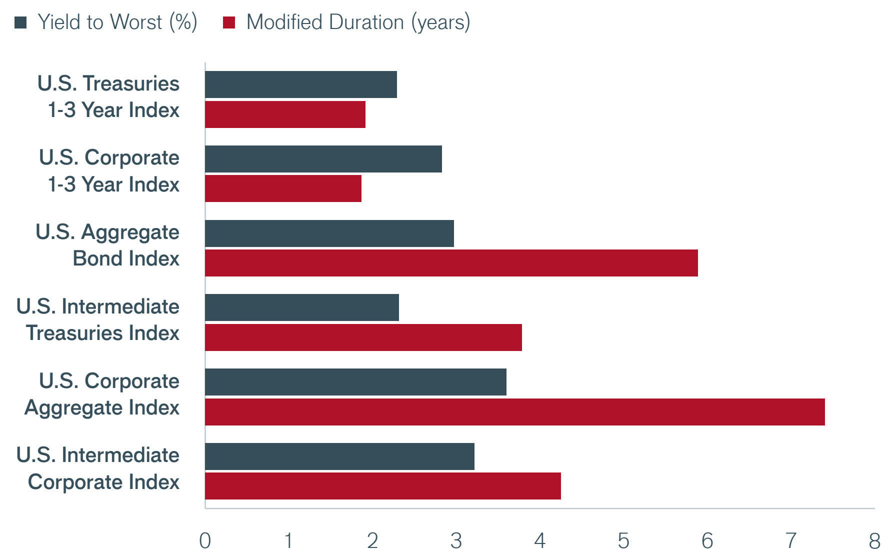
-1.4%
Annual Real Return on Cash Since Global Financial Crisis

Source: Federal Deposit Insurance Corporation

Source: FactSet

Today's flattened yield curve is a boon to these cash investors. At a time when less-risky shorter-term Treasuries offer similar yields as riskier longer-term Treasuries, the average cash investor can add incremental yield by moving to short-term Treasuries.

Shorter-Dated Bonds Currently Exhibit Favorable Risk Profiles

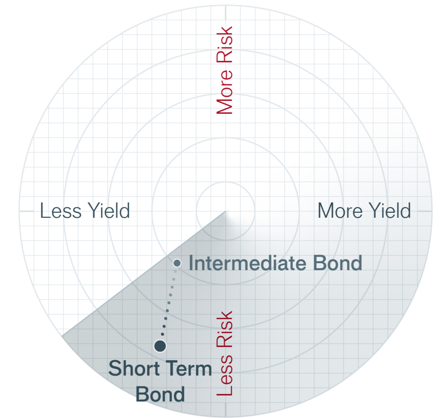


Source: Barclays Live, as of 4/30/19.

Bloomberg Barclays indices shown represent investment-grade, fixed-rate debt of the U.S. bond markets described by their names. Yield to Worst: The lowest potential yield an investor would earn – accounting for all provisions – short of a security defaulting. Modified Duration: A measurement of a bond's sensitivity to interest rates, with a higher number, measured in years, being more sensitive.

Deposits in bank accounts may be insured by the FDIC or another government agency, an investment in securities is not.

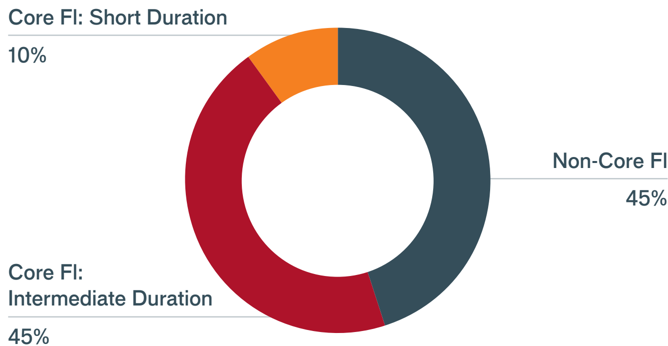
1b Derisk Traditional Core Bonds, Keep the Yield



Whereas cash investors need not reach past short-term Treasuries to obtain the vast majority of the yield improvements, the inverse is true for investors passively invested in intermediate-term bonds. Moving a portion of assets from traditional intermediate bonds with a duration of around five or six years to short-term fixed income with a one- to two-year duration can potentially reduce fixed income risk without meaningfully reducing yield.

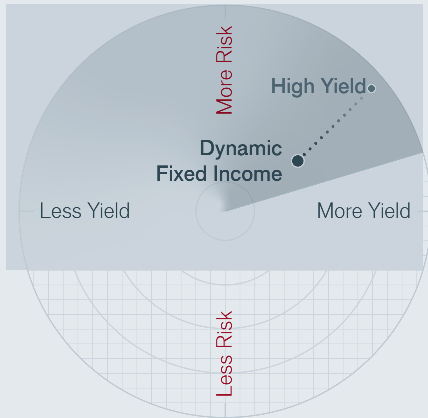
What portion of fixed income portfolios could potentially benefit from this intermediate bond opportunity? Our Fixed Income Industry Portrait helps answer that question. Developed from our proprietary database of thousands of advisor portfolios on which we've consulted during our Portfolio Construction and Strategy work, these portraits allow us to zero in on the typical advisor's core fixed income allocation.

Core Fixed Income Industry Portrait



With the vast majority of advisor core fixed income allocated to intermediate duration, short duration is a compelling diversification opportunity because it can reduce portfolio interest rate risk without a meaningful yield reduction. In other words, short duration has the potential to outperform if interest rates rise, and today's yield curve implies that this benefit might not come at the cost of lower yields.

② Dynamic Credit: Lowering Risk in High Yield

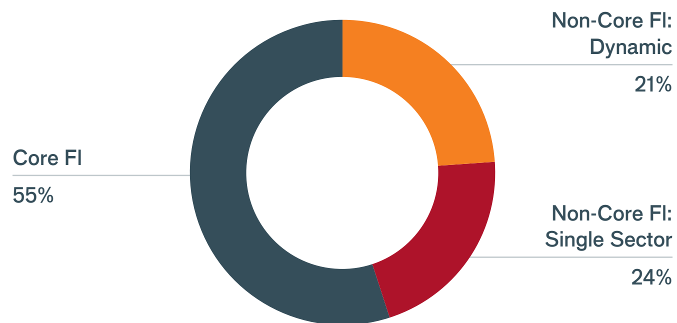


For investors seeking portfolio yield, utilizing a dynamic manager can help balance the risks of fixed income markets within the boundaries of interest rate risk and credit risk. However, the universe of dynamic managers is far from homogenous. There is no shortage of innovation in this category, which has raised the hurdle for managers' due diligence. As discussed in the introduction, no amount of innovation has changed the fact that increased yield carries increased risk. The implication here is that investors need to scrutinize existing and potential dynamic credit holdings and look not just at yield, but also at the complexity with which that yield is created.

When balancing income potential with the ability to articulate expectations to clients, we believe the most complicated solutions are often the wrong solutions. We focus on straightforward solutions in the dynamic credit space that limit exposure to esoteric asset classes (e.g., derivatives, leverage, currency, etc.) and other complex approaches that can generate unintended risk.

Drawing once again on our proprietary database's Industry Portraits, let's take a look at the typical advisor's non-core fixed income allocations:

Non-Core Fixed Income Industry Portrait



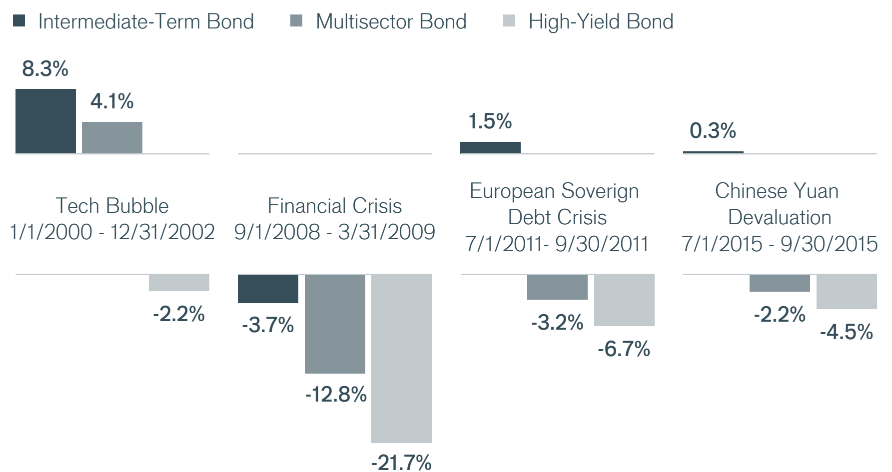
Many advisors have reallocated away from core fixed income, moving about 45% of the average fixed income portfolio into non-core fixed income. The effect of this diversification is straightforward: it shifts the portfolio risk posture. While this trade has helped generate income, it has also increased equity-like risk in fixed income at a time when credit spreads are relatively tight and near long-term averages. While we believe there are ample opportunities in higher yielding, equity-like fixed income markets, we also believe that investors must employ discretion when using these higher octane fixed income strategies within their portfolios.

To help mitigate the increased risk, investors may want consider shifting to dynamic, multisector credit strategies that seek to maintain exposure to higher yields in credit markets while potentially derisking single sector risk.

Here, we revisit a few historical market events and their effects on three groups of fixed income, from lowest risk (Intermediate-Term) to highest risk (High-Yield), with Multisector proving its merit as a middle ground:

Returns During Extreme Market Events

Dispersion among the fixed income universe



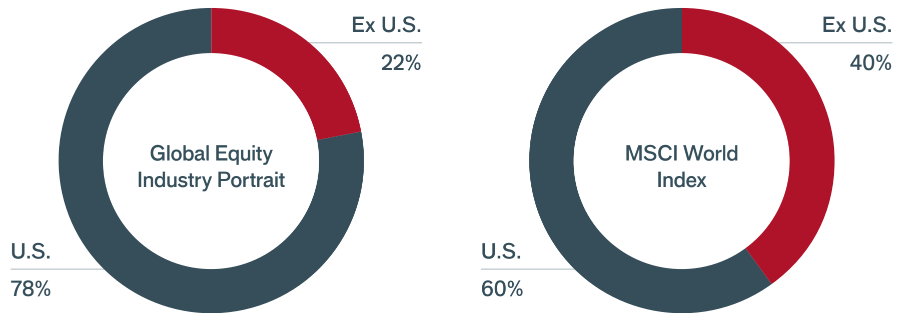
Source: Morningstar

③ The Equity Income Blind Spot

With many income portfolios largely allocated to equities, and the vast majority of those equities commonly invested in the U.S., some of the biggest income-increasing opportunities in portfolios may actually be found in the equity allocation.

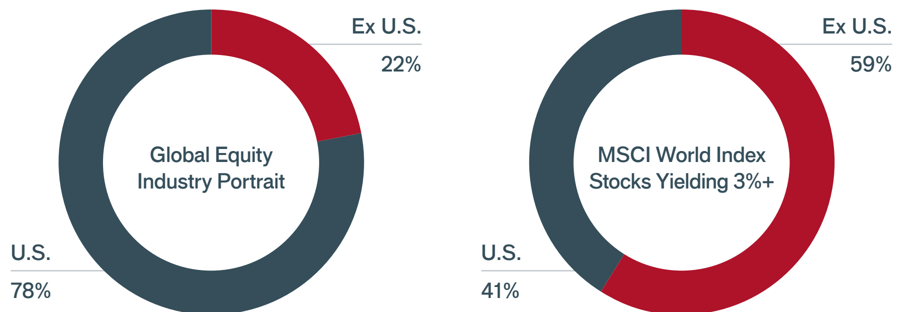
Let's revisit our proprietary Industry Portrait of advisor asset allocations, focusing this time on the average global equity allocation. The first chart illustrates the Global Equity Industry Portrait as compared to the MSCI World Index[SM] benchmark (a suitable benchmark to illustrate an arguably neutral global equity allocation): with the average advisor allocating about 22% of their equities overseas, they can nearly double their overseas equity allocation and still be considered "neutral" compared to the MSCI World Index.

Global Equity Industry Portrait vs. MSCI World Index

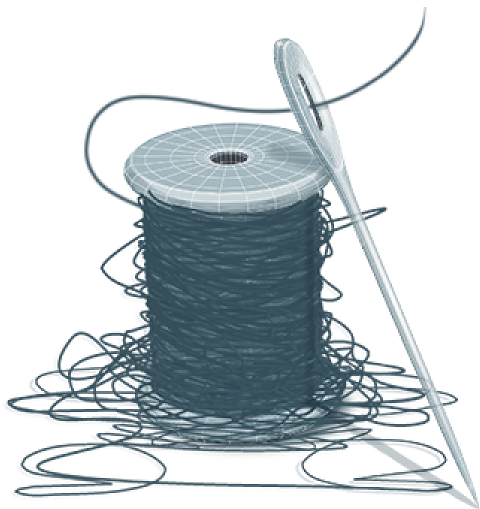


Let's look again at the Global Equity Industry Portrait. This time, instead of MSCI World, we'll compare our portrait to the stocks within MSCI World that yield at least 3% – which is meaningfully higher than the average U.S. equity yield:

Global Equity Industry Portrait vs. MSCI World Index Stocks Yielding 3% and Above



With such a large concentration in U.S. equities, some investors might not recognize the significant income potential in overseas equities. Depending on their risk tolerance, investors may find a significant income opportunity in reallocating equities globally, where yields can commonly be double or triple that of U.S. equities.



As we continue to discuss with our clients the importance of balancing income and risk for more conservative income-producing portfolios, we maintain our forward-looking view:

- The flattened yield curve has created opportunities to utilize short duration for cash and passive core bond investors.
- Higher yielding, equity-like fixed income still shows potential, but risk can and should be managed through dynamic, multisector approaches.
- The equity income blind spot creates a meaningful yield shortfall in most equity portfolios; a global equity approach can help meaningfully improve total portfolio yield.

About Janus Henderson's Portfolio Construction and Strategy Team

The PCS Team performs customized analyses on advisor portfolios, providing differentiated, data-driven diagnostics. From a diverse universe of thousands of models emerge trends, themes and potential opportunities in portfolio construction that we believe will be interesting and beneficial to any investor.

For more information, please visit **janushenderson.com.**

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Fixed income securities are subject to interest rate, inflation, credit and default risk. The bond market is volatile. As interest rates rise, bond prices usually fall, and vice versa. The return of principal is not guaranteed, and prices may decline if an issuer fails to make timely payments or its credit strength weakens.

Foreign securities are subject to additional risks including currency fluctuations, political and economic uncertainty, increased volatility, lower liquidity and differing financial and information reporting standards, all of which are magnified in emerging markets.

Any risk management process discussed includes an effort to monitor and manage risk which should not be confused with and does not imply low risk or the ability to control certain risk factors.

Diversification neither assures a profit nor eliminates the risk of experiencing investment losses.

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