Investment Insights Series

Janus Henderson
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When Conventional Wisdom Fails

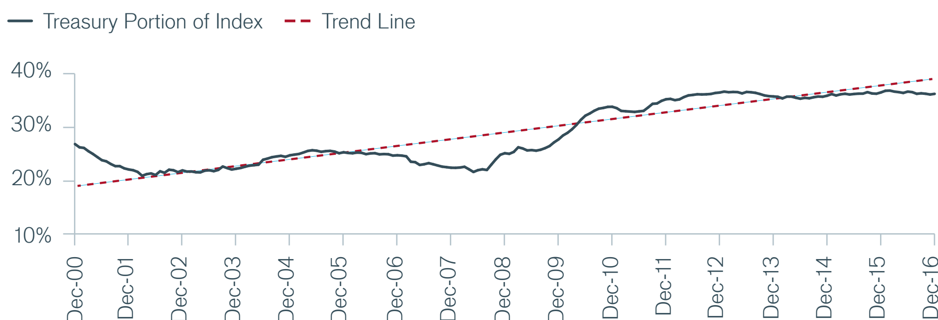
Underappreciated Risks of Fixed Income's Flagship Benchmark

For thirty years, the Bloomberg Barclays U.S. Aggregate Bond Index (Agg) has been the most widely used proxy for the U.S. fixed income market. The index represents the investment-grade, U.S. dollar-denominated, fixed-rate taxable bond market. Despite the universal acceptance of the Agg, we believe many investors are largely unaware of its construction flaws. We caution investors seeking broad bond market exposure through exchange traded funds and mutual funds that passively track this benchmark to be mindful of its changing risk profile.

Weightings Based Upon Outstanding Debt

The index comprises Treasury securities, government-related debt, investment-grade corporate credit, mortgage-backed securities (MBS), asset-backed securities (ABS) and commercial mortgage-backed securities (CMBS). Allocations are determined by levels of outstanding debt, with the largest issuers often representing substantial weightings in the index. As the U.S. government issued more Treasurys after the 2008 financial crisis, their weight in the index increased dramatically from 22% in June 2008 to 36% at the end of 2016. In terms of corporate credit, because allocations are established by issuance, the Agg emphasizes companies with the most highly levered balance sheets. In equity capitalization-weighted indices, a company's weight increases as it grows its business; however, the weightings in the Agg are commensurate with the amount of leverage a company takes on. In certain circumstances, increased leverage equates to greater credit risk. The index often skews toward capital-intensive, cyclical industries. Businesses with strong and improving fundamentals – which may be poised for ratings upgrades – tend to be underrepresented.

U.S. Treasurys Represent an Increasing Percentage of the Agg



Source: Bloomberg Barclays indices.

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- Despite the universal acceptance of the Agg, many investors may be unaware of its construction flaws and changing risk profile.
- Index weights are determined by issuance, which has contributed to escalating duration, while the Agg's yield trends lower.
- The Agg represents a small subset of the U.S. bond market and employs backward-looking construction techniques, inefficiencies active managers may be able to exploit.

Duration Extension and Low Yields

Given the growing exposure to longer-dated Treasurys, the Agg's duration has reached all-time highs, extending from 3.71 years in December 2008 to 5.89 years at the close of 2016. U.S. Treasury securities offer lower coupon payments than other fixed income instruments and typically provide little income cushion to combat interest rate increases. Similarly, MBS – which represent just over 25% of the Agg – offer low coupons and little spread over Treasurys. They also tend to extend duration in a rising-rate environment. Many corporate benchmark constituents took advantage of low interest rates to push out debt maturities in recent years, further extending the index's duration. Meanwhile, the benchmark's corporate credit allocation, it can be argued, isn't providing sufficient yield cushion to absorb losses from interest-rate volatility.

The Duration of the Agg Has Reached All-Time Highs, While Its Yield Is Trending Lower

Source: Bloomberg Barclays indices.

> **Going forward, index performance will be highly sensitive to small moves in interest rates.**

Small Subset of the U.S. Bond Market

With 10,069 securities and a market value of $19.1 trillion at the end of 2016, many will be surprised to learn that the Agg represents less than half of the total U.S. fixed income market. The index excludes high-yield corporate bonds, bank loans, convertible and preferred securities, inflation-linked bonds and floating-rate securities. For corporate bonds, the index maintains an inclusion threshold of $300 million per issue, which often leads to the omission of smaller and potentially mispriced and underfollowed issues. In our view, these excluded securities represent many of the most attractive risk-adjusted return opportunities in the asset class.

> **The Agg represents only 48% of the total U.S. fixed income market.**

Source: Securities Industry and Financial Markets Association (SIFMA). As of 12/30/16

Backward-Looking Construction Techniques

The index's construction methodology includes monthly rebalancing. Upgraded securities are not added and downgraded securities are not removed until month end, thus creating additional misrepresentation of the underlying bond market. Moreover, the index is dependent upon the Nationally Recognized Statistical Rating Organizations (NRSROs) – S&P, Moody's and Fitch – for determining which entities are deemed investment grade. Due to their reliance on backward-looking data, the NRSROs have long been criticized for reacting too slowly. Specifically, they have been critiqued for being slow to downgrade companies that ultimately went bankrupt in the 2000-2002 technology crash and 2007-2009 financial crisis. We believe the reliance upon rating agencies often creates inefficiencies from which active managers can benefit.

A Case for Active Fixed Income Management

Core Plus fixed income strategies typically have flexibility to exploit the inefficiencies created by debt-weighted index construction methodologies and backward-looking ratings agencies. We believe many of the best total and risk-adjusted return opportunities are in the corporate credit markets. These instruments generally offer higher yields than the MBS and Treasurys prevalent in the Agg. Furthermore, the corporate credit sector remains an area where fundamental, bottom-up analysis combined with robust risk management can improve a manager's potential to provide risk-adjusted outperformance.

Investors passively replicating the index, and trading concurrently with it, may not always receive the best pricing on issues moving from high yield to investment grade. By contrast, active managers may be able to identify and invest in crossover names positioned for ratings upgrades before they are included in the Agg. The key to this competitive advantage is a focus on strong company fundamentals and performance potential, as opposed to the amount of debt outstanding.

Periods of market repricing can create additional opportunities for active managers to buy securities at attractive valuations and reposition at different points along the yield curve. Active managers can also adapt to changing market environments by dynamically allocating across asset classes, sectors and securities. These steps can help investors preserve capital and position themselves for the next market cycle. The median active Core Plus manager has outperformed the index over the past decade, evidence that the Agg may not represent the most effective approach to the U.S. fixed income market.

Active Managers Have Outperformed Over a Variety of Time Periods

	1 Year	5 Years	7 Years	10 Years
Median Active Core Plus Manager	3.34%	2.94%	4.15%	4.67%
Bloomberg Barclays U.S. Aggregate Index	2.65%	2.23%	3.63%	4.34%
Active Outperformance	0.69%	0.71%	0.52%	0.33%

Source: Morningstar.
Notes: As of 12/31/2016. Performance is net of fees. Based on the U.S. Intermediate-Term Bond category, Institutional shares, active funds only.

Fixed income plays an important role in an investor's portfolio — but manager selection is critical in order to avoid benchmark pitfalls and navigate challenging credit and rate periods.

For more information, please contact your financial advisor or visit **janushenderson.com.**

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FOR MORE INFORMATION CONTACT JANUS HENDERSON INVESTORS

151 Detroit Street, Denver, CO 80206 / 800.668.0434 / www.janushenderson.com

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