4Q18 Portfolio Commentary

Janus Henderson INVESTORS

# Flexible Bond Fund
# VIT Flexible Bond Portfolio

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## Investment Environment

Slowing economic growth in Europe and China, weakening U.S. data and a lack of resolution in U.S.-China trade relations shook investor confidence over the period. In December, the Federal Reserve (Fed) raised interest rates for the fifth consecutive quarter. Fed rhetoric added to market volatility as it created concern over the possibility that the central bank might maintain its hiking cadence despite economic and market weakness. Oil prices also made headlines as the West Texas Intermediate (WTI) price per barrel tumbled more than 40% intra-quarter. Amid these events, a risk-off mindset prevailed. Weakness in equity markets and increasing risk premiums contributed to widening corporate credit spreads (the difference in yield between a security and its underlying risk-free benchmark). Investment-grade spreads over Treasuries widened nearly 45% from September. High yield fared worse, widening 66%. As financial conditions tightened, liquidity became more challenged, exacerbating market volatility late in the period.

Investors turned to risk-free assets, and yields fell across the Treasury curve. A repricing in market expectations for the Fed's ability to hike in 2019 also contributed to falling yields. The yield on the 10-year Treasury note ended December at 2.68%, down from 3.06% in September. Led higher by the rally in rates, the Bloomberg Barclays U.S. Aggregate Bond Index returned 1.64%.

## Performance Discussion

The Fund underperformed its benchmark, the Bloomberg Barclays U.S. Aggregate Bond Index, for the three months ending December 31, 2018.

Tightening financial conditions, diminished liquidity and the credit rating downgrades of a few large investment-grade complexes helped to confirm our view that we are progressing through the later stages of the credit cycle. Given our late-cycle concerns and the darkening macroeconomic picture, we sought to lower the Fund's risk exposure during the period. While we found liquidity to be challenged, and reaching our target positioning difficult, we did reduce our corporate bond allocation by 7.5%. Amid the market's repricing of Fed expectations, we also reevaluated our floating rate exposure and lowered our allocations to bank loans and asset-backed securities (ABS). We nearly doubled our Treasury allocation to roughly 24% and extended duration (a measure of sensitivity to changes in interest rates) to 101% versus the index.

Despite our efforts to reduce risk, it was our risk exposure that detracted most from relative performance. Our out-of-index allocation to high-yield corporate credit was particularly detrimental given the dramatic spread widening in the asset class. We seek higher-quality, high-yield names, with consistent free-cash-flow generation potential and management teams committed to paying

### Highlights

- Concerns of a policy misstep by the Fed coupled with slowing global economic growth and continued trade tensions challenged risk assets during the quarter.
- The Fund underperformed its benchmark, with our out-of-index exposures to both high yield and bank loans weighing most on performance.
- We are monitoring the pace of slowing growth and the impact of Fed policy for insight into whether this is another speed bump in an extended economic cycle or if recession probabilities are increasing.

down debt, but even those names were challenged. The leading detractor for the quarter was Freeport-McMoRan. The copper miner's balance sheet improvement progress was overshadowed by fears of a slowdown in China coupled with trade war uncertainty, given that China consumes a significant portion of the world's copper. We appreciate the value of Freeport's assets, and ultimately expect the miner to benefit from limited supply and growing demand for copper – an essential component of electric vehicles – as the electrification of vehicles accelerates. We also like the company's commitment to deleveraging and expect management to continue paying down debt in coming months.

An allocation to commercial mortgage-backed securities also detracted from relative results. Two of our holdings were negatively impacted by weakness in brick-and-mortar retail and the tightening in capital markets, which brought into question the ability for these issuers to refinance their deals and extend maturities. Our position in Starwood Retail Property Trust, a position collateralized by four shopping malls, was among the leading individual detractors on a relative basis. We significantly reduced our position by quarter end.

Our out-of-index exposure to bank loans further weighed on relative performance amid the period's risk-off sentiment. The lack of duration in bank loans, given their floating rate structure, also proved costly as market expectations shifted from Fed hikes over the next three years to potential cuts in 2019. A significant portion of our ABS exposure is also front end and floating rate. These assets did not benefit from the strong rally in Treasury yields as many benchmark constituents did.

Our practice of security avoidance proved beneficial during the quarter. Minimal exposure to government-related securities, which include government agency debt as well as debt issued by state-owned firms, was the leading asset class contributor to relative results. Lack of exposure to certain Mexico-domiciled issuers was particularly accretive. Our underweight in the banking sector also aided relative performance. The sector is often turned to first as a source of liquidity. We believed that valuations had already accounted for the industry's healthy balance sheets and improved capital ratios, and we were mindful of a lack of improvement in net interest margins, despite rising rates earlier this year.

At the individual issuer level, our lack of exposure to several of the large investment-grade complexes that were downgraded from single-A to BBB also aided relative results. These downgrades were driven by a combination of challenged fundamentals, levering acquisitions and elevated leverage profiles. General Electric is one such example. GE's fundamentals have been weak for an extended time, and in lieu of deleveraging, it has focused on returning over $80 billion of capital to shareholders since 2015. New CEO Larry Culp's efforts to turn around the company and repair the balance sheet may take place over time, but the highly leveraged balance sheet was no longer able to support single-A ratings. Our zero weight in the credit when it fell out of the single-A index led GE to be a modest contributor.

For detailed performance information, please visit janushenderson.com/performance.

## Outlook

There are plenty of risk factors on the horizon, including slowing global economic growth, unresolved trade disputes, the potential for Fed policy error and the continued progression of the credit cycle. As a result, we expect market volatility to persist.

We will be closely monitoring U.S. economic data, particularly inflation figures, as well as Fed rhetoric. This will be pivotal in assessing the likelihood of the Fed hiking in excess of what is warranted and potentially accelerating a U.S. slowdown, versus it pausing in 2019. We are mindful of wage pressures and an uptick in oil prices near period end, as well as the importance of the U.S. dollar. Continued dollar weakness could create inflationary pressures and threaten the Fed's ability to pause. However, our base case is that the Fed will be more cautious in its cadence throughout 2019. As we approach the end of the Fed's hiking cycle, we will continue to review our floating rate allocation. And, as always, we will employ a tactical approach to yield curve positioning with a focus on capital preservation.

While the U.S. economic and corporate fundamental outlooks are slowing, we do not expect an immediate acceleration toward the cycle's end. We are monitoring the pace of slowing and the impact of Fed policy for insight into whether we are going through another modest slowdown in this extended cycle or if recession probabilities are increasing for 2020. High debt loads and diminishing liquidity create headwinds for the outlook. Tighter financial conditions and escalated market volatility could also negatively impact business confidence and capital investment trends in 2019. Despite recent spread widening, overall levels have only repriced to longer-term averages, which we generally do not believe offer just compensation for the stated risk factors and the likely increase in defaults and downgrades to come. Our outlook is cautious and we intend to be deliberate in our corporate credit positioning, emphasizing our highest-conviction names with consistent free-cash-flow generation potential, strong management teams and a commitment to paying down debt. Thorough vetting of opportunities, coupled with security avoidance remains critical as we strive to deliver on our core tenets of capital preservation and strong risk-adjusted returns.

## Top Relative Contributors and Detractors Held for the Quarter Ended 12/31/18

| Top Contributors | Average Weight (%) | Relative Contribution (%) | Top Detractors | Average Weight (%) | Relative Contribution (%) |
|---|---|---|---|---|---|
| GE Capital Corp. | 0.22 | 0.01 | Freeport-McMoRan Inc. | 0.95 | -0.07 |
| Federal Home Loan Mortgage Corp. | 9.45 | 0.01 | Starwood / Srpt 2014-Star C | 0.33 | -0.05 |
| Fannie Mae Remic Trust 2018-27 | 0.33 | 0.01 | U.S. Treasury Notes/Bonds | 16.34 | -0.04 |
| Federal National Mortgage Association | 12.44 | 0.00 | Government National Mortgage Assn. | 3.03 | -0.04 |
| Energy Transfer Equity LP | 0.33 | 0.00 | EnLink Midstream Partners, LP | 0.55 | -0.04 |

The holdings identified in this table, in compliance with Janus Henderson policy, do not represent all of the securities purchased, held or sold during the period. To obtain a list showing every holding as a percentage of the portfolio at the end of the most recent publicly available disclosure period, contact 800.668.0434 or visit janushenderson.com/info.

Relative contribution is the difference between the contribution by ticker to the portfolio's performance versus that ticker's contribution to the benchmark's performance. It reflects how the portfolio's holdings impacted return relative to the benchmark. Cash and tickers not held in the portfolio are excluded. Certain derivatives, such as Interest Rate Swaps, may be excluded.

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

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**Please consider the charges, risks, expenses and investment objectives carefully before investing. For a prospectus or, if available, a summary prospectus containing this and other information, please call Janus Henderson at 800.668.0434 or download the file from janushenderson.com/info. Read it carefully before you invest or send money.**

Past performance is no guarantee of future results. Call 800.668.0434 or visit janushenderson.com/performance for current month-end performance.

Discussion is based on the performance of Class I Shares.

The discussion and data quoted are based upon the results, holdings and characteristics of the similarly managed Janus Henderson mutual fund. Such data may vary for the Janus Henderson VIT portfolio due to asset size, investment guidelines and other factors. We believe the mutual fund most closely reflects the portfolio management style for this strategy.

As of 12/31/18 the top ten portfolio holdings of Janus Henderson Flexible Bond Fund are: United States Treasury Note/Bond (6.98%), United States Treasury Note/Bond (2.65%), United States Treasury Note/Bond (2.55%), United States Treasury Note/Bond (2.20%), United States Treasury Note/Bond (2.13%), United States Treasury Note/Bond (1.70%), United States Treasury Note/Bond (1.56%), Freddie Mac Gold Pool (1.10%), United States Treasury Note/Bond (1.08%) and United States Treasury Note/Bond (1.00%). There are no assurances that any portfolio currently holds these securities or other securities mentioned.

The opinions are as of 12/31/18 and are subject to change without notice. Janus Henderson may have a business relationship with certain entities discussed. The comments should not be construed as a recommendation of individual holdings or market sectors, but as an illustration of broader themes.

For fixed income portfolios, relative contribution is calculated by rolling up securities by ticker and comparing the daily returns for securities in the portfolio relative to those in the index. Relative contribution is based on returns gross of advisory fees, and may differ from actual performance.

**Performance may be affected by risks that include those associated with non-diversification, portfolio turnover, short sales, potential conflicts of interest, foreign and emerging markets, initial public offerings (IPOs), high-yield and high-risk securities, undervalued, overlooked and smaller capitalization companies, real estate related securities including Real Estate Investment Trusts (REITs), derivatives, and commodity-linked investments. Each product has different risks. Please see the prospectus for more information about risks, holdings and other details.**

**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.**

**High-yield or "junk" bonds involve a greater risk of default and price volatility and can experience sudden and sharp price swings.**

**Increased portfolio turnover may result in higher expenses and potentially higher net taxable gains or losses.**

**Bloomberg Barclays U.S. Aggregate Bond Index** is a broad-based measure of the investment grade, US dollar-denominated, fixed-rate taxable bond market.

Index performance does not reflect the expenses of managing a portfolio as an index is unmanaged and not available for direct investment.

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