RECONFIGURING CORE-PLUS FIXED INCOME FOR THE TRUMP INFLECTION

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The long-term ramifications of the Trump victory are yet to be understood. We hope that the business-positive aspects (tax cuts, regulatory rollback and easier repatriation) overwhelm the potential dark side of protectionism in supporting cr edit valuations (in other words, that Good Trump out-trumps Bad Trump). For income-oriented investors, complementing core fixed income with high-yield corporates has been commonly used to boost income potential. With rates likely to tick higher but credit remaining resilient, a possible variation on the core-plus idea could be to complement an all-weather portfolio with an interest rate-hedged high-yield strategy.

For much of this year, we have encouraged investors to look at their core fixed income exposures in a different light. Core bond strategies need not be driven by market capitalization or the discretion of an active portfolio manager. Disciplined, passively managed strategies can be constructed to enhance income potential while broadly maintaining the risk characteristics of the investment-grade universe. In addressing income scarcity in many core beta strategies, these core alternatives could provide a needed solution and flexible foundation for a fixed income portfolio. One such strategy is the Bloomberg Barclays U.S. Aggregate Enhanced Yield Index (Agg EY), which shifts weights toward higher-yielding securities within the broad investment-grade universe. This strategy picks up roughly 60 basis points (bps) above the yield of the Bloomberg Barclays U.S. Aggregate Index (Agg).[1]

We believe a variation on the "core-plus" strategy that combines enhanced core positions with zero duration high-yield strategies might best position investors for the coming months. The blend has the potential to increase yield while reducing duration. A portion of interest rate risk is exchanged for additional credit risk.

How does an interest rate-hedged strategy within the high-yield market work? An investor simply invests in a portfolio of high-yield bonds and then—using short positions in either Treasury bonds or futures—constructs offsetting rate exposures across the curve. So the net Treasury rate risk exposure is zero. High-yield bonds are predominantly driven by credit risk, but the value of this interest rate hedge extends more broadly to the overall portfolio.

The table below illustrates how blends between enhanced core and high-yield zero (HY Zero) strategies can be combined to achieve various duration targets and the yield and spreads to core benchmark that result from such combinations. To target a duration of five years, you would need to allocate about 26% to HY Zero with about a 74% allocation to Agg EY. This resulting Agg EY and HY Zero portfolio mix has a yield to worst of 3.91%, which is 1.34% more than the Agg.[2]

Targeting Duration by Blending a High-Yield Zero Duration Strategy with an Enhanced Yield Core Portfolio

Index Portfolio Weights		Duration	Yield to Worst	
100% Bloomberg Barclays U.S. Aggregate Enhanced Yield Index (Agg EY)		6.7 years	3.13%	0.56%
86.8% Agg EY	13.2% HY Zero	5.9 years	3.53%	0.96%
74.2% Agg EY	25.8% HY Zero	5.0 years	3.91%	1.34%
59.3% Agg EY	40.7% HY Zero	4.0 years	4.37%	1.80%
44.5% Agg EY	55.5% HY Zero	3.0 years	4.82%	2.25%
29.7% Agg EY	70.3% HY Zero	2.0 years	5.27%	2.70%
14.8% Agg EY	85.2% HY Zero	1.0 year	5.72%	3.15%
100% U.S. High Yield Zero Duration (HY Zero)		0 years	6.17%	3.60%

Sources: WisdomTree, Bloomberg, BofA Merrill Lynch, as of 11/30/16. 5.9 duration chosen as it represents the yield of the Bloomberg Barclays U.S. Aggregate Index.

For definitions of indexes and terms in the chart, visit our glossary.

Over the last year-and-a-half, we have seen 10-Year Treasury yield rates do a round-trip (2.18% to 1.39% to 2.38%) and credit spreads rise and fall; a mixture of 80% enhanced core with 20% interest rate-hedged high yield has outperformed the Agg by 0.98%, albeit with higher volatility (3.7% against 3.2%). Credit remains fairly priced relative to still-low Treasury term premium and mortgage-backed spreads. With politics potentially more corporate friendly and durations still extended, an enhanced core-plus strategy that trims a little interest rate risk could serve investors well in the coming months, in our view.

[1]Source: Bloomberg, as of 11/30/16.

[2]Sources: WisdomTree, BofA Merrill Lynch, Bloomberg, as of 11/30/16.

Important Risks Related to this Article

Fixed income investments are subject to interest rate risk; their value will normally decline as interest rates rise. In addition, when interest rates fall, income may decline. Fixed income investments are also subject to credit risk, the risk that the issuer of a bond will fail to pay interest and principal in a timely manner or that negative perceptions of the issuer's ability to make such payments will cause the price of that bond to decline.

Annualized Performance of Indexes as of 11/30/16

	1Y	Since Index Inception	Index Inception Date
Bloomberg Barclays U.S. Aggregate Enhanced Yield Index	3.19%	2.48%	5/31/2015
The BofA Merrill Lynch 0-5 Year U.S. High Yield Constrained Zero Duration Index	11.06%	2.62%	12/6/2013

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DEFINITIONS

Credit : A contractual agreement in which a borrower receives something of value now and agrees to repay the lender at some date in the future.

Valuation : Refers to metrics that relate financial statistics for equities to their price levels to determine if certain attributes, such as earnings or dividends, are cheap or expensive.

High Yield Corporate (Bond) : a type of corporate bond that offers a higher rate of interest because of its higher risk of default.

Hedge : Making an investment to reduce the risk of adverse price movements in an asset. Normally, a hedge consists of taking an offsetting position in a related security, such as a futures contract.

Market Capitalization : Market cap = share prices x number of shares outstanding. Firms with the highest values receive the highest weights in approaches designed to weight firms by market cap.

Passive : Indexes that take a rules-based approach with regular rebalancing schedules that are not changed due to market conditions.

Investment grade : An investment grade is a rating that signifies a municipal or corporate bond presents a relatively low risk of default.

Bloomberg Barclays U.S. Aggregate Enhanced Yield Index : a constrained, rules-based approach that reweights the sector, maturity, and credit quality of the Barclays U.S. Aggregate Index across various sub-components in order to enhance yield.

Basis point : 1/100th of 1 percent.

Bloomberg U.S. Aggregate Bond Index : Represents the investment-grade, U.S. dollar-denominated, fixed-rate taxable bond market, including Treasuries, government-related and corporate securities, as well as mortgage and asset backed securities.

Duration : A measure of a bond's sensitivity to changes in interest rates. The weighted average accounts for the various durations of the bonds purchased as well as the proportion of the total government bond portfolio that they make up.

Short (or Short Position) : The sale of a borrowed security, commodity or currency with the expectation that the asset will fall in value, the opposite of Long (or Long Position).

Treasury : Debt obligation issued by the U.S. government with payments of principal and interest backed by the full faith and credit of the U.S. government.

Futures/Futures Contract : Reflects the expected future value of a commodity, currency or Treasury security.

Treasury yield : The return on investment, expressed as a percentage, on the debt obligations of the U.S. government.

Credit spread : The portion of a bond's yield that compensates investors for taking credit risk.

Volatility : A measure of the dispersion of actual returns around a particular average level. .

Mortgage-backed spreads : represents spreads on mortgage-backed securities. Spread represents the portion of the bond's yield that compensates investors for taking on additional risk over a benchmark security with a similar maturity profile.