

ENHANCE YOUR AGG POSITION FOR THE CURRENT MARKET ENVIRONMENT

Rick Harper — Chief Investment Officer, Fixed Income and Model Portfolios

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As we've highlighted over the last several weeks, [investors should be taking a closer look at their bond portfolios](#) and determining if allocations to the [Barclays U.S. Aggregate Index \(Agg\)](#) are consistent with their investment objectives. In our view, while the Agg provides a time-tested barometer for fixed income performance, as an investment strategy, the approach is suboptimal. We believe investors should consider looking inside the Agg at its components as one way to position going forward. **Return Prospects from Short-Dated Treasuries Are Not Compelling** When considering a change in investment strategy, it may make sense for investors to rethink the reason they own bonds in the first place: simply put, bonds help to generate steady returns when equity markets slide. Next, why do investors own [Treasuries](#)? Most likely to manage [volatility](#) in their bond portfolio and potentially benefit if the economy starts to slip. Shifting our focus to the Agg, why should an investor hold 22% of a fixed income portfolio in 1- to 5-Year¹ Treasuries that [yield](#) 0.85%² Regardless of investors' views of changes in policy at the Federal Reserve (Fed), this paltry level of income could be costing them performance. Over the last six years since the financial crisis, the exposure to U.S. Treasuries of the Agg has swelled to nearly 40%.³ This shift in exposure was not driven by any particular investment rationale, but rather a simple increase in issuance patterns over the last several years. In our view, exposure to certain segments of the Agg may only make sense in some of the least-favorable, lowest-probability economic environments. **Credit Appears Compelling, Particularly in the Long Run** Year-to-date, [securitized debt](#) has outperformed Treasuries, which have outperformed credit.⁴ Even so, in the medium term, we believe we would need to see a meaningful deterioration in the global economy to have credit underperform Treasuries. As a result of widening in [credit spreads](#) year-to-date, we view [valuations](#) today as compelling. Interestingly, [Baa credit](#) spreads would need to widen by an additional 60 [basis points](#) (bps)⁵ in the next year in order to underperform the total return of U.S. Treasuries. Should this occur, spreads would be at their widest levels since the global financial crisis of 2008. While concerns about credit have cropped up, most notably in high-yield Materials and Energy credits, we believe that [fundamentals](#) are strong in the [investment-grade](#) space. Additionally, with Baa credit spreads currently higher than the all-in yield of a 10-Year [Treasury bond](#), this signals to us that the market is attractively priced. In fact, this has occurred only two times in history: briefly during the euro crisis of 2011 and the global financial crisis of 2008.⁶ **Implementation Considerations** In response, we believe investors should consider looking within the Agg as one way to enhance the income of their portfolios. As a result, we have shown the net impact on yield, [duration](#) and sector positioning by swapping a hypothetical allocation between the Agg and the [Barclays U.S. Aggregate Enhanced Yield Index](#). While many investors have historically increased their exposure to bonds outside the Barclays Aggregate as a way to enhance income, we believe our approach could deliver better risk-adjusted returns than allocating solely to [market capitalization-weighted](#) credit indexes. **Yield and Duration for Blends of Agg and**

	Agg		Enhanced		Yield,	9/30/2015
	100% Agg	75% Agg / 25% Agg Enhanced Yield	50% Agg / 50% Agg Enhanced Yield	25% Agg / 75% Agg Enhanced Yield	100% Agg Enhanced Yield	
Yield	2.31%	2.52%	2.73%	2.93%	3.14%	
Duration	5.65	5.90	6.15	6.40	6.65	

Blends of Agg and Agg Enhanced

Sector Breakdown for Yield, 9/30/2015

	100% Agg	75% Agg / 25% Agg Enhanced Yield	50% Agg / 50% Agg Enhanced Yield	25% Agg / 75% Agg Enhanced Yield	100% Agg Enhanced Yield
Credit	34%	38%	41%	45%	49%
Securitized	30%	31%	32%	33%	34%
U.S. Government	37%	32%	27%	22%	17%

Sources: Barclays, WisdomTree, as of 9/30/15. Past performance is not indicative of future results. You cannot invest directly in an index.

As we show above, for a modest uptick in duration, investors can also meaningfully enhance the income component of their portfolios while retaining the familiar risk versus return profile of the Agg. This is primarily achieved by reducing exposure to shorter-maturity Treasuries and over-weighting corporate bonds, which we believe offer the potential for greater total returns. Ultimately, our timing could prove to be early, and it may be possible that this approach will underperform. However, in the medium term, we believe our updated approach to the Barclays Agg could ultimately add to higher total returns over the market cycle. ¹As measured by [duration](#). ²Source: Barclays, as of 9/30/15. ³Source: Barclays, as of 9/30/15. ⁴Source: Barclays, as of 9/30/15. ⁵Source: Barclays, as of 9/30/15. ⁶Sources: Barclays, WisdomTree, as of 9/30/15.

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Fixed income investments are subject to interest rate risk; their value will normally decline as interest rates rise. 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. Investing in mortgage- and asset-backed securities involves interest rate, credit, valuation, extension and liquidity risks and the risk that payments on the underlying assets are delayed, prepaid, subordinated or defaulted on.

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DEFINITIONS

Bloomberg Barclays U.S. Aggregate Index OAS : the amount of compensation in excess of Treasuries that investors demand for lending to borrowers in the Bloomberg Barclays U.S. Aggregate Index.

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.

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

Yield : The income return on an investment. Refers to the interest or dividends received from a security that is typically expressed annually as a percentage of the market or face value.

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.

Securitized debt : a debt security whose value is backed by an asset or pool of assets such as a mortgage.

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

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.

Basis point : 1/100th of 1 percent.

Fundamental value : The value of a firm that is related to a company's actual operations and production as opposed to changes in share price.

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

U.S. Treasury Bond : a debt security issued by the United States government.

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.

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.

Maturity : The amount of time until a loan is repaid.