

# WHAT DRIVES RETURNS (AND VOLATILITY) OF THE BARCLAYS U.S. AGGREGATE INDEX?

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Over the last couple of months, [volatility](#) across asset classes has ticked up markedly. Interestingly, although interest rates have declined from their highs of the year, rates haven't fallen that much compared to the downdraft in global equity prices. As a result, the returns of the [Barclays U.S. Aggregate Index \(Agg\)](#) remain approximately unchanged year-to-date. With interest rates low, the ability to generate returns remains constrained. In response, many investors have sought higher-yielding opportunities outside the Agg. While we also subscribe to this model, another compelling option in the current environment may be to look inside the Agg in order to generate more attractive returns. Below, we examine the rotation in performance among the various components of the Agg over the last five years. **Calendar Year**

Performance	2010		2011		2012		2013		2014		YTD	
	Return	Volatility	Return	Volatility	Return	Volatility	Return	Volatility	Return	Volatility	Return	Volatility
	6.5%	2.9%	7.8%	2.4%	4.2%	2.0%	-2.0%	3.2%	6.0%	2.3%	0.5%	2.9%
	U.S. Aggregate		U.S. Aggregate		U.S. Aggregate		U.S. Aggregate		U.S. Aggregate		U.S. Aggregate	
	20.8%	5.3%	9.8%	3.7%	11.3%	3.7%	0.2%	2.8%	8.3%	3.7%	1.4%	1.0%
	CMBS		Treasury		Baa Credit		CMBS		Baa Credit		ABS	
	10.0%	4.4%	9.5%	4.8%	10.0%	2.2%	-0.3%	1.3%	7.6%	3.1%	1.1%	2.0%
	Baa Credit		Baa Credit		CMBS		ABS		A Credit		Agency	
	8.5%	4.0%	8.2%	4.5%	9.8%	3.6%	-1.3%	2.4%	7.4%	2.7%	1.1%	2.6%
	A Credit		A Credit		A Credit		Aaa Credit		Aa Credit		CMBS	
	7.1%	3.7%	7.8%	3.6%	6.6%	3.2%	-1.4%	2.0%	6.1%	2.3%	1.0%	1.4%
	Aa Credit		Aa Credit		Aa Credit		Agency		MBS		MBS	
	5.9%	4.2%	6.5%	4.2%	3.2%	1.4%	-1.4%	2.8%	5.1%	2.1%	0.9%	3.6%
	Treasury		CMBS		ABS		MBS		Treasury		Treasury	
	5.9%	2.7%	6.2%	1.6%	3.5%	1.6%	-1.9%	4.8%	4.2%	1.7%	0.7%	2.4%
	ABS		MBS		Aaa Credit		A Credit		CMBS		Aaa Credit	
	5.4%	2.2%	6.0%	2.6%	2.6%	1.0%	-2.1%	5.8%	3.7%	1.6%	0.1%	4.2%
	MBS		Aaa Credit		MBS		Baa Credit		Aaa Credit		Aa Credit	
	5.1%	3.0%	5.1%	1.6%	2.2%	1.2%	-2.7%	4.4%	3.6%	1.4%	-0.3%	4.3%
	Aaa Credit		ABS		Agency		Aa Credit		Agency		A Credit	
	4.4%	2.2%	4.8%	1.5%	2.0%	3.0%	-2.8%	2.8%	1.9%	0.9%	-1.7%	4.0%
	Agency		Agency		Treasury		Treasury		ABS		Baa Credit	

Source: Bloomberg, as of 8/31/15. Past performance is not indicative of future results. You cannot invest directly in an index. Asset-backed security (ABS): A fixed income security whose value or cash flows depend on the value of another asset, such as a loan, lease or receivable. Commercial mortgage-backed security (CMBS): Fixed income security that is composed of multiple underlying commercial mortgages. Mortgage-backed security (MBS): Fixed income security that is composed of multiple underlying residential mortgages.

Credit ratings apply to the underlying holdings of the Index, and not to the Index itself. Standard & Poor's, Moody's and Fitch study the financial condition of an entity to ascertain its creditworthiness. The credit ratings reflect the rating agency's opinion of the holdings' financial condition and histories. The ratings displayed are based on the highest of each portfolio constituent as currently rated by Standard & Poor's, Moody's or Fitch. Long-term ratings are generally measured on a scale ranging from AAA (highest) to D (lowest), while short-term ratings are generally measured on a scale ranging from A-1 to C.

**Lower for Longer** The elephant in the room for the Agg is that nearly 40% of its holdings are in [U.S. Treasuries](#).<sup>1</sup> With yields still low by historical standards, one way to generate returns in this segment of the market is for rates to stay low or decline. Indeed, with rates roughly unchanged year-to-date, the Treasury component of the Agg is up by less than 1%, yet it has been one

of the largest contributors of volatility due to the updrafts and downdrafts in rates. Comparing 2015 to recent history, rising rates in 2013 led to negative total returns for the Agg. Given that the move in rates was the primary driver of returns, U.S. Treasuries led this decline. In thinking about positioning in 2015, if investors believe that rates are likely to remain approximately flat or even lower, we believe they should be increasing their exposure to [credit](#). With only one exception (2011), exposure to [Baa credit](#) actually improved performance compared to pure interest rate risk in Treasuries. With credit underperforming YTD, now could be an interesting time to increase allocations should an investor believe that any change in U.S. [monetary policy](#) will likely not have much of an impact on longer-term [bond yields](#) and credit conditions. **Lowest Volatility, Low Returns** So far in 2015, the primary drivers of bond volatility have come from the vacillating views of the [Federal Reserve \(Fed\)](#) action and widening credit [spreads](#). Indeed, the best performing segments of the Agg have been in the securitized sector ([asset-backed](#), [mortgage-backed](#) and [commercial mortgage-backed securities](#)). Compared to other components of the Agg, they tend to have the shortest [duration](#) and the least impact from widening credit spreads. While their positive returns and low volatility have been additive so far this year, historically these segments of the market have tended to provide modest returns. In fact, over the previous five years, they have tended to perform in the lower one-third of the various segments in the market. In light of tight valuations, we don't see much of a catalyst for sustained outperformance. **A Potential Path Forward** In our view, while the Agg remains the de facto benchmark for many investors, its potential for income and total returns remains compromised. As a result, WisdomTree partnered with Barclays to create an index that enhances the yield of the Agg through a mechanical, rules-based process. Among the constraints, the [Barclays U.S. Aggregate Enhanced Yield Index](#) (Agg Enhanced Yield) focuses on [tracking error](#) and sector caps relative to the Agg in order to maintain a comparable volatility profile, but with greater income potential. This goal is generally achieved by reducing exposure to U.S. Treasury securities and increasing exposure to credit. While this approach has lagged by 30 [basis points \(bps\)](#) since its inception in July 2015, we believe the likely path forward could see credit outperform Treasuries in the medium term.<sup>2</sup> The Agg Enhanced Yield should compete with the traditional Agg for core fixed income allocations: potential yield pickup of 81 bps with only a modest increase in duration.<sup>3</sup> Given the risk investors have to stretch for in yield outside the Agg, shifting allocations within the Agg should be considered a more intuitive benchmark for core-focused strategies. <sup>1</sup>Source: Barclays, as of 8/31/15.

<sup>2</sup>Source: Bloomberg, as of 10/8/15. <sup>3</sup>Source: Bloomberg, as of 10/8/15.

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## DEFINITIONS

**Volatility** : A measure of the dispersion of actual returns around a particular average level.&nbsp;.

**Barclays U.S. Aggregate Bond Index, 1-3 Year** : This index is the 1-3 Yr component of the U.S. Aggregate index.

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

**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.

**Monetary policy** : Actions of a central bank or other regulatory committee that determine the size and rate of growth of the money supply, which in turn affects interest rates.

**Bond yield** : Refers to the interest received from a bond and is usually expressed annually as a percentage based on its current market value.

**Federal Reserve** : The Federal Reserve System is the central banking system of the United States.

**Spread** : Typically refers to a difference between a measure of yield for one asset class and a measure of yield for either a different subset of that asset class or a different asset class entirely.

**Asset-backed security** : A fixed income security whose value or cash flows depends on the value of another asset, such as a loan, lease, or receivable.

**Mortgage-backed securities** : Fixed income securities that are composed of multiple underlying mortgages.

**Commercial mortgage-backed securities** : a fixed income security that is composed of multiple underlying commercial mortgages.

**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.

**Tracking Error** : Can be discussed as both the standard deviation of excess return relative to a specific benchmark, or absolute excess return relative to a specific benchmark.

**Basis point** : 1/100th of 1 percent.