# PERFORMANCE ROTATION AMONG GLOBAL FIXED INCOME SECTORS

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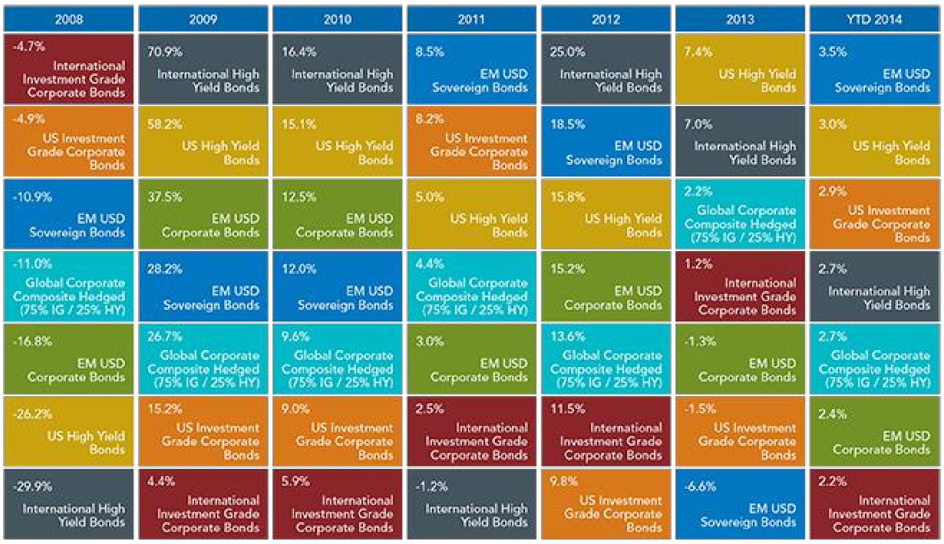
From 2009 through the middle of 2013, fixed income investing turned out to be fairly straightforward. The more credit risk and interest rate risk investors assumed in their portfolio, the higher their returns. In the second half of last year, interest rates rose and emerging markets fell out of favor. So far in 2014, falling interest rates have boosted longer-maturity bonds. Emerging markets are also making up for losses experienced last year. But a key takeaway, in our view, is that over the past five years, having the flexibility to rotate among the various flavors of fixed income around the world yielded the best results.[1] As interest rates continue to grind lower and credit spreads continue to tighten, selectivity will continue to become even more critical, in our view. The low-hanging fruit for credit investors might be gone, but selective opportunities still exist. Perhaps more importantly, potential to avoid the problem spots in the market could have a significant impact on performance in the coming years. **Performance Rotation across Corporate Bond Sectors**



| 2008 | 2009 | 2010 | 2011 | 2012 | 2013 | YTD 2014 |
|---|---|---|---|---|---|---|
| -4.7% International Investment Grade Corporate Bonds | 70.9% International High Yield Bonds | 16.4% International High Yield Bonds | 8.5% EM USD Sovereign Bonds | 25.0% International High Yield Bonds | 7.4% US High Yield Bonds | 3.5% EM USD Sovereign Bonds |
| -4.9% US Investment Grade Corporate Bonds | 58.2% US High Yield Bonds | 15.1% US High Yield Bonds | 8.2% US Investment Grade Corporate Bonds | 18.5% EM USD Sovereign Bonds | 7.0% International High Yield Bonds | 3.0% US High Yield Bonds |
| -10.9% EM USD Sovereign Bonds | 37.5% EM USD Corporate Bonds | 12.5% EM USD Corporate Bonds | 5.0% US High Yield Bonds | 15.8% US High Yield Bonds | 2.2% Global Corporate Composite Hedged (75% IG / 25% HY) | 2.9% US Investment Grade Corporate Bonds |
| -11.0% Global Corporate Composite Hedged (75% IG / 25% HY) | 28.2% EM USD Sovereign Bonds | 12.0% EM USD Sovereign Bonds | 4.4% Global Corporate Composite Hedged (75% IG / 25% HY) | 15.2% EM USD Corporate Bonds | 1.2% International Investment Grade Corporate Bonds | 2.7% International High Yield Bonds |
| -16.8% EM USD Corporate Bonds | 26.7% Global Corporate Composite Hedged (75% IG / 25% HY) | 9.6% Global Corporate Composite Hedged (75% IG / 25% HY) | 3.0% EM USD Corporate Bonds | 13.6% Global Corporate Composite Hedged (75% IG / 25% HY) | -1.3% EM USD Corporate Bonds | 2.7% Global Corporate Composite Hedged (75% IG / 25% HY) |
| -26.2% US High Yield Bonds | 15.2% US Investment Grade Corporate Bonds | 9.0% US Investment Grade Corporate Bonds | 2.5% International Investment Grade Corporate Bonds | 11.5% International Investment Grade Corporate Bonds | -1.5% US Investment Grade Corporate Bonds | 2.4% EM USD Corporate Bonds |
| -29.9% International High Yield Bonds | 4.4% International Investment Grade Corporate Bonds | 5.9% International Investment Grade Corporate Bonds | -1.2% International High Yield Bonds | 9.8% US Investment Grade Corporate Bonds | -6.6% EM USD Sovereign Bonds | 2.2% International Investment Grade Corporate Bonds |

Values represent calendar-year returns. Past performance is not indicative of future results. You cannot invest directly in an index. Index performance does not represent actual fund or portfolio performance. A fund or portfolio may differ significantly from the securities included in the index. Index performance assumes reinvestment of dividends but does not reflect any management fees, transaction costs or other expenses that would be incurred by a portfolio or fund, or brokerage commissions on transactions in fund shares. Such fees, expenses and commissions could reduce returns. International Investment Grade Corporate Bonds, U.S. Investment Grade Corporate Bonds and U.S. High Yield Bonds represented by the Barclays Global Aggregate Corporate ex-U.S. Total Return Index Hedged USD, the Barclays U.S. Aggregate Corporate Total Return USD and the Barclays U.S. Corporate High Yield Total Return Index, respectively. EM USD Corporates and EM USD Sovereigns are represented by the JPMorgan CEMBI Broad and JPMorgan EMBI Global Composite Indexes, respectively. International High Yield Bonds are represented by the Merrill Lynch ex-U.S. Issuers High Yield Constrained Index. Sources: Zephyr, Barclays, JPMorgan, BofA Merrill Lynch, as of 3/31/14.

*For definitions of terms and indexes in the chart, please visit our Glossary*. As shown in the graphic above, the common theme since the global financial crisis has been to increase credit risk in portfolios and also to be willing to take a global approach to fixed income. In fact,U.S high yield debt has been a top three performer every year since 2008. Outside the U.S., emerging markets have also performed well, excepting 2013. Perhaps one of the most interesting elements, though, is the continued slow performance in the international investment-grade market. While it arguably represents one of the most resilient asset classes—having delivered positive performance in every year since 2008 (where it declined by only 4.7%)—it has remained one of the slowest-performing cuts of fixed income due to European economic difficulties in recent years. However, with the economic picture in Europe slowly improving, certain issuers in this subset of the market may present unique opportunities for value. In terms of interest rate risk, the market's view has shifted in recent months. In the second half of 2013, virtually no analyst thought rates would fall in 2014. Now, after U.S. rates have fallen back to levels not seen since last June amid investors' grappling with Fed tapering, the common refrain has changed to rates remaining "lower for longer." While the consensus sees U.S. rates still higher by the end of the year, allowing a portfolio management team whose sole focus is fixed income could be an effective way to manage risk. In our view, enlisting the expertise of a portfolio manager focused on balancing these risks could have a great deal of value in the current market environment. While these decisions will be only as effective as the analysis supporting them, we believe that allowing a dedicated team to help navigate the current uncertainty in the market may help many investors get better risk-adjusted returns in the long run.

[1]Source: Bloomberg, as of 3/31/14

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## DEFINITIONS

**Credit risk** : The risk that a borrower will not meet their contractual obligations in conjunction with an investment.

**Interest rate risk** : The risk that an investment's value will decline due to an increase in interest rates.

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

**High Yield** : Sometimes referred to as "junk bonds," these securities have a higher risk of default than investment-grade securitie.

**Tapering** : A shift in monetary policy by which the Federal Reserve would begin decreasing the amount of bonds it purchases.

**Risk-adjusted returns** : Returns measured in relation to their own variability. High returns with a high level of risk indicate a lower probability that actual returns were close to average returns. High returns with a low level of risk would be more desirable, as they indicate a higher probability that actual returns were close to average returns.