Seeking to boost the yield on your Eurozone core fixed income exposure?

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WisdomTree
Contributor

Fixed income markets have seen yields decrease significantly over the past few years, forcing investors into alternative and nonconventional sources of income. Despite the end of Quantitative Easing (QE) in the Eurozone fast approaching, the European Central Bank (ECB) has clearly and repeatedly emphasised its commitment to maintaining current interest rate levels until at least the second half of 2019. Even after this point, the ECB will likely take its time in normalising interest rates given subdued inflationary expectations in the near future. Hence, even if the ECB's QE tapering relieves some pressure on yields in the short run, the low interest rate environment looks set to continue, barring any major change in the ECB's stance.

Against this backdrop, investors may consider means to increase the yield on their core fixed income allocation. The Bloomberg Barclays Euro Aggregate Enhanced Yield Index (Enhanced Euro Agg) and the Bloomberg Barclays Euro Treasury Enhanced Yield Index (Enhanced Euro Treasury) provide an opportunity to do so, while maintaining risk control.

How does it work?

The Enhanced Euro Agg uses the Bloomberg Barclays Euro Aggregate Bond Index (Euro Agg) as a starting portfolio, running an optimisation procedure to increase the index yield while respecting a series of constraints that keeps risk exposure close to its level in the Euro Agg. The Euro Agg aims to be a broad representation of the investable Eurozone fixed rate, investment grade sovereign and corporate bond market.

Similarly, the Enhanced Euro Treasury applies a comparable methodology to the Bloomberg Barclays Euro Treasury Bond Index (Euro Treasury) as outlined above, which aims to be a broad representation of the investable Eurozone fixed rate and investment grade sovereign bond market.

These "enhanced" indices seek to be a broad representation of their target market, while improving the yield compared to plain market-cap exposures. The yield enhancement mechanism follows a 3-step process

1) Divide the Euro Agg/Euro Treasury Indices constituents into buckets: The securities in the original indices are grouped in different categories ("buckets") across:

- Sector, country, maturity1, and credit2 quality for Euro Agg (36 buckets)
- Country and maturity for Euro Treasury (21 buckets)

2) Determine and apply constraints: Constraints apply to control risk and limit turnover:

- Tracking error should be less than 35bps each month
- Duration cannot be more than 1 year greater than that of the original index
- Limitations apply on the extent the enhanced index baskets can deviate from the original basket
- Portfolio turnover due to rebalancing is capped at 5%

3) Run an optimiser to determine new weights for the buckets: The optimiser shifts the buckets weights to achieve the best yield possible while respecting the constraints. The constituents keep the same relative weight within each bucket.

What are the optimisation results?

Generally speaking, the main result from the optimisation process is a shift in weights from low yielding segments towards higher yielders spaces. This translates into lower Sovereign debt and higher Corporate debt weights for Enhanced Euro Agg (as shown in Figure 1).

For Enhanced Euro Treasury (as shown in Figure 2), the optimisation leads to higher weights for peripheral debt (Italy and Spain), and a lower weight for low yielding countries (mostly Germany and France).

Figure 1: Enhanced Euro Agg tilted towards corporates

Source: Bloomberg, WisdomTree, as of 29 June 2018.

Historical performance is not an indication of future performance and any investments may go down in value.

Figure 2: Euro Treasury Enhanced Yield tilted towards peripheral debt

Source: Bloomberg, WisdomTree, as of 29 June 2018.

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What happens in terms of yield and risk?

Figure 3 shows how the optimisation shifts the portfolio towards slightly higher duration, for an increased level of yield. Deviation in duration is bounded to +/-1 year in the monthly rebalance process.

Historically, duration deviation ranged between +0.0 and +1.0 year, while yield enhancement ranged between 21.0 and 87.0bps for the Enhanced Euro Agg. For the Enhanced Euro Treasury, duration tilt ranged from +0.2 to +1.0, for a yield increase between 6.3 and 75.2bps.

Figure 3: Yield is enhanced for a modest increase in duration

Source: Bloomberg, WisdomTree, as of 29 June 2018.

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Overall, the optimised yield strategies enable investors to harvest an extra 49 bps/58 bps return for an extra 0.78%/0.94% volatility since inception for the Euro Agg Enhanced and the Euro Treasury Enhanced, respectively. They provide a tool to fine tune portfolio characteristics for benchmark-conscious managers.

Figure 4: Performance and volatility comparison: backtested since inception

*Inception date: 31 October 2002 for Euro Agg indices, 31 December 2001 for Euro Treasury indices. Includes backtested data since inception.

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1 Maturity: the amount of time until a loan is repaid

2 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.

Important Risks Related to this Article

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