

What Drives Returns (and Volatility) of the Barclays U.S. Aggregate Index?

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Bradley Krom

U.S. Head of Research

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 of the Barclays U.S. Aggregate Index**

	2010	2011	2012	2013	2014	YTD
Return	6.5%	7.8%	4.2%	-2.0%	6.0%	0.5%
Volatility	2.9%	2.4%	2.0%	3.2%	2.3%	2.9%
Return	20.8%	9.8%	11.3%	0.2%	8.3%	1.4%
Volatility	5.3%	3.7%	3.7%	2.8%	3.7%	1.0%
Return	10.0%	9.5%	10.0%	-0.3%	7.6%	1.1%
Volatility	4.4%	4.8%	2.2%	1.3%	3.1%	2.0%
Return	8.5%	8.2%	9.8%	-1.3%	7.4%	1.1%
Volatility	4.0%	4.5%	3.4%	2.4%	2.7%	2.6%
Return	7.1%	7.8%	6.6%	-1.4%	6.1%	1.0%
Volatility	3.7%	3.4%	3.2%	2.0%	2.3%	1.4%
Return	5.9%	6.5%	3.7%	-1.4%	5.1%	0.9%
Volatility	4.2%	4.2%	1.4%	2.8%	2.1%	3.6%
Return	5.9%	6.2%	3.5%	-1.9%	4.2%	0.7%
Volatility	2.7%	1.6%	1.6%	4.8%	1.7%	2.4%
Return	5.4%	6.0%	2.6%	-2.1%	3.7%	0.1%
Volatility	2.2%	2.6%	1.0%	5.8%	1.6%	4.2%
Return	5.1%	5.1%	2.2%	-2.7%	3.6%	-0.3%
Volatility	3.0%	1.4%	1.2%	4.4%	1.4%	4.3%
Return	4.4%	4.8%	2.0%	-2.8%	1.9%	-1.7%
Volatility	2.2%	1.5%	3.0%	2.8%	0.9%	4.0%

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.¹ 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.² 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.³ 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. ¹Source: Barclays, as of 8/31/15. ²Source: Bloomberg, as of 10/8/15. ³Source: Bloomberg, as of 10/8/15.

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