Labs: Portfolio Diagnostics Services

PORTFOLIO DIAGNOSTICS REPORT

In Defense of Defensive Fixed Income

Avoiding the “High Yield Headache”

The reports of core bonds’ death appear to have been greatly exaggerated. Through our consultations with thousands of advisors, we’ve heard considerable pessimism around the viability of traditional interest rate-sensitive fixed income. The fact of the matter is, like other financial markets, interest rate markets are proven to be very difficult to predict (see our related article: ***Forecast Your Clients’ Needs, Not the Rates Market***) and, like other aspects of your asset allocation, diversification is always important in fixed income (see our related article: ***Shifting Gears***).

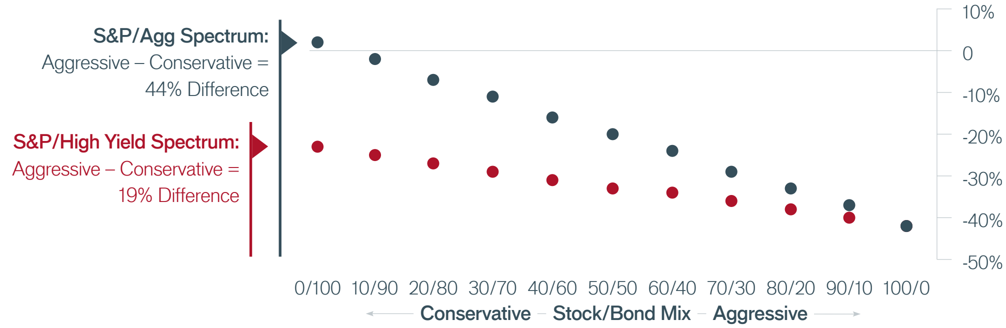
Here we focus on the strategic case for intermediate-term traditional bonds as a portion of a diversified fixed income asset allocation. This strategic case consists of two primary points:

1. You can’t make a model spectrum without core bonds
2. Point #1 is predicated on a conservative, risk-managed implementation

1 You can’t make a model spectrum without core bonds

Core bonds create dispersion in a model spectrum; e.g., core bonds make a “Balanced” model balanced and a “Conservative” model conservative. To wit, each dot on the below chart represents a stock-bond blend, from most conservative (all bonds) on the left to most aggressive (all stocks) on the right, and its performance during a major Global Financial Crisis drawdown from September 2008 until March 2009. The gray dots represent blends of the S&P 500® Index with traditional core bonds, while the red dots represent blends of the S&P 500® Index with high-yield bonds. While all model spectrums generally include a mix of stocks and bonds, the types of bonds used create drastically different results:

Portfolio Spectrum Performance (9/2008–3/2009)



Source: Janus Henderson Analytics, Morningstar. S&P = S&P 500 Index, Agg = Bloomberg Barclays U.S. Aggregate Bond Index, High Yield = ICE BofA Merrill Lynch U.S. High Yield Index.

First, think of a very aggressive client. Perhaps a smart/lucky (take your pick) 30-year-old who made millions on an app or cryptocurrency...you get the idea. During this 2008 period, this aggressive client likely would have been allocated somewhere on the right side of the chart and experienced a drawdown to the tune of 30%-40%. Pleasant? Certainly not. Suitable? Probably.

Janus Henderson
—KNOWLEDGE. SHARED—

The "High Yield Headache"
Asset allocation complications that are created when high yield replaces too much of one's core bonds

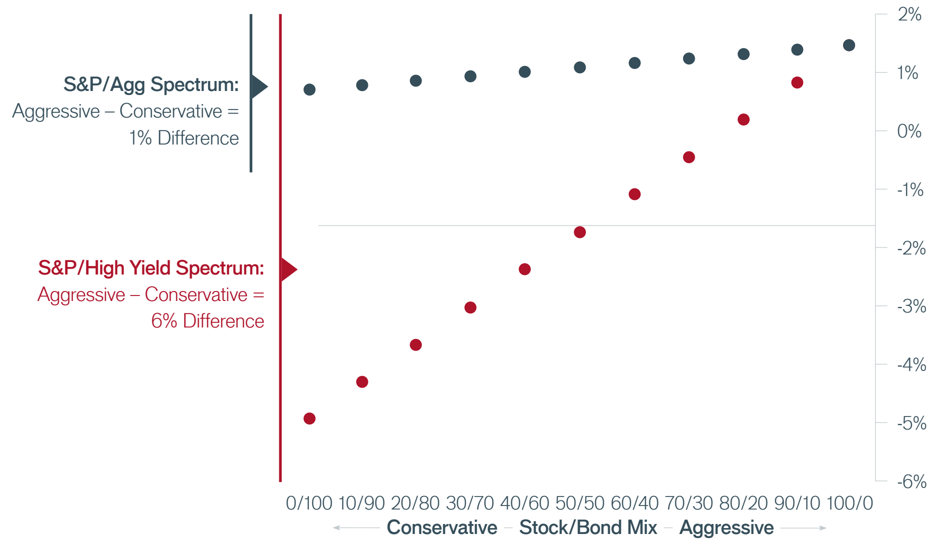
Now, think of a very conservative client. Perhaps an elderly individual paying for their own nursing home, health care expenses and still sending $10 checks to each grandchild on their birthdays…you get the idea. This conservative client's experience might have been drastically different in 2008 depending on what types of bonds were used to build their conservative model. If high-yield bonds were deemed better than traditional bonds up until this crisis hit, the conservative client would have likely experienced a drawdown to the tune of 20%-30%. Suitable? Probably not.

These potentially large drawdowns in conservative portfolios are one symptom of the "High Yield Headache": i.e., asset allocation complications that are created when high yield replaces too much of one's core bonds.

It's not just 2008; 2015 is another great example of the Headache. By 2015, many investors had spent years convinced that interest rates were guaranteed to go up and that high yield was, in a sense, "lower risk" than traditional core fixed income. High yield is not meant to shoulder an entire model spectrum, and the below chart illustrates this point: high yield was affected by some specific pain that didn't affect U.S. stocks or traditional fixed income as dramatically. In fact, 2015 created the potential for conservative portfolios to underperform aggressive portfolios when high yield was relied upon for too much of the bond portion of a model spectrum:

2015 created the potential for conservative portfolios to underperform aggressive portfolios.

Portfolio Spectrum Performance, Calendar Year 2015



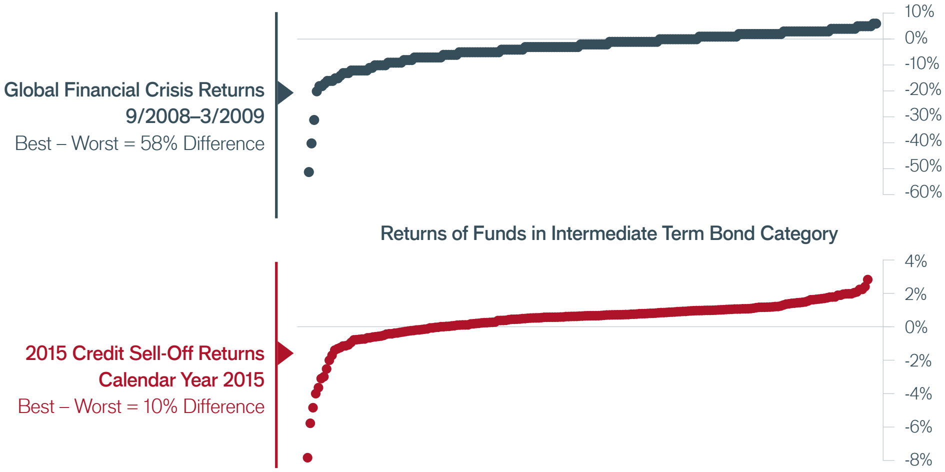
Source: Janus Henderson Analytics, Morningstar. S&P = S&P 500 Index, Agg = Bloomberg Barclays U.S. Aggregate Bond Index, High Yield = ICE BofAML US High Yield.

2 Point #1 is predicated on a conservative, risk-managed implementation

Like most other fixed income fund categories, the intermediate-term bond category is far from homogenous. A large array of U.S. fixed income sub-asset classes combined with a wide range of "plus" (i.e., non-core allocation) behavior within "core plus" strategies creates a necessary layer of extra due diligence. This due diligence is time well spent because, just as you can't create a model spectrum without core bonds, you can't properly implement core bonds without a conservative, risk-managed core bond strategy.

If we revisit 2008 and 2015, this time through the lens of all funds' performance within the Morningstar intermediate-term bond category, we see the High Yield Headache rear its ugly head once again. During the 2008 drawdown, the performance gap between the best- and worst-performing funds was nearly 60%, and in 2015, a relatively much less dramatic year, the difference was still around 10%:

You Can't Make a Model Spectrum without a Conservative Core Bond Strategy



Source: Janus Henderson Analytics, Morningstar. Intermediate term bond I shares only.

The Best Defense

Risk management and due diligence remain as important as ever while market predictions and risk concentrations remain the enemy of a sustainable, long-term wealth plan.

Defensive Fixed Income as Medicine for the High Yield Headache

As the next five years in financial markets are poised to look and feel different than the previous five years, this does not mean the strategic case for core bonds should face an existential reexamination. In our view, risk management and due diligence remain as important as ever while market predictions and risk concentrations remain the enemy of a sustainable, long-term wealth plan for any individual.

We offer a powerful framework to help organize the huge universe of fixed income managers and, more importantly, convey a clear, forward-looking approach to fixed income for clients. You can read more about our approach to goals-based fixed income portfolio design **here.**

About Janus Henderson's Portfolio Construction Services Team

The PCS Team performs customized analyses on advisor portfolios, providing differentiated, data-driven diagnostics. From a diverse universe of thousands of models emerge trends, themes and potential opportunities in portfolio construction that we believe will be interesting and beneficial to any investor.

For more information, please visit **janushenderson.com.**

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Fixed income securities are subject to interest rate, inflation, credit and default risk. The bond market is volatile. As interest rates rise, bond prices usually fall, and vice versa. The return of principal is not guaranteed, and prices may decline if an issuer fails to make timely payments or its credit strength weakens.

Diversification neither assures a profit nor eliminates the risk of experiencing investment losses.

S&P 500® Index reflects U.S. large-cap equity performance and represents broad U.S. equity market performance.

High Yield is being represented by the ICE BofA Merrill Lynch High Yield Index.

Bloomberg Barclays U.S. Aggregate Bond Index is a broad-based measure of the investment grade, US dollar-denominated, fixed-rate taxable bond market.

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