Portfolio Construction and Strategy

QUESTION & ANSWER

Managing Multiple Goals in Today's Interest Rate Environment

After 30 years of high absolute yields and strong capital appreciation, today's fixed income investors find themselves in a world where yields are not just low but likely to remain low. With nearly half of the world's bonds paying less than 1%, and close to a quarter of global bonds paying negative yields*, how can investors find the yield that they need?

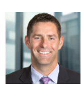
The investment industry's response has been to provide an increasingly diverse basket of options, ranging from aggressive single-sector solutions such as high yield or emerging market bond funds to adding leverage to boost overall returns (and risk) to an array of more flexible, "dynamic" options. Given the low-yield environment, investors have been drawn to these alternatives. But how can you select an option that can generate attractive yield without taking on inappropriate levels of risk?

To understand the choices and implications better, we recently sat with the Co-Portfolio Manager of our Multi-Sector Income Fund, Seth Meyer, and our Head of Portfolio Construction and Strategy, Adam Hetts, to discuss the changes and opportunities in today's bond fund universe.

Seth Meyer, CFA
Portfolio Manager

Adam Hetts, CFA
Head of Portfolio Construction and Strategy

Q Seth, broader, more flexible approaches have become increasingly popular. As a portfolio manager, how do you feel it's best to structure a diversified investment strategy?



A core bond fund, 20 years ago, used to be able to provide you a decent amount of yield while not taking a lot of duration. The problem today is that the indices have extended in duration and yields have gone lower. And this has created an issue where financial advisors and others have to look elsewhere to get income, like core plus strategies. We think the best structure is one that finds a balance between the "core" and the "plus."

The key is really about clearly defining the risks and the opportunities. The way we think about balancing the "core" and the "plus" is really taking a more flexible approach to asset allocation to provide greater opportunity to dial up or dial down the risks in the "plus" category. Generally, the "core" was there to dampen volatility, and that hasn't changed, even in today's environment. The purpose of "core" holdings in your portfolio is to help provide a more stable outcome in risk-off environments like Q418 or August 2019. We think of the "plus" as yield enhancers, there to boost the income when the risk-adjusted opportunity looks attractive. The "plus" allocations are there to try to solve the problem of too little yield and too much duration that plague so many core and core plus funds. Our goal is to have the opportunity, the flexibility, to hold enough duration so there is diversity in periods of credit market weakness and enough yield to provide high current income. Ideally, we are seeking high, consistent income with less than half the risk of a dedicated high-yield portfolio.

Janus Henderson
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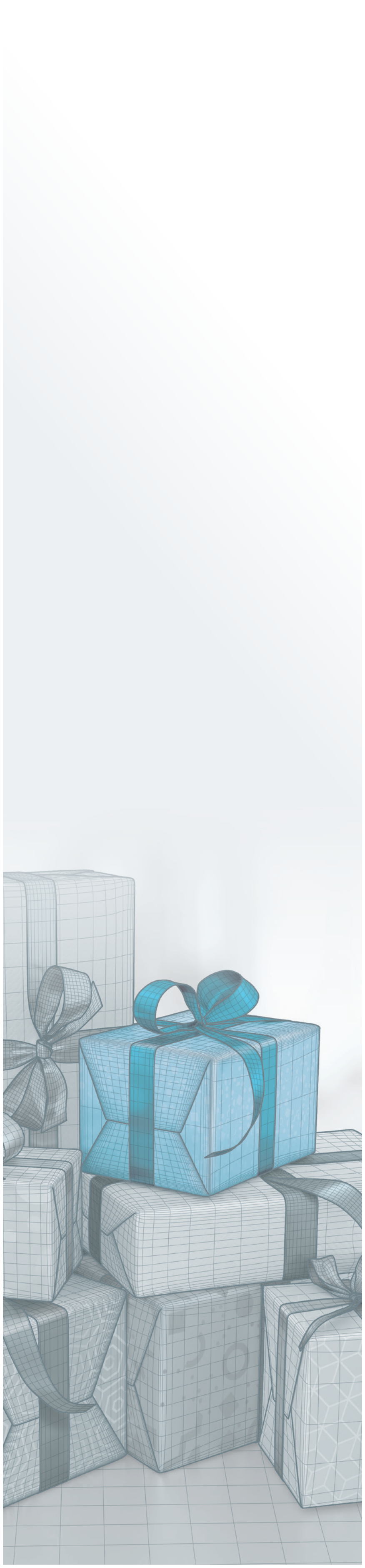
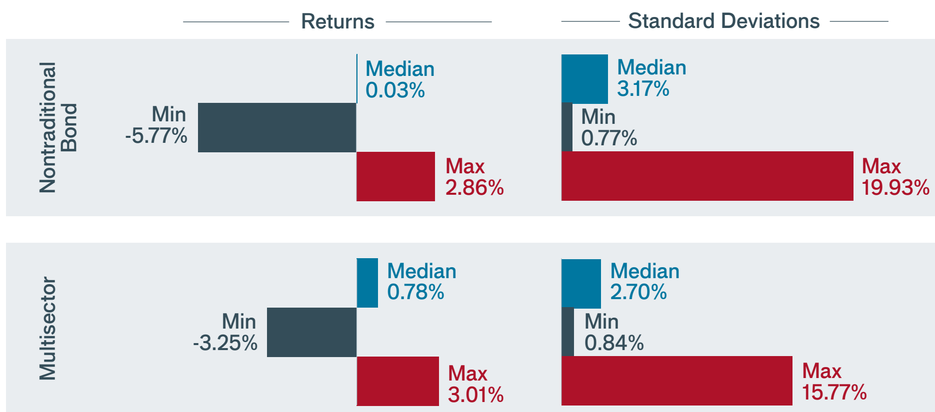
* Source: Bloomberg, as of 11/30/19



Seth brings up some of the levers an active, flexible fixed income manager can use. We're closely watching which managers are using which levers and how their risk profile is affected. For example, after we saw some major volatility surface this last August, we did a postmortem on the Morningstar Multisector and Nontraditional Bond categories. In the month of August alone, the gap between best and worst performers was high single digits, and the highest volatility funds in the categories ran annualized standard deviations in the mid- to high teens. Those are risk/return numbers that equities normally put out! Point is, there is a lot of opportunity to be more flexible in your approach to fixed income, but, like Seth points out, managers have to be careful about clearly defining potential risks and rewards.

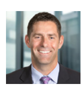
The Good, the Bad and the Ugly

Morningstar Multisector and Nontraditional Bond Category Average Returns and Standard Deviations (August 2019)



Source: Morningstar, Inc.

Q In your view, what is the most important factor for risk management?



I think Adam and I would agree that it is diversification. For example, high yield is the first place most investors look at when they think about diversifying away from a traditional "core" portfolio, but it isn't the only available market for generating income. Whether it is asset-backed securities, mortgages or bank loans – having a diverse basket of income sources can really lower the volatility (risk) of your overall portfolio and maintaining an appropriate level of duration (for us, 3 to 5 years) to help offset potential volatility in the "plus" sectors. And I really can't stress this enough: There are a lot of opportunities for income, for yield, in the universe of bonds. But if you own the wrong one – sometimes it is just a single company – and the bond's value collapses, the damage done to the returns of the overall portfolio are directly proportional to how much of the bond was owned. If the portfolio is diverse, it will be smaller. If it's not, the effect could be significant. It is just so important to diversify, at the sector level, the industry level and the security level.

We do agree. Proper diversification is paramount. In today's environment, a large portion of investors – in their search for yield – have "diversified" away from traditional bond benchmarks, often taking on more risk, whether intended or unintended. It is for exactly this reason that in our engagements with our clients, we are focused on places where they can diversify away from these additional risks without creating meaningful yield reductions. And what that usually comes down to is identifying where they have made (again, intended or unintended) concentrated allocations to certain sectors and then finding a way to diversify that risk – most often by increasing their allocations to broader, more flexible, dynamic approaches.

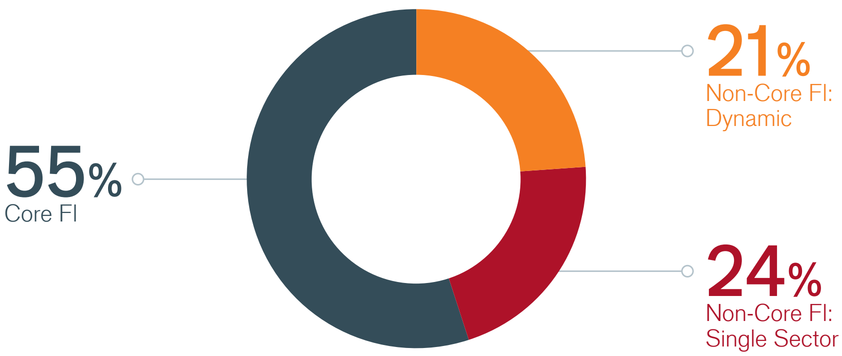
Adam, what are you seeing in actual client portfolios? What is the typical mix of single-sector versus multi-sector allocations?

Throughout the custom portfolio engagements we've performed for our advisor clients, we've gathered a database of over 7,000 advisor portfolios. It makes for very interesting views of what's happening across the country in actual portfolios: with respect to fixed income diversification, 45% of the average fixed income portfolio has been diversified away from the core. If we drill down into that 45%, more than half is typically allocated to single sector strategies. Just to be clear, by single-sector we mean, say, allocating some percentage of your portfolio to a dedicated emerging market fund or dedicated high-yield fund.

And this is why when I talked earlier about looking for places we can reduce risk, this is usually the target. History shows us that reallocating these single-sector positions into a broader, dynamic portfolio has generally been successful in maintaining a similar yield profile but also reduces volatility in the overall bond portfolio.

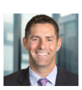
Industry Portrait: Fixed Income

Based on our proprietary database of thousands of advisor portfolios on which we've consulted during our Portfolio Construction and Strategy work:



As of 11/30/19

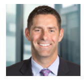
Seth, as a multi-sector portfolio manager, can you talk us through how that works?



There is a lot of thought and research that goes into a multi-sector portfolio. It is one of the reasons that we have co-managers, so that we are drawing on the different backgrounds and experience of our fixed income team. Our complementary areas of expertise allow us to dynamically allocate to those sectors in which we are finding the best risk-adjusted opportunities and underweight those we feel expose the portfolio to heightened risk. We pay close attention to correlation of not only our "core" and "plus" buckets within the portfolio but also across the sectors within each of those segments of the portfolio. What we are doing is trying to find a balance of these different risks available to us that can generate the income we're looking for while dampening overall portfolio volatility.

In our view, it is important – even in a multi-sector or diversified fund – to balance the income-generating exposures with others that can serve the traditional defensive role of bonds. Especially in volatile markets, fixed income portfolios should act like fixed income.

Q **Thank you both. I'd like to end with our starting question: How should a bond investor balance risk and return in today's low-yield environment?**



When you invest in a bond portfolio, you are taking two main risks: credit risk and interest rate volatility. Your yield target and risk tolerance will determine how to balance these two risks. We believe that the key to success is a well-defined process in a multi-sector fund. The process should have clearly articulated goals, strong risk management and demonstrable success in generating income and dampening volatility. What you most want to avoid is your bond fund not performing like a bond fund when you need it to.

The current environment is tough, given the low absolute level of yields, and many investors understandably have been willing to take more risk to increase their yield. We feel that most fixed income portfolios have room to reduce risk concentrations without experiencing a meaningful reduction in yield.

When balancing income potential with the ability to articulate expectations to clients, our philosophy is that the most complicated solutions are often the wrong solutions. Even in this low rate environment, we feel that most fixed income yield and return goals can be met with relatively straightforward solutions that don't heavily depend on esoteric asset classes and overly complex approaches.

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

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Fixed income securities are subject to interest rate, inflation, credit and default risk. As interest rates rise, bond prices usually fall, and vice versa. High-yield bonds, or "junk" bonds, involve a greater risk of default and price volatility. Foreign securities, including sovereign debt, are subject to currency fluctuations, political and economic uncertainty, increased volatility and lower liquidity, all of which are magnified in emerging markets.

Mortgage-backed securities (MBS) may be more sensitive to interest rate changes. They are subject to extension risk, where borrowers extend the duration of their mortgages as interest rates rise, and prepayment risk, where borrowers pay off their mortgages earlier as interest rates fall. These risks may reduce returns.

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

Bank loans often involve borrowers with low credit ratings whose financial conditions are troubled or uncertain, including companies that are highly leveraged or in bankruptcy proceedings.

Duration measures a bond price's sensitivity to changes in interest rates. The longer a bond's duration, the higher its sensitivity to changes in interest rates and vice versa. **Standard Deviation** measures historical volatility. Higher standard deviation implies greater volatility.

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