

## Shifting Gears

### Activating a Goals-Based Fixed Income Strategy

For traditional fixed income investors, much of the last 40 years has been a relatively enjoyable ride; the 1980s began with double-digit interest rates that have steadily fallen, creating large amounts of bond return and income as well as crisis management along the way. Instead of investors paying a premium for portfolio crisis management, traditional fixed income paid investors that premium.

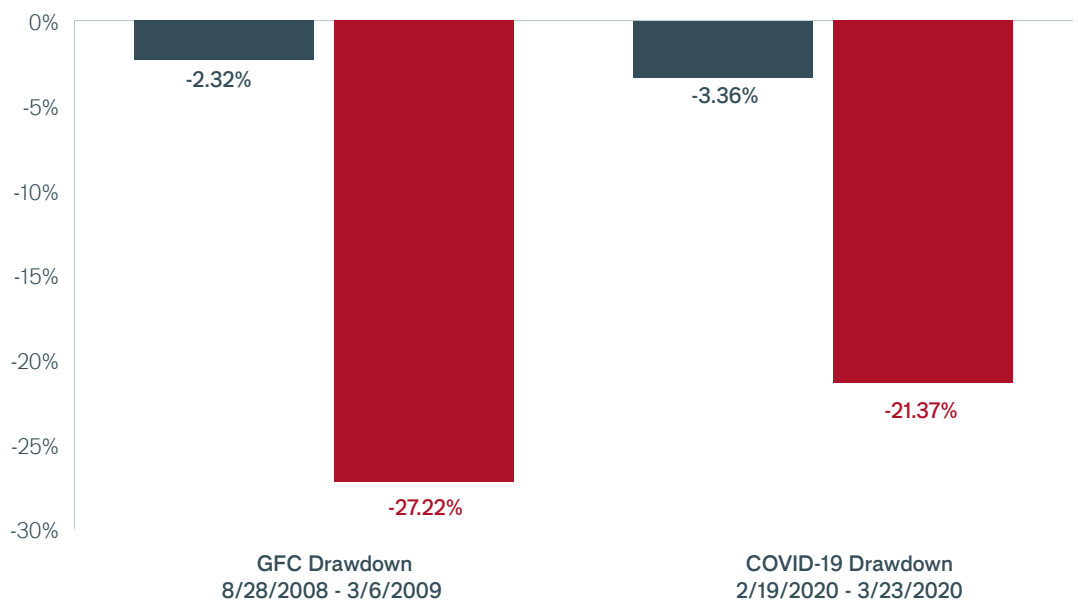
This benefit has slowly evaporated over the past 10 years, as rates have plunged to near zero or negative levels, and now the extreme market turmoil from the COVID-19 pandemic has put investors at a crossroads: high-quality, traditional fixed income will always be a crucial bedrock for investment portfolios but emerging from this crisis with extremely low – or even negative – government bond rates means this “insurance” might become more expensive. It’s no wonder, then, that many investors are viewing the fixed income implications of the COVID-19 crisis as existential.

Many of these same investors viewed the Global Financial Crisis (GFC) as a once-in-a-lifetime event, and over the course of the following decade-long bull market shrugged off GFC trauma and poured money back into some of the riskiest fixed income markets. However, in just a month’s time, the February/March 2020 sell-off had investors drawing comparisons to the GFC and asking: once-in-a-lifetime, or once-in-a-decade?

### Once-in-a-Lifetime, or Once-in-a-Decade?

#### Fixed Income Crisis Performance: GFC vs. COVID-19

■ BBgBarc Global Aggregate Bond Total Return USD ■ ICE BofA Global High Yield Bond Total Return USD

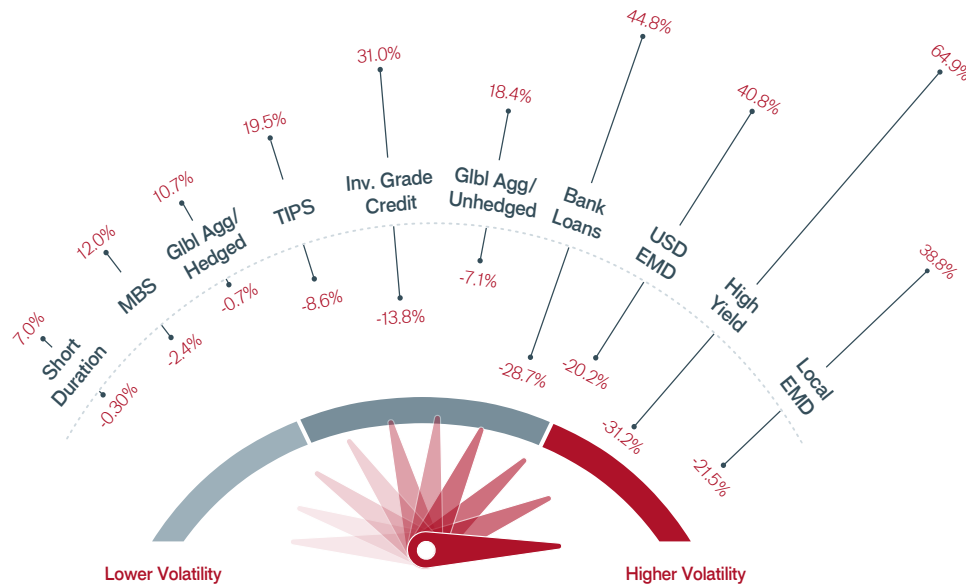


As of 23 March 2020

Source: Janus Henderson Portfolio Construction and Strategy Team

## Farewell to an Old Era, Hello to New

Since the GFC, traditional lines in fixed income investing have been blurred by low rates, large price swings, high duration risks and a proliferation of new strategies. This environment has turned fixed income from what has traditionally been a fairly straightforward asset class – one that seeks to provide downside protection and income – into one that investors may find disorientating:



### A Disorientating Environment\*

- ▶ Double-digit dispersions among major fixed income asset classes
- ▶ Ranked from lowest volatility to highest
- ▶ Figures represent best and worst 12-month returns

\*Calculated using 12-month rolling windows with 1-month step over 10 years trailing (1 July 2007 to 31 May 2020, in USD total return). Categories represented by corresponding indices from Bloomberg Barclays, JPMorgan and Credit Suisse.

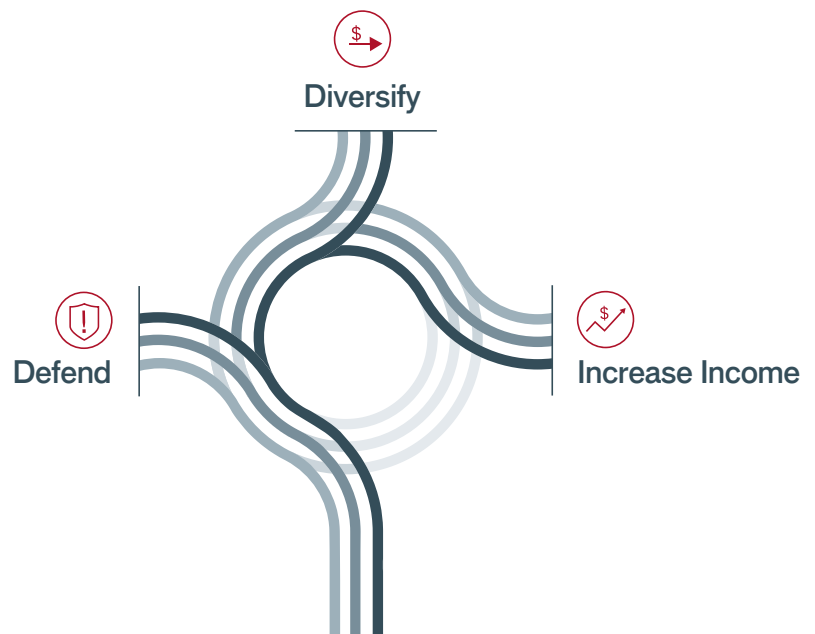
**Past performance is not a guide to future performance.**

## New Era, New Framework

The latest crisis has created a long list of questions, such as: “Is high yield the new risk manager, since it might perform better than government debt if rates rise?” or “With rates at historical lows, should I be looking beyond government debt in core fixed income?” We think there has been too much focus on finding a single solution, when the best solution is probably a mix – and that mix depends on an investor’s goals:

### A Goals-Based Approach

- ▶ Have a forward-looking mindset
- ▶ Reduce the universe of fixed income managers into three distinct objectives
- ▶ Allocate across these objectives according to one’s goals



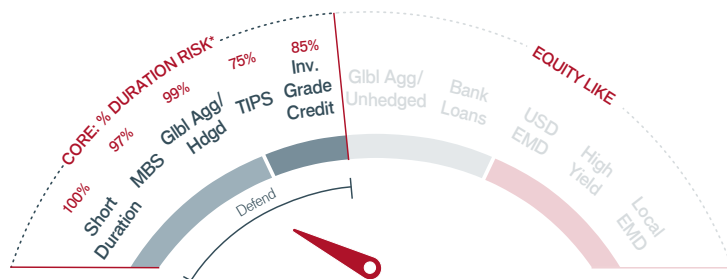
## Breaking Down Our Three Fixed Income Objectives

Consolidating the breadth of fixed income instruments into three objectives can seem challenging to those not yet familiar with our framework. Below, we outline how Defend, Diversify and Increase Income can be defined by their respective goals, personalities and criteria.

### Defend

Risk-managing, core fixed income

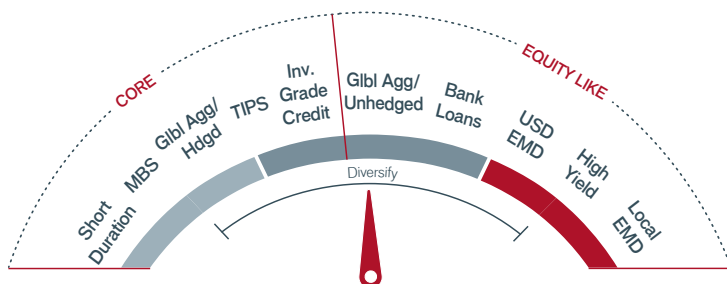
- **Goal:** Seeks to provide capital preservation during a market downturn
- **Personality:** Low volatility, low correlation to traditional equities, high quality, high interest rate sensitivity; composed of primarily investment grade securities
- **Criteria:** Allocates to currency-hedged, global developed market credit, securitised or government debt



### Diversify

Move beyond traditional benchmarks

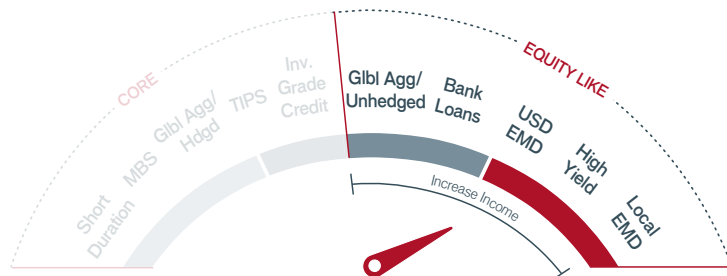
- **Goal:** Dynamically combine some elements of capital preservation with higher income potential
- **Personality:** Go-anywhere approaches combining elements from Defend and Increase Income categories, more risk-aware than approaches in the Increase Income category
- **Criteria:** Allocates across the quality spectrum with higher alpha targets than benchmark-constrained portfolios. May include ability to short. Common strategy names include terms like “strategic income,” “multi-sector” and “unconstrained.”



### Increase Income

High income opportunities

- **Goal:** Highest return and income potential via exposure to equity-like fixed income on a global scale
- **Personality:** High volatility, high correlation to traditional equities
- **Criteria:** Benchmark-constrained, long-only exposure typically to below-investment grade and/or lower in the capital structure, or investment in emerging markets



\*To analyze the extent to which duration drives the overall risk of each major core fixed income asset class, we look to Janus Henderson’s proprietary risk management software, Quantum. As illustrated in the above graphic, Quantum shows that the vast majority of each core asset classes’ risk budget is driven by duration, as of September 2020.

**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.

Equity-like fixed income vehicles are investments that may be less susceptible to changes in interest rates or other factors than traditional fixed income. They are higher risk than traditional fixed income, without necessarily the same returns as a true equity investment.

**Alpha** compares risk-adjusted performance relative to an index. Positive alpha means outperformance on a risk-adjusted basis.

**Short:** Short sales are speculative transactions with potentially unlimited losses, and the use of leverage can magnify the effect of losses.

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## Implementation: No Single Destination

We believe clients may be best served by a multi-faceted, goals-based approach. Even in the face of today's low rate environment, core fixed income's role is as essential as ever: core bond allocations are strategic allocations intended for capital preservation during a crisis. However, the post-COVID environment will require that forward-looking investors pursue a new level of due diligence for each destination of capital within their fixed income allocation:



### **Defend** Dig Deeper

- ▶ **New Consideration:** With most global sovereign bond rates below 1% or negative, traditional benchmarks with large, passive weightings to sovereign debt are no longer a bond investor's North Star.
- ▶ **New Roadmap:** Dig deeper into the defensive tool kit; understand new opportunities and trade-offs within securitised, investment-grade corporates, and both short and intermediate duration.

### **Diversify** A Brave New World

- ▶ **New Consideration:** COVID-era volatility has been relentless in exacerbating the gaps and concentrations in fixed income allocations. There has been a decade's worth of new dynamic fixed income strategy launches, but COVID-19 and the GFC prove that no amount of innovation has escaped the fact that increased yield carries increased risk.
- ▶ **New Roadmap:** Diversifying strategies are dynamic tools that can "re-risk" core fixed income overweights and/or "de-risk" overly aggressive fixed income allocations. However, we believe investors need to focus on managers who streamline their approach and limit exposure to complex approaches that can generate unintended risk.

### **Increase Income** Expertise and Grit

- ▶ **New Consideration:** A historical bull market in the riskiest – and highest-returning – fixed income markets was followed by a sell-off marked by both its speed and magnitude, creating exceptional opportunities alongside the potential for another drastic sell-off.
- ▶ **New Roadmap:** Wide spreads do not guarantee positive prospective returns, but investors need to pay heed to opportunities when presented. Sector- and security-selection expertise tied to appropriate timing and a strong stomach are the necessary ingredients in order to navigate dislocations in these markets.

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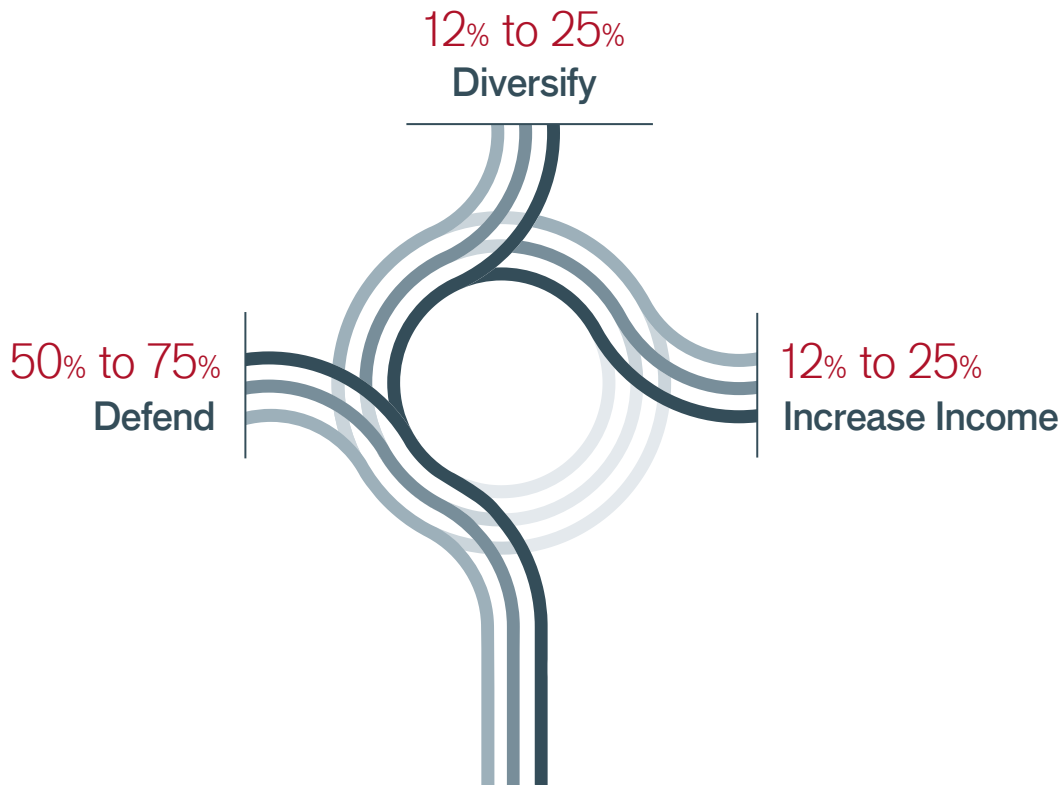
## Strategic Allocation: The Majority Stays in Core

As we partner with thousands of investment professionals on a customised basis to help them solve for their clients' needs, we can distill our experience into these general allocation size ranges across the three fixed income objectives in our framework.

We believe the majority (50%-75%) of most fixed income portfolios should stay in the core, but savvy investors need to strongly consider the pros and cons of each component in the core category.

Outside the core, we advocate allocations to both Diversify and Increase Income categories. Each has its own benefits and costs in different market environments, and investors are best served by having a balanced exposure to each and managing their clients' expectations based on strictly defining the strategies deployed for each objective, as per the prior section of this article.

This powerful framework helps organise the huge universe of fixed income managers and, most importantly, conveys a clear, forward-looking approach to fixed income for clients.



## About Janus Henderson's Portfolio Construction and Strategy Team

The PCS Team performs customised analyses on investment 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.

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