The Potential Pitfalls of a Key Bond Market Benchmark

Investments mirroring the Bloomberg Barclays U.S. Aggregate Bond Index feature ultra-low yields—and increasing interest-rate risk

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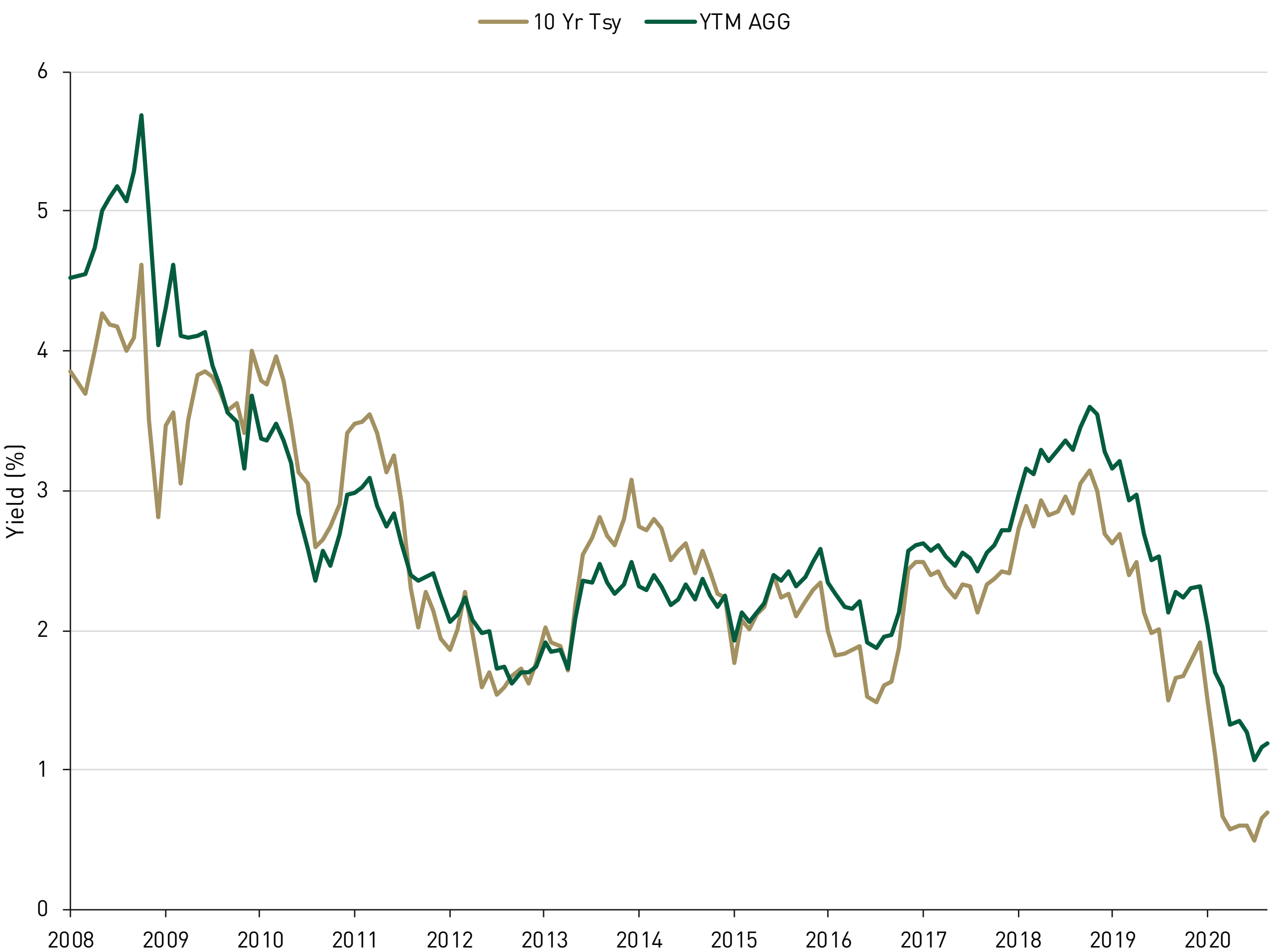
Figure 1. The Yield on the "Agg" Has Fallen to Very Low Levels

Yield to maturity (month-end except for September 2020) for the 10-year U.S. Treasury note and the Bloomberg Barclays U.S. Aggregate Bond Index, January 31, 2008–September 18, 2020



Source: Bloomberg Barclays Indices. Data as of September 18, 2020. YTM AGG=Yield to maturity on the Bloomberg Barclays U.S. Aggregate Bond Index

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BOND MARKET

The broad U.S. bond market benchmark, the Bloomberg Barclays U.S. Aggregate Bond Index (popularly known as the "Agg") posted an 8.7% return in 2019, its best showing since 2012. Last year started with a significant dovish shift in U.S. Federal Reserve (Fed) policy, which led to increased demand for interest-rate risk. Because of the Fed's policy pause, followed by rate cuts in the second half of the year, the environment remained supportive of bonds throughout 2019. The Agg has again rewarded its investors in 2020 as rates have continued to plummet across the yield curve, with a year-to-date return of 6.93% through September 18, 2020.

Despite the recent strong performance of the Agg since the beginning of 2019, we believe that investors who remain invested in the index via the popular AGG ETF (iShares Core U.S. Aggregate Bond ETF) should be wary of the current composition, characteristics, and risks of today's Agg. Here's why.

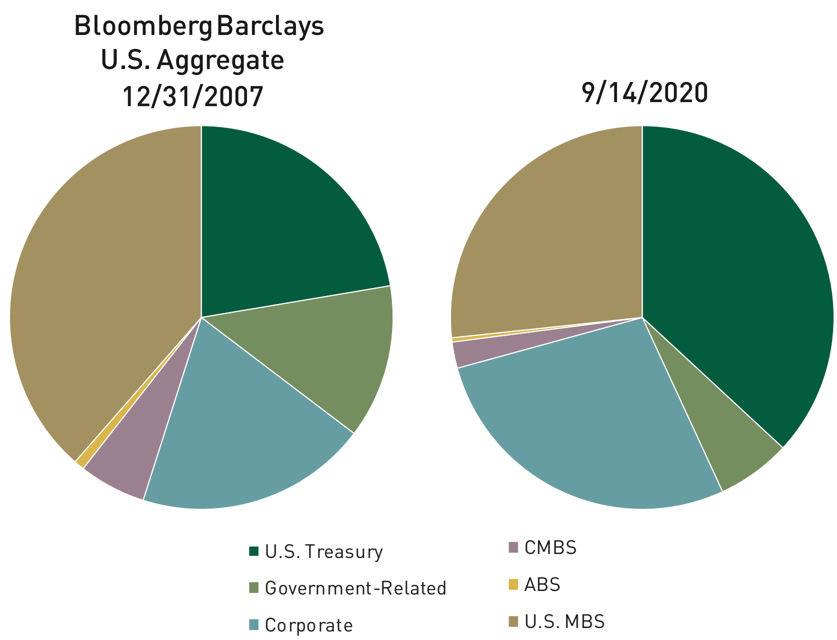
The Agg Looks Quite Different in 2020

The market cap-weighted nature of AGG means that its asset allocation is determined by the weightings of each asset class in its broader investable universe—all U.S. investment-grade fixed rate bonds, with index components for government and corporate securities, mortgage pass-throughs, and asset-backed securities.

We can see in Figure 2 that since the 2008–09 global financial crisis (GFC), the most significant change in the composition of the index has been a large increase in the weighting of U.S. Treasury securities. This change reflects the enormous amount of debt issued by the U.S. government to help lift the nation's economy out of a recession following the GFC, along with another wave of Treasury issuance to counter the effects of the COVID-19 driven market pullback in March 2020.

Figure 2. The Composition of the "Agg" Has Changed Greatly Over the Years

Composition of the Bloomberg Barclays U.S. Aggregate Bond Index, based on market value



Source: Bloomberg. Data as of September 14, 2020. CMBS=Commercial mortgage-backed securities. ABS=Asset-backed securities. MBS=Mortgage-backed securities.

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Changing Fixed Income Characteristics and Risks

In addition to understanding that the broader fixed income universe's composition has changed significantly since 2008, investors should be mindful of the following characteristics of today's Agg, and related vehicles such as the AGG ETF.

1. VERY LOW YIELD

In 2008, the 10-year U.S. Treasury yield opened the calendar year at 3.91%. As of September 18, 2020, it sits at a scant 0.70%. Consequently, the Agg now has an average yield to maturity of just 1.19%. (See Figure 1, first page.)

2. INCREASED INTEREST-RATE RISK

As mentioned earlier, over the years the Agg and portfolios that track the index have been increasingly dominated by government debt, increasing interest-rate risk while offering less and less yield. As shown in Figure 3, the effective duration of the Agg has risen sharply since the GFC and recently touched a historical high of 6.17 years.

Figure 3. Duration Has Increased Markedly on the "Agg"

Effective duration for the Bloomberg Barclays U.S. Aggregate Bond Index, January 1, 2008–September 18, 2020

Source: Bloomberg Barclays Indices. Data as of September 18, 2020.

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3. YIELD TO DURATION RATIO

Given the changed composition of the Agg, historically low yields, and duration near multi-decade highs, the Agg's yield-to-maturity (YTM)/duration ratio is remarkably low at 0.19. We believe this reflects some rather unattractive "bond math," i.e., an unfavorable risk-reward profile. (See Figure 4.)

Figure 4. Yield/Duration Ratio Suggests a Less Attractive Risk/Reward Profile for the "Agg"

Yield-to-maturity (YTM)/duration for the Bloomberg Barclays U.S. Aggregate Bond Index, January 1, 2008–September 14, 2020

Source: Bloomberg Barclays Indices. Data as of September 14, 2020.

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Summing Up

Investors tracking the market-weighted Bloomberg Barclays U.S. Aggregate Bond Index have enjoyed strong returns since the beginning of 2019 on the back of a dovish Fed and plummeting interest rates across the yield curve. However, given significant changes to the broader fixed income landscape over the years—including elevated amounts of U.S. government debt outstanding, lower interest rates, and higher levels of interest-rate risk, as measured by duration, investors may want to rethink owning debt portfolios with low yields and high duration profiles. One potential way to counter these trends is through a multi-sector bond strategy, with the flexibility to pursue attractive investments across multiple asset classes.

A Note about Risk: The value of investments in fixed-income securities will change as interest rates fluctuate and in response to market movements. Generally, when interest rates rise, the prices of debt securities fall, and when interest rates fall, prices generally rise. High-yield securities, sometimes called junk bonds, carry increased risks of price volatility, illiquidity, and the possibility of default in the timely payment of interest and principal. Bonds may also be subject to other types of risk, such as call, credit, liquidity, interest-rate, and general market risks. Longer-term debt securities are usually more sensitive to interest-rate changes; the longer the maturity of a security, the greater the effect a change in interest rates is likely to have on its price. Lower-rated bonds may be subject to greater risk than higher-rated bonds. No investing strategy can overcome all market volatility or guarantee future results.

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Treasuries are debt securities issued by the U.S. government and secured by its full faith and credit. Income from Treasury securities is exempt from state and local taxes.

Duration is a measure of the sensitivity of the price (the value of principal) of a fixed-income investment to a change in interest rates.

Exchange Traded Fund (ETF) is a security that tracks an index, a commodity or a basket of assets like an index fund, but trades like a stock on an exchange. ETFs experience price changes throughout the day as they are bought and sold

Yield to maturity is the rate of return anticipated on a bond if held until it matures.

The **Bloomberg Barclays U.S. Aggregate Bond Index** represents securities that are SEC-registered, taxable, and dollar denominated. The index covers the U.S. investment grade fixed rate bond market, with index components for government and corporate securities, mortgage pass-through securities, and asset-backed securities. Total return comprises price appreciation/depreciation and income as a percentage of the original investment.

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