The Case for Adding Credit to a Core Bond Portfolio

In our view, 2020 remains a year when taking some exposure to risk assets, including credit-sensitive bonds, could potentially be rewarding for fixed-income investors.

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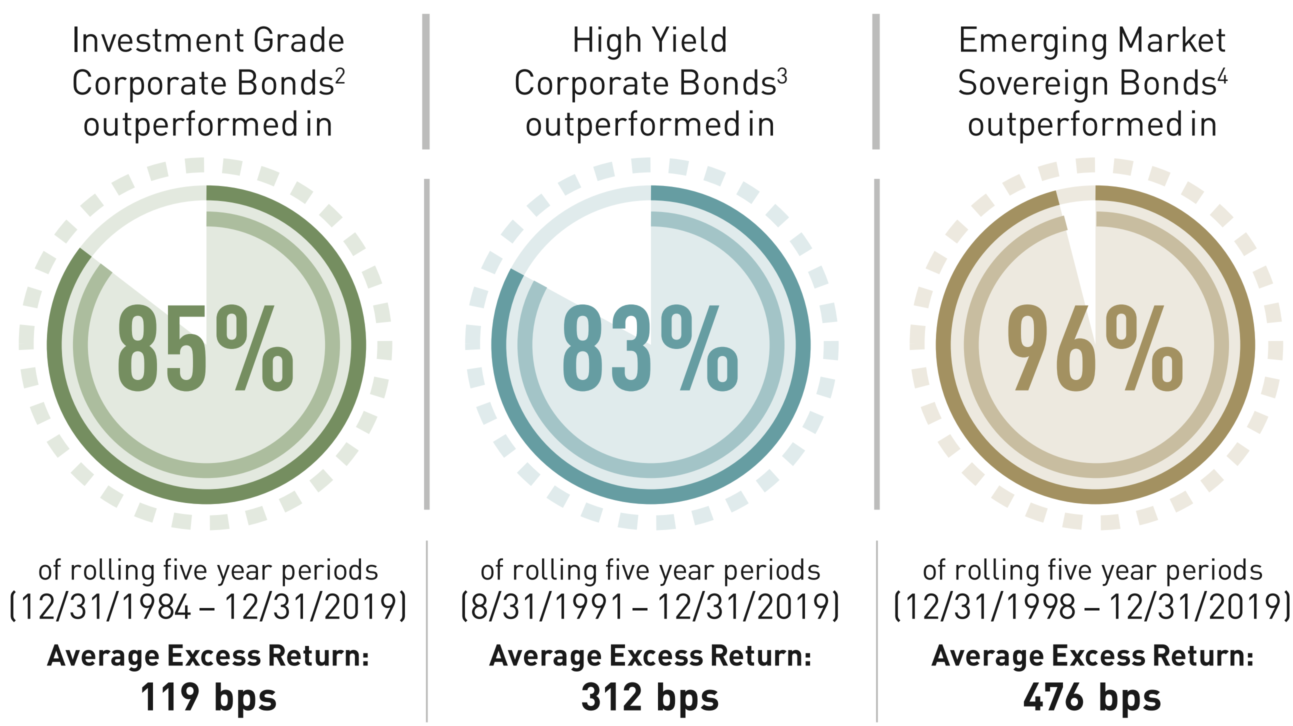
Chart 1. Historically, Credit-Sensitive Bonds Have Consistently Outperformed U.S. Treasuries Over the Long Term

Credit Sector Returns Relative to Treasuries[1] (as of December 31, 2019)



Sources: Bloomberg Barclay indexes, Bloomberg, and Morningstar. For illustrative purposes only. **Past performance is not a reliable indicator or guarantee of future results**.

[1]Bloomberg Barclays U.S. Treasury Bond Index.

[2]Bloomberg Barclays U.S. Corporate Bond Index.

[3]ICE BAML U.S. High Yield Index.

[4]The JP Morgan GBI-EM Global Diversified Index. Rolling five-year returns as of December 31, 2019.

Beginning dates for the rolling five-year return series are the inception dates of the respective indexes.

In Brief

- While credit exposure paid off for investors in 2019, we believe the U.S. economic backdrop continues to remain supportive for 2020.
- The long-term performance of credit-sensitive bonds over the safety of government-related securities suggests that investors may want to maintain a strategic allocation to credit.
- Investors may want to consider a flexible multi-sector strategy that can provide diversified exposure to multiple sources of returns and may offer the potential for higher total returns relative to core bonds over a full market cycle.

Adding

As we highlighted in our recent 2020 Investment Outlook, we believe the environment remains supportive of the credit markets. While credit spreads are below their long-term average, we believe we will see continued economic growth with little sign of a U.S. recession on the horizon. If paired with low inflation and an accommodative central bank policy, a positive backdrop for investment-grade and high-yield credit sectors may remain. We prefer taking on credit risk to duration risk in fixed income; with the negative term premium in U.S. Treasury bonds, there is little compensation for taking on duration risk in fixed income today.

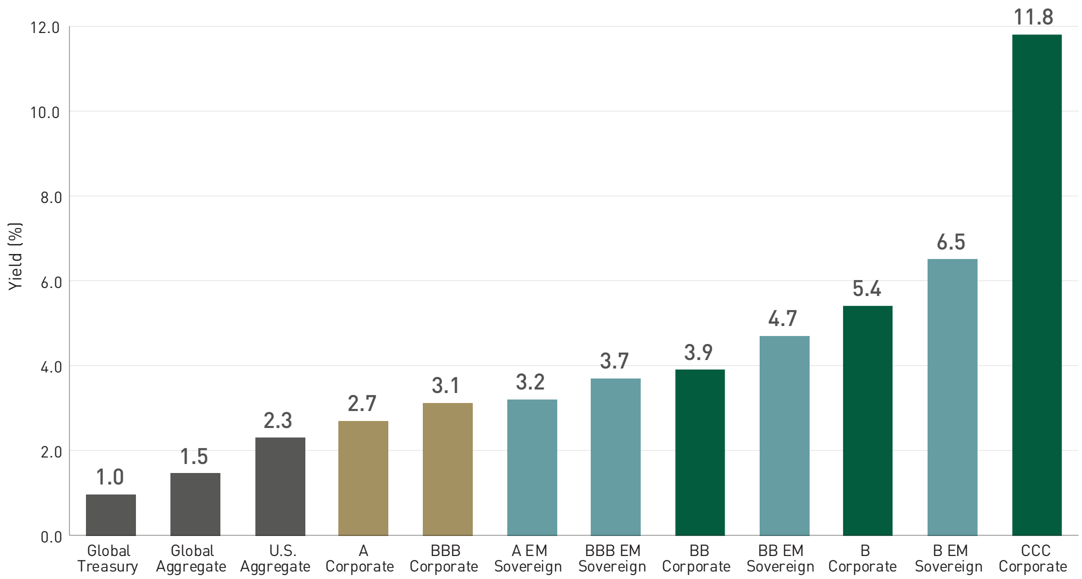
Given that many investors tend to have a large portion of their portfolios allocated to "core" bonds – strategies that are heavily weighted toward longer-duration, government-related securities – an allocation to credit can serve potentially as a complement and provide portfolio diversification.

However, there seems to be investor bias towards safety, especially now that we are in the midst of the longest U.S. economic expansion (although not the strongest) on record, and spreads are below average. Investors seem comfortable taking on the duration risk of core bonds, but are hesitant to increase allocations to credit-sensitive sectors, including lower-rated corporate bonds. But as indicated in the data in the accompanying chart looking at long term performance, investors may be well-served to maintain an allocation to credit in their portfolios.

Chart 1 summarizes the results of rolling five-year periods comparing the returns of various credit-sensitive sectors relative to U.S. Treasury securities over a longer term. The analysis shows that high-yield bonds, for example, have outperformed Treasuries in 83% of the rolling five-year periods dating back to the period ended 1991. During episodes of economic uncertainty or market volatility, credit spreads will tend to widen and credit-sensitive sectors will tend to underperform Treasuries. But over longer historical holding periods, the additional spread that high-yield bonds offer to compensate investors for additional credit risk generally leads to higher returns over time. This would suggest that investors may want to consider high yield as a strategic allocation, rather than trying to time the market by tactically moving in and out of the asset class.

Chart 2. A Broad Range of Opportunities for Income

% Yields (as of December 31, 2019)



Sources: Bloomberg Barclays and JP Morgan indexes. (See Glossary of Terms for index definitions.) For illustrative purposes only.

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A similar story can be seen when reviewing performance of investment-grade corporate bonds, which have outperformed U.S. Treasuries in 85% of periods dating back to 1984, and in emerging-market sovereign bonds, which outperformed in 96% of periods dating back to 1998. While it is difficult to accurately predict short-term market moves, over longer holding periods allocating to credit has historically paid off for investors.

Investors can access these segments of the market through dedicated, single-asset strategies, or in a diversified multi-sector strategy that has the flexibility to invest across these sectors. Those who may not want a full allocation to high yield, for example, given the current level of spreads, may wish to consider a more diversified multi-sector strategy that includes an allocation to U.S. high yield, as well as U.S. investment-grade corporate bonds, emerging market bonds, securitized products, and government-related securities.

Within each segment, there can be a wide dispersion of returns and spread opportunities. Within leveraged credit sectors, for example, we see relatively rich valuations within 'BB'-rated bonds and bank loans, and more attractive valuations in other quality segments. As such, investors may benefit from a diversified portfolio with the flexibility to invest across multiple asset classes, and can adapt the portfolio positioning for the market environment, looking for relative value across countries, sectors, industries, and credit quality segments.

Summing Up

While credit exposure paid off for investors in 2019, we believe the economic backdrop remains supportive for 2020. As Giulio Martini, Lord Abbett Partner and Director of Strategic Asset Allocation, stated in our 2020 Investment Outlook, *"... in our view, 2020 remains a year where a position of taking exposure to risk assets: stocks, both U.S. and non-U.S., and credit, could continue to be very rewarding to investors."* But the long-term performance of credit-sensitive bonds over the safety of government-related securities suggests that investors may want to maintain a strategic allocation to credit. A flexible multi-sector strategy that can provide diversified exposure to multiple sources of returns, and the flexibility to adapt to the market environment may offer the potential for portfolio diversification and higher total returns relative to core bonds over a full market cycle.

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.

Diversification does not assure a profit or protect against loss.

Statements concerning financial market trends are based on current market conditions, which will fluctuate. There is no guarantee that markets will perform in a similar manner under similar conditions in the future.

Forecasts and projections are based on current market conditions and are subject to change without notice. Projections should not be considered a guarantee.

This Market View may contain assumptions that are "forward-looking statements," which are based on certain assumptions of future events. Actual events are difficult to predict and may differ from those assumed. There can be no assurance that forward-looking statements will materialize or that actual returns or results will not be materially different from those described here.

Glossary of Terms

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.

A **basis point (bp)** is one one-hundredth of a percentage point.

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.

Spread is the percentage difference in current yields of various classes of fixed-income securities versus Treasury bonds or another benchmark bond measure. A bond spread is often expressed as a difference in percentage points or basis points (which equal one-one hundredth of a percentage point).

The **yield** on a security is the amount of cash (in percentage terms) that returns to the owners of the security, in the form of interest or dividends received from it.

The **Bloomberg Barclays Global Treasury Index** tracks fixed-rate, local currency government debt of investment grade countries, including both developed and emerging markets. The index represents the treasury sector of the Global Aggregate Index and contains issues from 37 countries denominated in 24 currencies.

The **Bloomberg Barclays Global Aggregate Bond Index** is a broad-based measure of the global investment-grade, fixed-income markets.

The **Bloomberg Barclays U.S. Aggregate Bond** 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.

The **Bloomberg Barclays U.S. Corporate High Yield Bond Index** is a market value-weighted index which covers the U.S. non-investment grade fixed-rate debt market. The index is composed of U.S. dollar-denominated corporate debt in the industrial, utility, and finance sectors.

The **Bloomberg Barclays Corporate A-Rated Bond Index** is the A component of the U.S. Corporate Investment Grade index. The U.S. Corporate Investment Grade index includes publicly issued U.S. corporate and specified foreign debentures and secured notes that meet the specified maturity, liquidity, and quality requirements. Other subcomponents include the Bloomberg Barclays U.S. B Corporate Bond Index, the Bloomberg Barclays U.S. BB Corporate Bond Index, the Bloomberg Barclays U.S. BBB Corporate Bond Index, and the Bloomberg Barclays U.S. CCC Corporate Bond Index.

The **Bloomberg Barclays U.S. High Yield Index** covers the universe of fixed rate, non-investment grade U.S. debt. Canadian and global bonds (SEC registered) of issuers in non-emerging market countries are also included.

The **Bloomberg Barclays U.S. Treasury Bond Index** is the U.S. Treasury component of the U.S. Government Index. The index includes public obligations of the U.S. Treasury with a remaining maturity of one year or more.

The **J.P. Morgan Emerging Markets Bond Index Global Diversified ("EMBI Global")** tracks U.S. dollar-denominated emerging-market sovereign bonds. The yields are the individual ratings of that index.

ICE BAML US High Yield Index tracks the performance of U.S. dollar denominated below investment-grade corporate debt publicly issued in the U.S. domestic market.

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