WHAT DRIVES RETURNS (AND VOLATILITY) OF THE BARCLAYS U.S. AGGREGATE INDEX?

Bradley Krom – U.S. Head of Research
10/19/2015

Over the last couple of months, volatility across asset classes has ticked up markedly. Interestingly, although interest rates have declined from their highs of the year, rates haven't fallen that much compared to the downdraft in global equity prices. As a result, the returns of the Barclays U.S. Aggregate Index (Agg) remain approximately unchanged year-to-date. With interest rates low, the ability to generate returns remains constrained. In response, many investors have sought higher-yielding opportunities outside the Agg. While we also subscribe to this model, another compelling option in the current environment may be to look inside the Agg in order to generate more attractive returns. Below, we examine the rotation in performance among the various components of the Agg over the last five years.

Calendar Year Performance of the Barclays U.S. Aggregate Index

	2010	2011	2012	2013	2014	YTD
Return / Volatility	U.S Aggregate 6.5% / 2.9%	U.S Aggregate 7.8% / 2.4%	U.S Aggregate 4.2% / 2.0%	U.S Aggregate -2.0% / 3.2%	U.S Aggregate 6.0% / 2.3%	U.S Aggregate 0.5% / 2.9%
Return / Volatility	CMBS 20.8% / 5.3%	Treasury 9.8% / 3.7%	Baa Credit 11.3% / 3.7%	CMBS 0.2% / 2.8%	Baa Credit 8.3% / 3.7%	ABS 1.4% / 1.0%
Return / Volatility	Baa Credit 10.0% / 4.4%	Baa Credit 9.5% / 4.8%	CMBS 10.0% / 2.2%	ABS -0.3% / 1.3%	A Credit 7.6% / 3.1%	Agency 1.1% / 2.0%
Return / Volatility	A Credit 8.5% / 4.0%	A Credit 8.2% / 4.5%	A Credit 9.8% / 3.6%	Aaa Credit -1.3% / 2.4%	Aa Credit 7.4% / 2.7%	CMBS 1.1% / 2.6%
Return / Volatility	Aa Credit 7.1% / 3.7%	Aa Credit 7.8% / 3.6%	Aa Credit 6.6% / 3.2%	Agency -1.4% / 2.0%	MBS 6.1% / 2.3%	MBS 1.0% / 1.4%
Return / Volatility	Treasury 5.9% / 4.2%	CMBS 6.5% / 4.2%	ABS 3.7% / 1.4%	MBS -1.4% / 2.8%	Treasury 5.1% / 2.1%	Treasury 0.9% / 3.6%
Return / Volatility	ABS 5.9% / 2.7%	MBS 6.2% / 1.6%	Aaa Credit 3.5% / 1.6%	A Credit -1.9% / 4.8%	CMBS 4.2% / 1.7%	Aaa Credit 0.7% / 2.4%
Return / Volatility	MBS 5.4% / 2.2%	Aaa Credit 6.0% / 2.6%	MBS 2.6% / 1.0%	Baa Credit -2.1% / 5.8%	Aaa Credit 3.7% / 1.6%	Aa Credit 0.1% / 4.2%
Return / Volatility	Aaa Credit 5.1% / 3.0%	ABS 5.1% / 1.6%	Agency 2.2% / 1.2%	Aa Credit -2.7% / 4.4%	Agency 3.6% / 1.4%	A Credit -0.3% / 4.3%
Return / Volatility	Agency 4.4% / 2.2%	Agency 4.8% / 1.5%	Treasury 2.0% / 3.0%	Treasury -2.8% / 2.8%	ABS 1.9% / 0.9%	Baa Credit -1.7% / 4.0%

Source: Bloomberg, as of 8/31/15. Past performance is not indicative of future results. You cannot invest directly in an index. Asset-backed security (ABS): A fixed income security whose value or cash flows depend on the value of another asset, such as a loan, lease or receivable. Commercial mortgage-backed security (CMBS): Fixed income security that is composed of multiple underlying commercial mortgages. Mortgage-backed security (MBS): Fixed income security that is composed of multiple underlying residential mortgages.

Credit ratings apply to the underlying holdings of the Index, and not to the Index itself. Standard & Poor's, Moody's and Fitch study the financial condition of an entity to ascertain its creditworthiness. The credit ratings reflect the rating agency's opinion of the holdings' financial condition and histories. The ratings displayed are based on the highest of each portfolio constituent as currently rated by Standard & Poor's, Moody's or Fitch. Long-term ratings are generally measured on a scale ranging from AAA (highest) to D (lowest), while short-term ratings are generally measured on a scale ranging from A-1 to C.

Lower for Longer The elephant in the room for the Agg is that nearly 40% of its holdings are in U.S. Treasuries.[1] With yields still low by historical standards, one way to generate returns in this segment of the market is for rates to stay low or decline.

Indeed, with rates roughly unchanged year-to-date, the Treasury component of the Agg is up by less than 1%, yet it has been one of the largest contributors of volatility due to the updrafts and downdrafts in rates. Comparing 2015 to recent history, rising rates in 2013 led to negative total returns for the Agg. Given that the move in rates was the primary driver of returns, U.S. Treasuries led this decline. In thinking about positioning in 2015, if investors believe that rates are likely to remain approximately flat or even lower, we believe they should be increasing their exposure to credit. With only one exception (2011), exposure to Baa credit actually improved performance compared to pure interest rate risk in Treasuries. With credit underperforming YTD, now could be an interesting time to increase allocations should an investor believe that any change in U.S. monetary policy will likely not have much of an impact on longer-term bond yields and credit conditions. **Lowest Volatility, Low Returns** So far in 2015, the primary drivers of bond volatility have come from the vacillating views of the Federal Reserve (Fed) action and widening credit spreads. Indeed, the best performing segments of the Agg have been in the securitized sector(asset-backed, mortgage-backed and commercial mortgage-backed securities). Compared to other components of the Agg, they tend to have the shortest duration and the least impact from widening credit spreads. While their positive returns and low volatility have been additive so far this year, historically these segments of the market have tended to provide modest returns. In fact, over the previous five years, they have tended to perform in the lower one-third of the various segments in the market. In light of tight valuations, we don’t see much of a catalyst for sustained outperformance. **A Potential Path Forward** In our view, while the Agg remains the de facto benchmark for many investors, its potential for income and total returns remains compromised. As a result, WisdomTree partnered with Barclays to create an index that enhances the yield of the Agg through a mechanical, rules-based process. Among the constraints, the Barclays U.S. Aggregate Enhanced Yield Index (Agg Enhanced Yield) focuses on tracking error and sector caps relative to the Agg in order to maintain a comparable volatility profile, but with greater income potential. This goal is generally achieved by reducing exposure to U.S. Treasury securities and increasing exposure to credit. While this approach has lagged by 30 basis points (bps) since its inception in July 2015, we believe the likely path forward could see credit outperform Treasuries in the medium term.[2] The Agg Enhanced Yield should compete with the traditional Agg for core fixed income allocations: potential yield pickup of 81 bps with only a modest increase in duration.[3] Given the risk investors have to stretch for in yield outside the Agg, shifting allocations within the Agg should be considered a more intuitive benchmark for core-focused strategies. [1]Source: Barclays, as of 8/31/15. [2]Source: Bloomberg, as of 10/8/15. [3]Source: Bloomberg, as of 10/8/15.

Important Risks Related to this Article

Fixed income investments are subject to interest rate risk; their value will normally decline as interest rates rise. In addition, when interest rates fall, income may decline. Fixed income investments are also subject to credit risk, the risk that the issuer of a bond will fail to pay interest and principal in a timely manner or that negative perceptions of the issuer’s ability to make such payments will cause the price of that bond to decline.

Barclays Capital Inc. and its affiliates (“Barclays”) are not the issuer or producer of the Funds, and Barclays has no responsibilities, obligations or duties to investors in the Funds. Barclays and the Barclays Indexes are trademarks owned by Barclays Bank PLC and licensed for use by WisdomTree with respect to the WisdomTree Trust as the Issuer of the Funds. Barclays’ only relationship with WisdomTree is the licensing of these Barclays Indexes, which is determined, composed and calculated by Barclays without regard to WisdomTree or the Funds. While WisdomTree may for itself execute transaction(s) with Barclays in or relating to these Barclays Indexes in connection with the Funds that investors acquire from WisdomTree, investors in the Funds neither acquire any interest in these Barclays Indexes nor enter into any relationship of any kind whatsoever with Barclays upon making an investment in the Funds. The Funds are not sponsored, endorsed, sold or promoted by Barclays, and Barclays makes no representation or warranty (express or implied) to the owners of the Funds, the issuer or members of the public regarding the advisability, legality or suitability of the Funds or use of these Barclays Indexes or any data included therein. Barclays shall not be liable in any way to the Issuer, investors or to other third parties in respect of the use or accuracy of these Barclays Indexes or any data included therein or in connection with the administration, marketing, purchasing or performance of the Funds.

Foreside Fund Services, LLC, is not affiliated with the other entities mentioned.

For standardized performance and the most recent month-end performance click here NOTE, this material is intended for electronic use only. Individuals who intend to print and physically deliver to an investor must print the monthly performance report to accompany this blog.

For more investing insights, check out our Economic & Market Outlook

View the online version of this article here.

IMPORTANT INFORMATION

U.S. investors only: Click here to obtain a WisdomTree ETF prospectus which contains investment objectives, risks, charges, expenses, and other information; read and consider carefully before investing.

There are risks involved with investing, including possible loss of principal. Foreign investing involves currency, political and economic risk. Funds focusing on a single country, sector and/or funds that emphasize investments in smaller companies may experience greater price volatility. Investments in emerging markets, currency, fixed income and alternative investments include additional risks. Please see prospectus for discussion of risks.

Past performance is not indicative of future results. This material contains the opinions of the author, which are subject to change, and should not to be considered or interpreted as a recommendation to participate in any particular trading strategy, or deemed to be an offer or sale of any investment product and it should not be relied on as such. There is no guarantee that any strategies discussed will work under all market conditions. This material represents an assessment of the market environment at a specific time and is not intended to be a forecast of future events or a guarantee of future results. This material should not be relied upon as research or investment advice regarding any security in particular. The user of this information assumes the entire risk of any use made of the information provided herein. Neither WisdomTree nor its affiliates, nor Foreside Fund Services, LLC, or its affiliates provide tax or legal advice. Investors seeking tax or legal advice should consult their tax or legal advisor. Unless expressly stated otherwise the opinions, interpretations or findings expressed herein do not necessarily represent the views of WisdomTree or any of its affiliates.

The MSCI information may only be used for your internal use, may not be reproduced or re-disseminated in any form and may not be used as a basis for or component of any financial instruments or products or indexes. None of the MSCI information is intended to constitute investment advice or a recommendation to make (or refrain from making) any kind of investment decision and may not be relied on as such. Historical data and analysis should not be taken as an indication or guarantee of any future performance analysis, forecast or prediction. The MSCI information is provided on an “as is” basis and the user of this information assumes the entire risk of any use made of this information. MSCI, each of its affiliates and each entity involved in compiling, computing or creating any MSCI information (collectively, the “MSCI Parties”) expressly disclaims all warranties. With respect to this information, in no event shall any MSCI Party have any liability for any direct, indirect, special, incidental, punitive, consequential (including loss profits) or any other damages (www.msci.com)

Jonathan Steinberg, Jeremy Schwartz, Rick Harper, Christopher Gannatti, Bradley Krom, Tripp Zimmerman, Michael Barrer, Anita Rausch, Kevin Flanagan, Brendan Loftus, Joseph Tenaglia, Jeff Weniger, Matt Wagner, Alejandro Saltiel, Ryan Krystopowicz, Jianing Wu, and Brian Manby are registered representatives of Foreside Fund Services, LLC.

WisdomTree Funds are distributed by Foreside Fund Services, LLC, in the U.S. only.

You cannot invest directly in an index.

DEFINITIONS

Volatility : A measure of the dispersion of actual returns around a particular average level. .

Barclays U.S. Aggregate Bond Index, 1-3 Year : This index is the 1-3 Yr component of the U.S. Aggregate index.

U.S. Treasury Bond : a debt security issued by the United States government.

Credit : A contractual agreement in which a borrower receives something of value now and agrees to repay the lender at some date in the future.

Monetary policy : Actions of a central bank or other regulatory committee that determine the size and rate of growth of the money supply, which in turn affects interest rates.

Bond yield : Refers to the interest received from a bond and is usually expressed annually as a percentage based on its current market value.

Federal Reserve : The Federal Reserve System is the central banking system of the United States.

Spread : Typically refers to a difference between a measure of yield for one asset class and a measure of yield for either a different subset of that asset class or a different asset class entirely.

Asset-backed security : A fixed income security whose value or cash flows depends on the value of another asset, such as a loan, lease, or receivable.

Mortgage-backed securities : Fixed income securities that are composed of multiple underlying mortgages.

Commercial mortgage-backed securities : a fixed income security that is composed of multiple underlying commercial mortgages.

Duration : A measure of a bond’s sensitivity to changes in interest rates. The weighted average accounts for the various durations of the bonds purchased as well as the proportion of the total government bond portfolio that they make up.

Bloomberg Barclays U.S. Aggregate Enhanced Yield Index : a constrained, rules-based approach that reweights the sector, maturity, and credit quality of the Barclays U.S. Aggregate Index across various sub-components in order to enhance yield.

Tracking Error : Can be discussed as both the standard deviation of excess return relative to a specific benchmark, or absolute excess return relative to a specific benchmark.

Basis point : 1/100th of 1 percent.