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# HOW DO ENHANCED YIELD FIXED INCOME INDEXES STACK UP VS. ACTIVE?

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The research team at AQR Capital Management recently published a piece<sup>1</sup> that attempted to explain why [actively managed](#) fixed income funds were able to deliver higher [information ratios](#) against their benchmarks than U.S. [large-cap](#) equity managers. The conclusion? Active fixed income managers tended to be over-weight [credit risk](#) compared to their benchmarks. While hardly surprising, that is precisely the rationale we focused on more than two years ago when collaborating with Barclays to create the [Bloomberg Barclays U.S. Aggregate Enhanced Yield Index](#) (Enhanced Yield Index). In this piece, we examine how the [WisdomTree Barclays Yield Enhanced U.S. Aggregate Bond Fund \(AGGY\)](#), designed to track the Index, has stacked up against other active managers in this space.

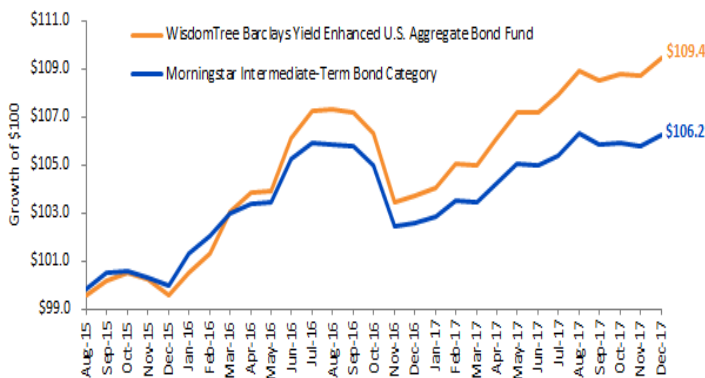
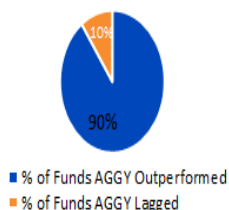
## Strategy Review

The Enhanced Yield Index uses the same investable universe as the [Bloomberg Barclays U.S. Aggregate Index](#), but then seeks to maximize [yield](#) while adhering to a series of constraints to limit risk. The resulting portfolio will generally be over-weight credit risk and under-weight [U.S. Treasuries](#). Throughout its history, it has increased yield by 50 to 75 [basis points \(bps\)](#) while keeping [duration](#) within one year of the benchmark. All else being equal, the higher the starting yield of a bond portfolio, the higher the expected returns. Therefore, by extracting higher yields from the [investment-grade](#) investable universe, returns should increase. By applying constraints, we are also attempting to be cognizant about keeping [tracking error volatility](#) to 0.35% per month.

## Real-Time Performance

As we show in the chart below, while our historical research was instructive, what really matters is how the strategy performs in real time. Since mid-2015, [credit spreads](#) have generally tightened, and interest rate volatility has generally been low. Overall, this environment has been favorable for most flavors of active and passive fixed income. Since inception, AGGY has outperformed 91% of all funds in the Morningstar Intermediate-Term Bond Category.<sup>2</sup> Over the last year, it has outperformed 90% of all funds.<sup>3</sup> Put another way, our approach has outperformed more than 815 active and passive managers in the core bond category. In our view, this continues to strengthen the case that it's possible to enhance strategy returns by enhancing indexes versus relying on subjective portfolio manager discretion.

AGGY Percentage of Peers Outperformed (Common Period)



Fund/Index/Category	Average Annual Total Returns as of 12/31/17								
	Fund Information			NAV Returns (%)			Market Price Returns (%)		
	Ticker	Exp. Ratio	Inception Date	YTD	1-Year	Common Period	YTD	1-Year	Common Period
WisdomTree Barclays Yield Enhanced U.S. Aggregate Bond Fund	AGGY	0.12%	7/9/2015	5.2%	5.2%	3.6%	5.2%	5.2%	3.6%
Bloomberg Barclays U.S. Aggregate Index				3.6%	3.6%	2.5%	3.6%	3.6%	2.5%
Morningstar Intermediate-Term Bond Category				3.8%	3.8%	2.5%	3.8%	3.8%	2.5%

Sources: Morningstar, WisdomTree, 9/30/07–12/31/17. "Common period" refers to 7/31/15–12/31/17 due to availability of Morningstar category performance data. 7/9/15 represents the AGGY inception date. Nine hundred three investments included in peer group for Morningstar Intermediate-Term Bond Category.

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Conclusion

Fixed income managers have a variety of tools at their disposal to try to outperform the market. While some may be able to consistently outperform their benchmarks, it seems far more likely that many of these approaches boil down to systematic biases in their portfolios. While these approaches may not always outperform, we believe our approach to enhanced indexing can provide a value to investors comfortable with increasing risk at the margin in order to boost returns over market cycles.

<sup>1</sup>Source: “The Illusion of Active Fixed Income Diversification,” AQR Capital Management Alternative Thinking, 2017.

<sup>2</sup>Source: Morningstar rankings based on total returns 8/1/2015 through 12/31/17. Peer group rank 86 out of 903 funds.

<sup>3</sup>Source: Morningstar rankings based on total returns from 12/31/2016 through 12/31/17. Peer group rank 99 out of 986 funds.

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## DEFINITIONS

**Active manager**: Portfolio managers who run funds that attempt to outperform the market by selecting those securities they believe to be the best.

**Large-Capitalization (Large-Cap)**: A term used by the investment community to refer to companies with a market capitalization value of more than \$10 billion. Large cap is an abbreviation of the term “large market capitalization”. Market capitalization is calculated by multiplying the number of a company’s shares outstanding by its stock price per share.

**Credit risk**: The risk that a borrower will not meet their contractual obligations in conjunction with an investment.

**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.

**Bloomberg U.S. Aggregate Bond Index**: Represents the investment-grade, U.S. dollar-denominated, fixed-rate taxable bond market, including Treasuries, government-related and corporate securities, as well as mortgage and asset backed securities.

**Yield**: The income return on an investment. Refers to the interest or dividends received from a security that is typically expressed annually as a percentage of the market or face value.

**Treasury**: Debt obligation issued by the U.S. government with payments of principal and interest backed by the full faith and credit of the U.S. government.

**Basis point**: 1/100th of 1 percent.

**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.

**Investment grade**: An investment grade is a rating that signifies a municipal or corporate bond presents a relatively low risk of default.

**Tracking error volatility**: A measure of dispersion between the returns of 2 investments.

**Credit spread**: The portion of a bond’s yield that compensates investors for taking credit risk.