WHAT ARE YOU MISSING OUT ON WITH THE AGG?

by Henry Pasts, Executive Vice President and Analyst, BTS Asset Management, Inc.

Take a closer statistical look on what you could really miss out on when you focus the fixed income portion of your portfolio only on Agg-like investments.

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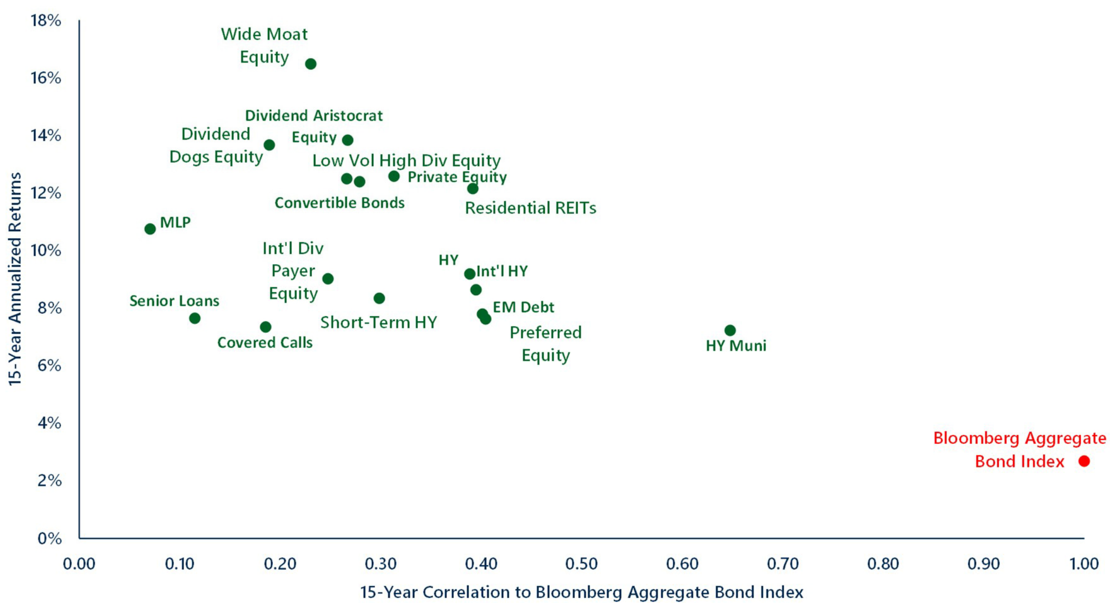
In one of our previous papers, “Finding Opportunity Beyond the Agg”, we discussed the potential shortcomings of the Bloomberg Aggregate Bond Index (the Agg). In this paper, we’ll take a closer statistical look at what you could really miss out on when you focus the fixed income portion of your portfolio only on Agg-like investments.

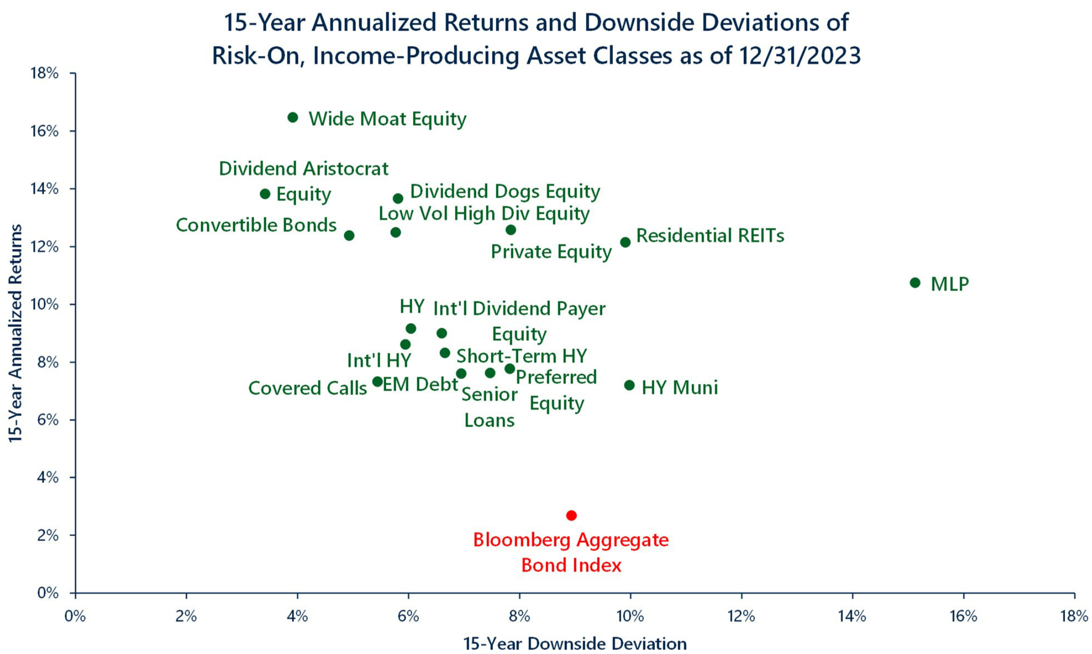
One of the potential shortcomings of the Agg is the highly correlated nature of its components. We specifically stated in our previous paper that the top two components of the Agg, Treasuries and Residential-Mortgage Backed Securities, have a correlation to one another of over 80%, so when you invest in an Agg-like security, you are not fully enjoying the benefits of diversification. When looking beyond the Agg to asset classes such as High Yield Bonds, Emerging Market Debt, Senior Loans, and even income-producing equity asset classes such as Dividend Aristocrats and Covered Calls, you are potentially adding significant diversification benefits to your portfolio. This can be seen in the chart below, where every asset class shown has a correlation to the Agg of less than .50 when looking at the past 15 years. Furthermore, as measured on the y-axis, each of these asset classes has 15-year annualized returns that historically surpass those of the Agg.

15-Year Annualized Returns and Correlations of Risk-On, Income-Producing Asset Classes vs. Bloomberg Aggregate Bond Index as of 12/31/2023



Source: Morningstar Direct. For illustrative purposes only. Past performance does not guarantee future results. Each of these asset classes has its own set of investment characteristics and risks and investors should consider these risks carefully prior to making any investments. No level of diversification or non-correlation can ensure profits or guarantee against losses.

Another important consideration can be the risk-adjusted returns that may be uncovered by looking beyond the Agg. One of our preferred risk measures is downside deviation, which defines risk only as downside surprises to a return stream, rather than the more traditional standard deviation, which also treats upside surprise as risk. The chart below shows the same asset classes that we included in the correlation chart above, but this time plots 15-year downside deviation along the x-axis. The takeaway here is that in addition to providing potential diversification benefits and higher 15-year returns than the Agg, the majority of these asset classes do so with less risk than the Agg, as measured by downside deviation over this 15-year timeframe. The handful of asset classes that fall to the right of the Agg in this chart, such as Residential REITs and HY Munis, have historically exhibited greater downside risk than the Agg over this time horizon, but with their higher 15-year returns, have also been at times worthy of consideration in a well-balanced fixed income portfolio.



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In summary, we believe two of the most important statistical considerations in constructing a portfolio are diversification as measured by correlation, and risk-adjusted returns using downside deviation as a risk measure. And when analyzing several income-producing asset classes in relation to the Agg in regard to these statistical measures, our view is that the Agg can leave much to be desired.

Bloomberg Aggregate Bond Index is comprised of government securities, mortgage-backed securities, asset-backed securities and corporate securities with maturities of one year or more to simulate the universe of bonds in the market. Short-Term HY - The ICE BofA 0-5 Year US High Yield Constrained Index tracks the performance of short-term US dollar denominated below investment grade corporate debt publicly issued in the US domestic market. Senior Loans - The Morningstar LSTA US Leveraged Loan Index is a market-value weighted index designed to measure the performance of the US leveraged loan market. EM Debt - The Bloomberg Emerging Markets Hard Currency Aggregate Index is a flagship hard currency Emerging Markets debt benchmark that includes USD-denominated debt from sovereign, quasi-sovereign, and corporate EM issuers. Int'l HY - The Bloomberg Global High Yield Index is a multi-currency flagship measure of the global high yield debt market. The index represents the union of the US High Yield, the Pan-European High Yield, and Emerging Markets (EM) Hard Currency High Yield Indices. The high yield and emerging markets sub-components are mutually exclusive. HY - The Bloomberg US Corporate High Yield Bond Index measures the USD-denominated, high yield, fixed-rate corporate bond market. Securities are classified as high yield if the middle rating of Moody's, Fitch and S&P is Ba1/BB+/BB+ or below. Bonds from issuers with an emerging markets country of risk, based on Bloomberg EM country definition, are excluded. HY Muni - Bloomberg Municipal Bond 10 Year (8-12) TR Index Unhedged USD covers the USD-denominated long-term tax exempt bond market. The index has four main sectors: state and local general obligation bonds, revenue bonds, insured bonds and pre-refunded bonds. Low Vol High Div Equity - S&P 500 Low Volatility High Dividend Index is made up of 50 stocks from S&P 500 that offer high dividend yields. The index is designed to provide exposure to high yield stocks in the US while meeting stability and diversification requirements. Dividend Dogs Equity – S-Network Sector Dividend Dogs Index is a portfolio of fifty stocks derived from the S&P 500 Index. The SDOGX methodology selects the five stocks in each of the ten GICS sectors that make up the S&P 500 which offer the highest dividend yields as of the last trading day of November. Dividend Aristocrats Equity - The S&P 500 Dividend Aristocrats index is designed to measure the performance of S&P 500 index constituents that have followed a policy of consistently increasing dividends every year for at least 25 consecutive years. Int'l Dividend Payer Equity - The Dow Jones Global Select Dividend aims to represent the stock performance of 100 leading dividend-paying companies worldwide. MLP - The Alerian MLP Infrastructure Index is a composite of energy infrastructure Master Limited Partnerships (MLPs). The capped, float-adjusted and capitalization-weighted index is disseminated real-time on a price-return basis (AMZI) and on a total-return basis (AMZIX). Wide Moat Equity - The Morningstar® Wide Moat Focus Index provides exposure to companies with Morningstar® Economic Moat™ Ratings of wide that are trading at the lowest current market price/fair value ratios. Moat ratings and fair value estimates are determined through independent research conducted by the Morningstar Equity Research team. Residential REITs - The MSCI US REIT Index is a total-return index comprising the most actively traded real estate investment trusts. MSCI commenced calculation of the index on 6/20/05. Prior to that, AMEX began calculation with a base level of 200 from 12/30/94. Sub-industries began on 5/1/06 as the result of 2006 Annual GICS review. Covered Calls - The CBOE S&P 500 BuyWrite Index (BXM) is a benchmark index designed to track the performance of a hypothetical buy-write strategy on the S&P 500 Index. Convertible Bonds - Bloomberg US Convertibles Composite Total Return Unhedged USD.

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