As we embark on a new investing year, we are hearing concerns from investors regarding their fixed-income allocations. Conventional wisdom is: a) reduce duration, as interest rates are likely to rise, and b) increase liquidity to protect against systemic risk. While we are not convinced that rates will move significantly higher in 2011, we do acknowledge that it is a risk. The chances of another systemic event are also real and are worthy of consideration. So what should an investor do? One thing we can recommend with confidence is that investors continue with active management.

A natural response from the events that unfolded in 2007 and 2008 is to reduce risk and, in many cases, go passive—the thinking being that passive exposure will provide greater liquidity and less risk and that fixed-income will need to be an anchor to windward within a portfolio allocation. Regarding the move to a passive approach, our view is caveat emptor—let the buyer beware. We are not attempting to discredit passive investing. Rather, we want to highlight changes that are likely to occur to the popular benchmarks and explain how those changes will likely impact performance.

Indices are dynamic portfolios. The many changes that are unfolding in the aggregate indices may or may not be in investors’ best interests. Presented below are a number of changes that we expect to see in the aggregate indices over the next several years:

- The allocation to US Treasuries (UST) is likely to continue to increase as the US government continues to run trillion-dollar-plus deficits (Exhibit 1).
- The maturity profile of the Treasury sector is extending and will likely continue to do so.
- The agency MBS allocation has declined as a percentage of the indices, and is likely to keep declining as the housing market continues to struggle. Additionally, there could be volatility in this sector, since it is susceptible to the actions of the US Congress, as Freddie Mac and Fannie Mae remain in conservatorship with no resolution in sight.
- The coupon concentration in agency MBS now is in 4.5% and 5.0% coupons, whereas previously it had been in 5.0% and 5.5%. This has led to a longer duration despite a decline in yields. The duration of these issues will extend further if and when interest rates increase, resulting in a longer overall duration for the indices.

Exhibit 1

Historical Composition & Projected Changes for the Barclays Capital U.S. Aggregate Index

As of 31 Dec 10

Source: Barclays Capital, Western Asset
• The US Federal Reserve (Fed) holds over $2 trillion of the securities that are represented in the indices—making it difficult for investors to get access to these securities.

• Non-US issuers—both sovereign and corporate—are increasing as a percentage of the benchmarks.

• Indices will likely provide lower yields and lower returns than those to which investors have become accustomed.

Now, perhaps more than ever, it is critical to a) know your index and b) actively manage these exposures to help meet long-term investment objectives (Exhibit 2). If objectives have evolved to focus more on liquidity and quality, passive is not necessarily the answer. An active approach emphasizing liquidity and quality can potentially meet an investor’s objectives while still allowing for enhanced returns.

What can be done to protect a portfolio from a rising interest rate environment? Those who are focused on liability-hedging actually stand to benefit from rising rates, as higher discount rates will reduce the present value of their liabilities. Given that allocations to fixed-income are generally well below 50%, the benefits of rising rates will far outweigh any potential underperformance in the sector. Simply put, there is generally no need to make changes.

Others who are more focused on total rate-of-return investing can focus on either reducing duration (a tactical move) or moving to an unconstrained mandate that is not tied to a market benchmark (a strategic move). Another alternative is to stay the course with Core and Core Plus allocations, allowing managers to make tactical shifts in sector, issuer, duration and yield curve profiles to defend against rising interest rates and/or to take advantage of positive market moves.

In 2010, the duration of the Barclays aggregate benchmark increased by 0.41 despite the fact that the yield (yield-to-worst) of the benchmark declined to 2.97% from 3.68% (Exhibit 3). This reflects the structural changes that are occurring in the index. All else being equal, we would expect to see the index duration decline as rates decline. A significant component of the duration extension was the extension of agency MBS duration. As homeowners refinanced into lower coupons, the duration of the sector extended to 4.16 years from 3.57 years as the yield declined to 3.67% from
4.15%. Now that the average coupon rate has been reduced, the duration of this sector is likely to extend further if we experience a further increase in rates.

**Is the Aggregate Really an Aggregate?**

It is important to look at the range of opportunities that exist within the fixed-income market. In Exhibit 4, one can see that the Barclays aggregate index includes only UST, agencies, investment-grade credit and securitized debt. Other opportunities—specifically US floating rate, Treasury Inflation-Protected Securities (TIPS), below investment-grade and non-USD-denominated—are omitted.

This suggests that benchmarks are not particularly well diversified despite the suggestion of their titles. Correlations among the constituents tend to be high, as can be seen in Exhibit 5. The constituents of the benchmarks have correlations that range from 0.69 to 0.85, while other fixed-income sectors demonstrate significantly less correlation.

Higher-yielding sectors such as high-yield debt, bank loans and emerging markets are perceived to have higher risk. But investors need to clearly define what risk means given that current yield spreads range from 290 basis points (bps) to 550 bps, the economy is recovering, interest rates are low, default rates are declining, and significant stimulus (both monetary and fiscal) remains in the system. Is the primary concern risk of principal loss (default), or is it deviation from expected returns? The answer could have significant implications for asset allocators, especially if one concludes the primary risk is deviation from expected returns, as Treasuries are likely to be impacted most profoundly in a rising rate environment. The obvious opportunities are fewer

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**Exhibit 4**

**Fixed-Income Opportunities**

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<tbody>
<tr>
<td>Barclays Capital U.S. Aggregate</td>
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<td>3,560</td>
<td>5,372</td>
<td>588</td>
<td>1,324</td>
<td>151</td>
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<td>6,073</td>
<td>1,484</td>
<td>939</td>
<td>466</td>
<td>160</td>
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</table>

As of 31 Dec 10  
Source: Barclays Capital

**Exhibit 5**

**Correlations**

<table>
<thead>
<tr>
<th></th>
<th>Barclays Aggregate</th>
<th>Barclays Government</th>
<th>Barclays Credit</th>
<th>Barclays MBS</th>
<th>Barclays TIPS</th>
<th>Barclays High Yield</th>
<th>S&amp;P LSTA Performing Loans Index</th>
<th>JPM EMBI+</th>
<th>Citi WGBI USD Unhedged</th>
<th>JPM GBI EM Global Diversified</th>
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</thead>
<tbody>
<tr>
<td>Barclays Aggregate</td>
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<tr>
<td>Barclays Government</td>
<td>0.93</td>
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<tr>
<td>Barclays U.S. Credit</td>
<td>0.88</td>
<td>0.69</td>
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<tr>
<td>Barclays MBS</td>
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<td>0.85</td>
<td>0.70</td>
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<tr>
<td>Barclays TIPS</td>
<td>0.60</td>
<td>0.53</td>
<td>0.57</td>
<td>0.49</td>
<td>1.00</td>
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<tr>
<td>Barclays High Yield</td>
<td>0.14</td>
<td>-0.11</td>
<td>0.39</td>
<td>0.02</td>
<td>-0.19</td>
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<tr>
<td>S&amp;P LSTA Performing Loans Index</td>
<td>-0.03</td>
<td>-0.32</td>
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<td>0.16</td>
<td>0.60</td>
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<tr>
<td>JPM EMBI+</td>
<td>0.27</td>
<td>0.09</td>
<td>0.44</td>
<td>0.24</td>
<td>0.25</td>
<td>0.42</td>
<td>0.25</td>
<td>0.16</td>
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<tr>
<td>Citi WGBI USD Unhedged</td>
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<td>0.63</td>
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<td>0.52</td>
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<td>JPM GBI - EM Global Diversified</td>
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<td>0.62</td>
<td>0.30</td>
<td>0.39</td>
<td>0.47</td>
<td>0.40</td>
<td>0.79</td>
<td>0.56</td>
<td>1.00</td>
</tr>
</tbody>
</table>

Source: Barclays Capital, JPMorgan, S&P, Western Asset, Citigroup
and spreads, in general, are tighter. Still, a disciplined, active, bottom-up issuer and sector selection process will likely prove both necessary and profitable.

While the sector opportunities within the benchmarks may be limited, the number of readily available securities is also more limited than it appears. As of December 31, there were 6,742 issues in the Barclays aggregate benchmark, representing over $13 trillion of market value. The Fed owns approximately $2 trillion of these securities, and many of the included issues are not particularly liquid. Add to this the trillions owned by banks, insurance companies and pension funds that do not trade frequently, and the ability to effectively replicate the index in a passive strategy can be called into question.

Exhibit 6 compares yields of various indices. Tactical and strategic allocations across sectors can materially alter the yield profile and the duration profile of a portfolio and can create a more compelling investment opportunity than a passive portfolio.

The Shortcomings of Fixed-Income Indices
Allocations within fixed-income indices are determined based on issuance; the more debt that an entity issues, the larger the allocation within the indices. In 2002, we witnessed a default by WorldCom, one of the largest single corporate issuers within the aggregate. WorldCom was the largest issuer by virtue of the size of its outstanding debt. Active management seeks to identify excessive issuance and minimize (underweight) exposure to these issuers. Given the current environment—one in which Fannie Mae and Freddie Mac are in conservatorship, the US government is running significant deficits and interest rate volatility is increasing—greater caution is called for. Increased issuance should likely be met with reduced allocations, not increased allocations.

**Summary of Rules for Inclusion in the Barclays Capital U.S. Aggregate Index**

- USD-denominated and non-convertible.
- Fixed-rate, although can carry a coupon that steps up or changes according to predetermined schedule.
- Rated investment-grade (Baa3/BBB-) by at least two of the rating agencies.
  - If only two agencies rate the bond, the lowest rating is used to determine eligibility.
  - If only one agency rates the bond, it must be investment-grade rated.
- Must have at least one year until final maturity.
- Must have at least $250 million par amount outstanding.
- ABS must have at least $500 million deal size and $25 million tranche size.
- CMBS must have original deal size of at least $500 million and $25 million tranche size.
- In order to remain in the index, CMBS must have current outstanding transaction size of at least $300 million.

*Source: Barclays Capital*
Investor Concerns
Investors are correctly seeking to increase the level of liquidity in their portfolios. 2008 imparted many lessons, not the least of which is the need to have a safe, liquid pool of assets that can be accessed for rebalancing purposes. We endorse that idea, but that does not translate into taking a purely passive approach. Maintaining liquidity and risk levels that are consistent with this objective is of greater importance. Having an active mandate can facilitate this objective. Guidelines should be crafted to ensure appropriate portfolio construction. Opting for a one-size-fits-all solution—a passive, benchmark-based portfolio—will detract from returns and likely leave the investor less than satisfied with the results.

The Importance of Income
In an environment characterized by slow growth, excess capacity, weak labor markets, tight credit, and subdued consumer spending, one could conclude that equity returns will be somewhat less than long-term expectations. Add to that the fact that many investment plans, notably pension plans, are maturing and requiring substantial cash flows. These conditions necessitate more income within the portfolio. With Treasury rates near the low end of their historical range, and sector yields—notably investment-grade corporate and agency MBS—at attractive spreads but low absolute yields, the relative advantage of active management is currently of particular value. Globally, there are many sectors that offer enhanced yield and return opportunities. These include emerging market debt (both external and local, corporate and sovereign), non-agency MBS and below-investment-grade debt (both fixed and floating). Each of these sectors is excluded from the major aggregate indices. In an actively managed portfolio, allocations can be made to these sectors in limited amounts in an effort to boost the overall income from the portfolio. Additionally, each of these sectors tends to be less interest rate-sensitive than UST. Inflation-linked debt is likewise excluded and can also provide significant benefits in a rising rate environment.

The Quality of Ratings
The rules for the major indices focus quite heavily on ratings. Given the failings of the rating agencies in recent years, we believe that investors or their agents should conduct their own due diligence on individual credits and should have their own views on credit quality. Ratings guidelines often provide a false sense of security and encourage a “buy high/sell low” mentality, as investors are forced to sell following significant downgrades. Bottom-up issuer analysis will be critical to investing success in the coming years. Index providers will merely react to changes in credit conditions; an active manager is charged with anticipating these changes. While results may deviate at times from expectations in the short-run, longer observation periods—as well as a commitment to a long-term approach and to an investment philosophy—demonstrate the ability of active management to provide significant rewards to the strategic investor.

Conclusion
Index rules limit an investor’s opportunity set. We know that diversification reduces risk and enhances return over the long run, but recent market events have caused many to question this thesis. With investors’ long-term return expectations for fixed-income at 6% and current yields for the aggregate indices at or near 3% (Exhibit 3), it is clear that a purely passive approach will be a drag on overall portfolio performance. While the need for liquidity and quality is real, a passive approach is not the only way to achieve these ends.

Consultation and collaboration with active managers can result in the potential for higher returns and greater diversification while providing the desired level of liquidity. Traditional measures of quality are questionable so a customized investment plan emphasizing liquidity and safety of principal is likely to be more important to achieving a plan’s goals.
Guidelines can be adapted to meet these goals and objectives without accepting a passive approach. A passive approach under the current construct of the major indices will systematically allocate more of the portfolio to chronic debt issuers. Through their issuance patterns, these issuers will determine the performance characteristics of the indices—not investors. Yes, liquidity will be enhanced in a passive approach, but at what cost?

What is needed is a deep understanding of the role that the fixed-income allocation is intended to play. An extensive collaboration with an active manager is needed to craft and implement an investment strategy that is designed to meet the plan’s articulated goals and objectives. Reduced reliance on rating agencies and an increased reliance on diversification, yield enhancement and inflation protection are important considerations.

Knowing your index and focusing on effective diversification while meeting specific liquidity and quality objectives can improve both liquidity and returns and will likely reduce the unintended consequences that we are likely to see from a purely passive approach.