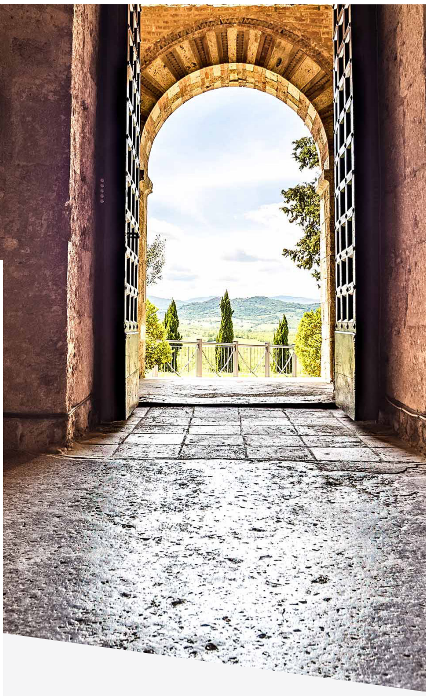
Fixed income beyond the Agg



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Investors should consider including diversified credit to pursue higher yields and help reduce overall portfolio volatility.

Traditionally, fixed-income investors looking to generate income with low volatility have relied on products that track the Bloomberg Barclays U.S. Aggregate (the Agg) — a proxy for the bond market composed largely of government-issued debt. The Agg's performance is primarily driven by changes in interest rates. This served investors well in the long period of falling interest rates, but today's environment is very different. Yields on safe-haven debt are near zero, so the traditional "low-risk" portfolio has become increasingly susceptible to price volatility. Different times call for a different strategy.

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COLUMBIA THREADNEEDLE INVESTMENTS

Looking beyond the U.S. Aggregate Bond Index

Download the full paper: Looking beyond the U.S. Aggregate Bond Index Management

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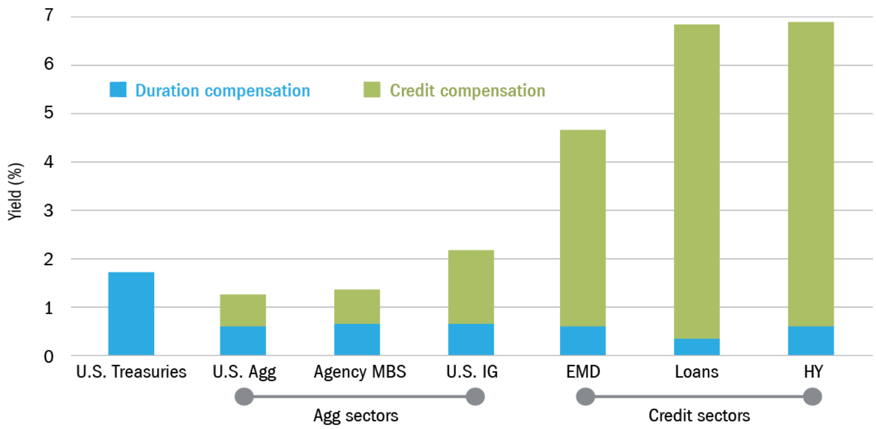
Credit risk may boost yield

Credit risk is the possibility of default, resulting from a borrower's failure to repay their debt. Investors earn a yield premium for assuming this risk. The relative lack of credit risk in the Agg helps explain why its yield now trails many fixed-income alternatives.

Sectors like high-yield bonds, leveraged loans and emerging market debt feature substantial yield premiums to entice investors to take on more credit risk. As a result, most of their yield represents compensation for credit rather than interest rate risk.

Yield premiums grow when moving down the quality spectrum



Source: Columbia Threadneedle Investments as of 06/30/20. **Past performance is not a guarantee of future results.** The **Bloomberg Barclays U.S. Aggregate Bond Index** (U.S. Agg) is a market-value-weighted index that tracks the daily price, coupon, pay-downs and total return performance of fixed-rate, publicly placed, dollar-denominated and non-convertible investment-grade debt issues with at least $250 million par amount outstanding and with at least one year to final maturity. The **Bloomberg Barclays U.S. Treasury Index** (U.S. Treasuries) includes public obligations of the U.S. Treasury. The **Bloomberg Barclays U.S. Mortgage-Backed Securities Index** (Agency MBS) measures the performance of investment-grade, fixed-rate, mortgage-backed pass-through securities. The **Bloomberg Barclays U.S. Corporate Index** (U.S. IG) measures the investment-grade, fixed-rate, taxable, corporate bond market. The **Bloomberg Barclays Emerging Market USD Aggregate Index** (EMD) is an unmanaged index that tracks total returns for external-currency-denominated debt instruments of the emerging markets. The **Credit Suisse Leveraged Loan Index** (Loans) tracks the investable market of the U.S.-dollar-denominated leveraged loan market. It consists of issues rated "5B" or lower, meaning that the highest rated issues included in this index are Moody's/S&P ratings of Baa1/BB+ or Ba1/BBB+. All loans are funded term loans with a tenor of at least one year and are made by issuers domiciled in developed countries. The **Bloomberg Barclays U.S. High Yield Corporate Index** (HY) is a market-value-weighted index which covers the U.S non-investment-grade fixed-rate debt market. Indices shown are unmanaged and do not reflect the impact of fees. It is not possible to invest directly in an index. Duration is a measure of the sensitivity of a bond's price to changes in interest rates.

Credit risk as a counterweight

Investors might assume that introducing credit alongside high-quality bonds like those in the Agg results in a riskier portfolio. But in fact, credit and interest rate risk are negatively correlated. This means they outperform at different times and can serve as counterweights to each other. This helps to smoothe portfolio returns over time.

- Interest-rate risk performs best when central banks ease monetary policy to combat slowing economic growth. A flight-to-quality can also create demand for safe-haven assets. Credit risk might struggle in this environment.
- Credit risk performs best when risk-taking is in favor, economic growth is stronger and yield premiums sufficiently compensate for perceived default risk.

This complementary performance suggests that introducing credit risk into an otherwise high-quality, interest-rate driven portfolio provides diversification and may lessen volatility of returns.

There's an important caveat to diversifying with credit: Simply reaching for yield in some of the most volatile sectors of the market can expose investors to unintended risks, including a higher correlation to equities and less downside protection. It's important to maintain a flexible, prudent approach and be willing to adapt as market conditions change.

Bottom line: Consider credit risk to pursue yield and provide diversification

The Agg has been synonymous with the U.S. bond market for decades, but low yields and interest rate uncertainty diminish its appeal as an investment solution. Looking beyond the Agg to include diversified credit may provide investors with both higher yields and less overall portfolio volatility.

DISCLOSURES

Diversification does not assure a profit or protect against a loss. There are risks associated with fixed-income investments, including credit risk, interest rate risk, and prepayment and extension risk. In general, bond prices rise when interest rates fall and vice versa. This effect is usually more pronounced for longer term securities.

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