# Tracking the Agg? Why the bond index may not work for investors.

October 15, 2021

*The Agg is more than an index. It's the basis for financial products that represent large fixed-income allocations for many investors. What's wrong with that?*

Many investors use products that track the Bloomberg Barclays U.S. Aggregate Bond Index (the Agg) as their core fixed-income allocation. But the Agg has some drawbacks, and investors would be better served by looking beyond the benchmark.

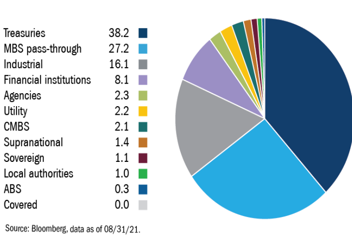
**The background**

As portfolio management techniques advanced in the 1970s, it became increasingly important to measure bond performance. So in 1973, a bond index was created, and after a series of acquisitions culminating in 2016, it became known as the Bloomberg Barclays U.S. Aggregate Bond Index or the Agg. In 2021, the Agg is composed of over 10,558 bonds worth nearly $22 trillion.

**The problem**

- **The Agg is weighted toward the companies and agencies that have the most debt.** In equity markets, investors typically rely on market-capitalization-weighted benchmark indices like the S&P 500 Index — the bigger the company, the bigger its position in the index. Arguably, this approach works because the size of a company can be indicative of its success. But when it comes to fixed income, the same logic doesn't apply. The largest components of the Agg are the companies and agencies with the most debt outstanding. Having a lot of debt doesn't necessarily make them a better bond investment; it just means they have a lot of debt.

Bloomberg Barclays U.S. Aggregate Bond Index, sector breakdown (%)




Source: Bloomberg, data as of 08/31/21.

- **The Agg is heavily weighted toward U.S. government exposure.** Just because there are thousands of securities in the Agg doesn't mean that it's well-diversified across sectors of the bond market. In 2007, the Agg was 22% U.S. Treasuries, but that has increased to 38% in 2021. Factoring in debt issued by government agencies and mortgage-backed securities (MBS), the total government exposure is now over 70%.

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- **The largest components of the Agg don't provide a lot of diversification.** The top two components of the Agg — U.S. Treasuries and MBS — have an 81% correlation. That means that historically, returns for those sectors moved in the same direction most of the time. Less-correlated sectors either form a much smaller component of the Agg or — in the case of sectors like U.S. corporate high-yield and emerging market bonds — are not represented in the Agg at all.

**Bottom line**

The bond benchmark represents the largest issuers of debt, but not necessarily the best opportunities for fixed-income investors. It also doesn't foster diversification, with high historical correlations among its largest components. We believe fixed-income investors should look beyond the benchmark. To learn more about the Agg and solutions to its shortcomings, read our white paper.

AUGUST 2021

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**Key findings**

- Allocating by debt outstanding creates a lopsided yield distribution, with a barbell-like overconcentration both in relatively safe-haven assets with a limited income profile and in fundamentally risky debt profiles.
- The benchmark index does not foster diversification, with a two-thirds weighting to government affiliated bonds and high correlation between the two largest sectors.
- Investors should consider a multi-sector bond strategy filtered for opportunity rather than indebtedness. Such a strategy could address the investment universe screened by yield, quality and liquidity.

**The growth of the U.S. bond market**

The United States, initially as the Continental Congress, first incurred debt in 1776 when it borrowed funds to finance the Revolutionary War.[1] Total Treasury debt remained fairly small in the first half of the 19th century but rose sharply with the Civil War and again with World War I (Exhibit 1). After declining slightly, the debt increased nearly threefold during the Great Depression and exploded in the 1940s as the government financed expenditures related to World War II.

From its postwar low in 1949, outstanding Treasury debt grew gradually for nearly two decades before accelerating at the time of the Vietnam War and during the subsequent period of high inflation. In the 1980s, the growth of the stock of debt picked up further, spurred by the tax cuts and rapid increases in defense spending of the decade.[2] America's continuing and growing budget deficits, combined with the unprecedented government intervention in U.S. financial markets in 2008 — including the mortgage-backed securities (MBS) issued by Fannie Mae and Freddie Mac — have driven the explosion in U.S. government debt outstanding.

**Exhibit 1: U.S. government debt outstanding**
1790–2020



Source: U.S. Department of the Treasury. Data as of 06/30/20.

[1] Rafael A. Bayley, The National Loans of the United States of America from July 4, 1776 to June 30, 1880, as Prepared for the Tenth Census of the United States (Washington, DC: U.S. Government Printing Office, 1882).
[2] The Treasury Securities Market: Overview and Recent Developments.

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Download the whitepaper

The Bloomberg U.S. Aggregate Bond Index (the Agg) is a broad-based benchmark that measures the investment grade, U.S. dollar-denominated, fixed-rate taxable bond market. The index includes Treasuries, government-related and corporate securities, MBS (agency fixed-rate and hybrid ARM pass-throughs), ABS and CMBS (agency and non-agency).

The Standard & Poor's (S&P) 500 Index tracks the performance of 500 widely held, large-capitalization U.S. stocks.

Past performance is not a guarantee of future results. It is not possible to invest directly in an index.

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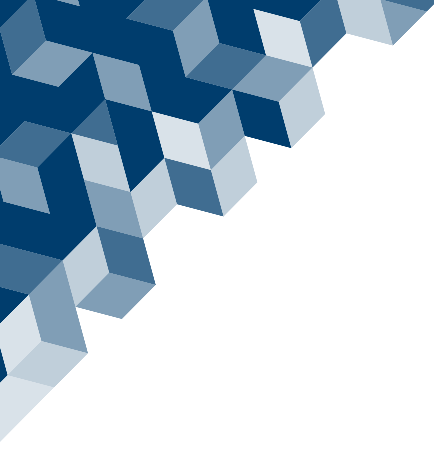

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