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

Edward Kerschner, CFA, Chief Portfolio Strategist

The Agg wasn't, shouldn't be, was never intended to be an investment.

The benchmark in the fixed income market is the Agg. You were never supposed to, though, invest in a benchmark. A benchmark is what you compare your investments to. The Agg, for some reason, has become an investment. There's an ETF that tracks the Agg. It's the biggest ETF there is. The problem here is why would you invest in a market cap-weighted index. What that means is, a market cap-weighted index in the stock markets like the S&P, it makes sense to a reasonable degree. Big companies, that's a measurement of success. But if you take a bond index that's representative of the market capitalization of bonds, you're buying the biggest borrowers. You don't want to own in proportion to who's issued the most debt. You want to invest in proportion to where there's the best opportunity.

The Agg right now is a very concentrated index. What does that mean? 37% Treasuries. Then you add mortgage-backed securities which are really a government-backed, and other government-backed securities. And you end up with an index that's 70% government. So, you don't get a lot of diversification. You're putting all your eggs in the proverbial same basket.

One of the things you probably want to do is look at parts of the bond market that maybe aren't in the Agg. You want things that zig when the Agg zags. What does that mean? It's called diversification. If you think about diversification, if you look at U.S. Treasuries versus high yield bonds, high yield bonds are very risky and Treasuries are very safe. But if I combine the two, they have what's called a negative correlation. When one goes one way, the other goes the other way? I can get a portfolio that has a little more risk than Treasuries but more yield, with less risk than just if I was in the high yield market.

What I'm saying is, you want to go beyond the bond benchmark. You want to go beyond the Agg. Let's include components of the bond market like high-yield, like investment-grade, like emerging markets, so we can benefit from diversification, lower correlations, create what's called a more efficient portfolio.

The views expressed are as of October 2017, may change as market or other conditions change and may differ from views expressed by other Columbia Management Investment Advisers, LLC (CMIA) associates or affiliates. Actual investments or investment decisions made by CMIA and its affiliates, whether for its own account or on behalf of clients, may not necessarily reflect the views expressed. This information is not intended to provide investment advice and does not take into consideration individual investor circumstances. Investment decisions should always be made based on an investor's specific financial needs, objectives, goals, time horizon and risk tolerance. Asset classes described may not be suitable for all investors. Past performance does not guarantee future results, and no forecast should be considered a guarantee either. Since economic and market conditions change frequently, there can be no assurance that the trends described here will continue or that any forecasts are accurate.

"The Agg right now is a very concentrated index…." Source: Bloomberg, 8/31/17.

The Bloomberg Barclays US Aggregate Bond Index (U.S. Aggregate) 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.

It is not possible to invest directly in an index.