PORTFOLIO DIAGNOSTICS REPORT

From Wallflower to Center Stage:

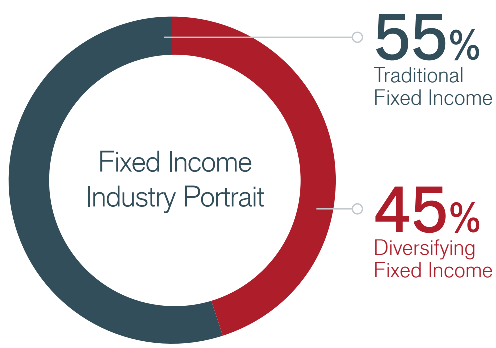
The State of Modern Fixed Income Portfolios

Key Takeaways

- Based on our database of advisor portfolios, the typical fixed income allocation has transformed from the wallflower of most portfolios to a much more diverse – and potentially riskier – portion of the portfolio.
- The size and complexity of the fixed income universe has grown considerably in the last decade as investors look to simultaneously dial down duration risk and achieve higher returns.
- The conundrum of balancing the need for yield with the risk of rising rates may be solved by allocating to fixed income according to client goals.

Until recently, fixed income was the wallflower of most portfolios. What it lacked in glitzy returns it made up for in steady income and low correlations to stocks. Now, following an unprecedented period of falling interest rates, coupled with a wave of new products and strategies, the typical fixed income portfolio of today bears little resemblance to that of even a decade ago.

Industry Portrait: Average Advisor Fixed Income Allocation



Nearly half of the average advisor's portfolio has been diversified outside of the core.

A recent analysis of more than 5,000 advisor portfolios by Janus Henderson Portfolio Construction Services (PCS) underscores just how much this universe has changed – and the growing divide between how advisors approach fixed income. The average fixed income portfolio is now 55% traditional and 45% diversifying, with the latter including dynamic and single-sector strategies that own securities whose risk/return profiles resemble those of equities. Meanwhile, the average masks a significant dispersion in the data between investors who are on the hunt for higher yield and those who fear rising rates.

To be sure, best practices for asset allocation are evolving, as they should. Nevertheless, many investors are entering uncharted territory. Many are loading up on fixed income securities and alternatives that may prove too risky for volatile markets. On the other end of the spectrum, many have become so conservative with fixed income that these portfolios present a different danger – being overly sensitive to rising interest rates.

A better strategy? Go back to the basics. The days of getting high income and high stability from fixed income may be over – for this market cycle at least – but advisors who align fixed income strategies with client goals need not worry about the latest fear or fad in fixed income.

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2.8x New **vs. 1.9x** Traditional

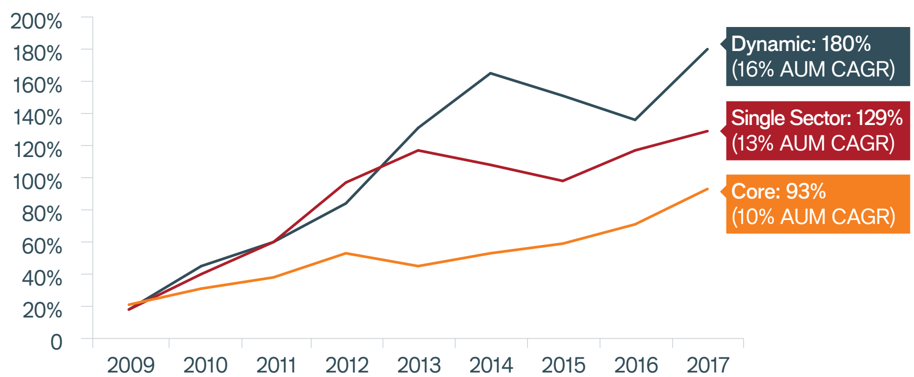
Cumulative flows into new, dynamic solutions have nearly doubled those into traditional core solutions.

Not Your Father's Fixed Income

The size and complexity of the fixed income universe has grown considerably over the last decade as investors, who are simultaneously looking to dial down duration risk and achieve higher returns, have expanded their investment horizons. They've poured assets into traditionally risky single-sector fixed income investments, such as high-yield corporates and bank loans, as well as into relatively new, dynamic solutions, including strategic income, multi-sector and unconstrained bond funds.

Since 2009, cumulative flows into these relatively new dynamic solutions have increased at a much higher rate than traditional core solutions (180% vs. 93%). Single-sector fixed income investments have also shown higher growth than core (129%).

2009 – 2017 Flows as % of 2009 AUM: Core vs. Single Sector vs. Dynamic



This means sectors that were once on the fringe are increasingly mainstream. The average advisor portfolio now has almost half of its fixed income asset allocation outside the core, with 23% of its assets in single-sector fixed income investments and 22% in dynamic strategies.

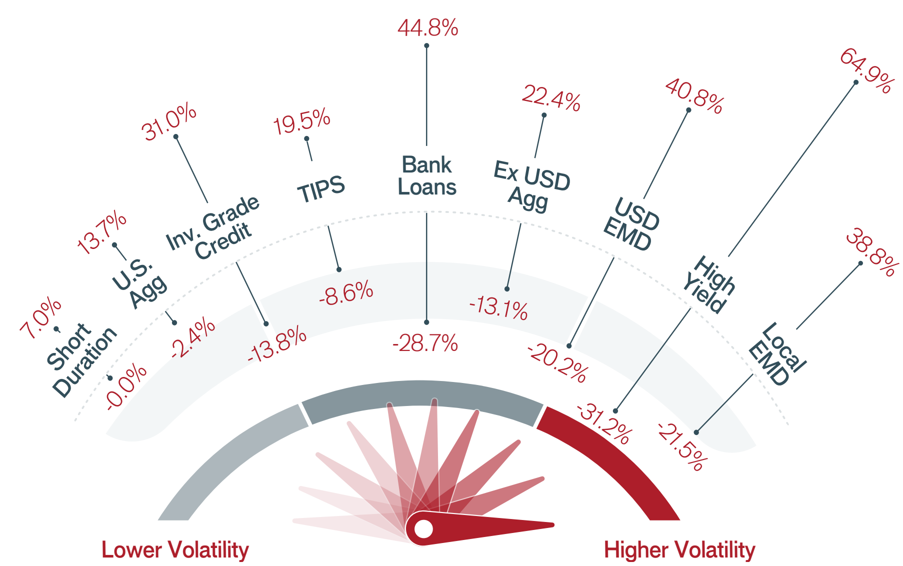
At first glance, these portfolios appear to be adequately diversified. In reality, riskier fixed income often behaves more like equity.

Consider single-sector credit investments. Within this group, high-yield bonds are the most popular strategy. Yet, during the best and worst rolling 12-month periods from the start of the Global Financial Crisis*, this asset class swung from losses greater than -31% to gains of more than 65%. The same can be said for bank loans, where extreme 12-month returns were -29% and 45% over the same period.

A Disorienting Environment

Riskier fixed income often behaves more like equity.

- Double-digit dispersions among major fixed income asset classes
- Ranked from lowest 10-year volatility to highest
- Figures represent best and worst 12-month returns



Source: Morningstar

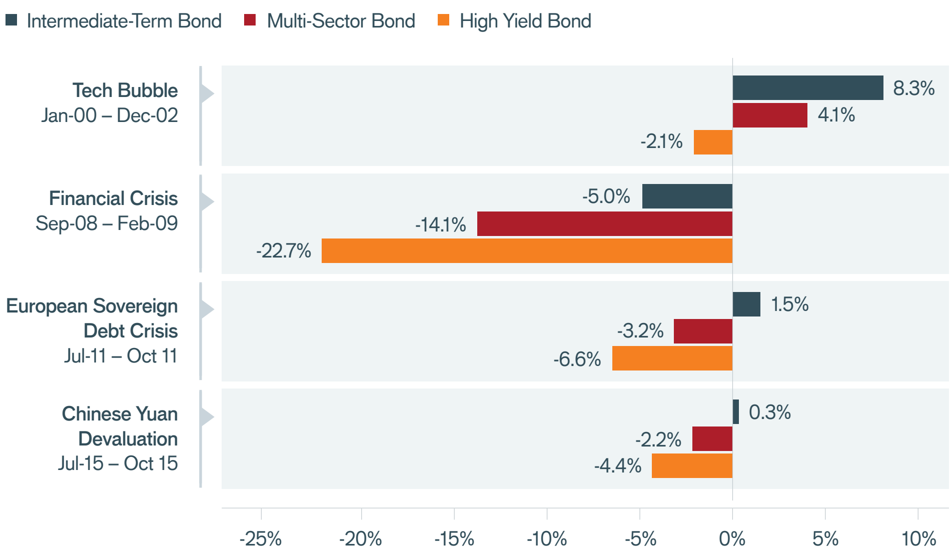
Note: CAGR = Compound Annual Growth Rate
*Calculated using 12-month rolling windows with one-month step over 10 years trailing through 6/30/18.

While these diversifying assets may check the boxes on higher yield and more potential to outperform during rising rates, they might defy one of the key reasons to own fixed income in the first place: to add ballast to an overall portfolio during equity market sell-offs.

Investors with too much exposure to diversifying fixed income during the financial crisis suffered double-digit losses, versus low-single-digit declines for most traditional bonds.

The 2008 losses in some of these strategies were dramatic, but it doesn't take a 100-year flood to show how much potential dispersion lies within the fixed income universe:

Fixed Income Returns During Extreme Market Events



Source: Morningstar.

Dispersion occurs when taking the microscope to any set of investments. Within fixed income, however, this dispersion potentially has disproportionate consequences in portfolios: during a market crisis, traditional fixed income can very likely offer the opposite investment result (gains) as diversifying fixed income (losses).

Fixed Income Conundrum

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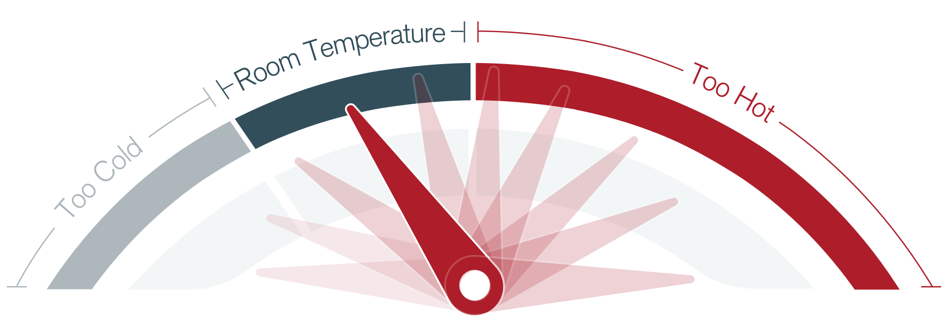
A Growing Divide Between Advisors

Throughout our advisor consultations, these types of dispersions are frequently top of mind. Over the thousands of these consultations, we've seen a wide array of fixed income allocations and categorize them across these main categories:



Too Cold

A quarter of advisor portfolios contain more than 75% of assets in traditional categories, missing potential diversification benefits.

Room Temperature

A quarter of advisor portfolios fall within the "Goldilocks zone" for most long-term fixed income investors, which is 50% to 75% core. This mix potentially offers enough core to preserve capital in stock market downturns and enough diversification to drive higher income and help offset the potential impact of rising rates.

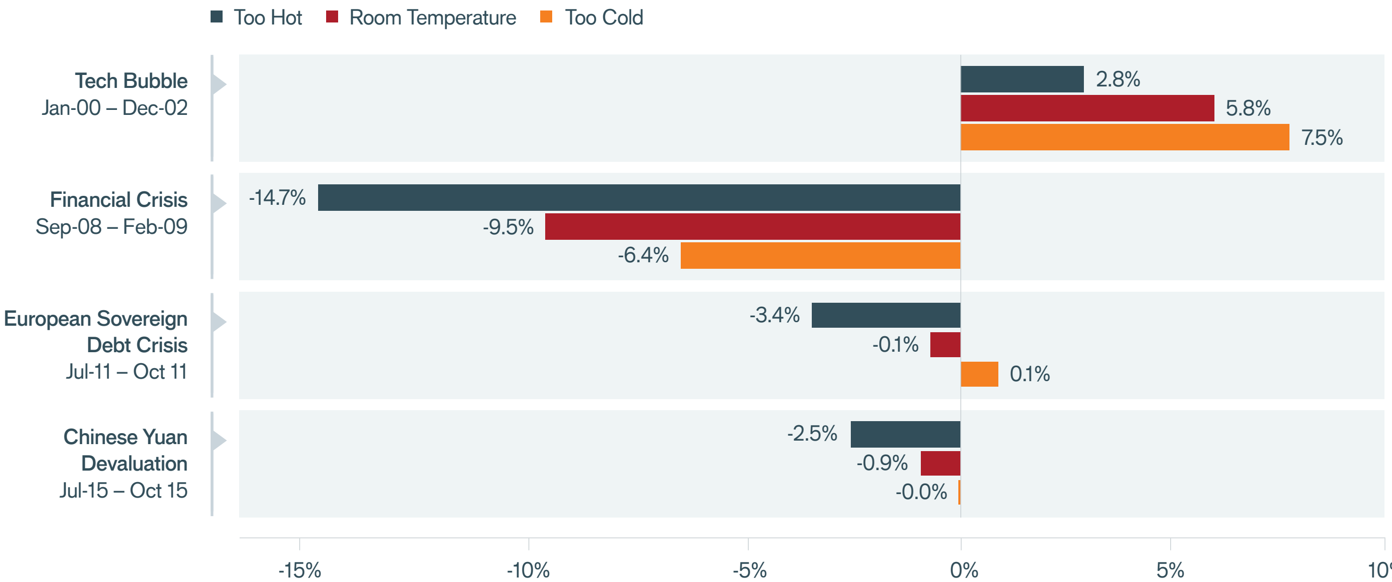
Too Hot

The remaining half of advisor portfolios fall on the extreme end of aggressive, with less than half of fixed income in traditional assets.

From Wallflower to Center Stage

One way in which we can illustrate the consequence of this dispersion between allocation styles is to revisit the same market events. Instead of comparing fixed income asset classes, these figures show the differences across the three categories of advisor fixed income allocations and highlight potentially meaningful differences between seemingly similar allocations:

Fixed Income Allocation Returns During Extreme Market Events



Source: Morningstar. Too Hot is defined as 33.3% Core, 33.3% High-Yield and 33.3% Multi-Sector. Too Cold is defined as 90% Core, 5% High-Yield and 5% Multi-Sector. Room Temperature is defined as 66% Core, 16.6% High-Yield and 16.6% Multi-Sector. Core is represented by the U.S. Fund Intermediate-Term Bond category, High-Yield by the U.S. Fund High Yield category and Multi-Sector by the U.S. Fund Multisector Bond category.

Focus on Goals, Not Solutions

Investors have been struggling with the fixed income conundrum for years: That is, how to balance the need for yield with the risk of rising rates. The best solution may be the simplest: Identify the client's primary goals and allocate accordingly. While the world of fixed income appears overly complex, each investment's objective generally aligns with one of three client goals: defense, diversification or income.

Janus Henderson Portfolio Construction Services partners with thousands of advisors on a customized basis to design portfolios that reflect their clients' goals. Using a proprietary framework that organizes and analyzes the vast universe of fixed income investments, Janus Henderson helps advisors map out a clear and forward-looking approach to fixed income. Read more about goals-based fixed income portfolio design at janushenderson.com/reframing-fixed income.

About Janus Henderson's Portfolio Construction Services Team

The PCS Team performs customized analyses on advisor portfolios, providing differentiated, data-driven diagnostics. From a diverse universe of thousands of models emerge trends, themes and potential opportunities in portfolio construction that we believe will be interesting and beneficial to any investor.

For more information, please visit **janushenderson.com.**

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Fixed income securities are subject to interest rate, inflation, credit and default risk. The bond market is volatile. As interest rates rise, bond prices usually fall, and vice versa. The return of principal is not guaranteed, and prices may decline if an issuer fails to make timely payments or its credit strength weakens.

Bank loans often involve borrowers with low credit ratings whose financial conditions are troubled or uncertain, including companies that are highly leveraged or in bankruptcy proceedings.

Diversification neither assures a profit nor eliminates the risk of experiencing investment losses.

Duration measures a bond price's sensitivity to changes in interest rates. The longer a bond's duration, the higher its sensitivity to changes in interest rates and vice versa.

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