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A Fix for Fixed Income

Introduction

Recently we have been meeting with many of our institutional clients to discuss their options for achieving yield objectives in an increasingly challenging fixed income environment. Static or benchmark-driven investment policies can be an impediment to achieving desired yield targets. If we consider the Barclays Aggregate as representative of the bond market, the potential returns available are unlikely to repeat the strength of the past few years, and are in fact likely to be less than what most investors expect or require of their fixed income allocations.

The main points of this research paper are:

- Unlike 2009, today there is very little opportunity to add significant long-term value using only single-sector strategies. We recommend investors pursue a more tactical strategy for their fixed income allocation over the next few years.
- The common historical approach of managing fixed income portfolios in a “benchmark-driven” strategy, where managers use slight sector weight variations to the benchmark to add value, is likely to be relatively ineffective in the current environment. Sector yields are compressed and security selection opportunities are limited, resulting in little potential excess return from this strategy. Similarly, the appeal of a long-term allocation to a specific sector is limited since returns are likely to be similar and influenced by many of the same factors.
- A tactical strategy utilizes all sectors of the market and is designed to make significant portfolio changes as the market opportunities change. We believe this will provide the best opportunity to add long-term value in an environment where returns in fixed income are going to be challenged.

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The Outlook for Fixed Income

The biggest problem for investors over the next few years is that the potential return for the fixed income asset class is as challenging as it has ever been. If we consider the Barclays Aggregate as representative of the bond market, the potential returns available are unlikely to repeat the strength of the past few years, and are in fact likely to be less than what most investors expect or require of their fixed income allocations.

Our central expectation is for interest rates to remain relatively unchanged throughout this year. If this is the case and you are invested in a portfolio aligned with the Barclays Aggregate Index, the return would be in the 2-2.5% range. Materially lower interest rates (and higher bond market returns) do not appear likely in this environment unless there is significant economic weakness. Higher interest rates of much significance will raise the specter of negative total returns in the bond market for the first time since 1999. The magnitude is uncertain, but it seems that returns in the bond market are likely to be low for the next few years.

This presents investors and investment managers with a difficult scenario. One conclusion may be to shorten maturities and construct a defensive portfolio until interest rates rise and more attractive yields are available. Even with fewer attractive opportunities in the market today, we don't feel this is the best strategy since yields may remain low for some time. Short-term yields in most high-quality assets are near zero and represent a significant opportunity cost relative to the strategy we recommend pursuing and that we feel is the best strategy to manage fixed income.

This is Not 2009 – Single Sector Strategies will Not Dominate

In April 2009, in a white paper titled “The Unbundling of Fixed Income,” we addressed the state of the fixed income markets and implications for investors and investment managers. Since then, the evolution of the markets has created an environment that is arguably even more challenging and requires further thought as to the best strategy for diversified fixed income portfolios over the next few years.

In our April 2009 paper, we advocated that investors deviate from standard benchmark weight guidelines (such as the Barclays Aggregate Bond Index) by overweighting credit sectors (investment grade and high yield corporate bonds) and underweighting government-related sectors (treasury, agency, MBS). Specifically, during 2009 we implemented a significant overweight to investment grade and high yield credit in our diversified fixed income portfolios. We also had many clients approach us to manage corporate bond-only portfolios to take advantage of the opportunity.

These changes were successful in that for much of the next 18 months, credit-based assets significantly outperformed higher quality assets such as Government bonds. The following table (Figure 1) shows the cumulative returns of the bond market sectors from March 2009 through January 2012:

Figure 1: Cumulative Returns in Fixed Income

Barclays Index	3/31/2009 – 1/31/2012
Aggregate	22.6%
Treasury	14.1%
Credit	41.7%
MBS	16.5%
High Yield	83.9%

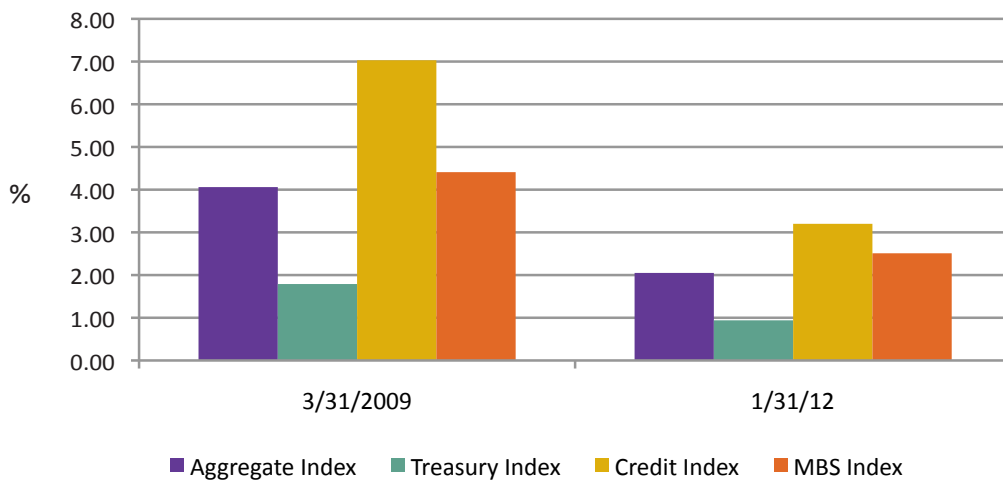
Source: Barclays Capital

Past performance is not indicative of future returns.

Do we advocate single-sector fixed income tactics today? The answer is not as clear as it was in 2009.

In 2009, the case for a structural allocation to specific credit-driven sectors, such as corporate bonds, was much stronger than it is today. Figure 2 below shows the yields available in the investment grade market in both periods, and illustrates that there is much less differentiation between sectors today, and therefore returns are likely to be similar across most fixed income sectors. With a yield near 7% in 2009, an allocation to credit offered attractive returns and in our view, compensated you for the uncertainties that existed at that time. The yield today (3.2%) offers much less compensation for uncertainty at a time when there are many issues around the world that may have a significant impact on the economy. We believe investors should consider strategies that can utilize all sectors of the market, and not make a long-term static allocation to single-sector strategies.

Figure 2: Comparative Fixed Income Sector Yields



Source: Barclays Capital

Static Broad Market Strategies or Index-Driven Strategies Will Come Up Short

2011 presented a number of challenges, and much of the volatility was driven by the Euro-zone debt crisis. Credit-sensitive assets generally underperformed and government bond yields declined to all-time lows in most maturities. For the first time in its history, the Federal Reserve announced that it would leave short-term interest rates unchanged for a prolonged period. The Federal Reserve also provided additional stimulus in a modern version of “Operation Twist”, where it is actively selling short-term Treasuries to purchase longer maturities. This, along with a weaker-than-expected economic recovery has significantly reduced government bond yields.

At the same time, due to aggressive monetary policies and solid, yet unimpressive economic growth, corporations were able to repair their balance sheets and improve credit quality. This contributed to declining risk premiums in both investment grade and high yield starting in late 2009. Due to decreasing government bond yields, coupled with tightening risk premiums for credit-related assets, the yield of the entire bond market (represented by the Barclays Aggregate Index, a broad-market index) now stands at the lowest level since the index was created in 1976 (Figure 3). Allocations to broad market index-driven strategies in the current environment are unlikely to produce attractive returns over the next few years.

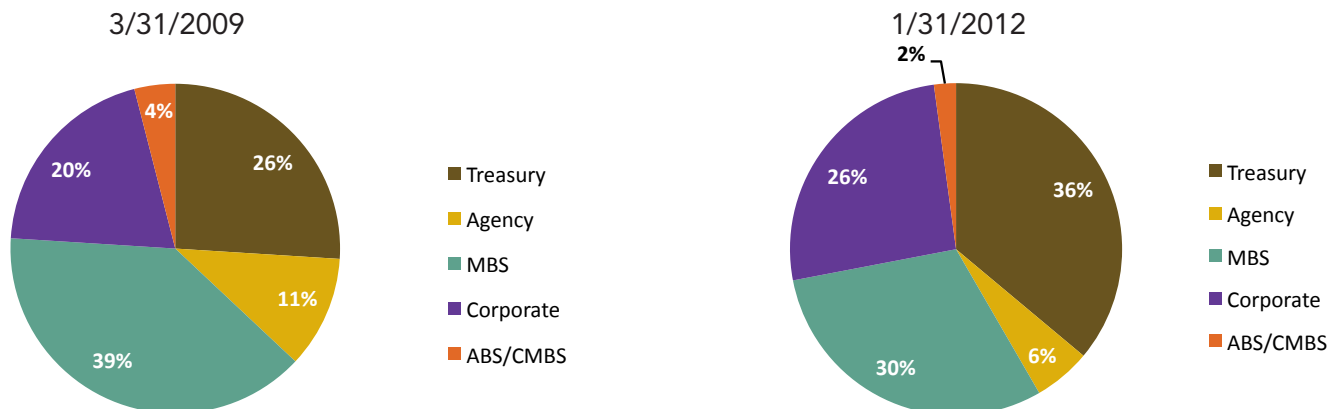
Figure 3: Barclays Aggregate Index Yield to Worst



Source: Barclays Capital, Bloomberg

One of the issues we highlighted in 2009, and one that still exists today, is the large allocation (75%) to government and government-related securities (Treasury, Agency, Agency MBS) within traditional aggregate bond indices (such as the Barclays Capital Aggregate Index). In fact, the allocation to US Treasury securities has increased since 2009 as the funding needs of the US Government has grown relative to other fixed income instruments (Figure 4). Government bonds can offer value in the short-term, but we feel the long-term value of these sectors is limited and investors should be cautious when making a structural allocation to an index-driven strategy. Figure 4 shows the large weighting of government-related sectors within the Barclays Capital Aggregate index.

Figure 4: Sector Allocation of Barclays Capital Aggregate Index:



Source: CMS Bondedge

Investors that use bond market index products or mandate their investment managers be allocated similar to indices are limiting the opportunity to actively change strategy to capture short-term market opportunities, and are most likely not maximizing the long-term return potential of their fixed income allocation.

Today's Strategy Requires a Diversified Manager with a History of Tactical Shifts

One of our core beliefs is that utilizing a broad range of strategies within a fixed income portfolio provides the best opportunity to generate attractive returns. This belief is critical in executing a tactical strategy that requires analyzing and determining relative value across multiple sectors. Contrast this with a manager with a stated bias in managing portfolios, such as consistently investing heavily in credit or mortgage-backed securities. These managers often have impressive long-term track records, which admittedly are correlated to the performance of a few static factors. Interim volatility is often high compared to diversified managers, which makes timing an important decision when investing with such a manager. As a diversified manager, our goal is build portfolios that represent attractive risk/reward profiles that can withstand many different market environments.

Using a tactical investment approach does raise the question: what is the appropriate way to benchmark a manager that is using such an approach? There are many good options, but we think the best is to maintain the broad market benchmark, but accept a higher level of volatility versus the benchmark (tracking error), allow the manager significant discretion as to the sector weightings, and extend the horizon that is used to judge a managers skill.

Managing a portfolio in a tactical manner will result in large deviations from the benchmark, both in terms of sector allocation and portfolio characteristics such as interest rate risk and yield curve positioning. This can be termed as "benchmark agnostic", where the characteristics of the benchmark are a peripheral concern, in favor of allocations that represent a good risk/return combination. Because the manager is taking a longer-term view of the markets in terms of sector allocations and characteristics, it is important for investors to judge performance over a multi-year period (3-5 years). A shorter horizon would limit the ability to withstand interim volatility while investing for long-term value.

A tactical fixed income portfolio may only consist of a few sectors or exposures to certain interest rate risks, but the key difference is the ability to adapt to different market environments, be flexible and willing to change quickly, and have the breadth and depth within the organization to efficiently execute the strategy over a long period of time.

