

NO NEED FOR HEAVY LIFTING IN FIXED INCOME: CONSIDER THE BARBELL APPROACH

February 2019

Without a doubt, the interest rate outlook within the Eurozone has undergone a visible transformation. Indeed, earlier fears of an imminent increase in rates, have been replaced by a 'lower for longer' mindset due to disappointing economic numbers and lack of inflation pressures. Against this backdrop, we are asked on a regular basis: what prudent strategy fixed income investors can follow to not only help mitigate the potential for a further move up in rates, but also take income-conscious needs into consideration? A time-tested approach which aims to solve for both factors is the barbell strategy.

The barbell strategy falls into the category of tools used to help mitigate some portfolio risks and is widely used across the investment industry. Implementing a barbell strategy approach can potentially help manage interest rate risk and the negative impact that unexpected events could have on portfolio returns. Black swan events such as the 2008 financial crisis or the dot-com crash of 2000 come to mind with the resulting volatility and negative portfolio returns leaving a memorable dent.

For those readers who are unfamiliar with such an approach, a fixed income barbell is a strategy that essentially replicates the weight-lifting apparatus by investing in bonds at both ends of the maturity spectrum. In other words, the investor utilizes two parts of the yield curve: on the one side, the focus will tend to be centered around an intermediate or longer-duration vehicle while the other end of the spectrum will concentrate on a short duration instrument. These two 'weights' on the barbell serve two different purposes. The intermediate/longer duration aspect can help to solve for income needs while the short duration investment serves as the 'rate-mitigating' force. A key benefit to this strategy is that it allows an investor to gain exposure to bonds offering higher yields in the long end of the yield curve without having to invest their entire portfolio in the same segment of the market. If rates rise, the portion of the portfolio invested in short-term bonds can be rolled over into other short-term bonds at higher rates. Additionally, the short-term share of the portfolio can also be the more flexible portion offering investors greater liquidity to adapt portfolio allocations.

How can you apply a simple barbell strategy to your core Euro Treasury bond exposure?

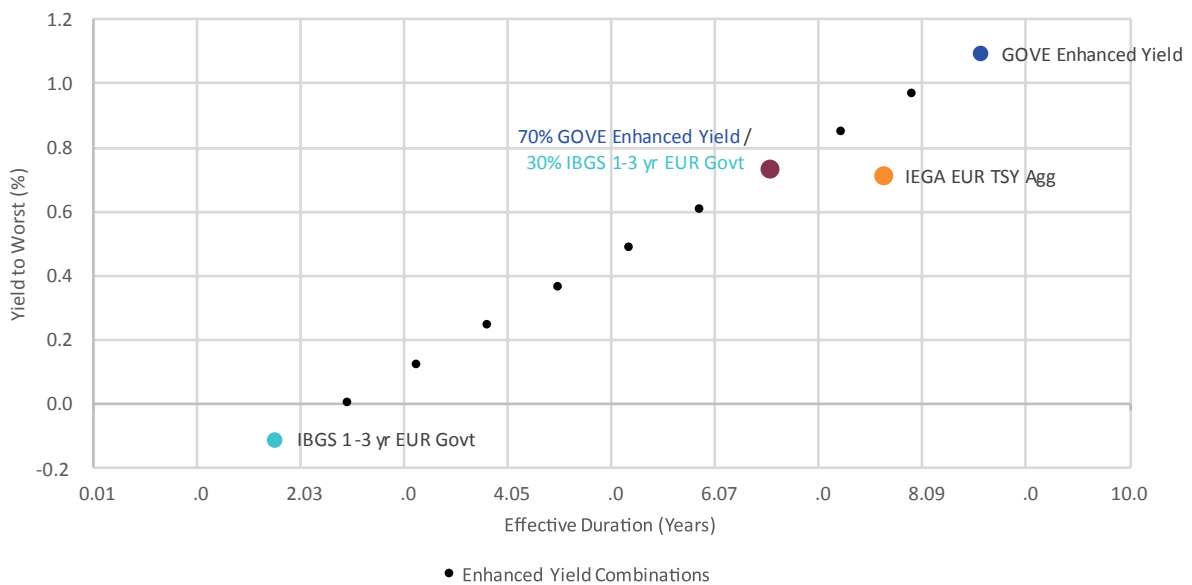
In this Strategy Insights piece, we focus on two specific exchange traded funds (ETF) invested in Euro Government bonds as an illustrative example of how to apply a barbell strategy: The WisdomTree EUR Government Bond Enhanced Yield UCITS ETF – EUR, ticker GOVE IM (GOVE) and the iShares € Govt Bond 1-3 Year UCITS ETF, ticker IBGS LN (IBGS).

- + GOVE is a yield enhanced fund whose underlying index re-weights the sectors of the Bloomberg Barclays Euro Treasury Bond Index seeking to achieve a higher yield while controlling for tracking error and serves as the longer duration weight within the barbell.
- + IBGS seeks to track the Bloomberg Barclays Euro Government Bond 1-3 Year Index and will stand as the short duration weight within the barbell.

The goal of combining these two funds is to achieve a yield similar to an investor’s traditional Euro government bond exposure while also lowering duration (a measure of a bond’s sensitivity to changes in interest rates).

In our illustration, we are using the iShares Core € Govt Bond UCITS ETF, ticker IEGA LN (IEGA) which seeks to track the performance of the Bloomberg Barclays Euro Treasury Bond Index and will serve as the benchmark for this traditional Euro government bond exposure.

FIGURE 1: YIELD TO WORST AND EFFECTIVE DURATION COMPARISON - ENHANCED YIELD 1-3 YEAR



Source: Bloomberg, iShares provider website data as of 04 February 2019. The above exchange traded funds are used as an example of how to apply a barbell strategy. For illustrative purposes only. **Historical performance is not an indication of future performance and any investments may go down in value. You cannot invest directly in an index.**

The above graph illustrates how an investor can implement various allocations between these two ‘weights’ of the barbell in order to achieve the desired result. We would like to highlight the example barbell portfolio combination of 70% GOVE and 30% IBGS. As of this writing, this ‘barbell’ offers a yield of 0.73%, or actually 2 basis points above IEGA, while reducing duration by more than 1 year as well.

At this point, we do not envision an outright recession for the Eurozone in 2019, but the 'stars appear to be aligning' for a visible drop-off in growth for the year, with Gross Domestic Product (GDP) estimates falling in the +1.0% - +1.5% range. Needless to say, the European Central Bank (ECB) has also looked at the same data points, and apparently has drawn a similar conclusion. In fact, at its recent policy meeting, the ECB acknowledged that growth would likely be "weaker than previously anticipated." Against this backdrop, it seems increasingly apparent that there may be no rate hike in 2019, a sentiment echoed in the futures market. Alternatively, given the historically low rate backdrop, a prudent fixed income investment strategy should also weigh the need for potential 'interest rate risk' if conditions were to somehow change.

CONCLUSION

A barbell strategy offers investors a solution which takes both income needs and rate risk into the equation, two important objectives for a fixed income portfolio. The ECB's monetary policy decisions are a crucial element to the Eurozone fixed income investment landscape, and given the aforementioned outlook, we'll continue to revisit this issue, but a 'barbell' provides a strategic approach for investors to help them navigate the various rate possibilities that may loom ahead.

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