

## First Quarter 2011 Knowledge College

### The Evolving U.S. Bond Market

As the U.S. fixed income universe has evolved through time, so has the composition of its most followed benchmark. The *Barclays Capital U.S. Aggregate Bond Index* is commonly used by investors to measure performance relative to the U.S. dollar-denominated investment grade fixed income market. As investors evaluate their fixed income allocations, the increasing weight to Government-backed (explicitly and implicitly) securities has risen dramatically. This Knowledge College discusses the evolution of the *Barclays Capital U.S. Aggregate Bond Index* and explores the potential impacts for both active and passive investors.

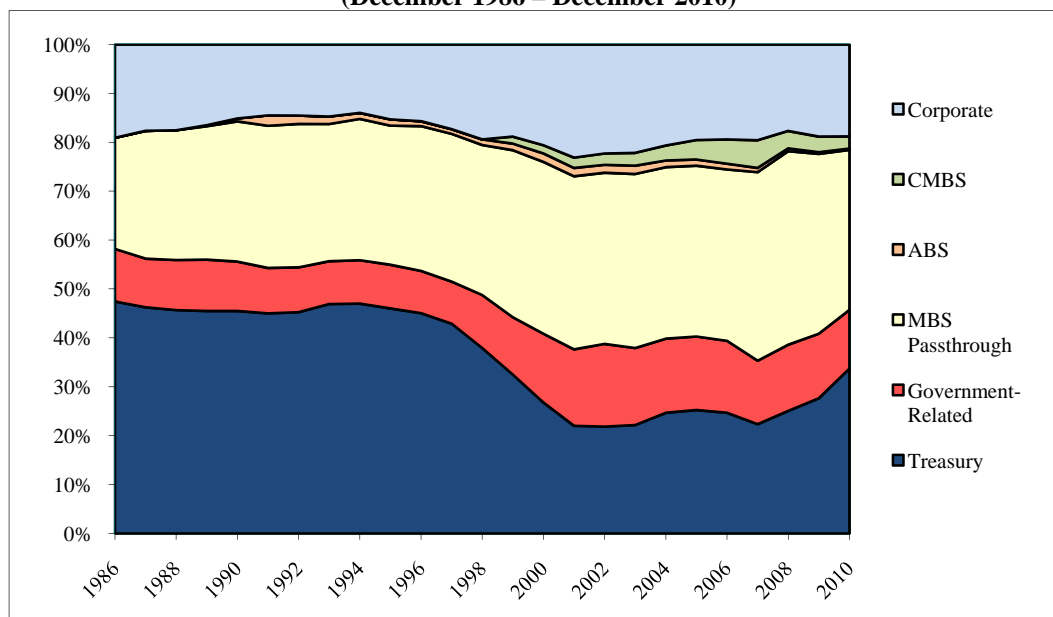
#### Historical Perspective

- The *Barclays Capital U.S. Aggregate Bond Index* (originally Lehman Brothers) inceptioned in January 1986 by combining the U.S. MBS and U.S. Government/Credit Indices.
- In 1994, U.S. Treasuries peaked at 47% of the Index before declining to 22% in 2002.
- From 1994 to 2001, corporate securities increased from 14% to 23% of the Index.

#### Recent Developments

- In September 2008, the U.S. Government placed Freddie Mac and Fannie Mae into conservatorship. When accounting for their MBS Passthrough securities, the Index is now 78% U.S. Federal Government-affiliated.
- Propelled by significant recent issuance, the U.S. Treasury weight increased over 50% (from 22% to 34% of the Index) between December 2007 and December 2010.

**Sector Composition of the Barclays Capital U.S. Aggregate Bond Index  
(December 1986 – December 2010)**



Source: Barclays Capital and Babson Capital, December 31, 2010.  
Government-Related comprises agency, local authority, U.S. denominated sovereign and supranational debt.



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### **Possible Consequences or Solutions**

- Passive investors have a significant allocation to U.S. Government securities which have historically done poorly in rising rate environments.
- Current active managers who underweight U.S. Treasuries may have a structural advantage if corporate securities outperform their U.S. Government-related counterparts.
- Typical active manager tracking error relative to the *Barclays Capital U.S. Aggregate Bond Index* may increase in the future.
- Passive investors should consider allocating to an additional credit-only index to bring their overall U.S. Government-affiliated exposure down to a more reasonable level.

The heavier U.S. Government exposure brings unintended consequences and may warrant increased active investment. Investors should at least be mindful of these dynamics when selecting managers, active or passive.

For more information, visit our [website](#) or contact any of the professionals at DiMeo Schneider & Associates, L.L.C.