PIMCO

Model Portfolios May Help Advisors Avoid Costly Fixed Income Timing Traps

AUTHOR

Justin Blesy
Senior Vice President
Asset Allocation Strategist

Ryan McMahon
Vice President
Global Wealth Management

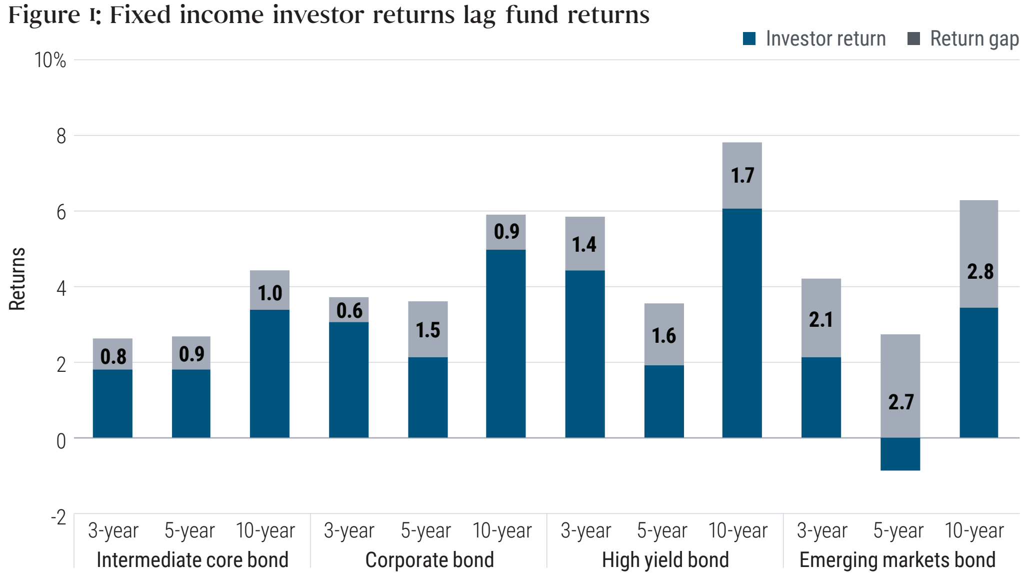
Mark Thomas
Executive Vice President
Global Wealth Management

We believe a disciplined approach to bond investing is critical to achieving desired return and risk objectives. Model portfolios may help.

"Buy the dips" is a refrain often heard after equity market sell-offs. The logic is sound: If your outlook hasn't changed and equities suddenly become cheaper, it may make sense to consider adding to your allocation. However, we don't often hear a similar response in fixed income markets when yields rise or spreads widen – even though that is often when we find future return prospects are brightening and it may be an advantageous time to buy. In reality, the reaction is typically quite the opposite: We often see investors selling core bond allocations after rates have risen or selling credit allocations after spreads widen. Model portfolios that emphasize forward-looking return potential when allocating across fixed income sectors may help avoid this tendency.

"Timing traps" are hard to resist, and can potentially have significant implications for returns. Flow data from Morningstar bears this out: Across a variety of fixed income sectors and time periods, the performance of the average fund in a given category beat the average investor's return, inclusive of flows (see Figure 1). This means investors' timing decisions cost them on average anywhere from one to three percentage points of returns annualized – a meaningful portion of the total return potential of their fixed income allocations.

Figure 1: Fixed income investor returns lag fund returns



Source: Morningstar as of 30 June 2019. Data includes all share classes and is after fees.

Past performance is not a guarantee or a reliable indicator of future results. Chart is provided for illustrative purposes and is not indicative of the past or future performance of any PIMCO product.

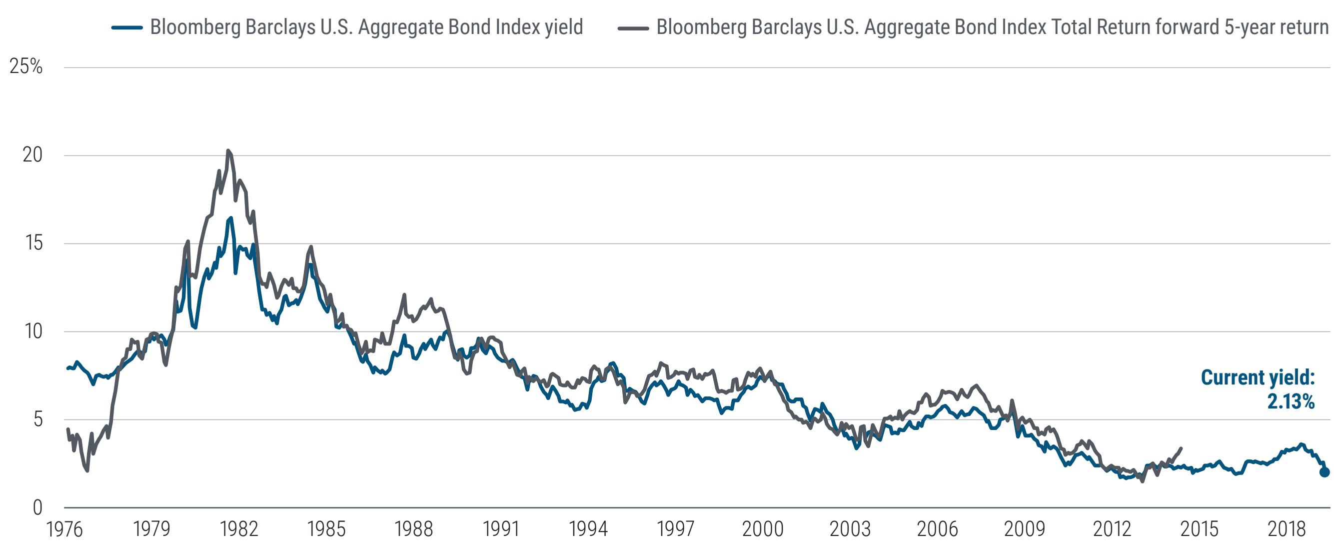
POOR TIMING DECISIONS MAY DENT RETURNS

Part of the challenge is that investor flows into fixed income typically follow attractive *trailing* returns, after yields have fallen and spreads have tightened. However, lower yields and tighter spreads have often been indicators of weaker returns to come. For example, the long-term forward returns of the Bloomberg Barclays U.S. Aggregate Bond Index have been tightly tied to starting yields, regardless of the path of interest rates (see Figure 2). While the 10.17% one-year trailing return on the aggregate index as of 31 August may look quite attractive (as 10-year Treasury yields fell 123 basis points (bps) over the same period), today's starting yield of 2.13% is likely a much better indicator of long-term *future* returns, if historical trends hold.

Breaking down the flow patterns demonstrates how some investors may have missed out on the full upside of core bonds over the past year. As Figure 3 shows, investor flows started to turn negative just after yields reached their peak in September 2018 (and trailing returns reached their low point), and continued to flow out even as equity markets began to sell off in December. Inflows then returned in 2019 after performance had already rebounded. The result of this behavior, according to Morningstar, is that returns for the average core bond investor were just 8.33% inclusive of flows over the past year, versus the 10.17% return for the U.S. aggregate index.

A similar pattern occurs in credit markets. As credit spreads widen (and bond prices decline), performance often suffers, making trailing returns look weak. However, future return prospects typically improve as investors receive greater compensation for taking on risk. The oil crash in late 2015 provides an instructive example. Following the December 2015 oil price plunge, high yield spreads widened 370 bps to reach 839 bps as of 11 February 2016, and one- and three-year trailing returns fell to -10.90% and -0.44%, respectively (as measured by the Bloomberg Barclays US Corporate High Yield Index). However, forward return prospects were brighter, given the wider starting spreads. As markets recovered from the 11 February 2016 trough, forward returns followed, with a one-year return of 25.96% and a three-year annualized return of 10.89%. Of course, past performance is not a guarantee of future returns.

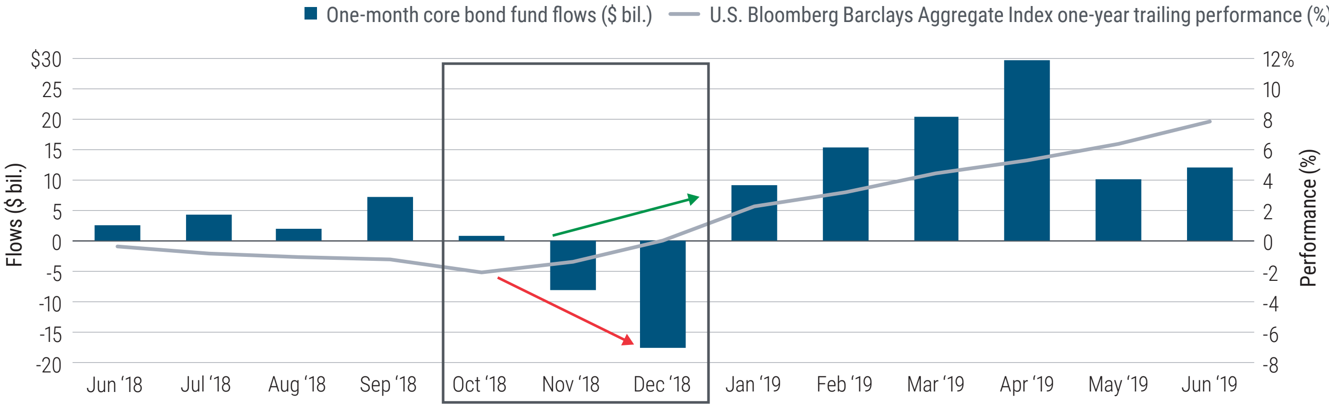
Figure 2: Starting yields have been strongly correlated with forward returns



Past performance is not a guarantee or a reliable indicator of future results. Chart is provided for illustrative purposes and is not indicative of the past or future performance of any PIMCO product.

Source: Bloomberg Barclays as of 31 August 2019. Yield and return are for the Bloomberg Barclays U.S. Aggregate Bond Index.

Figure 3: Bond flows illustrate why discipline is key in maximizing returns



Source: Morningstar and Bloomberg Barclays as of 30 June 2019. Core bond flows represent the asset flows of all funds included in the Intermediate Core Bond and Intermediate Core-Plus Bond Morningstar Categories. Data includes all share classes.

Past performance is not a guarantee or a reliable indicator of future results. Chart is provided for illustrative purposes and is not indicative of the past or future performance of any PIMCO product.

MODEL PORTFOLIOS PROMOTE DISCIPLINE

That said, *knowing* that it may be advantageous to invest in sectors with negative trailing returns and actually doing it are two different things: It takes discipline to invest in assets that have underperformed. Recognizing this, PIMCO's fixed income model portfolios are designed to help financial advisors position their client portfolios for the road ahead by emphasizing **forward-looking return potential** when allocating across fixed income sectors. In this way, our model portfolios promote a strategic approach to fixed income that may help avoid the tendency to jump into or out of positions in ways that could potentially hurt future returns.

Our capital market assumptions process recognizes that starting yields have historically been useful indicators of long-term future returns. However, we also model the path of interest rates and credit spreads that can lead to deviations from this central tendency over shorter periods of time. This approach helps us in our efforts to take advantage of market dislocations while seeking to reallocate toward sectors with higher starting yields and wider spreads and away from those that may have strong trailing returns but more muted future prospects.

Lower starting yields and the potential for renewed volatility make fixed income portfolio construction particularly challenging today, and missteps can be costly. The right tools and a sound framework may be able to help financial advisors navigate the current fixed income environment and seek to avoid the timing traps that may cut into their clients' returns.

VISIT OUR MODEL PORTFOLIOS PAGE TO LEARN HOW PIMCO CAN HELP YOUR CLIENTS MAKE THE MOST OF THEIR FIXED INCOME ALLOCATIONS.

PIMCO

The PIMCO Models described in this material are available exclusively through investment professionals.

PIMCO Models are based on what Pacific Investment Management Company LLC (together with its affiliates, "PIMCO" believes to be generally accepted investment theory. PIMCO models are for illustrative purposes only and may not be suitable for all investors. PIMCO Models are not based on any particularized financial situation, or need, and are not intended to be, and should not be construed as, a forecast, research, investment advice or a recommendation for any specific PIMCO or other strategy, product or service. Individuals should consult with their own financial advisors to determine the most appropriate allocations for their financial situation, including their investment objectives, time frame, risk tolerance, savings and other investments. Volatility is historical and is likely to change over time. PIMCO has not undertaken, and will not undertake, any analysis to determine any specific models' suitability for specific investors.

The risks of a PIMCO Model allocation will be based on the risks of the PIMCO mutual funds (each, a "Fund") included in the PIMCO Model allocation ("Underlying Fund"). The PIMCO Model allocation is subject to the risk that the Underlying Funds and the allocation and reallocation of the PIMCO Model among the various Funds may not produce the desired result. The PIMCO Models may not reflect the impact that material economic and market factors might have had on PIMCO's decision making if PIMCO were actually managing a portfolio with assets pursuant to the PIMCO Model. The PIMCO Model allocations to Underlying Funds have changed over time and may change in the future. The selection and weighting process across Underlying Funds is informed based on return estimates driven by PIMCO's forward looking view and risk estimates driven by PIMCO's analytic infrastructure. Management risk is the risk that the investment techniques and risk analyses applied by PIMCO will not produce the desired results, and that certain policies or developments may affect the investment techniques available to PIMCO in connection with managing the strategy.

PIMCO Model allocations are licensed or otherwise made available to investment professionals. PIMCO Models' allocations are updated on a defined production cycle. The Underlying Funds are available by prospectus only. Implementing investment professionals may or may not implement the PIMCO Model's allocation as provided, and actual allocations to Underlying Funds may vary. There are expenses associated with the underlying Funds in addition to any fees charged by implementing investment professionals. Additionally, the implementing investment professional may include cash allocations, which are not reflected herein

All investments contain risk and may lose value. Investing in the **bond market** is subject to risks, including market, interest rate, issuer, credit, inflation risk, and liquidity risk. The value of most bonds and bond strategies are impacted by changes in interest rates. Bonds and bond strategies with longer durations tend to be more sensitive and volatile than those with shorter durations; bond prices generally fall as interest rates rise, and low interest rate environments increase this risk. Reductions in bond counterparty capacity may contribute to decreased market liquidity and increased price volatility. Bond investments may be worth more or less than the original cost when redeemed. **Diversification** does not ensure against loss.

There is no guarantee that these investment strategies will work under all market conditions or are suitable for all investors and each investor should evaluate their ability to invest long-term, especially during periods of downturn in the market. Investors should consult their investment professional prior to making an investment decision.

PIMCO does not provide legal or tax advice. Please consult your tax and/or legal counsel for specific tax or legal questions and concerns. The discussion herein is general in nature and is provided for informational purposes only. There is no guarantee as to its accuracy or completeness. Any tax statements contained herein are not intended or written to be used, and cannot be relied upon or used for the purpose of avoiding penalties imposed by the Internal Revenue Service or state and local tax authorities. Individuals should consult their own legal and tax counsel as to matters discussed herein and before entering into any estate planning, trust, investment, retirement, or insurance arrangement.

Bloomberg Barclays U.S. Aggregate Index represents securities that are SEC-registered, taxable, and dollar denominated. The index covers the U.S. investment grade fixed rate bond market, with index components for government and corporate securities, mortgage pass-through securities, and asset-backed securities. These major sectors are subdivided into more specific indices that are calculated and reported on a regular basis. **The Barclays U.S. Corporate High-Yield Index** the covers the USD-denominated, non-investment grade, fixed-rate, taxable corporate bond market. Securities are classified as high-yield if the middle rating of Moody's, Fitch, and S&P is Ba1/BB+/BB+ or below. The index excludes Emerging Markets debt. It is not possible to invest directly in an unmanaged index.

For financial professionals: The implementation of, or reliance on, a model portfolio allocation is left to your discretion. PIMCO is not responsible for determining the securities to be purchased, held and sold for a client's account(s), nor is PIMCO responsible for determining the suitability or appropriateness of a model portfolio allocation or any securities included therein for any of your clients. PIMCO does not place trade orders for any of the your clients' account(s). Information and other marketing materials provided to you by PIMCO concerning a model portfolio allocation –including holdings, performance and other characteristics -may not be indicative of a client's actual experience from an account managed in accordance with the model portfolio allocation.

PC401_65290

CMR2019-0904-413336