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THE PORTFOLIO VIEW *:

Unbundling your fixed income risks: Know what works for your portfolio

BlackRock Portfolio Analysis & Solutions, March 2020

** A series of short papers to provide a high-level view on themes and topics BlackRock believes you should consider when implementing changes to your Asset Allocation, and on which we can assist you.*

Deciding on the ***fixed income asset allocation of a portfolio in the current market environment is harder than ever.*** It calls for ***deeper understanding of the risks, returns, and the role of such a core and significant part of a multi-asset portfolio.*** We believe technology, and strong portfolio and risk management practices are needed more than ever in assessing even more ***extreme trade-offs.***

The ability of government bonds to generate ***income*** in a suppressed yield environment has been challenged and has pushed investors to potentially shift fixed income allocations into higher-yielding asset classes such as: investment grade credit, high yield, and emerging markets debt. Yet, such a move needs to be considered alongside the potential ***protection*** government bonds can provide in a multi-asset context. Regular assessments and ***balancing of these two objectives*** is paramount, together with a ***monitoring of unintended bets*** that could materialise as markets dislocate, distancing the portfolio from its liquidity, risk, costs, income, and alpha generation targets.

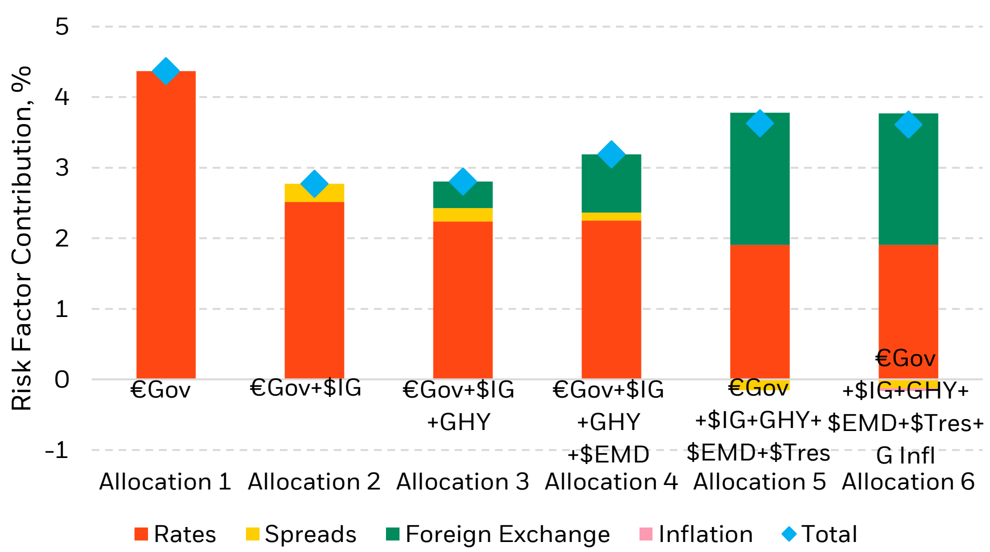
US Treasuries were impacted by the market weakness in March, yet, historically, they have proven to be a ***"safe haven"*** to weather heightened market volatility. While US Treasuries are not immune to risk, their addition to a predominantly European-focused Fixed Income portfolio still has the potential to ***enhance diversification*** through both on-boarding of US currency and US rates exposures. From a long-term perspective, and if we continue to see the expansion of monetary policy globally, accompanied by increasing fiscal stimulus, ***inflation-linked government bonds*** could be an alternative asset class to consider. As we approach a lower bound on rates, that could diminish the attractiveness of nominal government bonds, we invite investors to assess the potential of such exposures in the context of their portfolios, ***un-bundling the overall risks of their Fixed Income allocations across factors such as rates, inflation, credit, and currency***.

Client Case Study – Part 1

Get to know your Fixed Income risks

We have helped several clients explore how the ***risk profile of their Fixed Income allocation can evolve as different sectors / exposure are added.***

Evolution of fixed income risk contributions



Allocation compositions:

Allocation 1: 100% BBG Barc Glob Treas Euro Bond Index; **Allocation 2:** 30% BBG Barc Glob Treas Euro Bond Index + 70% BBG Barc Euro Agg Corporate Index; **Allocation 3:** 30% BBG Barc Glob Tres Euro Bond Index + 50% BBG Barc Euro Agg Corporate Index + 20% Markit iBoxx Glob Dev Markets Liq HY Capp Index**;** **Allocation 4:** 30% BBG Barc Glob Tres Euro Bond Index + 40% BBG Barc Euro Agg Corporate Index + 20% Markit iBoxx Glob Dev Markets Liq HY Capp Index + 10% J.P. M EMBI Glob Core Index; **Allocation 5:** 15% BBG Barc Glob Tres Euro Bond Index + 40% BBG Barc Euro Agg Corporate Index + 20% Markit iBoxx Glob Dev Markets Liq HY Capp Index + 10% J.P. M EMBI Glob Core Index + 15% ICE US Tres Core Index; **Allocation 6:** 10% BBG Barc Glob Treas Euro Bond Index + 40% BBG Barc Euro Agg Corporate Index + 20% Markit iBoxx Glob Dev Markets Liq HY Capp Index + 10% J.P. M EMBI Glob Core Index + 15% ICE US Tres Index + 5% BBG Barc US Government Inflation-Linked Index

Source: BlackRock, as at 31/07/2020. Risk factor contribution as at 31/12/2019. For illustrative purposes only.

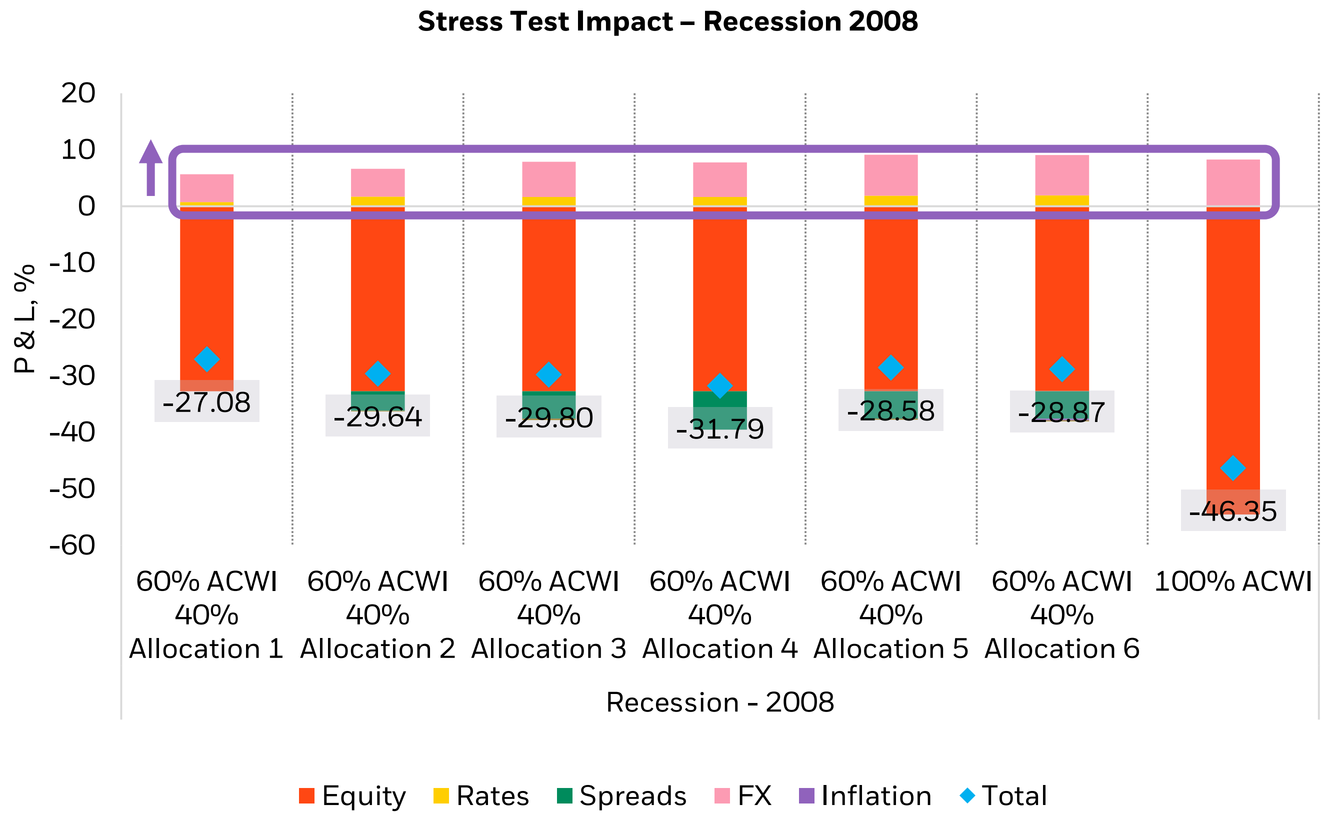
An additional helpful perspective in this assessment comes from observing the ***behaviours of different Fixed Income allocations under given stress scenarios***.

Client Case Study – Part 2

What if?

We have worked with several clients to test their portfolios, particularly on helping to understand their Fixed Income allocations under different scenarios, including extreme historical ones such as the 2008 global recession. Based on the results, when testing the six allocations defined in the previous Client Case Study in the context of a 60 / 40 multi asset portfolio – a portfolio invested 60% in MSCI ACWI Index, and the remaining 40% in the defined Fixed Income allocations - long term, ***investors may wish to consider :***

1. ***Adding US Rates or US TIPS exposures*** to a predominantly European Fixed Income allocation, which could potentially ***enhance diversification*** and may offer defence even in extreme market downturns. See Portfolios 5 and 6 below, where the negative P&L effect from the equity and spread sell offs is reduced, almost to the level of Portfolio 1.
2. ***Investment Grade Credit*** can be *an* ***attractive source of income in certain environments going forward***, but it comes at the 'cost' of a ***higher equity-like risk exposure*** – more vulnerable in extreme stress scenarios when both spreads and equity assets tend to behave in a similar way. See Portfolios 2, 3, and 4 below.
3. The ***FX*** risk factor is a ***significant contributor*** to portfolio risk – yet, in certain scenarios, can ***partially offset losses*** (similarly to the rates risk factor). A deliberate and targeted approach to FX can reduce portfolio volatility and enhance portfolio performance. We encourage investors to re-consider their currency exposures especially ***as dollar hedging costs vs Euro have been falling since mid-2019.*** See Portfolios 5 and 6 below.



Scenario definition:

2008 Recession Scenario: 3 December 2007 – 9 March 2009. Starting date for this scenario is the official beginning of the recession in the US. The end date is the lowest point of the S&P 500 Index in the recent decade. **There is no guarantee that stress testing will eliminate the risk of investing in this fund or strategy nor that the profit and loss movements depicted in the stress testing will replicate in the future.**

Source: BlackRock, as at 31/07/2020. For illustrative purposes only.

Want to know more?

If you are looking to make changes to your portfolio, or would be interested in better understanding how your existing portfolio might be impacted within these current markets, speak with your BlackRock Relationship Manager and request a BPAS Portfolio Consultation today.

Risk Warnings

Capital at risk. The value of investments and the income from them can fall as well as rise and are not guaranteed. Investors may not get back the amount originally invested.

Past performance is not a reliable indicator of current or future results and should not be the sole factor of consideration when selecting a product or strategy.

Changes in the rates of exchange between currencies may cause the value of investments to diminish or increase. Fluctuation may be particularly marked in the case of a higher volatility fund and the value of an investment may fall suddenly and substantially. Levels and basis of taxation may change from time to time.

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