Is The Barclays Agg Index Baloney?

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Is it time to sack the "Agg?"

The Barclays Capital Aggregate Bond Index, or Agg, has long been considered the best barometer of the U.S. bond market — but it may no longer be relevant, according to some fixed income experts.

The Agg is hopelessly biased and out of touch, argues Dave Haviland, portfolio manager at Needham, Mass.-based Beaumont Capital Partners, because the length of the data set used to determine its composition is too short.

"The Barclays Aggregate Bond Index is too new to get a picture of a full market cycle in bonds," Haviland says. "It's an aggregate of sub-indexes from the early 1980s that were back-tested to the 1970s. The Agg can't help but have a declining interest rate bias throughout its data set — bond yields have generally fallen since 1981, but that isn't the case today."

Approximately 35-years ago, interest rates began to decline from historical highs until bottoming out after the global financial crisis. Haviland argues that the Agg missed a significant portion of a more than 50-year interest rate cycle — and the only portion in which interest rates steadily increased.

The historical declining-rate bias plagues the entire financial industry, says Brett Wander, senior vice president and chief investment officer for fixed income at San Francisco-based Charles Schwab.

"Most people working in this industry started right around or after rates were super high in the 1980s," Wander says. "You had high inflation and 10- and 30-year yields well beyond double digits. Over the past 30 years yields have declined. We're accustomed to an environment where yields go down over time, generally speaking. It's been a three decade-plus bull market for yields driven by declining global inflation."

As Haviland points out, this bias is mostly due to the Agg's source material: several of its sub-indexes date back to as recently as 1986. As a result, the Agg has only had negative returns in three of the calendar years it has existed.

"It's not that the index is new, it's that the historical data associated with its performance is limited," Wander says. "Critics say that since the advent of the Agg we haven't seen a significant bear market like we saw in the 1970s, and I think there's something to that."

The Agg's predecessor launched in the 1970s as a market-cap weighted bond index capturing most classes of fixed income at the time: Treasuries, government agency bonds, mortgage-backed securities, investment-grade corporate bonds and some foreign bonds traded within the U.S.

Today the Agg is approximately one-third Treasuries, one-third mortgage-backed securities, and one-third investment-grade corporate credit —two-thirds of the index is directly impacted by U.S. monetary policy.

By excluding municipal bonds, many foreign bonds and much of the high yield universe, the Agg no longer represnets the fixed income universe, says David Mazza, head of ETF and mutual fund research at Boston-based State Street Global Advisors.

"The Agg only provides investment-grade exposure, which today offers the lowest yield per unit of interest rate risk in any period of history going back 35 years," Mazza says. "Risk has gone up, while return has gone down. Your break-even for owning the Agg this year is the worst in history."

In addition, the fixed income universe includes asset-backed and non-agency mortgage backed securities and leveraged loans that aren't represented in the Agg.

Managers already struggle with the size of the Agg — with more than 9,000 securities, trying to track the Agg precisely would involve some products with limited liquidity and availability. In lieu of trying to capture the entire index,, managers approximate its performance using a portion of its holdings.

Thus, investors really buy managers' best efforts to track the index — but Ira Jersey, fixed income strategist and portfolio manager at New York-based Oppenheimer Funds, questioned whether the Agg should be tracked at all due to its market cap weighting.

"There's a dynamic that occurs in bond indicies," Jersey says. "Whereas companies, countries and issuers who issue more debt and become less credit worth receive a bigger share of the index. That's a serious flaw in market-cap weighted bond indices."

When its market cap weighting combines with low interest rates, the Agg is susceptible to concentration companies and sectors rapidly taking on more debt, says Jersey. "An indexed investor ends up owning more risk in the part of their portfolio that they think is safe."

Anne Walsh, assistant CIO for fixed income at New York-based Guggenhiem Partners, says the Agg's market-cap weighting exposed investors to bubbles in almost every decade of its existence.

"If you look back at history, the Agg predecessors launched 1970s, when the biggest borrowers were utilities — so of course they were overweight utilites," Walsh said. "Then in the 1970s and 1980s, we had a number of defaults in utilities. Oops."

The pattern was repeated in the 1990s with the run up in tech firms, only to have the bubble burst in 1999, and in the next decade 2000 with financial institutions and the mortgage crisis, notes Walsh.

"Now we get up to where we are now and it's government securities that are the overweight," Walsh says. "If an advisor or an asset manager is simply investing naively along side the Agg, they're potentially adding risk to their portfolios that they're not even aware of, you're not really getting the safety and security that investors seek."

Today, much of that risk comes from interest rates. As opposed to just buying bonds outright, where the purchaser will see a return of their principal if the bonds' guarantees are met, bond funds that follow indexes like the Agg have no return of principal guarantee. So if and when interest rates rise again, causing bond prices to fall, investors will suffer a loss in the supposedly "safe" part of their portfolios.

At Guggenheim, purposefully avoiding the Agg steers managers like Walsh away from crowded trades and poor values and towards opportunities for outperformance.

"By adding securities that aren't in the Aggregate Index, you're building portfolios on a relative risk basis that end up better from a safety and a total return perspective," Walsh says. "The U.S. fixed income markets are $37 trillion in size, and less than half of that appears in an index. The Barclay's Agg is three-fourths in government securities. We like to look for value in other places, in non-indexed parts of the market."

Due to historically low interest rates, the Agg is concentrated in Treasuries, which means it doesn't deliver the yields many income-focused investors are looking for.

Advisors and investors who invest in the Agg often also buy riskier portions of the market to achieve their return targets — which are usually based on the Agg's biased past performance, says Bob Smith, chief investment officer at Austin, Texas-based Sage Advisory..

Most investors also assume that Treasury bonds are relatively "safe" investments — but that's not necessarily the case, says Haviland.

Before 1971, U.S. Treasury bond prices and yields were stabilized by the gold and silver reserves backing federal debt, and the government controlled interest rates during times of war to prevent a 'black swan' volatility or liquidity event — but Haviland says that since these controls are either gone or uncertain today, investors and advisors can't count on them when building portfolios.

Without a strong, realistic fixed income benchmark, measuring success in the bond universe becomes difficult except through comparing funds, strategies, managers and product providers to their peers. Fixed income managers are left trying to beat a flawed index, meeting investor expectations founded on an unrealistic benchmark and an investing public that still generally assumes that the Agg represents relative safety when that's not necessarily the case.

After more than three decades as the bond market's biggest benchmark, though, the Agg could be too old and set in its ways to change, notes Jersey.

"I'm not sure if there's any impetus for the indices to change," Jersey says. "Some of them have been around for a very long time, and now there's a lot of money managed against them. Not because they're the perfect benchmarks, but because asset managers like Oppenheimer are expected to."

Thus, the Barclay's Aggregate Bond Index continues as a Shakespearean fixed income benchmark of choice, "full of sound and fury, signifying nothing."
