JANUS

Redefining Risk in Fixed Income

What most investors don't know about the new risks in fixed income

Summary The world has changed for fixed income investors. The four primary sectors in the fixed income market have essentially converged into two. Interest rate risk in the U.S. is at its highest level in decades. Sector risk/return characteristics have been significantly altered—perhaps permanently. These factors are coming together to create an environment of heightened risk for fixed income investors.

THE BOTTOM LINE: Traditional approaches to evaluating and managing risk are no longer enough. This new paradigm not only elevates the importance of corporate credit, but it will also require investors and the fiduciaries of their assets to look at fixed income risk in new ways.

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New world = new risks

The recent financial crisis resulted in major structural changes to the fixed income market (see sidebar). New risks too have emerged, yet many investors have yet to develop strategies to adequately understand or assess these risks. While interest rate risk is perhaps the most apparent, other risks such as the use of a radically changed benchmark to gauge investor risk tolerance and reliance on agency ratings to assess security risk are no less significant.

Historically, the Barclays Capital U.S. Aggregate Bond Index (Agg) has been a widely used proxy for investing in the fixed income market and therefore has been an accepted expression of risk tolerance for most fixed income investors. Most passive investment strategies are built to mirror the Agg, and the performance of most fixed income managers is measured against the Agg.

This is potentially dangerous as the structural changes in the fixed income market have increased the level of risk associated with the Agg, which in turn means a higher level of risk for passive investors. In addition, the Agg's sensitivity to interest rates has become very high, resulting in an implicit bullish bet on interest rates for those pursuing a passive investment strategy.

Structural changes in the fixed income market have increased the level of risk associated with the Agg

Increased duration means higher interest rate sensitivity. With more than 70% of the Agg now controlled by the U.S. government and possessing Treasury-like characteristics, its interest rate sensitivity has increased considerably. The low interest rate

It's a Changed World

In our 2009 brief entitled *Why Credit Matters*, we argued that a major structural change was occurring within the fixed income market and that it would transform the way investors and asset managers approach fixed income investing. At the center of our thesis was the convergence of three sectors of the fixed income market—agency mortgages or mortgage-backed securities (MBS), government agencies and U.S. Treasuries—into one large government sector. That left corporate credit as essentially the lone non-government alternative (see Exhibit 1).

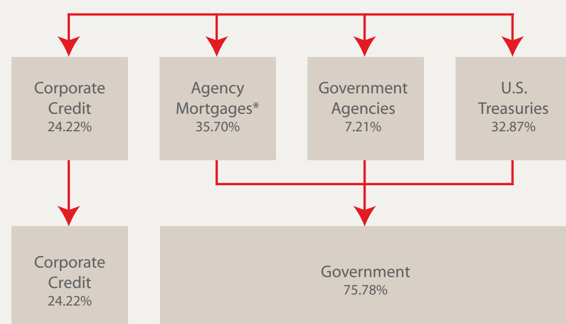
Driving the transformation was the unprecedented government intervention, particularly in the mortgage and agency markets. The seminal event occurred in September 2008 when the U.S. government placed Fannie Mae and Freddie Mac into a conservatorship. From that point, spreads of agencies and agency mortgages relative to U.S. Treasuries began to narrow while the correlations of returns for these segments relative to corporate credit began to increase. Given these dynamics, we projected that corporate credit would play a larger role in the pursuit of outperformance within fixed income. Our thesis has largely played out as we expected, with corporate credit outperforming and the traditionally less-risky segments of the fixed income market (agencies and agency mortgages) becoming riskier with little potential for outperformance.

Exhibit 1

Converging Sectors

THEN: Four Basic Sectors in Fixed Income

% of the Barclays Capital U.S. Aggregate Bond Index as of 3/31/11



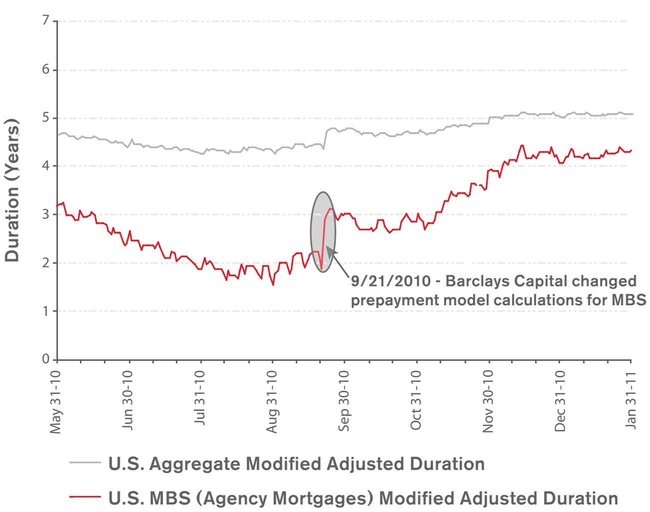
NOW: Compression has resulted in two sectors: Corporate Credit and Government

**The securitized market includes agency mortgages and asset-backed securities/commercial mortgage-backed securities (ABS/CMBS). Given the small size of the ABS/CMBS sectors and their combined small weighting in the Barclays Capital U.S. Aggregate Bond Index (2.74% as of March 31, 2011), it is generally not considered a primary sector in fixed income.*
As of March 31, 2011
Source: Janus, Barclays Capital

environment, large financing needs of the U.S. government and changing characteristics of agency mortgages have driven an increase in the Agg's duration[1], thus making it more sensitive to changes in interest rates. In addition, agency mortgages have seen a substantial slowing in prepayment rates, prompting Barclays Capital to modify the way it accounts for mortgage prepayments in its duration calculations for the mortgage component of the Index. The result of this model change in September 2010 was a dramatic increase in the duration of agency mortgages, from nearly 1.3 years at the end of August 2010 to more than 4.4 years through January 2011 (see Exhibit 2). This duration extension contributed to the increase in the Agg's overall duration over that same period. In March 2011, Barclays announced plans to update the model again on April 21, 2011, resulting in an additional increase in the duration of agency mortgages (0.35 years, estimated) and overall Agg (0.11 years, estimated).

Exhibit 2

U.S. Agency Mortgage Duration Extension



As of January 31, 2011
Source: Bloomberg, Barclays Capital

Another contributing factor to the Agg's 22% rise in duration has been the large budget deficits and resulting financing needs of the U.S. government, which led to a greater issuance of longer dated Treasuries. The combination of slower mortgage prepayments and greater supply of U.S. Treasuries with longer maturities amplified the effects of interest rate movements on the Agg in 2009 and 2010.

Passive strategies: bullish on interest rates and doomed to underperform in a rising rate environment. In response to the financial crisis and related disappointing performance by fixed income managers, many investors and plan sponsors chose to reallocate fixed income assets to passive strategies. While we understand the rationale for this decision, we are extremely concerned that most do not understand the risks they have implicitly chosen to bear by doing so. For instance, it is unlikely that investors have become more comfortable with taking on greater interest rate risk, particularly when most clients we talk with expect a secular upward trend in interest rates. Yet whether they realize it or not, those pursuing a passive investment strategy are making a bullish call on interest rates as a result of the structural changes in the Agg.

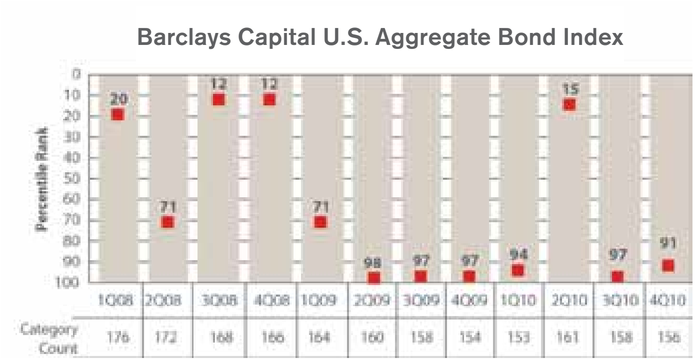
Those pursuing a passive investment strategy are making a bullish call on interest rates

In addition, as Exhibit 3 shows, the Agg's total return for six of the past seven quarters placed it in the 91st to 98th percentile of its peer group. Passive investment strategies clearly underperformed most active strategies during this time, and we think there is a high probability that this poor relative performance will persist given the Agg's composition and the likelihood of rising interest rates. Since the beginning of 2008, the performance of the Agg has shown a strong inverse relationship to interest rates and tightening credit spreads. Exhibit 3 shows the Agg has outperformed when interest rates were heading lower, and underperformed when rates were headed higher or spreads where tightening. While the Agg did manage to outperform during the second quarter of 2010, it was largely because of a flight to U.S. Treasuries. The dominance of the new government sector will continue to leave the Agg highly sensitive to interest rate movements for the foreseeable future as it will likely take years to unwind the unprecedented government intervention still in place.

[1]Duration measures a bond price's sensitivity to changes in interest rates. The longer a bond's duration, the higher its sensitivity to changes in interest rates, all else being equal.

Exhibit 3

eVestment Alliance Core Plus Fixed Income Quarterly Percentile Ranking



As of December 31, 2010
Source: eVestment Alliance (eA)

Managing risks in the rear view mirror won't work

Many investors and their fiduciaries are still managing fixed income risk by looking in the rear view mirror—that is, they have not evolved their approach to account for the new risks that have emerged. Using agency ratings as the primary measure of risk in fixed income is no longer enough. And using the Agg as a baseline for investors' risk tolerance is no longer prudent. Investors must evolve their approach and take a more sophisticated view of risk while assessing credit, structural and interest rate risk.

Getting in front of the new risks: potential solutions. We believe active duration management, allocation to corporate credit and security selection are key to managing the risks presented in this new environment. First and foremost, we believe investors should disengage from the Agg as a baseline or "neutral" measure of risk. In other words, instead of assuming benchmark risk, which includes greater interest rate duration and less credit spread duration, we believe that taking more active risk versus the Agg could actually reduce absolute portfolio risk in a rising rate environment. Affording fixed income managers greater flexibility to deviate from the Index could allow them the ability to better manage interest rate sensitivity and structural risk. For instance, an active manager with the latitude to significantly overweight corporate credit can shorten the duration of a portfolio so that it is potentially less sensitive to interest rates and can create more yield cushion to protect in a rising rate environment. This flexibility allows managers the potential to take advantage of periods in a secular bear market when rates rally.

Affording fixed income managers greater flexibility to deviate from the Index could allow them the ability to better manage interest rate sensitivity and structural risk

Investment Policy Statements Need to Evolve

It is likely that many Investment Policy Statements (IPSs) are outdated, having guidelines in place that were drafted prior to the financial crisis. An IPS is very similar to the investment framework advisors create to help analyze and make investment recommendations. For example, an IPS may have attempted to manage risk by limiting a fixed income manager's ability to vary the sector weightings of the portfolio relative to the Agg. The objective was to keep tracking error low, thus reducing the risk of underperformance. In addition, IPSs have also tended to rely heavily on agency bond ratings to manage risk, allowing managers to hold only small investments, if any, in corporate credit while giving them the ability to have nearly unlimited agency mortgage holdings. This has largely been driven by the assumption that most agency mortgages are of higher quality than corporate bonds. Ratings agencies, however, do not provide an opinion on a security's sensitivity to interest rates. Clearly, both of these tactics ignore the growing interest rate sensitivity and governmental regulatory risks of agency mortgages. Instead of assessing these risks, the Agg, and therefore investors using it as a benchmark or investing in it passively, are implicitly accepting them.

Another issue that should be of significant concern for fiduciaries of assets is the likely mismatch between investors' risk tolerances and the risk characteristics of the Agg. With the duration of the Agg increasing and more than 70% of it now highly sensitive to interest rates, failing to update an IPS to account for these new dynamics assumes that investors' risk tolerances have increased. In short, we believe many IPSs need to evolve to align investors' risk tolerances with the new risks in fixed income. This may include allowing significant deviation from the Index in terms of duration, sector allocation and security selection.

A disciplined risk management process focused on preservation of capital and risk-adjusted total return is a critical overarching component to this strategy. Instead of a manager using quality ratings and weighting limitations around the Agg as risk controls, we believe a better approach is to assess a portfolio's VAR (value at risk). A VAR analysis looks at the actual risk a security is contributing to the portfolio—not just the assumed risk based on rating or holding size. This also allows a manager to perform stress tests on the portfolio and portfolio holdings based on that measure of risk. We believe this approach, which attempts to match the estimated volatility in a fixed income portfolio to investors' risk tolerances, is more prudent than simply accepting the Agg's volatility.

The key to future fixed income outperformance: a flexible approach and desire to protect capital

The world has changed for fixed income investors, and new risks have emerged that if not addressed, will likely have serious implications. Given the market transformation and the likelihood of a secular rise in interest rates, having a strategy to manage interest rate sensitivity will be critical to achieving positive total returns in the years to come. Disengaging from the Agg as a baseline for risk and giving fixed income managers more flexibility to manage duration and interest rate risk could go a long way toward achieving this goal. IPS guidelines, many of which have not been updated since the financial crisis, need to evolve to align investors' risk tolerances with the new risks in fixed income and afford managers the flexibility required to manage these risks. A strategy focused on active duration management, allocation to credit and security selection combined with a disciplined risk management process is, in our opinion, the best way to mitigate risk in this new and challenging world.

For a more detailed discussion of the structural changes that have occurred in the fixed income market and the importance of corporate credit in the new landscape, please visit our website to read "Why Credit Matters."

Corporate Credit Cushion

With a strategy focused on security selection in corporate credit, a fundamental manager can shorten the duration of a portfolio so that it is less sensitive to interest rates and has more yield cushion to protect in a rising rate environment. Historically, a reduction in interest rate duration and increase in spread duration has contributed to portfolio outperformance when rates were rising due to growth. High coupons shorten the duration of corporate credit as compared to Treasuries during periods of rising rates. With investment grade and high yield credit yielding on average more than 100 and more than 400 basis points (bps) above U.S. Treasuries, respectively, those segments can absorb some of the impact of a rise in interest rates.

Historically, corporate credit has had a lower correlation to interest rate movements than U.S. Treasuries: investment grade securities have had a correlation of approximately 0.80 and high yield securities a correlation of approximately 0.60. So all else being equal, if U.S. Treasuries were to move down 100 bps in price, investment grade would only move down 80 bps and high yield 60 bps, thus protecting value better in a rising rate environment. In addition, in three previous rising rate environments, both high yield and investment grade securities added excess return over U.S. Treasuries (see Exhibit 4). Not only are corporate credit spreads less sensitive to interest rates, but we believe they will continue to narrow through long-term averages based on strong company fundamentals and increased demand for credit by investors.

Exhibit 4

Impact of Credit Spreads in Previous Rising Rate Environments

Period	Asset Class	Treasury Return[1]	Corporate Credit Excess Return[2]	Average Spread
1 yr ended 10/31/94	Investment Grade	-5.61%	0.96%	72 bps
	High Yield	-4.18%	5.36%	329 bps
1 yr ended 1/31/00	Investment Grade	-4.09%	1.50%	112 bps
	High Yield	-3.16%	4.81%	482 bps
1 yr ended 5/31/04	Investment Grade	-2.29%	2.64%	105 bps
	High Yield	-1.46%	15.28%	456 bps

Source: Barclays Point
[1]Same duration/key rate to Corporates.
[2]Over similar duration Treasury.

Please consider the charges, risks, expenses and investment objectives carefully before investing. For a prospectus or, if available, a summary prospectus containing this and other information, please call Janus at 877.33JANUS (52687) or download the file from janus.com/info. Read it carefully before you invest or send money.

Past performance is no guarantee of future results.

Although bonds generally present less short-term risk and volatility than stocks, the bond market is volatile. Bonds entail interest rate risk (as interest rates rise, bond prices usually fall, and vice versa). This effect is usually more pronounced for longer-term securities. Bonds are subject to issuer credit risk, and the risk of default, or the risk that an issuer will be unable to make income or principal payments. Additionally shorter-term bond investments typically have greater inflation risk, or the risk that the return of an investment will not keep up with increases in the prices of goods and services, than stocks. Lower-quality debt securities that generally offer higher yields, involve greater risk of default or price changes due to potential changes in the credit quality of the issuer.

The hypothetical example shown on page 5 Exibit 4 does not represent the returns of any particular investment.

eVestment Alliance's (eA) software has been used by Janus Capital Group to create the category percentile rankings and exhibit. A fee was paid to the firm for the use of the software. The results are presented gross of fees and are annualized for periods of one year or longer.

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