RECOVER WISELY: BE GLOBAL, BE PICKY

Portfolio Construction and Strategy

Despite a violent COVID-driven correction in the first quarter of 2020, markets responded with a rebound throughout the remainder of the year and returns were primarily positive across asset classes. The 2021 Janus Henderson Market GPS Investment Outlook suggests cautious optimism for performance outcomes while exhorting investors to diversify in order to mitigate outlier risks.

We on the Portfolio Construction and Strategy team believe financial professionals and their clients should carefully consider these viewpoints as they set out to navigate the investing seas of 2021. Analysis of over 11,000 model portfolios in our proprietary database shows two essential insights based on the current market outlook:

EQUITY MARKET CONCENTRATION

Narrow market leadership is not a new phenomenon, but we are now navigating a historical divergence between winners and losers; the current construction of equity indices poses potential performance challenges should those concentrated names muddle along in 2021 while equity returns broaden into other cap-sizes and investing styles.

FROM PASSIVE TO PICKY

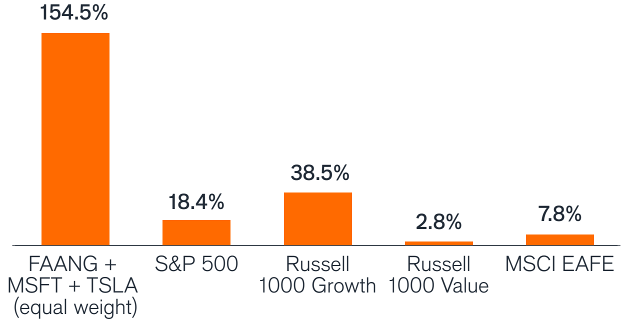
Timed beta exposures to duration and credit benefited fixed income portfolios during the COVID-19 drawdown and subsequent snapback, respectively. With the U.S. 10-year Treasury yield above 1%, a steepening yield curve and much tighter credit spreads, investors will have to consider an environment requiring a more selective approach with a wider investible universe by going global and a firmer understanding of fixed income sub-asset classes.

Traditional Equities

100% Juice from Concentrate

Once again, the S&P 500® Index outperformed its international counterpart, the MSCI EAFE, in 2020. This marks the ninth year out of the past 11 in which U.S. equities have outperformed international equities. This may give pause to any investor considering how diversification across traditional equity asset classes will benefit their portfolios but it's no secret that a handful of large-cap stocks, specifically tech, now dominate many indices and drove a significant portion of recent equity gains.

FAANG + MSFT + TSLA
Comparative performance – calendar year 2020



Source: Morningstar, as of 31 December 2020.

Giants like Facebook, Amazon, Apple, Netflix and Google (FAANG), Microsoft and Tesla combine for almost 40% of the Russell 1000® Growth Index and 24% of the S&P 500.[1] Returns from just this basket of stocks (shown on the previous page) dwarf the returns generated by other traditional equity investment options in 2020.

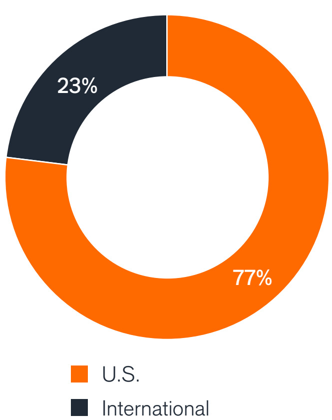
Concentrated market leadership is not a new phenomenon. Perhaps surprisingly, since 1926, in terms of dollar wealth creation, just 4% of companies drove 100% of gains.[2] Nevertheless, the current concentration among equity indices suppresses investor's ability to leverage a portfolio measure like Active Share, defined as the percentage of stock holdings in a manager's portfolio that differs from their benchmark, to assess overall portfolio diversification. Additionally, the index situation creates consternation when considering underweighting or not owning these major names as such a decision can significantly impact performance.

The Path Forward

We expect strong economic growth to reemerge in 2021 in the wake of diminishing headwinds from the global pandemic and the U.S.-China trade war of 2019. And while we've discussed the narrowness of market leadership based on the digital economy, we foresee a broadening recovery as vaccines are widely implemented and consumers can reengage with the physical economy.

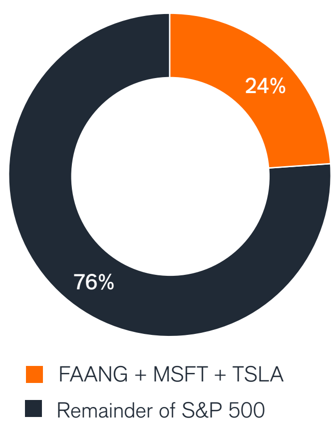
Furthermore, the health of consumer balance sheets, supported by a robust housing market and the swift market recovery from the lows of the first quarter of 2020 could unleash pent-up demand in hard-hit industries such as dining, entertainment and travel.

Average Advisor Equity Exposure



Source: Janus Henderson Portfolio Construction & Strategy Portal Database, as of 31 December 2020.

S&P 500 Index Breakdown

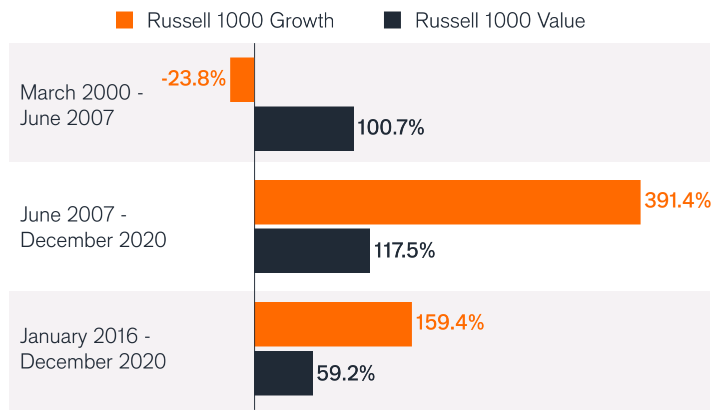


Source: Morningstar, as of 31 December 2020.

Given this outlook, financial professionals need to be cognizant of the potential dangers of their implicit (or explicit) overweight to U.S. Growth equities demonstrated by the previous pie charts which show how the FAANG + MSFT + TSLA equation drives the S&P 500 (a large blend index) to have a growth tilt.

Furthermore, the historic run of outperformance for growth relative to value over the past two decades has only widened in the last five years. While large value outperformed growth by almost 125% cumulatively from March 2000 to June 2007, large growth subsequently has outperformed value by 274%. Most of that outperformance has been driven by the wide divergence of large-cap growth and value stocks over the last five years where growth has outperformed by over 100% cumulatively. Even the slightest reversion to the mean could catch investors flat-footed based on the implicit overweight to growth in the S&P 500.

A Historical Divergence
U.S. Large Growth vs. Value



Source: Morningstar, as of 31 December 2020.
Performance shown is cumulative.

As the economy reopens, market returns should broaden, and market leadership should transition from COVID crisis beneficiaries to real economy stocks. Prudent forward-looking investors will need to reexamine their equity allocations. These investors should look down cap size for opportunities, across global marketplaces to access differentiated cash flows and, finally, consider strategies that complement incumbent managers by adding alpha through stock selection in misunderstood and underappreciated areas – a departure from the old "growth versus value" paradigm and into a new post-disruption economy.

[1] Source: Morningstar, as of 31 December 2020.

[2] Bessembinder, Hendrik (Hank), Wealth Creation in the U.S. Public Stock Markets 1926 to 2019 (February 13, 2020).

Traditional Fixed Income

Sovereign Fixed Income's Inefficient Frontier

Even in the face of today's low-rate environment, core fixed income's role is as essential as ever: core bond allocations are strategic allocations intended for capital preservation during a crisis. However, the post-COVID low-rate environment will require that forward-looking investors pursue a new level of due diligence for each destination of capital within their core fixed income allocation.

With most global sovereign bond rates below 1% or negative, traditional benchmarks with large, passive weightings to sovereign debt are no longer a bond investor's North Star. Instead of abandoning core fixed income, investors must dig deeper into the defensive tool kit to understand new opportunities and trade-offs within core fixed income investments – global sovereigns, securitized and investment-grade corporates across the entire yield spectrum.

The financial industry's and financial media's obsession with U.S. 10-year Treasury rate has been a disservice to investors working to renovate their fixed income portfolios in the face of a new, post-COVID interest rate regime. Abandoning core fixed income because of low U.S. Treasury yields is throwing the baby out with the bathwater. Fixed income markets are far from efficient, and that is good news for investors grappling to find balance between the needs of risk management and portfolio income.

As shown in the chart, high duration and low yields in U.S. Treasuries is just the beginning of the story. Investments such as short-term credit, mortgage-backed securities (MBS) and high-quality collateralized loan obligations (CLOs) may result in a higher yield without adding additional interest rate risk while still providing the necessary risk management to the broader portfolio.

Navigating an increasingly difficult fixed income environment will continue to be a challenge for investors in the year ahead. There are no easy choices – only tradeoffs. We believe clients are best served by taking a multi-faceted, goals-based approach to pursue scarce income while carefully balancing risk.

Fixed Income's Inefficient Frontier

Source: Bloomberg, as of 31 December 2020.
Note: Yield cushion defined as Yield to Worst (YTW) divided by duration

YIELD CUSHION, DEFINED AS A SECURITY'S YIELD DIVIDED BY DURATION, IS A COMMON APPROACH THAT LOOKS AT BOND YIELDS AS A CUSHION PROTECTING BOND INVESTORS FROM THE POTENTIAL NEGATIVE EFFECTS OF DURATION RISK. THE YIELD CUSHION POTENTIALLY HELPS MITIGATE LOSSES FROM FALLING BOND PRICES IF YIELDS WERE TO RISE.

IN THE CHART ABOVE, THE HIGHEST YIELD CUSHIONS WOULD BE FOUND IN SECURITIES PLOTTING CLOSEST TO THE TOP-LEFT CORNER OF THE CHART.

Diversifying Fixed Income

The Depth and Breadth of Credit

Rates remain extremely low globally and with the likelihood of continued Federal Reserve (Fed) support for the foreseeable future we believe the search for yield will continue to make diversifying fixed income an attractive place in 2021. That said, credit spreads have taken a round trip, from their dramatic widening at the start of the COVID-19 crisis to a recovery with spreads significantly tighter. In the face of tighter spreads, investors will need to rely on more tools than the passive beta exposure that helped their portfolios since March.

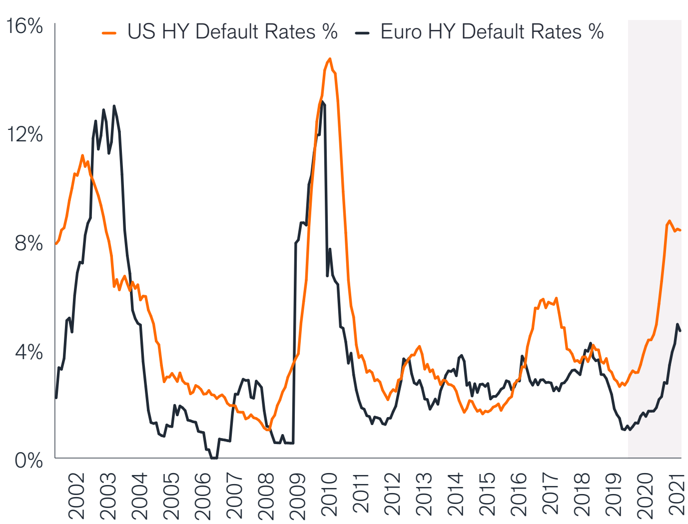
Global Breadth

One direction to turn is outside the U.S. There are many reasons to consider a global allocation; regional diversification, yield curve diversification, lower correlations, etc. One more specific example relates to navigating the default landscape over the coming year. We believe that while the COVID-19 crisis shouldn't result in as many defaults as in previous recessions, there will be losers that have yet to emerge, particularly in troubled sectors such as energy.

Investors are wise to consider globally diversifying their high-yield exposure for three key reasons:

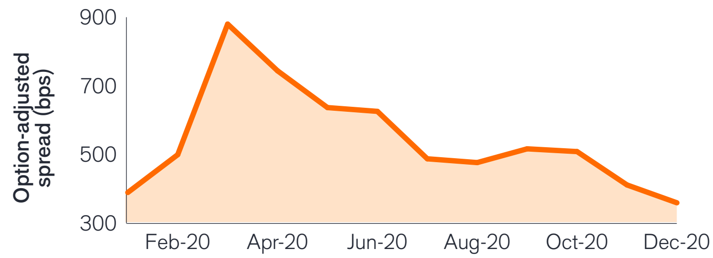
1. U.S. vs. Euro HY Default Rates

Ex U.S. markets exhibit significantly different structures. For example, as you can see in the chart below, the twin energy and COVID crises of 2020 have created a wide divergence in U.S. vs. European default rates.



Source: Bloomberg, as of 31 December 2020.

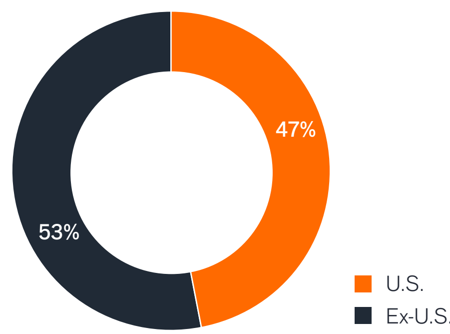
U.S. High-Yield Spreads



Source: Bloomberg, as of 31 December 2020.
Note: Data shown reflects the option-adjusted spread of the Bloomberg Barclays U.S. Corporate High Yield Index.

2. Regional Breakdown of the Global High-Yield Index

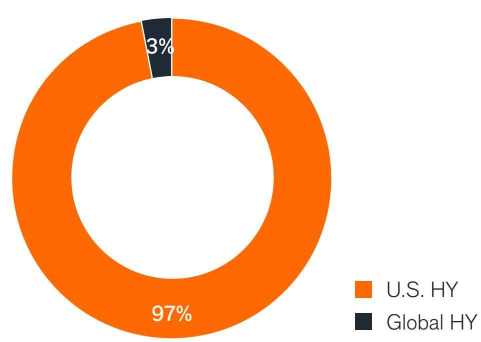
Over half of the global high-yield market is located outside the U.S., creating meaningful opportunities for security selection.



Source: Bloomberg, as of 31 December 2020. Breakdown shown is of the Bloomberg Barclays Global High Yield Index.

3. Average Advisor High-Yield Exposure

U.S. investors show significant home bias in their high-yield allocation, resulting in myriad global diversification opportunities.

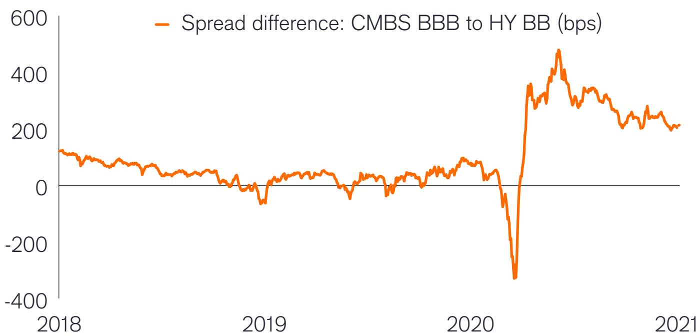


Source: Janus Henderson Portfolio Construction and Strategy Portal Database, as of 31 December 2020.

U.S. Depth

In the U.S. we've seen a tremendous rally across broader high-yield and investment-grade bonds, so investors are now forced to be pickier with their security selection and look for opportunities outside of traditional corporate credit. While credit has largely recovered thanks to support from the Fed in 2020, there are areas of the market that were left behind. Commercial mortgage-backed securities (CMBS) is one such market. As you can see in the accompanying chart, the snapback of the bond market recovery missed the CMBS space, and this lack of investment has left spreads much wider than the broader high-yield market, providing opportunity for greater tightening in the coming months.

Slower Recovery for CMBS



Source: Bloomberg, as of 31 December 2020.

The credit spread widening we witnessed in March 2020 created a scenario in which timing was paramount and security selection was secondary. Although spreads have tightened, defaults could continue, and we believe it's important to take an active approach and pass the baton from broad credit beta to security selection driven alpha.

About Janus Henderson's Portfolio Construction and Strategy Team

The PCS team performs customized analyses on investment portfolios, providing differentiated, data-driven diagnostics. From a diverse universe of thousands of models emerge trends, themes and potential opportunities in portfolio construction that we believe will be interesting and beneficial to any investor.

Janus Henderson
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