

# TRENDS AND OPPORTUNITIES

## SHOCK THERAPY:

PORTFOLIO SOLUTIONS FOR THIS YEAR'S MARKET TURMOIL

Portfolio Construction and Strategy (PCS) Insights

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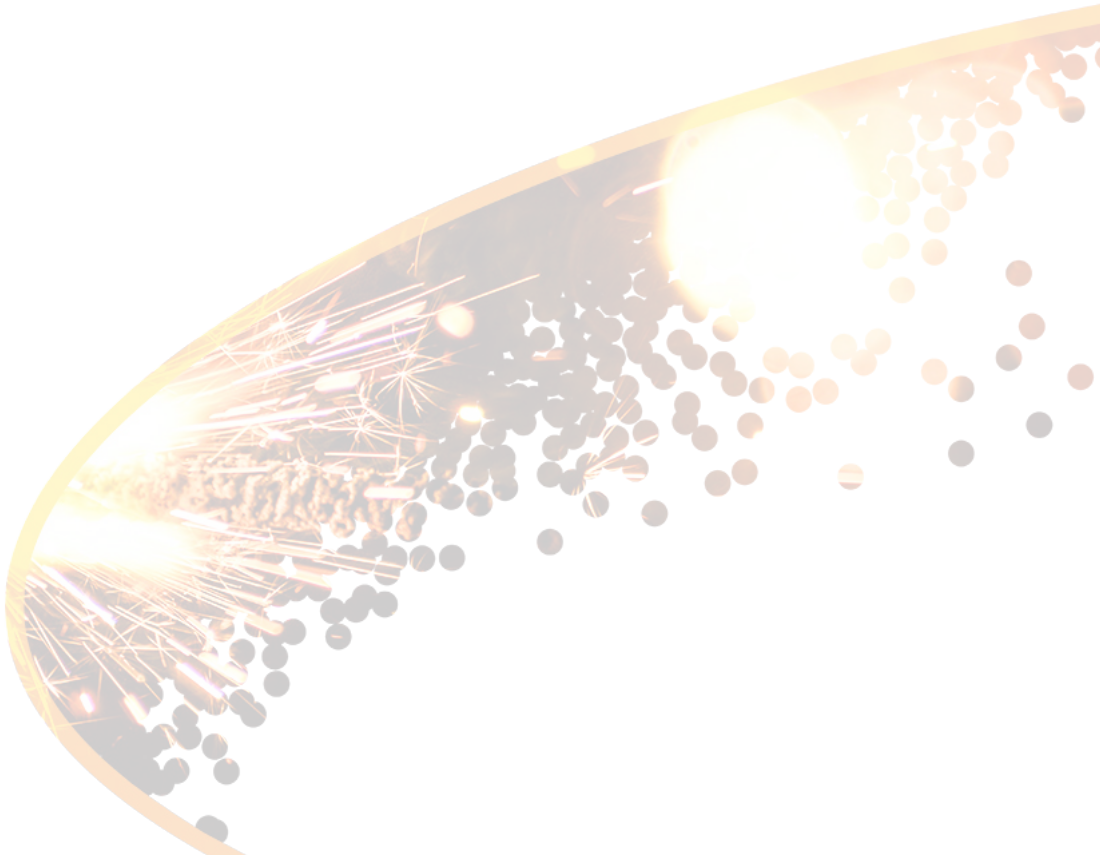
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# SHOCK THERAPY

## PORTFOLIO SOLUTIONS FOR THIS YEAR’S MARKET TURMOIL

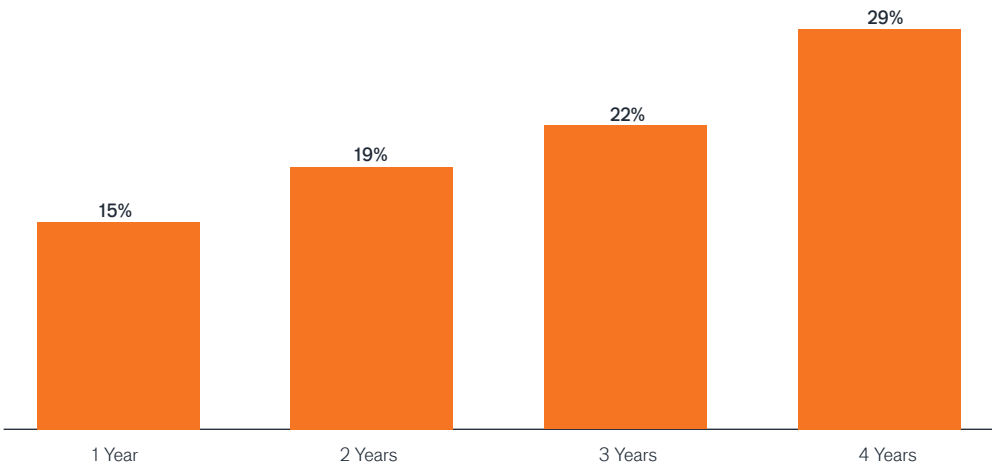
In our previous edition of Trends and Opportunities early this year, we focused on U.S. mid caps as an equity portfolio’s “new center of gravity,” examined the merits of being broad in ex U.S. equities to avoid the growth/value dance, and explained how multi-sector bond strategies shine when examined through the lens of “empirical” duration. Since that publication, investors have grappled with severe market shocks from slowing growth, inflation, and interest rate volatility. In this edition of Trends and Opportunities, we aim to offer some therapy for those shocks by providing a long-term perspective on the markets and economy and presenting quality equities and mortgage-backed securities (MBS) as potential solutions to help investors build a resilient portfolio.

### Putting volatility in historical context

After living through this year’s volatility, “shock” is probably an understatement. On the bright side, while the history of the S&P 500® Index tells us there is likely more pain to come, it also tells us that patient investors have historically experienced more upside than downside over the long term. Since 1939, every time the S&P 500 has crossed the 20% loss threshold into bear market territory, additional downside usually occurs. However, inclusive of that drawdown, the next 12 months have resulted, on average, in a positive gain of 15% and a full recovery has always occurred within four years.

In our view, we have now reached the point where investors should view the current landscape as a blank slate and seek to take advantage of new opportunities. No one can call the bottom, but anyone can call a dip: For medium- and long-term investors, the question shouldn’t be if they should take advantage, but how.

Average cumulative S&P 500 performance after 20% drawdown 1939 - 2021



Source: Janus Henderson Portfolio Construction and Strategy, Bloomberg as at 31 August 2022.

The slowing growth, inflation, and interest rate volatility we are currently experiencing are generating market shocks of unusual prominence and magnitude. These shocks will likely drive ongoing volatility to which investors, unfortunately, will need to grow accustomed. To help investors overcome that trifecta of market shocks, the Portfolio Construction and Strategy Team is focused on providing “shock therapy” in the form of portfolio solutions tailored to this new investing paradigm, while at the same time addressing the ubiquitous asset allocation gaps and concentrations we see in investor portfolios every day through our consultations with financial professionals.



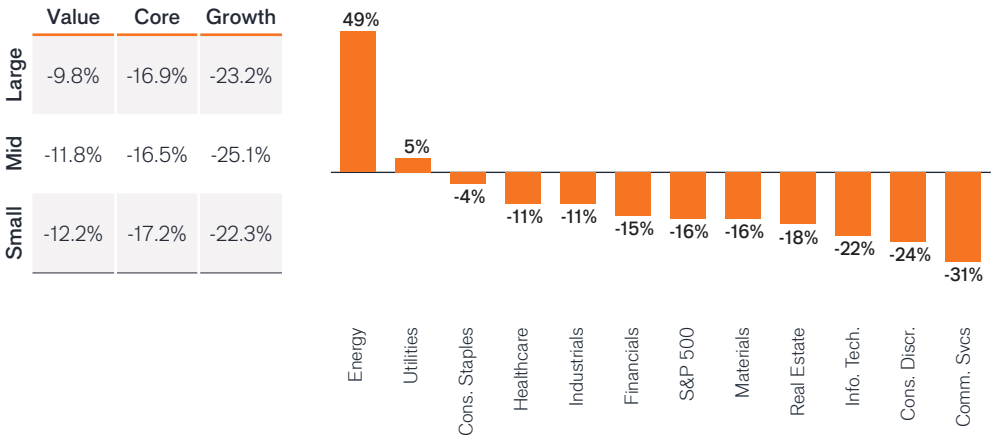
In this Trends and Opportunities report, we highlight portfolio solutions focused on:

- ▶ **Equity portfolios**
  - U.S. equity: Quality is a virtue
  - International equity: Keep it real (return) with high dividends
- ▶ **Fixed income portfolios**
  - Core fixed income: MBS as a home base
  - Diversifying fixed income: Multi-sector to manage myriad risks
- ▶ **Balanced strategies**
  - Manage market vertigo with a balanced approach

U.S. Equity style, size, and sector returns

EQUITY: U.S.

QUALITY IS A VIRTUE



Source: Morningstar, YTD returns through 31 August 2022. Style/size table based on Russell indices, sector chart based on GICS sectors of S&P 500 Index.

The Quality Equity MOAT: A framework to battle stagflation

	Key Risk	Defense
Margins	Inflation	Wide margins, pricing power
Ownership	Slowing Growth	Nimble management to navigate a downturn
Advantages	Slowing Growth	Competitive advantages and durable growth opportunities
Tenacity	Rate Volatility	Low leverage and/or long-term financing

YTD Recap

- ▶ As widely expected, rising rates and inflation have taken the largest toll on growth (down -23.2% YTD), which has shown roughly twice the downside of value (-9.8%).
- ▶ At a sector level, that same pressure on growth shows in the underperformance of Communication Services (-31%) and Information Technology (-22%), and with Consumer Discretionary (-24%) also suffering due to its particular sensitivity to economic conditions.
- ▶ Even in the face of slowing growth, classically cyclical sectors have performed relatively well (e.g., Energy +49%, Industrials -11%, Financials -15%, Materials -16%).

Outlook

- ▶ As multiple compression now gives way to a focus on earnings as the key determinant of stock performance, investors need to be mindful that not all earnings are created equal: the composition of earnings could carry significant forward-looking implications as companies battle global supply chains, financing costs, fickle consumer demand, and other headwinds.
- ▶ Earnings forecasts do not fully reflect company-level challenges ahead, and focus should turn to idiosyncratic risks and opportunities.
- ▶ With so much bad news priced into equities, we believe there is proportionately more upside opportunity than downside risk remaining.

PCS Perspective

- ▶ The unique nature of this year’s sell-off has given rise to an equally unique recovery environment, marked by many fits and starts, where sector and style decisions shouldn’t be made according to a typical recovery playbook.
- ▶ Those typical playbooks depend on superficial categories – e.g., growth vs. value, cyclical vs. defensive – which have lost relevance for this unique recovery.
- ▶ Instead, think mechanically and map today’s biggest risks to the moving parts of individual companies: e.g., margins, leverage, competitive landscape, management strategy.
- ▶ To simplify this extremely complex task, our MOAT framework for quality equity investing seeks to identify individual stocks which mitigate – and even capitalize on – today’s biggest risks so that investors can defend against stagflation and be prepared for the subsequent upside.

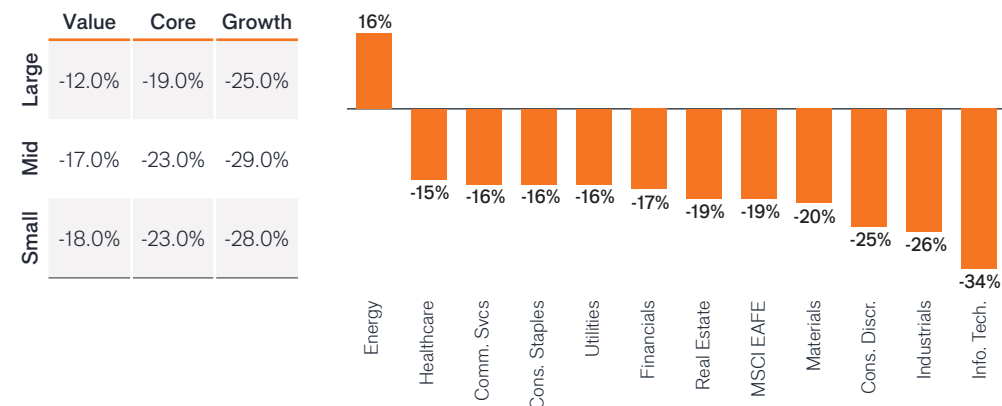
MSCI EAFE style, size, and sector returns

Higher-yielding stocks, with growing dividends, have outperformed the broader market YTD

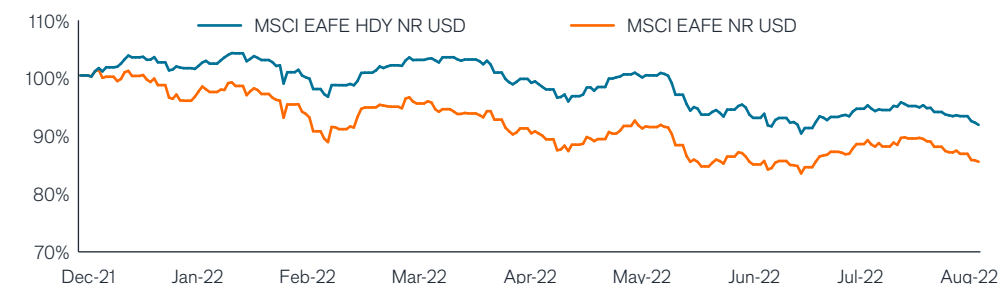
Dividend yield and dividend growth provide majority of the real equity return (since 1970)

## EQUITY: INTERNATIONAL

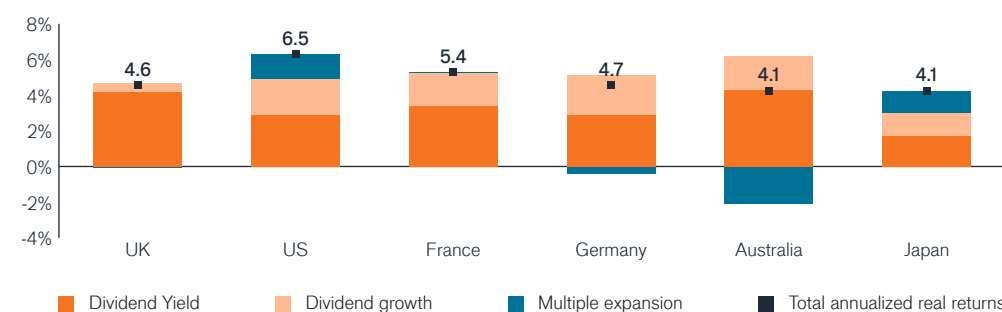
KEEP IT REAL (RETURN) WITH HIGH DIVIDENDS



Source: Morningstar, YTD returns through 31 August 2022. Style/size table and GICS sector chart based on MSCI EAFE indices.



Source: Morningstar, YTD returns through 31 August 2022.



Source: SG Cross Asset Research/Equity Quant, MSCI, Refinitiv. As of 30 June 2022.

## YTD Recap

- ▶ The Russia/Ukraine conflict, tightening monetary policies, and elevated inflation negatively weighed on the ex U.S. equity market during the first half of the year.
- ▶ The classically defensive technology sector was hit hardest due to higher discount rates compressing valuations, while the more cyclical consumer discretionary sector also faced inflation headwinds, resulting in a more conservative consumer spending pattern overseas.
- ▶ As companies have struggled with rising rates and inflation, higher-yielding stocks with growing dividends have outpaced the broad market year to date as the higher income potential helped offset lower price returns.

## Outlook

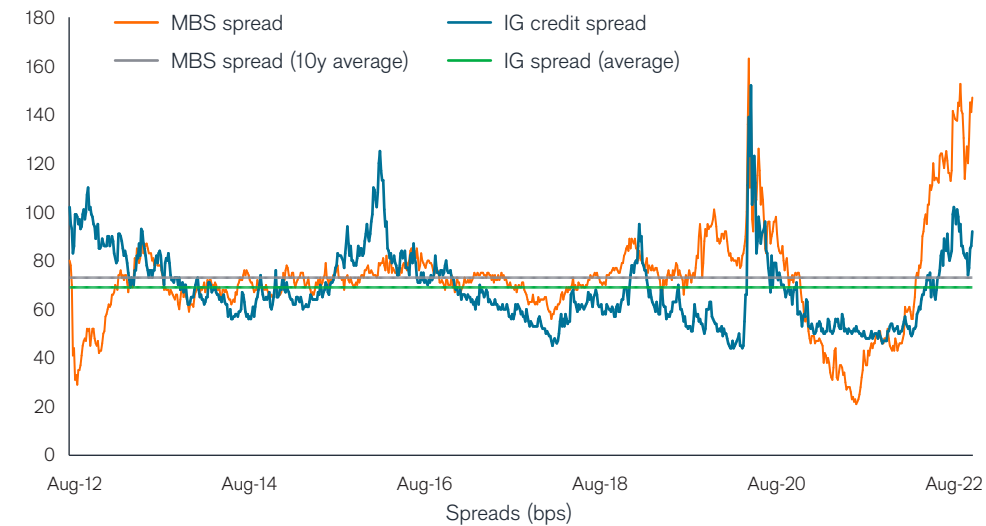
- ▶ Ex U.S. equities may present valuable diversification opportunities as many of these markets provide more cyclical, value-oriented exposure relative to the U.S.
- ▶ This shift toward value-oriented markets provides the opportunity for investors to increase allocations to companies that historically pay high dividends, which can be an indicator of high quality and are often accompanied by sustainable cash flows, good profitability, and strong balance sheets.
- ▶ While faced with more near-term geopolitical uncertainty, the ex U.S. market is at an earlier stage in the post-COVID demand recovery and offers high-quality dividend paying companies that tend to be more resilient through periods of volatility.

## PCS Perspective

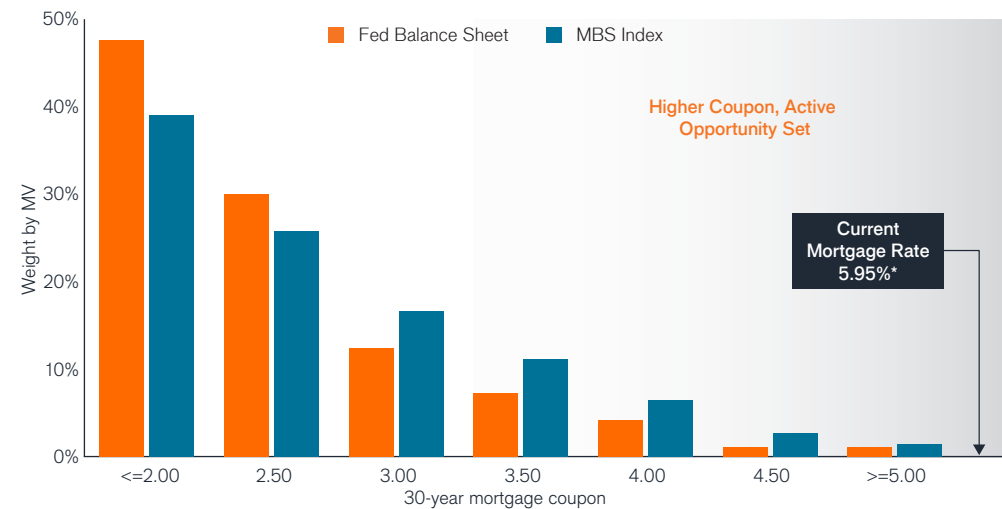
- ▶ At this point in the economic cycle, ex U.S. equities offer a wide array of diversification benefits across geographies, styles and sectors – all while seeking to provide higher dividend yields for investors seeking income diversification and higher real yields to help combat inflation.
- ▶ Additionally, dividends provide the bulk of real equity returns over the long term. This is especially important during higher inflation regimes, where stocks with higher, growing dividends have a propensity to outperform the broader market.
- ▶ Not all high dividend paying stocks are created equal, however. Active management is warranted to avoid structurally declining companies and value traps by focusing on sustainable cash flows and strong balance sheets that provide support for consistent portfolio income generation.

## CORE FIXED INCOME

### MBS AS A HOME BASE



Source: Bloomberg, Janus Henderson Investors, as of 31 August 2022.



\*Source: Bloomberg, as of 31 August 2022.

Sell-off has hurt MBS more than IG credit

Opportunity favors active management

### YTD Recap

- ▶ The unprecedented sell-off across fixed income has been particularly pronounced in mortgage-backed securities (MBS), which underperformed Treasuries while simultaneously seeing spreads widen more than investment-grade credit.
- ▶ Quantitative tightening (QT) is driving this repricing, leading to an increase in MBS supply, hurting sentiment, and creating heightened uncertainty around the asset class.
- ▶ When mortgage rates plummeted in 2020 and 2021, record numbers of borrowers refinanced at historically low rates. This year, rates have risen sharply and swiftly to over 5.50%.

### Outlook

- ▶ This year's dramatic mortgage rate rise has led to higher-coupon mortgage bond opportunities for investors, with a compelling yield cushion to mitigate against future volatility.
- ▶ With 72% of outstanding mortgages sitting at rates below 3.50%, prepayment risk has declined dramatically, mitigating what is traditionally a dominant risk in MBS investing.
- ▶ While the potential for additional volatility from QT still exists, we now believe that spreads in the sector are broadly mispriced, offering noteworthy total return opportunities.

### PCS Perspective

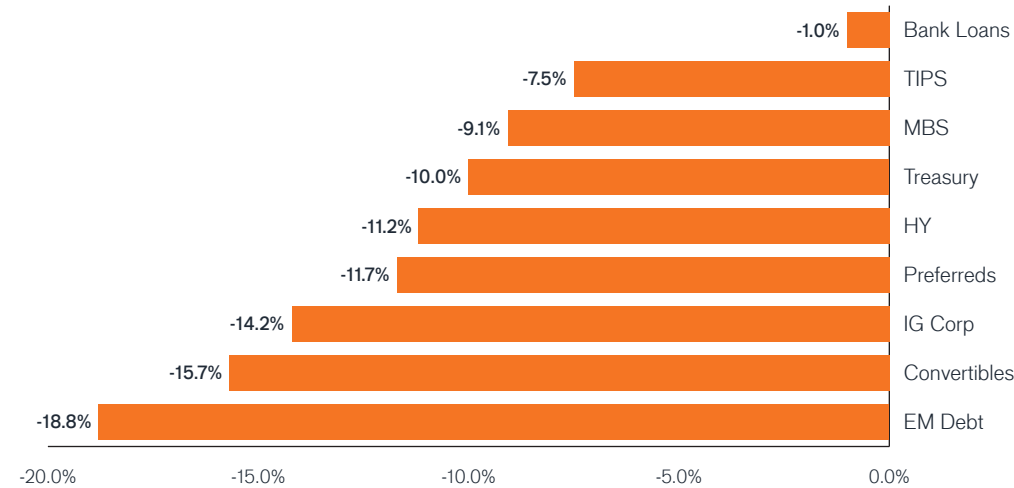
- ▶ MBS > Agg: Like the broader Bloomberg U.S. Aggregate Bond Index (Agg) benchmark, MBS can serve as a ballast in investor portfolios during times of volatility. However, due to this year's dramatic spread and mortgage rate movements, MBS now offer higher yield with similar or lower duration risk than the U.S. Agg.
- ▶ Active > Passive: Compared to passive MBS allocations, which are often concentrated in older, lower-yielding mortgages more affected by QT, active allocations in MBS may be warranted for two important reasons:
  1. Active management can help increase yield and mitigate risk from QT by allocating to newer, higher-coupon mortgages.
  2. Through security selection, active management seeks to mitigate prepayment risk; this is particularly important with newer, higher-yielding mortgages that are closer to market rates.



## DIVERSIFYING FIXED INCOME

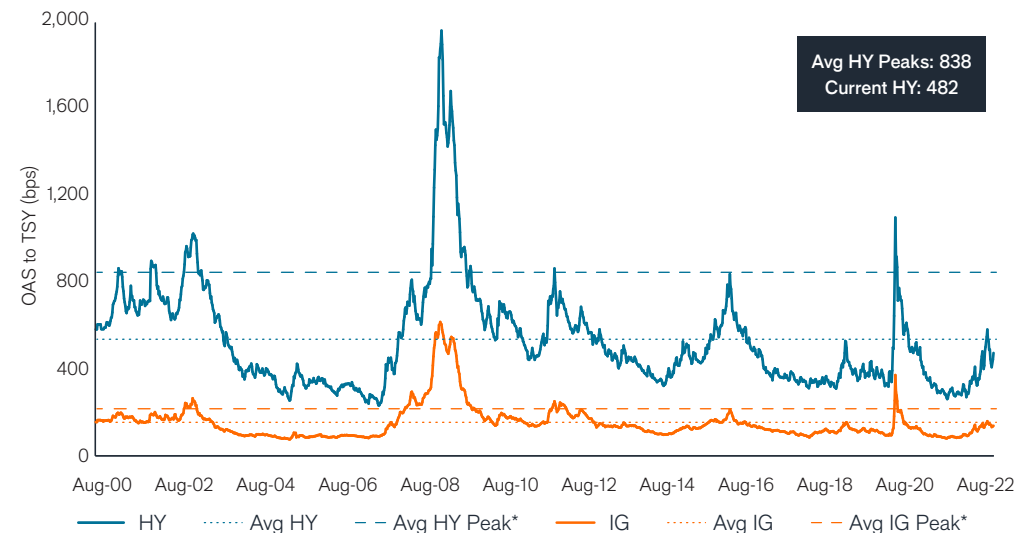
### MULTI-SECTOR TO MANAGE MYRIAD RISKS

YTD: An uneven sell-off



Source: Morningstar, as of 31 August 2022. S&P/LSTA US Leveraged Loan TR, Bloomberg US Treasury US TIPS TR USD, Bloomberg US MBS TR USD, Bloomberg US Treasury TR USD, ICE BofA Fxd Rate Pref TR USD, Bloomberg US High Yield Corporate TR USD, Bloomberg US Corp Bond TR USD, ICE BofA US Convt Bonds TR USD, JPM EMBI Global Diversified TR USD.

Single sector spreads have room to widen



Source: Bloomberg, as of 31 August 2022. \*Avg Peak spread levels exclude '08 and '20 sell-offs.

### YTD Recap

- ▶ There has been significant divergence among sectors within the diversifying fixed income universe this year.
- ▶ Emerging Markets has dealt not only with the impacts of quantitative tightening (QT) but also with more direct ramifications from the Russia/Ukraine conflict. Floating-rate bank loans have held up better due to their rate-resetting component as the Federal Reserve (Fed) has hiked 225 basis points in 2022 so far.
- ▶ As the narrative has shifted from inflation to slowing growth, credit spreads – particularly in the below investment-grade universe – have begun to widen.

### Outlook

- ▶ Wider spreads and higher rates now provide greater total return potential for investors willing to take on more risk in fixed income. However, the recovery will likely be marked by dispersion across and within credit asset classes.
- ▶ Floating-rate bank loans may lose some luster as the hiking cycle slows and credit quality becomes more important, while emerging markets continue to grapple with a strong U.S. dollar, pandemic uncertainty, and geopolitical risk.
- ▶ High-yield spreads have approached levels generally seen as attractive but still remain far from what is typically seen in a recession.

### PCS Perspective

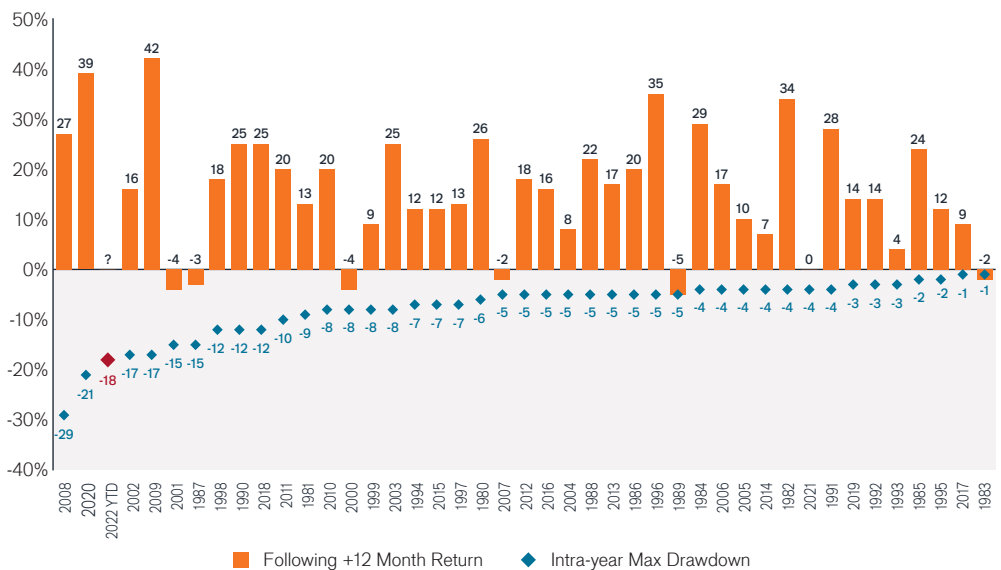
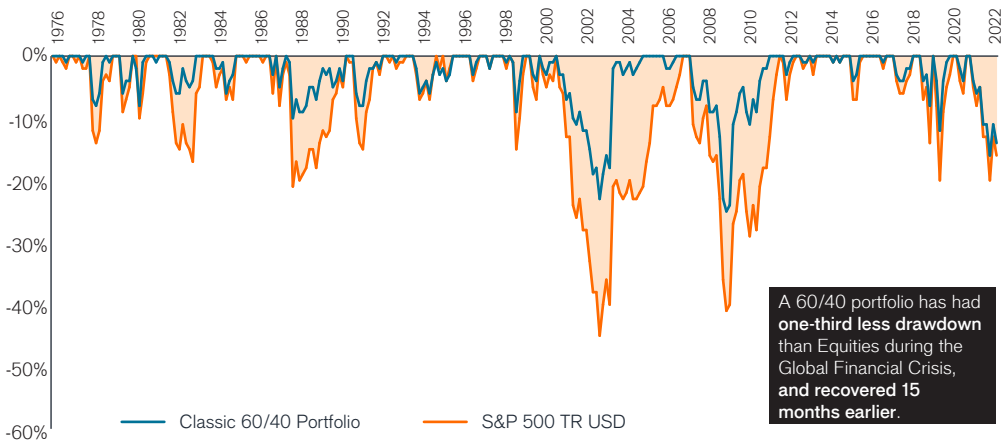
- ▶ This year's sell-off presents some extremely attractive discounts (and even dislocations) in many high-risk and high-yield asset classes, offering opportunities for potential strong returns.
- ▶ However, investors would be wise to remain cautious and expect further volatility and losses to accompany the high return potential of these asset classes.
- ▶ Inflexible, single-sector, benchmark-constrained credit implementation may leave investors too exposed to near-term volatility related to recession uncertainty.
- ▶ In contrast, flexible multi-sector bond strategies may help investors "average in" to higher-yielding opportunities, while at the same time allowing them to remain nimble enough to increase or decrease their risk budget as market volatility evolves: i.e., multi-sector is a useful middle-ground of the fixed income risk spectrum to "re-risk" core over weights and/or "de-risk" benchmark-constrained single-sector credit exposures.

Diversification and risk mitigation: The 60/40 portfolio historically experienced lower drawdowns and faster recoveries

60/40 portfolio intra-year declines in perspective

## BALANCED STRATEGIES

### MANAGE MARKET VERTIGO WITH A BALANCED APPROACH



Source: Morningstar, Portfolio Construction and Strategy, as of 31 August 2022.

### YTD Recap

- ▶ During the first half of the year, equities entered into bear market territory as a result of rising global inflation, geopolitical conflict, and central banks embarking on a regime of quantitative tightening (QT).
- ▶ Unfortunately, this strong shift to QT sent bond returns sharply negative alongside equities, resulting in underwhelming performance for the classic “60/40” equity/bond portfolio.
- ▶ In fact, the 60/40 has seen its worst six-month drop since 1988 and its second-worst year (so far) in total returns since the Global Financial Crisis (-16.1% in the first half of 2022 vs. -22.1% in 2008).<sup>1</sup>

### Outlook

- ▶ The sell-off in both equity and fixed income markets can largely be attributed to the shift from a quantitative easing to a tightening environment, and we believe much of the repricing has already occurred.
- ▶ A successful allocation to a balanced fund may help investors maneuver these difficult markets by encouraging them to stay the course and avoid the temptation of market timing.
- ▶ Although returns have been painful, a double-digit decline in a 60/40 portfolio is not uncommon. History shows us that investors who were patient with their portfolios during corrections were often rewarded with a rebound within the 12 months following a bear market.

### PCS Perspective

- ▶ Balanced strategies comprise a large, diverse category of managers that can be primarily used in three different ways, with three different risk considerations:
  1. To outsource an entire portfolio: Consider pairing differentiated managers to reduce idiosyncratic risk
  2. As a core portfolio: Counterintuitively, seek out managers with higher correlations to a typical 60/40 allocation, indicating higher core and lower satellite exposures.
  3. As a tactical overlay: Avoid managers categorized as merely “static” or “dynamic” and focus on “flexible” (i.e., largely unconstrained) managers to maximize diversification.
- ▶ A successful 60/40 “balanced” allocation needs a clear intention as to its role in the broader portfolio, including risk behavior, time horizon, and objective, as well as a thorough due diligence of its regional, sector, and asset class exposures.

Source: Morningstar, Janus Henderson Portfolio Construction and Strategy, as of , as of 31 August 2022.



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**Volatility** is a statistical measure of the dispersion of returns for a given security or market index.

**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.

**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 and vice versa.

**Credit Spread** is the difference in yield between securities with similar maturity but different credit quality. Widening spreads generally indicate deteriorating creditworthiness of corporate borrowers, and narrowing indicate improving.

**Basis point (bp)** equals 1/100 of a percentage point. 1 bp = 0.01%, 100 bps = 1%.

**Dividend Yield** is the weighted average dividend yield of the securities in the portfolio (including cash). The number is not intended to demonstrate income earned or distributions made by the portfolio.

**Quantitative Easing (QE)** is a government monetary policy occasionally used to increase the money supply by buying government securities or other securities from the market.

**Diversification** neither assures a profit nor eliminates the risk of experiencing investment losses.

**Mortgage-backed securities (MBS)** may be more sensitive to interest rate changes. They are subject to extension risk, where borrowers extend the duration of their mortgages as interest rates rise, and prepayment risk, where borrowers pay off their mortgages earlier as interest rates fall. These risks may reduce returns.

**Fixed income securities** are subject to interest rate, inflation, credit and default risk. As interest rates rise, bond prices usually fall, and vice versa. **High-yield bonds, or "junk" bonds**, involve a greater risk of default and price volatility. **Foreign securities**, including sovereign debt, are subject to currency fluctuations, political and economic uncertainty and increased volatility and lower liquidity, all of which are magnified in emerging markets.

**Actively managed portfolios** may fail to produce the intended results. No investment strategy can ensure a profit or eliminate the risk of loss.

**U.S. Treasury securities** are direct debt obligations issued by the U.S. Government. With government bonds, the investor is a creditor of the government. Treasury Bills and U.S. Government Bonds are guaranteed by the full faith and credit of the United States government, are generally considered to be free of credit risk and typically carry lower yields than other securities.

**Bond prices** generally move in the opposite direction of interest rates, thus bond prices may decline as interest rates rise, and vice versa.

**Interest rate movements** will affect a fund's share price and yield.

**Growth and value investing** each have their own unique risks and potential for rewards, and may not be suitable for all investors. Growth stocks are subject to increased risk of loss and price volatility and may not realize their perceived growth potential. Value stocks can continue to be undervalued by the market for long periods of time and may not appreciate to the extent expected.

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C-0922-45095 09-30-23

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