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GLOBAL AGGREGATE MASTERING THE WORLD'S LEADING BOND INDEX

MAY 2025



EXECUTIVE SUMMARY

- The Bloomberg Global Aggregate Bond Index (the Global Agg) is one of the world's most widely used bond indices and is arguably the index that best encompasses the vast scale and diversity of global bond markets.
- The index includes both government debt and investment grade corporate credit diversified across a range of markets and currencies.
- Returns were volatile around the pandemic, but with yields now back at pre-global financial crisis levels we believe this has created a more stable foundation for future returns.
- We outline nine strategies that active managers can employ as they seek to outperform the Global Agg:
 - **Duration and yield curve strategies:** Positioning portfolios based on market yield outlooks
 - **Security selection via fundamental analysis:** Identifying undervalued securities
 - **Capturing new-issue premia:** Taking advantage of higher yields offered on new debt
 - **Exploiting market fragmentation:** Leveraging the diverse range of debt issues
 - **Sector strategy:** Avoiding sectors with concerning outlooks
 - **Beta management:** Adjusting credit risk exposure
 - **Relative value:** Capitalizing on value fluctuations across markets
 - **Cross country trades:** Seeking to take advantage of relative economic performance
 - **Inflation vs nominal:** Using inflation-linked bond markets to express an inflation view
- Tariff uncertainty is increasing volatility in bond markets, but when volatility rises, it creates opportunities for active managers to exploit. When we look back at history, we can observe a clear correlation between higher volatility and higher excess returns.
- We highlight the hidden risks of passive investment in fixed income markets, with many passive strategies doomed to structurally underperform due to the inefficiencies inherent in bond markets.

REVISITING THE BLOOMBERG GLOBAL AGGREGATE BOND INDEX

TRACKING BOND MARKETS THROUGH THE DECADES

Incepted in December 1998, with a history backdated to 1 January 1990, the Bloomberg Global Aggregate Bond Index (Global Agg) is one of the world's most commonly used bond indices. The Global Agg is a high quality, broadly diversified, multi-currency universe. Its scale is vast, encompassing more than 30,000 securities from more than 3,100 issuers and with a market capitalization of over \$70 trillion¹. When looking for an index that truly encompasses the vast scale and diversity of global bond markets, we believe the Global Agg is unmatched.

Through its decades-long history, the Global Agg has consistently ground out returns, but experienced a period of greater volatility during the global pandemic and the years that followed (see Figure 1). Yields plunged to new lows as lockdowns were rolled out around the world, then rose sharply as disrupted supply chains caused inflation to surge. With yields back at levels not seen for nearly 20 years (see Figure 2), we believe this has created a more stable foundation for future returns.

Figure 1: Solid long term performance bar a pandemic blip¹

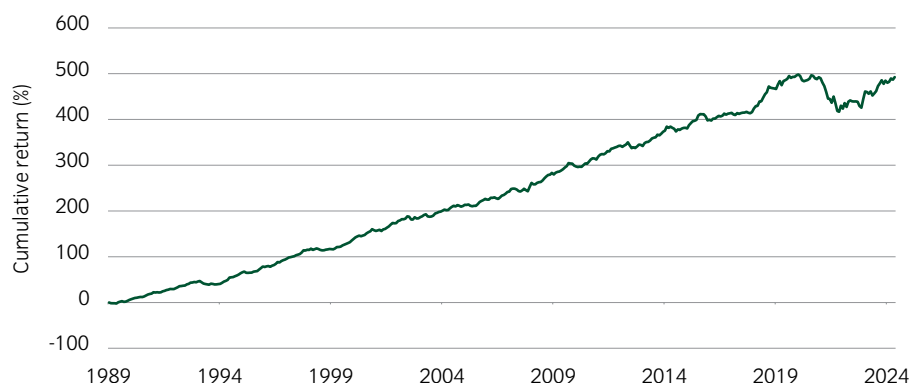


Figure 2: Yields are back to pre-global financial crisis levels¹



¹ Source: Bloomberg Global Aggregate Bond Index. As of April 30, 2025. **Past performance is not indicative of future results. Investment in any strategy involves a risk of loss which may partly be due to exchange rate fluctuations.**

VAST IN SCALE AND DEPTH: BREAKING IT DOWN

From a credit perspective, the index can be broken into four key components:

- **Government bonds:** Represent the largest component, being just over half of the index, and includes inflation-linked securities.
- **Corporate bonds:** These are bonds issued by corporate issuers split across the three major categories of industrials, utilities and financials and are close to 20% of the index.
- **Government-related bonds:** These are generally corporate issuers, but usually with some element of government ownership or control, and around 15% of the index.
- **Securitized bonds:** US mortgage-backed securities (MBS), commercial mortgage-backed securities (CMBS), asset-backed securities (ABS) and covered bonds make up over 10% of the index.

Government and government-related bonds issued by major developed markets typically offer more safety through economic downturns, as well as potential for capital gains if yields fall due to a flight-to-quality. Meanwhile corporate credit may provide greater potential positive excess returns if spreads tighten, often when economic outlooks improve, and corporate sectors face more favorable prospects.

At a geographic level, the Global Agg is biased towards US dollar-denominated debt as that is the deepest and largest bond market, but it also includes large exposures to European and Asian markets, providing international diversification. The benefits of this are clear, as the Global Agg (hedged into US dollars) has historically outperformed the US Aggregate Index (see Figure 4).

Figure 3: A globally diversified index²

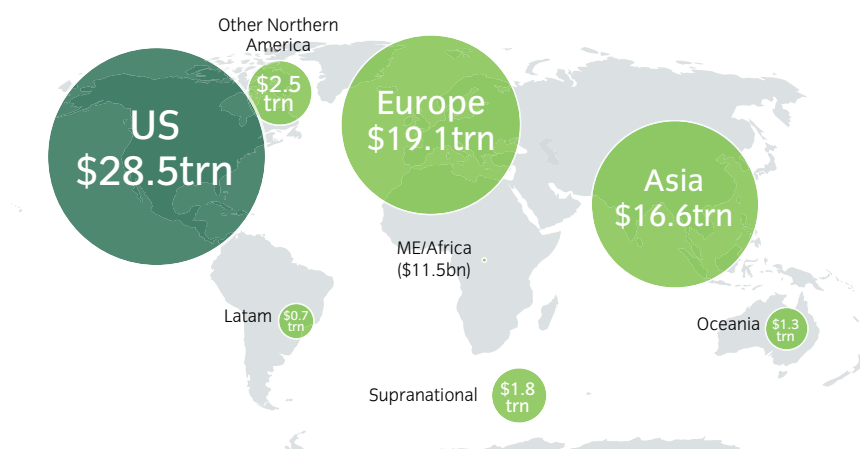
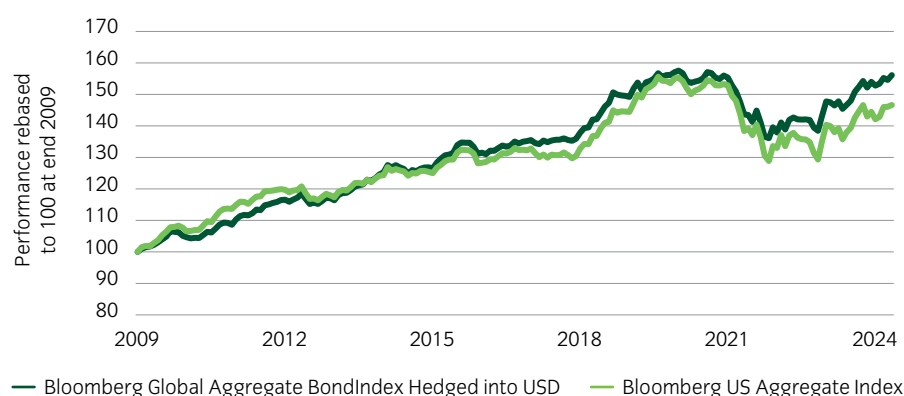


Figure 4: A global approach has generated higher returns²



² Source: Bloomberg Global Aggregate Bond Index. As of April 30, 2025. Past performance is not indicative of future results. Investment in any strategy involves a risk of loss which may partly be due to exchange rate fluctuations.

NINE WAYS ACTIVE MANAGERS CAN SEEK TO BEAT THE GLOBAL AGG

BEATING BENCHMARKS AND EXPLOITING INEFFICIENCIES

While equity markets assign the highest index weights to companies with the largest market capitalization and generally the highest profits, fixed income benchmarks are skewed towards issuers with the most debt outstanding. This creates a myriad of structural inefficiencies across bond markets that active managers can seek to exploit.

As a result, the index is merely the starting point for returns.

We present nine strategies that skilled active managers with a robust investment process can use as they seek to generate returns in excess of the index:

- 1 Duration and yield curve strategies:** Active managers can strategically position their portfolios based on their outlook for market yields. If they anticipate a decline in yields, they might add longer-maturity issues, which are expected to benefit the most from such a scenario. More sophisticated strategies may involve targeting specific segments of the yield curve or varying investments across different maturities.
- 2 Security selection via fundamental analysis:** Fundamental credit analysis aims to identify securities whose valuations do not accurately reflect the company's current and future fundamental strength or weakness. When selecting an issuer's securities, it is crucial to choose those with robust balance sheets and easy access to money markets.
- 3 Capturing new-issue premia:** New debt may be issued for various reasons, such as funding growth or acquisitions. In the corporate world, issuers often offer new debt at slightly higher yields than the market to attract buyers – a phenomenon known as new-issue premia. Active managers can capitalize on this by keeping a close eye on opportunities in primary issuance markets.
- 4 Exploiting market fragmentation:** When an investor buys a bond, a single corporate issuer may have a range of debt issues across different maturities and currencies, each with different legal documentation, and even exposed to different parts of the capital structure. Each issue may be a different size, with variable levels of liquidity. This fragmentation introduces a range of options for an active manager to consider and potentially take advantage of.
- 5 Sector strategy:** Whole industry sectors in fixed income markets can sometimes have valuations that do not reflect the current or future strength or weakness of their constituent companies. Active managers have the flexibility to avoid investing in sectors where they believe the outlook is concerning.
- 6 Beta management:** The constituents of a bond index represent a certain level of aggregate credit risk at any given time. Active managers have the flexibility to take on higher or lower credit risk compared to the index. This decision can be influenced by the stage of the credit cycle, average valuations, or a tactical market view.
- 7 Relative value:** The value of fixed income instruments, especially credit, can fluctuate across markets or between segments of the fixed income universe at any given time. Active managers can seek to capitalize on these variations by overweighting credit in the market that offers the greatest value and underweighting credit in the market that offers the least value.
- 8 Cross country trades:** Diverging economic conditions can impact the relative performance of government bond markets. A manager might decide to overweight the bond market of a country with a positive economic outlook while underweighting the bond market of a country with a negative outlook. Historically, Italy was perceived as a weaker economy within Europe, whereas France was seen as one of the strongest. However, this perception has shifted considerably in recent years, with Italian bonds significantly outperforming their French counterparts as a result.
- 9 Inflation vs nominal:** Many governments issue inflation-linked bonds, with coupon and principal repayments linked to a broad measure of inflation. If market rates diverge from the inflation outlook held by a manager, they can seek to over or underweight inflation-linked bonds to reflect that view.

THE POWER OF INCREMENTAL RETURNS

The broad reach of the Global Agg means that it encompasses numerous pockets of value that can be exploited. Active managers have the potential to amplify this by pivoting to the areas of greatest value at any given time. By maintaining a diverse range of risk positions aimed at generating small additional returns from multiple sources, it can be possible to aggregate these into a meaningful excess return without being reliant on any specific investment environment.

TAKING ADVANTAGE OF TARIFF UNCERTAINTY

RECESSION RISKS HAVE GROWN, AND VOLATILITY HAS FOLLOWED

Although our central case is for the US to avoid recession, the risks to growth are undoubtedly skewed to the downside due to the uncertainty introduced by the new US trade policy. Typically, we would expect the Federal Reserve to respond to a weakening outlook with a more dovish stance, accelerating the pace of rate cuts to support growth. However, tariffs are likely to drive inflation higher, at least in the short term, complicating the job for the Fed.

However, as markets struggle to keep pace with the constantly changing political backdrop, volatility has increased, leading to market dislocations and periods of indiscriminate spread widening. We believe this environment is likely to persist for some time, meaning volatility across asset markets is likely to remain elevated.

FOR ACTIVE MANAGERS, VOLATILITY CREATES OPPORTUNITY

Evidence suggests that active managers in credit markets are typically able to achieve the greatest excess returns over their benchmarks (known as alpha), when implied volatility in these markets is elevated. We outline this in Figure 5, where it is clear that the level of excess return generated by the median manager in the MercerInsight universe rises along with volatility. When we add in a representative actively managed Insight strategy, the relationship is even more pronounced.

Figure 5: Excess returns have increased at higher levels of implied volatility³



³ Source: Insight and Mercer. Insight global credit strategy outperformance in USD terms, of Bloomberg Global Aggregate Credit Index hedged into USD, gross of fees. Mercer Insight Universe median manager alpha versus global credit sector benchmark index. **Past performance is not indicative of future results. Investment in any strategy involves a risk of loss which may partly be due to exchange rate fluctuations.**

THE HIDDEN RISKS OF PASSIVE FIXED INCOME INVESTING

While active investors can look for ways to exploit the structural inefficiencies within fixed income indices, passive investors find themselves hostage to them.

CORPORATE DEBT IS CONCENTRATED IN THE LOWEST RATING BUCKET

One of the most significant issues facing passive investors is the steady deterioration in credit quality that we have witnessed over recent decades. Although the Global Agg contains only corporate credit that is rated investment grade, the credit quality of investment grade corporate bonds has deteriorated over time as pressure has grown from shareholders to leverage corporate balance sheets.

We can illustrate this in Figure 6, which shows that BBB-rated issues now represent just under 50% of the Global Agg's corporate component, while the best rated AAA and AA-rated issues represent under 10%. This means that passive bond investors are now forced to invest a greater proportion of their assets in credits teetering on the edge of investment grade and, given the way bond indices work, biasing towards those companies with the greatest amount of debt.

Figure 6: BBB-rated credits dominate the Bloomberg Global Corporate Aggregate Index⁴



DOWNGRADES ARE COMING

Corporate downgrades have been uncommon in recent years, but we believe this could change significantly in the years ahead. Insight projects that around \$50bn of investment grade corporate debt will be downgraded to high yield in 2025, up from \$6.7bn in 2024⁵.

Economic conditions have helped prevent downgrades in recent years as the US recovered strongly from the pandemic and many companies termed out their debt in 2020, partly shielding themselves from rising rates. However, these conditions are gradually reversing.

Coupons and yields are starting to converge as issuers refinance (Figure 7) and economic growth is likely to prove more challenging. This heightens the risk that even some large corporates could be downgraded to below investment grade, becoming what is known in the market as a fallen angel.

⁴ Source: Insight and Bloomberg. Data as of March 31, 2025.

⁵ Any projections or forecasts contained herein are based upon certain assumptions considered reasonable. Projections are speculative in nature and some or all of the assumptions underlying the projections may not materialize or vary significantly from the actual results. Accordingly, the projections are only an estimate.

Figure 7: Rising interest costs could impact the more vulnerable BBB corporates⁶



When an investment grade bond is downgraded to high yield, many passive Global Agg funds are forced to sell them, often at the worst possible time, as they are no longer eligible for inclusion within the index. As markets anticipate this wave of forced sales, more of the bonds are sold, which typically exacerbates these bonds' underperformance. However, for those active managers able to take off-benchmark positions, there is a potential opportunity to purchase the issue in anticipation of a price recovery as the forced sales draw to a close. Since 2004, excess returns on fallen angels have averaged -10% over the six months before a downgrade, but +20% over the 12 months after⁷.

Considering these factors, along with the transaction costs needed to keep up with index changes, many passive strategies are doomed to structurally underperform after fees.

CONCLUSION

For many investors, the Global Agg is the natural choice of benchmark for their fixed income assets. The index offers exposure to a broad range of global bond markets, with a substantial allocation to government related debt. Its investment grade credit and securitized components can act to enhance the income generated by the index without compromising risk or liquidity.

With the yield of the Global Agg back at pre-financial crisis levels, it should create a more stable foundation for future returns. But the income generated from the index is potentially just the starting point.

In our view, the structural inefficiencies inherent in bond markets provide significant opportunities for active managers to outperform the Global Agg. Tariff uncertainty is creating volatility across asset markets, and we expect this to persist for some time. But higher volatility is nothing to be feared: for active managers volatile markets can increase the number of opportunities to exploit, and we observe that higher volatility has historically led to higher levels of outperformance.

At the same time, investors need to be aware of the inherent dangers of passive investment in fixed income. Fixed income markets differ to equity markets as they are weighted towards those issuers with the greatest level of debt. With a greater concentration of corporate debt in the lowest rated BBB category, we believe downgrades are likely to increase. As bonds drop below investment grade and are removed from the index, passive investors become forced sellers, often at the worst possible time. An active or systematic approach that seeks to exploit such inefficiencies can turn such dynamics to an investor's advantage.

⁶ Source: Bloomberg, Insight, December 2024.

⁷ Bloomberg, Insight, December 2024. **Past performance is not indicative of future results. Investment in any strategy involves a risk of loss which may partly be due to exchange rate fluctuations.**

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