iShares
by BlackRock

RETHINKING FIXED INCOME IN PORTFOLIOS

PORTFOLIO CONSTRUCTION WITH BOND ETFs

Bonds have a renewed importance in portfolios

After years of being starved of income, **decade-high levels of yield have reignited the appeal for bonds**, and renewed the importance of fixed income in portfolios.

The new investing regime that we find ourselves in, as laid out by the BlackRock Investment Institute (BII) , has highlighted the expectation of heightened macro and market volatility going forward, requiring us to be nimble in our asset allocation and granular in our exposures.

Indeed, **the cost of getting the asset mix wrong in the new regime is far higher than during the Great Moderation** – the four-decade period of stable activity and inflation, with the new regime challenging our traditional thinking around portfolio diversification. Asset allocation has never been so important.

It's time for investors to stop thinking in 'active versus passive' terms. **Every investment decision is an active one**. In this context, **ETFs play an important role in allowing investors to build diversified portfolios** using a combination of broad and targeted exposures, cost effectively and with transparent and liquid investments. Investors are now also increasingly seeing the advantages of blending bond ETFs with actively managed strategies to build better diversified portfolios.

In this paper we explore **our approach to using bond ETFs in the modern day portfolio**. We start by presenting a disciplined step-by-step approach to portfolio construction to assist investors in re-evaluating their fixed income allocation. Through **case studies and portfolio construction examples** we demonstrate how blending various exposures of **BlackRock's Fixed Income Pyramid** can build better diversified portfolios that meets investor objectives, whilst simultaneously diversifying risk.

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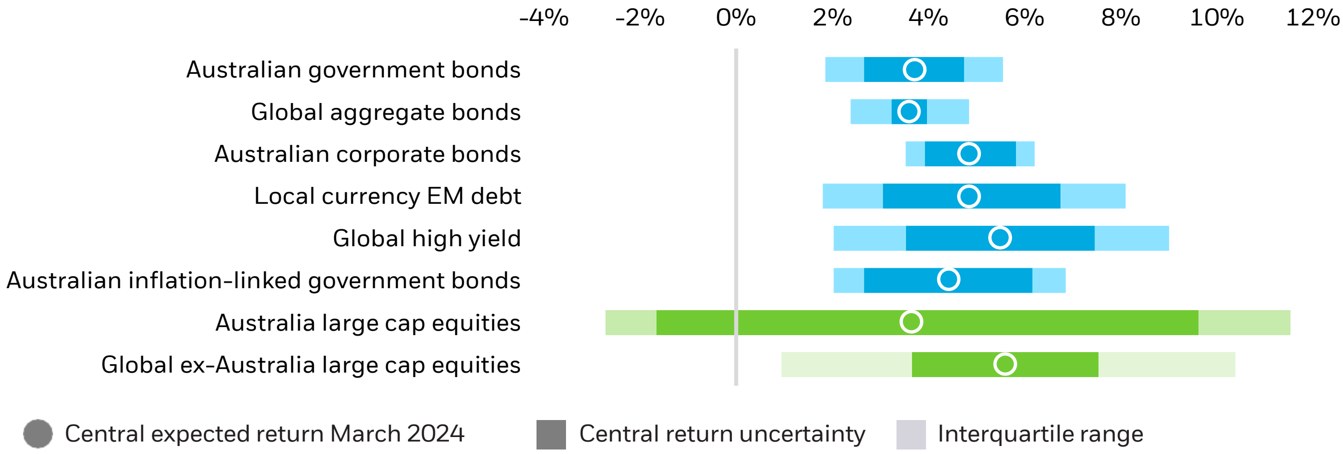
Recall. Retool. RETHINK.

Following the RBA's unprecedented pace of rate hikes, adviser portfolios could have underweight fixed income by up to as much as 30%. Yet after the great reset of yields, forward looking expected returns are meaningfully more positive, as shown in Figure 1.

In this new market regime, the first step of re-allocating back to fixed income within a broader portfolio is arguably the most important, given asset allocation is the largest driver of portfolio returns. The key questions are how much fixed income, which exposures, and how?

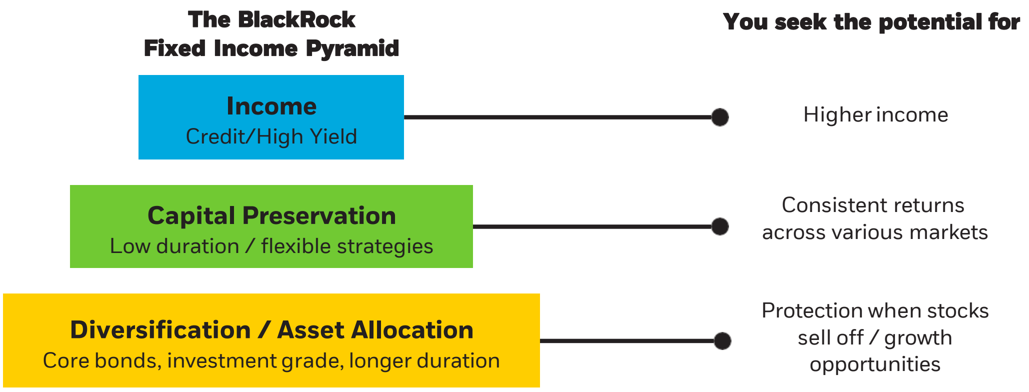
FIGURE 1: BII CAPITAL MARKET ASSUMPTIONS, 5 YEAR HORIZON IN AUD TERMS[1]



Fixed income isn't a one fund asset class. Fixed income broadly serves three key roles in a multi-asset portfolio. The BlackRock Fixed Income Pyramid (Figure 2) – simplistically made up of Diversification (from equities), Capital Preservation and Income – can help clients think through the role of bonds. However, no one bond fund can meet all these objectives in today's environment, because not all portfolios have exactly the same needs.

FIGURE 2: THE BLACKROCK FIXED INCOME PYRAMID

Consider what role each fund plays, and then optimise your bond mix based on your larger asset allocation.



1 Source: BlackRock Investment Institute, May 2024. Data as of 28 March 2024. **This information is not intended as a recommendation to invest in any particular asset class or strategy or as a promise - or even estimate - of future performance.** Notes: Return assumptions are total nominal returns. Australian dollar return expectations for all asset classes are shown in unhedged terms, with the exception of global corporate bonds, hedge funds, global aggregate bonds and global government bonds. Our CMAs generate market, or beta, geometric return expectations. Asset return expectations are gross of fees. The darker bands show our estimates of uncertainty in our mean return estimates. The lighter bands are based on the 25th and 75th percentile of expected return outcomes – the interquartile range for more detail read Portfolio perspectives. Indices are unmanaged and used for illustrative purposes only. They are not intended to be indicative of any fund or strategy's performance. It is not possible to invest directly in an index.

Build better portfolios with a disciplined four step process

We believe in adopting a disciplined and well-thought out process to portfolio construction, consisting of four steps:

1. **Benchmarking** involves translating a client's investment objectives and risk tolerance into a strategic asset allocation to function as a point of reference to monitor the performance of investments and the overall portfolio.
2. The **budget** phase requires an evaluation of opportunities and risk. Risk is more predictable and manageable than returns, so consider what the most suitable level of risk is needed to achieve a client's objectives, and weigh up where it is most important to minimise costs, fees and taxes.
3. **Investing** involves exploring and selecting the most appropriate investment vehicles.
4. Finally, **monitor** the portfolio's performance overtime and frequently revisit client objectives, risk dynamics and overall portfolio efficiency to determine whether rebalancing is required.

FIGURE 3: THE BLACKROCK PORTFOLIO CONSTRUCTION PROCESS

01	02	03	04
Benchmark	**Budget**	**Invest**	**Monitor**
Translate investor outcomes to asset allocation	Evaluate opportunities, risks and costs	Explore and select investment strategies	Measure success and rebalance with discipline

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Optimising your bond portfolio

In our new regime investors need to be more thoughtful and disciplined in constructing an optimised bond allocation to best balance risk and reward.

01 Understand client goals

Benchmark

The first step to building any portfolio is to understand a client's objectives, preferences, and risk tolerance, as these considerations should fundamentally shape overall asset allocation and subsequent investment exposures. The BlackRock Fixed Income Pyramid provides a useful first point of reference for this conversation and captures the three ways fixed income can operate to complement a broader portfolio.

Develop an understanding of the client's overall appetite for growth, income generation or capital preservation. Keeping in mind the bond paradox, consider their preference for yield, their liquidity needs and risk tolerance, to determine how bond allocation can be tailored to the whole portfolio.

Also identify any investment preferences the client may have, including the ideal domestic and global allocation mix, foreign exchange hedging to manage volatility, ESG preferences or any desire to seek targeted exposures to certain sectors.

02 Optimise your bond mix

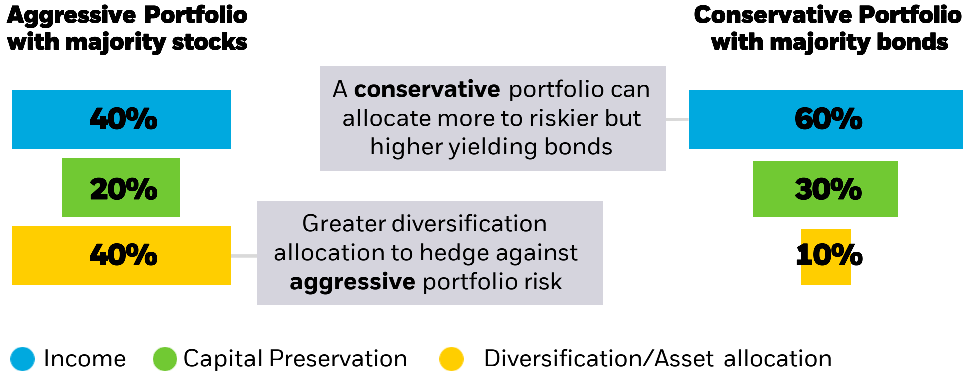
Budget

When managing bonds, optimise your bond mix based on your larger asset allocation. The more aggressive the overall portfolio, the more conservative the bonds may need to be.

This might be counterintuitive, but the "bond paradox" is such that as your overall portfolio gets riskier, the bonds within it should be more conservative. Aggressive portfolios typically need duration and high credit quality to deliver equity diversification.

Figures 4A and 4B demonstrate how an income-driven and a growth-oriented bond portfolio will incorporate different blends of fixed income strategies, depending on the overall portfolio. An aggressive portfolio will benefit from blending in a larger mix of diversification and capital preservation strategies to reduce overall risk exposure than that of a more conservative investor.

FIGURE 4A: A BOND PORTFOLIO DESIGNED TO GENERATE INCOME
Use BlackRock's Fixed Income Pyramid to build a bond allocation that is based on your overall portfolio and tailored to your client's needs.



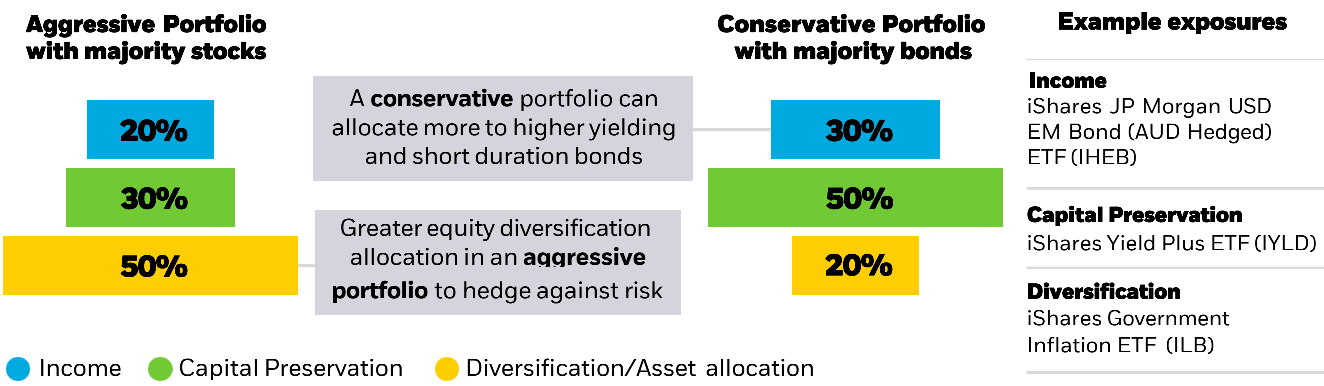
Example exposures

Income
iShares Global High Yield Bond (AUD Hedged) ETF (IHHY)

Capital Preservation
iShares Enhanced Cash ETF (ISEC)

Diversification
iShares Core Composite Bond ETF (IAF)

FIGURE 4B: A BOND PORTFOLIO DESIGNED TO PROTECT WHEN STOCKS SELL-OFF



03 Choose your exposures

Invest

In this step, choose fixed income exposures to build a portfolio that meets client goals by **balancing interest rate risk (duration) and credit risk**. The iShares fixed income ETF range offers you options across the three distinct roles of bonds to optimise your bond mix (Figure 5).

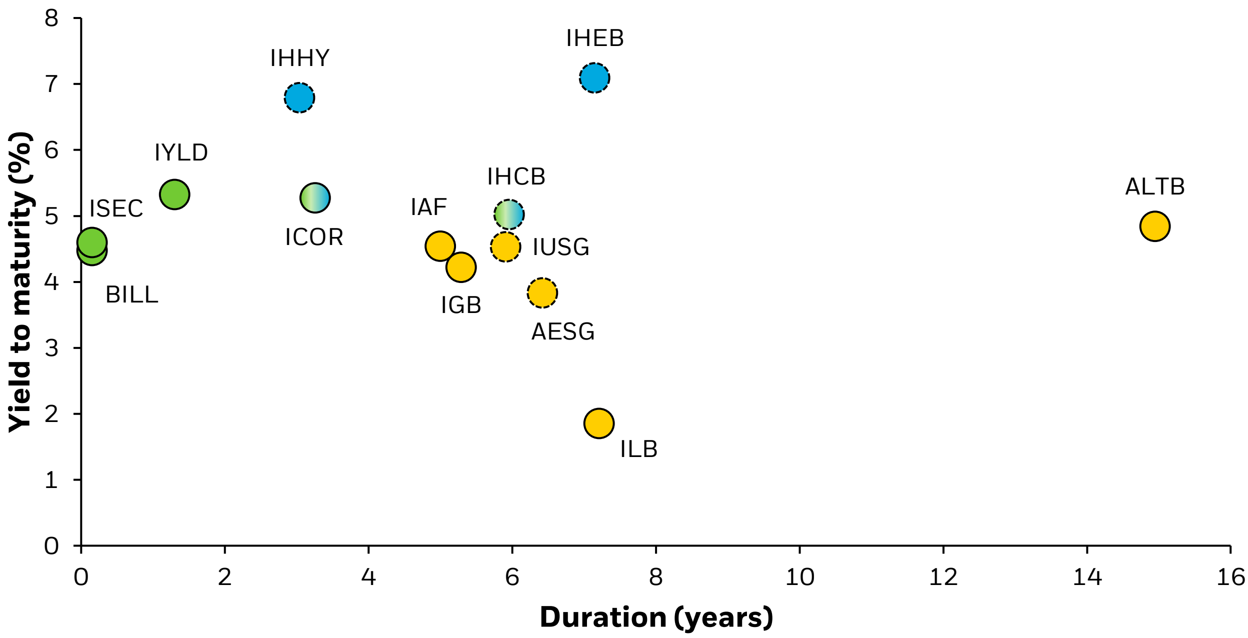
Consideration around manager selection becomes very important at this stage – when selecting ETFs, you look for managers who can deliver the index return closely and are cost effective; when selecting active managers, you look for those who have a robust and thorough quantitative and qualitative selection investment process.

04 Staying nimble

Monitor

In a new regime characterised by uncertainty and volatility, adopting a more nimble and dynamic approach to portfolio construction is key for maximising returns and managing risk going forth. Investors should be prepared to more frequently and quickly adopt strategic tilts in response to changing market expectations.

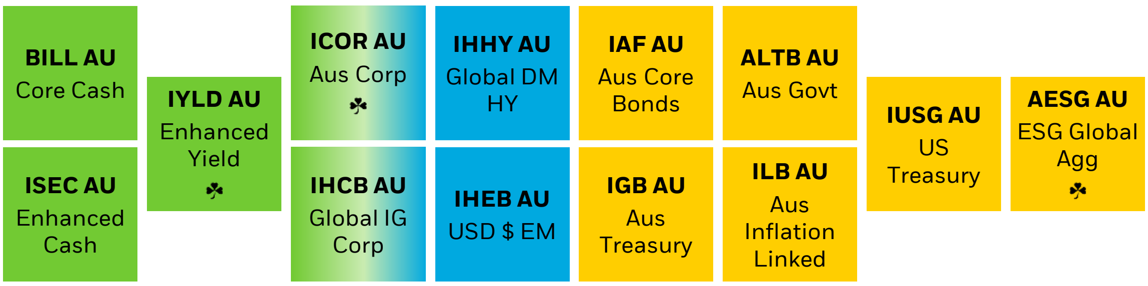
FIGURE 5: SELECTED iSHARES FIXED INCOME FOR AUSTRALIAN INVESTORS



Try to earn a little more from your cash with short duration bond ETFs.

Seek a higher level of income with corporate bonds, high yield bonds or emerging market debt.

Broad market bond ETFs can offer low correlation relative to stocks, which can help reduce overall risk in a portfolio.



Source: BlackRock, as of 30 June 2024.

✤ denotes Screened/Sustainable offering. Mentioning of iShares Fund does not construe as any investment advices or recommendations. Please refer to the iShares Fund prospectus for more details, including the risk disclosure.

This information is for illustration purposes only. It should not be relied upon by the reader as investment advice or recommendation regarding the iShares funds. This includes ASX-listed bond ETFs only.

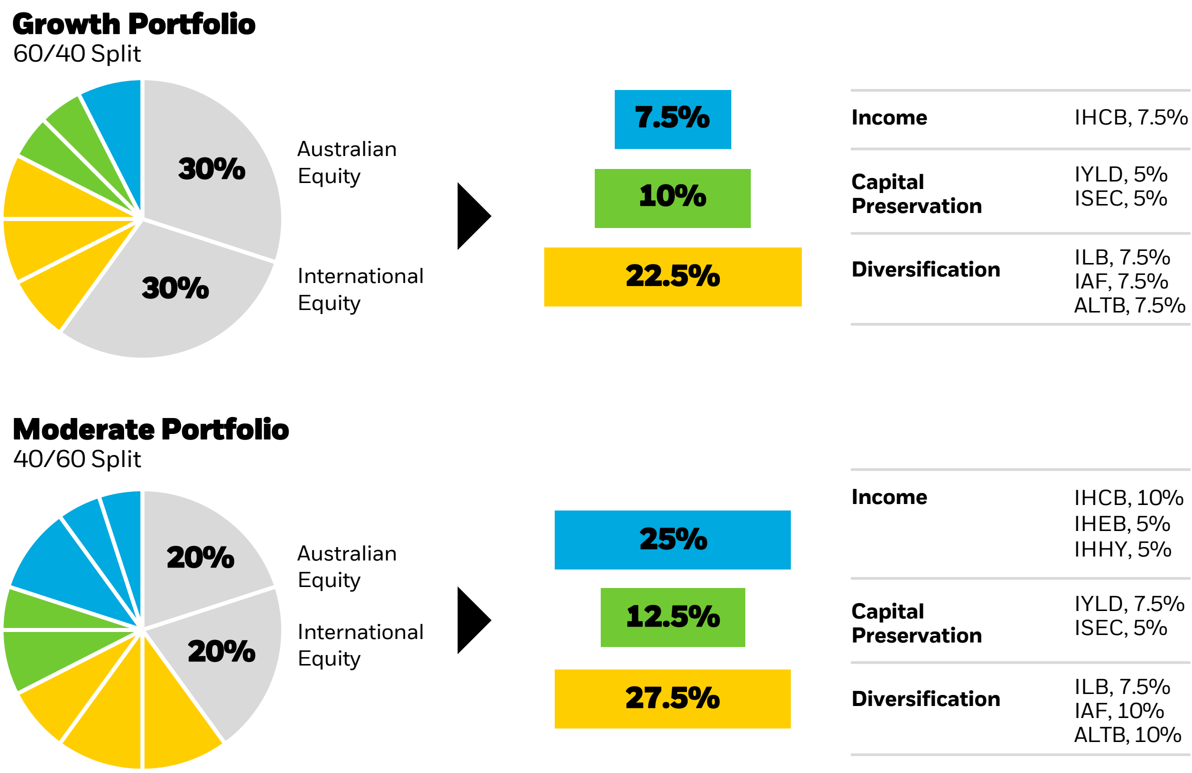
Practical examples

Historically most investors building portfolios made binary choices between an index-tracking strategy and an actively managed one. Those favouring active management often chose a few of the “best” managers to represent their fixed income allocations. One drawback of this approach is that multiple actively managed strategies may pursue objectives that are in opposition to one another, which can effectively cancel out high-conviction views at the portfolio level.

01 | Building a bond portfolio with ETFs

Consider the two portfolios below in Figure 6. The Growth Portfolio, with a 60/40 equity to bond split incorporates a more conservative bond sleeve to balance out its greater allocation to equities, while the Moderate Portfolio incorporates riskier income focused bonds to balance out its more conservative 40/60 equity to bond split.

FIGURE 6: ASSET ALLOCATION OF EXAMPLE PORTFOLIOS



Differentiation within fixed income can make a big difference in outcome.

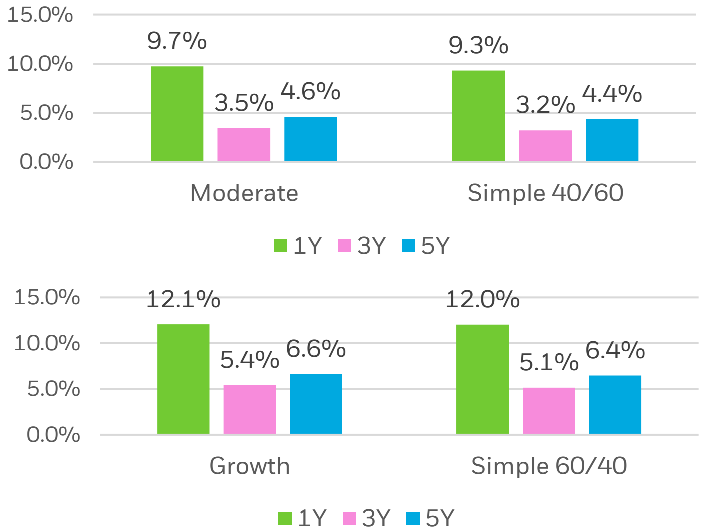
Figure 7 demonstrates that granularity in fixed income exposure can potentially add sources of return, compared with a simple portfolio represented by broad exposures in domestic and international equities and bonds.

In the Moderate Portfolio, when bond allocations are higher, the differentiation is more pronounced.

Utilising the Bond Pyramid approach allows for returns to potentially be enhanced whilst managing overall portfolio risk.

FIGURE 7: HISTORICAL PORTFOLIO PERFORMANCE

June 2019 – June 2024



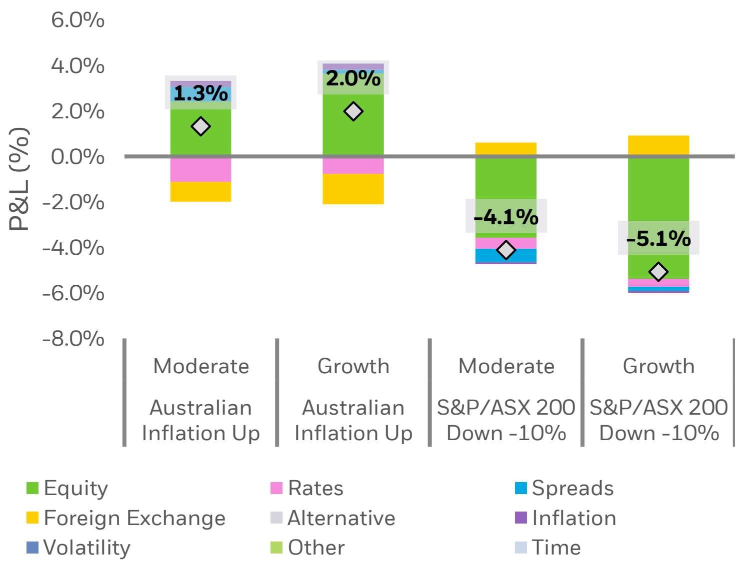
"Simple 60/40" constructed with 30% IOZ, 30% IWLD and 40% IAF. "Simple 40/60" constructed with 20% IOZ, 20% IWLD, 50% IAF and 10% BILL. Data presented is hypothetical, subject to change and not representative of any funds or investments. Sample portfolios are for illustrative purposes only, and do not represent a recommendation of any security or asset allocation strategy. This analysis serves as a general summary, which is not exhaustive and should not be construed as investment advice. There is no guarantee that stress testing will eliminate the risk of investing in this fund or strategy.

From a risk perspective, the riskier, income-driven bonds within the Moderate Portfolio diversify income sources, at the expense of higher spread exposures.

Recalling the Bond Paradox, riskier bonds can provide diversification when the overall risk profile of the multi asset portfolio is lower.

The granular exposures used within the portfolios allow for risk to be spread over a more diverse set of risk factors, helping the portfolios in periods of stress markets (Figure 8).

FIGURE 8: STRESS TESTING



Source: BlackRock, Aladdin ®. Data as at 30/06/2024. Analysis conducted using 72 monthly observations with constant weighting.

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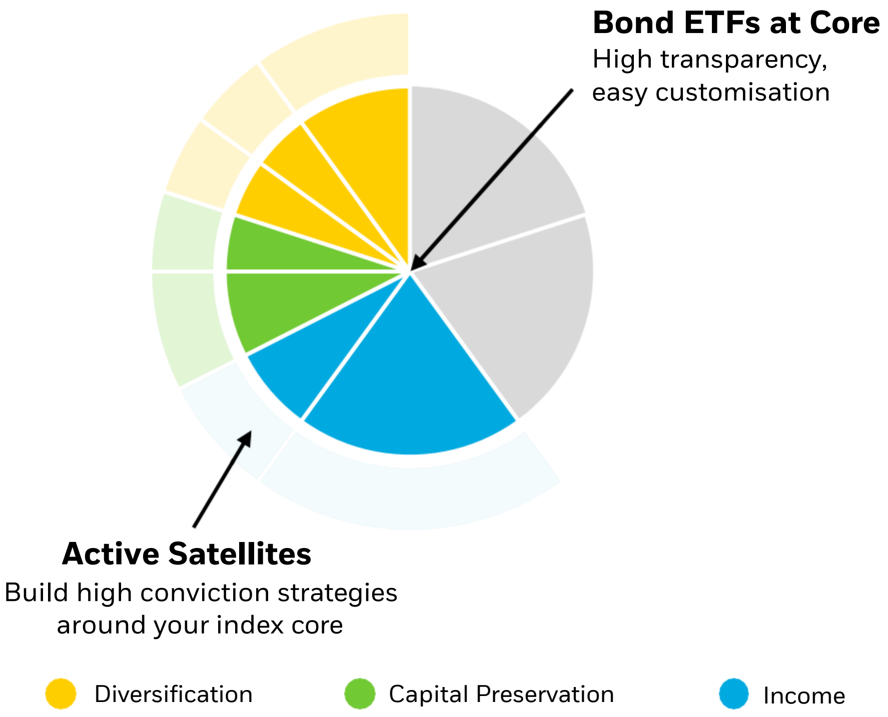
Blending your core with active satellites

Every investment decision is an active one – the question of how we blend index with alpha-seeking exposures is a question of risk tolerance, return/income requirement, cost and the portfolio constructor's ability/resource to be able to select and monitor strategies.

To supplement the ETF portfolios built, an active sleeve of higher conviction and further diversifying exposures can be added as satellites. Indeed the most common implementation of this method is to build an ETF portfolio first aligned with the overall asset allocation, and "spending" risk and cost budget until a final portfolio is reached. The result is a portfolio which potentially benefits from the best of both active and index exposures.

FIGURE 9: IMPLEMENT BONDS VIA A CORE-SATELLITE APPROACH

Blending index-tracking bond ETFs with actively managed strategies can help investors calibrate portfolio objectives such as income, capital preservation, or equity risk diversification.



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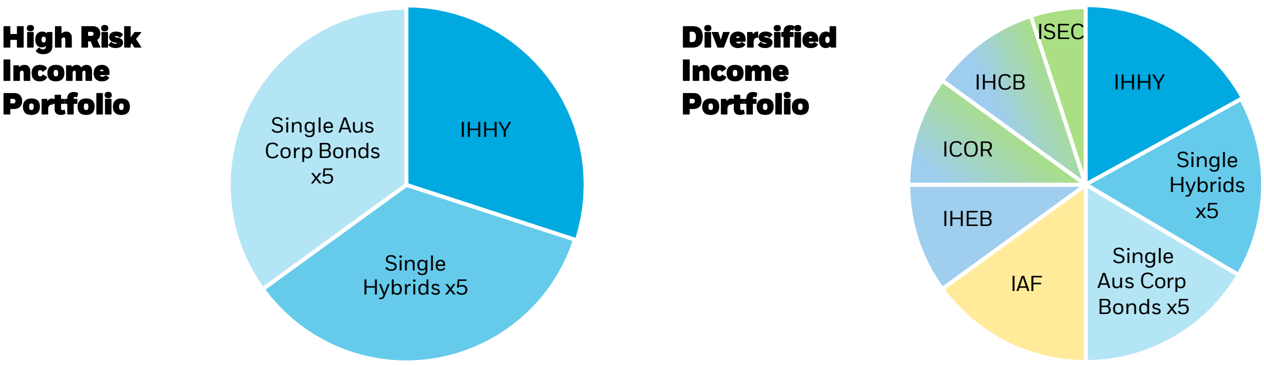
02 | Diversifying income portfolios with ETFs

Higher yielding bonds in segments such as high yield (with credit ratings below BBB), single corporate bonds and hybrids, are now seemingly more attractive. However, an income-focused portfolio should not simply invest in high income securities. These alone concentrates risk on idiosyncratic companies and their creditworthiness. Hybrids also carry higher equity risk, exhibiting more price volatility when markets move.

Yield is important, but it's important to measure income vs risk. The approach set out in the Fixed Income Pyramid – building an income portfolio with diversification and capital protection exposures, manages risk more effectively.

Figure 10 compares two portfolios: (1) An income portfolio invested purely in higher risk income exposures; and (2) A diversified income portfolio holding broad bond exposures, Corporates and EM Debt in addition to blending in diversification and cash preserving bonds too.

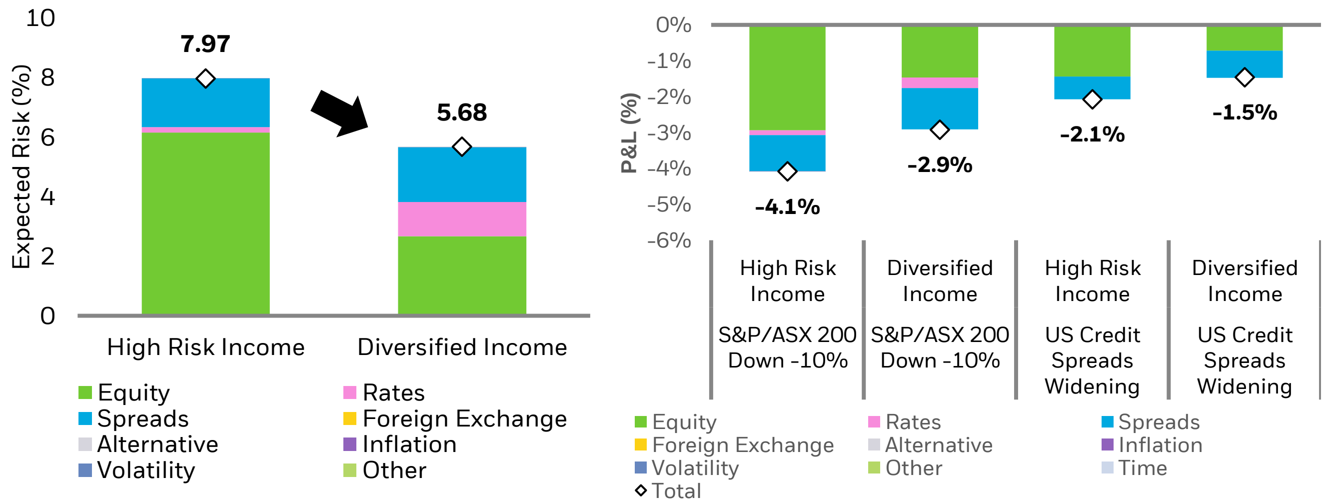
FIGURE 10: ASSET ALLOCATION INCOME PORTFOLIOS



By integrating broad and targeted bond ETFs, overall expected risk is markedly reduced by over 2%, risk contribution is more evenly diversified across various risk factors. With equity risk contributing less to overall portfolio risk, the Diversified Income Portfolio is also better protected during the widening of credit spreads and equity sell-offs (Figure 11).

'High Risk Income Portfolio' constructed with 33% Single Australian Corporate Bonds, 33% Single Hybrids and 33% IHHY. 'Diversified Income Portfolio' constructed using 16.5% Single Australian Corporate Bonds, 16.5% Single Hybrids, 17% IHHY, 15% IAF, 10% ICOR, 10% IHEB, 10% IHCB and 5% ISEC.

FIGURE 11: RISK CONTRIBUTION & STRESS TESTING



Source: BlackRock, Aladdin ®. Data as at 30/06/2024. Analysis conducted using 72 monthly observations with constant weighting.

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Conclusion: Bonds are back

As market and macro volatility persists and inflation continues to create uncertainty in the global economy, it's clear that portfolios will need to be managed more dynamically to account for the future market shocks we expect to see. A set and forget simple asset allocation could be replaced by more granular and nimble portfolios.

We have shown in this paper that bond ETFs can be used to:

- **optimise your overall multi-asset portfolio when considering the bond paradox**
- **blend index and active strategies to achieve precise outcome**
- **enhance income portfolios through diversifying risks while maintaining similar yield level**

Throughout the market turbulence we've faced in the past three years, bond ETFs shine as an efficient vehicle to construct portfolios. With yields back at levels not seen for a decade, ***now* is the time to rethink your fixed income in client portfolios.**

Why iShares for bond ETFs?

Expertise

iShares pioneered the first fixed income ETF in 2002 and is the world's largest fixed income ETF provider[1]

Wide range of solutions

With the world's largest range of fixed income ETFs[2], iShares offers solutions to maximise portfolio potential

Competitive performance

iShares ETFs perform as designed and have delivered strong market performance, even in times of volatility

Quality at a low cost

iShares ETFs are low cost and help you invest more of your clients' hard earned money

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1 BlackRock; BlackRock's global AUM across all fixed income ETPs was at US$895 billion as of 29 April 2024. All figures are represented in USD.

2 iShares Global Business Intelligence, as of 24 April 2024. iShares has fixed income ETFs listed in Australia, Canada, Germany, Hong Kong, Japan, Mexico, Singapore, Switzerland, United Kingdom and United States.

Want to know more?

Visit the BlackRock website or contact your BlackRock representative.

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PERFORMANCE DATA

Performance figures represent past performance and are not indicative of future performance. Current performance may be higher or lower than that shown. Net performance figures are calculated after fund management fees and expenses, and assume reinvestment of distributions. Gross performance figures are calculated gross of ongoing fees and expenses. Unless otherwise stated, performance for periods greater than one year is annualised and performance calculated to the last business day of the month.

IMPORTANT INFORMATION

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