A Dynamic Approach to Core Fixed Income Investing

By the Loomis Sayles Core Fixed Income Team:
Portfolio Managers Christopher Harms, Clifton Rowe and Kurt Wagner; Product Manager Gene Morrison

KEY TAKEAWAYS

- Core fixed income investing may be necessary for a diversified portfolio, but it's not necessarily simple.
- Replicating the benchmark does not result in peer-leading returns.
- We believe tactical sector allocation through beta adjustments and strong security selection are necessary ingredients for excess return.
- Our dynamic, active approach has resulted in a strong long-term track record.

With interest rates low globally and US rates poised to rise, interest in core fixed income is understandably tepid. But, we believe investment grade fixed income should always have a place in a diversified portfolio. The critical question is how to implement it.

Core strategies need to do more than just manage tracking error to a benchmark, typically the Barclays Aggregate Bond Index. Replicating a benchmark can come with some undesired tradeoffs. As of 3/31/2016, the Barclays Aggregate Bond Index posted below-median returns in the core fixed income manager universe for the 1-, 3-, 5- and 10-year periods.[i] These returns highlight the shortcomings of an autopilot approach to core fixed income investing. Importantly, many active core strategies can and have generated attractive relative returns for investors over a market cycle.

A Deceptively Complex Puzzle

The investment universe for core strategies is vast and comprised of US Treasurys, agencies, agency mortgages, investment grade corporate bonds, CMBS and ABS. The economic and fundamental drivers of these investment grade sectors are markedly different. Therefore, making impactful, well-timed use of these sectors can be a challenge, even for the savviest investor. As illustrated in the table on the next page, each sector of the universe uniquely contributes to a diversified portfolio. Within the Loomis Sayles Core Fixed Income strategy, we dynamically allocate among these sectors based on top-down views and populate them with our best bottom-up security ideas.

	SECTOR ATTRIBUTES	OUR VIEWS OF SECTOR ROLES AND IMPLEMENTATION
US TREASURYS	• Guaranteed by the US Government • Large, liquid market • High quality • Wide range of maturities	• Provide portfolio liquidity • Manage duration • Protect portfolio in risk-off environments
INVESTMENT GRADE CORPORATE BONDS	• Connected to corporate health and profits • Typically offers yield advantage over Treasurys • Diversified across industries • Varying maturities	• Tend to favor when spreads are attractive relative to Treasurys • Compare different issues along the curve to find the best valuation
AGENCY MBS	• High-quality securities guaranteed by US agencies (FNMA, FHMC and GNMA) • Large, liquid market • Typically offers yield advantage over Treasurys	• Provides additional yield potential without significantly increasing credit risk • Identify securities mispriced by the market on option-adjusted spreads • Exploit supply/demand imbalances in the TBA market • Invest in agency-backed instruments outside the Barclays MBS Index
CMBS	• Secured by US commercial real estate • Corporate-like attributes but more seniority • Offers yield pick-up and collateral support • Helps improve portfolio diversification • Limited shareholder-friendly activity	• Identify opportunities from proprietary loan models and careful analysis of structural features • Focus on high-quality CMBS in both conduit and single-property deals
ABS	• Linked to US consumer debt • Tends to be shorter duration and higher quality • Liquid market • Offers spread over Treasurys	• Identify specific parts of the capital structure that offer attractive prices after considering tranche variability • Identify ABS issuers with experience managing risk factors

The table reflects the current opinions of the authors as of 6/1/2016. Views are subject to change at any time without notice. Other industry analysts and investment personnel may have different views and assumptions.

Macro sector teams, composed of portfolio managers, traders and macro analysts, furnish top-down macroeconomic insights, which are important inputs into our portfolio allocation. Market sector teams leverage the firm's credit cycle framework, a model that analyzes changing credit conditions over time, to forecast sector returns, comprehensively assess risks and provide relative value recommendations. Using our sector team views as a baseline, we develop sector allocations across the core fixed income universe. To size these allocations, we primarily consider contribution to beta, a measure of risk and return potential.

Why Use Beta?

We believe beta is a more accurate way to measure our relative risk than simply relying on market value. Relative risk in beta terms may be different than market value weights because beta also incorporates duration, spread and historical volatility. In simplest terms, a beta greater than zero implies an overweight, while a beta of less than zero implies an underweight. Higher values also indicate greater relative risk exposure. For example, the two bonds in the table below are from the same industry, have identical portfolio market value weights and are represented in the benchmark. However, contribution to beta, both absolute and relative, differs materially due to unique duration and spread characteristics.

CONTRIBUTION TO BETA EXAMPLE

	BOND A	BOND B	BENCHMARK
SPREAD	25 bps	150 bps	50 bps
DURATION	2 years	10 years	4 years
DURATION TIMES SPREAD	50	1,500	200
BETA RELATIVE TO INDEX	0.3	7.5	1.0
MARKET VALUE WEIGHT	*Portfolio Position* 0.75%	*Portfolio Position* 0.75%	*Benchmark Position* 0.50% each
ABSOLUTE CONTRIBUTION TO BETA	0.19%	5.63%	Bond A: 0.13% Bond B: 3.75%
RELATIVE MARKET VALUE	+0.25%	+0.25%	
RELATIVE CONTRIBUTION TO BETA	0.06%	1.88%	

Source: Loomis Sayles. The information presented above is shown for illustrative purposes only as a sampling of beta model tool output. These scenarios have inherent limitations and rely on opinions, assumptions and mathematical models that can turn out to be incomplete or inaccurate. ***Past performance is no guarantee of future results****.*

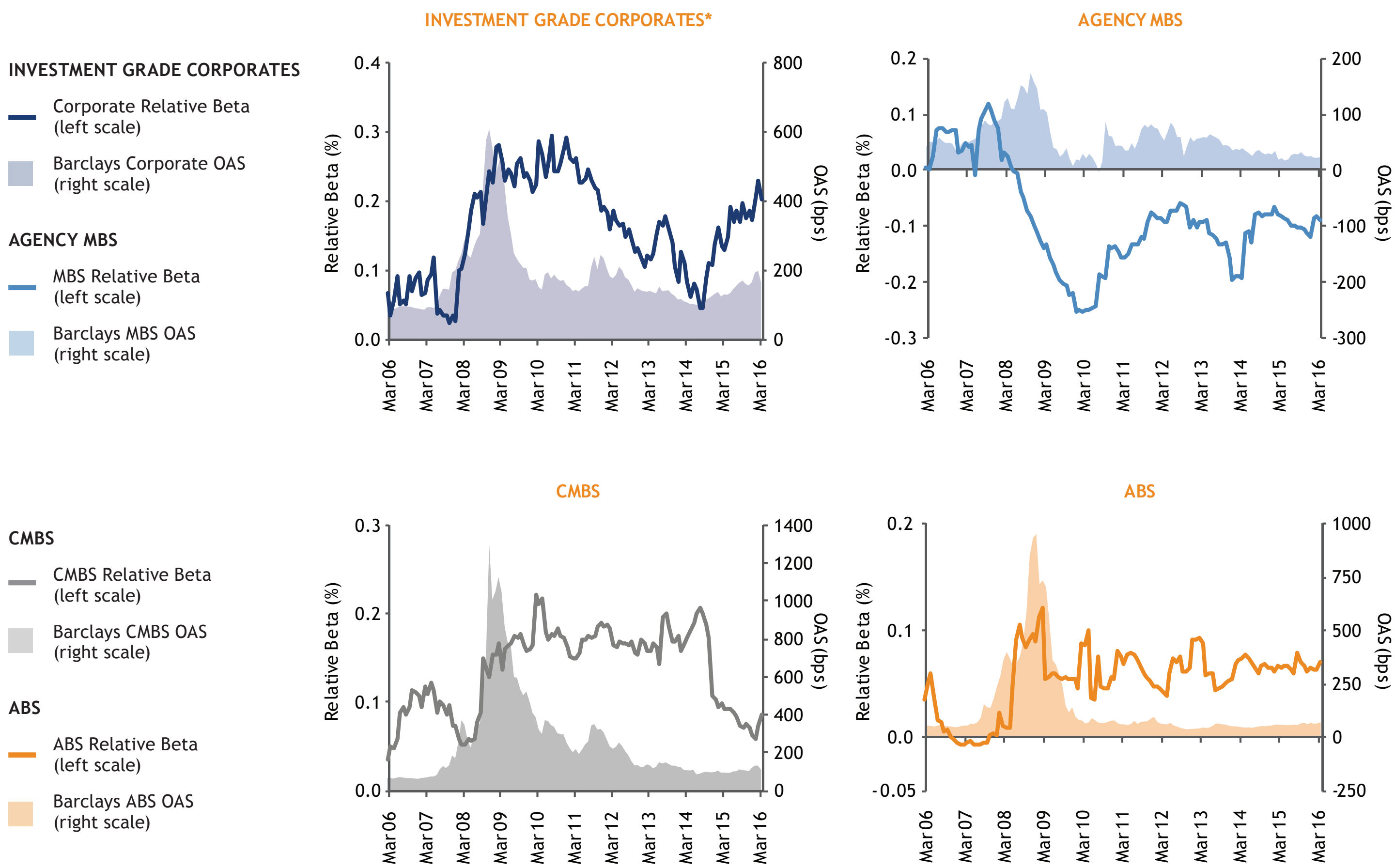
For us, contribution to beta is more than just a historical reflection of risk or volatility. It is a dynamic investment tool that we use to actively assess prospective relative risk at the security, sector and portfolio level. Our customized contribution-to-beta models guide us in determining optimal sector weights by considering valuations, spread levels and different market outcomes.

Our Active Approach to the Sector Allocation

We have dynamically shifted our beta exposures across sectors over time, as the charts on the next page illustrate. Specifically, contribution to beta for investment grade corporates was high from 2008 through 2010, when spreads were wide and valuations attractive. We gradually reduced investment grade corporate beta as spreads tightened, reaching historic lows in June 2014. Over the same period, we maintained our CMBS beta exposure in a tight range, even though CMBS spreads mirrored investment grade spreads. We believed the risk/return tradeoff for CMBS remained favorable; while their spreads were similar to corporate bonds, they maintained a higher average credit quality and exhibited significantly less event risk.

More recently, investment grade corporate spreads widened, valuations improved, and we increased our beta exposure. We have also continued to overweight ABS and modestly added back to CMBS after paring back commercial mortgages significantly last year. We are underweight agency MBS since we view the sector as relatively less attractive due to elevated prepayment risk. As you can see, sector betas are dynamic and change as the relative attractiveness of each market evolves over time. We believe this is a key aspect of our active approach that allows us to construct better portfolios.

REPRESENTATIVE ACCOUNT SECTOR CONTRIBUTION TO BETA



The corporate beta represents the corporate portion of the representative account as determined by Barclays Industry level one.

Source: Loomis Sayles from 3/31/2006-3/31/2016. Beta characteristics are shown for a representative account as supplemental information for the most actively managed sectors typically utilized in this strategy. Beta measures the risk of each sector in the portfolio relative to the risk of that sector in the Barclays US Aggregate Index (recognized as an industry-wide representative index). A beta above zero means that the portfolio has greater risk in that sector than in the Barclays US Aggregate Index. Due to system limitations, it is difficult to analyze this data on a composite basis. This representative account was selected because it closely reflects the Loomis Sayles Core Fixed Income investment strategy. Due to guideline restrictions and other factors, there is some dispersion between the returns of this account and other accounts managed in the Core Fixed Income investment style.

Indexes are unmanaged and do not incur fees. It is not possible to invest directly in an index.

Past performance is no guarantee of future results.

High-Conviction Security Selection

After determining sector allocation, we populate portfolios with our best ideas sourced from deep fundamental research. In partnership with Loomis Sayles' credit and securitized research analysts, we identify what we think are attractive securities and determine appropriate position sizes based on issuer contribution to beta, relative valuation and liquidity. Importantly, fixed income markets have become less liquid but more transparent; an evolution that we believe validates our focus on strong credit research as a key driver of security selection.

As has been widely reported, Wall Street banks' proprietary trading desk activity has declined due to new regulations while corporate issuance has continued at a robust clip. As a result, bond markets have become less liquid with higher levels of outstanding debt. For money managers like Loomis Sayles, this creates opportunities. We focus on leveraging our deep fundamental credit research to opportunistically identify and purchase fundamentally strong securities at better valuations, exploiting dislocations from lower liquidity.

At the same time, market information has increased with FINRA's Trade Reporting and Compliance Engine (TRACE). We are now able to analyze market data to assess what bonds are trading, how often and at what levels. Quantitative insight into market dynamics provides valuable information that informs portfolio construction and implementation.

Furthermore, we have continued to refine the quantitative tools that support our fundamental research. For example, our corporate relative value (CRV) model analyzes an issuer's curve to identify mispriced securities. When augmented by the depth of our credit research, we can initiate positions or swap into more favorably priced issues. Similarly, we track trends and nuances of prepayment patterns in securitized debt. We have built data warehouses to monitor prepayment speeds for different types of mortgage pools. Our securitized analysts also assess the fundamental asset and liability structures backing these bonds. We believe the depth and breadth of our credit and securitized research, combined with the recent evolution of fixed income markets, provides us a competitive advantage in security selection.

OUR APPROACH TO AGENCY MBS

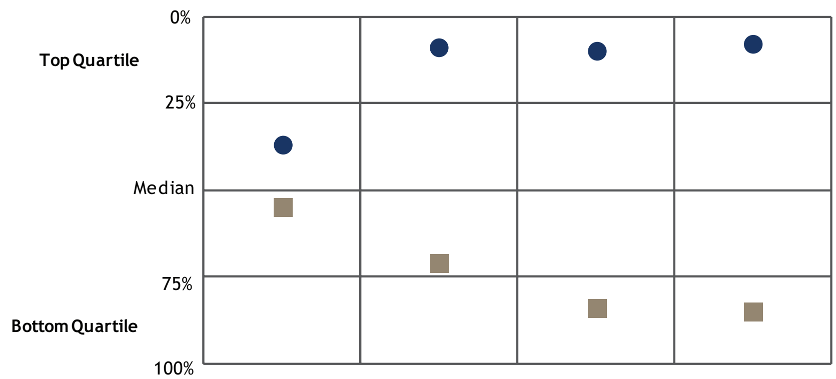
Agency MBS is known for market depth and liquidity. Historically, the sector has also offered higher yields versus Treasurys without significantly increasing credit risk. We look for agency MBS sectors that have a prepayment risk premium but exhibit lower prepayment patterns. The commercial mortgage-backed segment, for example, typically has very stringent prepayment penalties that make it onerous and costly for the underlying loans to refinance. Agency CMBS often offers a higher yield than single-family MBS. Higher return for less risk may seem contradictory, but we find it prevalent in many sub-sectors of the MBS market.

Benefits of an Integrated Approach

Some investors fear a core fixed income allocation will relegate them to interest rate risk, macroeconomic headwinds and lackluster returns. If investors sit statically in an asset allocation, this may be the case. Active core fixed income investing requires more than assembling a portfolio from disaggregated pieces of the Barclays Aggregate Bond Index. We believe it requires an integrated approach driven by top-down sector insights and deep fundamental security research. As evidenced by our strong long-term track record below, our dynamic investment process of tactical sector allocation and strong security selection has been successful when measured against the benchmark and a majority of our peers.

CORE FIXED INCOME COMPOSITE AS OF 3/31/2016

Trailing Returns & Ranking vs. Index



	1 Year	3 Years	5 Years	10 Years
● Core Fixed Income (Gross of Fees)	2.22	3.39	4.90	6.11
% Ranking	**37th**	**9th**	**10th**	**8th**
Core Fixed Income (Net of Fees)	2.00	3.18	4.68	5.86
■ Barclays US Aggregate Index	1.96	2.50	3.78	4.90
% Ranking	**55th**	**71st**	**84th**	**85th**
Median	**2.05**	**2.72**	**4.20**	**5.35**
Observations	**233**	**228**	**224**	**202**

Source: eASE Analytics System; eVestment Alliance is the ranking agency. Universe: eA US Core Fixed Income. Annualized performance is calculated as the geometric mean of the product's returns with respect to one year. Returns for multi-year periods are annualized. Gross returns are net of trading costs. Net returns are gross returns less effective management fees. Median is the middle value for the observations as of the end of each period shown. Although we believe it is reliable, we cannot guarantee the accuracy of data from a third party source.

Past performance is no guarantee of future results.

RECIPIENT OF THE CORE FIXED INCOME CATEGORY AWARD AT THE INSTITUTIONAL INVESTOR 7TH ANNUAL US INVESTMENT MANAGEMENT AWARDS ON MAY 19, 2016.

Investment Manager Award Methodology

A short-list of top performing managers in each of the following strategies are identified by Institutional Investor magazine's editorial and research teams in consultation with eVestment's research team. Investment strategies are analyzed based on factors used by institutional investors in their own eVestment searches, including 1-, 3- and 5-year performance, Sharpe ratio, information ratio, standard deviation and upside market capture.

More than 1,000 leading US pension plans, foundations, endowments and other institutional investors are surveyed and asked to vote for up to three of the top performing managers in each strategy in which they invested during the past year.

Institutional Investor's editorial team analyzes the results of the survey to determine the investment manager winners.

AUTHORS

CHRISTOPHER HARMS
VP, Portfolio Manager

CLIFTON ROWE, CFA
VP, Portfolio Manager

KURT WAGNER, CFA, CIC
VP, Portfolio Manager

GENE MORRISON, CFA
VP, Product Manager

Endnotes

[i] *eVestment Alliance as of 5/2/2016 based on 3/31/2016 data.*

About Risk

Investing involves risk, including risk of loss. Portfolios that invest in bonds can lose their value as interest rates rise, and an investor can lose principal. Investments in mortgage securities are subject to prepayment risk, which may limit the potential for gain during a declining interest rate environment and increase the potential for loss in a rising interest rate environment.

Disclosure

Diversification does not ensure a profit or guarantee against a loss.

Indexes are unmanaged and do not incur fees. It is not possible to invest directly in an index.

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This paper is provided for informational purposes only and should not be construed as investment advice. Opinions or forecasts contained herein reflect the subjective judgments and assumptions of the authors only and do not necessarily reflect the views of Loomis, Sayles & Company, L.P. Investment recommendations may be inconsistent with these opinions. There is no assurance that developments will transpire as forecasted, and actual results will be different. Data and analysis does not represent the actual or expected future performance of any investment product. We believe the information, including that obtained from outside sources, to be correct, but we cannot guarantee its accuracy. The information is subject to change at any time without notice.

MALR015244