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MANAGER INSIGHT

Strategic Alpha: A Case for Nontraditional Absolute Return Fixed Income

By the Loomis Sayles Strategic Alpha Team

KEY TAKEAWAYS

- Flexible investment constraints and active risk management can help nontraditional absolute return strategies pursue uncorrelated returns throughout market cycles.
- Nontraditional absolute return fixed income builds upon traditional and long-only opportunistic fixed income strategies by emphasizing stability and downside protection.
- Loomis Sayles Strategic Alpha is a benchmark-agnostic core bond alternative, offering the potential for greater diversity and risk mitigation.

A Brave New World

In many respects, we are witnessing a brave new world of fixed income investing. Fixed income product offerings have evolved considerably in recent years as investors demand increasingly sophisticated solutions for challenging market conditions. Heightened concerns about interest rates and credit risk, as well as the search for downside protection and uncorrelated returns, are among the factors driving investors' interest in nontraditional fixed income.

Loomis Sayles is a longtime leader in nontraditional fixed income and has been managing strategies untethered to benchmarks for decades. As a complement to our multisector offerings, which can pursue opportunities globally, we developed Strategic Alpha—a nontraditional absolute-return-oriented fixed income strategy. How best can a strategy such as Strategic Alpha be applied in a portfolio context?

We believe Strategic Alpha can effectively serve as an alternative to traditional "core" allocations. For investors who are reconsidering the traditional fixed income mission, Strategic Alpha can provide a new anchor. The strategy looks to maintain volatility targets historically associated with core products, while also seeking attractive diversified returns and managed drawdown. For investors who choose to stay with core fixed income as a portfolio anchor, Strategic Alpha can act as a complement that broadens the base of investments.

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What is Nontraditional Absolute Return Fixed Income?

Nontraditional absolute return fixed income strategies are varied and do not fit neatly into a box. In seeking to define this category, below, we compare common characteristics of nontraditional absolute return approaches with those of other well-established, widely used fixed income strategies. Each approach can play a role within a broadly diversified portfolio. The key for investors is to find a strategy that provides a risk/return profile in line with their specific objectives.

STRATEGY		CORE FIXED INCOME	MULTISECTOR	NONTRADITIONAL ABSOLUTE RETURN
OBJECTIVE		Excess Return Through the Cycle	Total Return	Uncorrelated, Positive Returns Through the Cycle
BENCHMARK AWARENESS		Relatively Tight Tracking Error	Wide Tracking Error	Benchmark Agnostic
RISK NEUTRAL POINT		Benchmark	Benchmark	Cash
SOURCES OF MARKET RISK	CURVE/TERM STRUCTURE RISK	Benchmark +/-	Long	Long/Short
	CREDIT/SPREAD RISK	Benchmark +/-	Long	Long/Short
	CURRENCY RISK	Zero to Modest Long	Zero to Long	Long/Short
HEDGING		Manage Risk versus Benchmark	Manage Risk versus Benchmark	Isolate Beta and Alpha Opportunities
RISK MANAGEMENT FOCUS		Tracking Error	Absolute Volatility	Absolute Volatility and Drawdown

This table is for illustrative purposes only and represents the investing universe in general. It does not represent any specific Loomis Sayles products.

Core Strategies: Traditional core fixed income products are designed to provide income, liquidity and ballast to a diversified investment portfolio. At the same time, they introduce interest rate risk because they are tethered to high-quality benchmarks. A low-yielding environment likely reduces the diversification benefits of a fixed income allocation, and the portfolio's sensitivity to rates can drag on return if US Treasury rates rise for a prolonged period. In such an environment, adding this liquidity and ballast could become expensive from an opportunity-cost perspective.

Multisector Strategies: Multisector strategies loosen the constraints of core fixed income considerably by affording managers the flexibility to look outside of the benchmark for exposures in an attempt to outperform a market-weighted index against which they are measured. This freedom to seek opportunities, often in the form of higher-yielding, lower-quality securities, may introduce additional credit and liquidity risk to the portfolio, while also potentially enhancing long-term returns and mitigating interest rate risk.

Nontraditional Absolute Return Strategies: Absolute return strategies also allow managers the flexibility to opportunistically venture away from benchmarks. These strategies typically emphasize the risk side of the risk-return relationship, seeking to actively mitigate downside and limit volatility. This approach generally allows for long/short investing and the use of derivatives to broaden the investment universe and add portfolio protection. The objective of most nontraditional absolute return approaches is to achieve high risk-adjusted returns, often within specifically defined volatility parameters.

The Tenets of Loomis Sayles Strategic Alpha

When creating our Strategic Alpha strategy, we started with a few basic tenets, which now drive the way we invest. Simply stated, we aim to define the big picture in order to consider the impact of the macroeconomy and its cyclical nature on the behavior of various sectors. Then we look to employ astute bottom-up security selection to populate those views. Finally, we focus on managing risk and protecting capital.

Getting the Big Calls Right

Harvesting and protecting risk premium from market cycles: We begin by looking at macroeconomic factors. These typically drive credit cycles, which in turn can drive asset class behavior. Broadly speaking, there are three key risk drivers, or betas, that can be harvested within fixed income. We refer to them as the "3Cs": **Curve**, **Credit** and **Currency** risk.

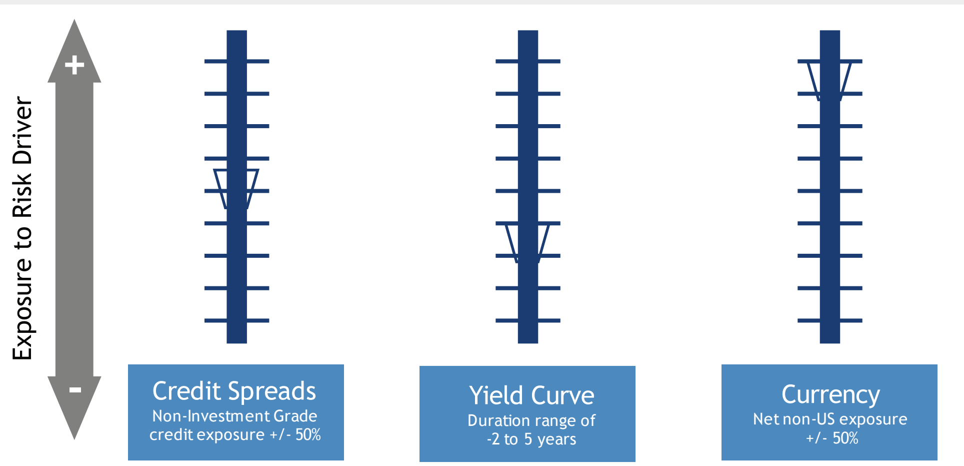
Curve risk, or the term structure premium, impacts returns for all bonds to one degree or another, but it is most relevant to US Treasurys and other high-quality bonds, which are more interest rate sensitive. Strategic Alpha has a duration range, a measure of general rate sensitivity, between negative two years and positive five years, providing essential flexibility in many market conditions. **Credit risk**, which is associated with credit spread volatility and default premiums, can dominate returns for corporate and sovereign debt. These measures increase as one moves down the quality spectrum. **Currency risk** is a prominent risk factor when investing globally.

By properly identifying and analyzing the different phases of the credit cycle (credit repair, recovery, expansion/late cycle, downturn), Strategic Alpha seeks to profit from tactically adjusting exposures to these risk drivers throughout each phase. Comparing the anticipated upside return potential against the downside risk helps assess whether an exposure is justified. We believe this approach is better equipped to produce a more stable risk/return payoff throughout various market and credit cycles than one that remains constantly long beta.

FLEXIBILITY TO DYNAMICALLY ADJUST PORTFOLIO RISK DRIVERS ALLOWS THE STRATEGY TO POTENTIALLY BENEFIT IN ANY MARKET ENVIRONMENT

This hypothetical example is being shown for illustrative purposes only. While the strategy seeks to actively manage risk, investing still carries the risk of loss and no investment portfolio is without some risks.

GLOBAL PORTFOLIO RISK DRIVERS



Diversification: The unconstrained nature of Strategic Alpha enables us to cast a wide net for opportunities. Strategic Alpha has the flexibility to utilize and dynamically adjust each of the 3Cs in an effort to produce a well-diversified portfolio with a desired risk/return profile. Through the use of proprietary analytics, we attempt to estimate performance under various potential market conditions and adjust exposures and risk levels accordingly. This can be done by employing tools such as credit default swaps, interest rate futures, currency forwards and other derivatives.

Seeking non-correlated returns: We believe a benchmark-agnostic strategy that combines top-down and bottom-up disciplines can produce returns from a variety of investments that have historically low correlation to traditional fixed income and equity allocations.

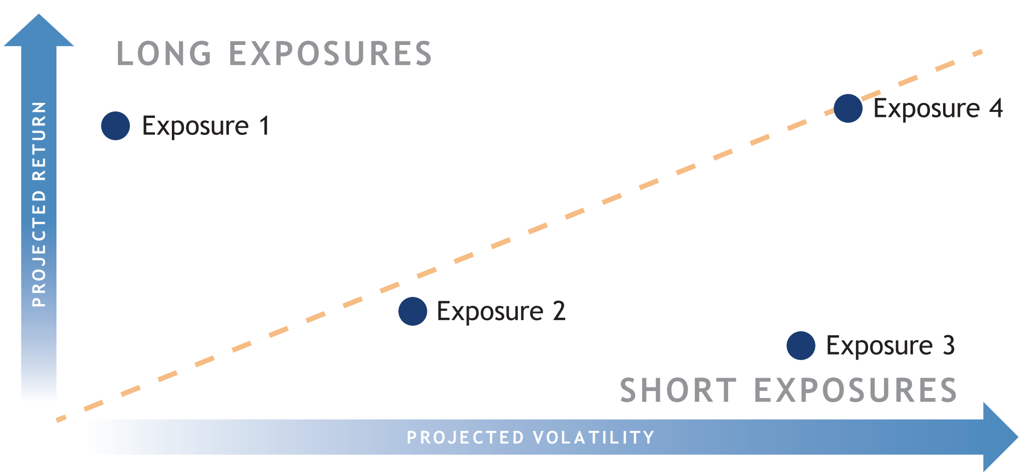
Populating the Portfolio Through Strong Security Selection (Alpha vs. Beta)

The Importance of Security Selection: We believe fixed income markets are inefficient. Therefore, alpha can be obtained through security selection built on robust fundamental analysis and a proprietary research framework that focuses on intrinsic value (e.g., enterprise value) and margin of safety. Strategic Alpha taps into Loomis Sayles' deep research capabilities and insight from sector teams (made up of analysts, portfolio managers, strategists and traders) as it seeks to identify attractive long or short alpha opportunities. Unwanted beta risk can be hedged as needed to better isolate the alpha source that is being targeted.

WE SYSTEMATICALLY WEIGH PROJECTED UPSIDE AGAINST PROJECTED DOWNSIDE FOR EACH PORTFOLIO EXPOSURE AND THEN ALLOCATE CAPITAL TO OPPORTUNITIES WE BELIEVE OFFER THE HIGHEST RISK-ADJUSTED RETURN.

This hypothetical example is being shown for illustrative purposes only.

MEASURING UPSIDE VS. DOWNSIDE RISK HELPS DETERMINE CAPITAL ALLOCATION



Focusing on Risk

Truncate the drawdown: The mitigation of drawdown risk, in our view, should be a key component of any product designed to be an alternative to traditional core fixed income. Strategic Alpha has a stated risk tolerance of 4% to 6%[i] measured by standard deviation over a full market cycle. This target expectation is comparable to the historical volatility exhibited by most core and core plus strategies.[ii] Managing to a stated volatility threshold drives many other investment decisions and demonstrates our focus on managing potential downside risk.

Additionally, top-down and bottom-up investment ideas are judged in part on the expected return being at least equal to or greater than the perceived drawdown. Because of the flexibility inherent in a nontraditional fixed income approach, we actively manage the risks in our portfolio. Frequent stress testing of the portfolio is invaluable in estimating drawdown potential and in subsequently making active adjustments to maintain the desired level of risk. We believe this active process is especially important during periods of rising rates, when interest rate exposure may not provide the same portfolio benefits as it does when rates are falling.

Managing Beta: We believe proper beta management requires a disciplined hedging strategy coupled with the use of sophisticated quantitative tools that can accurately measure top-down risks that originate from the 3Cs. This is done both in isolation and on an aggregate basis, taking into account how the different beta risks interact together. Working with our Quantitative Research & Risk Analysis group, the Strategic Alpha team has developed hedging strategies using liquid interest rate, credit and currency derivatives that can quickly and efficiently adjust the expected level of risk, stemming from each of the 3Cs. These capabilities are designed to provide Strategic Alpha with a tactical advantage relative to most long-only, benchmark-aware strategies, given liquidity constraints in the cash markets.

Broadening the Anchor

We believe nontraditional absolute-return-oriented strategies may serve as an effective replacement for, or complement to, traditional core fixed income strategies, introducing similar return and volatility targets while broadening the investable universe. By using derivatives to actively manage portfolio risks and harvest premium, these strategies have the ability to provide the diversification and downside protection that other strategies may not.

What constitutes the optimal nontraditional fixed income exposure? Plan sponsors and other investors should consider, among other factors, their risk and return profile, income needs and desired liquidity when evaluating absolute-return-oriented strategies. Loomis Sayles has been managing unconstrained multisector strategies with long-term total return objectives for decades, and we are seen by many institutional investors as leaders in this space. The Strategic Alpha strategy builds on these capabilities by leveraging the same deep, diverse research and risk management resources. We believe incorporating an absolute-return-oriented strategy of this nature into a diversified portfolio can prove increasingly valuable as the market environment changes.

This report was originally published in October 2014. We have updated the content as necessary and otherwise believe the information is current and relevant.

AUTHORS

MATT EAGAN, CFA
Portfolio Manager
VP, Loomis Sayles & Company

KEVIN KEARNS
Portfolio Manager
VP, Loomis Sayles & Company

TODD VANDAM, CFA
Portfolio Manager
VP, Loomis Sayles & Company

ROGER ACKERMAN
Product Manager
VP, Loomis Sayles & Company

Endnotes

[i] *Although the investment manager actively seeks a targeted risk level, there is no guarantee the strategy will be able to maintain its targeted risk level.*

[ii] *Since-inception standard deviation of the Bloomberg Barclays US Aggregate Bond Index, a proxy for the investment universe, is 5.38%. (Data from January 1976 to December 2016; source: eASE Analytics System, eVestment Alliance.)*

Disclosure

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