# COMPLEMENTING THE CORE: INTRODUCTION TO FLEXIBLE INCOME

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## HIGHLIGHTS

- The Fort Washington Flexible Income Strategy is a multi-sector fixed income strategy designed to provide investors with a high level of current income and capital protection with differentiated returns compared to traditional fixed income.
- The strategy is differentiated in the market due to its premium yield, high conviction security selection, diversified approach to sector allocation, unique view of duration management, and high quality bias.
- Flexible Income provides investors with an expanded investment opportunity set and increased flexibility compared to traditional Core and Core Plus strategies.
- Fort Washington's unique approach utilizes cause and effect relationships to assess relative value between asset classes and balances interest rate risk with credit risk. The strategy is implemented by an experienced team of 30+ investment professionals with proven track records overseeing +$40 billion in fixed income assets.[1]
- The current market environment supports an overweight to risk assets but with a strong emphasis on managing risks late in the cycle.

## WHAT IS THE FORT WASHINGTON FLEXIBLE INCOME STRATEGY?

The Flexible Income strategy is a multi-asset fixed income strategy that seeks to produce a high level of current income with capital protection through investing primarily in public and private fixed income, with a modest allocation to public equity. The strategy focuses on flexible sector diversification and high conviction security selection, resulting in attractive risk adjusted returns via multiple sources of yield and alpha.

[1] Assets as of 12/31/18, across multiple strategies.

## WHAT DIFFERENTIATES FLEXIBLE INCOME FROM OTHER MULTI-ASSET FIXED INCOME STRATEGIES?

**Premium Yield.** Flexible Income has a top quintile yield relative to its peers, and the yield is well above traditional fixed income strategies (typically 2% over the Bloomberg Barclays US Aggregate).[2]

**High Conviction Security Selection.** Bottom-up security selection in fixed income has proven to be a reliable source of alpha. Flexible Income is a portfolio of 75 – 150 securities, focusing on the best ideas of our investment teams.

**Sector Diversification.** Non-traditional fixed income strategies often have large concentrations in a single sector, such as high yield or preferred securities. Flexible Income is broadly diversified by sector, resulting in multiple sources of return.

**Duration Management.** Unconstrained fixed income strategies take large, and sometimes negative, duration positions. Flexible Income uses duration as a risk mitigation tool, and seeks to avoid taking large duration positions due to the difficulty in predicting interest rates.

**Quality Bias.** Flexible Income has a top quintile yield without taking excessive risks. The average credit quality of the holdings in the strategy is Investment Grade rated, while the average credit quality of most portfolios in the peer group is rated as High Yield.

## WHY INVEST IN THE STRATEGY TODAY?

**Flexibility.** Having the flexibility to react to market dislocations in a timely manner can be a benefit of non-traditional fixed income approaches such as Flexible Income.

**Enhanced Return.** Multi-Sector bond strategies have outperformed traditional strategies over the past 3, 5, 10, and 15 year periods[2] with only a moderate increase in risk.

**Higher Yield.** For investors looking for increased yield, Flexible Income, on average, is likely to provide a yield in excess of the Bloomberg Barclays US Aggregate by 2%,[3] higher than most traditional strategies.

**Expanded Opportunity Set.** Traditional strategies are largely invested in sectors and securities that are represented in common market indices. Flexible Income goes beyond common market indices into areas that may be less trafficked, providing more opportunities for alpha.

**Portfolio Diversification.** Traditional strategies are often invested in the major index sectors of Investment Grade Corporates, Securitized, and Government Securities. Flexible Income provides dedicated exposure to diversifying fixed income asset classes with low correlation to traditional fixed income strategies.

## WHAT IS THE INVESTMENT PROCESS?

| | |
|---|---|
| **1) Risk Appetite**<br>Determine how much risk to take | • Consider the current state of the economy and asset valuations<br>• Balance interest rate risk with credit risk (duration: typically 4 to 8 years)<br>• Measure risk through cause and effect relationships ("Recession Risk") |
| **2) Sector Allocation**<br>Identify optimal sector combinations | • Maximize yield and total return in concert with risk appetite<br>• Focus on estimates of risk and return, and uncertainty around those estimates<br>• Seek opportunities in niche markets (whole business ABS, private debt, etc.) |
| **3) Security Selection**<br>Perform fundamental analysis | • High conviction approach allows for alpha generation (approximately 75-150 issuers)<br>• Established sector track records of outperformance<br>• 30+ dedicated sector portfolio managers and analysts |

[2] Source: Morningstar Multisector Bond Universe and Intermediate-Term Bond Universe as of 1/31/2019
[3] Source: Bloomberg, Fort Washintgon

## HOW IS RELATIVE VALUE BETWEEN ASSET CLASSES ASSESSED?

The Fort Washington Flexible Income strategy takes a value investors approach to investing. This means the strategy focuses on measurement, not forecasting, and makes explicit measurements of risk and return. For each asset class, we make return estimates for two scenarios: growth shock, or recession, and normalized, or upside. Once these estimates of risk and return are made, it allows for an apples to apples comparison of the risk-adjusted attractiveness between different asset classes.

This forward looking approach based on cause and effect relationships is differentiated in the market place, where most investors use traditional relative value and risk metrics involving historical correlations and volatility.

## HOW IS INTEREST RATE DURATION MANAGED?

Rather than taking large duration positions within the strategy, we use interest rate duration as a valuable risk mitigation tool. Interest rates often fall when risk assets sell off, as investors flee to less risky assets such as Treasuries. By maintaining exposure to interest rate duration, the strategy has downside protection in volatile environments—a characteristic often desired when investing in fixed income.

## WHO MANAGES THE STRATEGY?

The Fort Washington Flexible Income strategy is managed by a deeply experienced team of 4 portfolio managers and over 30 sector portfolio managers and analysts. This same team, the multi-asset fixed income team, is also responsible for the management of the Fort Washington Core, Core Plus, and Intermediate Fixed Income strategies.

The portfolio management team consists of Tim Policinski, Dan Carter, Austin Kummer, and Brendan White, whom average 26 years of experience and 17 years with the firm. This team is responsible for the overall risk appetite, sector allocation, duration, and macro positioning.

The strategy utilizes sub-sector portfolio managers (Investment Grade Corporate, High Yield, Structured Products, Emerging Markets Debt, etc.) for the composition of the sub-allocations (i.e. bottom up positioning). These portfolio managers have discretion over their sub-portfolios subject to overall portfolio risk, sector constraints, duration risk and other targets set by the aforementioned portfolio management team (e.g. sector or duration may be constrained due to portfolio risk management).

The Flexible Income investment team manages over $40 billion in assets across a variety of fixed income strategies.

**$52.9B**
total managed assets*

**1990****
Registered Investment Advisor since

**10**
marketed strategies with track records of 10+ Years

**90**
investment professionals averaging 20+ Years of experience

**$40.3B**
fixed income assets

**$7.7B**
public equity

**$3.7B**
private equity

*Includes assets under management as of 12/31/18 by Fort Washington Investment Advisors, Inc. of $49.2 billion and $3.7 billion in commitments managed by Fort Washington Capital Partners Group, a division.
**Registration as an investment advisor does not imply any level of skill or training.

## HOW IS THE PORTFOLIO POSITIONED TODAY?

**Allocation.** The strategy added to its exposure within High Yield Corporates at the start of 2019 as we found valuations attractive and fundamentals healthy. An allocation to Treasury Inflation Protected Securities (TIPS) was also made after a sharp decline in inflation expectations, which we feel was largely overdone. The strategy has a 16% position in US Government securities that could be used as a source of cash if we see risk asset valuations become more attractive. Our largest sector exposure is in Investment Grade Credit (26%), where we feel the risk/reward is the most favorable amongst risk assets. Non-investment grade exposure is currently near 42%, which is well below the 50% target maximum, leaving capacity to increase risk if the opportunity presents itself.

**Selection.** Within investment grade credit, we have found value in the intermediate part of the curve with a preference for BBB's that are priced wide to the market with potential for outperformance from both carry and price appreciation. Our High Yield positioning is weighted towards shorter maturity bonds that have a yield premium to the market and a path to refinance. Within Securitized, our exposure is concentrated in whole business ABS opportunities where we believe risk is mispriced. Emerging Market Debt positioning is in US Dollar denominated debt, favoring corporate borrowers versus sovereign, and those where funding sources outside of the public markets have been secured over the near term. We continue to like Business Development Companies, which provides exposure to middle market loans with significant yield premiums to public markets.

**Rates.** We believe rates are fully valued and currently reflect the uncertainty surrounding the economic outlook, embracing growth deceleration and a less active FOMC. There is little downside for rates at these levels unless actual economic weakness materializes. Our current interest rate positioning is less a prediction on interest rates, but more used as a risk mitigation tool as we look to balance interest rate risk and credit risk. Absent a severe inflationary environment, moderate interest rate exposure provides important downside protection should risks materialize and risk assets underperform. The Flexible Income investment team manages over $40 billion in assets across a variety of fixed income strategies.

### Portfolio Characteristics (As of 03/31/19)

- Weighted Average Yield to Worst 5.0%
- Effective Duration 4.9
- Weighted Average Maturity 7.5
- Number of Securities 120

| Credit Quality (% of Fixed Income) | | Sector Allocation | |
|---|---|---|---|
| AAA | 21% | Investment Grade Corporate | 26% |
| AA | 0% | Non-Investment Grade Corporate | 22% |
| A | 4% | U.S. Treasuries | 6% |
| BBB | 39% | TIPS | 7% |
| BB | 17% | Securitized | 18% |
| B | 17% | Preferred Securities | 0% |
| CCC and Below | 3% | Emerging Markets Debt | 9% |
| N/A | 0% | Private Debt/BDCs | 8% |
| | | Public Equity | 2% |
| | | Cash | 3% |

Source: Fort Washington and POINT. Past performance is not indicative of future results. Portfolio characteristics subject to change at any time without notice. Supplemental information, see Flexible Income Composite presentation for full performance and disclosures.

Total strategy assets as of 03/31/19. Assets as of 12/31/18. Includes assets under management by Fort Washington of $49.2 billion and $3.7 billion in commitments managed by Fort Washington Capital Partners Group (FW Capital), a division.



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