



## NON-TRADITIONAL FIXED INCOME OPPORTUNITIES



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### HIGHLIGHTS

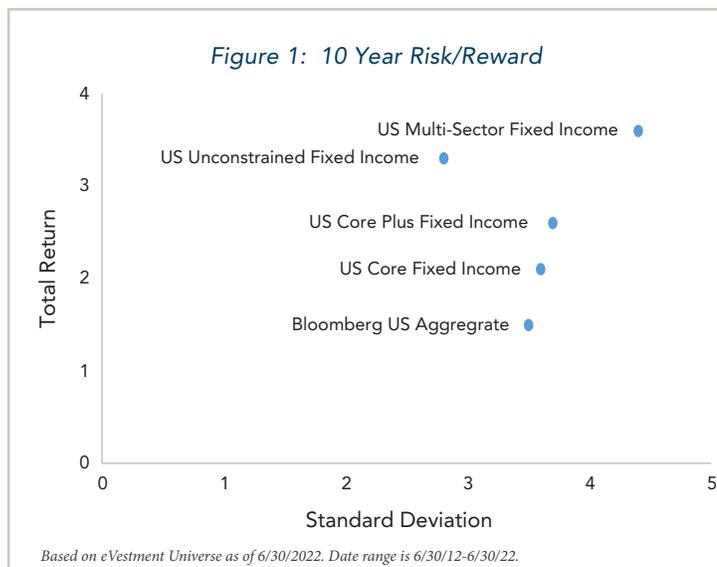
- ▶ Many investors, including Endowments & Foundations, Pension Plans, and Insurance Companies, are increasingly turning to non-traditional fixed income strategies as a way to complement their traditional Core and Core Plus portfolios.
- ▶ Non-traditional approaches, such as Multi-Sector and Unconstrained Fixed Income, may provide investors with enhanced returns, higher yield, portfolio diversification, flexibility, and exposure to unique asset classes.
- ▶ Investors must be prudent when allocating to the space and should understand the risks associated with the different non-traditional fixed income approaches.
- ▶ Unconstrained—or go anywhere funds—often take large interest rate bets and have a high degree of credit risk, which can produce unfavorable results in times of distress. Unconstrained funds are also wide ranging in scope, resulting in a high degree of uncertainty around their risk and return profile and what investors can expect over time.
- ▶ A well-managed Multi-Sector approach with a focus on risk management that balances interest rate risk with credit risk can be well suited for investors seeking to enhance risk adjusted returns and income over the long run.

### WHAT ARE THE COMMON MULTI-ASSET FIXED INCOME APPROACHES?

#### Traditional

**Core.** Core fixed income strategies are often managed against a common benchmark, such as the Bloomberg US Aggregate Index. The opportunity set is often constrained to index-only constituents, which includes a meaningful allocation to U.S. Government securities and excludes non-investment grade rated securities. Duration is typically managed close to the benchmark, resulting in moderate interest rate exposure that approximates the overall fixed income market. The result is a lower risk strategy that can provide modest outperformance vs. the Bloomberg US Aggregate Index (~0.50% to 0.75%).

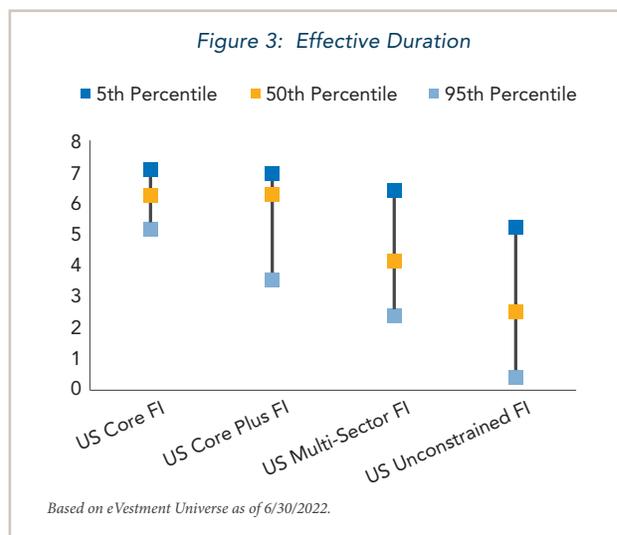
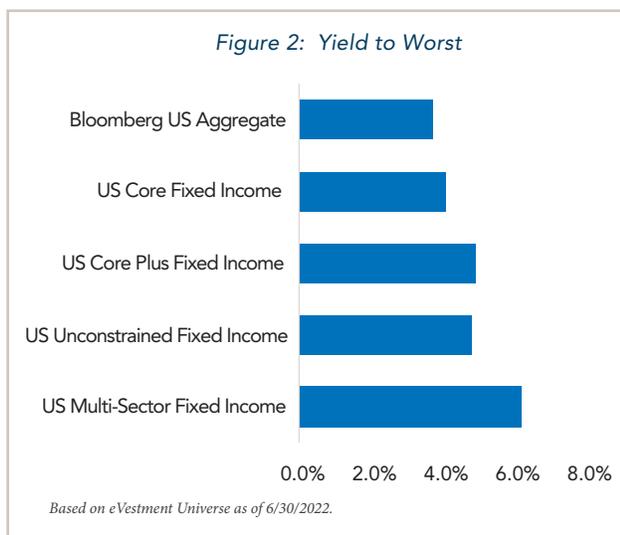
**Core Plus.** Core Plus strategies are similar to Core mandates but include “plus” sectors. Plus sectors are non-index sectors that are often non-investment grade rated, with most strategies allowing up to 40% to 50% of their portfolio in plus sectors. Such sectors include High Yield and Emerging Markets Debt. Additionally, Core Plus strategies often employ derivatives and modest leverage, and duration is managed close to the benchmark, similar to Core mandates. Core Plus strategies have higher risk compared to Core but have provided excess returns over time that have been almost double that of Core strategies (~1.0% to 2.0%) (Figure 1).



### Non-Traditional

**Multi-Sector.** Multi-Sector fixed income strategies provide investors with non-traditional exposure to fixed income markets with enhanced and differentiated returns compared to traditional fixed income. Multi-Sector strategies are similar to Core Plus approaches, but often have dedicated Plus exposures that can make up the majority of the portfolio at times, and with much less exposure to U.S. Government securities. Multi-Sector approaches have more discretion over duration exposure compared to traditional approaches, but typically don’t take active duration positions. Although Multi-Sector strategies have broad flexibility in management of the portfolio, they often have clearly defined objectives that mainly focus on credit risk. As a result, Multi-Sector strategies are higher yielding compared to more traditional strategies, with the median fund yielding 6.2% compared to 3.7% for the Bloomberg US Aggregate Index<sup>1</sup> (Figure 2). Multi-Sector funds may generate excess returns of 2% to 4% compared to the Bloomberg US Aggregate Index.

**Unconstrained.** Unconstrained fixed income strategies are often labeled “go anywhere” funds. Due to the manager’s full discretion over exposures in these strategies, they come with added risks that can deviate significantly from traditional fixed income strategies. These strategies can take large positions in credit, currency, and equity markets, and are typically managed on an absolute basis, not relative to a universal benchmark. Common amongst unconstrained strategies is their ability to take large duration bets, including negative duration. Figure 3 shows the wide duration ranges of Unconstrained strategies compared to common multi-asset fixed income strategies.



<sup>1</sup>eVestment US Multi-Sector Fixed Income universe. Assets as of 6/30/2022 across multiple strategies. For informational purposes only. Past performance is not indicative of future results.

## WHAT ARE THE RISKS AND BENEFITS ASSOCIATED WITH *NON-TRADITIONAL* APPROACHES?

### Benefits

**Portfolio Diversification.** Core and Core Plus strategies are primarily invested in the major index sectors of Investment Grade Corporates, Securitized, and Government Securities. Non-traditional approaches provide dedicated exposure to diversifying asset classes such as High Yield, Emerging Markets Debt, Preferreds, and non-index Securitized sectors such as ABS, CMBS, and CLOs.

**Enhanced Return.** Multi-Sector bond strategies have historically outperformed traditional strategies<sup>2</sup>.

**Higher Yield.** Multi-sector funds on average provide yields in excess of the Bloomberg US Aggregate of 2%. With the recent rise in bond yields, the total return potential for multi-sector funds is attractive for fixed income investors and compares favorably against other non-fixed income asset classes when considering risk/reward.

**Flexibility.** Having the flexibility to react to market dislocations in a timely manner is a benefit of non-traditional fixed income approaches. Their agility and ability to take positions in various sectors and instruments is an important aspect of generating alpha.

**Expanded Opportunity Set.** Core and Core Plus strategies are largely invested in index-only sectors and securities. Multi-Sector and Unconstrained approaches venture beyond index sectors into areas that may be less trafficked, providing more opportunities for outperformance.

### Risks

**Interest Rate Risk.** Unconstrained strategies often make large bets on the direction of interest rates, which traditionally have proved to be unreliable sources of return in for portfolios. This leaves investors with significant credit risk and limited downside protection.

**Credit Risk.** Multi-Sector and Unconstrained funds often have higher credit risk compared to traditional approaches. Plus sectors (High Yield, Emerging Markets Debt, etc.) can be up to 100% of the portfolio, compared to 40% to 50% for Core Plus.

**Diversification.** Concentrated risks can pose issues for investors in Unconstrained funds, which often take outsized positions in various markets, including credit, currency, equity, and interest rates.

**Risk/Reward Uncertainty.** Unconstrained funds have limited restrictions around their fund objectives and guidelines, resulting in high uncertainty around their risk and return profile and what investors can expect over time.

### Summary of Non-Traditional Approaches

	Multi-Sector	Unconstrained
Strategy	Defined objectives	Go anywhere
Interest Rate Risk	Moderate	Wide ranging
Credit Risk	Moderate to High	High
Diversification	High	Moderate to Low
Leverage	Modest	Variable
% "Plus" Sectors	0% - 100%	0% - 100%
Sectors	Core Plus + ABS, CLO, CMBS, Loans, Preferreds, Privates, Equity	Go anywhere, short and long

<sup>2</sup>Morningstar Multisector Bond Universe and Intermediate-Term Bond Universe as of 6/30/2022

## WHERE DO NON-TRADITIONAL APPROACHES FIT IN AN INVESTOR'S PORTFOLIO?

Non-traditional fixed income can complement Core and Core Plus strategies. Core and Core Plus strategies have clearly defined objectives, and their risk/return profiles come with a higher degree of expectation. An allocation to non-traditional fixed income can provide valuable benefits to a fixed income portfolio, including enhanced returns, higher yields, and uncorrelated returns while only increasing risk marginally.

A non-traditional fixed income allocation can also serve as a standalone fixed income solution for investors. Those looking to add more risk to their portfolio, but maintain the traditional benefits of fixed income, can make non-traditional fixed income a principal component of their overall fixed income allocation. The flexibility and agility allowed within non-traditional approaches takes the place of asset allocation decisions by investors, becoming an all-in-one fixed income solution.

Finally, investors can use non-traditional fixed income as a substitute for equity strategies. Investors hesitant to allocate to equity late in the cycle, but in search of higher returns, can turn to non-traditional fixed income as a possible solution.

## WHO SHOULD CONSIDER NON-TRADITIONAL FIXED INCOME?

Investors are constantly looking for ways to enhance returns and achieve objectives without taking on excessive risk. This search for improving risk-adjusted returns is essential to any successful asset management framework.

- **Foundations & Endowments.** One benefit of non-traditional fixed income is the above average yield. The yield on the Bloomberg Barclays US Aggregate has been well below 5% for the past 10 years, creating a difficult environment for those reliant on a high income stream. Non-traditional fixed income funds typically have yields well above traditional strategies, making them an attractive allocation for Foundations & Endowments needing to meet their spending requirements.
- **Pension Funds.** Many defined benefit pension plans have become fully funded due to the strong bull market we've seen over the past decade. As a result, investors are looking to reduce equity exposure. Non-traditional fixed income is a viable alternative to equities as pension plans de-risk, offering higher yields and returns than traditional fixed income, while having less risk than equities. Alternatively, those looking to increase returns due to unfunded status may do so by shifting their fixed income portfolio into non-traditional opportunities that can potentially increase returns while maintaining traditional fixed income benefits of capital protection. Defined contribution plans can offer non-traditional fixed income as an alternative exposure for those looking to diversify their fixed income portfolio or enhance their overall return without adding excessive risk.
- **Insurance Companies.** Non-traditional fixed income strategies often provide enhanced returns in a capital efficient manner, making them attractive for most insurance investors. Dedicated high risk asset allocations, such as high yield or equities, carry high capital charges making them less efficient from a capital standpoint. Non-traditional approaches have large investment grade allocations that have favorable capital treatment.
- **Corporate.** Corporations seeking to improve absolute and risk-adjusted returns may benefit from the strategic nature of non-traditional fixed income approaches. The agility inherent in these strategies becomes increasingly important as investors navigate through the later stages of the cycle.
- **Individuals.** Non-traditional fixed income approaches offer consistent, uncorrelated returns to traditional asset classes. This helps to reduce volatility for investors' portfolios while also providing a valuable income stream that exceeds that of most asset classes available to retail investors.

Fort Washington manages a variety of multi-asset fixed income strategies, including Core, Core Plus, and Strategic Income. Fort Washington's Strategic Income strategy, a multi-sector non-traditional fixed income offering, will be discussed in more detail in the second part of this two-piece series.

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