# Fund Manager Commentary

*As of March 31, 2023*

## Fund Highlights

- Targets goals through a short duration, low risk approach
- Emphasizes mortgage-backed and asset-backed securities, which are backed by income-producing assets; inefficiencies in these markets make them attractive for active management
- Seeks to keep duration less than a year, which reduces duration risk compared to longer duration portfolios
- Higher credit quality portfolio seeks to avoid higher risk strategies, such as non-dollar currencies and lower quality credits
- Seeks to complement more "opportunistic" fixed income, equity or hedge fund strategies

## Market Recap

The hallmark of the first quarter was volatility. In January, markets were sanguine about growth, inflation, and future U.S. Federal Reserve Board (Fed) rate hikes. This calm was upended in February by strong economic data, highlighted by a blowout jobs report and firm inflation readings. Interest rates rose sharply and credit spreads widened as markets priced in more Fed tightening and increasing concerns over a future recession. In March, the failure of Silicon Valley Bank and Signature Bank, and the forced merger of Credit Suisse Group AG and UBS Group AG, shifted the narrative to strains within the U.S. financial system (especially in regional banks) potentially creating a negative feedback loop for the broader economy. Interest rates fell sharply and credit spreads widened further as uncertainty and volatility spiked. While the U.S. Treasury, Fed and FDIC issued a joint statement and announced policies to limit immediate systemic risk, the tightening in credit conditions as a result of these events is likely to negatively impact growth over coming quarters. Recession risk is elevated and expectations for the path of the federal funds rate has fallen sharply to end the quarter.

Amid the volatility and stress in the banking sector, consumer spending thus far has remained resilient. The labor market continued to post healthy job gains and wage growth in the first quarter. Solid consumer income, buoyed by historically low unemployment and excess savings from pandemic-era programs, continued to support growth. However, risk to the downside will increase as the cumulative effect of Fed tightening is felt and banks further constrain credit in the economy.

Global growth has surprised to the upside, providing somewhat of a positive offset. Europe avoided a recession amid a mild winter and the outlook for China is brighter as they reopen from COVID restrictions. Importantly, inventories are plentiful and supply chains have largely normalized, resulting in lower downstream inflation pressures to consumer goods.

In late 2022, data for both headline and core inflation showed signs of meaningful deceleration. However, January data, along with revisions to prior data, indicated the deceleration was less impressive than previously thought. While goods price inflation continued to move lower, sticky components of services-related inflation (including shelter costs) showed little signs of improvement. This, combined with unrelenting strength in the labor market caused the Fed to raise rates 25 basis points (bps) in February and pledge "ongoing increases". Treasury yields rose sharply (2-year U.S. Treasury +97bps) through the rest of the month.

In early March, stress in the banking system caused a reversal of the February rate move and reduced expectations for a higher terminal federal funds rate. However, tighter financial conditions resulting from banks' reduction of credit availability should produce an effect similar to additional Fed rate hikes, effectively elevating recession concerns. On the other hand, the consumer is on historically sound footing and there are encouraging signs that inflation will fall further. In our view, the downside risk of recent events, combined with lower inflation and a healthy consumer, will continue to put manageable downward pressure on rates in 2023.

*(continued)*

◊ *Fort Washington is a member of Western & Southern Financial Group*

Performance data quoted represents past performance, which is no guarantee of future results. The investment return and principal value of an investment in the Fund will fluctuate so that an investor's shares, when redeemed, may be worth more or less than their original cost. Current performance may be higher or lower than performance data given. ***For performance information current to the most recent month-end, visit TouchstoneInvestments.com/mutual-funds.***

Spreads across short duration structured product sectors and quality ranges are generally ~80th percentile relative to history while short duration corporate spreads are ~70th percentile – attractive levels from a historical perspective but reflecting uncertainty and a slowing economy. If the economy deteriorates faster than expected, spreads are likely to widen further. However, if the drag from bank credit tightening is less than feared and the Fed engineers a "soft landing", or a shallow recession, the current level of spreads is attractive. Weighing these risks, we believe current valuations and the uncertain outlook support a neutral risk weighting with a bias toward shorter durations and higher credit quality in ultra short duration portfolios.

## Portfolio Review

The Touchstone Ultra Short Duration Fixed Income Fund (Class A Shares Load-Waived) underperformed both its primary benchmark, the ICE BofA 3-Month U.S. Treasury Bill Index, and its secondary benchmark, the ICE BofA 1-Year U.S. Treasury Note Index, for the quarter ended March 31, 2023.

The largest driver of performance during the quarter was income. Rates were a net positive, contributing to returns while wider spreads were a drag on performance. Sector performance was somewhat mixed with Collateralized Loan Obligations (CLO), Commercial Mortgage-Backed Securities (CMBS) and Asset-Backed Securities (ABS) performing well, while Residential Mortgage-Backed Securities (RMBS) and Corporates lagged moderately. RMBS lagged due to weak price performance in the Reverse Mortgage and Reperforming Loan subsectors. Financials produced a significant drag on the Corporate sector, particularly two regional bank names – Synovus Financial Corp. and Comerica Inc. which widened with the regional bank scare.

The Fund's gross yield was unchanged for the quarter. The inversion in the ultra-short duration curve (3 months to 3 years) increased notably during the quarter, moving from -12 bps to -91 bps. As a result, in our view, the 0.5 year part of the curve is a very attractive place to invest for the combination of high nominal yield and lower interest rate and spread volatility. The current high nominal yields should also help to buffer price volatility moving forward.

As noted previously, spreads across ultra short duration subsectors were volatile during the quarter, driven by the March banking crisis. Short duration corporate spreads are now about the 70th percentile relative to history while short duration structured product spreads are in the 80-85th percentile. Short duration valuations are attractive based on both spread levels and the shape of the curve.

Positioning changes were significant as cash declined from a recent high while ABS increased and CMBS increased. Cash was used to fund redemptions and to take advantage of higher rates and wider spreads during the first quarter. Credit quality improved due to the cycling out of tier 2 commercial paper (BBB equivalent rating) into higher quality ABS.

The Fund's current duration positioning remains at the short end of the historical range at 0.5 years. Given the increase in the inversion of the curve, longer duration portfolios tended to perform better. The Fund's key rate duration positioning added about 30 bps of performance during the quarter. Management believes the broader peer group is positioned similarly to the Fund at about 0.5 years and received a similar contribution to returns.

## Outlook and Conclusion

Rate volatility has been high since the Fed began raising rates and spiked massively in March to levels not seen since the Great Financial Crisis. Given the macro uncertainty, we expect volatility to remain elevated (but not as high as March levels) and spreads to remain wide. Businesses are already feeling the impact of higher rates and bank lending conditions are certain to tighten in the coming quarters, making for a challenging environment for corporate bonds. Consumers, on the other hand, remain in a relatively strong position with unemployment low, strong wage growth and historically low debt burdens. The portfolio is positioned well for this environment with relatively low corporate exposure (19%) and a high allocation to structured products (73%), much of which is ultimately tied to the performance of the consumer.

The Fund also maintains a significant exposure to CMBS (25%) which has been under pressure with rising rates, and challenges in the retail and office segments of the market. While management is not concerned about impairment in this segment of the portfolio (most of the securities are AAA-rated with substantial credit enhancement), more commercial loans are moving into special servicing which could produce extension risk. We are maintaining our current positions but will look to reduce exposure as prices recover and bonds mature.

CLO's, while secured by high yield bank loans, are one of the highest conviction and highest returning trades in the portfolio. These securities are floating rate, AAA-rated, with high credit enhancement levels and, perhaps most importantly, very low spread duration. We are monitoring loan performance closely and limiting sector exposure to about half of typical sector limits.

While we are concerned about both macro and micro volatility as the Fed grapples with inflation, the evolving bank crisis and an eventual recession, we believe the current market environment characterized by high short-term yields and historically wide credit spreads offers investors a compelling value. With the income component of return now significantly higher, volatility of returns should improve. We will continue to invest in the shorter part of the curve and maintain an up-in-quality bias in this environment. Additionally, most of the portfolio holdings are now priced at a significant discount and will benefit from a "pull to par" as those bonds amortize and mature. Investors who can tolerate a small degree of volatility are likely to be rewarded.

*(continued)*

As of March 31, 2023, Synovus Financial Corp. 5.20% 08/11/2025 made up 0.39%, UBS Group AG 1.01% 07/30/2024 made up 0.69%, Comerica Inc. 3.70% 07/31/2023 made up 0.74%, and Credit Suisse Group AG, Silicon Valley Bank, and Signature Bank each made up 0.00% of the Touchstone Ultra Short Duration Fixed Income Fund. Current and future portfolio holdings are subject to change.



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## Fund Facts *(As of 03/31/23)*

| Class | Inception Date | Symbol | CUSIP | Annual Fund Operating Expense Ratio* Total | Net |
|---|---|---|---|---|---|
| A Shares | 04/12/12 | **TSDAX** | 89155T680 | 0.74% | 0.69% |
| C Shares | 04/12/12 | **TSDCX** | 89155T672 | 1.48% | 1.19% |
| Y Shares | 04/12/12 | **TSYYX** | 89155T664 | 0.50% | 0.44% |
| Z Shares | 03/01/94 | **TSDOX** | 89155H678 | 0.79% | 0.69% |
| INST Shares | 04/12/12 | **TSDIX** | 89155T656 | 0.46% | 0.39% |
| S Shares | 10/27/17 | **SSSGX** | 89155T581 | 0.99% | 0.94% |
| **Total Fund Assets** | **$565.1 Million** | | | | |

**Expense ratio is annualized. Data as of the current prospectus. Touchstone Advisors has contractually agreed to waive a portion of its fees and/or reimburse certain Fund expenses in order to limit certain annual fund operating expenses (excluding Acquired Fund Fees and Expenses "AFFE," and other expenses, if any) to 0.69% for Class A Shares, 1.19% for Class C Shares, 0.44% for Class Y Shares, 0.69% for Class Z Shares, 0.39% for Class INST Shares and 0.94% for Class S Shares. These expense limitations will remain in effect until at least 01/29/24.*

*Share class availability differs by firm.*

## Annualized Total Returns** *(As of 03/31/23)*

| | 1Q23 | YTD | 1 Year | 3 Year | 5 Year | 10 Year | Inception |
|---|---|---|---|---|---|---|---|
| Excluding Max Sales Charge | | | | | | | |
| A Shares | 0.91% | 0.91% | 1.53% | 1.62% | 1.35% | 1.10% | 2.96% |
| C Shares | 0.79% | 0.79% | 1.14% | 1.15% | 0.87% | 0.71% | 2.35% |
| Y Shares | 0.97% | 0.97% | 1.90% | 1.91% | 1.65% | 1.38% | 3.07% |
| Z Shares | 1.02% | 1.02% | 1.65% | 1.66% | 1.37% | 1.13% | 2.97% |
| INST Shares | 1.10% | 1.10% | 1.95% | 1.96% | 1.68% | 1.42% | 3.08% |
| S Shares | 0.96% | 0.96% | 1.39% | 1.41% | 1.14% | 0.87% | 2.71% |
| Benchmark 1^ | 1.07% | 1.07% | 2.50% | 0.89% | 1.41% | 0.87% | 2.37% |
| Benchmark 2^^ | 1.25% | 1.25% | 1.02% | 0.08% | 1.29% | 0.85% | — |
| Including Max Sales Charge | | | | | | | |
| A Shares | -1.07% | -1.07% | -0.54% | 0.95% | 0.94% | 0.90% | 2.89% |
| C Shares | -0.21% | -0.21% | 0.15% | 1.15% | 0.87% | 0.71% | 2.35% |

*Max 2.00% sales charge for Class A Shares and 1% Contingent Deferred Sales Charge for Class C Shares held less than 1 year.*

*^Benchmark 1 - ICE BofA 3-Month U.S. Treasury Bill Index[1]*

*^^Benchmark 2 - ICE BofA 1-Year U.S. Treasury Note Index[2]*

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*****The performance presented for Class A, C, Y, INST and S Shares combines the performance of an older class of shares (Z Shares) from the Fund's inception, 03/01/94, with the performance since the inception date of each share class.***

**Please consider the investment objectives, risks, charges and expenses of the Fund carefully before investing. The prospectus and the summary prospectus contain this and other information about the Fund. To obtain a prospectus or a summary prospectus, contact your financial professional or download and/or request one at TouchstoneInvestments.com/resources or call Touchstone at 800.638.8194. Please read the prospectus and/or summary prospectus carefully before investing.**

**Not FDIC Insured | No Bank Guarantee | May Lose Value**

*[1]The ICE BofA 3-Month U.S. Treasury Bill Index is an unmanaged index of Treasury securities maturing in 90 days that assumes reinvestment of all income.*

*[2]ICE BofA 1-Year U.S. Treasury Note Index is an unmanaged index comprised of a single issue purchased at the beginning of the month and held for a full month. The issue selected at each month-end rebalancing is the outstanding two-year Treasury Note Bill that matures closest to, but, not beyond one year from the rebalancing date.*

*The indexes mentioned are unmanaged statistical composites of stock market or bond market performance. Investing in an index is not possible. Unmanaged index returns do not reflect any fees, expenses or sales charges.*

## A Word About Risk

**The Fund invests in fixed-income securities which can experience reduced liquidity during certain market events, lose their value as interest rates rise and are subject to credit risk which is the risk of deterioration in the financial condition of an issuer and/or general economic conditions that can cause the issuer to not make timely payments of principal and interest also causing the securities to decline in value and an investor can lose principal. When interest rates rise, the price of debt securities generally falls. Longer term securities are generally more volatile. The Fund invests in mortgage-backed securities and asset-backed securities which are subject to the risks of prepayment, defaults, changing interest rates and at times, the financial condition of the issuer. The Fund invests in investment grade debt securities which may be downgraded by a Nationally Recognized Statistical Rating Organization (NRSRO) to below investment grade status. The Fund invests in U.S. government agency securities which are neither issued nor guaranteed by the U.S. Treasury and are not guaranteed against price movements due to changing interest rates. The Adviser engages a sub-adviser to make investment decisions for the Fund's portfolio; it may be unable to identify and retain a sub-adviser who achieves superior investment returns relative to other similar sub-advisers. Events in the U.S. and global financial markets, including actions taken to stimulate or stabilize economic growth may at times result in unusually high market volatility, which could negatively impact Fund performance and cause it to experience illiquidity, shareholder redemptions, or other potentially adverse effects. Banks and financial services companies could suffer losses if interest rates rise or economic conditions deteriorate. The Fund invests in foreign securities which carry the associated risks of economic and political instability, market liquidity, currency volatility and accounting standards that differ from those of U.S. markets and may offer less protection to investors. The Fund invests in municipal securities which may be affected by uncertainties in the municipal market related to legislation or litigation involving the taxation of municipal securities or the rights of municipal security holders in the event of bankruptcy and may not be able to meet their obligations. The Fund may experience higher portfolio turnover which may lead to increased fund expenses, lower investment returns and higher short-term capital gains taxable to shareholders. The Fund invests in repurchase agreements which are considered loans by the Fund and may suffer a loss of principal and interest in the event of counterparty defaults. The Fund invests in Collateralized Loan Obligations (CLOs) that have risks that largely depend on the type of underlying collateral and risks may include illiquidity, limited active market, the possibility that distributions from collateral securities will be insufficient to make interest or other payments, the potential for a decline in the quality of the collateral, and can bear the risk of default by the loans. Current and future portfolio holdings are subject to change.**

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