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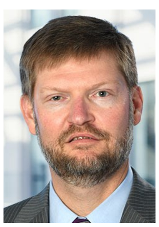
Touchstone Ultra Short Hits $1 Billion; Miller & Mayfield

This month, ***Bond Fund Intelligence*** interviews **Fort Washington Investment Advisors'** Senior Portfolio Manager **Brent Miller** and Portfolio Manager **Laura Mayfield**, who manage investments for the **Touchstone Ultra Short Duration Fixed Income Fund**. **We discuss their focus and policies, why spread duration is an underappreciated metric and how the pair navigate the "flat relative value landscape."** Our Q&A follows.

BFI: *Give us some history.*
Miller: Fort Washington has been involved in the ultra-short space since 1995. **Scott Weston** and I have been running ultra-short duration portfolios together at Fort Washington since 2001, and **Laura Mayfield** joined our team in 2010. Touchstone started offering funds in 1994. **The Ultra Short Duration Fund was acquired by Touchstone in 2006, and then Fort Washington began sub-advising it in 2008.** Fort Washington also sub-advises **Touchstone Active Bond Fund**, **High Yield Fund** and **Ohio Tax Free Bond Fund**. Touchstone also has other funds sub-advised by other institutional asset managers.



Brent Miller

BFI: *What's new with this fund?*
Mayfield: At the portfolio level, with the strong rally in corporate bond spreads at the end of the year, **we've rotated out of some of our corporate exposure at relatively tight levels, and rotated more heavily into structured products — CMBS, ABS and RMBS** — where we continue to find pockets of value. **We're always a structured-product focused fund, but even more so today than we have been over recent years.**

At the broader level … what's been new over the last few years is, with **Basel III** and **Money Market Reform**, a **heightened awareness brought to the ultra-short space from investors looking to optimize their cash or their cash like portfolios**. Our view is that traditionally banks had a pretty tight handle on a lot of the cash account relationships with corporations. That no longer seems to be the case.... **For managers like ourselves, we've seen increased interest and flows, we believe as a direct result of both the industry shakeup and our strong track record in the space.** We think we're well positioned to help those types of cash investors move away from their bank relationships with our customizable range of front-end investment strategies, which includes the **Touchstone Ultra Short Duration Fixed Income Fund**.

Fort Washington Investment Advisors, Inc.
A member of Western & Southern Financial Group

BFI: *What do and don't you buy?*
Miller: The Ultra Short Duration Fund is investment grade only, so we're limited to securities that are rated investment-grade by every rating agency that rates that security. The Fund also has a one year maximum portfolio duration. There's no explicit limit on security duration, however we tend to target securities that have less than a three-year duration. The Fund has industry concentration limits of 25 percent. There are no issuer or security concentration limits, but we typically target one percent positions.

In terms of duration, the Fund's typical operating range is going to be in the ½-year to 0.9-year duration range. We tend to target higher quality securities than just merely investment grade.... The strategic focus, as Laura mentioned, is on **structured products**, particularly in the **'off-the-run' ABS sectors** that were battle tested during the financial crisis. **The larger firms ... tend to disregard these sectors because the markets are just too small to move the needle.** Some of these sectors are only $5 billion to $10 billion in total issuance. Conversely, **smaller firms can't play effectively in these spaces because they don't have the right resources or expertise**. So we think at our level of assets under management, **Fort Washington is 'right-sized' to play effectively in these esoteric ABS sectors**, and the **Touchstone Ultra Short Duration Fixed Income Fund** benefits from that.

Another characteristic of the securities we tend to invest in for the Fund is **short spread duration**. Like we saw during the financial crisis, there were a number of '**wolves in sheep's clothing**,' **funds that had short option adjusted durations but had a lot of spread duration**. Thinking about some of the funds that blew up … they bought a lot of longer maturity AA, A, and BBB non-agency securities. At that time, they were getting an extra 25 to 40 bps of spread. But when spreads blew out, those funds were down anywhere from 15 to 40 percent.

So we think maintaining a short spread duration is the key to managing risk in this space. The way we manage that is by focusing on cash flow. In the Fund, anywhere from 50 to 70 percent of the principal typically matures every year, and we think that helps mitigate the spread duration risk. I just don't think a lot of investors in the ultra-short space pay enough attention to spread duration. **They're so focused on the interest rate risk component that they're not always as aware of what can happen when spreads widen significantly**.

BFI: *What's your biggest challenge?*
Miller: The biggest challenge that we see for the Ultra Short Duration Fund and all of Fort Washington's ultra-short duration mandates is the **flat relative value landscape**. A lot of the investable universe seems to offer substantially similar yields. **So, it's been difficult for us**

(Continued on page 2)

*(**Touchstone Ultra Short** from p.1)*

to differentiate ourselves from our peer group. If you look at that peer group, the range of returns over the last couple of years has been very tight.

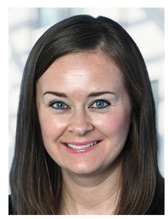
In the ultra-short space, there's always the temptation to extend out the curve or take additional credit risk to get more yield. But right now, you have to take a lot more risk to stand out. Fund investors, we think, need to look closely at the funds that are sticking out.... They need to understand how much spread duration these funds have and how much credit risk is being taken, just to make sure that there isn't any hidden volatility that's embedded in these funds.

The majority of the Ultra Short Duration Fund's investors … we've found, are simply looking for a modest risk premium over cash. They want a volatility profile consistent with a true ultra-short duration strategy. They don't want the volatility of a longer duration bond. They value a fund that is going to perform with relatively low volatility, not the low volatility of a money market fund necessarily, but lower volatility in exchange for a modest pickup in yield over money market funds. **We don't think it's the right environment to reach for yield.** We fight for every basis point we can, and we take a critical eye to every security that we invest in.... We also work very hard to optimize the cash in the Fund.

This kind of environment has made ultra-short an attractive place among investment grade fixed income strategies. Due to the wider array of investment types that we can buy in the Fund compared to, say, a money market strategy, we've been able to maintain a healthy yield over prime money market funds. But conversely, with the yield curve having become so flat and credit curves having also gotten very flat, it just doesn't make a lot of sense to park money in the two to three-year part of the curve or the intermediate part of the curve currently. **We think it's time to declare victory in the two plus year part of the curve and move into an ultra-short strategy that is typically going to offer a much lower risk profile.** You will likely give up very little, if any, yield to do that, so it's a very compelling risk return tradeoff right now.

***BFI:** What about inflows?*

Mayfield: The Fund's size has grown pretty steadily.... We are generally able to get heavy inflows put to work within a day and then have them optimized generally within a week or two.... **We like to be accessible to our investor base**, whether it's somebody doing the due diligence on the investment strategy or someone wanting to monitor us after they've made an investment in the Fund. We like to have a two-way dialog with our investors. Sometimes that also can help us understand potential liquidity needs of the holders.



Laura Mayfield

***BFI:** What is your outlook for 2020?*

Miller: Our outlook is that the Fed stays pretty much on hold.... **In terms of what that means for the Ultra Short Duration Fund, we're biased [towards] the shorter end of our duration range**.... Right now, the Fund's duration is around half a year. The Fund also has a high quality bias ... and is **even more overweight in structured products versus corporate bonds than we usually are**. Being short duration is not really a rate call as much as it is where we're finding the best relative value, which is in shorter average life floating rate securities. We have more floating rate exposure now than we've probably ever had.

We also have a lot of exposure to very short, fixed-rate ABS and CMBS. The quality bias is more a function of our overweight to structured products versus corporate bonds because that part of the portfolio tends to be more highly rated. That's pushed the Fund's average credit quality rating up.

***BFI:** Any thoughts on the future?*

Mayfield: **We think [the segment] has really strong appeal for both types of investors [cash and core fixed].** One thing that will be interesting to see play out going forward is how risk will manifest itself in a **diverse peer group**. We've been in a pretty low volatility period for some time now, **which has helped mask the downside risk of some peers.... But going forward, at some point we're bound to have a more volatile environment and these risks will be exposed....** We think that **Touchstone Ultra Short Duration Fixed Income Fund** has one of the best profiles out there, when you consider both the **return profile and the volatility or downside risk profile**. ◈

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A Word About Risk

The Fund invests in fixed-income securities which can 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 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 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 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 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 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. Current and future portfolio holdings are subject to risk. The Advisor engages a sub-advisor to make investment decisions for the Fund's portfolio; it may be unable to identify and retain a sub-advisor who achieves superior investment returns relative to other similar sub-advisors.

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