Key Takeaways

- For the quarter, the strategy outperformed its benchmark, the Bloomberg Barclays Global Aggregate Bond index
- Non-government sectors outperformed and global treasury yields remained in a narrow range, anchored by highly accommodative monetary policy from global central banks
- The U.S. dollar declined against more developed currencies, adding to returns, as demand for U.S. dollars ebbed with the continuing global recovery. Emerging market (EM) currencies lost ground

Current Strategy and Outlook

The response to the COVID-19 pandemic has accelerated or exacerbated trends that were already in place. The resulting uneven pressures will create winners and losers with broad strokes across the fixed income spectrum and is being referred to as the “K-economy.”

From our view, the winners and losers in the post-COVID world fall into two camps. In the first camp are investments that are being affected by trends that were already in place and have accelerated because of the world’s response to the pandemic and the resulting uneven economic recovery. For example, among commercial mortgage-backed securities (CMBS), a potential “loser” would be brick and mortar properties anchored by lower-tiered malls. These properties already were facing significant pressure from the shift towards online retail; the response to COVID-19 simply exacerbated their problems and accelerated the deterioration in their fundamentals.

In the second camp are sectors and investments that are being affected disproportionately by the COVID-19 pandemic. In this camp there will be industries that will either be negatively affected such as the decline in air travel and entertainment, or on the positive side online retail and other technology that have adapted to changes caused by the continuation of work-from-home.

Meanwhile, the “K-economy” isn’t limited to corporates, but influencing opportunities at the country level across EM. While it’s not guaranteed, EM countries tend to have an advantage with higher potential growth, a benefit to the sector. Opportunities for buys and sells across EM exist and allocations will be country specific.

Assessing countries, sectors and industries through this lens of winners and losers will be critical to investment success going forward, with security selection having the potential to yield an outsized impact on performance in the months ahead.
Regarding currencies, we believe the U.S. dollar will continue to reflect broader market sentiment on global economic prospects and the progression of COVID-19, and would expect further depreciation. Accommodative global central bank policies and an uptick in economic growth are supportive for select EM currencies, but the uneven nature of the “K-recovery” will continue to increase the performance dispersion between winners and losers.

Portfolio Review

Outperformance was driven by sector allocation and the continued healing of global credit markets after the turbulence created by COVID-19 events in 1Q20. Overweights to non-government sectors spanning securitized and corporate sectors versus global treasuries, in aggregate, contributed strongly to performance, as global developed market treasuries were largely range-bound. The corporate rally extended across the credit curve, with lower-rated securities outperforming higher rated securities. Meanwhile, U.S. securitized credit also performed well, benefiting from the normalization in the economy and a resilient U.S. consumer. Positive contribution from EM interest rate positioning was modestly offset by EM currency exposures, while currency positioning in developed markets detracted. Gains from underweights in the Australian dollar were offset by detractions from our underweight in the British pound and overweight in the Norwegian krone.
The Bloomberg Barclays Global Aggregate Index is an unmanaged index that provides a broad-based measure of the global investment-grade fixed-rate debt markets. The Index does not reflect fees, brokerage commissions, taxes or other expenses of investing. Investors cannot invest directly in an index.

Principal Risks: All investing involves risks of fluctuating prices and the uncertainties of rates of return and yield. Currency To the extent that the Portfolio invests directly in foreign currencies or in securities denominated in, or that trade in, foreign (non-U.S.) currencies, it is subject to the risk that those currencies will decline in value relative to the U.S. dollar or, in the case of hedging positions, that the U.S. dollar will decline in value relative to the currency being hedged. Derivative Instruments Derivative instruments are subject to a number of risks, including the risk of changes in the market price of the underlying securities, credit risk with respect to the counterparty, risk of loss due to changes in interest rates and liquidity risk. The use of certain derivatives may also have a leveraging effect which may increase the volatility of the Portfolio and reduce its returns. Foreign Investments/Developing and Emerging Markets Investing in foreign (non-U.S.) securities may result in the Portfolio experiencing more rapid and extreme changes in value than a fund that invests exclusively in securities of U.S. companies, due to smaller markets, differing reporting, accounting and auditing standards, and nationalization, expropriation or confiscatory taxation, foreign currency fluctuations, currency blockage, or political changes or diplomatic developments. Foreign investment risks typically are greater in developing and emerging markets than in developed markets. Asset-Backed (including Mortgage-Related) Securities Defaults on or the low credit quality or liquidity of the underlying assets of the asset-backed (including mortgage-related) securities held by the Portfolio may impair the value of the securities. Credit Derivatives The Portfolio may enter into credit default swaps, either as a buyer or a seller of the swap. As a buyer of the swap, the Portfolio pays a fee to protect against the risk that a security held by the Portfolio will default. As a seller of the swap, the Portfolio receives payment(s) in return for its obligation to pay the counterparty an agreed upon value of a security in the event of a default of the security issuer. Credit default swaps are largely unregulated and susceptible to liquidity, credit, and counterparty risks. Other risks of the Portfolio include but are not limited to: Leverage, Liquidity, Other Investment Companies, Call, Credit, High-Yield Securities, Prepayment and Extension and Securities Lending. Investors should consult the Portfolio’s Prospectus and Statement of Additional Information for a more detailed discussion of the Portfolio’s risks. An investment in the Portfolio is not a bank deposit and is not insured or guaranteed by the Federal Deposit Insurance Corporation, the Federal Reserve Board or any other government agency.

The strategy employs a quantitative investment process. The process is based on a collection of proprietary computer programs, or models, that calculate expected return rankings on variables such as earnings growth prospects, valuation, and relative strength. Portfolio construction uses a traditional optimizer that maximizes expected return of the portfolio, while managing tracking error.

Data imprecision, software or other technology malfunctions, programming inaccuracies and similar circumstances may impair the performance of these systems, which may negatively affect Fund performance. Furthermore, there can be no assurance that the quantitative models used in managing the Fund will perform as anticipated or enable the Fund to achieve its objective.

The strategy is available as a mutual fund or variable portfolio. The mutual fund may be available to you as part of your employer sponsored retirement plan. There may be additional plan level fees resulting in personal performance that varies from stated performance. Please call your benefits office for more information.

Variable annuities and group annuities are long-term investments designed for retirement purposes. If withdrawals are taken prior to age 59½, an IRS 10% premature distribution penalty tax may apply. Money taken from the annuity will be taxed as ordinary income in the year the money is distributed. An annuity does not provide any additional tax deferral benefit, as tax deferral is provided by the plan. Annuities may be subject to additional fees and expenses to which other tax-qualified funding vehicles may not be subject. However, an annuity does provide other features and benefits, such as lifetime income payments and death benefits, which may be valuable to you.

Variable investments, of any kind, are not guaranteed and are subject to investment risk including the possible loss of principal. The investment return and principal value of the security will fluctuate so that when redeemed, it may be worth more or less than the original investment. In addition, there is no guarantee that any variable investment option will meet its stated objective. All guarantees are based on the financial strength and claims paying ability of the issuing insurance company, who is solely responsible for all obligations under its policies.

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