Unconstrained Fixed Income

Strategy overview
Unconstrained and flexible approach, investing broadly across the global debt markets.

Key Takeaways
- For the quarter, the strategy outperformed its benchmark, the Merrill Lynch LIBOR Three-Month Constant Maturity index
- The recovery in the U.S. and global economy led to outperformance in credit sectors, while lingering concerns regarding COVID-19 and the steady hand of the Federal Reserve left U.S. rates rangebound in the third quarter
- Sector allocation contributed the most to relative performance followed by security selection, which also added over the period

Portfolio Review
The recovery in the U.S. and global economy led to outperformance in credit sectors, while lingering concerns regarding COVID-19 and the steady hand of the Federal Reserve left U.S. rates rangebound in the third quarter. Continued signs of economic healing as evidenced by sentiment surveys, employment trends and upward revisions to Q3 U.S. GDP forecasts, supported risk taking across corporate and securitized sectors. The corporate rally extended across the credit curve, with lower-rated securities outperforming higher-rated securities. Securitized credit also performed well, with CMBS posting the best excess returns in the Aggregate index for the quarter. The one sector to lag was Agency MBS, where performance was challenged in today's low-rate environment and concerns about continued re-financing trends impacting pre-payments.

In September, the Fed extended its commitment to its Zero Interest Rate Policy ("ZIRP"), with the latest dot plot forecasts highlighting official short-term rates would remain close to zero through 2023. Meanwhile, the long-awaited announcement from the Fed on inflation targeting caused a brief uptick in real yields as the Fed revealed they are inclined to let inflation run higher for longer to achieve a long-term average inflation target. We expect the result of this policy means the Fed will be slower to raise official rates and be less proactive when compared to previous Fed cycles.

While we pivoted our portfolios to capture what we viewed as a tactical opportunity in corporate credit, our bias remains skewed towards securitized credit and the U.S. consumer. From a recovery perspective, securitized credit has lagged; fiscal- and monetary-policy-driven spending and programs directed towards securitized credit markets have been slower to become active. Longer term, we continue to believe that securitized credit represents attractive exposure to the relatively strong fundamentals of the U.S. consumer.

Sector Allocation and Duration/Curve Positioning
- Outperformance was driven primarily by the strategy’s allocation to securitized credit.
- Non-agency RMBS and credit risk transfer (CRT) securities were the most significant contributors to performance.
- Sector allocations to CMBS and ABS also added to returns.
- CRT spreads tightened significantly over the period as securitized credit sectors stabilized after the March sell-off.
- The strategy’s allocations to IG corporates, high yield and bank loans were additive to performance as corporate spreads tightened over the period.
- Emerging market allocations also added to performance.
Currency positioning across currencies modestly detracted during the quarter.
Duration and curve positioning added to performance as rates declined and spreads tightened.

Security Selection
The strategy’s security selection was positive. In securitized, our exposure to more credit-sensitive non-agency CMBS investments was the largest contributor as the sector continues to recover.
Positive security selection within ABS was largely attributable to higher-yielding CLOs.
Negative security selection to agency MBS was offset by selection to IG corporates.

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 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.

Assessing 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.

1 The firm relies upon quantitative models for certain investment strategies in developed currency markets.

The Bank of America Merrill Lynch U.S. Dollar Three-Month LIBOR Constant Maturity Index is designed to track the performance of a synthetic asset paying LIBOR to a stated maturity. The index is based on the assumed purchase at par of a synthetic instrument having exactly its stated maturity and with a coupon equal to that day’s fixing rate. That issue is assumed to be sold the following business day (priced at a yield equal to the current day rate) and rolled into a new instrument. The Index does not reflect fees, brokerage commissions, taxes or other expenses of investing. Investors cannot directly invest in an index. BofA Merrill Lynch® indices used with permission, are provided “AS IS”, without warranties, and with no liability. BofAML does not sponsor, endorse, review, or recommend Voya or its products or services.

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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 based 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.

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