Unconstrained Bond Funds:
Bad Idea, or Good Idea Poorly Executed?

Chris Wilson, CFA
Senior Client Portfolio Manager, Fixed Income

Bryan Lazarus, CFA
Fixed Income Product Manager

Lessons Learned

#1
It's About Low Correlation to Rates AND Stocks (Not just Rates)

#2
Manager Selection is Always Important—in the Nontraditional Category it Matters Even More

#3
Nontraditional is a complement, not a replacement to Core Fixed Income

Executive Summary

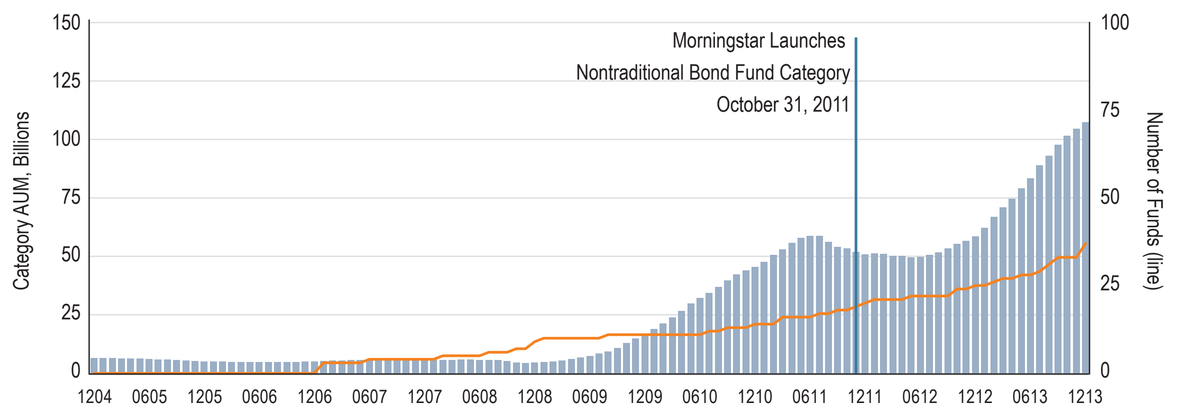
- In the years following the Global Financial Crisis, many traditional fixed income investors turned their attention to Nontraditional bond funds to address the low yields and heightened macro risks of the time.
- Nontraditional's successful navigation of the 2013 Taper Tantrum set high expectations that turned mostly into disappointment over the following years.
- Learning from history, we believe that Nontraditional bond funds were not a bad idea, but rather a good idea poorly executed.
- With the right approach, these funds can be a crucial component in complementing a well-diversified portfolio.

High Expectations, Mixed Results

During the years following the Global Financial Crisis when traditional fixed income investors were contending with historically low yields and significant macro risks, many turned their attention to a portion of the market that seemed capable of solving their problems: Nontraditional bond funds. As a multi-sector fixed income solution with enhanced flexibility to maximize opportunities and respond to changing market dynamics, Nontraditional fixed income strategies were convincingly offering the prospect of strong risk-adjusted performance and better positioning investors for what many believed was an imminent end to the 25-year bull market in interest rates.

In the summer of 2013, when interest rates spiked over 1%, and 10-year U.S. Treasuries and the Intermediate Term Bond Fund category fell by 8.21% and 4.39%, respectively, Nontraditional bond funds fell only 2.34%, effectively passing their first test with flying colors and earning resounding approval from investors and asset managers alike. Inflows into the category doubled by the end of 2013, as did the number of Nontraditional products available (Figure 1). Many began to dub the asset class the "The New Core" with the prospect of better risk-adjusted returns than the traditional Intermediate-Term bond funds.

Figure 1. Nontraditional and Fund Offerings have doubled
Morningstar® Nontraditional Bond Fund Category



Source: Morningstar

However, the resounding success of the strategy's first major test set high expectations that turned mostly into disappointment over the following years. Looking at performance alone, a review of all 276 quarterly time horizons from January 2013 through September 2018 showed that Nontraditional bond funds outperformed Intermediate-Term bond funds a mere 38% of the time. Furthermore, when comparing the two strategies for the same period based on Nontraditional' s stated value proposition—i.e., having lower correlations to interest rates, lower volatility and less downside risk—the results are mixed (Figure 2).

Looking first at interest rate correlation, the category did earn a solid pass, with 82% of Nontraditional bond funds producing a low correlation over that time. However, the category's results on the other two metrics were less encouraging.

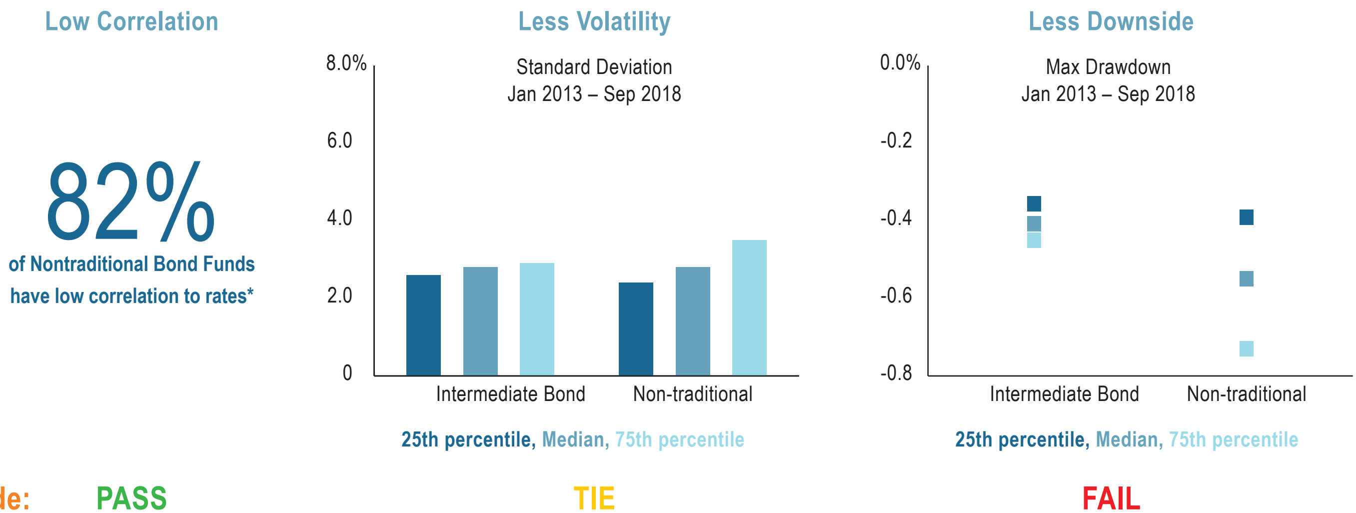
As Figure 2 highlights, the standard deviation for managers in the 25th, median, and 75th percentiles among the two categories are roughly in line, resulting in a tie. However, the same cannot be said for downside protection. Focusing on the same percentile rankings for both categories, while the median Nontraditional manager's max drawdown is considerably lower than the median Intermediate-Term manager, the 75th percentile Nontraditional mangers performed comparatively much worse, resulting in a failing grade.

As such, we believe these results can provide valuable lessons that can help investors find true value and strong results with Nontraditional bond funds, and make an investment that is more likely to meet expectations and deliver on their objectives.

Lesson Learned #1:
It's About Low Correlation to Rates AND Stocks (Not just Rates)

While maintaining low correlations to traditional fixed income is achieved by most Nontraditional funds, we feel it is not the entire picture in terms of overall portfolio diversification. Indeed, while 82% of Nontraditional bond funds demonstrated low correlation to interest rates, only 56% showed low correlation to stocks. As such, only 42% of the category showed low correlations to BOTH. In our view, having low correlations to rates and equities in a single allocation would have been a more effective way to achieve the level of diversification needed from the prevailing market risks of recent years. Case-in-point, it was the higher correlations to equity markets (the result of significant credit exposures) that drove the disappointing performance for many funds in the category during equity and high yield market pull-backs in 2015 and 2016. We believe this defeats the primary purpose of fixed income, which is to diversify equity market sensitivity, not increase it in order to reduce rate volatility.

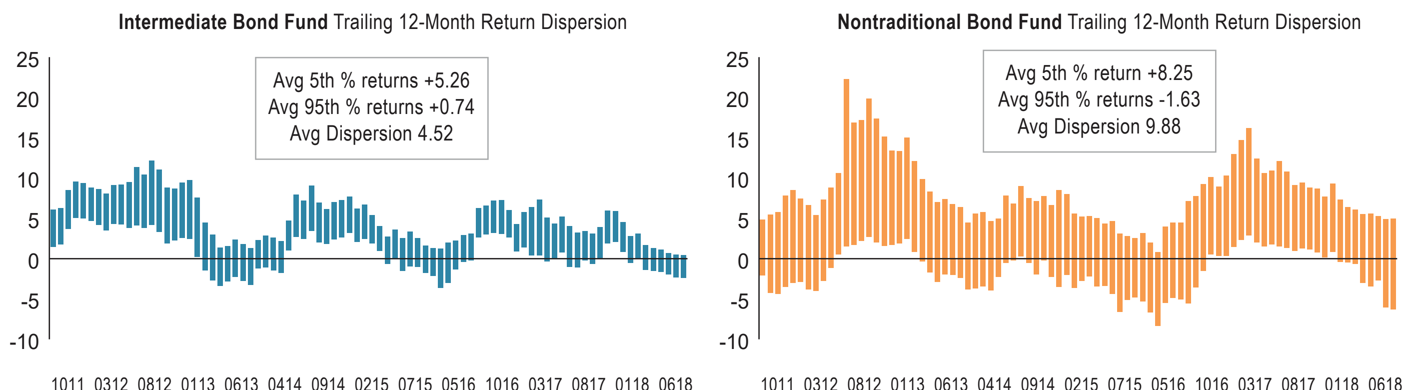
Figure 2. Nontraditional Bond Fund Scorecard: When Lofty Expectations Meet Reality



Source: Morningstar®, Bloomberg Barclays and Voya Investment Management.

* Low Correlation as represented by the number of shares classes with a correlation between -0.5 to +0.5 relative to the Bloomberg Barclays US Treasury Index for the period 01/01/13 – 09/30/18, using monthly data. Standard Deviation as represented by the annualized standard deviation for the 25th percentile, Median and 75th percentile for the Morningstar Intermediate-Term Bond Fund and Nontraditional Bond Fund categories. Max Drawdown as represented by the maximum drawdown for the 25th percentile, Median and 75th percentile for the Morningstar Intermediate-Term Bond Fund and Nontraditional Bond Fund categories.

Figure 3. Greater Return Dispersion Highlights Importance of Manager Selection



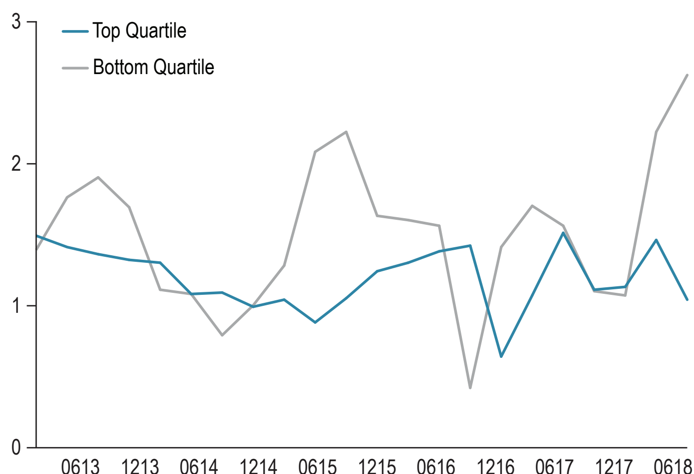
Source: Morningstar® and Voya Investment Management. Returns as represented by the 5th and 95th percentile managers for the Intermediate-Term Bond Fund category (left display) and Nontraditional Bond Fund category (right display). Average Dispersion as measured by the difference between the 5th percentile and 95th percentile managers. Data through 09/30/18.

Lesson Learned #2: Manager Selection is Always Important—in the Nontraditional Category it Matters Even More

While manager selection in all fund categories is important, we believe it is even more crucial within Nontraditional fixed income. Given the greater amount of discretion that Nontraditional managers have versus their Intermediate-Term counterparts around portfolio construction, the range of investment approaches taken among Nontraditional managers is quite wide as well. Figure 3 shows the difference in returns between managers in the 5th percentile and 95th percentile in each category. In the Nontraditional category, there is a significantly wider dispersion in returns between outperforming and underperforming managers. In fact, at 9.88%, it is more than double the average dispersion for the Intermediate-Term category, which we believe underscores the increased importance of manager selection and the need for investors considering Nontraditional allocations to have a strong understanding of their prospective manager's strategy.

Duration positioning is one of the most important items for investors to review when considering a Nontraditional bond allocation. Strategies around duration vary significantly in the Nontraditional space and as Figure 4 highlights, this difference has had a meaningful impact on performance. Since 2013, bottom quartile managers in the Nontraditional space have had significantly wider swings in duration positioning. These Nontraditional managers seemed more intent on using their flexibility to take large bets on the directionality of interest rates, which, on their own only increase overall risk in our view. Indeed, as important as we believe having a Nontradtional allocation is, picking the right manager is even more crucial considering the severity of impact that a bottom performing manager could have versus a bottom performing Intermediate-Term manager.

Figure 4. What about Duration?
Average Duration for Top and Bottom Quartile Funds



Source: Morningstar and Voya Investment Management. Average duration as measured by the average of the top quartile and bottom quartile share classes for the Morningstar Nontraditional Bond Fund Category, using quarterly data, for the period 01/01/13 – 06/30/18 as reported by Morningstar.

Note: Not all funds report duration to Morningstar.

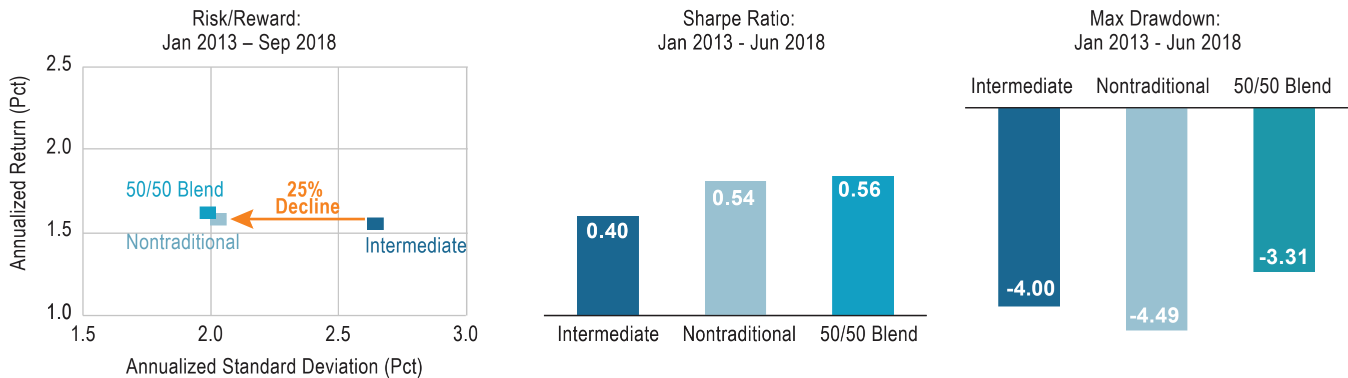
Lesson Learned #3: Nontraditional is a complement, not a replacement

While we are strong proponents of including unconstrained fixed income funds in well-diversified portfolios, we certainly appreciate its limits. In our view, Nontraditional is an important complement to an Intermediate Bond allocation, not a *New Core* (Figure 5).

Figure 5 illustrates in terms of risk-adjusted performance and downside protection, the positive impact that complementing a core allocation with Nontraditional can have over the life of the

Continued on back page.

Figure 5. A Core Complement, not a New Core



Source: Morningstar® and Voya Investment Management. Intermediate as defined by the Morningstar Intermediate-Term Bond Category Returns, Nontraditional as defined by Morningstar Nontraditional Bond Fund Category Returns and 50/50 Blend as defined by an equal-weighted portfolio of Intermediate-Term Bond and Nontraditional Bond Fund categories, re-balanced annually.

period. The charts show performance for each category on its own as well a 50/50 blend of the two. The display on the left shows that while the returns for the two categories are quite similar, Nontraditional has produced returns with significantly less risk. Accordingly, Nontraditional has a higher Sharpe Ratio (per the display in the middle) than Intermediate, but when you blend the two 50/50, you not only get an even better Sharpe Ratio, but a significantly lower maximum drawdown. This is explained by the fact that the drawdown periods for the categories did not overlap, allowing each to effectively mitigate the other's respective drawdown. Most Intermediate-Term bond funds experienced their maximum drawdowns during the 2013 Taper Tantrum, while most Nontraditional funds experienced theirs between 2015 and 2016 during the energy and emerging market turmoil that led to a blowup in high yield, emerging markets and equities. *In short, blending the strategies has historically provided investors with higher returns, lower risk, and significantly greater downside protection than either strategy in isolation.*

Today's environment calls for an unconstrained approach

With those three lessons in mind, we believe that unconstrained bond funds are a good idea worthy of consideration in investors' portfolios. In the uncertain environment of today, with shifting interest rates and equity market volatility, maintaining low correlations to both will be highly important as investors look to reduce sensitivity to prevailing market risks. In our view, Nontraditional managers who remain focused on the long term, primarily using their flexibility to manage volatility, are the ones most likely to occupy that top 25% versus those who rely heavily on short-term opportunistic and macro positioning. As such, by complementing—not replacing—Intermediate-Term bond allocations with well-understood and highly selective Nontraditional bond funds, investors can better position their portfolios for through-the-cycle, long-term consistency.

Investment Risks

All investments in bonds are subject to market risks. Bonds have fixed principal and return if held to maturity, but may fluctuate in the interim. Generally, when interest rates rise, bond prices fall. Bonds with longer maturities tend to be more sensitive to changes in interest rates.

All investing involves risks of fluctuating prices and the uncertainties of rates of return and yield inherent in investing. High Yield Securities, or "junk bonds", are rated lower than investment-grade bonds because there is a greater possibility that the issuer may be unable to make interest and principal payments on those securities. As Interest Rates rise, bond prices may fall, reducing the value of the share price. Debt Securities with longer durations tend to be more sensitive to interest rate changes. High-yield bonds may be subject to more Liquidity Risk than, for example, investment-grade bonds. This may mean that investors seeking to sell their bonds will not receive a price that reflects the true value of the bonds (based on the bond's interest rate and creditworthiness of the company).

Disclosures

This commentary has been prepared by Voya Investment Management for informational purposes. Nothing contained herein should be construed as (i) an offer to sell or solicitation of an offer to buy any security or (ii) a recommendation as to the advisability of investing in, purchasing or selling any security. Any opinions expressed herein reflect our judgment and are subject to change. Certain of the statements contained herein are statements of future expectations and other forward-looking statements that are based on management's current views and assumptions and involve known and unknown risks and uncertainties that could cause actual results, performance or events to differ materially from those expressed or implied in such statements. Actual results, performance or events may differ materially from those in such statements due to, without limitation, (1) general economic conditions, (2) performance of financial markets, (3) interest rate levels, (4) increasing levels of loan defaults, (5) changes in laws and regulations, and (6) changes in the policies of governments and/or regulatory authorities. **Past performance is no guarantee of future results.**

©2018 Voya Investments Distributor, LLC • 230 Park Ave, New York, NY 10169 • All rights reserved.

CMMC-UNCONSTRAINED 121418 • IM-1206-46731-1219 • **203966**