SEIX INVESTMENT ADVISORS LLC®

Total Return Bond Management: Full Market Cycle Demystified

An over-emphasis on interest rates risks missing the potential spread cycle alpha opportunities that result in more consistent outperformance across investment grade strategies.

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BOND MANAGEMENT 101

Total return bond management is ultimately about generating excess yield by opportunistically overweighting spread sectors when risk premiums are most attractive. Success over a full market cycle requires the discipline to harvest gains, reduce spread risk and not reach for yield when risk premiums are compressed. Given the mean-reverting nature of the spread sectors, we believe this discipline best protects our clients' capital amidst the typical late cycle "reach for yield" momentum behavior that chases less and less return per unit of risk. Such discipline is critical in the investment grade universe that naturally offers a negative risk skew. Remember, investment grade bonds typically offer an income stream with some potential upside if the spread offered at purchase is attractive (i.e., the spread can tighten and provide modest capital appreciation). This upside potential is asymmetric with the potential downside should a manager's bond-picking skills prove inadequate. In short, winning can be as much about not losing when investing in investment grade bonds at or toward the end of the cycle.

Current market deliberations have evolved into a narrow, singular emphasis on the direction of rates, with a particular obsession only on when and how high interest rates will rise. While the direction of rates will always drive nominal returns, the timing and certainty of such a shift is hardly the easy call it is made out to be. In fact, the certainty of rising rates and the subsequent "bloodbath" in bond markets have been a consensus expectation for many, many years.

"We believe rising interest rates in the foreseeable future are far from certain, a contrarian view we have steadfastly held for several years," says James F. Keegan, Chief Investment Officer and Chairman of Seix Investment Advisors. "From our perspective, delivering stronger long-term risk-adjusted returns in this core bond segment is more about understanding how the spread cycle changes risk/reward dynamics over time in the context of the overall interest rate cycle." Identifying how evolving risk premiums shape opportunity can add considerable relative return potential in almost all types of interest rate markets.

MANAGING MARKET CHANGE

"Our goal as a total return manager is to deliver consistent outperformance over full market cycles," says Perry Troisi, Managing Director and Senior Portfolio Manager at Seix. "At the core of our investment process is a rigorous bottom-up research methodology, with portfolios built security-by-security based on disciplined underwriting criteria and a very seasoned team of sector specialists and career analysts. Each investment decision is driven by a detailed individual security evaluation in three critical areas of analysis: fundamentals and technicals in the context of relative valuations." The nature of bond investing, however, also requires an awareness of how the macro climate might affect portfolio risk/reward attributes.

Key to this credit market analysis is an understanding of how to deploy risk capital effectively throughout the bond market cycle. Many investment grade bond managers tend to outperform in one type of environment, often at the risk of underperforming when conditions change. Taking a more active approach to calibrating risk exposures as yield spread dynamics continuously adjust can help pursue greater performance consistency through changing markets, rather than shining under one particular set of conditions. Over the long term, we expect these steadier results to secure stronger risk-adjusted returns, even though performance might appear more staid as the cycle extends and ages. "Long-term outperformance is about consistently employing risk effectively across cycle changes, not in just one particular market climate," states Keegan.

"We believe a longer-term, full cycle view is a more prudent approach, with investors better served by evaluating how a strategy performs trough-to-trough or peak-to-peak throughout a bond market spread cycle to gain more meaningful insights into manager performance and consistency."

Jim Keegan - Chief Investment Officer and Chairman, Seix Investment Advisors

Think about the metrics investors typically use to rank bond manager performance. Perhaps they compare yields or one-, three- and five-year total returns. The trouble, of course, is that these performance snapshots are rarely aligned with actual changing market cycles. As such, they can be incomplete measures that are arbitrary at best, and potentially misleading at worst. Unfortunately, fund flows almost invariably seem to follow these types of return fluctuations at precisely the wrong time, potentially introducing unnecessary volatility into an investor's portfolio.

DEFINING A CYCLE WITH CONTROLLABLE RISKS

Seix believes that yield spreads, rather than interest rates, reflect the best measure of a bond market cycle for several reasons:

- **Long-term interest rate trends are usually more secular than cyclical in nature.** In fact, the current declining environment began in 1982 – more than 30 years ago. Within this secular interest rate cycle there have been many spread cycles.

- **Short- and intermediate-term interest rate movements are typically more about shifting investor psychology.** Hence, they offer more limited—and often more risky—potential to capitalize on opportunistic duration plays or mispricings along the yield curve in a consistently meaningful manner.

- **Yield has historically been the largest determinant of the segment's return.** Extreme price movements can certainly have a significant performance impact, but capturing the most attractive yields while avoiding undue risk has historically generated the strongest risk-adjusted returns over time.

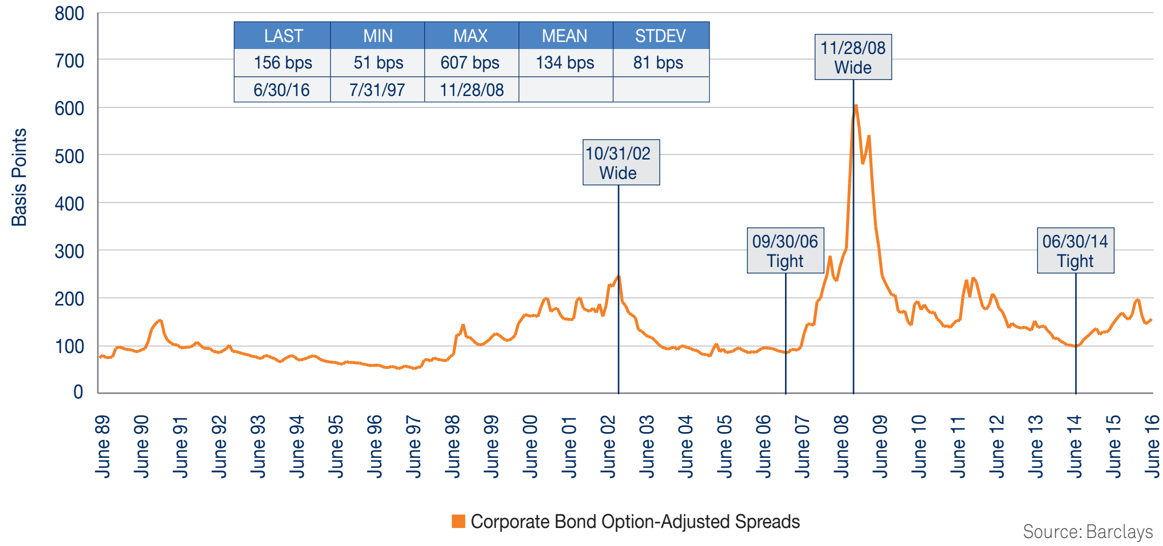
- **Yield spread movements offer more actionable portfolio strategies.** Managers may be able to periodically capitalize on short-term interest rate changes, but few investors are desirous of outsized market-timing interest rate bets. In contrast, yield spread cycle changes can provide attractive opportunities to manage risk exposure within the asset class, as well as delineate which sectors appear to offer the most compelling risk/return profile at any given part of the spread cycle.

Several past yield spread cycles are shown in Exhibit 1 below, which details historical option-adjusted spreads for investment grade corporate bonds, one of the primary spread sectors in the investment grade market. The wider the spread, the greater the potential reward investors are provided for taking on the sector risk. All other things being equal, viewing market opportunity through this lens can provide a clearer picture of when it appears appropriate to take on additional relative sector or security risk within the underlying investment grade bond universe.

> *"Spread cycles can help identify when risk premiums make sense – and when they don't."*
>
> Perry Troisi - Managing Director and Senior Portfolio Manager, Seix Investment Advisors

Of course, the investment grade bond segment offers a diverse mix of investment potential that extends well beyond U.S. Treasuries and corporate credits. Government-related securities, asset-backed securities and mortgage-backed securities (residential and commercial) all have spread cycles to consider. Capturing the optimal risk/reward balance in any particular market climate requires viewing the individual securities within each of these sectors in the overall context of how they compare to one another.

Exhibit 1: Investment Grade Corporate Bond Option-Adjusted Spreads
(6/30/89 – 6/30/16)



Source: Barclays

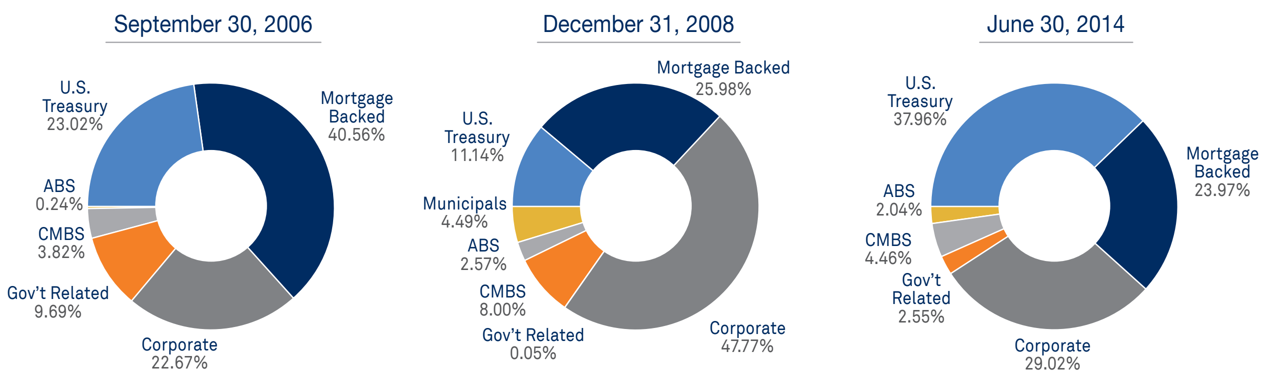
Option-adjusted spreads measure yields relative to comparable duration U.S. Treasury yields, adjusted to take into account embedded options, offering a more accurate risk/reward measure than simply comparing bond yields to maturity.

POSITIONING FOR EVOLVING SPREAD ENVIRONMENTS

Exhibit 2 on page illustrates how this spread cycle analysis can drive portfolio positioning. The three charts in Exhibit 2 show sector holdings for the Seix Core Plus Strategy at various points in the past spread cycle. “In 2006, when spreads were at a cyclical trough, the strategy held a smaller corporate credit allocation with greater U.S. Treasury exposure given that the market was not, in our view, compensating investors adequately for the added risk exposure,” explained Troisi. Two years later, spreads had widened to a dramatic cyclical peak, offering extremely attractive opportunities across higher-yielding sectors that resulted in almost the exact opposite positioning: minimal U.S. Treasury exposure and higher allocations to the primary spread sectors.

Once yield spreads began to tighten as the spread cycle evolved and higher-yielding bonds began to experience greater momentum, relative valuation opportunities across sectors naturally shifted. Spreads again reached a cyclical bottom in mid-2014, and U.S. Treasury holdings were expanded to help mitigate overall risk exposure across the portfolio, this time at the expense of mortgage-backed securities, which appeared less attractive from a risk/reward perspective. "It is interesting to note that although our research process focuses on individual security analysis, we find that our portfolio over/underweight allocations are typically validated by these macro shifts in relative valuations," noted Keegan.

Exhibit 2: Portfolio Sector Allocations (% of duration contribution)



Source: RidgeWorth Seix Total Return Bond Fund

IMPLICATIONS FOR CURRENT HOLDINGS

"At this point in the cycle, we believe a more cautious allocation of risk appears warranted," Troisi stated. The current investment grade corporate option-adjusted spread is 156 basis points,1 slightly above the long-term historical mean of 134 basis points. "Whereas, we are still identifying select opportunities in higher-yielding sectors, in this type of investment environment we also want to ensure ample portfolio liquidity should a market dislocation present broader buying opportunities," continued Troisi.

Many investors tend to reflexively reach for yield when spreads are near cyclical troughs, even though that has frequently proven to be the most inopportune time to take on additional risk exposure. Strategies taking the most risk today generally may be posting the most favorable numbers, but return dispersions are low given that lower risk premiums offer less compensation for such risk. This small advantage evaporates quickly when the market shifts, as it has in past cycles.

[1] As of 06/30/16.

There are certainly numerous headwinds that could easily curtail the performance of riskier bond holdings. Seix's Investment Grade team continues to anticipate that interest rates are likely to stay lower for longer than general market expectations. The main drivers behind this belief are the persistently slow growth environment and disappointing economic performance that continue to hang over markets after seven-plus years and trillions of dollars of monetary stimulus intended to strengthen this anemic economic recovery. The broader implications of these dynamics across investment grade sectors are how they have translated into constrained top-line growth in this low nominal gross domestic product (GDP) environment, which has led to more aggressive financial engineering to create earnings-per-share (EPS) growth at the expense of capital investment. "Consequently, we want to be on the right side of the risk equation when markets turn down,' explained Keegan.

> *"We want to be providers of liquidity when the market is illiquid to help ensure our valuation entry points offer the greatest risk/reward potential."*
>
> Jim Keegan - Chief Investment Officer and Chairman, Seix Investment Advisors

CONCLUSION

Investors' obsession with interest rates may cause them to miss the more practical opportunity to add consistent performance alpha to their investment grade bond allocations. Seix believes that spread cycles have offered deeper, more actionable alpha opportunities through appropriate risk positioning across changing market environments. Analyzing metrics such as option-adjusted spreads can serve as the compass in the context of fundamental and technical analysis against which to deploy risk capital or move into capital preservation mode across the investment grade universe, taking advantage of the most attractive relative risk/reward opportunities at any given point in the cycle. With this in mind, investors can focus on a real target that can help add meaningful alpha to their long-term return potential.

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Alpha is a measure of performance on a risk-adjusted basis.

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Spread is the difference between the bid and the ask price of a security or asset.

Standard Deviation is a statistical measure of dispersion about an average, which depicts how widely returns varied over a certain period of time.

Yield Curve shows the relationship between yields and maturity dates for a set of similar bonds, usually Treasuries, at any given point in time.

The assertions contained herein are based on RidgeWorth's opinion. This information is general and educational in nature and is not intended to be authoritative. All information contained herein is believed to be correct, but accuracy cannot be guaranteed. This information is based on information available at the time, and is subject to change. It is not intended to be, and should not be construed as, investment advice. Investors are advised to consult with their investment professional about their specific financial needs and goals before making any investment decisions.

All investments involve risk. There is no guarantee a specific investment strategy will be successful.

Bonds offer a relatively stable level of income, although bond prices will fluctuate providing the potential for principal gain or loss. Intermediate-term, higher-quality bonds generally offer less risk than longer term bonds and a lower rate of return. Generally, a portfolio's fixed income securities will decrease in value if interest rates rise and vice versa. Although a portfolio's yield may be higher than that of fixed income portfolios that purchase higher rated securities, the potentially higher yield is a function of the greater risk of that fund's underlying securities. Mortgage-backed investments involve risk of loss due to prepayments and, like any bond, due to default. Because of the sensitivity of mortgage-related securities to changes in interest rates, a portfolio's performance may be more volatile than if it did not hold these securities. Although a portfolio's yield may be higher than that of fixed income portfolios that purchase higher-rated securities, the potentially higher yield is a function of the greater risk of that fund's underlying securities.

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