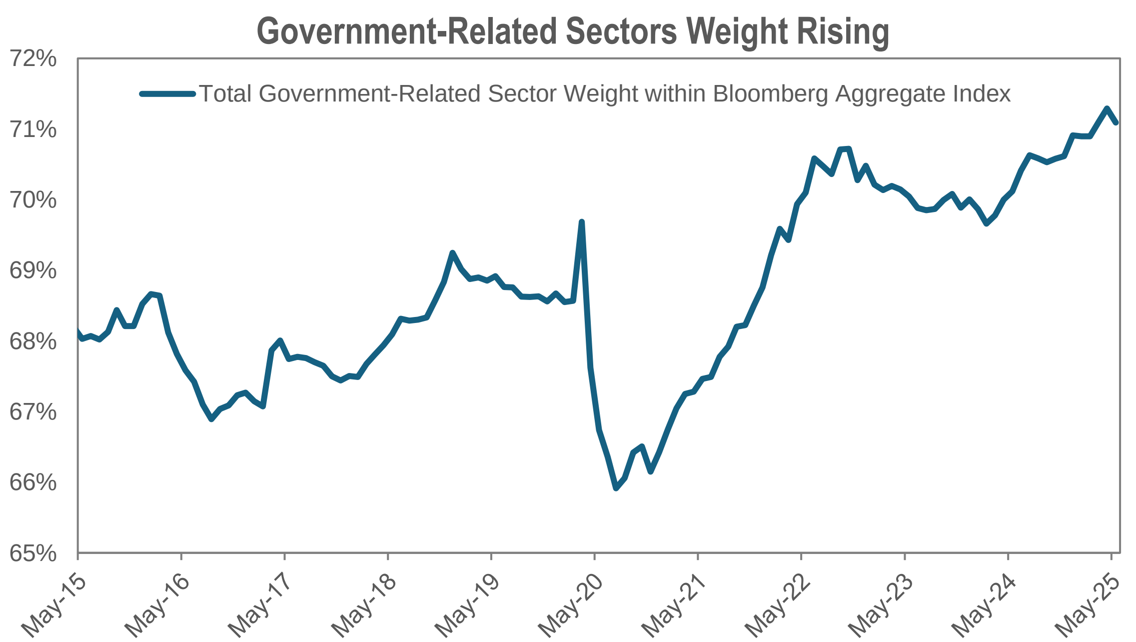
Bond Appétit - The Active Manager's Discerning Palate

For executive chefs, food innovation involves skillfully pairing flavors, textures, and techniques to create a harmonious dish and bespoke dining experience. The motivation is similar for fixed income portfolio managers, some of whom have historically used US government securities as their primary ingredients and broad indices as their foundational recipes. As bond chefs, if you will, we at IR+M tailor portfolios to accommodate investors' discerning and ever-evolving palates, balancing sweetness and acidity – or in this case – safety and risk. As US government securities become a larger and atypically risky segment of the market, we look for ways to incorporate other elements into our portfolio recipe.

Over 70% of a Single Ingredient…

Within the US bond market, the growth of government-backed sectors has been driven in large part by the increase in outstanding Treasury debt. Perpetual fiscal deficits are financed through additional Treasury borrowing, which results in mounting US debt.

- Currently, over $13 trillion of Treasury debt meets the Bloomberg Aggregate Index's inclusion criteria. When coupled with agency-backed debt (ie. agency debentures, mortgage-backed securities and agency commercial mortgage-backed securities), there has not been a larger percentage weighting in the last 10 years.
- As deficits persist, the Treasury sector is expected to continue growing relative to the broader fixed income universe. This trend leads investors to question whether this historically safe haven is becoming riskier.

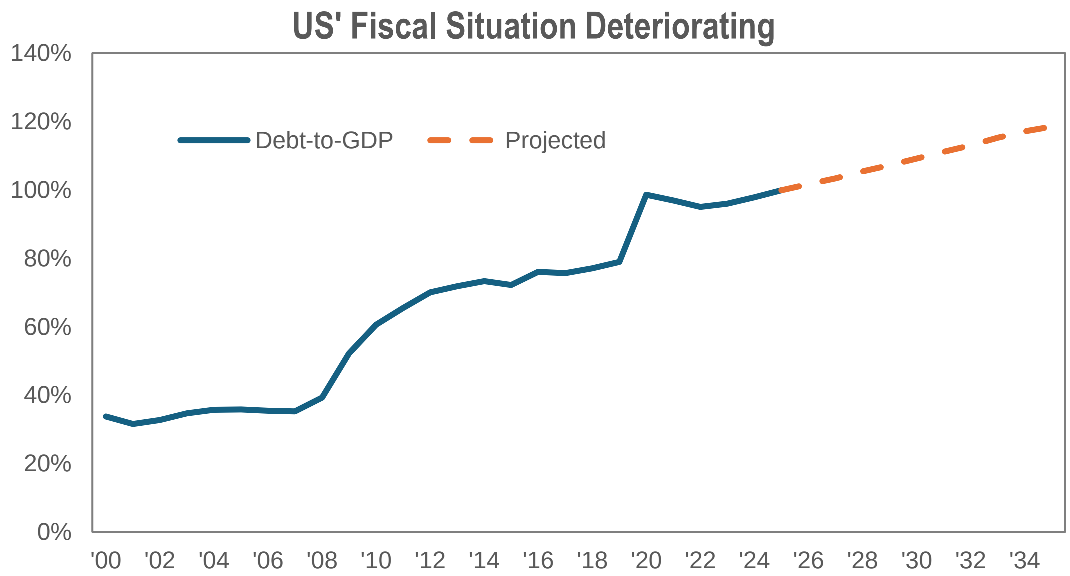


… At Least it's Safe, Right?

Like shifting sentiments regarding what constitutes nutritious foods (some readers may fondly recall sugary, fruit-flavored treats), securities backed by the US Government must now be evaluated with a much higher degree of scrutiny.

- Gone are the days of the US' AAA credit rating, which when paired with an unparalleled degree of liquidity, created the ultimate safe-haven assets. In May, Moody's downgraded the US' credit rating from Aaa to Aa1, following moves by S&P (2011) and Fitch (2023). Although the decision was largely a non-event, it highlighted the increased focus on the US fiscal outlook.

- With Treasuries, today's reality includes debt-ceiling default concerns, episodes of illiquidity not generally associated with the asset class and rumors of foreign selling as protection against some of the current administration's stated trade objectives.
- Bonds backed by Freddie Mac (FHLMC) and Fannie Mae (FNMA) now have their own added degree of risk. Government-Sponsored Entities (GSE) reform has been revived – most recently with President Trump calling for FNMA and FHLMC to go public – amplifying uncertainty to the Bloomberg Aggregate Index's second largest cohort. Increased allocations to these now riskier sectors of the market, without appropriate compensation, could leave some investors with indigestion. Fortunately, investors have options, depending on whether they believe these are *perceived* risks or *actual* risks.



I'll Take a Serving of the Aggregate Index… As Is, Please

Like that meal you have eaten innumerable times at your favorite restaurant, a passive investment strategy is designed to deliver no surprises. A portfolio positioned almost identically to the benchmark, in terms of the sector and issuer weights, will likely deliver index-like returns.

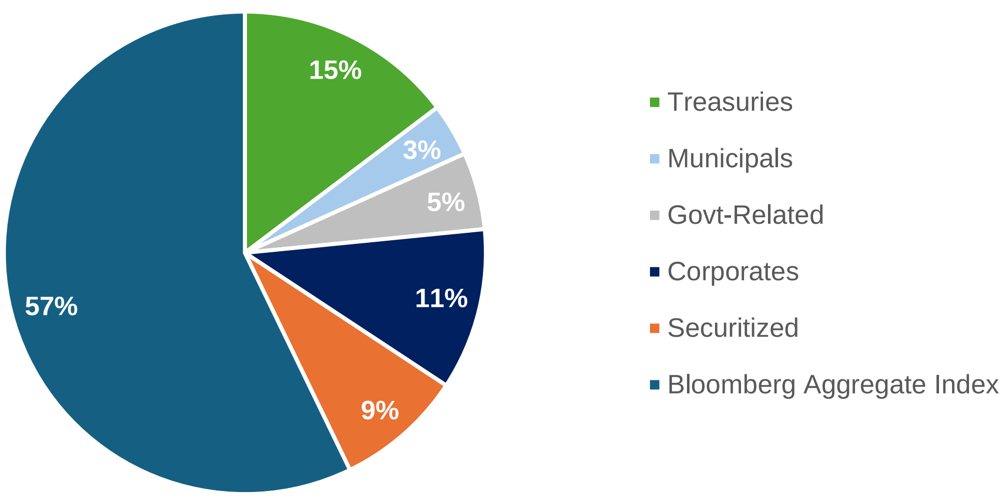
- A passive approach can lead to outsized allocations in the largest issuers—some of which may present less attractive valuations or heightened credit risks. Without active management, investors risk being disproportionately exposed to these issuers, potentially sacrificing return potential.
- Fixed income investors relying on passive strategies may confront the reality that their government-backed bond allocations may not behave – or taste – as expected. Traditional safe-haven assets have exhibited atypically strong correlations with risk assets, complicating portfolio diversification.
- This quarter highlighted this phenomenon as risk assets and long-duration Treasuries alike sold off following tariff announcements. The traditional flight to quality failed to materialize, underscoring the need for a more proactive approach to your fixed income allocation.

Are Substitutions Allowed?

Waitstaff are often asked if menu items contain potential allergens or if the chef allows substitutions ("Can I have a salad instead of fries, please?"). With dining, the end goal is to create a more pleasurable and tailored experience for the customer. Similarly, as active managers, we devote considerable time to thinking what bond or sector substitution would address a client's objectives and potentially enhance performance.

- While a Core/Core Plus strategy benchmarked to the Bloomberg Aggregate Index includes government-backed sectors, we believe in the power of deliberate asset allocation. Rather than completely avoiding Treasuries and agency securities, investors can benefit from strategic diversification that incorporates high-quality alternatives with prudent risk profiles.
- These securities may offer the potential for enhanced yield, improved credit quality, and better risk-adjusted returns, making them compelling additions to a well-constructed portfolio. Often, these securities are either not included, or underrepresented, within traditional indices.

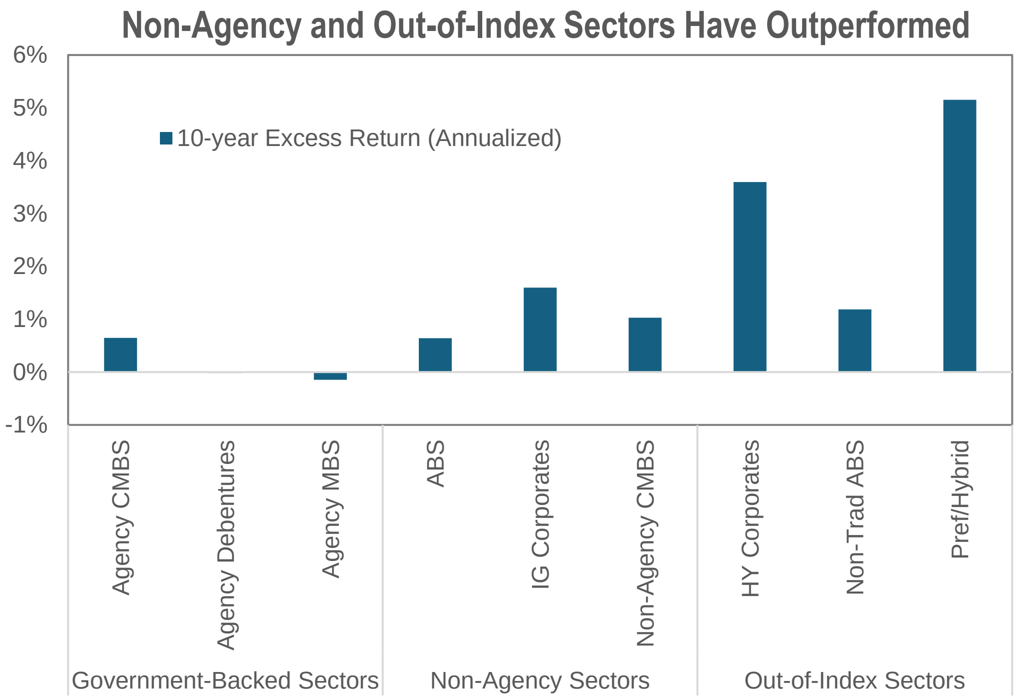
The Bloomberg Aggregate Index Only Accounts for 57% of the Total US Fixed Income Market



I'm Allergic, Can You Make the Dish Without That Ingredient?

Absolute-ly! In the world of fixed income, active managers can remove certain ingredients – such as securities, sectors, or benchmarks – from portfolios; at IR+M, we call that our Absolute Return Strategy. Absolute Return is largely benchmark-agnostic, as opposed to those strategies that use a government-heavy index as a guidepost.

- With Absolute Return, a manager has the broad flexibility to rotate between sectors and ratings (both investment grade and high yield), with a controlled duration that is not explicitly tied to a benchmark. For bottom-up bond selectors like IR+M, it is a sweet spot. We focus on the higher probability, more easily repeatable generators of alpha (credit, structure) and eschew the considerably more difficult (duration).
- Absolute Return is not necessarily a replacement for investors' Core/Core Plus Aggregate-benchmarked allocation. However, it can be an alternative for those looking to reduce their government exposure, dynamically oscillate across sectors, and continue to emphasize preservation of capital.



Just as a chef skillfully uses flavors, textures, and techniques to create an inspired dish, active fixed income managers search for the precise ingredients for their portfolio recipe. With government-backed bonds becoming a larger and potentially riskier part of the market, investors may want to rethink their portfolio construction. At IR+M, we build portfolios bond by bond, balancing safety and return with investors' ever-evolving needs. Like a memorable entrée, we believe every ingredient – or security – in a portfolio should have a well-defined purpose.

All commentary and data as of 5/31/25 unless otherwise noted. Sources: Bloomberg, ICE BofA, JP Morgan, and Congressional Budget Office (CBO). Chart 1: Government-Related Weight includes Treasuries, Agency, Agency MBS and Agency CMBS sectors within the Bloomberg Aggregate Index. Chart 2: Historical and projected debt-to-GDP data sourced from the CBO's January 2025 report The Budget and Economic Outlook: 2025 to 2035. Chart 3: Amount outstandings as of 3/31/25. The Index is the Bloomberg Aggregate Index. Sectors listed represent the securities not included within the Bloomberg Aggregate Index and are US dollar denominated. Treasuries include TIPS. Corporates include both investment-grade and high-yield securities. All data other than securitized was sourced from Bloomberg as of 3/31/25. Securitized sectors sourced from JPM. Chart 4: Excess returns are based on monthly values from 5/31/15 to 5/31/25. Sectors represented by Bloomberg Indices include: Agency CMBS = I30885US Index, Agency Debentures = I09459US Index, Agency MBS ABS = LUABTRUU Index, IG Corporates = LUACTRUU Index, Non-Agency CMBS = I31063US Index, HY Corporates = LF98TRUU Index. ICE BofA Indices include: Non-Traditional ABS = R0O0 Index, Pref/Hybrid = PHGS Index. Most, but not all, of the securities within the ICE BofA Investment Grade Preferred & Hybrid Securities Index (PHGS) are included in the Bloomberg Aggregate Index. Out-of-index sectors listed are those sectors most common within IR+M portfolios. The views contained in this report are those of Income Research + Management ("IR+M") and are based on information obtained by IR+M from sources that are believed to be reliable but IR+M makes no guarantee as to the accuracy or completeness of the underlying third-party data used to form IR+M's views and opinions. This report is for informational purposes only and is not intended to provide specific advice, recommendations, or projected returns for any particular IR+M product. Investing in securities involves risk of loss that clients should be prepared to bear. More specifically, investing in the bond market is subject to certain risks including but not limited to market, interest rate, credit, call or prepayment, extension, issuer, and inflation risk. It should not be assumed that the yields or any other data presented exist today or will in the future. Past performance is not a guarantee of future results and current and future portfolio holdings are subject to risk. Securities listed in this presentation are for illustrative purposes only and are not a recommendation to purchase or sell any of the securities listed. Forward looking analyses are based on assumptions and may change. It should not be assumed that recommendations made in the future will be profitable or will equal the performance of the securities listed. Some statistics require assumptions for calculations which can be disclosed upon request. Source ICE Data Indices, LLC ("ICE Data"), is used with permission. ICE Data, its affiliates and their respective third party suppliers disclaim any and all warranties and representations, express and/or implied, including any warranties of merchantability or fitness for a particular purpose or use, including the indices, index data and any data included in, related to, or derived therefrom. Neither ICE Data, its affiliates nor their respective third party providers shall be subject to any damages or liability with respect to the adequacy, accuracy, timeliness or completeness of the indices or the index data or any component thereof, and the indices and index data and all components thereof are provided on an "as is" basis and your use is at your own risk. ICE Data, its affiliates and their respective third party suppliers do not sponsor, endorse, or recommend IR+M, or any of its products or services. "Bloomberg®" and Bloomberg Indices are service marks of Bloomberg Finance L.P. and its affiliates, including Bloomberg Index Services Limited ("BISL"), the administrator of the index (collectively, "Bloomberg") and have been licensed for use for certain purposes by IR+M. Bloomberg is not affiliated with IR+M, and Bloomberg does not approve, endorse, review, or recommend the products described herein. Bloomberg does not guarantee the timeliness, accurateness, or completeness of any data or information relating to any IR+M product. This material may not be reproduced in any form or referred to in any other publication without express written permission from IR+M.