IR+M INCOME RESEARCH + MANAGEMENT

IR+M UPDATE
IR+M Core Plus Turns Five!

July 27, 2022

As we reflect on our 35+ years as a firm, with a consistent bottom-up, duration-neutral approach to active fixed income investment management, we're excited to reach a new milestone in our Core Plus journey – the IR+M Core Plus Composite turns five on 7/31/2022! As part of our anniversary outreach, Ed Ingalls, Senior Investment Product Specialist, sat down with Jake Remley, Senior Portfolio Manager and Investment Committee Member, and Angela Meringoff, Senior Investment Product Specialist, to discuss our approach to Core Plus.

Core Plus Strategy: Q&A

Ed: Angela, let's start by having you tell us about IR+M's Core Plus philosophy.

Angela: Thanks, Ed. Our Core Plus philosophy follows the same time-tested philosophy we employ in our Core Strategy, which we've been managing for over 30 years. First and foremost, we think it's really difficult to predict the timing and magnitude of future interest rate changes, so we take rates off the table by keeping the portfolio in-line with the benchmark's duration, both overall and at the key-rate level. Just like in Core, we want to have a transparent, understandable, money-good portfolio. Core Plus is an extension of Core, where we take a somewhat broader U.S. dollar-denominated cash bond universe and cast a wider net to build an even greater yield advantage relative to the Bloomberg U.S. Aggregate Index. As in Core, we avoid currencies, derivatives, and other risks that are difficult to analyze, like political risk; an example of an exposure we avoided that is causing headlines in 2022 is Russian debt. Within the securitized market, when it comes to buying agency residential mortgage-backed securities (RMBS), we stay away from To Be Announced securities (TBAs), because as a bottom-up security selector, we want to know and understand the bonds we're putting into the portfolio and be able to assess the stability and predictability of the underlying cashflows. In summary, we value bottom-up analysis with a focus on fundamentals, stable and predictable cashflows, consistent risk-adjusted returns, and incremental yield over our traditional Core Strategy.

Ed: Thanks, Angela. Jake, let's turn to you. "Plus" may have different definitions, depending on who you ask, so how does IR+M define it?

Jake: As Angela mentioned, we're using our bottom-up expertise to go deeper and wider within the U.S. bond universe, providing us with more opportunities and securities to choose from. "Plus" is a very interesting part of the bond market, especially these days. If you take a look at high yield (HY), for example, you have a lot of BB-rated credits that from our perspective, look more like investment-grade credits from a fundamental standpoint. Our HY analysts work hard to find issues that are fundamentally sound, may have structures that are more investor-friendly than a typical HY bond, and offer more compensation than the average BBB-rated corporate. On the securitized side, there are a variety of sub-sectors we emphasize in Core Plus, which we believe offer more return potential with perhaps a little more mark-to-market volatility, while remaining fundamentally money-good at the end of the day.

eVestment Core Plus Universe 4-Year Trailing Metrics

	Excess Returns	Information Ratio	Sharpe Ratio	Upside Capture	Downside Capture
IR+M Core Plus Composite	1.27	0.62	0.56	122.58	102.41
Median Manager	0.94	0.43	0.50	115.89	100.27
Bloomberg U.S. Aggregate Index	---	---	0.33	100.00	100.00

Source: eVestment. All data in the above chart is as of 3/31/22 and was retrieved from eVestment on 7/22/22. Percentiles based on the US Core Plus Fixed Income Universe in eVestment. Metrics and returns shown are the ones IR+M feel are most commonly used when comparing risk relative to peers. The Upside Market Capture Ratio is a measure of the manager's performance in up markets relative to the Bloomberg Aggregate Index. The Downside Market Capture Ratio is a measure of the manager's performance in down markets relative to the Bloomberg Aggregate Index. The views contained in this report are those of 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 for, or projected returns of any particular IR+M product.

Core Plus Strategy: Q&A

Jake (continued): When you think about ABS, there are several non-traditional subsectors that have been growing over the past couple of years, including securitizations of franchise royalty streams, data center cash flows, and specialty commercial real estate leases. In the AAA-rated CLO space, we gain exposure to bank loans. We're trying to find CLO managers that align with how we think about credit, which is with a focus on fundamentals and bottom-up selection. We're really selective about which managers and specific deals we add to the portfolio. In agency RMBS, we have a great track record of prepayment analysis and try to leverage that a little bit more by having some exposure to low dollar-price interest-only (IO) and principal-only (PO) STRIPS. In non-agency RMBS, we favor senior tranches backed by jumbo and investor property mortgages, which offer a significant yield pick-up over generic Agency MBS pools without introducing meaningful credit risk.

Angela: That's a great recap, Jake. I would add that to us, "plus" isn't necessarily ideas that we don't use in Core. Our Core Plus portfolio draws on a lot of the same ideas that we use in Core, although we "turn up the dial" by emphasizing them more. Some examples there include Business Development Companies, REITS, well-structured non-agency RMBS, Whole Business Securitizations, and low-BBB-rated financials and industrials. These are issues that are investment grade but offer more compensation than average. We have a deep team of research analysts who perform their own work on every issuer and deal we buy. While taking rating agency opinions into account is part of the mosaic, we ultimately don't hang our hats on their ratings.

Ed: Good point, Angela. Relative to Core, we have increased exposure to some of the higher-yielding sub-sectors. That said, we will go down in credit in both the corporate and securitized sectors. Jake, will you please comment on the latter?

Jake: Sure. There are times when we see tremendous opportunities in specific subsectors. For example, there may be non-economic sellers in a dislocated market, or distorted relationships between senior and subordinated tranches. Although we are mindful of fat-tail economic risks and their impacts on lower rated tranches, our scenario work uncovers issues that skew more favorably from a risk-reward perspective. We don't really need to go down in credit to add yield, but when we see an opportunity, we're ready to go.

Ed: Great. So we're "turning up the volume" on our traditional Core Strategy. You mentioned a little more return, a little more risk or volatility, so what are the watch-outs?

Jake: I would highlight three watch-outs that we really focus on. One is liquidity. We may have a little less top-line liquidity in Core Plus than in Core, but we're still very focused on maintaining liquidity across the portfolio and within sectors, so that if markets dislocate and there are opportunities, we have sufficient dry powder to take advantage of that. Second, diversification. In this type of environment, or any environment when you have unexpected surprises in the world, you don't want to have one or two sectors really hurt you in the long run. So from our perspective, being diversified on the sector and the name level makes a lot of sense. And then last but not least, understanding what fair value is across the market cycle. We're not market-timers, so we're trying to take advantage of dislocations in the market, and we know that markets can remain dislocated for some period of time and we may have to hold a security until maturity. Being compensated fairly over a full market cycle makes sense to us. Investing takes patience and humility, and we celebrate both.

Ed: So maybe another way of saying that is we want to be a provider of liquidity in dislocated times, and take advantage of attractive opportunities.

Jake: Exactly. We want to have enough dry powder to take advantage of the unexpected if, and more likely when, that happens.

Core Plus Strategy: Q&A

Ed: Jake, you also mentioned agency-backed IOs and POs, which sound risky to some people, so can you also comment a bit more on our investment thesis around these securities?

Jake: From a credit perspective, the agency backing the specific IO or PO guarantees the underlying principal and interest payments. Our work around IOs and POs, along with all agency-backed RMBS, is not about *if* our client will get its money back, but *when*, as that drives the ultimate yield earned on the investment. Within agency CMOs, we've found interest-only tranches where the hedged outcomes are heavily skewed positive based on our proprietary prepayment research and scenario analysis. There is a big portion of the IO and PO market that is macro-driven based on short-term interest rate movements, but our focus is on what we've done well in the MBS space for a long time. We're data-driven, using models to analyze long-term prepayment trends and determine which underlying collateral characteristics have favorable frictions that will drive borrower prepayment behavior. We find that more-seasoned collateral tends to have a more consistent prepayment stream, regardless of the short-term direction or magnitude of moves in interest rates. More stable prepayments are critical to achieving more favorable outcomes. We get under the hood and find out where the inefficiencies are in the market relative to what we believe are the true prepayment trends for the long run.

Ed: That's great, Jake, thank you. Our Core Plus composite is turning five years old, but historically, how long have we been investing in plus sectors? Maybe you can give some examples of securities and portfolios that we've been managing since the Global Financial Crisis (GFC).

Jake: We've partnered with clients to manage higher-beta or more opportunistic strategies since the midst of the GFC. Part of that was taking on, or inheriting, other managers' portfolios that needed to be vetted for fundamental credit-worthiness, especially on the securitized side where you had a tremendous amount of credit erosion in the non-agency RMBS space. This work built our acumen in knowing what is going to be a sound structure, or sound collateral, and how we can best position ourselves through both the market and the economic cycle. Angela, anything you would add?

Angela: Thanks, Jake. We also saw some clients hire us to take advantage of the major dislocations in the bond markets. We had some clients hire us to go out and for example, buy short-duration BBBs and BBs in a portfolio to take advantage of wide spreads while capturing the inherent liquidity in the front of the yield curve. We had other clients who didn't give us benchmarks, and just said, "Go buy cheap bonds." We were able to canvas the markets and pick-up money-good bonds at depressed prices that implied severe (and unlikely) default and loss scenarios. Core Plus is an extension of all of these efforts that we've been engaged in for over twelve years now.

Ed: Angela, help us round-out this discussion. What is IR+M's value proposition in Core Plus?

Angela: Our value proposition in Core Plus is the same value proposition that we exhibit in Core. We have a consistent team and process. Both Core and Core Plus draw on the experience of our sector experts across our 60-person investment team. Also, we employ the same bottom-up security selection process that we've utilized in Core since the inception of that product over 30 years ago. Another aspect that's a differentiator for us, especially in securitized, as Jake mentioned, is that we have a proven track record of analyzing interesting structures and cash flow streams to see how bonds may perform in a variety of scenarios. And then lastly, we're very selective and nimble. We like to say that we "take what the market gives us"; we look for relative value opportunities across sectors as they present themselves, and we can rotate in and out of sectors and names as markets evolve.

Ed: Great, thanks so much to both of you for the update, and we look forward to seeing what the next five years bring!