SEI New ways. New answers.®

Active Fixed Income Investing: Finding Meaningful Opportunities

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Snapshot

- Fixed-income markets offer many opportunities for skilled active investment managers.
- For SEI, active investment management involves finding skilled managers and giving them room to work.
- We hire managers for their expertise and seek to minimize interventions that could work against their efforts.

Many investors associate "active investment management" with an image of traders frantically buying and selling in an effort to generate impressive performance. Within the context of SEI's fixed-income strategies, this stereotype does not apply.

Step 1: Hire Well

We believe a thoughtful combination of investment managers—for example, managers with a fundamental security-level focus complemented by managers with a top-down macro-economic approach—in proportions designed to capitalize on the available set of opportunities in a given asset class, can work effectively to power an investment strategy over a long time horizon.

Once we determine that a manager has the right skillset to fulfill a particular strategy, we seek to limit drastically resizing the manager's weight within a fund or influencing their positioning. We hired them for their expertise, after all, and these interventions could force managers to sell positions at the wrong time.

This doesn't mean that we are prone to inaction. SEI continually monitors each investment manager's contributions to fund-level risk and measures returns across different market cycles to gauge whether manager performance is consistent with our expectations. Risk contributions that fall outside of our guidelines, whether elevated or depressed, can lead us to change a manager's weight.

Such changes can generally be made through the management of cash flows, intentionally directing money to certain managers and away from others. This approach accomplishes our goal without hiring or firing managers, or generating unnecessary trading costs.

Step 2: Let Managers Enact Their Strategies

The merits of active investment management have an inverse relationship with market efficiency: the less efficient the market, the richer the opportunity set for active managers. Fixed-income markets, broadly, are less efficient than equity markets, which is one factor that helps to explain why active fixed-income managers have fared better as a group than active equity managers.

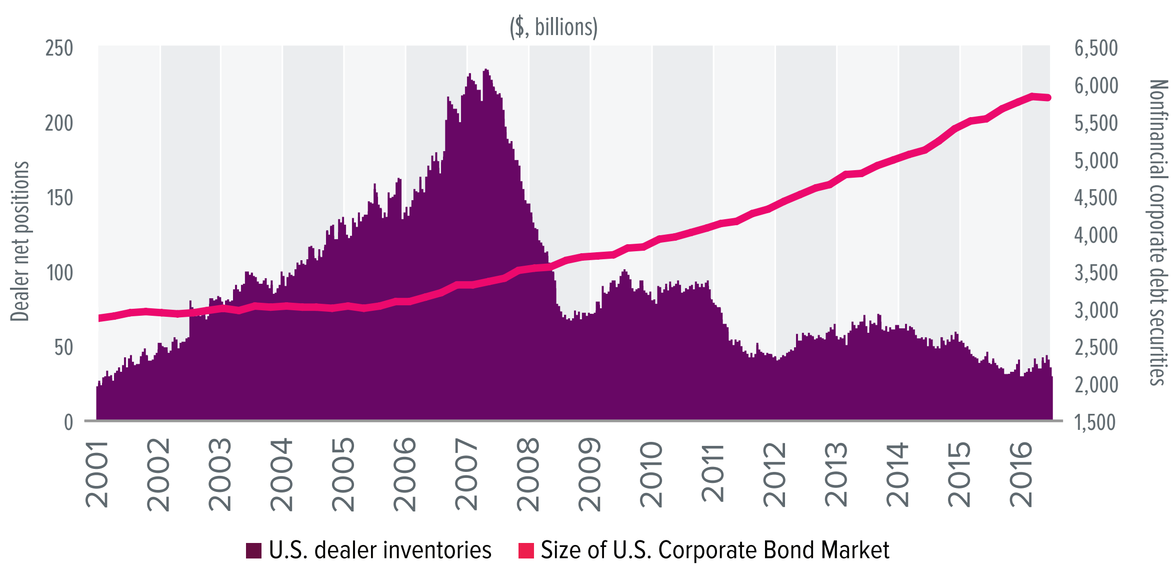
Inefficiency can have several causes: investor behavior (e.g. selling for fear of losses rather than for a sound fundamental reason), information asymmetry (e.g. different valuation approaches lead to different fair value targets), policy changes (e.g. regulations that require financial institutions to alter their role within a market), or structural impediments at the overall market or individual security level (e.g. absence of central price quotes). Each cause creates opportunity for skilled investors by temporarily forcing securities prices away from their estimated fair value.

One such opportunity has actually grown over the last decade due to regulations limiting banks from speculative principal transactions and requiring them to maintain higher levels of capital as a cushion against crisis-level conditions. While the goal of the legislation was to reduce the risk that a big bank would fail and require a taxpayer-funded bailout, an unintended consequence has been the reduced efficiency of fixed-income markets.

Bonds are bought and sold in decentralized over-the-counter markets, which contributes to their reduced efficiency compared to exchange-traded securities like equities, options and futures. Dealers (primarily major banks) have traditionally served as fixed-income market makers—buying from sellers and selling to buyers—ultimately helping to limit frictional transaction costs.

But banks have taken a large step back from that role. Exhibit 1 depicts the steep drop in the aggregate value of bonds held by dealers, which plummeted during the global financial crisis and continued to decline afterward. As the aforementioned legislation was enacted, banks were forced to reduce their bond inventories in order to raise capital at the same time that the size of the bond market climbed.

Exhibit 1: Liquidity Leaks from Bond Market



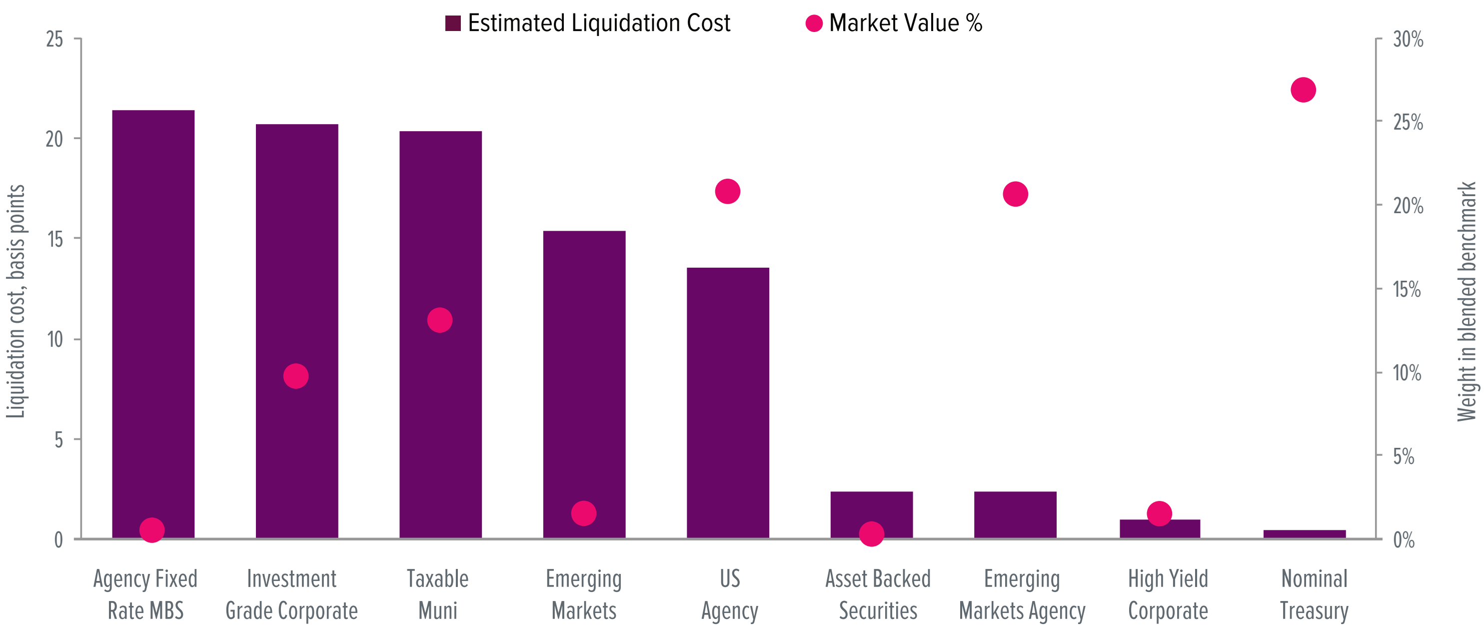
U.S. credit market in billions of dollars (both axes). July 1, 2001 to December 31, 2016. Source: Bloomberg, Federal Reserve Banks of New York and St. Louis

Diminished dealer participation has caused transaction costs to increase, rendering this ever-growing market less liquid.

We can see estimated liquidation costs and market share for each sub-asset class of a hypothetical benchmark portfolio in Exhibit 2. Some areas, like the U.S. Treasury market, are highly efficient, while others are inhospitable to high turnover or regular repositioning.

The constraints that arise from lower liquidity and higher costs have actually expanded the opportunity for disciplined investment managers to earn liquidity premium: they can purchase bonds at attractive prices when sellers have limited choices and then sell those bonds later at better prices when buyers are more active. Anything from a negative news cycle that focuses on a particular sector to hesitation ahead of a central-bank decision could scare buyers away from part of the fixed-income market for long enough to harvest liquidity premium.

Exhibit 2: Transaction Costs Add Up



80%/10%/10% Bloomberg Barclays U.S. Aggregate Bond/BofA ML U.S. High Yield Constrained/JP Morgan EMBI Global Diversified Indexes. As of May 30, 2017. Source: BlackRock Solutions

Cycles and Shifting Sentiment Equal Opportunity

The ability to capitalize on illiquidity requires a cyclical orientation. Cyclicality is characterized by improvement, deterioration, and then recovery as fundamental conditions and investor sentiment ebb and flow. Cycles are present in fixed-income markets in many ways over varying time frames.

For example, investment managers cannot be expected to reliably project the direction or distance that most interest rates will move, so we believe we can derive a benefit from remaining nimble.

To this end, some of the investment managers that we work with make shorter-term tactical decisions based on interest-rate and yield-curve expectations; these trades can be implemented with a toolkit that includes highly-liquid bonds like U.S. Treasurys, sometimes in conjunction with cash and derivatives, to help ensure precise and inexpensive exposures. Some of these decisions are in response to a market that has moved excessively in one direction, and that our managers expect will mean revert.

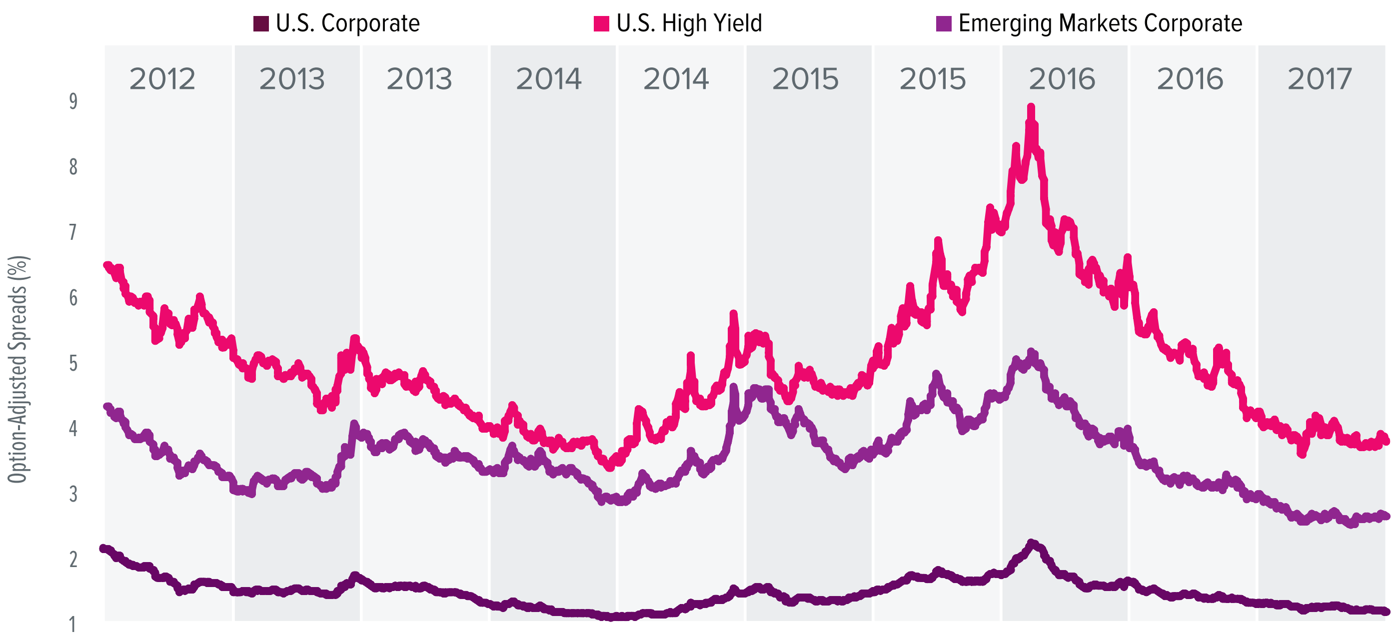
Outside of interest rates, investment managers can express shorter-term views on market sentiment. For example, when non-government sectors such as corporate bonds rally as investor risk appetite increases, managers can sell their holdings to take advantage of higher prices or by holding the cash received from maturing bonds; the latter method helps avoid liquidation costs and provides money that can be used to buy new or existing bond issues at better values when sentiment wanes.

In January 2016, we noted that "after narrowing during the latter part of 2015, credit spreads have widened again and we have been adding risk back selectively." In other words, wider spreads means bond yields have risen and prices have fallen, so our managers sought attractive buying opportunities.

More recently, in March 2017 we stated that we had "reduced exposure to bonds that exceeded valuation targets, as we believe a heavy new-issuance calendar could provide opportunities to add risk at more favorable levels."

Exhibit 3 provides a reference for these remarks, depicting the rise and fall of yield spreads over the relevant time frame. Wide spreads indicate negative investor sentiment, while falling spreads suggest an improving outlook.

Exhibit 3: Spreads Swing with Sentiment



July 2, 2012 to June 30, 2017. Source: Federal Reserve Bank of St. Louis. BofA Merrill Lynch Option-Adjusted Spreads for US Corporate Master, US High Yield Master II and Emerging Markets Corporate Plus Indexes.

Beyond the Benchmark

The aforementioned rate- and sentiment-based positioning decisions typically unfold over relatively short time frames. We think longer-term strategic decisions, which can result in off-benchmark allocations, also embody the spirit of a more disciplined approach to active management.

We believe that often times fixed-income benchmarks fail to capture some of the most compelling opportunities available in a given sub-asset class. Therefore, the mandates we assign to our investment managers allow for an expansive view on the universe, not just one that is limited to the most liquid, high-volume bond issues favored by benchmarks.

It's common to see attractive new issues that are not eligible for benchmark inclusion, and smaller deals offering great potential values are also unlikely to be included. Contrast this with issuers whose expanding debt renders them larger index constituents, and we see how fixed-income benchmarks can favor questionable quality over value.

Some market segments are absent from benchmarks altogether; as such, we maintain structural off-benchmark allocations in several fixed-income strategies, including:

- Emerging-Market Corporate Bonds: These are typically denominated in major foreign currencies (hard currency), so while they present sovereign risk premium like their emerging market government bond counterparts (due to the greater-perceived likelihood of government default), as well as credit risk, they do not exhibit a great deal of currency risk versus the U.S. dollar. Furthermore, a majority of these corporates are investment grade, a testament to the evolution that emerging markets have undergone in recent years. Once comparable to junk bonds, many emerging markets now issue investment-grade debt as well.

- Bank loans: These represent a low-duration allocation compared to similar quality high-yield bonds—meaning that they are less sensitive to interest-rate changes—because many bank loans feature a floating rate rather than a fixed one. They are also more senior in the capitalization structure, which means they possess defensive characteristics in credit-risk terms. Bank loans present a tradeoff, coupling these positive attributes with low liquidity, which we believe is worth the risk.

- Non-agency mortgage-backed securities (MBS): These may offer attractive expected returns on a risk-adjusted basis. Unlike agency mortgages, they have no implicit or contractual government backstop, but the increasing strength of housing market fundamentals in recent years supports their case. They also benefit from a strong technical dynamic in which limited new issuance helps ensure a favorable supply/demand imbalance.

Finding Income Outside of Bonds

Income-oriented strategies are primarily, but not exclusively, the domain of bond markets. A comprehensive approach to income generation could be expected to feature allocations from attractive income sources regardless of asset class. SEI's objective-based strategies focus precisely on this approach: we have developed and been managing a multi-asset income strategy with a focus on optimizing income relative to risk.

Our multi-asset income strategy includes allocations to many of the same bond-market segments featured in traditional fixed-income strategies, such as investment-grade and high-yield corporate bonds, emerging-market debt, and securitized sectors.

But it also allocates to U.S. equities as part of a covered-call strategy in which these holdings are paired with the sale of income-generating call options. This serves to limit part of the upside potential these holdings offer in favor of upfront income, which changes the risk structure of this allocation by creating a cushion against some losses.

SEI's multi-asset income strategy recently attained its five-year track record. Read **An Evolution of Income: SEI's Multi-Asset Income Fund** for a deeper look at this strategy's construction and history since inception.

Active Fixed Income Investing

A successful active approach requires identifying meaningful opportunities, and possessing the capabilities required to act on them. Our approach offers the potential to focus skilled investment managers on their respective areas of expertise and then balance their combined efforts in a portfolio.

SEI has contributed to the investment management industry's body of knowledge, including research demonstrating the importance of strategic (long-term) asset allocation decisions. Accordingly, we believe taking an inclusive approach to sub-asset classes that are absent or underrepresented in benchmarks can make a significant difference to performance over time.

The key advantage of this approach is that the manager closest to the market makes integral security-specific decisions. The size of the impact remains constrained by the value we believe that market holds, expressed through asset allocation, rather than for the sake of mirroring a benchmark.

Glossary

Mean reversion: Mean reversion refers to the theory that prices and returns eventually move back towards their historical average.

Option-Adjusted Spreads: Option-adjusted spreads estimate the difference in yield between a security or collection of securities and comparable Treasurys after removing the effects of any special features, such as provisions that allow an issuer to call a security before maturity.

Index Definitions

Bloomberg Barclays U.S. Aggregate Bond Index: The Bloomberg Barclays U.S. Aggregate Bond Index (formerly Lehman Brothers U.S. Aggregate Bond Index) is a benchmark index composed of U.S. securities in Treasury, Government-Related, Corporate, and Securitized sectors. It includes securities that are of investment-grade quality or better, have at least one year to maturity, and have an outstanding par value of at least $250 million.

BofA Merrill Lynch Emerging Markets Corporate Plus Index: The BofA Merrill Lynch Emerging Markets Corporate Plus Index tracks the performance of U.S. dollar- and euro-denominated emerging-markets non-sovereign debt publicly issued within the major domestic and Eurobond markets.

BofA Merrill Lynch US Corporate Master Index: The BofA Merrill Lynch US Corporate Master Index tracks the performance of U.S. dollar-denominated investment-grade-rated corporate debt publically issued in the U.S. domestic market.

BofA Merrill Lynch US High Yield Master II Index: The BofA Merrill Lynch US High Yield Master II Index tracks the performance of U.S. dollar-denominated below-investment-grade-rated corporate debt publically issued in the U.S. domestic market.

BofA Merrill Lynch US High Yield Constrained Index: The BofA Merrill Lynch US High Yield Constrained Index contains all securities in The BofA Merrill Lynch US High Yield Index but caps exposure to individual issuers at 2%. The BofA Merrill Lynch US High Yield Index tracks the performance of below-investment grade, U.S. dollar-denominated corporate bonds publicly issued in the U.S. domestic market.

JPMorgan EMBI Global Diversified Index: The JPMorgan EMBI Global Diversified Index tracks the performance of external debt instruments (including U.S.-dollar-denominated and other external-currency-denominated Brady bonds, loans, Eurobonds and local market instruments) in the emerging markets.

Important Information

This material represents an assessment of the market environment at a specific point in time and is not intended to be a forecast of future events, or a guarantee of future results. This information should not be relied upon by the reader as research or investment advice and is intended for educational purposes only.

There are risks involved with investing, including loss of principal. Diversification may not protect against market risk. International investments may involve risk of capital loss from unfavorable fluctuation in currency values, from differences in generally accepted accounting principles or from economic or political instability in other nations. Emerging markets involve heightened risks related to the same factors as well as increased volatility and lower trading volume. Bonds and bond funds will decrease in value as interest rates rise. High yield bonds involve greater risks of default or downgrade and are more volatile than investment grade securities, due to the speculative nature of their investments. Mortgage-backed securities are affected by, among other things, interest rate changes and the possibility of prepayment of the underlying mortgage loans. Mortgage backed securities are also subject to the risk that underlying borrowers will be unable to meet their obligations. Due to their investment strategies, the Funds may buy and sell securities frequently. The use of leverage can amplify the effects of market volatility on the Fund's share price and may also cause the Fund to liquidate portfolio positions when it would not otherwise be advantageous to do so in order to satisfy its obligations. Commodity investments and derivatives may be more volatile and less liquid than direct investments in the underlying commodities themselves. Commodity-related equity returns can also be affected by the issuer's financial structure or the performance of unrelated businesses. The Fund's use of futures contracts, forward contracts, options and swaps is subject to market risk, leverage risk, correlation risk and liquidity risk.

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