

## Strategic Income Funds Can Limit Volatility

By Bruce W. Fraser

April 2008

The traditional safe harbor of fixed income in times of extreme market volatility doesn't mean your clients have to settle for today's low yields on Treasuries. Strategic income funds, often overlooked, offer diversity, reduced risk and the potential for higher returns. Unlike single-sector funds, strategic income funds invest in several sectors and permit the portfolio manager to change the mix as conditions warrant. The general theory behind these funds is that when one sector they invest in zigs the others may zag, thus potentially limiting investors' risk.

For financial advisors who need to allocate their clients' assets in the fixed-income firmament, these funds provide a flexible solution—broad exposure to multiple classes instead of one, including high-yield bonds, investment-grade corporate bonds, convertibles and leveraged loan products. Traditionally, to get broad exposure to the bond market, an investor would need to own several different classes of bond funds, such as a corporate bond fund, a total return fund or a short-term or long-term duration fund, but might miss out on other segments of the bond market.

Strategic income funds have their pros and cons, and not everyone is enamored of them. Their main benefits are flexibility and diversification, says Paul Herbert, a senior mutual fund analyst at fund tracker Morningstar Inc. "It's one-stop shopping. You can get exposure to different bond asset classes in one place. It can be helpful for an advisor or an investor who doesn't want to have to look and research bonds in many different sectors. You're not bound to a certain sector."

Chris Towle, lead portfolio manager of the Lord Abbett Bond Debenture Fund and investment manager of high-yield and convertible investments at the firm, says, "Their flexibility gives us so many more options. Multisector funds have interest-rate sensitivity in that the manager can vary the rate sensitivity along the [duration] curve. They also have credit sensitivity, which is a way of building returns just as valid as interest-rate sensitivity, and some even have a modest degree of equity sensitivity by including convertible securities."

Strategic income funds are not without risk, of course. "The risk is that you can get caught looking the wrong way if you decided to go heavily in a certain area and it hasn't worked out," says Herbert. "Hopefully, you're diversified enough and that hasn't worked too badly against you."

There's also manager risk, he says. "There's an extra skill set the manager must have in that he has to allocate assets across the board correctly."

"The weakness of these kinds of funds is simply the flip side of their advantage," says Paul R. Sanford, chief investment officer of Tow Financial Advisors in Sherman Oaks, Calif. "If the manager fails or underperforms, it can happen in a big way. Thus, multisector bond funds are, in their purest sense, a leveraged bet on the skill of the manager."

One example of a fund that took a wrong turn last year is T. Rowe Price Spectrum Income Fund, which tends to outperform the bond market in a strong economic environment and underperform in a weak economy. "For well over a year," says Ned Notzon, portfolio manager, "we underweighted high-yield bonds thinking their spreads were too tight and we also had a modest overweighting in stocks thinking the economy would have a soft landing." But the economy turned out to be weaker than they expected so the fund's performance suffered.

Morningstar counts 157 funds in its multisector complex, including funds of all share classes. There are 55 distinct portfolios.

Far and away the biggest player is Loomis Sayles with two funds—the \$16.2 billion Loomis Sayles Bond Fund and the \$11.6 billion Strategic Income Fund. These are followed by the \$9 billion Oppenheimer Strategic Income Fund and the \$7.3 billion Lord Abbett Bond Debenture Fund. Also in this grouping are the \$5.2 billion Fidelity Strategic Income Fund and the \$6.1 billion Fidelity Advisor Strategic Income Fund (a load version), and the \$5.2 billion T. Rowe Price Spectrum Income Fund.

### Diversifying Cuts Risk

Strategic income funds each have different baskets. Their major components are U.S. government bonds, U.S. corporate investment-grade bonds and high-yield bonds. Some hold a sprinkling of U.S. government agency bonds such as Ginnie Maes. Usually a cap or floor applies to sectors to reduce risk. Most come with heavy loads and are sold through the advisor channel.

### Maximizing Return And Minimizing Volatility

The funds are multisector and that can mean multicountry as well. Many invest outside the U.S. in the sovereign bonds of developed countries as well as those of emerging market countries. Some started as high-yield bond funds in the 1970s. They began diversifying in the mid-to-late 1980s, with some adding leveraged loan products and convertibles to the mix. In the last 10 to 15 years, an increasing number have made use of derivatives and futures to offset risk and generate higher returns.

Oppenheimer Strategic Income Fund, for example, made fortuitous bets last year on Turkish and Brazilian currencies, garnering a 9.1% return, and was among the top-performing funds in Morningstar's multisector category. Loomis Sayles' two funds in this category also benefited greatly from investments in appreciating currencies in Asia and elsewhere, according to the firm.

Eaton Vance uses derivatives less to reduce risk than to generate higher returns in its foreign investments, the firm says. "Our global macro strategy is more nuanced than simple emerging-markets fixed-income investing. We pick values and particular markets, and we often cross-hedge to keep down volatility because we find there are certain things that are overpriced in those markets," says Mark S. Venezia, director of global fixed income at Eaton Vance and portfolio manager of the \$1.4 billion Eaton Vance Strategic Income Fund, which returned 8.14% last year.

## Rebalancing Gradually

Despite the market's doldrums, the multisector fund category has been expanding recently. Several fund houses, including Thornburg Investment Management and Hartford Mutual Funds, have rolled out new products over the last six months. Assets in the funds have also mushroomed. Lord Abnett's fund, for example, has more than tripled its assets since 1997.

For the most part, the funds have generated fairly consistent returns over the long term, says Morningstar. They suffered a major setback last year, however. While many of the bigger players did well, the group as a whole underperformed the general bond market, returning only 4.5%. "Many managers were caught off guard by the rapid deterioration in the high yields, especially during the second half of the year," says Morningstar's Herbert. The high-yield market returned just 1.7% last year.

Since then, managers have scrambled to adjust their high-yield positions. Eaton Vance, for example, has shaved high yield to less than 1% in its fund. Others see the carnage as a buying opportunity and are standing pat. Loomis Sayles and Lord Abnett, for example, have made only small reductions in their high-yield positions.

Bond veterans Dan Fuss and Kathleen Gaffney co-manage Loomis Sayles' two bond funds in this category. The funds have only slight differences. Gaffney says they have kept high-yield allocations pretty steady in both funds during the market's turbulence and are looking for bargains. High yields currently represent 23% of total assets in the bond fund, and 29% of total assets in the strategic income fund.

"We're comfortable with the specific high-yield credits we have," says Gaffney. "We've seen spreads widen at the beginning of the year, and we think they have further room to grow. We have plenty of room to add as the bargains come out. While the credit exposures [in high yields] may be higher than in other funds, we like certain credits that we think will do well through the full circle. We're really about picking bonds that have upside potential because the fundamentals are behind them." Loomis Sayles owns high-yield credits in General Motors, Ford, Lucent and Nortel, as well as other blue chip stocks.

Loomis Sayles Bond Fund posted an average total return of 8.53% last year compared with 7.23% for the Lehman Government/Credit Index, while the Loomis Sayles Strategic Income Fund returned 7.61%, compared with 6.97% for the Lehman Aggregate Index, a proxy for the broad bond market.

Towle says he has reduced credit risk in high yields in Lord Abnett's fund only slightly. "The credit spreads have widened out dramatically, and created tremendous value, so I reduced it somewhat prior to January, but now I'm finding that there is too much value there to reduce it any further."

The 35-year-old Lord Abnett Bond-Debenture Fund was among the first bond funds to invest in a variety of sectors. The fund, which is shepherded by Towle, three senior Lord Abnett partners and a team of analysts, has posted an average annual return of 9.07% since inception.

Unlike most other strategic income funds, the T. Rowe Price Spectrum Income Fund invests only in T. Rowe Price mutual funds, making it a fund of funds. There is no fee at the Spectrum level. "It's as if you invested in the underlying funds yourself," says manager Notzon.

The fund invests in emerging-market bonds, nondollar bonds and high-yield bonds, as well as in equities, which are some 15% of total assets. "We designed the fund to have roughly the volatility and yield of the investment-grade bond market, but to have roughly half the assets invested in and out of benchmark sectors," Notzon says.

Allocation decisions are made by the T. Rowe Price allocation committee, of which Notzon is chairman. Last year, the fund returned 6.19%. Since inception in 1990, it has returned 8.15%.

Strategic income funds have both their proponents and detractors among advisors. Both Aaron Skloff, of Skloff Financial Group, Berkeley Heights, N.J., and Tow Financial's Sanford, use them in clients' portfolios, citing their flexibility.

Says Skloff: "What I like about them is that the portfolio manager is given tremendous flexibility to control credit quality, duration, sector concentration and security concentration, all resulting in optimizing portfolio performance and risk control. The ability to control the duration of the portfolio benefits investors when the manager properly assesses the direction of interest rates."

Both advisors singled out Loomis Sayles' strategic income funds as especially well managed. Bill Walsh, president of investment firm Hennion & Walsh, Parsippany, N.J., is skeptical, however, about strategic income funds. He believes investors can get the same degree of diversification and growth with a target-date fund.

"You have to understand the inherent risk and volatility you are undertaking when you go into one of these funds," Walsh says. "To start, your principal is not guaranteed at maturity. Secondly, your income or dividend also is not locked in; it will change according to whatever is in that fund at that time, and many have highly speculative securities within their portfolios. If your objective is growth, some of the new target funds offer asset allocation, diversification and rebalancing."

Are these funds a buy for your clients at this time? Many experts say yes. These managers foresee volatility ahead in all the bond markets as investors sort out the implications of low interest rates. But all say broadly diversified shareholders have the best chance to do well, whether bonds recover quickly or slowly. □