

PERFORMING DUE DILIGENCE ON NONTRADITIONAL BOND FUNDS

by Mark Bentley, Executive Vice President, BTS Asset Management, Inc.



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Investors need to think outside the style box to make informed comparisons.

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A catch-all category

Morningstar introduced the Nontraditional Bond category in November 2011.¹ Most of the funds that went into the new category had been previously in the Multisector Bond category but were less constrained than others in that group with regard to security selection and interest rate risk.²

Morningstar also grouped several other varieties of bond funds into the new Nontraditional Bond category, including absolute return, long-short credit, and market neutral.³

Despite the huge range of styles represented by these various types of funds (see Sidebar), the Nontraditional Bond category has come to be most closely associated with "unconstrained" funds as well as "absolute return" funds. Here are comments from Morningstar's co-head of fixed-income manager research, Eric Jacobson, speaking in 2014:

*"As the category has grown, I would say that the majority of assets are pretty homogenous, in terms of overall styles. They tend to skew toward the so-called unconstrained mandates or styles, but that's really a description of what funds can do rather than what's in the portfolios.... But this is unfortunately the best way to do it, is to gather them up this way."*⁴

Elsewhere, Morningstar's Jacobson urges investors to really get to know any unconstrained funds they may be considering. It's possible for funds that look similar today to vary wildly tomorrow in their responses to market events.

Careful due diligence is the only way to understand the critical differences among unconstrained, absolute return, and other sub-groups within the Nontraditional Bond category. It's important to dig in and study the investment mandate, the manager's history in the space, risk controls, the potential for foreign exposure, including currency risk, and more.

By evaluating these and other areas, investors can get beyond "brand" to determine the best fit for a portfolio.

Morningstar's category definition focuses on examples and potentialities, not holdings:

"The Nontraditional Bond category contains funds that pursue strategies divergent in one or more ways from conventional practice in the broader bond-fund universe. Many funds in this group describe themselves as "absolute return" portfolios, which seek to avoid losses and produce returns uncorrelated with the overall bond market; they employ a variety of methods to achieve those aims. Another large subset are self-described "unconstrained" portfolios that have more flexibility to invest tactically across a wide swath of individual sectors, including high-yield and foreign debt, and typically with very large allocations. Funds in the latter group typically have broad freedom to manage interest-rate sensitivity, but attempt to tactically manage those exposures in order to minimize volatility. The category is also home to a subset of portfolios that attempt to minimize volatility by maintaining short or ultra-short duration portfolios, but explicitly court significant credit and foreign bond market risk in order to generate high returns. Funds within this category often will use credit default swaps and other fixed income derivatives to a significant level within their portfolios."

http://adminnew.morningstar.com/webhelp/glossary_definitions/categories/Nontraditional_Bond_Category.htm

Types of Nontraditional Bond funds

While the following are not formal Morningstar classifications, they are useful subgroups to consider:

Tactical allocation: Flexibility to invest across a wide swath of individual sectors, potentially with concentrated allocations. Note that some tactical funds are “unconstrained” in the sense of “investing anywhere” in the fixed income universe. Others stick to familiar asset types, such as high yield and investment grade bonds, but apply a tactical approach to these traditional assets. Morningstar may eventually separate these two types of tactical allocation funds.

Long-short: Combines long and short bond positions, typically seeking a reasonable return while reducing the credit or duration risks of some of the bonds in the portfolio.

Market neutral: Seeks to earn a return regardless of whether a market goes up or down by hedging out one or more market risk factors.

In theory, many products in the Nontraditional Bond space are “liquid alternatives.” That is, they offer the transparency and liquidity of mutual funds while typically giving the managers more flexibility than traditional mutual funds. That flexibility gives them characteristics in common with fully “alternative” asset classes such as hedge funds.

But in practice, most of these funds have hardly been “alternative” in terms of risk reduction or returns profile. For example, the Nontraditional Bond category, which largely consists of so-called unconstrained funds, has a five year correlation of 0.96 to high yield bonds and 0.90 to emerging market debt (see correlation table later in this article).

Growth of Nontraditional Bond funds

The Nontraditional Bond category has grown explosively since its introduction by Morningstar in November 2011. There are two main reasons for this rapid growth:

Post-2008 factors: Increased need for non-market correlated assets to mitigate risk—but with the potential to avoid giving up performance. Also, tactical products in the form of mutual funds offer increased transparency, liquidity, and lower fees than illiquid alternatives.

Interest rate environment: Baby boomers’ need for income and rising interest rate concerns.

What should you focus on when doing due diligence on Nontraditional Bond funds?

FIRM AND STRATEGY

Firm’s historical and current focus. There are many newcomers to the nontraditional bond space. Does the firm have experience managing bonds through a variety of credit markets? Some firms have built a reputation for tactical decisions, whereas others are known for their efforts to add marginal value to strategies that remain close to benchmark allocations over the long term.

Strategy. How long has the strategy been in operation? How has the strategy evolved over the number of years it’s been employed? What are the limits on the strategy with regard to the portfolio percentage allowed for various asset types? Are there limits on interest rate risk?

In addition to fully understanding the parameters of the strategy, it’s helpful to examine the manager’s actual track record running the strategy. Does the manager stay away from concentrated positions? Does the strategy tend to hug the benchmark?

Be sure to evaluate the types of holdings that are *allowed*, as well as the mix of holdings in the current portfolio. If foreign bonds and currencies are among the permitted asset types, are these consistent with your objectives?

BENCHMARK AND RETURNS

Appropriateness of benchmark. Nontraditional bond funds are often benchmarked against the Barclays Aggregate Bond Index or a best-fit index based on holdings. Are these good benchmarks for the fund you are exploring?

If the credit quality, interest rate characteristics, or risk management of the strategy don’t match up well with the benchmark’s characteristics, exercise great caution when interpreting measures of relative risk.

Returns history. What is the return history of the fund compared to the Nontraditional Bond category as a whole and to the Barclays Aggregate Bond Index? How has the fund performed through rising and falling interest rate environments?

The sequence of returns is especially important to consider. Particularly for funds that claim to help protect against downside risk, explore in detail how the fund has handled periods that were challenging. It's important to look for steady sequences of successful returns—how the strategy and market conditions came together—rather than just looking at a snapshot in time.

RISK MEASURES

Standard Deviation, Sharpe Ratio, Downside Deviation, and Sortino Ratio. It is important to dig into risk measures that go beyond Standard Deviation and the Sharpe Ratio. These two common measures are less meaningful for many nontraditional strategies than are Downside Deviation and the Sortino Ratio.

As a mathematical measure, Standard Deviation considers volatility to the upside as well as the downside. For strategies specifically seeking to limit downside risk, it's more helpful to focus on Downside Deviation, which focuses the attention on volatility to the negative but not the positive. Essentially, the point is to avoid penalizing funds for positive performance.

The same reasoning applies to the Sharpe Ratio (which, like Standard Deviation, takes into account positive surprises). The Sortino Ratio is a more meaningful metric for many nontraditional strategies because its calculation involves the variation in *negative* asset returns rather than both positive and negative returns.

Correlations. How does the fund perform relative to traditional categories such as high yield bonds, investment-grade bonds, Treasuries, or even stocks? Consider the table below, showing 5-year correlations of the Morningstar Nontraditional Bond category versus several asset types. One number stands out: the high correlation to high yield bonds. Investors seeking to diversify their risk exposure may wish to explore options much less correlated than this average value for the category.

NONTRADITIONAL CORRELATION MATRIX

	MORNINGSTAR NONTRADITIONAL BOND FUND CATEGORY	BLOOMBERG US AGGREGATE BOND INDEX	BLOOMBERG US CREDIT INDEX	BLOOMBERG CORPORATE HIGH YIELD INDEX	S&P 500 INDEX	BLOOMBERG EMERGING MARKETS INDEX
MORNINGSTAR NONTRADITIONAL BOND FUND CATEGORY	1.00					
BLOOMBERG US AGGREGATE BOND INDEX	0.56	1.00				
BLOOMBERG US CREDIT INDEX	0.79	0.92	1.00			
BLOOMBERG CORPORATE HIGH YIELD INDEX	0.95	0.58	0.79	1.00		
S&P 500 INDEX	0.79	0.50	0.67	0.84	1.00	
BLOOMBERG EMERGING MARKETS INDEX	0.92	0.48	0.71	0.86	0.75	1.00

Source: Morningstar. Five-year correlations as of December 31, 2024

Beta and Alpha. Beta and Alpha need special consideration in the context of investment vehicles that provide low correlation to benchmark indices. For funds that are highly correlated to an index, a high level of Beta suggests the fund's returns are likely to respond to swings in the market. Beta is less relevant when performance is largely uncorrelated to benchmark returns. The same reasoning holds true for Alpha. Alpha measures performance on a risk-adjusted basis. Alpha takes price risk and compares its risk adjusted performance to a benchmark. However, if Beta and Correlation are not high Alpha is less significant. While Beta and Alpha have an important place in most risk and return analyses, it is important to search for correlation from a downside risk perspective. Therefore, if two portfolios have the same downside deviation and low Beta, the argument can be made that Alpha becomes more relevant.

Upside and Downside Capture Ratios. These ratios measure the degree to which a given fund has under or outperformed a broad market benchmark based on monthly returns during periods of market strength and periods of market weakness.

If the fund goes up the same amount as the benchmark, the Upside Capture is 100%. A higher or lower ratio indicates the fund captured either more or less of the benchmark's positive returns, respectively.

Similarly, Downside Capture compares a fund's returns to the negative returns of the appropriate benchmark over a given period. Downside Capture is a particularly useful metric for conservative investors seeking capital preservation.

Past performance is not indicative of future results. Investors cannot directly invest in an index, and unmanaged index returns do not reflect fees, expenses, or sales charges.

In some cases, a fund may post negative returns during periods when the benchmark is up, or positive returns during periods when the benchmark is down. In these cases, the Upside and Downside Capture Ratios will be negative. In essence, these funds may zig when the market zags.

For an investor focused on capital preservation, a negative Downside Capture Ratio may be highly attractive.

Drawdowns and recovery. What is the fund's most severe drawdown in terms of percentage loss? For how many months did the slide last, and how did the fund compare to its benchmark or peers during that time? How long did it take for the fund to recover? These metrics can help investors discern more about the nature of the strategy and how the manager implements it during challenging times.

Disclosures

Long-Short Credit Morningstar category refers to funds that seek to profit from changes in the credit conditions of individual bond issuers and credit market segments represented by credit indexes. Typically, portfolios purchase bonds or sell credit default swaps with the expectation of profiting from narrowing credit spreads; or, the funds sell bonds or purchase credit default swaps with the expectation of profiting from the deteriorating credit of the underlying issuer. This category includes funds that use credit derivatives to hedge systematic risk of credit markets to isolate credit selection returns. Funds in this category frequently use derivatives to hedge interest rate risk. Bloomberg Barclays Aggregate Bond Index is comprised of government securities, mortgage-backed securities, asset-backed securities and corporate securities with maturities of one year or more to simulate the universe of bonds in the market. S&P 500 includes 500 leading companies in leading industries of the U.S. economy and is a proxy for the total stock market. Bloomberg Barclays U.S. Credit Index is comprised of publicly issued corporate and non-corporate securities, specified foreign debentures, and secured notes denominated in USD. Bloomberg Barclays U.S. Corporate High Yield Index is comprised of USD-denominated, non-investment grade, fixed-rate, taxable corporate bonds. Bloomberg Barclays USD Aggregate Emerging Markets Index includes fixed and floating-rate USD-denominated debt from emerging markets. Morningstar's Nontraditional Bond category consists of open-end funds that pursue strategies that are different from conventional practice in the broader bond-fund universe.

Up Capture Ratio measures the portfolio's compound return when the benchmark was up divided by the benchmark's compound return when the benchmark was up. Down Capture Ratio measures the portfolio's compound return when the benchmark was down divided by the benchmark's compound return when the benchmark was down. Cumulative Return is the total gain, expressed as a percentage of the initial value. Standard Deviation measures the degree of variation of returns around the average return; the higher the volatility, the higher the standard deviation. Sharpe Ratio is a risk-adjusted performance measure (the incremental average return over the risk-free rate - represented as 3% - divided by risk), where risk is defined by standard deviation. A higher Sharpe ratio may indicate higher risk-adjusted returns. Sortino Ratio is a risk-adjusted performance measure (the incremental average return over the minimum acceptable return - represented as 0% - divided by risk), where risk is defined by downside deviation. A higher Sortino ratio may indicate higher risk-adjusted returns. Downside Deviation considers returns that fall below the minimum acceptable return. 0% is used for the minimum acceptable return. Correlation measures how two securities move in relation to one another. Alpha measures a manager's value-added return over a benchmark index by comparing its actual return to the return expected based on the risk level. Beta measures sensitivity to market movements relative to a benchmark index. Alpha, Beta, and Correlation show the value of the BTS portfolio versus the listed benchmark.

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¹Eric Jacobson, Morningstar.com, "The New Non-Traditional-Bond Category," January 19, 2012.
<http://www.morningstar.com/advisor/t/51166436/the-new-non-traditional-bond-category.htm>

²Christine Benz and Eric Jacobson, Morningstar.com, "Be Careful With This New Crop of Bond Funds," November 11, 2011.
<http://www.morningstar.com/cover/videoCenter.aspx?id=439627>

³Christine Benz and Eric Jacobson, Morningstar.com, "Be Careful With This New Crop of Bond Funds," November 11, 2011.
<http://www.morningstar.com/cover/videoCenter.aspx?id=439627>

⁴Christine Benz and Eric Jacobson, Morningstar.com, "What's So Attractive About Nontraditional Bond Funds?" May 29, 2014.
<http://www.morningstar.com/Cover/videoCenter.aspx?id=649551>



About BTS Asset Management

Founded in 1979, BTS Asset Management is one of the oldest risk managers, managing traditional assets with a nontraditional approach. BTS has a multi-year track record in tactical fixed income and equity management. Our goal is to find opportunities with the potential to take advantage of rising markets while working to manage losses during downturns.

BTS:

- Seeks to preserve capital
- Aims to offer downside risk management and upside potential
- Strives to reduce volatility while delivering consistent long-term returns



FIND OPPORTUNITY

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