DIAMOND HILL

INVESTED IN THE LONG RUN

Rethinking Core Fixed Income: An Active Approach to Finding Alpha

March 2024

Over the past decade, core fixed income strategies have navigated through tumultuous storms. The era of quantitative easing brought about suppressed interest rates, causing a seismic shift in bonds' traditional role as portfolio shock absorbers. This led to a period of dwindling income generation, sparking debates on the time-honored 60/40 stock-bond allocation strategy.

However, as we fast forward to 2024, core fixed income is making a comeback, powered by the systematic tightening from the Federal Reserve. Benchmark rates have bounced back to levels unseen in over a decade, breathing new life into the dual roles of fixed income: income generation and portfolio diversification. With this resurgence, core bond portfolios are primed to regain their status as fundamental portfolio components.

With core fixed income back in vogue, investors need to understand the makeup of their core portfolios and how those components will react in various market environments — since the future is anything but certain. Recognizing the vast opportunity set that extends beyond traditional fixed income benchmarks is also crucial. Active, bottom-up managers can capitalize on that opportunity set, creating more attractive risk-return potential for actively managed core fixed income portfolios.

Broadening Horizons: How Active Managers Navigate Beyond Benchmarks

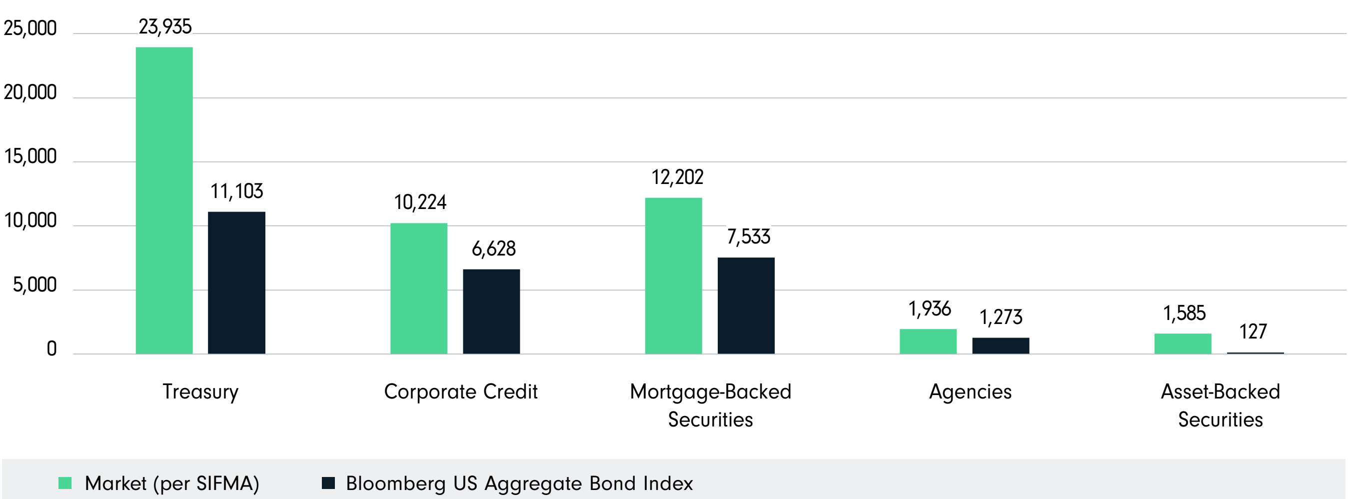
Among core bond strategies, ample opportunities exist for an active, benchmark-agnostic, bottom-up manager to add value. To understand the true opportunity for differentiation within an investment-grade core strategy, it is critical to understand what is included and excluded from common investing benchmarks.

The core bond universe is massive — approximately $52 trillion as of year-end 2022 (most recent data available), according to the Securities Industry and Financial Markets Association (SIFMA) — and includes a wide range of securities. However, the widely used Bloomberg US Aggregate Bond Index represented just $26.7 trillion as of year-end 2023.

Why the discrepancy? The index follows specific rules and limitations meant to manage inclusion and conduct rebalancing in a particular manner. Additionally, each security eligible for inclusion must adhere to specific liquidity constraints based on each sector. Exclusion criteria (see sidebar) disqualify certain areas of the market that can add value to an actively managed strategy. Exhibit 1 shows the index's categories and the opportunities outside the benchmark.

The index's limitations provide an opportunity for active managers who have the flexibility to invest outside of the benchmark, including among Treasury, mortgage-backed (MBS) and asset-backed securities (ABS).

Exhibit 1 — Opportunity vs the Index ($)



Source: Securities Industry and Financial Markets Association (SIFMA) as of 31 Dec 2022. Note: Market (per SIFMA) MBS and ABS most recently available data as of 31 Dec 2021.

Limitations of Index Inclusion

Bloomberg US Aggregate Bond Index – Liquidity Requirements for Inclusion

- Treasury, government-related and corporate securities: $300 million par amount outstanding
- Mortgage-Backed Securities (MBS): $1B par amount outstanding at the cohort level
- Asset-Backed Securities (ABS):
  - $500MM minimum deal size at issuance
  - $25MM minimum tranche size
- Commercial Mortgage-Backed Securities (CMBS):
  - $500MM minimum deal size at issuance
  - $300MM amount outstanding remaining in the deal
  - $25MM minimum tranche size

All securities in the index must also meet these conditions:

- Must be rated investment grade
- Have a fixed-rate coupon structure
- Be SEC-registered (or Rule 144A with registration rights)
- Have at least one year until final maturity

Finding the Sweet Spot in the Treasury Market

The Treasury market has historically been the most liquid fixed income market. It is generally viewed as the conservative alternative to corporate and securitized debt in times of crisis or uncertainty. The Diamond Hill Core Bond Strategy approaches the opportunity in this commoditized sector in two ways: by allocating across the yield curve and investing in Treasury STRIPS (separate trading of registered interest and principal securities).

While our Treasury allocation is typically considerably less than the index (17.4% vs. 41.6% as of 31 Dec 2023), the contribution to duration from the Treasury allocation is relatively close (1.99 years vs. 2.57 years). This is achieved through allocations in longer Treasury bonds compared to the index and the impact from longer duration STRIPS.

STRIPS can provide an opportunity to pick up incremental option-adjusted yield as principal STRIPS represent the issuance's final payment and, therefore, are paid in full at the final maturity date. STRIPS, which are excluded from the Bloomberg US Aggregate Bond Index (Exhibit 2), make up roughly 19% of the Core Bond strategy's Treasury allocation. In comparison, Treasury bonds (which have a maturity of greater than 10 years) make up nearly 48% of the strategy's Treasury weighting, while in the index, bonds represent 21% of the Treasury exposure.

Exhibit 2: Treasury Market Size vs Index Representation

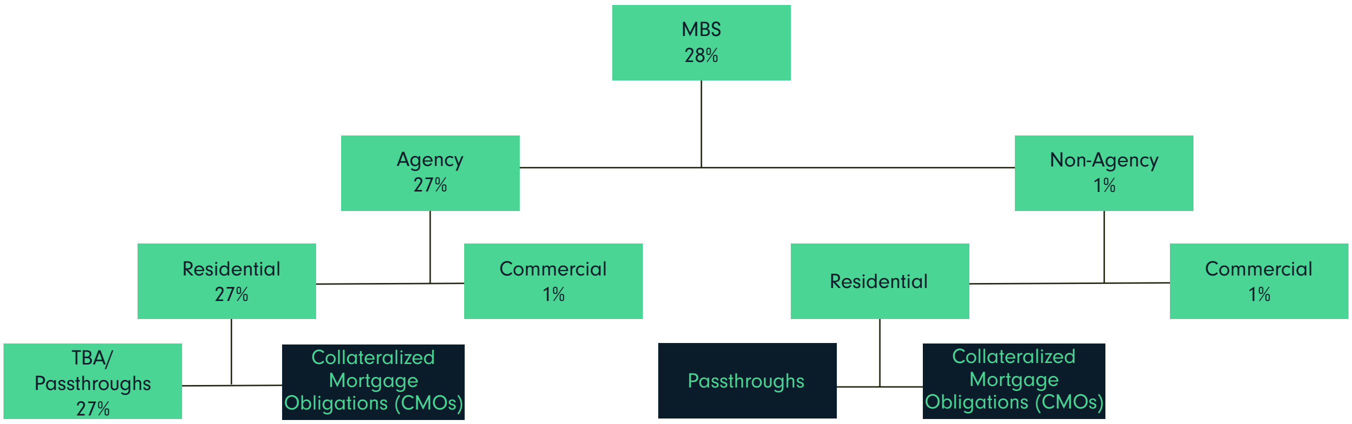
US Treasury	Market Size ($B)	Benchmark Allocation ($B)
Bills (less than one year)	5,676	0
Notes (2-10 years)	13,758	8,824
Bonds (10+ years)	4,355	2,279
TIPS	2,006	0
STRIPS	0	0
FRN	571	0
Total	**26,366**	**11,103**

Source: Bloomberg, SIMFA as of 31 Dec 2023. STRIPS' market size is $0, as their values are already represented in the Bonds/Notes count.

MBS: Looking Beyond the Benchmark

The mortgage market is vast and well-diversified, and its securities offer additional yield opportunities and a differentiated risk profile. However, index rules exclude a significant portion of this sector. Exhibit 3 illustrates which areas of the mortgage market are included in (green) and excluded from (navy) the index.

Exhibit 3: Non-benchmark Opportunities in MBS



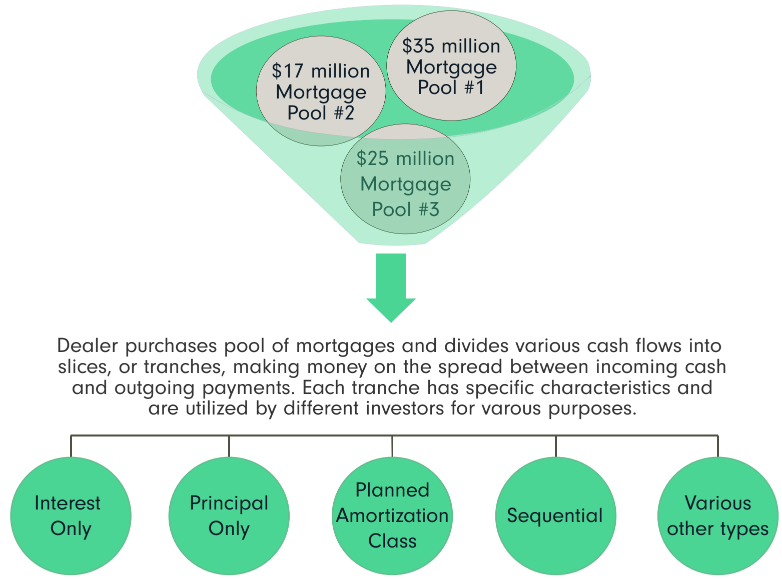
Source: Bloomberg, as of 31 Dec 2023.

In a "To Be Announced" or TBA mortgage transaction, the MBS seller agrees on a sale price without specifying which individual mortgages will be delivered on the settlement date. Basic characteristics are agreed upon, such as coupon rate and the face value of the bonds to be delivered, but not much else. This process ensures that the TBA market is typically the most liquid in mortgages by combining various pools into a standard format. Since these are highly liquid and readily tradable mortgage securities, they serve as the basis for pricing a variety of MBS. The cash flows in both TBA mortgages and specified pools implement the pass-through process, wherein investors receive a pro-rata share of both principal and interest for the mortgages included in the pool.

Specified pools are unlike TBAs because these securities are associated with specific mortgage pools rather than a generic market portion. Due to their relative heterogeneity, specified pools are not as liquid as the TBA market. Still, they allow for more granular detail on the underlying mortgages and the opportunity to focus on specific attributes of the mortgage loan, such as seasoned mortgages, specific geographies, or loans with maximum balances.

While the Diamond Hill Core Bond Strategy will invest in specified pools, most of the residential mortgage allocation comes from collateralized mortgage obligations (CMOs). CMOs were first introduced to the market in 1983, fueled by investors looking to split out various cash flows from specified pools. Investment banks dissected mortgage pools into various cash flows, each targeted to different tastes of risk/return for investors. CMOs were initially established as a sequential alternative to the pass-through market, as the cash flows in a mortgage pool were broken into tranches, each with an assumed weighted average life and each not paid until the bond ahead of it was paid off. As the market evolved, so did the CMO market, as investment bankers created more types of CMOs to address specific client needs. The combination of mortgage pools and subsequent breakdown into CMO tranches is illustrated in Exhibit 5. CMOs offer significant yield pick-up in exchange for some liquidity relative to TBA or specified pools, but they can also deliver protection from extension and prepayment risk.

Exhibit 4: Collateralized Mortgage Obligation (CMO) Structure



ABS: Discover Opportunities Among Index Exclusions

The ABS market remains the smallest subset within the investment grade fixed income market, with roughly $1.6 trillion in outstanding issuance (December 2021, most recent data available). The ABS market is particularly impacted by the index inclusion rule — approximately 95% of the ABS market is excluded from the benchmark. For a long time, the index rules stated that only ABS securitized by automobiles, credit cards and stranded-cost utilities would be included. A decision to include securitizations backed by motorcycles, device plans (cell phones) and equipment was implemented in April 2021, but the impact of the inclusion of these areas of the market was de minimis. At the end of 2020, the ABS allocation in the Aggregate index was 0.3%. After the expansion of index-eligible ABS, the allocation of ABS in the Aggregate index held steady at 0.5% (as of 31 Dec 2023).

The credit rating requirement from only S&P, Moody's and Fitch further limits the inclusion of ABS. It also discounts the opportunity available in securities rated by Kroll, DBRS and other nationally recognized statistical rating organizations (NRSRO) outside the big three. This market component has been growing substantially as issuers look to utilize rating agencies like Kroll with a stronger focus on the ABS market.

Market areas that have evolved since the financial crisis and are outside the benchmark include cell tower leases, consumer, property assessed clean energy (PACE), small business, whole business/franchise, timeshares, solar and structured settlements. Nearly half of the ABS sector is collateralized loan obligations (CLOs). (The Diamond Hill Core Bond strategy does not invest in CLOs, as these securities are more focused on corporate debt.)

These index exclusions create opportunities as larger managers are typically unable to establish meaningful positions in this sector. At Diamond Hill, we believe certain areas of the ABS market offer a compelling investment opportunity with significant credit enhancements and opportunities for diversification at attractive valuations, most of which are outside the benchmark.

What's at the core of Diamond Hill's Core Bond Strategy?

The Diamond Hill Core Bond Strategy takes a differentiated, transparent, bottom-up approach to investment management, focusing on finding relative value among the tens of thousands of securities in the investment grade fixed income market. This approach leads to allocations outside of the benchmark — driven by opportunities to add value — with a focus on the securitized market.

From a high level, sector allocations may be similar to benchmark weightings, but when one looks under the hood and examines the underlying securities, the difference in the Diamond Hill philosophy is revealed. The Treasury allocation is typically deployed into STRIPS, CMOs dominate the mortgage allocation, and the ABS allocation is diversified and unique. Using cash bonds instead of derivatives provides the portfolio with transparency that investors can review and understand.

With alpha generation intended to come from security selection and sector allocation, duration (sensitivity to interest rate fluctuations) is managed to a range within +/- 10% of the benchmark duration. From a credit quality standpoint, the strategy is a true core approach, with no allocation to below-investment-grade securities — though the strategy can continue to hold securities if they are downgraded.

We believe the best way to mitigate volatility inherent in riskier assets is by investing in a true core portfolio that focuses on higher-quality securities that can reduce the impact of market upheavals. Transparency is key, as investors need to understand what they own and how it can react in different market environments.

Agency MBS are issued or guaranteed by an agency of the US government such as Ginnie Mae, or by government sponsored- enterprise (GSEs), including Fannie Mae and Freddie Mac. **Non-Agency MBS** are issued by private firms, such as subsidiaries of investment banks, financial institutions and homebuilders. **Commercial mortgage-backed securities (CMBS)** are fixed-income investment products backed by mortgages on commercial properties rather than residential real estate. **Treasury Inflation-Protected Securities (TIPS)** are US Treasury securities, indexed to inflation in an aim to protect investors from a decline in the purchasing power of their money. As inflation rises, TIPS adjust in price to maintain its real value. A **floating-rate note (FRN)** is a debt instrument with a variable interest rate tied benchmark rate. **Investment Grade** is a bond quality rating of AAA, AA, A or BBB.

Bloomberg US Aggregate Bond Index is an unmanaged index representing the US investment grade fixed rate bond market, with index components for government and corporate securities, mortgage pass-through and asset-backed securities. Index data source: Bloomberg Index Services Limited. The index is unmanaged, includes net reinvested dividends, does not reflect fees or expenses (which would lower the return) and is not available for direct investment. Index data source: Bloomberg Index Services Limited. See diamond-hill.com/disclosures for a full copy of the disclaimer.