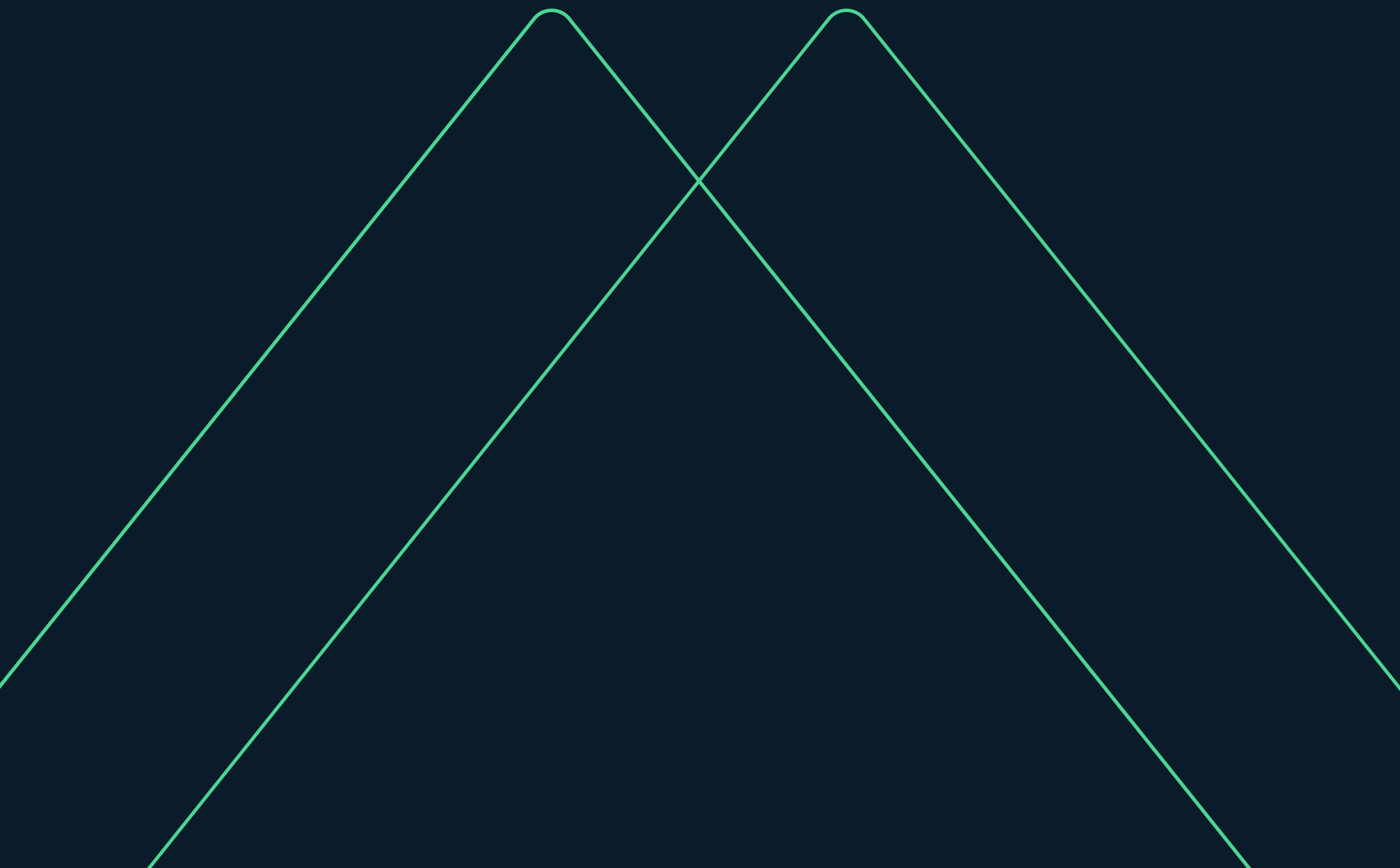
DIAMOND HILL

INVESTED IN THE LONG RUN

What's at the Core of Your Fixed Income Portfolio?

May 2022



Assessing the current environment

Just when the world was getting back to some semblance of normalcy, it took a spin for the surreal. We have witnessed the first land war in central Europe since World War II as Russian forces invaded Ukraine, and the Federal Reserve commenced a new tightening cycle, with the first interest rate hikes since late 2018, as US inflation hit a 40-year high.

Since the beginning of the year, the Bloomberg US Aggregate Bond Index is down -9.5% (as of 30 April 2022). That's not only the worst start to a year in history, it's the worst four-month period ever and it would be the worst calendar year on record if it was stretched out over an entire year. But periods of market dislocation, like the global financial crisis or what we're going through right now, can benefit investors over the long term — with great volatility and market dislocation comes great opportunity. Thus, the importance of a consistent investment approach that is applied over a long period of time through a variety of market environments.

These unsettling times are when transparency and a clear understanding of what a fixed income portfolio holds are most important. Fixed income strategies broadly performed well when the Federal Reserve was supporting all asset classes. But the start of 2022 has been a sort of reckoning for strategies that were taking on higher levels of risk, such as below investment grade allocations, derivatives, currency hedging or aggressive macro positioning. More recently, the market has been rewarding strategies that have remained committed to a true core approach, mitigating some of the losses since the beginning of the year. And that's really the goal of a core strategy — to protect on the downside as much as possible when there is uncertainty and volatility.

In a rising rate environment, duration (the sensitivity to interest rate movements) is going to be a headwind for fixed income strategies — it's simply the nature of bond math. How an investor mitigates those headwinds is crucial. Investing in areas outside of the benchmark — that are still representative of the benchmark, e.g., investment grade asset-backed securities or non-agency commercial mortgage-backed securities — can provide attractive yield with shorter duration, which can help limit the impact of some of those headwinds.

In a period of rising rates and potentially widening spreads, the goal of a core strategy becomes limiting the downside relative to the benchmark while positioning for a potential stabilization of rates, which will come at some point, and maintaining higher yielding income relative to the benchmark.

Identifying the true opportunity set

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. Among core bond strategies there are ample opportunities for an active, benchmark-agnostic, bottom-up manager to add value.

The core bond universe is massive — approximately $53 trillion as of 31 December 2021, according to 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 $24.7 trillion as of 30 April 2022.

Why the discrepancy? The index follows specific rules and limitations meant to control inclusion and to conduct rebalancing in a specific manner. Additionally, each individual security eligible for inclusion must adhere to specific liquidity constraints based on each sector. Exhibit 1 outlines the criteria for inclusion, which disqualify certain areas of the market that can add value in an active strategy. Exhibit 2 shows the index's categories and the opportunities outside of the benchmark.

The limitations of the index provide 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: Limitations of Index Inclusion

Bloomberg US Aggregate Bond Index – Liquidity Requirements for Inclusion

- Treasury, government-related and corporates: $300 million minimum par amount outstanding.
- MBS: pool aggregates must have $1 billion par amount outstanding.
  - Additionally, only auto, credit card and stranded cost utility ABS are included in the index.
- Commercial mortgage-backed securities (CMBS): $500 million minimum deal size with at least $300 million amount outstanding remaining in the deal and $25 million minimum tranche size.
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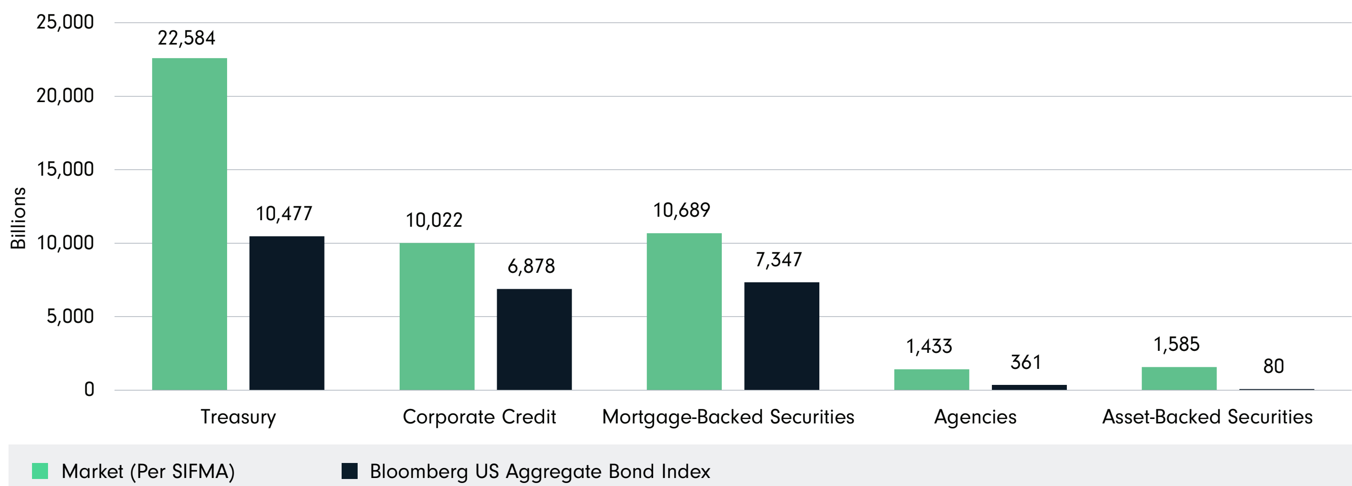
All securities in the index must also meet these conditions:

- Must be rated investment grade by two of three nationally recognized statistical rating organizations (S&P, Moody's, Fitch).
- Have a fixed-rate coupon structure.
- Be SEC-registered (or Rule 144A with registration rights).
- Have at least one year until final maturity.

Exhibit 2: Opportunity vs the Index ($)



Source: Securities Industry and Financial Markets Association (SIFMA) as of 31 Dec 2021.

Finding the sweet spot in the Treasury market

The Treasury market is historically the most liquid fixed income market and 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 (18.5% vs. 40.0% as of 30 April 2022), the contribution to duration from the Treasury allocation is very close (2.47 years vs. 2.59 years). This is achieved through allocations in longer Treasury bonds compared to the index as well as 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 3), make up roughly 34% of the Core Bond strategy's Treasury allocation while Treasury bonds (which have a maturity of greater than 10 years) make up nearly 43% of the strategy's Treasury weighting, while in the index, bonds represent 19% of the Treasury exposure.

Exhibit 3: Treasury Market Size vs Index Representation

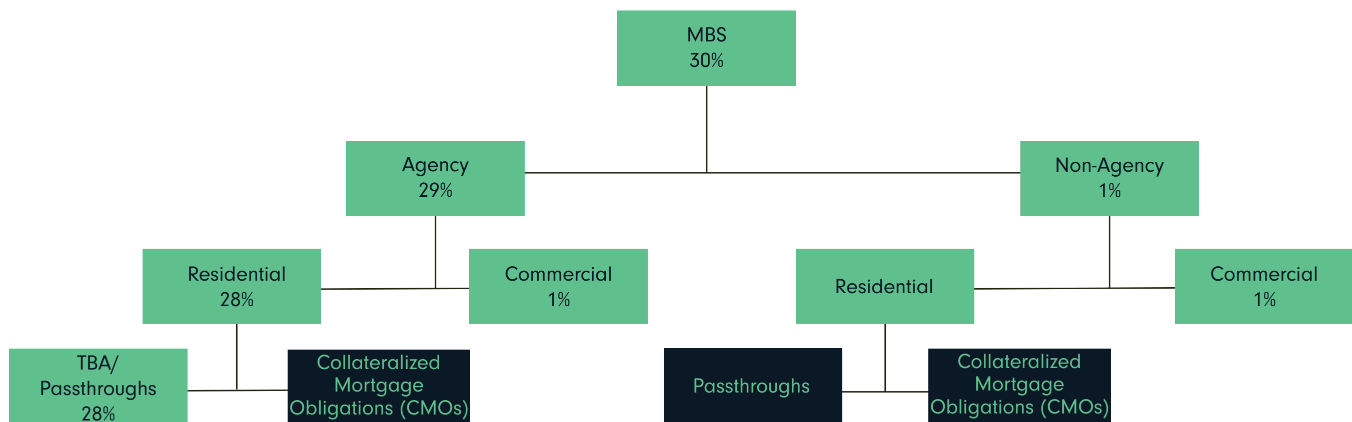
US Treasury	Market Size ($B)	Benchmark Allocation ($B)
Bills (less than one year)	3,828	0
Notes (2-10 years)	13,410	8,053
Bonds (10+ years)	3,656	1,932
TIPS	1,736	0
STRIPS	0	0
FRN	619	0
Total	23,249	11,753

Source: Bloomberg, SIFMA, as of 30 Apr 2022. The market size of STRIPS is $0 as these securities' values are already represented in the Bonds/Notes count.

Looking beyond the benchmark in mortgage-backed securities

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 4 illustrates which areas of the mortgage market are included in (green) and excluded from (navy) the index.

Exhibit 4: Non-benchmark Opportunities in MBS



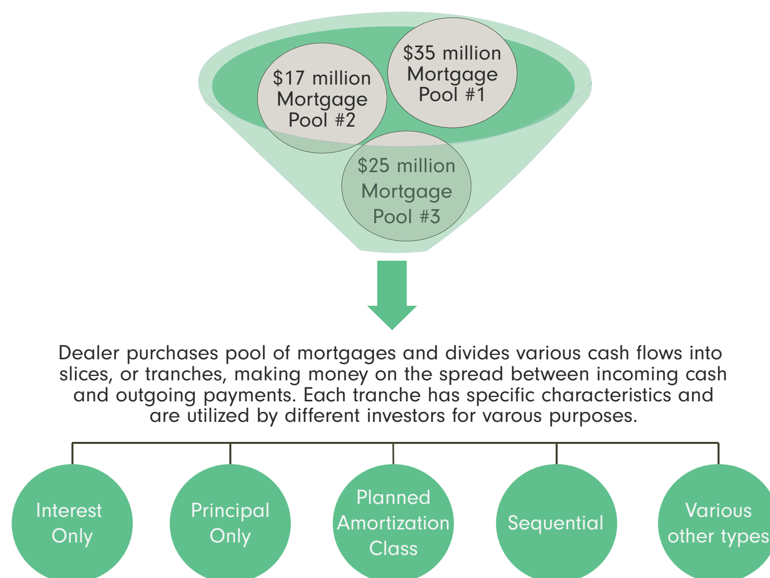
Source: Bloomberg, as of 30 Apr 2022.

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 a variety of different 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 in that these securities are associated with specific mortgage pools rather than a generic market portion. Specified pools are not as liquid as the TBA market due to their relative heterogeneity, but 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, the majority 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 originally 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 too 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 level of liquidity relative to TBA or specified pools, but they can also deliver protection from extension and prepayment risk.

Exhibit 5: Collateralized Mortgage Obligation (CMO) Structure



Discover opportunities among index exclusions in asset-backed securities

The ABS market remains the smallest subset within the investment grade fixed income market, with roughly $1.5 trillion in outstanding issuance (31 December 2021). The ABS market is particularly impacted by index inclusion rule—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 0.3%.

The requirement of a credit rating from only S&P, Moody's and Fitch further limits inclusion of ABS and discounts the opportunity available in securities rated by Kroll, DBRS and other nationally recognized statistical rating organizations (NRSRO) outside of the big three. This component of the market has been growing substantially as issuers look to utilize rating agencies like Kroll that have a stronger focus in 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 or CLOs, though the Diamond Hill Core Bond strategy does not invest in this area of the market as these securities are more focused on corporate debt.

These index exclusions create opportunity 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 of 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, with a focus on the securitized market driven by opportunities to add value.

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 will deploy into STRIPS, the mortgage allocation is dominated by CMOs and the ABS allocation is diversified and unique. The utilization of cash bonds in lieu of derivatives provides the portfolio with transparency — one 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 — one that focuses on higher quality securities that can serve to 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 that are 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.

The **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. See diamond-hill.com/disclosures for a full copy of the disclaimer. The index does not incur fees and expenses (which would lower the return) and is not available for direct investment.

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