Review and Outlook

Russell Investments Unconstrained Bond Fund

What challenges did the Fund face over 2018?

Almost all fixed income instruments are beholden in some way to what happens in the two main risk premia that are available in fixed income: interest rate risk and credit risk. Indeed, over 2018, the main challenge faced by the Fund was poor performance within interest rates and credit. After a last-minute rally towards the end of 2018, interest rates ended the year slightly down. Meanwhile, credit also suffered from a last-minute sell-off, leaving it flat for the year overall.

Against this market backdrop, excess returns over cash rates were relatively respectable; however, it failed to beat the target return (see opposite). Nonetheless, this performance is in line with expectations, given that the Fund manages its risk through significant diversification against the key risk premia.

What were the main contributors to performance (positive and negative)?

Core yield engine

- The core yield engine, consisting of exposure to short duration high yield, was flat over the course of the year.
- Both managers (Post and Hermes) delivered positive year-to-date (YTD) returns going into the fourth quarter, however came under pressure in November and December.
- Post, the U.S.-centric high yield manager, was able to hold onto its calendar year returns, while Hermes gave back its YTD returns.

How did the Fund perform in 2018?

Cash benchmark

The Fund delivered 2.5% (gross of management fees) in absolute return terms, whilst the 3-month LIBOR USD interest rate returned 2.34%. The Fund outperformed this cash benchmark by 16bps.*

Target return

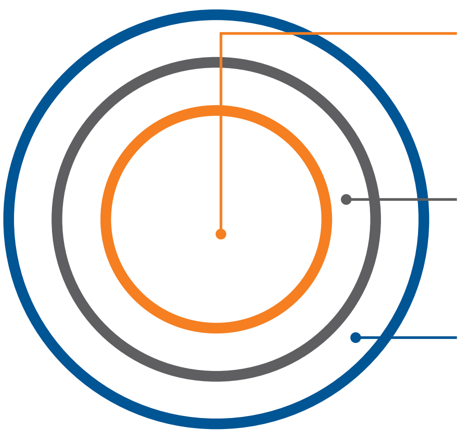
The Fund under-delivered its LIBOR + 300bps target, but was able to generate returns in excess of cash despite the challenging environment for both interest rates and credit.

Peer group

The Fund materially outperformed its Morningstar peer group by 391bps (net of fees). This is because many peers of the Unconstrained Bond Fund are heavily reliant on traditional fixed income risk premia, such and term premium and credit premium. Both of these premia were under pressure for the sustained periods over the course of the year.

* Source: Russell Investments, Confluence, Morningstar. As at 31 December 2018. Any past performance is not necessarily a guide to future performance.

Fund profile



Core yield engine (46%)

- Generate baseline return and income from most attractive part of the credit spectrum (1-5 years BB-rated)
- Flexibility to move credit quality or duration as opportunities arrive
- Active sector rotator

Opportunistic book (21%)

- Adds higher Sharpe Ratio investments to improve overall risk-adjusted return
- Longer duration high yield, local and hard currency emerging market debt
- Convertibles, non agency, bank capital, mortgages

Diversifiers (33%)

- Currency factors and real yield strategies
- Volatility management
- Duration and cash

Source: Russell Investments, 31 December 2018.

Opportunistic book

- In currencies, tactical exposure to the Mexican peso contributed to the overall performance.
- Elsewhere, our opportunistic strategy from Putnam was strong, thanks to the rising interest rate environment and upward re-pricing in its mortgage credit exposure, which drove solid returns during the first half of the year.
- However, returns were subdued in the latter half of the year as mortgage returns faced headwinds, particularly going into Q4.

Diversifiers

- 2018 was a year filled with several pockets of sharp increases in market volatility and as such, the Fund's long volatility exposure performed well. There were two notable periods during the year where the position met expectations – the volatility spike in February followed by the risk-off episode in November and December. The volatility exposure fulfilled its role by counter-balancing any downside pressure coming from the more pro-cyclical components.
- In addition, tactical exposure to U.S. treasury duration added to performance.
- The Fund's positioning strategies however, negatively affected performance over the course of 2018. Like the long volatility strategy, the positioning strategies performed better during bouts of heightened risk in the markets. Yet, overall, they underperformed. This was particularly the case with the rates positioning strategies that came under pressure as the yield spread between U.S. treasuries and German bunds pushed to near-record wides.

What are the key differentiators of the Russell Investments Unconstrained Bond Fund?

The Russell Investments Unconstrained Bond Fund seeks to harvest under-utilised risk premia which offers diversification to traditional credit, with lower volatility. By embracing active management, we seek to identify strategies that specifically thrive in volatile environments. The multi-manager approach provides investors with access to numerous strategies, uniquely blended to reduce risk without diluting alpha, in order to provide a smooth return profile.

The Fund focuses on delivering continuously positive returns over the cycle with lower sensitivity to interest rates versus traditional aggregate fixed income strategies. It offers downside protection using dynamic allocation and targeted diversification by investing in asset classes such as corporate credit, which has a meaningful return potential over cash and offers a high degree of efficiency.

Performance review (%) as at 31 December 2018

PERFORMANCE TO PERIOD END RETURNS SHOWN IN USD	1 MONTH	3 MONTHS	YEAR TO DATE	12 MONTHS	3 YEARS	5 YEARS	SINCE INCEPTION*
Return gross of management fee Class I Acc	-0.1	-0.2	2.5	2.5	–	–	3.0
Return net of management fee Class I Acc	-0.2	-0.5	1.6	1.6	–	–	2.2
Libor 3 Month USD	0.2	0.7	2.3	2.3	–	–	1.7

* Inception: 06 September 2016.

All returns greater than 1 year are annualised.

Discrete rolling 12 month performance (%)

RETURNS SHOWN IN USD	31/12/13 31/12/14	31/12/14 31/12/15	31/12/15 31/12/16	31/12/16 31/12/17	31/12/17 31/12/18
Return gross of management fee Class I Acc	–	–	–	3.7	2.5
Return net of management fee Class I Acc	–	–	–	2.9	1.6
Libor 3 Month USD	–	–	–	1.3	2.3

Past performance is not a guide to future performance.

What is your view of the fixed income market backdrop for 2019?

2019 looks set to be another action-packed year and our overall macro view is that we will face a difficult economic environment going forward. For unconstrained fixed income investors, there are three key themes to watch for 2019: the late-stage economic cycle, bond supply and credit spreads.

Economic cycle

The maturing economic cycle combined with market growth and rising interest rates means that major central bank support is less necessary. Whilst we have seen the U.S. Federal Reserve slow down their rhetoric around interest rate hikes and tightening monetary policy, the economic backdrop still remains strong in the U.S., with full employment and strong consumer activity. Investors could easily shift their focus back to inflationary pressures and the consequent impact on interest rates as the year progresses.

Bond supply

Supply of government bonds is likely to increase given that large deficits are financed through the bond market. The U.S. tax cuts in 2018 have dramatically increased the deficit with 4.5%-5% expected for the next 10 years on the current trajectory. The bond market will need to absorb this extra supply in order to finance this spending, which will put pressure on bond yields.

Credit spreads

Credit spreads have been tight for some time now, which hasn't left much room for disappointment. The recent performance of credit in the fourth quarter of 2018 has given a taste of what could happen, should economic growth disappoint. It is hard to justify the current lever of tight spreads with the low level of interest rates. One or the other needs to give, or perhaps even both.

How is the fund positioned in 2019?

At we entered the third quarter of 2018, the Fund held almost 23% in cash. As risk assets became cheap throughout the fourth quarter (such as credit), the Fund reduced some of its cash positions in order to increase exposure to the core yield engine as well as the volatility and opportunistic strategies. As such, cash was reduced throughout the quarter down to 14.5%. We have, therefore, entered into 2019 with more risk deployed in order to take advantage of the dislocated prices available in the market as 2018 came to a close. Already we are witnessing some early signs that indicate these positioning changes are proving beneficial to performance.

Looking forward, we expect that U.S. interest rate hikes will likely pause as some economic data has indicated the manufacturing sector is facing pressure in the face of trade conflict and weaker growth out of China. However, other segments of the economy remain strong, particularly (and very importantly) – the consumer. This, along with stabilisation in markets, could easily cause the Fed to resume its tightening bias. However, the market has been quick to price out all hikes and have even priced in a potential rate *cut*.

The switch from optimism to pessimism, and hiking to cutting, are signs of how skittish the market is and how tighter financial conditions have created volatility. It is my belief that this indecisiveness will afford buying opportunities from time to time with risk assets, while benefiting the volatility strategy within the portfolio.

What are the advantages of an unconstrained fixed income strategy in 2019?

One of the most common expectations from investors is that the unconstrained bond investing approach is a 'go-anywhere strategy', i.e. risk will be increased when the outlook is attractive, and risk will be decreased when the outlook is unattractive. The lack of benchmark requirements means that typical strategies have a very open spectrum of investible assets.

This is of course an opportunity. But, in our view, the full benefit of unconstrained bond investing is that it can be much more tailored and customised versus traditional investing approaches. Truly flexible unconstrained bond strategies should seek to find assets which have high risk-adjusted returns and a high degree of certainty around delivering on these returns. Against the 2019 economic backdrop, an unconstrained fixed income strategy like this offers investors the flexibility to ensure that assets are efficient and protected – both in terms of the risk exposures generally, as well as the risk of material drawdowns.

Successfully implemented, an unconstrained investing framework over 2019 should generate material returns above the risk-free rate whilst having built-in drawdown protection. These strategies are not riskless, and not a cash proxy, but offer attractive yields with meaningful real diversification. Meanwhile, thanks to their unconstrained and dynamic nature, these strategies could also work as an efficient governance solution.

Adam Smears

Global Head of Fixed Income Research

Based in Toronto, Adam Smears is Global Head of Fixed Income Research and lead portfolio manager of the Russell Investments Unconstrained Fixed Income Funds globally.

Adam has been lead portfolio manager of the Russell Investments Unconstrained Fixed Income Fund since 6 September 2016.

For more information

Visit russellinvestments.com

Fund details:

Libor +3%
Target return

2–4%
Volatility

0–4 years
Typical duration range

$594m
AUM.

A
Average credit rating

1.2
Effective duration

30+ years
Manager research experience

9 April 2013
Absolute Return Bond Fund.

The Fund was originally launched on 9th April 2013. However the Fund was subject to a material change on the 6 September 2016, at which point it adopted a new name and an amended investment policy. Any forecast, projection or target is indicative only and not guaranteed in any way. Source: Russell Investments, 31 December 2018.

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