DYNAMIC

A differentiated approach to unconstrained fixed Income

Changing global market dynamics

In 2019, there has been a clear shift in sentiment in fixed income markets and the results from our recent fixed income survey suggest that there is a very different outlook for the next 12 months, to the views held in 2018. The abrupt change in direction by the U.S. Federal Reserve (the Fed) has had an effect on many managers' views versus last year, for example:

- There has been a material reduction in investors' expectations for interest rate increases. Indeed, ongoing trade disputes have impacted economic data and market expectations.
- Managers have become more positive in their view for investment grade credit over the short term, compared to their 12-month forecast –the average credit beta is 1.1 times.
- 45% of managers expect the overall corporate fundamental picture (including leverage, interest cover and the quantity of cash flow generation) to stay similar to how it is now, whilst 41% expect it to modestly deteriorate. This is a significant shift from our end of 2018 survey, which saw 58% of managers anticipate modest improvements and 20% expect it to stay on a similar trajectory.

Against this backdrop, what are the advantages of an unconstrained fixed income strategy?

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. This is of course an opportunity.

However, many unconstrained bond market players have relatively high levels of interest rate risk or credit risk within their strategies. This is because they tend to rotate primarily through those particular risk-sensitive assets. Whilst credit risk and interest rate risk are the two most common concerns for pension investors, overreliance or focus on these two risks means that – at any one time, the strategy will be exposed to one or the other risk.

We have a slightly different view on the opportunity presented within unconstrained investing. Decoupling from the benchmark is important, but we think that strategies should also decouple from those traditional credit and interest rate risk markets and should seek out alternative diversification opportunities.

Against the 2019 economic backdrop, a truly 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.

How is the Russell Investments Unconstrained Bond Fund responding in 2019?

Key differentiators

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, and lower sensitivity to credit spreads relative to risky credit spread products.

It achieves this by complementing a customised credit portfolio with new risk premia that are diversifying and targeting alpha strategies in areas that help protect from drawdown risk.

Q1 Fund update

The Fund added to its inception-to-date outperformance. The core yield engine – namely Hermes and Post – drove outperformance in a quarter where credit and high yield spreads tightened. Allocation to Putnam's opportunistic mortgage prepayment strategy also contributed in a positive period for mortgage credit. Meanwhile, the allocation to H2O's long volatility strategy returned a small part of its longer-term outperformance in a less volatile period compared to the fourth quarter. In rates, the long positions to Australia and the U.S. were positive. In FX, the short position to the Israeli shekel early in the quarter and the long position to the Japanese yen offset the gains from a short position to the Swiss franc.

Performance (%)

Average annualised returns

RUSSELL INVESTMENTS UNCONSTRAINED BOND FUND USD PERFORMANCE (%) USD	1 MONTH	3 MONTHS	YEAR TO DATE	12 MONTHS	2 YEARS	SINCE INCEPTION*
Return Gross of Management Fee (0.85)	0.6	3.0	3.0	4.5	4.0	4.0
Return Net of Management Fee**	0.5	2.8	2.8	3.7	3.1	3.1
LIBOR 3-month USD	**0.2**	**0.7**	**0.7**	**2.5**	**2.0**	**1.8**

Source: Confluence. Data as at 31 March 2019. *Inception: 6 September 2016. Any past performance figures are not necessarily a guide to future performance. ** This share class fee is set high; client fees can be individually negotiated.

Discrete rolling 12-month performance (%)

Average annualised returns

RETURNS SHOWN IN USD	Q1 2017 – Q1 2018	Q1 2018 – Q1 2019
Return Gross of Management Fee (Class I Acc)	3.4	4.5
Return Net of Management Fee**	2.6	3.7
LIBOR 3-month USD	1.5	2.5

Source: Confluence. Data as at 31 March 2019. Inception: 6 September 2016. Any past performance figures are not necessarily a guide to future performance. ** This share class fee is set high; client fees can be individually negotiated.

PORTFOLIO GOALS

Objective:
Seek to provide total return

Target:
LIBOR +3% with 2-4% volatility in typical market environment, 4-8% in stressed market environment.

Portfolio Manager:
Adam Smears, Head of Fixed Income Research

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 our belief that this indecisiveness will afford buying opportunities from time to time with risk assets, while benefiting the volatility strategy within the portfolio.

For more information visit **russellinvestments.com**

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