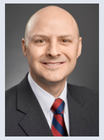
CHARTWELL INVESTMENT PARTNERS

WHERE CAN WE TURN FOR DECENT INCOME?

Andrew Toburen, manager of the Chartwell Short Duration BB-rated fixed income strategy, discusses the crossover area between traditional high yield and investment grade, and how it can provide value for income-seeking investors



ANDREW TOBUREN
SENIOR PORTFOLIO MANAGER, CHARTWELL INVESTMENT PARTNERS

What challenges are fixed income investors facing at the moment?

Around the globe, interest rates are very low, and in fact negative in many places. That's frustrating for advisors, investors and managers alike. It doesn't seem right that many investors have acted prudently, stayed the course with an investment plan, accumulated some degree of wealth or are on the path to accumulating wealth, yet find themselves in an environment of rotten investment choices.

Traditional fixed income allocations like the Aggregate Index have performed reasonably well over the last few years, but today they offer a very low yield and a relatively long duration.

So, fixed income is not doing what it's supposed to do?

Prior to the financial crisis, there was a more reasonable level of income available from core allocations in the asset class, maybe 5%, but it also provided a certain measure of total return potential or hedge against some riskier areas of a portfolio. A lot of that has changed. The difference today is that it's hard to envision a scenario where any significant price appreciation is achievable on a go-forward basis. Really, we are just left with the income component. Yet, still, the prospect of price declines could end up flipping total returns negative in many portfolios.

What options can investors pursue in this environment?

Investors do have choices. They can target longer duration portfolios for more income, but of course that brings greater interest rate risk. They can target lower credit quality for more income, but of course that adds a significant element of credit risk.

Emerging market or frontier market debt is another option, but they come with the associated geopolitical and currency risks. Elsewhere, structured notes or derivatives can be considered, although there is a certain amount of complexity and illiquidity risk in those types of investments.

One area that's grown institutionally is the private debt market. This is potentially an attractive area but investors will be rightfully concerned about liquidity. Often, your money is locked up for several years and you are exposed to the credit risk and underwriting standards of a new market that lacks the transparency of public markets.

So there are options, but our position is that none are great because each comes with an aspect of risk that investors may be uncomfortable with.

The Chartwell Short Duration BB-Rated portfolio is designed to harvest income while limiting risk. Can you talk us through the strategy and its parameters for risk?

We've tried to be thoughtful in designing an understandable strategy that aims to deliver consistent monthly income. The strategy's foundation lies on two key risk-control guardrails. The first guardrail is quality, where we focus on BB-rated corporate bonds. These bonds reside in the crossover area between the traditional high yield market and the traditional investment grade market. BB's have historically held up relatively well in down credit cycles, and this is an area where we're regularly able to uncover inefficiencies and capture extra income. The second guardrail is that the portfolio is short maturity. We limit the portfolio's average maturity to less than three years, which helps to mitigate both interest rate risk and credit risk. What we've found, is that these two structural risk guardrails can work in combination to help generate reasonable levels of consistent monthly income. Over full cycles, the incremental total return per annum has been 1% - 2% greater than traditional core fixed income allocations. Interestingly, the return profile has not been substantially more volatile than the Aggregate.

From a construction standpoint, we buy US dollar-denominated, publicly traded bonds in a transparent portfolio that is priced daily. We don't utilize any derivatives, credit default swaps, emerging market securities, structured notes or pay-in-kind / toggle bonds.

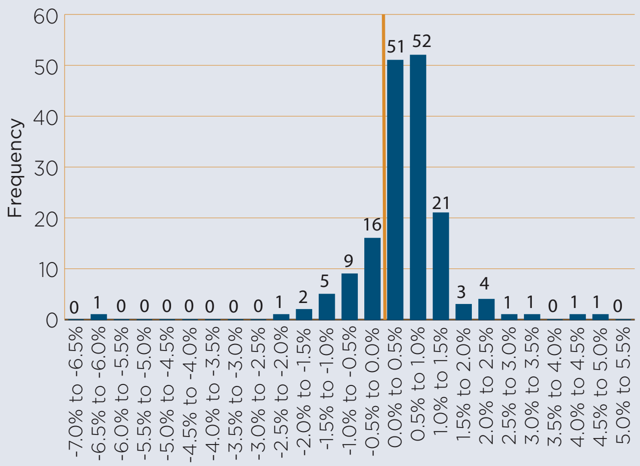
What challenges do you anticipate for the strategy going forward and for the sector more broadly?

Operating a short maturity strategy does present a challenge because we regularly have 30% or 40% of the fund come back to us each year through refinancing activity – bonds being called or tendered for. Our challenge is to continually redeploy funds and recycle exposure out into the market. That's where our team's fundamental credit research comes into play. We've focused on this space for the past fourteen years, and believe we've built up a knowledge base that helps us to stay invested and continue generating income.

More broadly, I do believe there is a risk for short maturity strategies that own the full credit spectrum of high yield bonds, which are the majority of assets raised in the last decade. Portfolios that own BB-rated bonds, B-rated bonds, and CCC-rated bonds have enjoyed a tailwind of easy credit conditions. Eventually, we believe we'll see softness in the economy, or even a recession. If we do, we think strategies without a quality guardrail can really take it on the chin – the underperformance can be substantial, as we saw in 2008.

In summary, Chartwell's approach to the short maturity corporate space employs two risk guardrails and tries to balance the trade-off between more income and risk. We focus on BB-rated securities, and typically don't own B-rated or CCC-rated credit. It's definitely a niche, a niche we like as part of an income solution.

HISTORICALLY MORE. CONSISTENT. INCOME.
Chartwell's Short Duration BB-Rated Strategy Distribution of Monthly Returns 12.01.2005 -12.31.2019



Inception date as of 12.01.2005.Source: Chartwell Investment Partners.
Chart data points represent the # of times the strategy has experienced positive and negative returns since inception. Past performance is not a guarantee of future results. All investing is subject to risk of loss in principal. Current performance may be lower or higher than the performance data quoted. The gross returns were calculated on a time weighted basis, including all dividends and interest, accrual income, real-ized and unrealized gains or losses and are net of all brokerage commissions, execution costs and do not give effect to investment advisory fees, which would reduce such returns. To receive a complete list and description of Chartwell Investment Partners' attribution for all securities, and/or a presentation that adheres to the GIPS® standards, please click here.

Aggregate Index is an index used by bond traders, mutual funds, and ETFs as a benchmark to measure their relative performance. The index includes government securities (ABS), and corporate securities to simulate the universe of bonds in the market. Credit Quality: Credit quality ratings are sourced from Standard & Poor's (the "S&P"), Moody's and Fitch's. Ratings values are based on the higher of either S&P or Moody's as to the quality of the securities they rate. The ratings from AAA (S&P) or Aaa (Moody's) (extremely strong capacity to meet its financial commitment) to D (S&P, Fitch's) or C (Moody's) (in default). Ratings are relative and subjective and are not absolute standards of quality.

Fixed income investment includes the following risks: credit, prepayment, call and interest rate risk. Credit risk refers to the loss in the value of a security based on a default in the payment to principle and/or interest of the security, or the perception of the market of such default. As interest rates rise the value of bond prices will decline. High-yield bonds have a higher risk of default or other adverse credit events, but have the potential to pay higher earnings over investment grade bonds. The higher risk of default, or the inability of the creditor to repay its debt, is the primary reason for the higher interest rates on high-yield bonds.