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September 2021

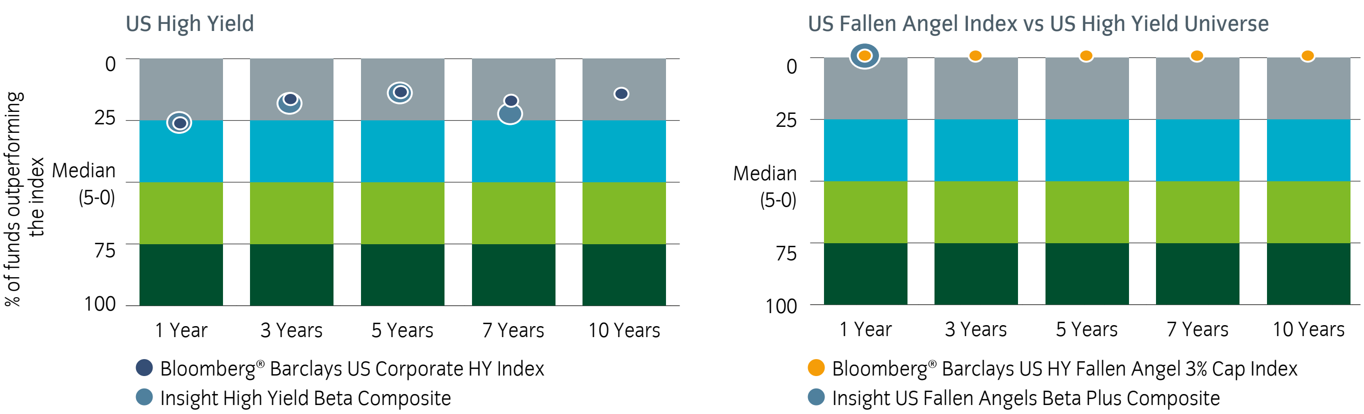
A BETTER WAY TO GENERATE BETA IN FIXED INCOME?

WE BELIEVE INVESTORS CAN NOW RELIABLY EXTRACT BETA FROM LESS LIQUID FIXED INCOME MARKETS WHERE TRADITIONAL ACTIVE AND PASSIVE STRATEGIES HAVE STRUGGLED TO MATCH THE INDEX.

TRADITIONAL MANAGERS HAVE STRUGGLED TO EXTRACT BETA FROM LESS LIQUID MARKETS

Traditional active, smart beta and passive strategies have struggled to deliver market returns in higher yielding and less liquid fixed income markets such as high yield credit, fallen angels and hard currency emerging market debt, with most historically underperforming indices after fees (Figure 1).

Figure 1: Less liquid indices have consistently delivered 'top quartile' performance against active and passive funds[1]



We believe there are three key reasons for this endemic underperformance, all of which relate to low market liquidity.

1. **High transaction costs**: Bid-ask spreads for single high yield bonds, for example, can be 60bp to 80bp with index turnover of over 50%, creating a structural drag on returns.
2. **Concentrated portfolios**: Given the impracticalities of trading each bond, strategies tend to be far more concentrated than indices. This means downgrades and defaults can have larger impacts on performance. This can force strategies to be managed in a defensive manner, meaning potential underperformance in 'up' markets.

   It can also be harder for traditional funds to hold smaller issuers and bonds, which tend to be the least liquid, potentially leaving significant 'illiquidity premia' on the table.
3. **Alpha deficit**: Structural performance drags place a greater burden on consistent alpha generation. This can mean targeting riskier and less certain sources of alpha. Furthermore, liquidity conditions make it harder to target potential inefficiencies.

[1] Net of Fee Peer Ranking. As of June 30, 2020. Source: eVestment. eVestment statistics are subject to change based on the number of universe constituents reporting. US High Yield and US Fallen Angel are the eVestment US High Yield UniverseUniverse and US High Yield Fallen Angel 3% Cap Index. Composite expenses, including management fees and other expenses were deducted from these returns. Past performance is not indicative of future results. Investment in any strategy involves a risk of loss which may partly be due to exchange rate fluctuations. The performance results shown are net of investment management fees and reflect the reinvestment of dividends and/or income and other earnings. Please refer to the important disclosures at the back of this presentation.

INTRODUCING EFFICIENT BETA: OVERCOMING CHALLENGES IN LESS LIQUID MARKETS

Insight has developed solutions designed to address investor frustration with fixed income performance, both passive and active, in less liquid markets. We call these strategies '**Efficient Beta**'[2].

We believe Efficient Beta approaches can overcome the liquidity challenges that traditional strategies can struggle with, to aim to deliver same-day two-way liquidity conditions even in challenging market conditions:

1. **Minimize transaction costs**: In our experience credit portfolio trading (or electronic 'custom basket' trading) can reduce transaction costs to ~20bp pa (from ~60bp to ~80bp) for high yield bonds (for example) without sacrificing portfolio turnover.
2. **Full diversification**: Efficient trading allows for fully diversified portfolios with low concentration risks to reduce the impacts of downgrades and defaults and target smaller bonds which may offer additional illiquidity premia.
3. **Reliable alpha generation**: Market inefficiencies can be most common in less liquid markets. We believe that an Efficient Beta approach can afford to take many smaller, lower-risk and higher-conviction active positions in an attempt to exploit these inefficiencies. We use a quantitative multi-factor credit model that tilts towards companies with, in our view, lower downgrade and default risk. We implement underweights or zero weights where our model has identified fundamentally overvalued or riskier bonds to 'win by not losing'.

NEW POSSIBILITIES IN FIXED INCOME EXPLAINED

Recent innovations in the fixed income market have opened the door to Efficient Beta strategies.

The changing fixed income landscape

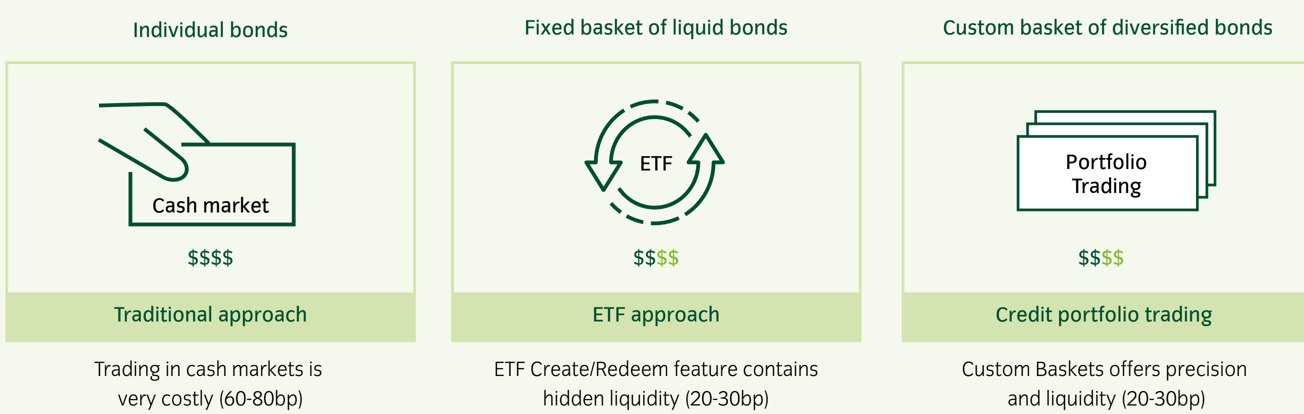
After the 2008 global financial crisis, new regulations made it harder for sell-side trading desks to provide efficient two-way liquidity in single bonds, resulting in rising transaction costs and dwindling liquidity. This led to the rapid development of the ETF infrastructure as ETFs are used as a liquidity outlet, a hedging tool, highly traded in security lending markets and options markets and ultimately as an intraday price discovery mechanism for illiquid fixed income markets. Fixed income ETFs make up 5% of corporate markets based on AUM but now comprises 20-30% of corporate bond markets based on traded volume[3].

The rise of credit portfolio trading

The downside of direct ETF exposure in less liquid asset classes is high management fees and risk of underperformance. However, ETFs provide market liquidity through the 'create and redeem' facility, by which ETF shares are created or destroyed based on investor demand by 'authorized participants'.

In 2012, our team additionally worked to unlock 'hidden liquidity' within the fixed income ETF ecosystem, and worked with ETF counterparties to develop 'credit portfolio trading', or electronic basket trading (Figure 2).

Figure 2: Fixed income market evolution has opened the door to customized bond basket trading[4]



[2] Not to be confused with 'smart beta', which is typically designed as an alternative to tracking market capitalization related indices.
[3] Bloomberg, September 2021. [4] For illustrative purposes only.

An expanded toolkit for alpha generation

Corporate bonds plus market completion tools such as ETFs and credit derivative indices are more sophisticated tools for harvesting credit risk premia, structural alpha and illiquidity risk premia. These tools can help managers target alpha or complete their desired risk allocations with a high degree of precision, liquidity and speed.

For example, credit index derivatives, comprised of a basket of single-issue derivatives, have become standardized and centrally cleared. Investors can utilize them to fine-tune portfolio risk exposures and reduce turnover. Further, the increased availability of analytical data has allowed quantitative managers to cultivate a deeper understanding of credit index derivative return drivers and basis risks.

MARKETS IN WHICH TO CONSIDER EFFICIENT BETA SOLUTIONS

High yield: Traditional passive high yield strategies have typically struggled to replicate index returns with low tracking error. However, by implementing an approach that reduces transaction costs, increases liquidity and targets more reliable alpha sources, we believe an Efficient Beta strategy can reliably deliver beta returns in line with the index. Within a multi-manager approach, it may also allow investors greater latitude to focus their active high yield exposure on strategies that are benchmark-agnostic and focus on 'pure alpha'.

Hard currency emerging market (EM) debt: Cost and liquidity can also be persistent sources of performance drag in EM hard currency markets. Purely passive and benchmark-aware active approaches have historically struggled to consistently match or beat the index. We believe an Efficient Beta solution can overcome frictional headwinds and target index-like returns after costs. Our objective is to construct portfolios that match the risk profile of the benchmark while taking small, or even micro, active decisions to reflect our model's assessment on individual bonds.

Fallen Angels: The Fallen Angels index return has consistently ranked number one when compared to high yield strategies (Figure 1). As such, we believe an Efficient Beta approach to Fallen Angels has the potential to outperform high yield. In our view, this opportunity exists in large part due to the inherent nature in which passive funds are 'forced sellers' of investment grade bonds that are downgraded to high yield, which creates mispricing opportunities. We believe investors may benefit from considering Efficient Beta approaches to Fallen Angels either on a standalone basis or within an investment grade corporate bond strategy.

BREAKING DOWN BARRIERS: WHERE DOES EFFICIENT BETA FIT?

We believe Efficient Beta represents a new model of fixed income management at the intersection of passive, smart beta and active. Strategies can also be delivered with fees that reside between active and passive.

We believe that Efficient Beta has the ability to offer a more certain way of accessing index-like returns in higher yielding but less liquid fixed income markets. If desired, due to our ability to package less liquid assets within very liquid vehicles, we believe it opens the door for investors to pursue active exposure through dedicated 'pure alpha' strategies managed in a benchmark-agnostic fashion.

In our view, credit portfolio trading can be employed as a market completion tool, beta management tool, liquidity layer, or as an alpha strategy to capture returns during market dislocations. The ETF ecosystem is expanding further, and we expect opportunities to enhance liquidity will continue to improve.

ABOUT INSIGHT

Insight's Efficient Beta team was an early adopter of the ETF ecosystem. In 2012 we pioneered credit portfolio trading, working with counterparties in the ETF market, recognizing its potential in overcoming transaction costs, overcoming cash drag and meeting the unique liquidity demands of beta strategies. Our team is experienced in quantitative active, indexing and ETF management, giving us a unique and modern approach to these illiquid fixed income asset classes

Our team includes six portfolio managers and analysts and seven quantitative researchers. Additionally, the team draws on the expertise of Insight's wider Fixed Income Group, with over 200 investment professionals globally.

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The Bloomberg US Corporate High Yield Bond Index measures the USD-denominated, high yield, fixed-rate corporate bond market. Securities are classified as high yield if the middle rating of Moody's, Fitch and S&P is Ba1/BB+/BB+ or below. Bonds from issuers with an emerging markets country of risk, based on Bloomberg EM country definition, are excluded (Future Ticker: I00012US).

The Bloomberg Barclays US High Yield Fallen Angel 3% Capped Bond Index is a component of the US Corporate High Yield Index that is designed to track USD-denominated, high yield, fixed-rate corporate bonds that have been downgraded from investment grade. Securities are classified as high yield if the middle rating of Moody's, Fitch and S&P is Ba1/BB+/BB+ or below. Bonds from issuers with an emerging markets country of risk, based on the indices' EM country definition, are excluded. The US High Yield Fallen Angel 3% Capped Bond Index was created in March 2016, with history backfilled to January 1, 2005.

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