LOOMIS | SAYLES

MANAGER INSIGHT

# Buy & Maintain: Understanding Loomis Sayles' Approach for Investment Grade Corporates

By the Loomis Sayles Investment Grade Buy & Maintain Team

**KEY TAKEAWAYS**

- Buy & maintain corporate bond strategies can be suited to provide steady income for institutional investors who are focused on capital preservation with specific yield objectives and/or defined cash-flow needs.
- Diligent credit selection and diversified portfolio construction at inception can be significant determinants of success in buy & maintain mandates, making the expertise of portfolio managers, analysts and traders critical.
- Proactive maintenance of a quality portfolio is an important part of maintaining target income and keeping a portfolio's risk profile in line with client requirements.

## Who is Buy & Maintain suitable for?

In our view, buy & maintain mandates may be the right solution for institutional investors with one or more of the following investment needs:

- Specific yield target
- Cash flow matching
- Low turnover to meet regulatory, accounting, hedging or tax requirements

We believe what sets buy & maintain portfolios apart in the spectrum of corporate bond strategies are their benchmark agnostic construction, heavy focus on credit migration and default, low turnover and highly significant customization (see page three: Buy & Maintain Portfolios in the Spectrum of Corporate Bond Strategies). Buy & maintain mandates seek to provide a cost-effective method to achieve steady income potential through well-diversified portfolios that consist of fundamentally sound credits typically capable of generating the necessary cash-flow patterns. The success of these strategies relies heavily on the skill and experience of portfolio managers, research analysts and traders working closely together.

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## What are the Key Characteristics of a Buy & Maintain Mandate?

### BENCHMARK AGNOSTIC

Since fixed income benchmarks are market-capitalization weighted, companies and industries with the most debt have a higher weighting in the index. Unlike benchmark-relative portfolios, buy & maintain mandates are not usually tied to such allocations and therefore do not favor companies or industries with large amounts of debt outstanding. This can allow more diversified portfolio construction across issuers and industries.

For some buy & maintain mandates, clients may identify a starting benchmark to help determine their yield or spread objective; however, benchmarks are not typically used as a performance measure.

### LOWER TURNOVER

Most buy & maintain mandates trade less frequently due to constraints such as gain/loss considerations, long-term currency hedges, need to maintain target yield or other accounting constraints. Given the longer investment horizon for these mandates, maintaining higher liquidity is typically less important. This allows the portfolio managers to favor attractive, albeit at times less liquid issues and potentially harvest an additional liquidity premium over the investment horizon.

### LONG-TERM FUNDAMENTAL FOCUS

Near-term volatility of issuers or industries can be less of a concern, whereas credit-quality migration in the long term takes on more importance. During credit selection, additional criteria to consider may include business viability given technological disruptions and shifting demographics, barriers to entry and macro-economic secular risks. This allows portfolio managers to focus more on long-term fundamental risk as opposed to short-term relative-value dislocations.

### HIGHLY CUSTOMIZED

These portfolios typically have a yield or spread focus and are targeted toward long-term holdings with minimal possible credit risk. They can be customized to clients' investment guidelines and are often constructed to meet specific cash-flow needs, turnover limitations, duration and quality objectives.

## Buy & Maintain Portfolios in the Spectrum of Corporate Bond Strategies

| | PASSIVE | CASH FLOW MATCHED | BUY & MAINTAIN | LOW TURNOVER | ACTIVE |
|---|---|---|---|---|---|
| OBJECTIVE | Seeks to provide a return and volatility to closely match an index | Seeks to meet future liabilities through cash flow matching | Seeks to achieve a specific yield/ return target within maturity parameters | Seeks to outperform an index while limiting capital gains and losses from transactions | Emphasizes long term total return potential |
| RETURN POTENTIAL | Similar to index | Index agnostic | Index agnostic | Index + alpha | Index + alpha |
| TURNOVER | Similar to index | Typically less than 10%* | Typically less than 10%** | Typically between 50-75% per year | Typically greater than 100% per year |
| NEED FOR BOND LIQUIDITY | Higher | Lower | Lower | Moderate | Higher |
| REALIZED INTEREST RATE SENSITIVITY | Similar to index | Lower | Lower | Moderate | Moderate*** |
| RISK TOLERANCE | Similar to index | Client directed | Client directed | Relative to index | Relative to index |
| FEES | Lower | Low to Moderate | Low to Moderate | Moderate | Higher |
| USE OF DEEP CREDIT RESEARCH | None | Higher | Higher | Higher | Higher |

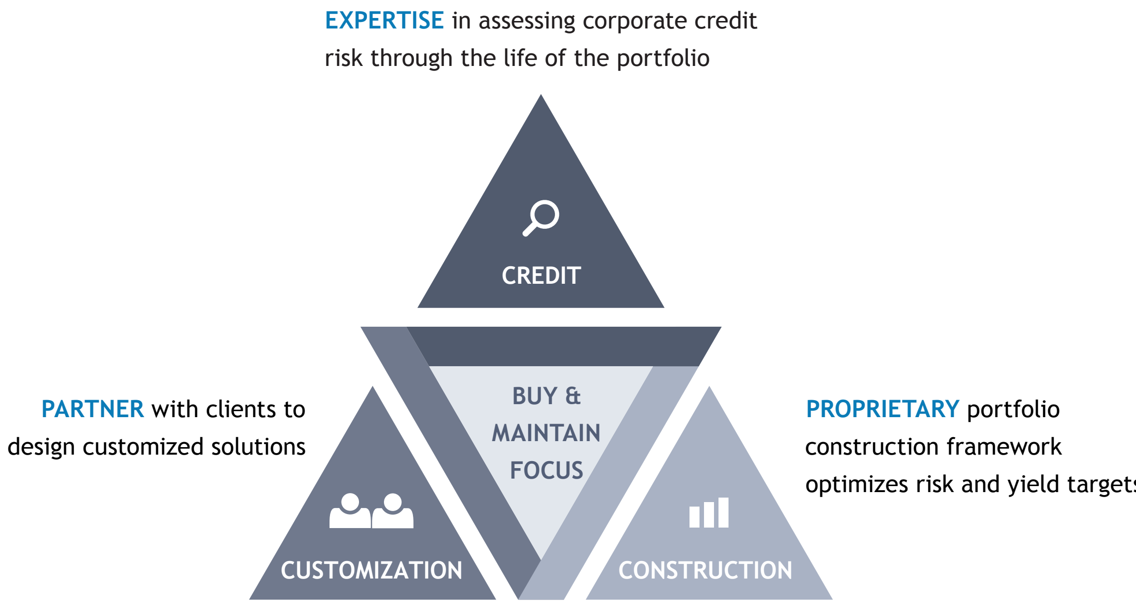
**Typically less than 10% if cash flow schedule is fixed and portfolio duration rolls down, and less than 50% if a constant duration is maintained*
***Typically less than 10% if portfolio duration rolls down, and less than 25% if a constant duration is maintained*
**** +/- 1 year of the index.*

*Classifications are considered typical for the style. Other industry investment personnel may have different views and assumptions. Descriptions assume normal market conditions.*

***There is no guarantee that the investment objective will be realized or that the strategy will generate positive or excess return.***

## The Loomis Sayles Buy & Maintain Discipline

The core tenet of the Loomis Sayles Buy & Maintain Investment Grade Corporate Bond Strategy is to seek attractive yield while minimizing credit risk. We do so by investing in a fundamentally robust, diversified portfolio where each bond is carefully selected to reflect long-term risk and return. We believe the expertise we bring to credit selection, portfolio construction and customization sets our strategy apart (see exhibit below).




### CREDIT

Given that a buy & maintain portfolio is not constructed for frequent trading and repositioning, a high level of care and diligence in credit selection is critical at portfolio inception. The primary risks to a customized buy & maintain portfolio are factors that could impede meeting a client's objectives—forced sales and defaults that result from credit migration. For clients with specific guidelines on downgrade-based selling, portfolios may realize steep losses from forced sales. Issuer defaults could lead to a permanent loss of capital and a lower-than-target portfolio yield. Given these potential risks, Loomis Sayles built its buy & maintain discipline on its longstanding strength—credit analysis. Loomis Sayles has been rating credits since 1926 and its career credit-research team covers 98% of the Bloomberg Barclay's Corporate Universe. Rigorous and fundamentally driven credit analysis is the cornerstone of our investment philosophy and a driving force behind our strong investment performance.

Our team of analysts has the expertise to determine forward looking ratings that may take into account not only current credit metrics, but projected longer-term fundamentals that are key for long-horizon buy & maintain portfolios. These include but are not limited to factors such as cash-flow stability, barriers to entry, secular industry headwinds and management quality. The portfolio management team continues to monitor the credit quality of the portfolios beyond inception and exercises a sell discipline that seeks to proactively reduce exposure to issuers with risks skewed to the downside.

### CONSTRUCTION

Building portfolios that can withstand the peaks and valleys of economic and credit cycles requires an expert and experienced investment management team that can weave together top-down macroeconomic themes with bottom-up security selection. The buy & maintain portfolio managers use their deep knowledge of the properties of credit risk and default phenomena to analyze, select and size issuers and industries judiciously. Our team makes critical decisions to limit exposure to issuers, sovereigns or industries that appear to offer unattractive, long-term risk-adjusted yield.

Loomis Sayles has spent years developing a proprietary portfolio-construction platform that takes into consideration client guidelines, internal credit ratings and outlooks as well as specific buy & maintain liquidity and risk parameters to assist in constructing optimal portfolios that can balance return with risk. The portfolio management team scrutinizes the credit worthiness of all issuers and ensures that the portfolio is well diversified across factors such as industries, countries/region, quality, and capital structure.

### CUSTOMIZATION

Buy & maintain mandates tend to be highly customized. We have partnered with clients across a spectrum of risk-and-return objectives to meet their individual needs. We are able to customize mandates to help accommodate specific yield or spread requirements, cash-flow needs, average-quality guidelines, regulatory restrictions, gain/loss restrictions, environmental, social and governance (ESG) factors and other client-specific guidelines. See Appendix for a broad overview of customization we have provided for clients.

## What is Maintain?

A buy & maintain mandate requires a high level of monitoring and maintenance. Loomis Sayles portfolio managers focus on preserving the optimal risk profile and yield target based on the original risk-return target and turnover guideline.

As part of our maintenance process, we constantly monitor the credit worthiness of each portfolio holding and proactively identify holdings that present material downside risk. For such holdings, the portfolio management team works closely with the credit research analysts and traders to perform detailed scenario analysis to estimate expected downside. The probability of default, while low for investment-grade credits, could rise sharply if quality declines and/or the investment horizon extends. We work with our clients during portfolio funding to determine a relevant downgrade bucket as well as appropriate parameters for a sell discipline. We are sensitive to the impact of realizing losses in the portfolio and thoroughly review each credit before taking action.

We exercise the same level of diligence when participating in tenders and exchanges. For mandates that allow reinvestment, we seek to find the best available opportunities to rebalance risk and enhance potential yield relative to hedging costs when necessary. We also may consider participating in the new-issue market to take advantage of potential attractive entry points for reinvesting.

## Continuous Collaboration of Investment Professionals Throughout Investment Process

Our tenured buy & maintain portfolio management team has an average of 28 years of investment industry experience. We believe our key to success has been our deep understanding of credit as well as close collaboration across our investment team, credit, quantitative and macro research analysts and traders. We have proprietary tools and platforms to construct, manage and effectively measure bespoke portfolios. We strategically partner with our clients through all phases of the portfolio providing ongoing, tailored and dedicated client service.

| STEP | | OBJECTIVE | TEAM INVOLVEMENT |
|---|---|---|---|
| 1 | PORTFOLIO DESIGN | Incorporate client objectives and guidelines, LS strategy, and the available universe to create the portfolio parameters | Investment Team<br>Credit Research<br>Trading Desk<br>QRRA |
| 2 | PORTFOLIO CONSTRUCTION | View the potential risk /return spectrum via portfolio optimization | Investment Team<br>Credit Research<br>Trading Desk<br>QRRA |
| 3 | INVESTMENT TEAM REVIEW | Review issuers and portfolio characteristics for the best fit to portfolio design. Re-run portfolio construction step to optimize the final portfolio | Investment Team<br>Credit Research<br>Trading Desk<br>QRRA |
| 4 | RAMP-UP | Establish and constantly monitor timeline, goals and execution margin for funding | Investment Team<br>Credit Research<br>Trading Desk<br>QRRA |
| 5 | MAINTENANCE | Monitor credit worthiness of holdings, review quality and characteristics for shifts or deterioration. Deploy available cash into best available opportunities | Investment Team<br>Credit Research<br>Trading Desk<br>QRRA |

*QRRA stands for Quantitative Risk Research & Analysis.*

## Conclusion

There are a variety of investment objectives that may prompt institutional investors to seek low-turnover, yield-focused investment strategies with long-term horizons and measured credit risk. We believe a buy & maintain strategy is a strong alternative for such investors because it can provide custom portfolios aligned with their guidelines, delivered with cost efficiency. Loomis Sayles' approach to custom buy & maintain portfolios is differentiated by its seasoned professionals who create diversified portfolios underpinned by rigorous research.

## Appendix: Loomis Sayles Buy & Maintain Portfolio Customization Examples

| | |
|---|---|
| **PORTFOLIO DESIGN** | **Allow unique guidelines and customization for clients:**<br>• Extensive restricted issuer lists<br>• ESG-related<br>• Risk/return objectives<br>• Removal of "large" or "common" issuers widely held by the client |
| **PORTFOLIO CONSTRUCTION** | **Interactive dialogue to set up appropriate portfolio guidelines, including:**<br>• Inclusion of a downgrade bucket<br>• Emerging market and/or country of risk exposure<br>• Allowance for 144A securities |
| **INVESTMENT TEAM REVIEW** | **Complete a thorough review to identify:**<br>• Absolute and relative exposures at industry, issuer and issue levels<br>• Issuers with potential headline risk<br>• M&A candidates that may require a new combined maximum exposure |
| **RAMP-UP** | **Fund portfolios under different market conditions and various client-mandated requests, including:**<br>• Very short periods for portfolio ramp-up<br>• Near US holidays<br>• Early trading windows to accommodate the clients' hedging window and the time difference in Europe |

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