Loomis Sayles Investment Grade Bond: Who We Are

By Matt Eagan, Elaine Stokes & Brian Kennedy, Full Discretion Portfolio Managers

KEY TAKEAWAYS

- We believe markets are inefficient and that we can add alpha with our long-term, research-driven, contrarian approach.
- We have a rigorous, repeatable investment process based on strategies that have added value throughout the economic cycle.
- Our flexible mandate can access a wide range of securities around the world, boosting our chances of finding attractive opportunities at any time.
- Our Investment Grade Bond portfolios look different from the major high-quality bond benchmarks, offering diversification.

We are value investors. That is not just a label. It is who we are and how we have managed the Loomis Sayles Investment Grade Bond Strategy for decades. We would say it is in our DNA.We believe markets are inefficient largely because they are driven by bouts of fear and greed.

In difficult economic times, or when frightening headlines appear, investors tend to get nervous and dump their holdings, often making few distinctions between genuinely distressed securities and better credits that are temporarily caught in the downdraft. In boom times, those same investors may get complacent, bidding up prices beyond their underlying worth, again ignoring differences in quality.

Our job—the job of a value investor—is to recognize when these mispricings occur and to step in and seize opportunities the markets offer. Value investors are generally contrarians. They have to be willing to lean against the market. That takes conviction. Our conviction comes from a robust research process and a long-term perspective, typically three-to-five years, which differentiate us from investors focused on the short-term market swings. We start with a top-down macro view, which helps us determine where we sit in the credit cycle and which industries may stand to gain or lose. We marry that with a proprietary bottom-up analysis that drills into the fundamentals of thousands of securities. Finally, we add in quantitative analysis, using tools that help us measure relative value and understand portfolio shocks. We have the freedom to buy securities across the world in a wide range of asset classes, which means that at any given time, we can pursue attractive opportunities.

So that's who we are. Now we want to give you a sense of how we seek out good investments, how we work and how our Investment Grade Bond portfolios may be different from core or high-quality bond benchmarks.

Where We Seek Opportunity

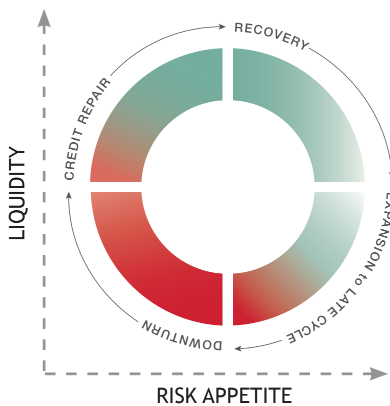
Experience and research have taught us that markets tend to move in familiar patterns. By recognizing those patterns, we believe we can add alpha by employing strategies that have demonstrated they work over the credit cycle. To put it another way, we have developed a rigorous, repeatable process. We may have to wait for some opportunities to present themselves, but we know what to look for and when to anticipate them.

We employ several strategies that have demonstrated reliability over time.

1. Define the Macro Backdrop – Calling the Credit Cycle

Credit cycle research is where we start our process. Just as the economy goes through phases, so too do credit markets. We break the cycle into four periods—downturn, credit repair, recovery and expansion to late cycle—each with its own dynamics and implications for investors. Credit cycle analysis helps us anticipate broad sector mispricings and identify which risk drivers we want to emphasize in the portfolio and which areas to avoid. It lays the foundation for our bottom-up credit work.

PHASES OF THE CREDIT CYCLE



In the **downturn**, spreads in the bond market widen (sometimes dramatically), defaults escalate and profits and incomes collapse. As the downturn ends and gives way to **credit repair**, surviving companies are forced to improve their balance sheets to fix the damage. This creates a sweet spot for selective investors to take advantage of an environment in which yields are high and bond prices are low. As credit spreads tighten during the **recovery**, investors who bought at elevated yields can realize capital gains. By **late cycle**, the risk-reward tradeoff is typically very different. Spreads tend to be narrow and investors need to be selective because many lower-quality securities may not compensate them for the level of risk. In this phase, it often makes sense to move into higher-quality names and build up cash reserves—dry powder that can be put to use later.

In times of stress, we have one more tool at our disposal: a willingness to provide liquidity. Buyers are hard to find when markets are nervous. Regulatory changes have made those buyers harder to find than in the past. A result: bigger swings in prices. Prices can move significantly during periods of distress as some bond holders may be forced to sell their most liquid positions to raise cash. In such an environment, a high-conviction investor, backed by solid research, can potentially move in and purchase fundamentally strong credits trading at significant discounts. During these episodes, we also use bottom-up fundamental research to sharpen our top-down view. For example, how do the market's default expectations square with what our analysts see at the security-specific level? We look for disconnects between top-down and bottom-up signals.

CASE STUDY: OUR TOP-DOWN AND BOTTOM-UP APPROACHES WORKING TOGETHER

In late 2015 and early 2016, commodity prices were tumbling, investors were concerned about China's economy, and many markets were acting as if the economic expansion was nearing an end. This triggered a major selloff in high yield bonds. Our macro view was different. We saw the slowdown as a pause in a global expansion that would continue. We believed the energy sector was going "off cycle," or experiencing its own downturn, a scenario that can create value. Our bottom-up work on individual securities confirmed that outlook. While market prices implied that a large number of companies might ultimately default, our worms-eye research indicated the failure rate would be considerably lower. The upshot: we had the confidence to pick up heavily discounted high yield bonds, especially in the beaten-down energy sector.

2. Security-Specific Strategies

To select our best ideas for the portfolios, we marry credit cycle analysis with our deep-value, research-driven approach to security selection. We look for sources of idiosyncratic risk—securities we think will trade according to their own drivers, not in lockstep with the market.

Certain approaches have shown their value over time in helping us find attractive individual securities.

- **Buying fallen angels.** In the high yield market, investing in fallen angels—investment grade bonds that have been downgraded to junk—has been a persistent source of opportunity. In part, this may be due to forced selling by investors whose mandates forbid them from owning securities with a below-investment grade rating, which can result in price distortion. We believe that with diligent fundamental research, skillful bond pickers can uncover fallen angels with the potential to recover and contribute to performance.

- **Identifying upgrade candidates.** We can potentially add to performance if we are able to identify securities that will be upgraded by the credit rating agencies over the next one to two years. An uptick in ratings is likely to result in spread tightening. The challenge is to have a research process that can discover those securities before the rest of the market catches wind of the improvement.

- **Investing in new issues.** We work with the Loomis Sayles credit research group and the trading desk to assess value in the new issue and secondary markets. Given Loomis Sayles' size, we can often secure favorable allocations to new deals and compelling opportunities in outstanding issues.

How We Work

Original research lies at the heart of our operation. Figuring out when the markets are sending the wrong signal is an approach we employ to help enhance performance. To do that, we look at hundreds of securities daily from as many different perspectives as we can.

On the macro level, we work with the Loomis Sayles macro strategies team, which studies the global economy as well as the economic prospects of individual countries. We also draw on the firm's sector teams, made up of portfolio managers, strategists, analysts and traders with expertise in different asset classes, such as investment grade credit, high yield bonds, emerging market bonds, convertibles, securitized assets, bank loans and commodities. Our partnership with the firm's deep fundamental research resources, including credit and securitized, gives us the analysis and conviction we require to execute our contrarian, deep-value style.

The goal is to use all these inputs to make buy and sell decisions. Along the way we want to hear different opinions and engage in lively debates that will force us to think: Is a given sector attractive? Which industry has a compelling risk-return profile? How big a position should we take in a particular security?

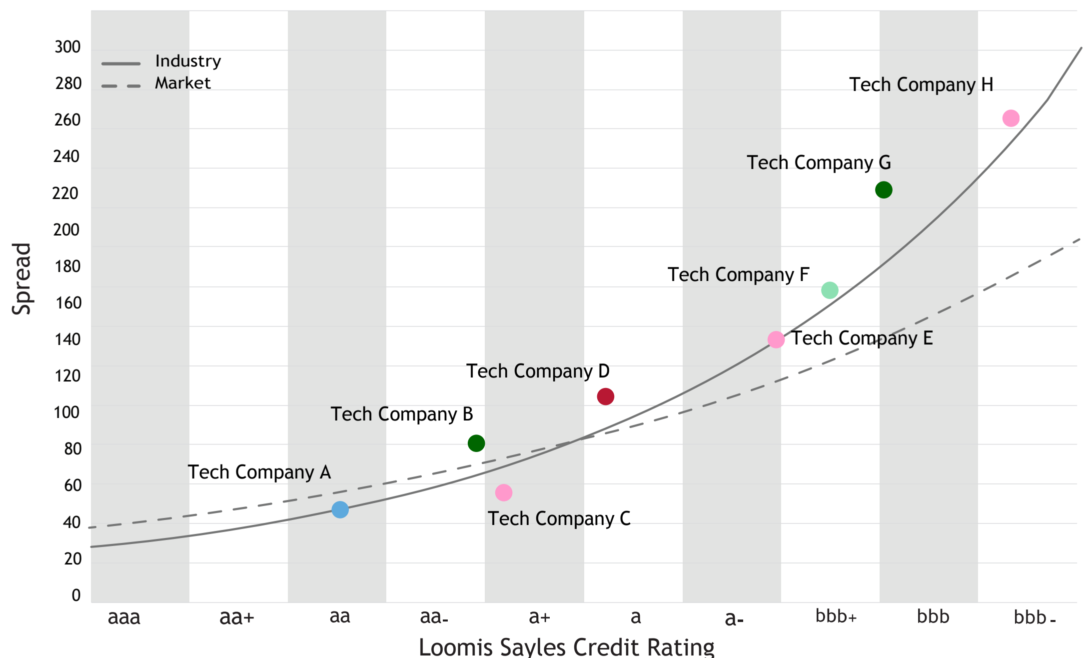
Over time, we have built research tools that bring a quantitative perspective to the discussions. One such tool, illustrated below, allows us to measure relative value across industries or to make comparisons about the attractiveness of individual bonds. It can generate new ideas and add a layer of confidence to decisions made by our analysts. Another tool allows us to use historical data to conduct scenario analysis and inform our view of the future. We are continually stress-testing our portfolios to see how they might behave under a range of possible outcomes. If the Federal Reserve is contemplating a rate hike, what will that mean for our portfolios? Our Regime Tool lets us apply past interest rate environments to today's portfolio and assess the impact. We can do the same analysis looking at past recessions or equity market selloffs.

UNIFIED RELATIVE VALUE TOOL

A snapshot of the Technology Industry

Industry chart is for illustrative purposes only as a sampling of risk management tool output.

The information is not intended to represent any actual issuers.



The point here is not to substitute the judgment of machines for human intuition. We view the two approaches as complementary. The tool's analysis is a useful starting point, but we take the analysis a step further. How might the next regime be different from the last? What are the unexpected risks the tool might be missing? By adding more eyes and brains to the process, we are improving the chances we will arrive at a beneficial place. In the end, we as portfolio managers make the final calls.

How We Look Different

Typically, our Investment Grade Bond portfolios will not look much like the major core or high-quality bond fund benchmarks, whose performance depends heavily on changes in interest rates. While we have a view on rates, which helps shape our decision-making, we are not in the business of predicting short-run rate fluctuations. Our strength is in evaluating credit, which is why our portfolio positioning generally favors the credit sectors. By focusing our energies there, we seek to add alpha where we believe our expertise can differentiate us.

In most cases, our portfolios will also have higher yields than the benchmarks. Given the breadth and depth of our research, and our contrarian style, we feel comfortable operating in the segments of each market that offer the highest spread—when our fundamental analysis tells us it would be prudent to do so.

For investors looking to diversify their bond fund exposure, we believe we offer a distinct alternative.

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Commodity, interest and derivative trading involves substantial risk of loss.

Diversification does not ensure a profit or guarantee against a loss.

Fixed income securities *may carry one or more of the following risks: credit, interest rate (as interest rates rise, bond prices usually fall), inflation and liquidity.* ***Foreign and emerging market securities*** *may be subject to greater political, economic, environmental, credit, currency and information risks. Foreign securities may be subject to higher volatility than US securities due to varying degrees of regulation and limited liquidity. These risks are magnified in emerging markets.* ***Below investment grade fixed income securities*** *may be subject to greater risks (including the risk of default) than other fixed income securities.* ***Mortgage-related and asset-backed securities*** *are subject to the risks of the mortgages and assets underlying the securities. Other related risks include prepayment risk, which is the risk that the securities may be prepaid, potentially resulting in the reinvestment of the prepaid amounts into securities with lower yields.*

Outlook as presented in this material reflects subjective judgments and assumptions of the portfolio team and does not necessarily reflect the views of Loomis, Sayles & Company, L.P. There is no assurance that developments will transpire as stated. Opinions expressed will evolve as future events unfold.

Past market experience is no guarantee of future results.

Before investing, consider the fund's investment objectives, risks, charges, and expenses. Please visit www.loomissayles.com or call 800-633-3330 for a prospectus and a summary prospectus, if available, containing this and other information. Read it carefully.

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