



A Multi-Sector Approach to Short-Term Bonds

May build investment resilience through diversification and liquidity.

July 2020

KEY INSIGHTS

- The low duration portfolio management team applies a multi-sector approach as we strive to capture an appropriate amount of risk-adjusted yield.
- The multi-sector approach reduces the strategy's dependence on any particular market and can help capture relative value across sectors.
- Actively managing liquidity risk is a key component of our analysis of bond market sectors and the strategy's allocations.



Michael Reinartz, CFA
*Lead Portfolio Manager for
US Short-Term Bond Strategy*

The low duration portfolio management team believes a multi-sector approach is the best way for a short-term bond portfolio to provide incremental income while taking less credit and interest rate risk than longer-maturity fixed income portfolios. This reduces the strategy's dependence on any particular market and can help capture relative value across sectors. We combine this approach with rigorous fundamental credit analysis to inform our security selection and help avoid downside scenarios as we strive to capture an appropriate amount of risk-adjusted yield. Actively managing liquidity risk is a key component of our analysis of bond market sectors and the strategy's allocations.

Multi-Sector Approach

The US Short-Term Bond Strategy is an investment-grade portfolio that can invest in a range of sectors, both in and out of benchmark. The Bloomberg Barclays 1–3 Year U.S. Government/

Credit Bond Index benchmark includes Treasuries, agency debt, and investment-grade corporate bonds.

The strategy also has the flexibility to invest in sectors that are not in the benchmark, such as securitized debt, which includes government-guaranteed agency mortgage-backed securities (MBS) as well as segments with credit risk, such as non-agency mortgage-backed securities (RMBS), commercial mortgage-backed securities (CMBS), and asset-backed securities (ABS). The drivers of credit quality in these securitized markets often differ from those affecting investment-grade corporate bonds.

This multi-sector approach provides diversification and allows us to take advantage of relative value opportunities based on the market environment and potential dislocations in valuation. When determining allocations across the various sectors, we can draw on the expertise of our global sector research

“...we actively manage the strategy’s exposure to liquidity risk.

specialists. We measure relative valuation in terms of yield or credit spread,¹ adjusted for volatility to manage risk and help ensure that we do not simply chase riskier sectors that have been outperforming in a positive market.

We also diversify exposures within sectors. For example, within the strategy’s allocation to investment-grade corporates, we manage exposure across industries as well as domestic versus international issuers. We are currently avoiding industries we think will experience negative structural change due to COVID-19 (the disease caused by the coronavirus), such as travel and leisure. Within securitized credit, we can diversify across types of bonds with different cash flow structures and varying credit risk.

Credit Analysts Inform Security Selection

At the security selection level, we rely on T. Rowe Price’s global team of credit analysts to provide insight into the fundamental condition of individual issuers and the structures of specific bonds. Corporate credit analysts specialize in particular industries, while securitized credit analysts develop expertise in segments like RMBS and ABS. We believe that research input from the credit analysts adds value over time through strong security selection and enhances the strong foundation provided by our multi-sector approach.

Active Management of Liquidity Risk

Liquidity in many fixed income sectors became limited in March as financial market participants realized the likely extent of the economic damage from the

coronavirus pandemic. Although liquidity has improved meaningfully after the Federal Reserve implemented various programs to support fixed income market segments, we actively manage the strategy’s exposure to liquidity risk. This can help us navigate periods of extreme market stress, such as March 2020 and the depths of the global financial crisis in 2008–2009.

The different fixed income sectors have distinct liquidity profiles. Treasuries are the most liquid bonds, while investment-grade corporates can present more challenges for buying and selling at efficient prices. We address this by laddering, or structuring the strategy’s corporate bond holdings so that they mature at regular intervals, and by generally favoring shorter-maturity corporates for their better liquidity. We learned in March that securitized credit instruments can have surprisingly limited liquidity at times. However, unlike most corporate bonds, securitized debt pays down principal over time, which is another way to generate organic cash flow in the portfolio.

Structural Allocation to Treasuries for Liquidity

Liquidity considerations are a key component of our multi-sector approach. The strategy has a structural allocation to Treasuries that should benefit from their liquidity even when trading at efficient prices in other sectors becomes limited. In addition, we ladder the portfolio’s corporate debt exposure in seeking to provide the strategy with predictable small increases in cash without relying on selling holdings.

¹ Credit spreads measure the additional yield that investors demand for holding a bond with credit risk over a similar-maturity, high-quality government security.



WHAT WE'RE WATCHING NEXT

As always, we rely on rigorous fundamental analysis to drive our investment decisions. We are closely collaborating with our corporate credit analysts and global economists to gauge the impact of the coronavirus pandemic on corporate earnings. Amid the ongoing uncertainty about the pace of reopening businesses and the economic recovery, the range of consensus expectations for corporate earnings has grown much wider. We believe that this may produce more opportunities to find individual corporate bonds with prices that do not accurately reflect their fundamentals.

Key Risks—The following risks are materially relevant to the strategy highlighted in this material:

Debt securities could suffer an adverse change in financial condition due to a ratings downgrade or default that may affect the value of an investment. Fixed income securities are subject to credit risk, liquidity risk, call risk, and interest rate risk. As interest rates rise, bond prices generally fall.

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