How the Global Unconstrained Bond Strategy is Designed to Help in Volatile Markets

Portfolio manager Arif Husain takes a look back at recent performance and discusses the future.

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Head of International Fixed Income, Lead Portfolio Manager of the Global Unconstrained Bond Strategy

KEY INSIGHTS

- The liquid profile of the strategy has been critical because it enabled us to adapt quickly to new information and price action.
- The Global Unconstrained Bond (CAD Hedged) Composite[1] delivered a positive first-quarter return during an environment of heightened volatility and a sharp correction in risk assets.
- Expect volatility to persist and risk assets to follow a seesaw-shaped recovery, where short-term dislocation in prices will present further opportunities.

The past few weeks and months have provided a useful—if sobering—reminder that volatility can strike suddenly and violently. Back in February, risk assets such as U.S. equity markets were reaching all-time highs; by March, they were in full-blown crisis mode. Market conditions became extremely challenging, which gave us the opportunity to demonstrate how the Global Unconstrained Bond Strategy can perform as a fixed income stabilizer during times of market stress. In this Q&A, Lead Portfolio Manager Arif Husain outlines the specific goals the strategy seeks to achieve and discusses how the strategy's composite delivered positive returns during the first quarter at a time when many other bond investors struggled.

Q: Given recent events, can you remind us what the goals are of the Global Unconstrained Bond Strategy?

The strategy has three key objectives: seeks to generate regular income/returns for our clients, to minimize drawdowns, and to provide genuine diversification away from equity markets. The recent turbulence in markets provided a reminder of why diversification can be so important. While risk assets such as equity and credit suffered some of their worse sell-offs since the global financial crisis, the Global Unconstrained Bond (CAD Hedged) Composite delivered positive returns. To achieve this, we focused mostly on government bond allocation as opposed to credit risk,

Core Goals of the Strategy

[1] Returns based on Dynamic Global Bond (USD Hedged) Composite. The Global Unconstrained Bond Strategy/Composite is advertised and marketed under the Dynamic Global Bond Strategy/Composite designation outside of Canada, but should be referred to as the Global Unconstrained Bond Strategy/Composite in Canada.

Performance Table

(Fig. 1) Global Unconstrained Bond (CAD Hedged) Composite

	1 Month	Year-to-Date	1 Year	Annualized 3 Years	Annualized 5 Years	Annualized Since Inception Jan. 31, 2015
Global Unconstrained Bond Strategy (Gross of Fees, Hedged to CAD)	1.25%	6.36%	4.73%	1.98%	2.35%	2.72%
FTSE TMX 91-Day T-Bill	0.05	0.76	1.73	1.38	1.03	1.00
Value Added (Gross of Fees)[1]	1.20	5.60	3.00	0.60	1.32	1.72

Periods ended May 31, 2020 .
Figures are calculated in Canadian Dollars.
Past performance is not a reliable indicator of future performance.
Returns based on Dynamic Global Bond (USD Hedged) Composite. The Global Unconstrained Bond Strategy/Composite is advertised and marketed under the Dynamic Global Bond Strategy/Composite designation outside of Canada, but should be referred to as the Global Unconstrained Bond Strategy/Composite in Canada.
The returns shown above were produced by calculating the alpha of the unhedged composite versus its unhedged benchmark for each one-month period and applying that excess return to the version of the benchmark as calculated by the vendor to produce a monthly hedged composite return. Monthly returns are linked to produce hedged returns for longer periods in the stated currency.
Gross performance returns are presented before management and all other fees, where applicable. Net of fees performance reflects the deduction of the highest applicable management fee that would be charged based on the fee schedule appropriate to you for this mandate, without the benefit of breakpoints.
The information presented is supplemental information for GIPS® purposes; however, because T. Rowe Price does not currently manage any accounts the strategy presented, a GIPS compliant presentation is not available. A complete list and description of the firm's composites is available upon request.
[1] Value Added figures represent Global Unconstrained Bond Strategy (Gross of Fees, Hedged to CAD) minus the benchmark in the previous row.
Sources: T. Rowe Price and FTSE/Russell (see Additional Disclosure).

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and we implemented various defensive hedging positions to keep risk in the portfolio balanced. From a liquidity standpoint, that gave us the ability to be dynamic and adapt quickly to changes in the market environment, which is particularly important during periods of volatility of the kind we experienced recently.

Q: How was the strategy positioned entering into the first quarter, and how did you react to the change in the environment?

Anticipating an improvement in global growth, we kicked off 2020 with the complete wrong positioning, which included a small overall negative duration stance and short duration exposures in high-quality countries. Crucially, however, we pivoted quickly in early February when our health care analysts and team of economists flagged concerns about the spread of the coronavirus and the risks to the global economy. We significantly increased the portfolio's overall duration profile in so-called "safe haven"[2] assets such as U.S. Treasuries and added to our defensive hedging positions through short positions in credit indexes and put options on U.S. equities.

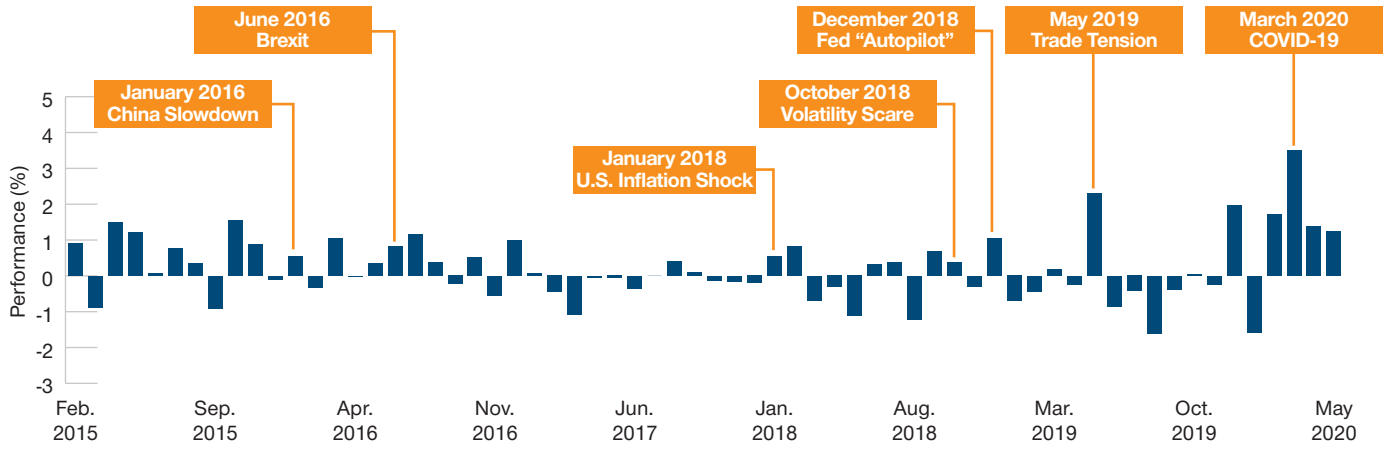
Q: What positions have worked well for the strategy and what haven't?

The changes we made in February—moving from a short duration to a long position stance in the U.S. and increasing defensive hedges expressed in credit and equity markets—were significant drivers of the composite's positive performance in the first quarter.

[2] A "safe haven" investment is one that investor's typically seek during a market downturn, as it may involve less risk. However, there is no assurance that any investment will have favorable performance or that it will protect against losses.

Performance at Times of Volatility

(Fig. 2) Monthly performance of the Global Unconstrained Bond (CAD Hedged) Composite gross of fees



As of May 31, 2020.
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Source: T. Rowe Price.

> Our ability to be nimble and change the portfolio quickly also served us well during the period.

The rapid evolution of the coronavirus roiled financial markets and led to sharp corrections in risk assets such as equity and credit, while U.S. Treasuries rallied strongly as they benefited from a massive flight to quality.

Our ability to be nimble and change the portfolio quickly also served us well during the period. We didn't just stick with February's positioning for the rest of the quarter—we made tactical changes around our allocation to U.S. Treasuries at a time when they started to exhibit irrational behavior. Our priority was to keep the portfolio's liquidity profile high, which gave us the flexibility to pursue new opportunities. This included adding duration in developed countries that were likely to cut interest rates, such as Australia and South Korea. We also added to emerging markets such as Brazil, Russia, and Indonesia as central banks in these countries had become more accommodative.

Not everything worked in the strategy's favor, however. We were on the wrong side of the oil crisis with exposure in U.S. inflation-linked bonds, for example. We also kept a short bias in the U.S. dollar going into the crisis against long positions in commodity-linked currencies such as the Russian ruble and Australian dollar, which dragged on performance. However, the balanced risk approach of the portfolio helped ensure that the impact of these losses was ultimately contained.

Q: What lessons have you learned since launching the strategy that helped navigate this crisis?

First, remain true to your objectives. In recent years, the strategy sometimes struggled during periods of low volatility

> Striking the right balance between specific risk-seeking positions and more defensive positions remains key.

and slow rallies in risk markets. This is because to balance the strategy's overall risk profile and act as a true diversifier to equity markets, defensive positions must always be maintained, which can drag on performance. We have done a lot of work in the past two years to better understand the impact of insurance premiums and how we can minimize the cost of our hedging positions. This has involved expanding the tools we use to include instruments such as total return swaps and employing new structures involving spread options, where the upfront cost can be smaller. While these structures usually offer less payout during small market corrections, they have proved beneficial at times of large price swings, as was the case in March.

Another key lesson from past crises is that volatility usually does not stay elevated for a prolonged period, so gains need to be quickly monetized to have a lasting impact. With this in mind, during the second half of March we decided to close the majority of our hedges, either outright or option-related, to capitalize on the profits made. While we don't claim to always capture the height of the market's correction, we have learned from previous sell-offs. Knowing when to take profits is just as important as implementing hedges since gains can quickly be eroded when volatility stabilizes and markets rebound.

Q: What is your outlook for fixed income markets?

In the near term, don't fight the central banks. The recovery from what could be one of the deepest economic contractions of modern times is likely to be slow, with the potential for setbacks along the way. In these types of conditions, core markets such as U.S. Treasuries and other high-quality government bonds could thrive thanks to their status as a "safe haven" in global fixed income being reinforced recently by all major central banks supporting the market.

We believe emerging market countries offer some excellent opportunities. A number of central banks there have decided to embark on their own versions of quantitative easing, which will boost their respective local government bonds but may have negative repercussions for their currencies.

Over a longer-term horizon, the ability to quickly alter the duration posture of the portfolio will matter. Historically, major central banks, such as the Federal Reserve, have been keen to lift rates away from zero and taper their balance sheet as soon as they can. When we see signs that central banks are showing less commitment to supporting markets, it will be time to sell core duration—and do so quickly as there's a real possibility of a repeat of the 2013 taper tantrum.

In the corporate world, dislocation will continue to dominate. Not every company will survive this crisis: Default rates are likely to pick up meaningfully over the coming year. Many companies will also likely lose their investment-grade status. It's not all doom and gloom, however. There are some great opportunities out there where company bond prices have been completely dislocated from fundamentals. Our bottom-up research is a tremendous asset that helps us to uncover those companies that are likely to survive—and, just as importantly, the companies to be avoided. In late March, we started adding select corporate issues and securitized bonds that our analysts identified as strong medium-term conviction ideas.

Financial markets are effectively in unchartered territory, and more periods of volatility lie ahead. We believe this environment will be conducive for our strategy, as we have the flexibility to adapt quickly to changes in market conditions and try to take advantage of any pricing anomalies and dislocations that might occur. We will continue to follow our trusted investment process. Striking the right balance between specific risk-seeking positions and more defensive positions remains key.

GIPS® Disclosure

Dynamic Global Bond (USD Hedged) Composite

Period Ended December 31, 2019
Figures Are Shown in U.S. dollar

	2015[2]	2016	2017	2018	2019
Gross Annual Returns (%)	5.23	5.07	-1.15	1.46	0.24
Net Annual Returns (%)[1]	4.87	4.68	-1.53	1.08	-0.13
3 Month LIBOR in USD (%)	0.28	0.75	1.28	2.34	2.36
Composite 3-Yr. St. Dev.	N/A	N/A	N/A	2.05	2.67
3 Month LIBOR in USD 3-Yr. St. Dev.	0.01	0.07	0.12	0.20	0.16
Composite Dispersion	N/A	N/A	N/A	N/A	N/A
Comp. Assets (Millions)	63.3	612.7	4,438.0	8,380.3	8,273.9
# of Accts. in Comp.	2	2	4	5	4
Total Firm Assets (Billions)	772.4	817.2	1,000.2	972.7	1,218.2[3]

[1]Reflects deduction of highest applicable fee schedule without benefit of breakpoints. Investment return and principal value will vary. Past performance is not a reliable indicator of future performance. Monthly composite performance is available upon request. **See below for further information related to net of fee calculations.**

[2]January 31, 2015 through December 31, 2015.

[3]Preliminary—subject to adjustment.

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Effective June 30, 2013, portfolio valuation and assets under management are calculated based on the closing price of the security in its respective market. Previously portfolios holding international securities may have been adjusted for after-market events. Policies for valuing portfolios, calculating performance, and preparing compliant presentations are available upon request. Dispersion is measured by the standard deviation across asset-weighted portfolio returns represented within a composite for the full year. Dispersion is not calculated for the composites in which there are five or fewer portfolios.
The strategy utilizes on a regular basis a variety of derivative instruments such as (but not limited to) currency forwards, fixed income futures, interest rate swaps, credit default swaps, synthetic indices, and options on all mentioned instruments, primarily to hedge certain market risks associated with the strategy's objective, to express directional opportunities on specific markets and to facilitate liquiditymanagement. Benchmarks are taken from published sources and may have different calculation methodologies, pricing times, and foreign exchange sources from thecomposite. Composite policy requires the temporary removal of any portfolio incurring a client initiated significant cash inflow or outflow greater than or equal to 15% of portfolio assets. The temporary removal of such anaccount occurs at the beginning of the measurement period in which the significant cash flow occurs and the account re-enters the composite on the last day of the current month after the cash flow. Additional information regarding the treatment of significant cash flows is available upon request.
The firm's list of composite descriptions and/or a presentation that adheres to the GIPS® standards are available upon request.

Fee Schedule

Global Unconstrained Bond Strategy. The Global Unconstrained Bond Strategy seeks to deliver consistent fixed income returns through a flexible, dynamic and diversified allocation to debt instruments from around the world. The strategy adopts a holistic and rigorous approach to risk management to protect clients on the downside, and particularly seeks to provide adequate diversification at times of equity markets' correction. (Created January 2015.)

First 55 million (CAD)	37.5 basis points
Next 55 million (CAD)	32.5 basis points
Above 110 million (CAD)	30 basis points on all assets[1]
Above 275 million (CAD)	25 basis points on all assets[1]
Minimum separate account size	100 million (CAD)

[1] A transitional credit is applied to the fee schedule as assets approach or fall below the breakpoint. Based on Dynamic Global Bond (USD Hedged) Composite. The Global Unconstrained Bond Strategy/Composite is advertised and marketed under the Dynamic Global Bond Strategy/Composite designation outside of Canada, but should be referred to as the Global Unconstrained Bond Strategy/Composite in Canada.

Risks—the following risks are materially relevant to the portfolio:

ABS/MBS risk—These securities may be subject to greater liquidity, credit, default and interest rate risk compared to other bonds. They are often exposed to extension and prepayment risk.

China Interbank Bond Market risk—market volatility and potential lack of liquidity due to low trading volume of certain debt securities in the China Interbank Bond Market may result in prices of certain debt securities traded on such market fluctuating significantly.

Contingent convertible bond risk—contingent convertible bonds have similar characteristics to convertible bonds with the main exception that their conversion is subject to predetermined conditions referred to as trigger events usually set to capital ratio and which vary from one issue to the other.

Country risk (China)—all investments in China are subject to risks similar to those for other emerging markets investments. In addition, investments that are purchased or held in connection with a QFII licence or the Stock Connect program may be subject to additional risks.

Country risk (Russia and Ukraine)—in these countries, risks associated with custody, counterparties and market volatility are higher than in developed countries.

Credit risk—a bond or money market security could lose value if the issuer's financial health deteriorates.

Currency risk—changes in currency exchange rates could reduce investment gains or increase investment losses.

Default risk—the issuers of certain bonds could become unable to make payments on their bonds.

Derivatives risk—derivatives may result in losses that are significantly greater than the cost of the derivative.

Emerging markets risk—emerging markets are less established than developed markets and therefore involve higher risks.

High yield bond risk—a bond or debt security rated below BBB- by Standard & Poor's or an equivalent rating, also termed "below investment grade, is generally subject to higher yields but to greater risks too.

Interest rate risk—when interest rates rise, bond values generally fall. This risk is generally greater the longer the maturity of a bond investment and the higher its credit quality.

Issuer concentration risk—to the extent that a portfolio invests a large portion of its assets in securities from a relatively small number of issuers, its performance will be more strongly affected by events affecting those issuers.

Liquidity risk—any security could become hard to value or to sell at a desired time and price.

Prepayment and extension risk—with mortgage and asset-backed securities, or any other securities whose market prices typically reflect the assumption that the securities will be paid off before maturity, any unexpected behavior in interest rates could impact portfolio performance.

Sector concentration risk—the performance of a fund that invests a large portion of its assets in a particular economic sector (or, for bond funds, a particular market segment), will be more strongly affected by events affecting that sector or segment of the fixed income market.

General Portfolio Risks

Capital risk—the value of your investment will vary and is not guaranteed. It will be affected by changes in the exchange rate between the base currency of the portfolio and the currency in which you subscribed, if different.

Counterparty risk—an entity with which the portfolio transacts may not meet its obligations to the portfolio.

Geographic concentration risk—to the extent that a portfolio invests a large portion of its assets in a particular geographic area, its performance will be more strongly affected by events within that area.

Hedging risk—a portfolio's attempts to reduce or eliminate certain risks through hedging may not work as intended.

Investment portfolio risk—investing in portfolios involves certain risks an investor would not face if investing in markets directly.

Management risk—the investment manager or its designees may at times find their obligations to a portfolio to be in conflict with their obligations to other investment portfolios they manage (although in such cases, all portfolios will be dealt with equitably).

Operational risk—operational failures could lead to disruptions of portfolio operations or financial losses.

Additional Disclosure

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