

DoubleLine Investment Philosophy

DoubleLine Capital LP was founded to offer investment services under a cardinal mandate: the delivery of better risk-adjusted fixed income returns to the client. Performing on this mandate depends on the avoidance of risk-taking that has led to catastrophic principal losses even under bond managers once reputed for conservative stewardship. Our investment team owns a track record of meeting this mandate, consistently, across Core as well as asset-centric strategies over the two decades leading to our creation of DoubleLine. Guiding the team is an investment philosophy based on these first principles:

Take no risk without a payoff for the client. Among other consequences, this principle precludes the use of derivatives that may offer administrative convenience to asset managers but expose clients to counterparty default risk for no added payoff.

Prospective investments must offer an asymmetric, positively skewed risk-reward profile. In other words, for inclusion in portfolio, a security must appear, through careful analysis, to expose the portfolio to greater potential payoff than potential loss.

Portfolios must offer outperformance under a range of future scenarios. In other words, DoubleLine shuns risk-taking based on unidirectional forecasts. For example, portfolios invested in credit are constructed with an aim to deliver outperformance or at least benchmark-like performance whether default rates fall, rise or remain range-bound over the client's investment horizon. In strategies whose returns are driven primarily by interest rate risk, portfolios are constructed with an aim to outperform or at least approximate the benchmark whether interest rates fall, rise or remain range-bound.

Bond markets reward slowly and punish abruptly. Under most conditions, the markets price credit, prepayment and other risks near "normal" valuations relative to U.S. Treasuries. In late stages of market cycles, spread income falls below historical average, leaving the asset vulnerable to reversals into price freefalls amid bid-less markets. At such junctures, exit becomes impossible without incurring severe losses to par.

Sector beta must be managed through preemptive allocation among asset classes. Once an asset class appears vulnerable, DoubleLine seeks to move aggressively to reduce portfolio exposure to that sector. Because no one can consistently time market turns, the successful re-posturing of a portfolio may occur "early" with respect to the sector top. DoubleLine is comfortable foregoing months or quarters of *de minimis* extra income from an overvalued, low-yielding sector to avoid risking par losses equivalent to years of spread income.

Pursuit of excess return by making interest rate bets is futile and hazardous. No one can consistently predict changes in the level, direction or term structure of interest rates. Furthermore, even assuming a highly accurate batting average for predicting Treasury yields, managing a portfolio based on duration bets would inflict intolerable tracking error for the vast majority of investors. DoubleLine does not attempt to anticipate changes in interest rates.

No Death Cases. The overarching objective of DoubleLine is to deliver better risk-adjusted return over the long term without risking what the investment team has come to call “Death Cases.” A Death Case is defined as a principal loss of sufficient magnitude to negate a portfolio’s chances of success.

The fixed income solution at DoubleLine dictates portfolio construction, sector allocation, security selection, trade execution and resourcing of the firm’s personnel and information systems. This global solution encompasses the employee ownership of DoubleLine itself: more than 70% of the firm’s equity is held by its Principals. Thus the ownership structure reinforces the stability of the investment team and our accountability to our valued clients. In fact, the name “DoubleLine” voices our cardinal mandate: like a careful motorist on a winding mountain road, the manager must not cross the double line into the oncoming lane of Death Case risk. DoubleLine follows this discipline across all strategies, including sector-focused strategies, such as Mortgage-Backed Securities, Developed Credit and Emerging Markets Credit as well as its Core Fixed Income and Asset Allocation strategies.

Investment Process

Financial history is replete with ruin due to lax management policies or misjudgment of risk. This record is shared by banks, insurers, credit rating agencies and investment managers, the latter including bond managers reputed for their supposed conservatism. Many of these disasters involve misplaced trust in predictive models. No matter how complex, models ultimately draw naïve conclusions about the future by extrapolating historical data. Being hostage to the past, these statistical exercises inevitably fail as the real world mutates. Consequently, model-driven decision makers underestimate the probability of extreme future outcomes, misleading them into Death Case risk. Some catastrophes stem from deadly synthetic strategies lurking beneath seemingly benign closet-indexing funds. In using synthetics, managers can overlook the risk of counterparty default or misunderstand the multiplier effects of leverage. In other cases, rigid tracking error budgets eclipse security selection and sector allocation based on fundamentals. Perhaps most incredibly, managers may knowingly expose clients to securities with Death Case risk because these seem to offer premium returns under alternative scenarios.

Advantaged Portfolios under Multiple Forward-Looking Scenarios

No one can consistently predict changes in econometric variables. Therefore, DoubleLine is relatively indifferent to forecasts. Instead, the investment team selects securities and allocates among asset classes in order to build portfolios with asymmetric, positively skewed risk-reward profiles. Portfolios are constructed to outperform under a range of future outcomes while avoiding Death Cases. This process applies regardless of the key driver of enhanced performance, be it management of interest rate risk, credit risk or currency risk, or some mix thereof.

To illustrate, consider a simplistic hypothetical choice between two asset classes: Ginnie Mae securities and U.S. Treasuries. Both are backed by the full faith and credit of the U.S. government, and each can be managed to the same interest rate volatility. Thus deciding relative weighting between the two asset classes can be reduced to questions of the prepayment risk embedded in Ginnie Maes. DoubleLine does not try to forecast precise prepayment volumes under forward-looking scenarios and so does not

gamble on prepayment forecasts. Instead, the investment team forms judgments about the adequacy of the compensation or yield for the prepayment risk under scenarios of higher, unchanged and lower prepayment volumes. If analysis shows that Ginnie Maes represent a “Win-Win-Win” (i.e., Ginnie Maes appear likely to outperform Treasuries under all three prepayment scenarios), the manager should concentrate heavily in Ginnie Maes. Under a “Tie-Tie-Win” profile or a “Win-Win-Small Loss” profile, the manager should favor overweighting Ginnie Maes. Profiles of “Tie-Tie-Tie” or worse mean overweighting Treasuries. Under no circumstances would DoubleLine buy Ginnie Maes risking a Ginnie Mae Death Case. “Win-Tie-Death Case”: stay in Treasuries. “Win-Death Case-Win”: stay in Treasuries. Even if analysis strongly indicates the opportunity for outsized returns under two of the three prepayment scenarios, but a third scenario holds a Death Case, the manager should avoid Ginnie Maes and stay in Treasuries.

Prepayment Scenarios	Set of Acceptable Investment Outcomes					Precluded Outcomes	
<i>Higher</i>	Secular Win	Large Win	Small Win	Tie	Small Loss	Large Loss	Death Case
<i>Unchanged</i>	Secular Win	Large Win	Small Win	Tie	Small Loss	Large Loss	Death Case
<i>Lower</i>	Secular Win	Large Win	Small Win	Tie	Small Loss	Large Loss	Death Case

Sector Rotation Can Manage Risk; Frozen Sector Betas Lock in Risk

Market history shows that the sectors of the Fixed Income universe cycle through periods improving and worsening fundamentals as well as periods of under and over valuation. Thus frozen sector betas can expose Core portfolios to significant principal loss and missed upside opportunity. DoubleLine uses aggressive sector allocation as a central risk management strategy. The team seeks to pare exposure as spread income weakens, quality of issuance observationally deteriorates and macroeconomic variables begin to soften. The corporate credit collapse of 2008 illustrates the danger of frozen sector betas and the benefit of DoubleLine’s preemptive approach to asset allocation. The Core Fixed Income and Asset Allocation team now at DoubleLine significantly underweighted credit in 2006-2007 in favor of Treasuries, Agency debentures and Agency mortgage-backed securities. As a result, diversified portfolios managed by the team sidestepped the credit beta before the market collapse of 2008. In 2009, the team opportunistically repositioned these portfolios to take advantage of distress-priced credit. The performance of the mutual fund TGCFX, managed by Jeffrey Gundlach and his team from the fund’s inception through December 4, 2009, provides an objective measure of the success of this asset allocation discipline.

The Fallacy of Equal-Weighted Outcomes

Some so-called active bond managers lock in perennial exposures to spread sectors. In some cases, they have fallen hostage to what DoubleLine calls the fallacy of equal-weighted outcomes. To state the obvious, credit spreads can tighten, remain unchanged or widen versus Treasuries. From that truism, many Core/Core Plus managers seem to proceed to a lethal non sequitur: apparently for purposes computational convenience, they make the brash assumption that each spread scenario – tighter, flatter, wider – represents a 1/3 probability. That a variable has three possible outcomes does not mean that the probabilities of those outcomes are equally weighted. In fact, the contrary is often the case. By definition, credit cycles include cyclical peaks, the point at which the probability of spreads narrowing becomes effectively 0. But even with spread income below historical average entering mid-2007, the herd of Core managers seemed to be invested for Win-Win-Maybe Win credit scenario: Scenario (1) a capital gain + spread income if spreads narrow, Scenario (2) spread income maintained if spreads remain unchanged, and Scenario (3) spreads widen but in some cases not enough for par losses to fully offset spread income. But in late-stage cycles, the actual alternatives are more like Small Win-Tie-Death Case.

Buying Right, Structuring Right and Earning Out the Cash Flows

A popular approach in bond investing is to purchase securities at higher yields than the generic market and risk-manage later. This turns managers into hopeful reactionaries. In their best case, they gamble on the “Greater Fool” theory, hoping to sell into a wave of spread compression. On the other hand, if prices crumble, they hope to react fast enough to trade out before suffering losses. This chase-yield-now, risk-manager-later mindset stirs up portfolio turnover, raising trading costs that cannibalize returns. Of even greater concern, random risk-taking in the pursuit of yield can leave portfolios vulnerable to Death Cases, be they in the form an explosion in defaults and extreme movements in interest rates. When such events occur, prices collapse in step-function; exit becomes impossible without deep losses to principal.

DoubleLine will not hesitate to purchase securities at the same yield as the market – or even at lower yields at important moments of perceived high risk. Rather than chasing incremental income, the investment team prospects for securities with the potential to build par value in different scenarios involving the key variables driving return for that particular asset class. DoubleLine seeks to buy securities right, structure portfolios right, and then earn the cash flows while building critical par value over time.

Paths to Low Portfolio Turnover

During the 15 to 20 years leading to the creation of DoubleLine, the investment team established a turnover record at the very low end in the management of MBS and Developed Corporate Credit portfolios and at the low end of the Core Plus manager universe, a considerable achievement given the team’s active sector rotation. In contrast, portfolios managed by many DoubleLine competitors have experienced much higher turnover at the security level.

Several sources enable the investment team to achieve low turnover. First, intermediate-term bond portfolios generate significant cash flows. DoubleLine draws from this source of liquidity to re-sculpt

portfolio exposures on an ongoing basis. Second, the team foregoes what it calls “minutiae trading”: trading for minor gains that would distract the team from the search for risks and opportunities with the prospect of making significant impact on returns. A third source of low turnover lies in the firm’s eschewing of derivatives contracts. Reliance on futures and swaps programs, dollar rolls and various credit hedges adds layers of complexity in the management of portfolio exposures. These techniques are popular among managers with such outsized assets under management that they cannot transact efficiently in the cash bond market. DoubleLine primarily avoids such instruments because these expose clients to the risk of counterparty default for no added compensation. As an added benefit, simplifying portfolio construction by avoiding derivatives eliminates a cause of minutiae trading.

Minds and Data

Market variables evolve continuously, a process that over time will destroy any quantitative effort to model future outcomes. Effective risk management is labor and data intensive. The manager must be capable of exploring the variables that drive securities cash flows and explore the range of outcomes that could occur if macroeconomic conditions change. This requires a large team of skilled analytical personnel, with a history of working together, and immense, ongoing investments in data and systems to organize and explore the data.

Portfolio Managers Face the Market

At DoubleLine, the role of the trader is most commonly assumed by portfolio managers. By definition, portfolio managers are the most seasoned traders. Their experience is irreplaceable in the stoppage of trading leakages. A firm relying on junior personnel to execute trades risks leakages that could overwhelm other benefits of the strategic ideas behind these transactions. Senior investment professionals at DoubleLine face the brokers and the markets, supported by middle-experienced professionals. Senior personnel on the trading desk also can respond more quickly to market opportunities than can a junior trader who lacks decision-making authority. The portfolio managers at DoubleLine have worked closely together for many years, enabling the team to rapidly vet potential trades and gain “first looks” at market opportunities.