Quarterly Commentary

October 2017
October was a quiet month due to the absence of any major catalysts. For the most part, attention was given to growth expectations for the U.S., the future chairperson of the Federal Reserve (Fed), and the potential for tax reform.

Growth expectations remain strong in the U.S. as the unemployment rate has fallen below the estimated full-employment level to 4.2%. Along with the ongoing downtrend in unemployment, consumer confidence remains strong. The Conference Board’s Consumer Confidence Index rose to 125.9 in October from 120.6 in September, making October’s reading the highest reading since December 2000. Meanwhile, business activity continued to expand, as measured by the Institute for Supply Management (ISM) Manufacturing Index which came in at 58.7 during October. The ISM Non-Manufacturing Index, accounting for the services industry, increased to 60.1 from 59.8. An Index level above 50 signals expansion across the respective sectors.

Anticipation also continued to build over the month as market participants tried to get a read on who would be appointed as the next Fed Chairperson in addition to other appointments to the Board of Governors. President Trump could appoint four of the seven Fed Governors, including the Chairperson. On November 2nd, Fed Governor Jerome Powell was announced as the next Fed Chair. His policy reforms will have an impact for years to come and are seen as closest to Janet Yellen’s policies with the goal of normalizing rates over the next several years. As for Janet Yellen, it appears she accomplished her goals of increasing interest rates and starting to unwind the Fed’s balance sheet. Our views on the potential impact of the Fed’s unwinding can be found in last month’s commentary. After two successful hikes through the first half of the year, the Fed appears to have finally met their own expectations after years of disappointing the market. According to Bloomberg’s World Interest Rate Probability (WIRP) function, the market implies an 82.8% chance of a Fed rate hike on December 13th. We believe the true probability is accurately reflected in the futures market and that the Fed will follow through and hike once more by year-end. A December hike would mark the third successful hike for Janet Yellen this year and the fifth hike during her term.

Additionally, potential tax reform continued to make headlines as the Committee on Ways and Means is expected to release a proposal. The proposal will be subject to debate and amendment, and time will tell if an agreement for reform will be met.

We continue to feel a sense of complacency amongst investors. The lack of volatility across risk assets reminds us to be patient and avoid knee-jerk reactions. This is the type of market environment where a decision to make no changes to asset and sector allocations is an equally intuitive investment decision. While we do not forecast a recession in the immediate future, further delays and disappointments in economic policy and rising bond yields are events that could lead to investor uncertainty.
According to the Bloomberg Barclays U.S. Treasury (UST) Total Return Index, Treasuries posted a modest loss of 0.12% in October, paring the year-to-date (YTD) advance to 2.14%. The 2-year yield touched 1.63% on October 27th, the highest level since October 2008. Rising expectations for a December rate hike have driven the rise in short-term interest rates. As of October 31st, Fed Funds futures priced in an 85% chance of a rate increase in December.

During the same period, the yield curve’s movements featured continued flattening trends. The yield spread between the 2-year and 10-year Treasuries dropped to 78 basis points (bps), close to a multi-year low, while the 5-year and 30-year spread fell to 83.2 bps on October 18th, the lowest since November 2007.

Inflation expectations, as reflected in breakeven rates, nudged slightly higher this month. The 10-year breakeven rate closed October at 1.88%, 3 bps higher than last month.

Throughout October, the market fixated on the guessing game of who will be the next Fed chair. A few significant yield movements can be attributed to this, such as October 16th and October 24th, when the odds of John Taylor becoming Fed Chair rose, and October 26th when Yellen was reported to be out of the running for Fed chair. Eventually, Jerome Powell emerged as the favorite ahead of Trump’s official announcement on November 2nd.

Though aggregate prepayment speeds increased by about 8% during October, they continued to be range-bound, a trend that speeds have followed for most of 2017. This doesn’t come as a surprise month-over-month (MoM) given 30-year Freddie Mac Commitment Rates have risen by about 11 bps. Concurrently, overall mortgage refinancing activity, as measured by the Mortgage Bankers Association (MBA) Refinancing Index, has declined by about 9% and overall purchasing activity, as measured by the MBA Purchase Index, has come down by about 3%.

### Agency Mortgage-Backed Securities

- Though aggregate prepayment speeds increased by about 8% during October, they continued to be range-bound, a trend that speeds have followed for most of 2017. This doesn’t come as a surprise month-over-month (MoM) given.
• Total gross Agency issuance was about $122 billion, unchanged from the prior month’s issuance levels. Overall issuance on a YTD basis has surpassed 2016’s totals for the time same time period. As noted in prior commentaries, higher turnover has been the primary driver for issuance during 2017 compared to 2016 when lower rates and refinancing activity were the main contributors.

• 30-year current coupon spreads against 5-year and 10-year Treasuries tightened in by a few bps.

• The Bloomberg Barclays U.S. MBS Index had a return of -0.02% and ended the period with a duration of 4.50 years.

Non-Agency MBS

• Non-Agency spreads were about 20 bps tighter during the month. The market tightened in line with other risk markets and continued to be supported by strong demand from market participants such as money managers looking to re-invest paydowns.

• There was $7.7 billion of legacy non-Agencies traded on bid lists during October compared to $4.8 billion during September. Increased supply from legacy holders led to the largest monthly volume this year. Subprime securities continued to make up a majority of activity.

• Delinquency roll rates increased in areas impacted by Hurricanes Harvey, Irma, and Maria. As servicers offer forbearance, delinquencies should remain elevated over the near-term.

Commercial MBS

• October private-label CMBS issuance volume increased by 1% MoM to $65.4 billion. Five conduit deals totaling $5.0 billion and six single-asset single-borrower (SASB) deals totaling $3.6 billion priced during the month. Private-label CMBS issuance volume YTD is 33% higher than through the same period in 2016. New issue volume continued to be driven by SASB deals, for which issuance is 97% higher than through the same period in 2016, while conduit issuance volume is up only 7% year-over-year (YoY).

• Secondary Principal & Interest CMBS trading totaled $21.7 billion in October, increasing 28% MoM and 17% above the 2017 monthly average of $18.5 billion through September. Secondary market cash spreads moved tighter with AAA last cash flows (LCF) tightening by 13 bps to swaps +73 bps and BBBs tightening by 25 bps to swaps +340 bps. CMBX spreads also tightened alongside broader equity and credit markets, with AAA 2012-2016 reference indices tightening by an average of 1 bp, and BBBs tightening by an average of 3 bps. The most recently issued conduit deal priced at swaps +83 bps and swaps +310 bps for the AAA and BBB tranches, respectively.

• The outstanding private label CMBS universe decreased by $370 million or 0.1% to $449.8 billion in October, with net issuance down...
7.1% YTD. The outstanding conduit universe was relatively unchanged at $330.6 billion, while the outstanding SASB universe decreased to $113.7 billion, down $940 million MoM, although up 16.8% YoY. The CMBS delinquency rate continued to decline, falling by 19 bps in September to 5.2%, the second largest one-month drop in the last 19 months.

### Asset-Backed Securities
- October proved to be a strong month for Asset-Backed Securities (ABS) as YTD issuance totaled $220 billion, surpassing the 2016 total of $209 billion. The increase in supply was absorbed readily with spreads moderately tighter.
- Traditional ABS sectors, such as Autos and Student Loans, continued to be well bid on both primary and secondary markets with the exception of specific shelves within the Student Loan sector.
- The Consumer Financial Protection Bureau (CFPB) took legal action against National Collegiate Student Loan Trusts (NCSLT) and their debt collector, Transworld Systems, Inc., for alleged improper debt collection practices. Due to the lengthy legal proceedings, valuations of NCSLT bonds have come under recent pricing pressure.
- The Bloomberg Barclays U.S. ABS Index returned 0.06% for the month of October and 0.42% for the third quarter of 2017.

### Investment Grade Credit
- The U.S. Investment Grade (IG) market delivered more of the same in October with the market up 0.34%. A combination of strong earnings and positive technicals pushed spreads to a pre-crisis low of 90 bps, to end the month at 91 bps over UST. Spreads tightened by 4 bps in the month for an excess return of 0.46%.
- Mutual fund inflows to IG credit accelerated in October, ending the last week of the month at $3.2 billion for a YTD total of $277 billion, or 14% of mutual fund assets. Supply ended the month at $135 billion, slightly above October 2016 supply of $130 billion.
- The best performing sectors were in the higher beta areas of Metals & Mining, with a return of 1.7%, and Energy, with a return of 1.1%, as Brent crude oil climbed to end the month above $60 a barrel.

### Collateralized Loan Obligations
- October was the second busiest month in 2017 in the new issue CLO front. We saw a total of $12.83 billion across 23 deals price in October.

### Total Fixed Rate Investment Grade Supply
October 31, 2016 to October 31, 2017

Source: Barclays Live
Monthly Commentary

- We’ve seen $95.3 billion in new issuance YTD. At the beginning of the year, the market expected roughly $60 billion in total issuance but was revised upwards in the middle of the year to $90 billion.

- New issue pricing continues to grind tighter with AAA spreads now pricing inside of 3-month LIBOR +120 bps and BBB spreads converging around 3-month LIBOR +250 bps. The AAAs have come in by roughly 10-20 bps while BBBs have tightened by 50-70 bps since September. The same spread tightening is evident in the secondary market with most bonds trading at a premium to par.

- In October, High Yield (HY) spreads approached multi-year tights before retracing wider into month-end. These stretched valuations were helped by good third-quarter earnings, a firmer backdrop for Energy companies and optimism surrounding the release of the GOP tax plan. This was somewhat offset by rate concerns and weak earnings in certain industries, including Healthcare and Retail. The Citi High-Yield Cash-Pay Capped Index returned 0.42%, though it was only because the coupon more than offset a price decline of 0.11%.

- Fund flows accelerated, with $1.1 billion in inflows according to Wells Fargo. Inflows to exchange-traded funds (ETF) continued to offset tepid demand for mutual funds, a steady trend since the start of the year. $12.6 billion in net outflows YTD from active mutual funds have been partially offset by $5.3 billion in inflows to passive ETFs.

- According to JPM, the par-weighted U.S. HY default rate increased slightly to 1.18% but is down from 3.57% at the start of the year. The issuer-weighted HY default rate increased to 2.85%, compared with 2.75% in September and down from 4.63% a year ago.

- All sectors were positive in the month except for Cosmetics, which returned -0.48%.

Bank Loans

- The S&P/LSTA Leveraged Loan Index posted a total return of 0.60% in October, the second highest monthly return of the year. This brings the YTD return to 3.59%. The pace of new issuance slowed in the month while investor demand remained strong, pushing prices higher. The percentage of loans priced at par or higher ended the month at 71%, up from 64% at the end of September.

- There was a strong bid for lower rated credits in October. CCC-rated names returned 1.72%, outpacing the single-B return of 0.60% and the BB return of 0.55%.

- The default rate remained subdued at the end of the third quarter at 1.41%, unchanged from September.

Emerging Markets

- Emerging Market (EM) sovereign and corporate external bonds posted positive performance in the month of October with low developed market yields continuing to drive structural demand for higher yielding EM debt.

- The JPM Emerging Market Bond Index (EMBI) Global Diversified’s return during the month was driv-

Commodities

- In October 2017, the broad commodity market rallied by 3.72% and 2.05%, as measured by the S&P Goldman Sachs Commodity Index (GSCI) and Bloomberg Commodity Index (BCOM), respectively.

- The Energy sector rallied 4.77% as Brent crude and WTI crude both rallied, with returns of 7.75% and 4.56%, respectively.

- Precious Metals declined 0.98% as Gold fell 1.11% while Silver increased 0.10%.

- The Industrial Metals sector rallied 4.27% as the best performer, Nickel, rallied 17.10% while the bellwether Copper also rallied 5.42%.

- The Agriculture sector declined by 1.81% in October as Corn, Kansas Wheat and Wheat declined by 2.67%, 5.93% and 6.64%, respectively.

- The best performing sector in October was Livestock, with a return of 9.94%, as lean hogs, live cattle and feeder cattle all rallied, with returns of 13.43%, 9.00% and 4.87%, respectively.

1. LIBOR = London Interbank- Offered Rate
en primarily by accrued interest. Credit spreads tightened a modest 2 bps to 284 bps, partially offsetting slightly higher 10-year UST yields, which rose 5 bps over the month to 2.38%.

- EM issuers continued to take advantage of the relatively benign global backdrop and tight spreads, with total gross sovereign and corporate external issuance of over $60 billion during the month. Gross external EM bond issuance YTD is at a record high.

- Factors that may affect risk appetite for the remainder of the year include rising developed market yields, a slowdown in global growth, early Italian elections and Brexit negotiations, as well as policy risk stemming from the U.S., Europe and China.

### International Sovereign

- Global government bonds posted negative returns in the month of October, driven primarily by foreign currency losses against the U.S. Dollar (USD).
- The USD, as measured by the DXY, rose against all its G-10 peers with relatively strong U.S. economic data, including the advance estimate of third quarter Gross Domestic Product (GDP), increased optimism about the passage of the U.S. Administration’s long-awaited tax reform plans, and concerns about a possibly hawkish change of leadership at the Fed.

- The Euro fell over the month with market participants viewing the outcome of the highly anticipated October meeting of the European Central Bank (ECB) as dovish. As expected, the ECB reduced the monthly pace of its asset purchase program to €30 billion from €60 billion and extended the program for another 9 months. However, it also left the door open to extending the program or increasing purchases if needed.
- The Japanese Yen fell against the USD this month. Prime Minister Abe’s coalition retained its super majority in parliament after a strong showing in the snap elections. Abe’s new government is expected to increase government spending, and have already proposed an additional supplemental budget. Also, the Bank of Japan (BoJ) kept their accommodative monetary policy unchanged while lowering core inflation projections for 2017 and 2018.
- The New Zealand Dollar was the worst performing G-10 currency during the month with market participants concerned about the new Labour government changing the mandate of the central bank and possible tightening of immigration policies.

### Infrastructure

- Investor demand for infrastructure-related assets remained strong in October as yields and spreads compressed further MoM.
- Utilities recovered nicely during October, indicating that the pricing
pressures of an abnormally strong hurricane season combined with mild third quarter temperatures were transitory. Within Infrastructure-related ABS, two new issues backed by solar receivables came to market at oversubscribed levels.

- Internationally, new issue deal volume was slow during the month, however Infrastructure-related assets remained well bid on the secondary market.

- In Washington tax reform has taken center stage, likely delaying details regarding the Trump Administration’s proposed $1 trillion in infrastructure spending until 2018.

U.S. Equities

- Repeating the theme of the year, in October the S&P 500 Index ended the month close to an all-time high. For the month, the Index gained 2.3%, bringing its YTD total return to 16.9%, and for 2017 has delivered a positive total return every month.

- Returns were skewed to the large cap growth segment of the market, with the Russell 1000 Growth Index return of 3.9% significantly outperforming the Russell 1000 Value return of 0.7%. The Russell Small Cap Value Index was barely positive, gaining 0.1% in the month. The Russell Small Cap Growth Index posted a larger gain (up 1.6%) but still lagged its large cap peers. Similarly, the equal-weight S&P 500 Index returned less than half as much (1.1%) as the familiar capitalization-weighted S&P.

- The Technology sector was the leadership group in October, as it has been for much of 2017. The S&P Technology Select Sector Index rose 6.5% in September. A number of well-known large capitalization Technology stocks delivered returns near or in excess of 10%, including Intel, Adobe, Microsoft and Apple, up 19.5%, 17.4%, 11.27% and 9.7%, respectively.

- October saw the beginning of the third quarter earnings season. By the end of the month and with over half the S&P 500 companies having reported, earnings for the third quarter were estimated by FactSet to have gained 4.7% on revenue growth of 5.7%. Owing in part to losses from Hurricanes Harvey, Irma and Maria, the Insurance sector depressed S&P 500 earnings. Excluding the Insurance sector, FactSet estimates third quarter earnings for the S&P 500 would have risen 7.4%.

Global Equities

- Global equities continued to rally in October with the Morgan Stanley Capital International All-Country World Index (MSCI ACWI) up 2.10% during the month. U.S. equities outperformed the broader market with the S&P 500 and Dow Jones up 2.33% and 4.44%, respectively. The Russell 2000 and Nasdaq Composite were both positive with returns of 0.85% and 3.62%, respectively.

- In Europe, equities performed in line with global equities with the Eurostoxx 50 up 1.95% during the month. Core European equities rallied with the DAX returning 3.12% and CAC returning 3.13%. In the periphery, the FTSEMIB was 0.25% and IBEX 0.92%. UK equities, as measured by the FTSE 100, returned 1.74%.

- Asian equities edged higher in October. Japanese equities posted strong returns, as measured by the Nikkei, up 8.13%. Chinese equities, as measured by the Shanghai Composite, performed well returning 1.24%. Korean equities, as measured by the KOSPI, returned 4.49%.

- EM equities outperformed developed markets with the MSCI EM Index returning 3.17%. Brazil’s Ibovespa gained 0.68%. Russian equities, as measured by the MSCI Russia Index, declined 1.13%. Indian equities, as measured by the MSCI India, returned 6.53%.
**Definitions**

**Basis Point** - A basis point (bps) equals to 0.01%.

**Bloomberg Barclays U.S. ABS Index** - The ABS component of the Bloomberg Barclays U.S. Aggregate Index. It includes securities whose value and income payments are derived from and collateralized ("or backed") by a specified pool of underlying assets including credit cards, auto loans, etc.

**Bloomberg Barclays U.S. Credit Index** - The US Credit component of the U.S. Government/Credit Index. This index consists of publically-issued U.S. corporate and specified foreign debentures and secured notes that meet the specified maturity, liquidity, and quality requirements. To qualify, bonds must be SEC-registered. The US Credit Index is the same as the former US Corporate Investment Grade Index.

**Bloomberg Barclays U.S. MBS Index** - An index that measures the performance of investment grade fixed-rate mortgage-backed pass-through securities of the Government-Sponsored Enterprises (GSEs): Ginnie Mae (GNMA), Fannie Mae (FNMA), and Freddie Mac (FHLMC).

**Bloomberg Barclays U.S. Treasury Index** - The Barclays Capital U.S. Treasury Index is the U.S. Treasury component of the U.S. Government Index. Public obligations of the U.S. Treasury with a remaining maturity of one year or more.

**Bloomberg Commodity Index (BCOM)** - An index calculated on an excess return basis that reflects commodity futures price movements. The index rebalances annually weighted 2/3 by trading volume and 1/3 by world production and weight-caps are applied at the commodity, sector, and group level for diversification. Roll period typically occurs from 6th-10th business day based on the roll schedule.

**Bloomberg World Interest Rate Probability (WIRP)** - A Bloomberg function based on futures trading data that gives probabilities of rate increases by central bank meeting date.

**Citi High-Yield Cash-Pay Capped Index** - This index represents the cash-pay securities of the Citigroup High-Yield Market Capped Index, which represents a modified version of the High Yield Market Index by delaying the entry of fallen angel issues and capping the par value of individual issuers at $5 billion par amount outstanding.

**Cotation Assistée en Continu 40 (CAC)** - The CAC 40 Index which is a French stock market index. It tracks 40 of the largest French stocks on the Paris Bourse, or stock exchange.

**Deutsche Borse AG German Stock Index (DAX)** - The German stock index, which represents 30 of the largest and most liquid German companies that trade on the Frankfurt Exchange.

**Dow Jones Industrial Average (DJIA)** - A price-weighted average of 30 significant stocks traded on the New York Stock Exchange and the Nasdaq.

**Earnings Before Interest, Taxation, Depreciation and Amortization (EBITDA)** - Net income with interest, taxes, depreciation, and amortization added back to it. This measure can be used to analyze and compare profitability between companies and industries because it eliminates the effects of financing and accounting decisions.

**Eurostoxx 50 Index** - A stock index of Eurozone stocks designed by STOXX, an index provider owned by Deutsche Borse Group and SIX group, with the goal of providing a blue-chip representation of Supersector leaders in the Eurozone.

**Financial Times Stock Exchange 100 (FTSE 100)** - A capitalization-weighted index of the 100 most highly capitalized companies traded on the London Stock Exchange.

**Financial Times Stock Exchange Milano Italia Borsa (FTSE MIB)** - The benchmark stock market index for the Borsa Italiana, the Italian national stock exchange, which superseded the MIB-30 in September 2004. The index consists of the 40 most-traded stock classes on the exchange.

**G-10** - A grouping of 10 countries identified by the World Trade Organization which are "vulnerable" to imports due to ongoing reform in the agricultural sector. This grouping includes Switzerland, Japan, South Korea, Taiwan, Liechtenstein, Israel, Norway, Iceland, Bulgaria and Mauritius.

**Hang Seng Index** - A free-float capitalization-weighted index of a selection of companies from the Stock Exchange of Hong Kong. The components of the index are divided into four subindices: Commerce and Industry, Finance, Utilities, and Properties.

**Ibovespa** - This accumulation index represents the present value of a portfolio begun on 2 January 1968, with a starting value of 100 and taking into account share price increases plus the reinvestment of all dividends, subscription rights and bonus stocks received.

**Indice Bursatil Espanol (IBEX)** - The official index of the Spanish Continuous Market. The index is comprised of the 35 most liquid stocks traded on the Continuous market. It is calculated, supervised and published by the Sociedad de Bolsas.

**Institute for Supply Management Manufacturing Purchasing Managers Index (ISM PMI)** - An index made up of data from 300 manufacturing firms collected by the Institute of Supply Management (ISM). It indicates the economic health of the manufacturing sector.

**Institute for Supply Management Non-Manufacturing Purchasing Managers Index (ISM PMI)** - An index made up of data from 400 non-manufacturing firms collected by the Institute of Supply Management (ISM).

**JP Morgan Corporate Emerging Markets Bond Broad Diversified Index (CEMBI)** - This index is a market capitalization weighted index consisting of US-denominated Emerging Market corporate bonds. It is a liquid global corporate benchmark representing Asia, Latin America, Europe and the Middle East/Africa.

**JP Morgan Government Bond Emerging Markets Bond Diversified Index (GBI EM)** - This index is the first comprehensive, global local Emerging Markets index, and consists of regularly traded, liquid fixed-rate, domestic currency government bonds to which international investors can gain exposure.

**JP Morgan Emerging Markets Bond Global Diversified Index (EMBI)** - This index is uniquely-weighted version of the EMBI Global. It limits the weights of those index countries with larger debt stocks by only including specified portions of these countries' eligible current face amounts of debt outstanding. The countries covered in the EMBI Global Diversified are identical to those covered by EMBI Global.

An investment cannot be made in an index.
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Japanese yen, Pound sterling, Canadian dollar, Swedish krona and Swiss franc.

U.S. Dollar Spot Index (DXY) - A weighted geometric mean of the United States dollar’s value relative to a basket of 6 major foreign currencies, including the Euro, Japanese yen, Pound sterling, Canadian dollar, Swedish krona and Swiss franc.

An investment cannot be made in an index.
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