Let’s Talk Total Return Strategy

Jeffrey Gundlach | April 2021

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Mr. Gundlach is CEO of DoubleLine. In 2011, he appeared on the cover of Barron's as "The New Bond King." In 2013, Institutional Investor named him "Money Manager of the Year." In 2012, 2015 and 2016, he was named one of "The Fifty Most Influential" in Bloomberg Markets. In 2017, he was inducted into the FIASI Fixed Income Hall of Fame. Mr. Gundlach is a summa cum laude graduate of Dartmouth College, with degrees in Mathematics and Philosophy.

How is the DoubleLine Total Return Strategy similar to the Benchmark? Why does the team prefer structured products?

The Total Return Strategy concept, which I started nearly 30 years ago, began as a result of observing that it was possible to have the same or higher income with the same or lower risk than that of the Bloomberg Barclays US Aggregate Bond Index (the “Agg”), which is the most commonly used index in the intermediate-term fixed income category. We looked at the historical performance and yields of the various major fixed income sectors, **and the data was powerfully convincing that the Agency mortgage-backed securities (MBS) market had lower volatility than the Agg and the market it covers and roughly the same return.**

Therefore, it was possible to have higher risk-adjusted returns just by indexing in Agency MBS rather than indexing with the Agg. The Agg generally comprises three sectors: roughly one-third government bonds, one-third corporate bonds and one-third Agency MBS. *(Figure 1)*

Bloomberg Barclays US Aggregate Bond Index
March 31, 2021

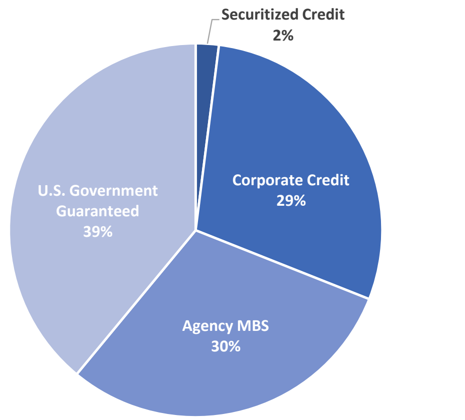

Figure 1
Source: Bloomberg

In the DoubleLine Total Return Strategy (the “Strategy”), we consider this same mix of government securities and credit. In the index, the credit risk is in corporate bonds, while the Strategy has largely avoided owning corporate bonds. **This happens to be one of the distinguishing characteristics: no corporate bond exposure.** Instead, the Strategy utilizes securitized credit: non-Agency residential MBS (RMBS), commercial MBS (CMBS), asset-backed securities (ABS) and collateralized loan obligations (CLOs). *(Figure 2)*

Total Return Strategy Credit Allocation
March 31, 2021

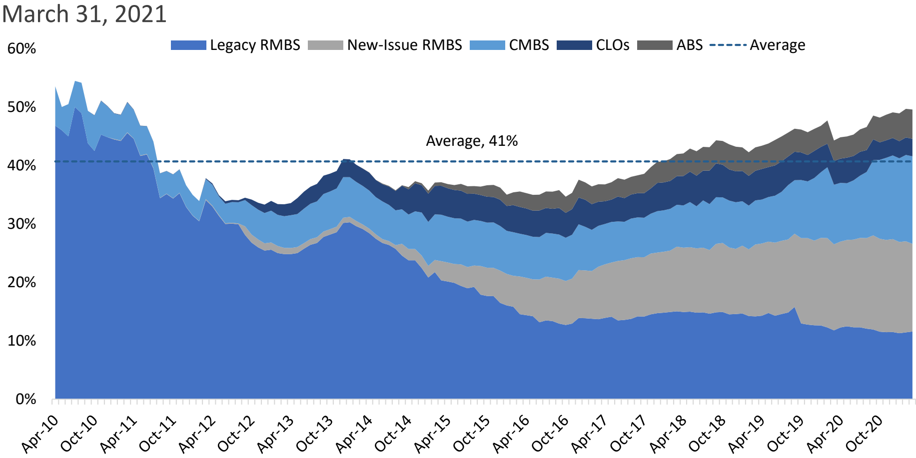

Figure 2
Source: DoubleLine

Allocations are as of March 31, 2021, are subject to change without notice and should not be considered a recommendation to buy or sell any security.

Views and opinions expressed herein are those of the individual portfolio manager and do not necessarily reflect the views of DoubleLine Capital LP, its affiliates or employees.

Using this barbell approach of Agency MBS and securitized credit, we're able to put together a portfolio that has the potential to have a lower interest rate risk with a higher yield than the Agg. *(Figure 3)* The goal of the Strategy is to have a higher income stream with lower observable risk and volatility with the potential for attractive risk-adjusted returns.

Yield per Unit of Duration: Fixed Income Asset Classes
April 30, 2021

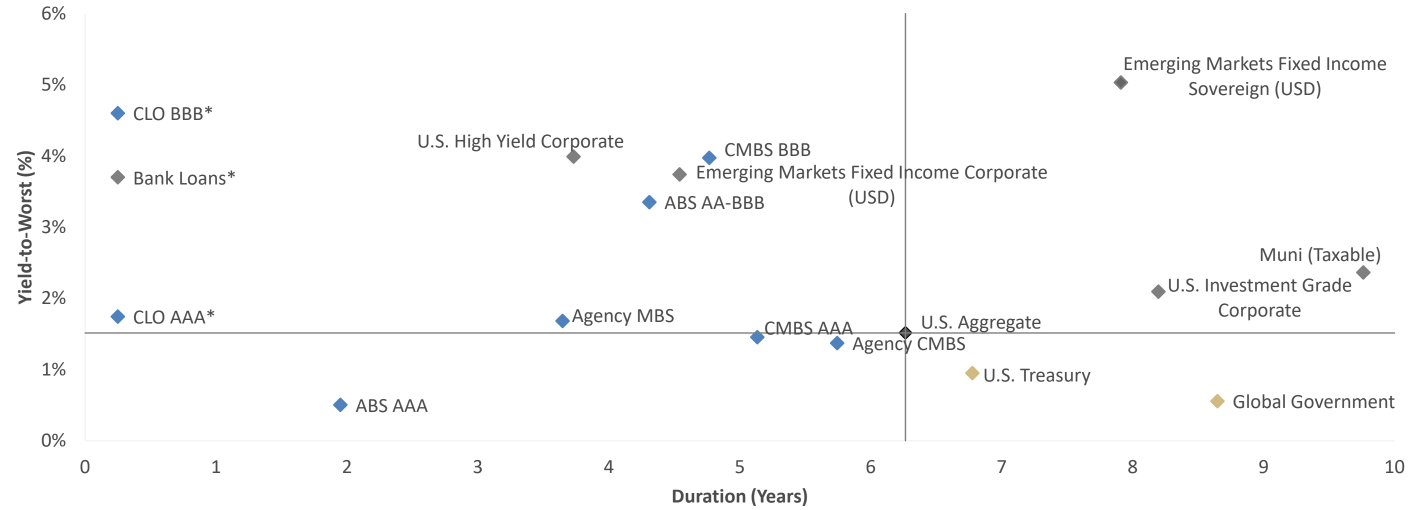

Figure 3
Source: Bloomberg, DoubleLine

*CLO and Bank Loans are typically floating rate assets, meaning quarterly coupon payments pay a variable rate of interest depending on a widely accepted interest rate. Duration is calculated as 0.25 years using an underlying base rate of 3-month LIBOR.

How do you risk mitigate in the portfolio?

When I started almost 30 years ago, thinking about the relative risks and rewards of fixed income sectors, it was clear that Agency mortgages had much better characteristics than either U.S. Treasury bonds or corporate securities. Thirty years later, we have observed that the relationship has held the entire time.

When we map out the standard deviation of the various sectors of the intermediate-duration fixed income market, represented by the Agg on a rolling basis, **the standard deviation of the Agency mortgage market has always been lower than both Treasuries and corporate bonds**, as well as municipal bonds, which are not part of the Agg. *(Figure 4)* Interestingly, the volatility of Agency MBS is also more stable.

Standard Deviation
March 31, 2021

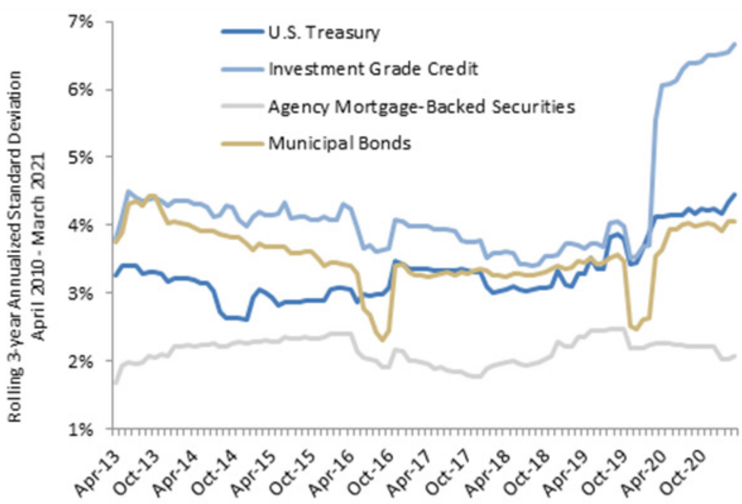

Figure 4
Source: Bloomberg

Similar to the Strategy’s dynamic allocations to both structured credit and Agency MBS, so too does the overall portfolio duration change over time. **One way in which risk is mitigated in the Strategy is by maintaining a lower duration than the Agg.** For much of the last few years, the Strategy’s duration has been approximately two to three years shorter than the Agg’s. *(Figure 5)* Our risk management process allows us to respond to changing market environments while the Strategy’s philosophy and process remains consistent.

Duration Versus U.S. Treasury Yield
March 31, 2021

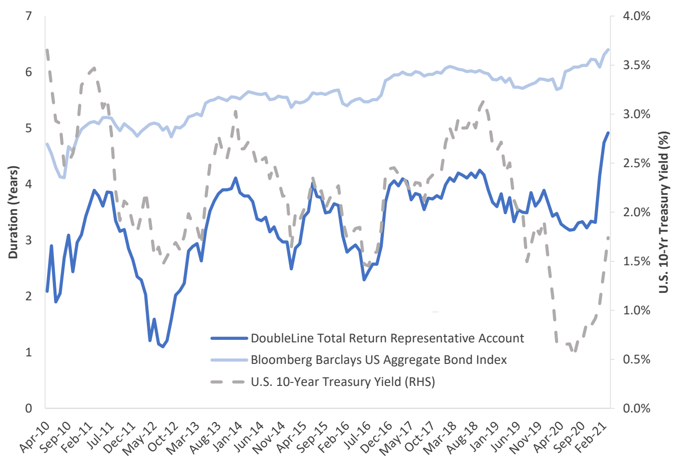

Figure 5
Source: Bloomberg, DoubleLine

Why do you favor structured credit over corporate credit?

In recent years, corporate bond issuance has more than doubled from the 2007 levels, with corporate CFOs taking advantage of lower interest rates and leveraging their balance sheets to very high levels. Corporate credit as a percentage of GDP in the United States is now at the highest level in history. *(Figure 6)* Buyers of corporate bond issuance may not know that they **will find themselves with unintended interest rate risk at a time when corporate bond spreads are very tight relative to history**.

This dynamic of increased corporate issuance, long duration and tight spreads is one of the reasons we prefer not to use corporate credit in the Strategy, as we believe that the yield-to-risk ratio of corporate securities is unfavorable relative to securitized credit. As of March 31, the duration of the Bloomberg Barclays US Corporate Bond Index was 8.5 years while the yield-to-worst ratio was 2.1%.

Corporate Debt to Gross Domestic Product (GDP)
March 31, 2021

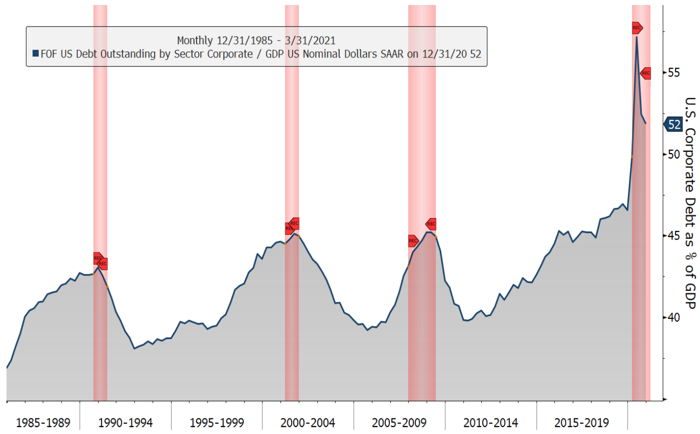

Figure 6
Source: Bloomberg. Red shaded areas indicate recessionary periods.

Investing in structured products and adding them to traditional fixed income portfolios can potentially enhance returns while minimizing volatility over a full market cycle.

Securitized credit often delivers a yield advantage with lower effective duration compared to investment grade (IG) corporate bonds and often displays:

- lower interest rate risk,
- lower credit spread risk
- and lower correlation to the S&P 500 relative to corporate credit alternatives.

Additionally, the structured product landscape has significantly evolved since the Global Financial Crisis, with stricter underwriting standards in parts of the market and conservative changes to rating agency criteria, which resulted in a material increase of required subordination for IG ratings. The implementation of the risk retention requirements of the Dodd-Frank Act of 2010 also increased “skin in the game.”

Why don’t all bond fund managers use a similar approach?

We often get asked why all bond fund managers don’t learn from the DoubleLine Total Return Strategy and adopt a similar approach. The answer is quite simple: We don’t think they know how. DoubleLine’s seasoned investment professionals have decades of experience investing in structured products through many market cycles and various interest rate environments.

Having been recognized as a leader in the space, DoubleLine's time-tested investment philosophy and process have established track records of attractive absolute and risk-adjusted returns. Many firms have traders focus on only one subsector, or the entire firm focuses on a single subset of the opportunity set available in structured products. Being able to trade all the subsectors successfully is only one part of DoubleLine's strategy equation.

The second part of the firm's approach relies on leveraging our experience to assess risks appropriately, which not only involves a deep understanding of the underlying collateral, sectors, and asset types, but it also requires knowing when to shift sector allocations in the face of changing market and credit conditions. We believe this second part of the puzzle gives DoubleLine its competitive advantage.

What opportunities do you see going forward and how will rising rates effect the strategy?

It's constructive to look at the performance of the Strategy over prior periods of rising rates versus the Agg and its components. When interest rates rise, generally, mortgages get longer in duration. However, Agency MBS still have a lower duration than Treasuries and IG corporate bonds. Typically, for that reason, **you see a lower standard deviation, lower drawdown, and higher return from Agency MBS relative to the Agg and its components**. *(Figure 7)*

Do you think you will close your Total Return Strategy at some point?

We strive to ensure our clients have the best experience possible, and if that means closing strategies to maintain performance, that's what we do. DoubleLine believes in offering high-quality products that will not compromise the return for clients. Fortunately, the structured product market is quite large, and we don't believe there are any capacity constraints for the DoubleLine Total Return Strategy currently. ■

Total Return Over Rate Regime Periods
March 31, 2021

10-Year U.S. Treasury Yield			Rising-Rate Periods		Domestic Fixed Income Sectors, Cumulative Total Return			
Trough (Percent)	Peak (Percent)	Δ in Basis Pts	Trough	Peak	Bloomberg Barclays US MBS Index	Bloomberg Barclays US Treasury Total Return Index	Bloomberg Barclays Aggregate US Bond Index	Bloomberg Barclays US Corporate Bond Index
7.34*	8.05*	71	3/31/1986	5/30/1986	-0.79%	-2.10%	-1.39%	-0.56%
6.92	9.59*	267	8/29/1986	9/30/1987	2.51%	-2.55%	-0.72%	0.01%
8.15*	9.28*	113	2/29/1988	3/31/1989	4.77%	3.56%	4.17%	4.93%
7.80*	9.02*	122	7/31/1989	4/30/1990	2.59%	0.11%	0.95%	0.52%
5.47*	8.03	256	10/29/1993	11/7/1994	-2.51%	-5.33%	-4.59%	-6.22%
5.53	7.06	154	1/18/1996	6/12/1996	-1.91%	-4.09%	-3.54%	-4.83%
4.16	6.79	263	10/5/1998	1/20/2000	1.37%	-4.57%	-2.35%	-3.86%
4.18	5.43	125	11/7/2001	4/1/2002	-0.53%	-4.85%	-2.44%	-2.78%
3.11	5.30	218	6/13/2003	6/12/2007	14.56%	5.51%	10.06%	9.20%
2.06	3.99	193	12/30/2008	4/5/2010	6.87%	-3.95%	6.79%	19.97%
2.39	3.74	135	10/7/2010	2/8/2011	-1.56%	-4.64%	-3.02%	-3.37%
1.39	3.03	164	7/24/2012	12/31/2013	-1.27%	-3.62%	-1.71%	0.53%
1.36	2.63	127	7/8/2016	3/13/2017	-2.35%	-5.44%	-3.78%	-3.18%
2.04	3.24	120	9/7/2017	11/8/2018	-2.31%	-3.58%	-2.96%	-3.01%
0.51	1.74	123	8/4/2020	3/31/2021	-0.99%	-6.06%	-3.70%	-3.62%

Figure 7
Source: Bloomberg, Barclays, DoubleLine
* Using month end data due to Bloomberg data set pre-1994. Peak to Trough using daily closes all time periods had 100bps+ increase.

Definitions and Terms

Agency and Non-Agency Residential Mortgage-Backed Securities (RMBS) – Debt-based security (similar to a bond), backed by the interest paid on loans for residences. The interest on loans such as mortgages, home-equity loans and subprime mortgages is considered to be something with a comparatively low rate of default and a comparatively high rate of interest, since there is a high demand for the ownership of a personal or family residence. "Non-Agency" refers to RMBS not issued by the government-sponsored entities. "Agency" refers to RMBS issued by one of three quasi-governmental agencies: The Government National Mortgage Association (GNMA or Ginnie Mae), the Federal National Mortgage Association (FNMA or Fannie Mae), and the Federal Home Loan Mortgage Corporation (Freddie Mac).

Asset-Backed Security (ABS) – Investment security, such as a bond or note, that is collateralized by a pool of assets, such as loans, leases, credit card debt, royalties or receivables.

Bloomberg Barclays US Aggregate Bond Index – This index represents securities that are SEC registered, taxable and dollar denominated. It covers the U.S. investment grade, fixed-rate bond market, with components for government and corporate securities, mortgage pass-through securities and asset-backed securities. These major sectors are subdivided into more specific indexes that are calculated and reported on a regular basis.

Bloomberg Barclays US Corporate Bond Index – This index measures the investment grade, fixed-rate taxable corporate bond market. It includes U.S. dollar-denominated securities publicly issued by U.S. and non-U.S. industrial, utility and financial issuers.

Bloomberg Barclays US Mortgage-Backed Securities (MBS) Index – This index measures the performance of investment grade, fixed-rate, mortgage-backed, pass-through securities of the government-sponsored enterprises (GSEs): Federal Home Loan Mortgage Corp. (Freddie Mac), Federal National Mortgage Association (Fannie Mae) and Government National Mortgage Association (Ginnie Mae).

Bloomberg Barclays US Treasury Total Return Index – This index measures U.S. dollar-denominated fixed-rate nominal debt issued by the U.S. Treasury with a remaining maturity of one year or more. Treasury bills are excluded by the maturity constraint but are part of a separate Short Treasury Index.

Collateralized Loan Obligation (CLO) – Single security backed by a pool of debt.

Commercial Mortgage-Backed Securities (CMBS) – Securitized loans made on commercial rather than residential properties.

Fannie Mae (FNMA) – The Federal National Mortgage Association is a government-sponsored enterprise that buys loans from mortgage lenders, packages them together, and sells them as a mortgage-backed security to investors on the open market.

Freddie Mac (FHLMC) – The Federal Home Loan Mortgage Corporation is a stockholder-owned, government-sponsored enterprise (GSE) chartered by Congress in 1970 to keep money flowing to mortgage lenders in support of homeownership and rental housing for middle income Americans.

Ginnie Mae (GNMA) – The Government National Mortgage Association (Ginnie Mae) is a federal government corporation that guarantees the timely payment of principal and interest on mortgage-backed securities (MBS) issued by approved lenders. Ginnie Mae's guarantee allows mortgage lenders to obtain a better price for MBS in the capital markets.

Legacy Residential Mortgage-Backed Securities (RMBS) – Securities issued pre-2008 financial crisis.

Non-Agency Mortgage-Backed Securities – Mortgage securities issued by private entities that have no guarantee.

it is not possible to invest directly in an index.