

Specialty Fixed Income: Yield Enhancers for a Rising-Rate Environment

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Introduction

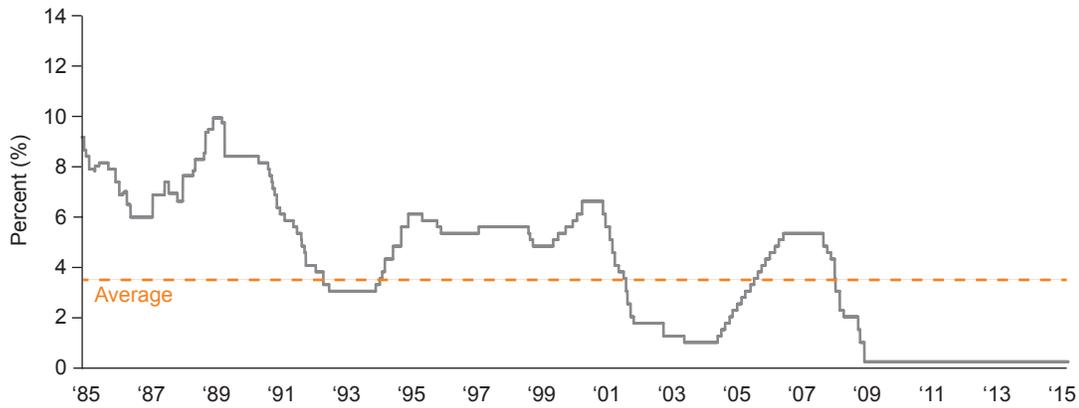
After more than 20 years of persistently declining interest rates (see Figure 1), the fixed income investment environment has grown more challenging of late — perhaps as challenging as it has ever been — as the low yields that have dominated the marketplace in recent memory are being supplanted by fears that rates are beginning to move higher. There are, however, a number of reasons to believe that interest rates, though likely to rise, will remain below their long-term historical average for some time. Moreover, a number of “specialty” income-oriented strategies not only deliver attractive yields in low-rate conditions but can also perform well in a rising-rate environment.

After a brief assessment of the fixed income investment landscape, in this paper we describe five such strategies:

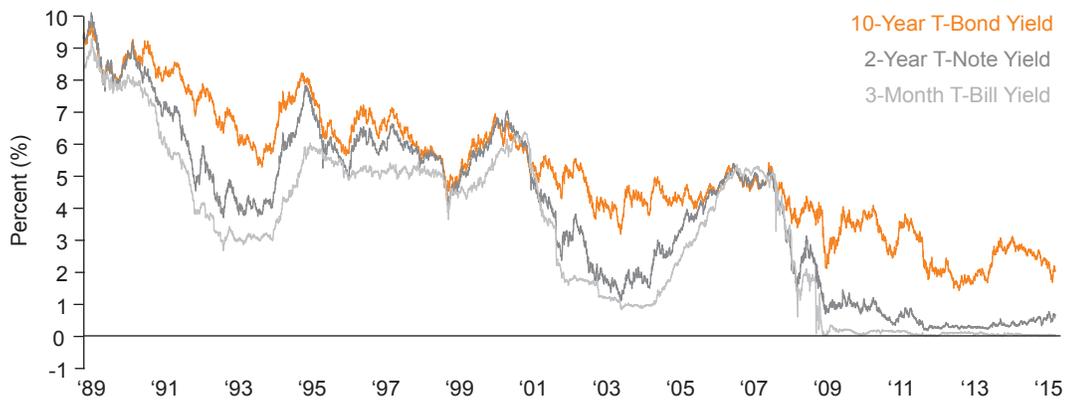
1. Senior Loans
2. High Yield Bonds
3. Private Credit
4. Commercial Mortgage Loans
5. Agency Mortgage Derivatives

Figure 1. Both the Fed Fund Rate and U.S. Treasury Yields Are Near Historical Lows

Federal Funds Target Rate



U.S. Treasury Yields



Source: Reuters, Bloomberg, FactSet, Voya Investment Management

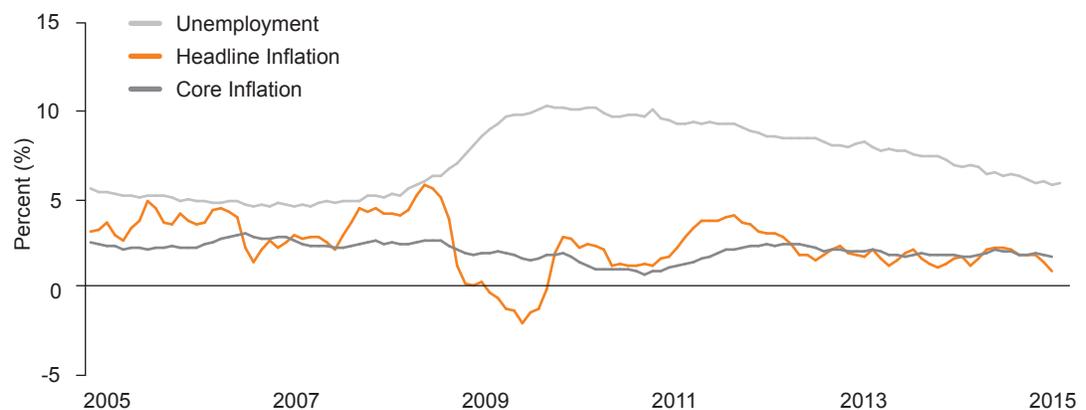
Note: 3-Month T-Bill Yield is annualized based on purchase at a discount and holding to maturity. The 2-Year and 10-Year Treasury Rates are annualized.

Tepid Economies, Structural Changes Suggest a Measured Normalization

The conventional wisdom states that interest rates have nowhere to go but up. This is probably true — to an extent. While we have already seen longer-term U.S. interest rates make tentative upward moves from their historical lows, the Fed's quantitative easing is behind us, and rate policy normalization is likely to proceed at a measured pace. In fact, markets are currently predicting the first federal funds rate hike to occur no sooner than mid-2015, as moderate but steady growth, measured improvements in unemployment and the absence of inflation pressures (as shown in Figure 2) should allow the Fed to take its time.

The Fed has also made it clear that there is no preset course for the long-awaited rate normalization; rather, the pace and duration of rate increases will be predicated on the Fed's perceived sustainability of the economic recovery. Economic growth outside the U.S. also suggests that central bank policy is likely to remain extremely accommodative worldwide. Europe has only recently begun their version of quantitative easing. Japan is in the midst of significant structural reform, and China is adjusting to a more moderate growth trend.

Figure 2. With Inflation Under Control and Unemployment Stubbornly High, Policy Normalization is Likely to Proceed at a Measured Pace



Source: FactSet

Note: Core CPI reflects consumer price inflation excluding food and energy.

The strength of the U.S. economy, however, is only one determinant of the path of interest rates. A number of structural shifts currently underway lead us to expect increased demand for fixed income assets that may help suppress rates. One such shift is aging global demographics and the increasing likelihood that workers will live longer into retirement. While the impact of an aging populace has already been witnessed in Japan, it is growing more evident in retiree pools across Europe and the U.S. This aged cohort should translate into increased demand for fixed income assets as it seeks reliable, low-risk sources of retirement income. Moreover, declining eligibility for and access to defined benefit pension plans likely will intensify individual demand for fixed income assets.

At the same time, increasing use of liability-driven investing by the remaining defined benefit plan sponsors is a significant structural shift in the pension arena. Low interest rates in recent years have presented major challenges to pensions, driving the value of future obligations higher and forcing sponsors to commit more assets to those liabilities. Meanwhile, recent improvements in funded status — due primarily to robust equity returns and higher liability discount rates — have sponsors looking to increase allocations to long-duration corporate bonds in line with their glide path targets, particularly as funded ratios have substantially increased.

A study by Hewitt EnnisKnupp¹ predicted that defined benefit plans will increase their demand for long corporate bonds by \$700 billion to \$1.25 trillion over the next seven years — four to seven times the average annual corporate issuance from 2010–12. This surge in demand could result in a significant supply/demand imbalance in the long end of the corporate credit market, resulting in even tighter spreads and further suppressed yields.

Beyond the supply and demand dynamics of the debt market, there are also some important fundamental shifts taking place within the fixed income asset class. Given the enormous debt accumulated in the years leading up to the 2008 financial crisis, the risk/return profile of sovereign bonds has changed dramatically — as was seen in the performance of European sovereign debt in 2011–12. This has inspired investors to look for other safe havens. Not only do the sovereign bonds of many countries offer negative or extremely low real returns, they are also highly exposed to the risks of higher public debt burdens. Higher allocations to non-sovereign fixed income sectors would help ameliorate these risks and provide a broad portfolio with a better risk/return profile as well as an improvement in underlying debt instrument fundamentals.

Liability-driven demand could result in a significant supply/demand imbalance in the long end of the corporate credit market.

¹ *Long Credit in Liability Driven Investments: A Tragedy of the Commons?*, Hewitt EnnisKnupp, May 2013.

We believe fixed income investors will need to focus on new sources of incremental yield.

As an example, more than 70% of the Barclays U.S. Aggregate Bond Index is comprised of Treasuries, agencies and mortgages, sectors that not only carry higher debt loads but are also the most sensitive to changes in U.S. interest rates. Given a medium-term outlook for rising rates and an improving U.S. economy, these sectors are poised to underperform spread sectors such as high yield corporates, as continued economic progress is likely to further strengthen already-strong corporate balance sheets. Meanwhile, sectors positioned to benefit from the rebounding housing market — including direct real estate lending and mortgage-backed bonds (residential and commercial mortgage-backed securities) — could be poised to outperform as economic expansion accelerates. Several other “specialty” fixed income strategies may also be well positioned for the new setting, as we discuss below.

Specialty Products Offer Unique Opportunities

As the term structure of interest rates gradually assumes a more nearly normal configuration in coming years, we believe fixed income investors will need to focus on new sources of incremental yield and return while reducing their expectations for investments that are more sensitive to duration risks. Given the structural impediments (discussed above) that may forestall or cap a rise in rates, allocations to specialty fixed income strategies may produce portfolios with higher yield potential, increased diversification and greater upside participation in the economic recovery. While some of the markets and strategies discussed below are non-traditional in the sense that they are not represented in the Barclays U.S. Aggregate Bond Index, they offer investors an opportunity to benefit from untapped and potentially inefficient markets, even in range-bound or rising-interest-rate regimes.

Senior Loans

Senior loans — also known as “leveraged loans” or “floating-rate loans” — are extensions of credit made to non-investment grade companies to finance acquisitions, refinance existing debt, support business expansion and for other general business purposes. They are called “senior” loans because they are generally secured by a borrower’s assets pursuant to a first priority or senior lien, and they are first in priority in receiving payments when a borrower services its debts. Because of this collateral security and seniority in a borrower’s capital structure, senior loans enjoy lower defaults and much higher recovery rates when defaults do occur.

Because of their ultra-short duration profile, senior loans have the potential to provide a natural hedge against rising short-term interest rates. Since senior loans typically pay interest at a variable or floating rate, as interest rates increase, so too does the interest received on senior loan investments. And unlike bonds, the prices of which typically decline as interest rates rise, the price of a senior loan is generally unaffected by changes in market interest rates.

Average yield spreads on senior loans (at 440 basis points as of February 28, 2015) remain well above long-term averages and are currently attractive relative to other debt sectors, providing a yield advantage over investment grade bond investments. Market technicals are also very supportive, with robust new-issue activity and healthy demand as investors look to floating rate loans for protection in a rising-rate environment. Finally, senior loans' low correlation with other asset classes make them the ideal diversifying complement to fixed interest investments (see Figure 3).

Figure 3. Senior Loans Have Delivered Significant Diversification Benefits Through Their Low Correlation With Other Asset Classes

Asset Class	Correlation
S&P 500	0.53
U.S. Small-Cap Equities	0.52
EAFE International Equities	0.55
U.S. Corporate Bonds	0.35
U.S. Treasuries > 20 Years	-0.42
Global Aggregate Bonds	0.04
High Yield Bonds	0.81

Source: FactSet, Voya Investment Management

Note: Correlation coefficients are calculated based on monthly total return data since 1995.

High Yield Bonds

High yield bonds are debt securities issued by companies rated below investment grade based on an assessment of their ability to pay interest and principal as scheduled. High yield bonds are often considered hybrid instruments, bearing the characteristics of both debt and equity securities and offering investors a way to participate in more growth-oriented opportunities within a broader fixed income allocation without the higher volatility that comes with pure equity investments. With correlations of 0.16 to the Barclays U.S. Aggregate Index and 0.62 versus the S&P 500 (both measurements from 1998 through February 28, 2015), high yield bonds are often used as a strategic diversifier within a fixed income portfolio.

Like traditional corporate bonds, high yield bonds pay a defined coupon until a stated maturity date; however, given that high yield bonds carry a higher risk of default than investment grade bonds, they must offer a higher rate of interest to attract investors. Like equities, the performance of high yield bonds is closely tied to issuer fundamentals like balance-sheet strength, earnings growth and company management. For example, corporate revenues and cash flows typically increase in line with improving macroeconomic conditions; companies may use this cash to reduce debt levels, which can result in higher credit protection and thus support a company's high yield bonds.

High yield bond total returns tend to be less volatile than those of equities.

High yield bond total returns tend to be less volatile than those of equities, given the coupon payments and the expectation that principal will be repaid at maturity. Furthermore, since the default spread component of high yield bonds is much greater than the interest-rate component, the interest rate sensitivity of high yield bonds is muted relative to both equities and other fixed income investments.

High yield bonds remain attractive relative to investment grade fixed income in the current environment. General macroeconomic trends are favorable, and default rates — a key barometer of high yield market health — remain benign. According to Moody's Investors Service, the 12-month trailing default rate for high yield bonds currently stands at 1.9%, down from 2.2% a year ago, and it is widely expected to remain in the 2–3% range for the next several years. This, combined with other fundamental measures such as interest coverage, is consistent with the continuing economic recovery and lends good fundamental support to the high yield bond market.

Performance in Rising-Rate Environments

Yield spreads in below-investment grade debt markets can serve as a buffer against rising interest rates, as risk premiums tend to decline in line with stronger economic conditions. As can be seen in Figure 4, both senior loans and high yield bonds outperformed investment grade bonds in each of the six periods over the past 20 years during which rates were rising as a result of Fed activity. The floating rates paid on senior loans were particularly meaningful when the Fed increased rates, making them the best performer in those periods. High yield bonds' duration-adjusted spreads of approximately 426 basis points as of February 28, 2015, also offer a potential cushion against rising rates, as shown in their record of excellent performance under those conditions.

Of course, performance in periods of rising rates cannot be the sole criterion for asset allocation decisions. The six periods illustrated below comprised only 25% of the past 20 years. A reasonable approach would be to take prudent positions in both senior loans and high yield bonds.

Figure 4. Below-Investment Grade Debt Has Outperformed When Rates Rise

Periods of Rising Interest Rates			Annualized Returns			
Begins	Period (Months)	Rise in 2-Year U.S. Treasury Yields	U.S. Gov't Bonds	Investment Grade Bonds	High Yield Bonds	Senior Loans
February 1994	11	+312 bps	-5.09	-6.27	-3.41	9.33
March 1996	5	+61 bps	-0.28	-0.51	5.01	8.56
November 1998	19	+227 bps	0.68	0.22	2.11	5.17
July 2003	37	+365 bps	1.66	2.39	8.73	6.35
April 2008	3	+72 bps	-7.44	-2.72	7.23	18.02
November 2010	5	+25 bps	-5.57	-2.09	11.22	11.16
Average	13	+177 bps	-2.67	-1.50	5.15	9.76

Source: Voya Investment Management

Note: January 31, 2000, to July 31, 2013. U.S. Government Bonds, Investment Grade Corporate Bonds, High Yield Bonds and Senior Loans are represented by the Barclays U.S. Government Bond Index, U.S. Corporate Bond Index, U.S. Corporate High Yield Index and Credit Suisse Leveraged Loan Index, respectively.

Past performance is not indicative of future results.

Private Credit

Private credit — also referred to as “private placements” or “direct lending” — are primarily investment grade, fixed-rate corporate debt sold only to institutional investors and are not subject to SEC registration. Functionally, a private placement is a hybrid of a public bond (a fixed interest rate and term length) and a traditional bank loan (greater upfront due diligence, prioritization in the capital structure, protection through financial covenants and a more intensive ongoing relationship with borrowers).

Private credit historically has achieved additional yield and total return compared to corporate public bonds of similar credit quality and duration due to higher upfront yields, prepayment and amendment/waiver fees, and lower loss given defaults. For example, Figure 5 illustrates Voya’s private credit experience from 2001 through the end of 2014. Private credit debt does have some prepayment risk, as it may be callable at any time. However, unlike public bonds, the call is at “make whole,” allowing an investor to maintain the initial yield of the investment over the remaining term regardless of whether interest rates have increased or decreased since inception. A comparison of private credit and public-market bonds can be seen in Figure 6.

Figure 5. Private Credit Offers Attractive Yield Advantage over Public Bonds
Historical Up Front Yield Advantage (December 31, 2014)

	Bond Equivalent Yield (%)	Spread to Treasuries (bps)	Spread to Publics (bps)	Average Life (years)	Weighted Average Rating
2001	7.10	260	78	7.1	BBB+
2002	6.68	242	75	8.2	BBB+
2003	5.46	203	91	8.8	BBB+
2004	4.90	152	66	7.5	BBB+
2005	5.49	136	60	7.8	BBB+
2006	6.44	168	80	6.3	BBB+
2007	6.30	166	58	8.1	BBB+
2008*	7.09	355	141	7.9	A-
2009**	5.82	256	100	10.2	A-
2010	4.84	214	82	8.3	BBB+
2011	5.04	209	74	10.1	BBB+
2012	4.04	252	92	9.0	BBB+
2013	4.30	225	77	10.64	BBB+
2014	4.61	217	74	10.45	BBB+
Average	5.57	212	79	8.48	BBB+

*Production efforts through first eight months of 2008; new production was shutdown after August.

**Production efforts commenced in August 2009.

Source: Voya Investment Management

Note: Reflects experience of Voya Private Credit investments over the period.

Since the onset of the global financial crisis in late 2008, the private credit market has enjoyed increased favor. And the market has continued to see exceptionally heavy deal flow notwithstanding interest rate changes as banks — which can be restrictive in their longer-term lending — and issuers trying to capture historically low yield opportunities jumped into the marketplace. Spreads to public investment grade bonds remain relatively wide, and the market environment indicates good value for new-issue private credit, with significant relative value across all maturities.

In sum, private credit can provide investors a number of attractive features over publicly traded corporate bonds regardless of the interest rate environment — higher income, better diversification by geography and industry (more utilities and fewer financials), and stronger covenant protection and recoveries. Private credit can serve as an excellent complement to investment grade corporate bonds, and also be applied as a diversifier and yield enhancer to liability-driven investment situations.

Figure 6. Private Credit Offers a Variety of Advantages over Public Bonds

	Investment Grade Private Credit	Public Bonds
Income	Fixed	Fixed
Security	Secured/Unsecured	Unsecured
Ranking	Senior and cannot be subordinated	Can be subordinated
Investor	Type Institutional asset managers	Institutional asset managers; banks and hedge funds
Covenants	Maintenance/comprehensive	None
Coupon Spread	20-100+ basis points over public bonds	65-300 basis points over Treasuries
Prepayment	Callable with Treasury +50 basis point “make whole” premium	Varies
Tenor	Flexible up to 30 years	2-100 years
Size	Average \$300 million	Average \$700 million
Liquidity	Actively traded private market	Actively traded public market
Information	Public and private – quarterly/semi-annual	Public – quarterly/semi-annual
Recoveries	70%	40%

Source: Voya Investment Management

Commercial real estate can be an attractive diversifier for long-term investors.

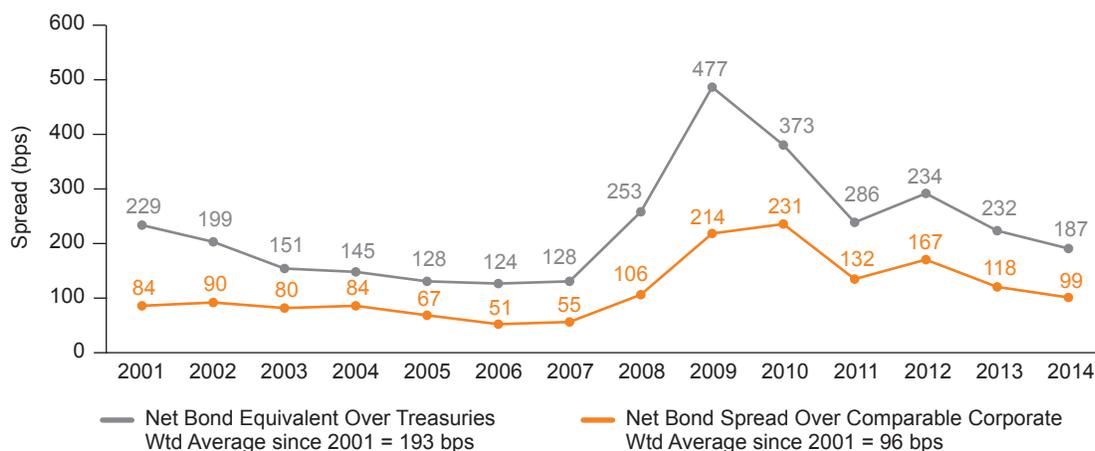
Commercial Mortgage Loans

Commercial mortgage loans, also known as “whole” loans, are another direct lending market. In this case, the debt instruments are secured by a first mortgage on an income-producing property. Revenues are collected as rent paid by the tenant/occupants of the commercial properties, which encompass retail, office, industrial and multifamily buildings.

As rents often increase with inflation, they provide a hedge against rising prices. Interest and principal payments on whole loans are made monthly, enhancing yield relative to other fixed income and equity real estate investments. Mortgages generally provide yield protection through make-whole covenants, while fee and servicing income also adds to total income.

Although less liquid than traditional fixed income investments, commercial mortgages have provided an attractive average duration-adjusted yield spread at about 1% over comparable corporate bonds for the past 12 years, as shown in Figure 7. Core commercial mortgage loans are also typically underwritten with relatively low leverage (a loan-to-value ratio of 65% or lower), complemented by strong fundamentals given the ongoing recovery of the commercial real estate market.

Figure 7. Commercial Real Estate Debt Offers Attractive Yield Spreads



Source: Voya Investment Management

As the U.S. economy delivers moderate but steady growth, fundamentals in the commercial real estate market have also improved as vacancies declined and rents have stabilized or increased. Given the yield advantage and strong underlying fundamentals, commercial mortgage loans can be an attractive diversifier for long-term investors.

Agency Mortgage Derivatives

Agency mortgage derivatives are among the most interesting investments in the fixed income market today. These investments allow investors access to a fundamentally cheap asset class to express relative value views in mortgages, in particular with respect to the prepayment experience uniquely associated with mortgage investments. This can be done by managing a duration-hedged portfolio of agency-backed mortgage securities to isolate pure opportunities that exist due to natural market inefficiencies and borrower behavior in the residential mortgage market.

Borrower behavior varies quite dramatically across mortgage pools. Given skill and experience, the most attractive mortgages can be identified and assembled into attractive risk-controlled portfolios. Most commonly, portfolios are fully rate hedged. However, portfolio customization is possible should a client wish to express a bias for rate or curve directionality.

Dynamics within the mortgage market suggest opportunity for investors in mortgage derivatives. The recent rise in interest rates has led to a larger opportunity set. For the past few years, most borrowers have had refinancing incentive; however, with mortgage rates well off the lows for this cycle, there is a growing universe of securities in which value will be based on housing turnover as opposed to refinancing. This comes at a time when more detailed loan-level data is becoming available. Consequently, there exists the possibility to do more extensive research on a larger set of relative value trades. Meanwhile, housing policy reform may open up even more potentially profitable trades.

In sum, duration-hedged agency mortgage derivatives can provide attractive return potential with unique portfolio diversification, as evidenced by virtually no correlation to traditional fixed income markets.

Dynamics within the mortgage market suggest opportunity for investors in mortgage derivatives.

Conclusion

While interest rates are likely to trend higher over the next several years, those expecting a profound spike may be disappointed due to a more gradual monetary reversal by the Fed, the absence of inflation and a variety of structural shifts in investor demand for yield-producing assets. However, by targeting non-traditional fixed income markets, investors may tap certain specialty strategies — including senior loans, high yield bonds, private credit, commercial mortgage loans and agency mortgage derivatives — poised to outperform in range-bound and rising-rate environments alike.

Important Information

There are no guarantees a diversified portfolio will outperform a non-diversified portfolio.

All investments in bonds are subject to market risks. Bonds have fixed principal and return if held to maturity, but may fluctuate in the interim. Generally, when interest rates rise, bond prices fall. Bonds with longer maturities tend to be more sensitive to changes in interest rates.

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