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TOPIC OF FOCUS: **STRATEGY**

Q&A

Short Duration Strategies at Western Asset

On the Web: https://bit.ly/31Y8W2P

Investors in money market funds are now confronted with near record-low yields. At the same time, investors in Core bond strategies may have concerns regarding how further inflation may impact higher duration allocations. Portfolio Manager Nicholas Mastroianni and Product Specialist Douglas Wade discuss the several different strategies that Western Asset offers in the short duration space and why we believe that an allocation to short duration strategies should play a part in an investor's overall portfolio.

Nicholas Mastroianni
Portfolio Manager

Douglas Wade
Product Specialist

KEY TAKEAWAYS

- While cash is generally thought of as being tied to money market funds for immediate liquidity needs, yields there are near historical lows.
- By moving a bit further out the yield curve, investors can achieve a higher yield while still maintaining a defensive posture against rising rates.
- Including some different types of short-dated credit provides investors with an opportunity to generate a meaningful pickup in yield.
- Investors in longer duration who are concerned about inflation may benefit from moving into short duration.
- Short duration strategies are typically thought of as being inherently less risky and less volatile investments relative to Core or Core Plus strategies.

Short Duration Strategies at Western Asset

By Nicholas Mastroianni, Portfolio Manager and Douglas Wade, Product Specialist

"Short duration strategies inherently offer better protection against rising rates."

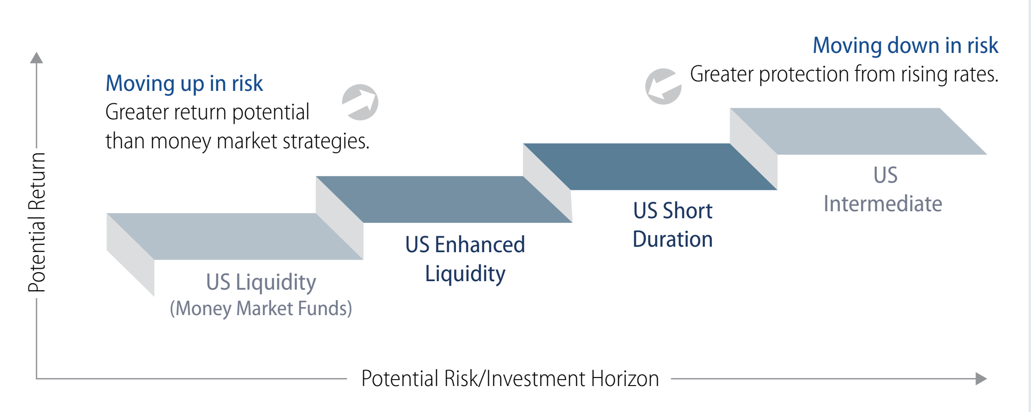
Doug Wade: Why should investors include an allocation to a shorter duration strategy?

Nick Mastroianni: We feel it is always wise to have a portion of one's total investment allocated to short duration. Cash is generally thought of as being tied to money market funds for immediate liquidity needs, but yields here are near historical lows. But by moving a bit further out the curve, we can take advantage of higher yields. And if you include some short-dated credit of various flavors, you have an opportunity to generate meaningful pickup in yield.

Investors in longer duration who are concerned about inflation may benefit from moving in to short duration. Short duration strategies inherently offer better protection against rising rates.

These dynamics are illustrated in Exhibit 1, which includes Western Asset's US Enhanced Liquidity and US Short Duration strategies:

Exhibit 1: Assessing Risk/Return in Short Duration Strategies



Source: Western Asset. For illustrative purposes only.

You can also review a table summarizing Western Asset's short duration strategies and their key attributes in Exhibit 3.

DW: How are the short duration strategies related to Core or Core Plus? Are they basically the same thing, just with less duration?

NM: While they share the same foundation, they are different animals. Like their Core and Core Plus brethren, our short duration strategies are broadly diversified across their eligible fixed-income sectors. Further, they are all designed to express similar overarching themes, although each strategy's specific objective and risk budget will determine how the themes are expressed.

"Western Asset's shorter-duration strategies are US-dollar-only, so there is no currency risk …"

A key difference is that short duration strategies are typically thought of as being inherently less risky and less volatile investments relative to a Core or Core Plus. This is something we take to heart and strive to reflect in portfolio construction. First, they have less duration risk compared with strategies that are further out on the curve. Short duration strategies will have credit risk, which we feel is an excellent place to earn additional yield, although the credit held will be of a higher quality. Maturities will be shorter, typically averaging about 3 years. Allocations will either be entirely or mainly in investment-grade credit, depending upon strategy or client preference. Further, Western Asset's shorter-duration strategies are US-dollar-only, so there is no currency risk for a US-dollar-based investor. While our shorter duration strategies by design have more risk than money market funds, protecting investor capital is nonetheless a paramount goal.

DW: Where do you see opportunities along the yield curve?

NM: As we've begun the slow transition away from emergency monetary policy, the front end of the yield curve—as measured by the difference between yields on 3-month bills and 3-year notes—has steepened. This is reflective of a move toward eventual policy normalization. Compared with the last 18 months, investors who move only modestly out the curve can now earn even more additional yield. Currently, yields in high quality, short duration strategies managed by Western Asset generally range from 0.90% to 1.45% (depending on the specific strategy). This stands as a meaningful pickup over traditional money market yields. And as we have discussed, the shorter duration profiles of these strategies still provide a cushion against the possibility of rates moving higher.

DW: Which sectors are most attractive for short duration investors?

NM: There are two areas in particular to highlight. First, all three short duration strategies have their largest exposures to short-dated investment-grade credit. This is an excellent area for adding meaningful incremental yield while still being positioned in a very high-quality sector where fundamentals are very sound. And with upward sloping curves, investors can achieve this additional yield while incurring only a modest amount of additional duration risk. We have a healthy allocation to financials, but also a focus on certain reopening trades, such as energy and transportation, which reflects our view that the recovery will continue. Further, short-dated credit has had very high Sharpe ratios,[1] which also gives us comfort with this sector. Sharpe ratios have been higher than 0.8 since the year 2000, as measured by the Bloomberg 1-5 Year Credit Index.

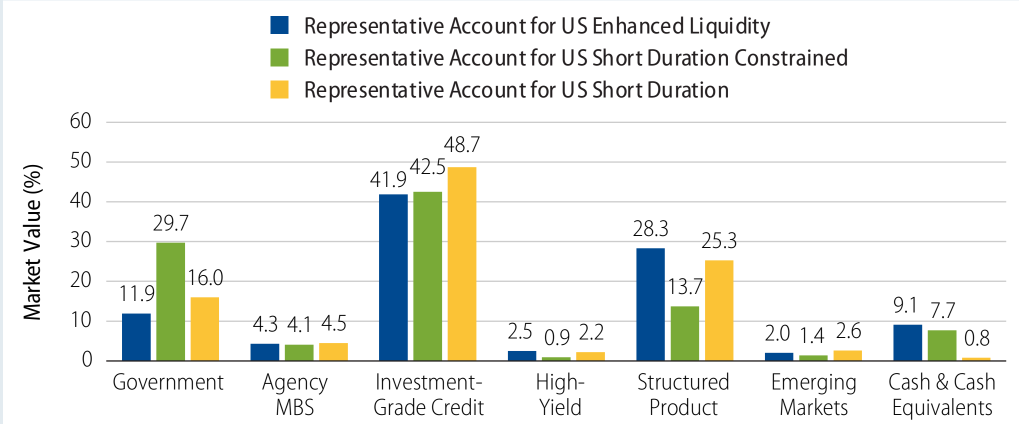
The second area of emphasis is structured product: non-agency mortgage-backed securities (MBS), commercial MBS (CMBS) and asset-backed securities (ABS). We like these sectors mainly because they offer enhanced opportunity for yield pick-up and as we can identify specific subsectors with attributes that are attractive to more conservative strategies. For example, we can hone in on areas with fairly low volatility or those that have a floating rate and benefit from built-in interest rate protection.

In terms of non-agency MBS, housing has performed strongly over the past year and positive housing fundamentals continue to support further home price appreciation, although at a slower pace as supply and demand normalize. We see value in legacy issues, reperforming loans and GSE credit-risk transfer (CRT) deals. In the CMBS space, fundamentals are improving but remain uneven across property types, so being selective is key. Single-Asset Single-Borrower (SASB) deals is one example of a subsector where we see value. In ABS, we are diversified across an array of subsectors, and generally favor well-protected senior ABS classes in high-quality sectors with low disruption from Covid. Two examples include government-backed Federal Family Education Loan Program (FFELP) student loans and auto loans, which are supported by the strength of the underlying sector.

[1] Sharpe ratio: The Sharpe ratio is a measure of risk-adjusted return. It is defined as the difference between the returns of the investment and the risk-free return, divided by the standard deviation of the investment returns. It represents the additional amount of return that an investor receives per unit of increase in risk.

Exhibit 2 compares positioning in Western Asset's three short duration strategies:

Exhibit 2: Positioning Comparison—US Enhanced Liquidity, US Short Duration Constrained and US Short Duration



Source: Western Asset. As of 30 Nov 21.
Past performance is not indicative of future results.

Exhibit 3: Western Asset Short Duration Strategies

	Money Market Funds	US Enhanced Liquidity	US Short Duration Constrained	US Short Duration	US Intermediate, US Core, US Core Plus
Risk Tolerance	Low	Low to moderate	Moderate	Moderate	Moderate to Higher
Primary Objective	Liquidity with a high level of income consistent with preservation of capital	Seeks to provide a higher return than money markets, while maintaining a high degree of liquidity	Seeks to exceed the benchmark by 25 bps annually over a 1-3 year period while emphasizing capital preservation	Seeks to exceed the benchmark by 75 bps annually over a 1-3 year period while emphasizing capital preservation	Seeks to exceed the benchmark by 75 bps to 150 bps annually while minimizing risk
Duration Range[2]	3 to 6 months	Up to 1 year	+/- 25% of benchmark	+/- 25% of the benchmark	+/- 25% of the benchmark
Benchmark	FTSE 1-Month Treasury Bill	FTSE 3-Month Treasury Bill	ICE BofAML 1-3 Year US Treasury Index	ICE BofAML 1-3 Year US Treasury Index	Bloomberg US Aggregate Index
Investment Profile	Mostly cash instruments (commercial paper, certificate of deposits, time deposits)	Cash instruments (commercial paper, certificate of deposits, time deposits) and limited exposure to investment-grade credit. Structured product depending on guidelines	Meaningful investment-grade credit exposure, moderate structured product exposure (agency MBS, non-agency MBS, CMBS, ABS). Cash instruments and governments	Meaningful investment-grade credit exposure, moderate structured product exposure (agency MBS, non-agency MBS, CMBS, ABS). Cash instruments and governments. Small allocations to high-yield and emerging markets	All major fixed-income sectors, including investment-grade credit, structured product (agency MBS, non-agency MBS, CMBS, ABS) and opportunistic exposure to high-yield, emerging markets and non-dollar securities (depending on strategy)
Commingled Vehicle(s)	Money market funds	WA Ultra-Short Income Fund	n/a	WA Short-Term Bond Fund, WA Short Duration Income ETF (WINC)	WA Intermediate Bond Fund, WA Core Bond Fund, WA Core Plus Bond Fund

Source: Western Asset. As of 30 Nov 21.
[2]Average duration range.