FOLIOBEYOND FIXED INCOME COMMENTARY FOR FEBRUARY 2021

Performance Summary

FolioBeyond's algorithmic Fixed Income strategy returned -0.13% and -0.71% in its static and dynamic volatility versions, respectively, for February. The strategies outperformed the Bloomberg Barclays U.S. Aggregate Bond Index ("AGG") return of -1.44%. As a reminder, the static volatility version targets a constant annual volatility of 3.5% (generally corresponding to the long-term average volatility of AGG). The dynamic volatility version targets the trailing 1-year volatility of AGG, which leads to higher risk targeting in more volatile environments like that experienced during the past twelve months.

Treasuries' steepening selloff accelerated in February, with the 2 to 10-year yield spread widening by another 30 basis points. As the 10-year Treasury yield rose by 33 basis points during the month, longer duration strategies were highly exposed. As mentioned in last month's commentary, FolioBeyond's algorithmic strategies have maintained a shorter duration profile than AGG but with higher current income, primarily from short duration High Yield exposure. If the curve steepens further, the model may favor extending duration slightly to pick up additional income.

As was the case in January, return attribution for our strategies consisted of gains in short duration credit exposures offset by losses in intermediate duration exposure, including Agency bonds.

STRATEGY	1- Month Return	YTD Return	1-Year Return	3-Year Return	5-Year Return	10-Year Return
FolioBeyond Dynamic Volatility*	-0.71%	-1.04%	1.62%	6.14%	6.18%	5.37%
FolioBeyond Static Volatility*	-0.13%	-0.21%	-0.73%	5.41%	5.67%	4.54%
Morningstar US Fund Multisector Bond Category Average	-0.23%	-0.14%	3.89%	4.32%	5.28%	4.08%
Bloomberg Barclays U.S. Aggregate Bond Index (“AGG”)	-1.44%	-2.15%	1.38%	5.32%	3.55%	3.58%
Dynamic Volatility Standard Deviation	-	-	***5.57%***	***3.86%***	***3.36%***	***3.42%***
Static Volatility Standard Deviation	-	-	***4.01%***	***3.42%***	***3.17%***	***3.57%***
Morningstar Multisector Bond Average Standard Deviation	-	-	***6.34%***	***3.84%***	***3.21%***	***2.80%***
AGG Standard Deviation	-	-	***4.80%***	***3.76%***	***3.48%***	***3.36%***
Dynamic Volatility Sharpe Ratio	-	-	***0.26***	***1.18***	***1.46***	***1.37***
Static Volatility Sharpe Ratio	-	-	***-0.25***	***1.13***	***1.40***	***1.10***
Morningstar Multisector Bond Average Sharpe Ratio	-	-	***0.58***	***0.74***	***1.26***	***1.23***
AGG Sharpe Ratio	-	-	***0.24***	***1.00***	***0.69***	***0.88***

Source: FolioBeyond's returns are from SMAs on Interactive Brokers (from January 1, 2019 for Static Volatility and from November 3, 2020 for Dynamic Volatility) and back-tested simulated results prior to that. AGG and Multisector Bond Category returns are from Morningstar.

** FolioBeyond Dynamic and Static Volatility returns are net of underlying ETF fees and 30 bp assumed management fee. Although the information herein is believed to be reliable, FolioBeyond makes no representation or warranty as to its accuracy, and information and opinions reflected herein are subject to change at any time without notice. The past performance information presented herein is not a guarantee of future results.*

Highlight: Tactical Asset Allocation vs. Passive Indexing

The recent movement in rates has partly upended various investment approaches in the Fixed Income world. The decades-long bull market had led portfolio managers to expect a good portion of total return from being indexed to long duration benchmarks. Momentum models based on historical returns were biased by taking data points from a falling rate environment. The challenge going forward is how to adjust the investment management process of a Fixed Income portfolio in a potentially rising rate environment with dynamic shifts in the shape of the yield curve.

We believe Fixed Income strategies should continue to be part of a long-term portfolio but with a greater emphasis on tactical sector allocation. Passive indexing exposes investors to significant duration risk relative to current yield levels offered in the generic government and Investment Grade sectors. One of the primary goals going forward should be to manage sector exposures dynamically and tactically without making risky macro calls. A Multifactor modeling approach offers an attractive solution that can produce additional price gains to supplement income generated from Fixed Income portfolios. This type of approach will also opportunistically adjust duration exposure at the appropriate time to take advantage of higher yields at the longer end of the curve.

Certain fixed income sectors still provide respectable income levels with some potential price appreciation. These opportunities should be considered in the context of these sectors' individual risk levels and correlation benefits in a diversified portfolio, as we discussed in our January 2021 commentary. Floating rate instruments will provide rising rates protection, but the impact of longer spread duration risk should be accounted for as well. Adding TIPs ("Treasury Inflation Protected Securities") for inflation protection may not provide the desired effect. How much inflation is priced into the TIPs market vis-à-vis current CPI expectations? Are investors comfortable with the underlying rate duration exposure in longer maturity TIPs? These types of fundamental questions need to be addressed before their inclusion in a portfolio.

Liquidity is another major factor that needs to be considered in creating a dynamic Fixed Income portfolio. Trading individual CUSIP bonds can often be challenging, especially in a volatile market environment. Sector ETFs have gained popularity and offer significant liquidity, even in stressed market environments. By properly utilizing the right mix of ETFs, sector rebalancing is greatly facilitated with minimal transaction costs.

FolioBeyond's model-based tactical approach offers an attractive solution for a meaningful portion of a Fixed Income portfolio. Its multifactor model captures relative value relationships and risk differentials to provide optimized portfolio allocations using a subset of 23 liquid sector ETFs. Its algorithmic approach seeks to be at the efficient frontier of the Fixed Income market with proper risk constraints incorporated into the optimization. This process has a high likelihood of generating attractive sector allocation alpha to supplement the current environment's lower yield levels. The good news is that volatility creates opportunities, and a systematic approach should be able to capture these inefficiencies in a timely manner.

Please contact us to explore how our optimized portfolio solutions can help you manage your overall fixed income portfolio in the current environment.

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