

FOLIOBEYOND FIXED INCOME COMMENTARY FOR Q1 2022

Navigating Portfolio Rebalancing Under Rising Rates

The historic adjustment that the fixed income market is undergoing is long overdue. Negative real rates, pent-up inflationary and labor market pressures, continued supply chain bottlenecks, and possible aggressive Fed tightening were bound to result in a massive reversal of the long-term bull market. While we have witnessed dramatic moves higher in interest rates during the first quarter of 2022, we believe this is likely to be the early innings of a more significant repricing of various asset classes until a temporary equilibrium is reached.

In response to volatility in the markets, strategies employed by fixed income investors have varied across a wide range. At the lower end of the risk spectrum, some have resorted to holding an unusually large cash balance. On the other end, investors have stuck to their traditional approach of rebalancing to a set percentage of core fixed income exposures with significant duration risk. In between are a variety of qualitative and model-based strategies with tactical portfolio adjustments. FolioBeyond has continued to espouse the merits of a multi-factor optimization approach for allocating to the fixed income space, customized to fit the goals and risk targets of investors.

FolioBeyond's advanced model implements an automated asset allocation process that optimizes portfolio construction across 24 fixed income sector ETFs. These ETFs represent fairly discrete sub-sector exposures in the broad fixed income market with virtually no overlap between the ETFs. In January of this year, FolioBeyond's Rising Rates ETF (ticker: RISR) was added as the 24th component representing the MBS Interest Only ("MBS IO") market. During the first quarter, FolioBeyond's optimized fixed income portfolio was down 1.51% but outperformed the Bloomberg Barclays U.S. Aggregate Bond Index ("AGG") by approximately 4.42%. This was achieved while maintaining a risk profile similar to AGG as measured by return volatility.

In order to understand the mechanics behind the outperformance, we can point to a number of important drivers of portfolio optimization. First, relative value relationships need to be measured accurately, on a forward-looking basis, after pricing out embedded option and credit risks. The relative flatness of the yield curve, all else being equal, has generally favored short duration rate and credit exposures.

Second, correlation effects, especially negative correlations, provide advantageous effects in a portfolio context. One component in our 24-ETF universe that stands out is RISR. With a minus 10-year duration type of exposure, it is highly negatively correlated with practically all other ETFs in our mix. Additionally, it generates positive current income that is attractive from a relative value perspective. Consequently, RISR is currently 10-15% of our model portfolio depending on whether it is based on a static risk target of 3.5% annualized volatility or a dynamic target tied to the trailing 12-month volatility of the AGG.

Third, momentum effects can be a significant factor in the secondary market, especially in a trending environment. The momentum effects of the individual ETFs are quantified and incorporated into the optimization model to reflect either the positive or negative effects of momentum in either direction.

To summarize, FolioBeyond's comprehensive multi-factor approach captures, in an objective manner, the major drivers of risk and return. Furthermore, the ability to refresh the optimization daily based on updated market data allows us to keep a finger on the pulse of daily market movements and the resulting impact on model results. The live model is also subject to additional constraints, including rebalancing triggers, and it typically produces allocations across 5 - 8 subsectors, with the frequency of rebalancing generally occurring 2 - 4 times a quarter.

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