Alpha Research & Management

Feb 2024 – ARAM AGG Plus Alpha - Returns and Newsletter

AGG Plus Alpha – Systematic Active Fixed Income Model Portfolios to outperform the AGG

	Feb24 % Net Return	2024 YTD Net %	Trailing 1 year Net %	2023 YTD Net %	Cum Net Return since 1/2016	12mo Trailing Beta to AGG	12mo Trailing Correl to AGG
Baseline: (ModelPort20)	**+1.73%**	**+2.1%**	**+11.3%**	**+11.5%**	**35.4%**	**0.24**	**60%**
Aggressive: (ModelPort55)	**+1.80%**	**+2.2%**	**+11.7%**	**+11.3%**	**49.9%**	**0.33**	**68%**
CoreAGG: (ModelPort91)	**+0.52%**	**+1.5%**	**+9.7%**	**+10.3%**	**24.7%**	**0.16**	**37%**
AGG ETF	**-1.79%**	**-1.9%**	**+3.0%**	**+5.7%**	**10.9%**	**1.0**	**100%**

Bond markets took a cold shower in February, as strong economic data tempered rate cut expectations. The 10-year UST rose to 4.21% from 3.91% (at the end of Jan), resulting in negative returns for most Fixed Income products. The AGG ETF returned -1.8%, GOVT -1.73% and MBB -2.18%. HYG returned 0.04%.

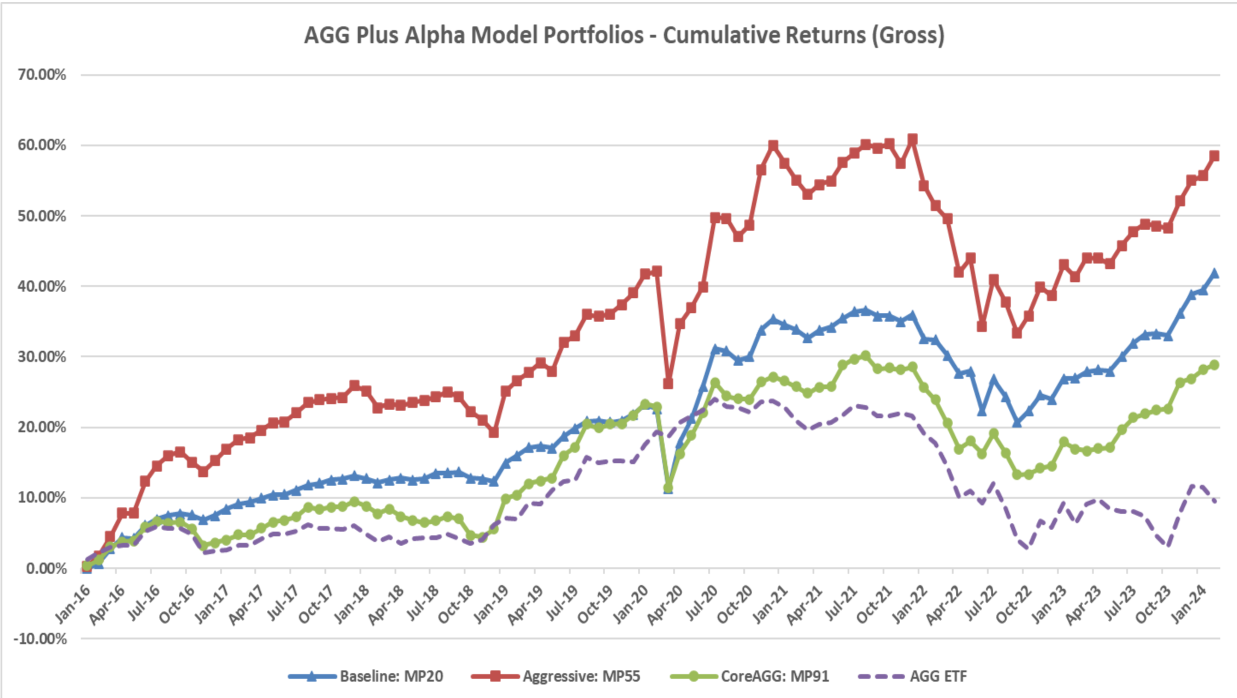
Our Active Model Portfolios shone in such a negative environment, with positive returns CRUSHING the AGG. We are now between 3% and 5% ahead of the AGG YTD in almost all our models! (That's enough outperformance to call it a year for typical bond managers.)

Notably, this also includes our CoreAGG model, highlighting the value and uniqueness of our Systematic Active Rebalancing algorithms. The CoreAGG model is limited to the sectors within the AGG – UST, IG Corps and US Agencies, and does not even use TIPs. **There is no need to stray from the AGG sectors to beat the AGG and generate higher returns than passive Fixed Income.**

Our Beta's and Correlations to the AGG also dropped, demonstrating the value of our Model Portfolios in an Asset Allocation construction.

Please see the Facts Sheets for more statistics.

We are seeking institutions and wealth managers that might have interest in licensing our customizable Model Portfolios or to seed an ETF.



Model Name	Baseline ModelPort20	Aggressive ModelPort55	Conservative ModelPort91
Risk Target Algorithm	Dynamic Risk	Risk Scaling	Dynamic Beta
Liquidity	100mm+	100mm+	100mm+
Diversification	Concentrated	Concentrated	Concentrated
Sectors - Core AGG	Yes	Yes	Yes
Sectors - TIPs	Yes	Yes	No
Sectors - HY and Bank Loans	Yes	Yes	No
Sectors - Convertibles	No	No	No

“Unconstrained” Model Portfolios

Our research on “Active Funds” revealed that many managers add unconventional sectors beyond TIPs and High Yield - Convertible Bonds, mREITs, Preferred Stocks, Foreign Bonds, and Munis - to outperform the AGG in their “Active” AGG-benchmarked strategies.

We have also created “Unconstrained” Model Portfolios that use some of these sectors. While most of these outperform the AGG and other AGG funds, in a similar matter as our other model portfolios, **in general, we are not fans of using these.**

We believe our Unconstrained Model Portfolios are superior to those of “Active Funds” that use other sectors to generate some “alpha” (in the “beta that is not identified yet” manner), but believe that our basic Model Portfolios proposed above are far superior to them all.

The resulting "unconstrained" portfolios have much greater volatility for not much more risk-adjusted return, as they create risks that are uncorrelated with rates, or are often too volatile due to leverage (REITs) to be invested in systematically or to be risk managed.

I can understand why some investors might be attracted to them – for a decade we have been in a rallying environment, and they do have higher returns – periodically - often due to leverage (or high dividend payouts – creating "value traps"). But, risk adjusted, they are not suitable for most investors, or attractive.

Here is a summary of some of our Unconstrained Model Portfolios.

	Feb24 % Net Return	2024 YTD Net %	Trailing 1 year Net %	2023 YTD Net %	Cum Net Return since 1/2016	Annual'd Standard Dev	Number of Positive Months
Baseline: (ModelPort20)	**+1.73%**	**+2.1%**	**+11.3%**	**+11.5%**	**+35.4%**	**5.9%**	**64%**
Unconstrained Concentrated MP105 (incl Converts, Pref, Reits)	**+1.02%**	**+1.3%**	**+9.9%**	**+10.6%**	**+30.2%**	**6.8%**	**63%**
Unconstrained Diversified MP107 (incl Converts, Pref, Reits)	**+0.95%**	**+0.99%**	**+9.2%**	**+10.6%**	**+29.7%**	**6.9%**	**68%**
Unconstrained Risk MP2 (incl Converts)	**+0.75%**	**-0.69%**	**+8.1%**	**+14.15%**	**+102.0%**	**15.2%**	**64%**
AGG ETF	**-1.79%**	**-1.9%**	**+3.0%**	**+5.7%**	**10.9%**	**5.2%**	**52%**

Next month, I'll show some interesting graphs that we alternately call 'The Constellation', or 'Jackson Pollack paintings". These graph the Risk/Return of the various funds we track and build our model portfolios with.

The funds that use Unconstrained construction are usually on the right side of the chart – high Standard Deviation – often in the lower right quartile.

<u>Portfolio Construction Boilerplate from our Jan 2024 newsletter:</u>

We customize portfolios using risk, liquidity, and sector parameters. We've selected some of our model portfolios to demonstrate the range of risk/return that is possible through Active Management in Fixed Income.

We believe we have created one of the first, if not the first, Active Management strategies in Fixed Income that is scalable, by using ETFs and other exchange traded products, and creating a systematic process to rebalance portfolios in response to regime changes.

<u>We target the risk of the AGG, creating portfolios that are lower risk due to the Alpha created.</u>

Our research piece titled ***'Are "Active" Fixed Income Funds Active?'*** was published last in January 2024. In this we created a framework to identify 'activeness' in fixed income funds through analysis of correlations and betas to the benchmark Agg Index – low correlation and volatile Betas are signs of an Active fund and strategy. The majority of Fixed Income funds that claim that they are active are not really so, and most end up being index huggers.

Our strategy allows Fixed Income to be viewed as a source of returns (and not insurance).

<u>Model Portfolio Construction</u>

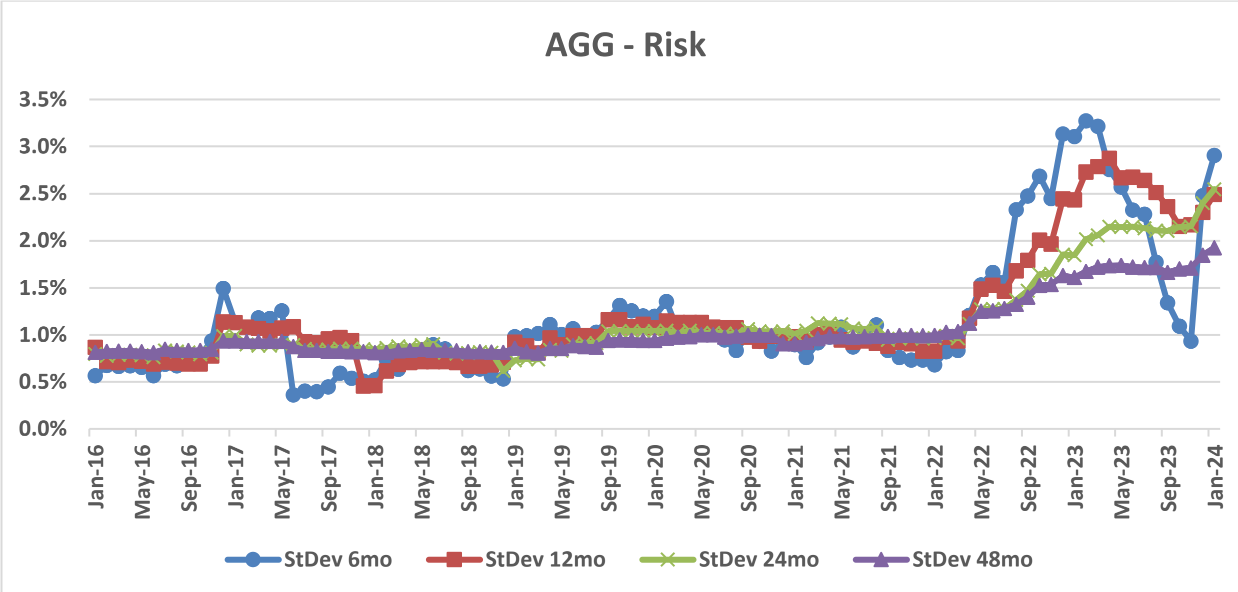
Portfolios are constructed from a palette of over 400 Fixed Income ETFs. Except in the Unconstrained Portfolio, we do not stray from US dollar bonds, and do not stretch for yield by using foreign bonds, preferred stock, options selling, or levered strategies.

We first select parameters for sectors, liquidity, weights and diversification that determine which and how many ETFs are selected for the portfolio construction. Using the recent risk and volatility of the benchmark Agg index as the risk target, a risk target algorithm is then selected to systematically create the portfolio. A rebalancing process is selected to determine when to periodically reapply the systematic portfolio construction.

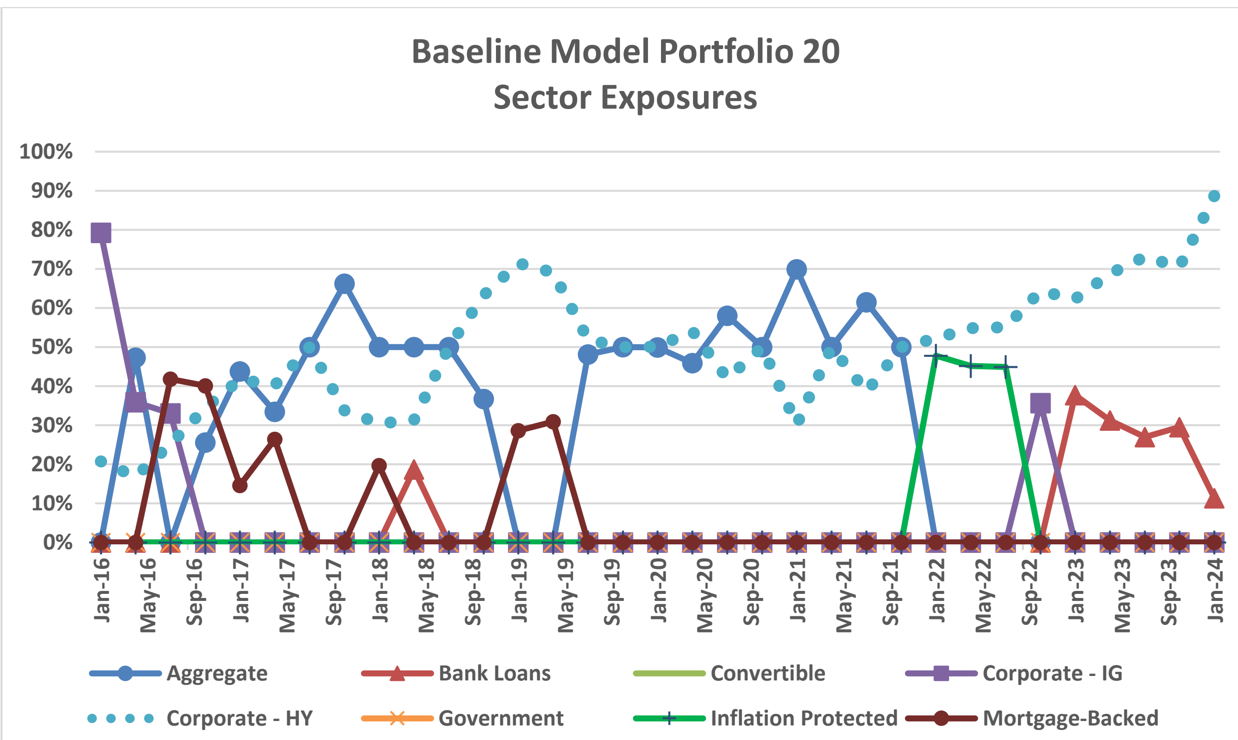
The combination of risk targeting and rebalancing makes the strategy Active, and the system automatically identifies and responds to regime and risk changes in the market environment.

Agg Risk is targeted to systematically construct portfolios

Changes in volatility, as well as returns (which capture rate changes), trigger portfolio rebalancing and reconstruction



Baseline Portfolio - Model Portfolio 20



Our Baseline model portfolio mimics the strategy of many managers by investing in sectors outside of the “Core Agg” construction of Investment Grade (“IG”) bonds. We also allow TIPs, bank loans, and High Yield corporate bonds to be considered. We limit ourselves to US Dollar bond holding ETFs.

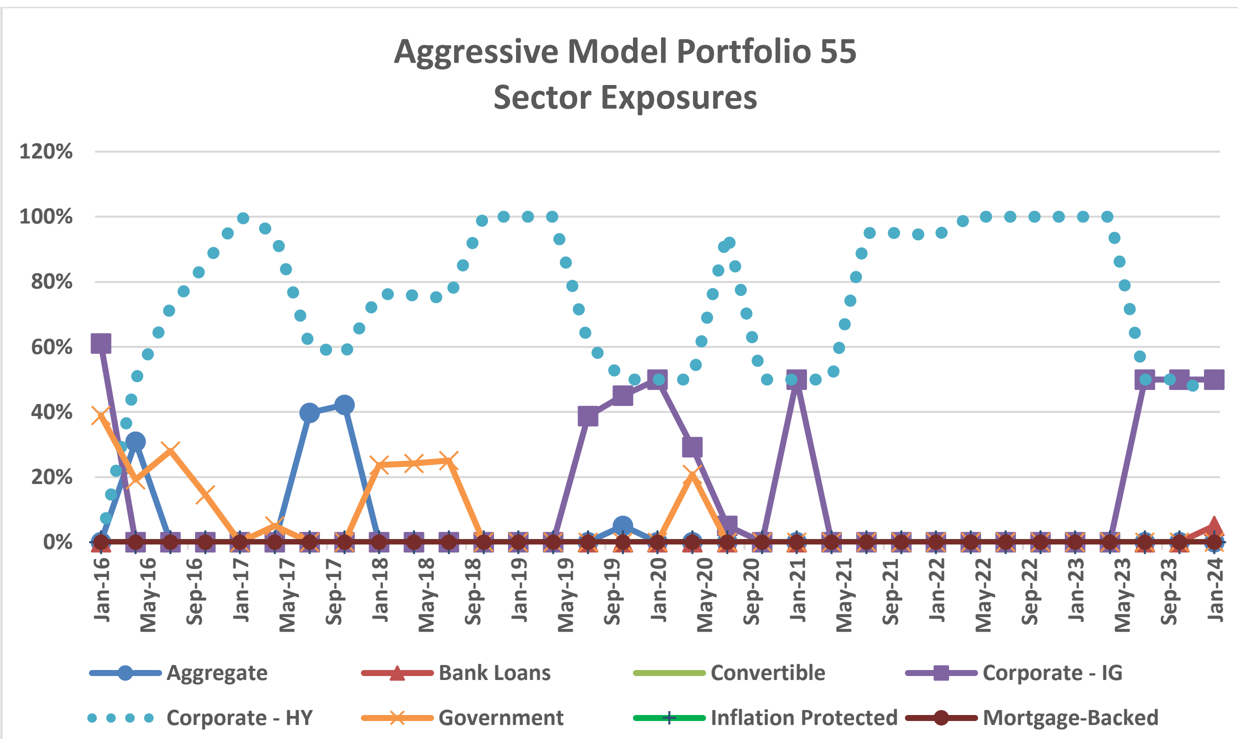
The Jan 2024 rebalancing shifted weights slightly between bank loans and corporate bonds (which turn out to be in short duration High Yield ETFs).

The system simultaneously responded to two primary factors starting in Fall 2022: the response to rising rates was to shorten duration; in order to match rising volatility and higher standard deviations, credit risk via HY and Bank Loans was embraced.

This model offers a significant improvement in both risk and return compared to the standard Agg financial products and funds where the majority of Fixed Income is invested.

The long term Beta to the Agg is only 0.6, with a 54% correlation, a result of the 2.9% annualized Alpha reducing relative risk.

<u>Aggressive Portfolio - Model Portfolio 55</u>



Our Aggressive model portfolio uses the same sectors as our Baseline portfolio (also allowing TIPs, bank loans, and high yield corporate bonds to be considered), but targets a higher volatility risk, to attempt to increase the long term Beta to 1.0.

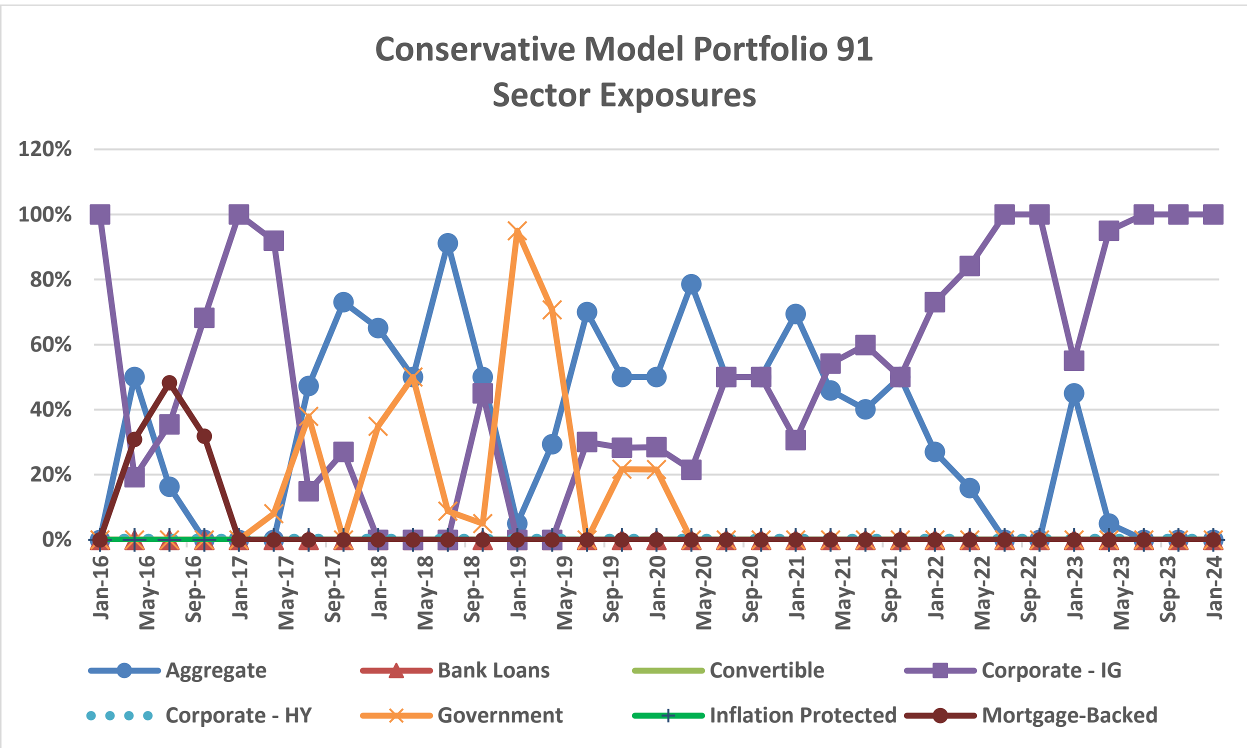
The resulting portfolios differ from the Baseline portfolio by occasionally using Govt and more IG corporate ETFs, primarily for higher duration.

The Jan 2024 rebalancing did not change the portfolio sectors significantly from the prior rebalancing.

This model should appeal to those who believe in an omnipresent Fed, who will bail out markets, allowing one to run higher risk in their portfolios.

The long-term Beta is 0.94, but with a correlation of only 59%, and Alpha of 4% annually.

Core Agg (Conservative) Portfolio - Model Portfolio 91



Our Conservative model portfolio strictly uses IG bonds as defined by the Agg Index. The Risk algorithm is Dynamic Beta, which attempts to match a Beta risk of 1 every time the system rebalances.

The sectors have not changed for many months, being almost entirely in IG corporate ETFs. However, over time, there has been rotation into and out of Agg, Govt and MBS ETFs.

This model should appeal to those investors and managers who get their high yield exposure through other means, or do not want high yield exposure.

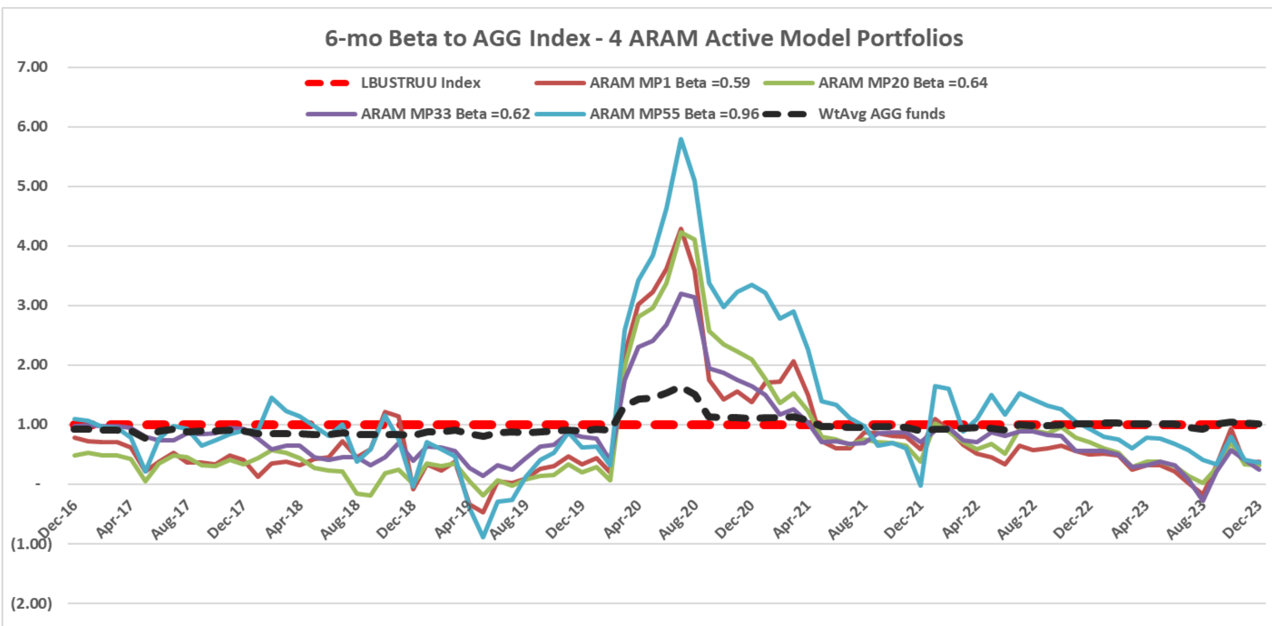
It is also proof that it is possible to generate Alpha in IG sectors through Active Management without resorting to high yield and non-dollar credit risk.

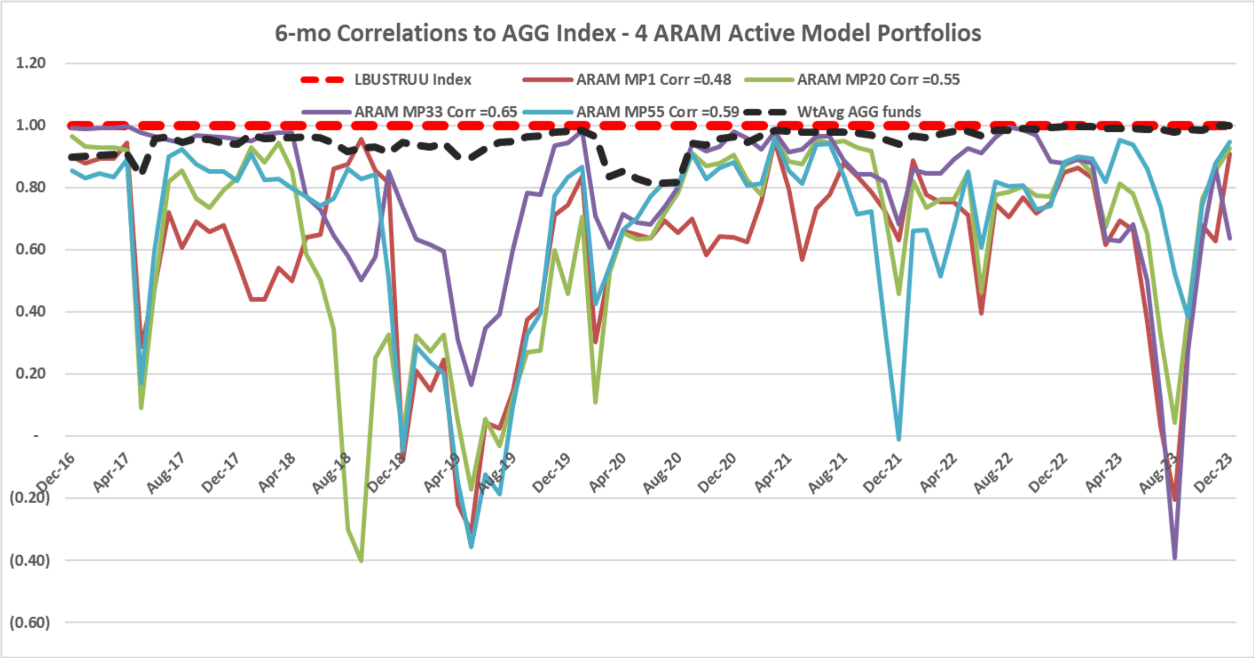
Of note is the outstanding 0.93% return for Jan 2024, versus negative returns for the Agg and market as a whole.

Also of note is the lack of recent MBS exposure. Most "Active" fund managers have been overweighting Agency MBS, especially after the MBS widening after Powell announced QT, and after bank blowups like SVB's. Our systematic construction suggests that this is not optimal.

Long-term Beta to the Agg is 0.7; correlation is 61%, and annual Alpha is 1.7%.

The following charts demonstrate the "activeness" of our model portfolios vs Agg Funds.





Please call with questions.

Regards, Samir

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Samir Shah
President and CIO
MBS Mantra, LLC (a CT Registered Investment Advisor)
(dba) Alpha Research and Management
Alpha Research and Consulting, LLC

"Alpha Through Analysis"®

203-388-8356 P
203-273-0360 C
sshah@mbsmantrallc.com
https://www.linkedin.com/in/samir-shah-6a9096a

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