



ACTIVE SHORT DURATION – THE SPECTRUM

ABSTRACT

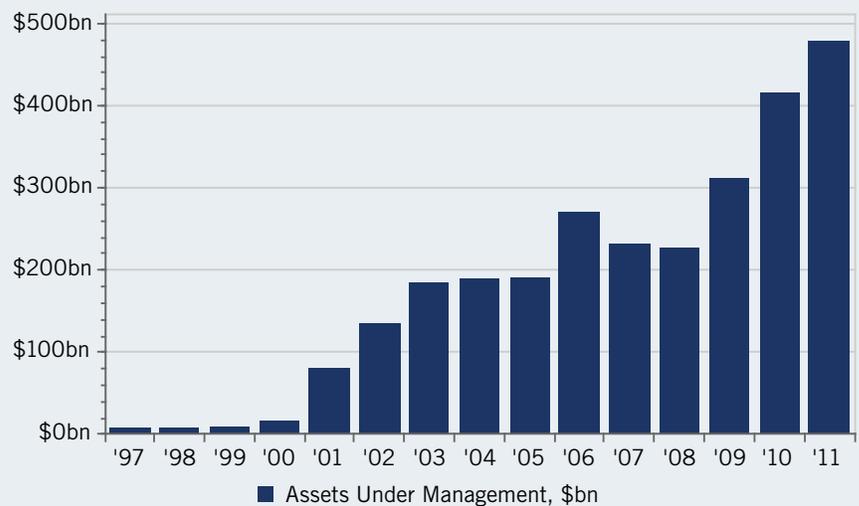
Active short duration mutual funds have been garnering much investor interest of late, as investors search for both yield as well as protection from duration risk in this low interest rate environment. As the term “active short duration” can have different nuances in the investment world, it is important to look behind the label to understand the strategic make-up of a portfolio, its benchmark, and the potential risks and rewards before making an investment decision. In our view, active short duration funds are essentially investment grade bond portfolios with a bias to the short term - actively managed to keep a target duration range. In this white paper, we consider the universe of short duration funds, their assets under management, commonly used benchmarks, and their historical performance and volatilities. We come to the conclusion that while the spectrum of short duration funds are generally meant for investors looking to invest in short term investment grade bonds, the type of instrument invested in by the fund as well as the portfolio management style should be considered before making the decision to match the investor’s appetite for risk and yield.

INTRODUCTION

Active short duration funds are essentially actively managed portfolios that are made up of short duration investment grade bonds. However, the term active short duration can have slightly different nuances in the investment world. One firm’s short duration fund could be made up of short term government Treasuries while another’s could be mostly longer term corporate bonds mixed in with short term derivative paper; both named short duration, but each with different risk-return attributes. We need to note at the onset that even though it is widely accepted that short duration funds are distinct from money market funds, some firms do categorize their money market funds under short duration, making it crucial for investors to look closely at the constituents of the portfolio before making an investment.

The short duration market has continued to grow actively (Chart 1) in this volatile market environment where short-term investment grade bonds can be an attractive defensive position to take. At this juncture, it is worthwhile to take a closer look at the short duration sector to consider its make-up and characteristics.

CHART 1: STRONG GROWTH OF THE SHORT DURATION MARKET DURING VOLATILE TIMES



Source: eVestment Alliance, FactSet and Babson Capital as of September 30, 2011

ACTIVELY MANAGING DURATION - KEEPING IT WITHIN A TARGET RANGE

The objective of actively managing duration of a fund is to seek a high total return from current income while minimizing fluctuations in principal value. Duration management is a rules-based approach and involves limiting the portfolio duration to a targeted range, by making specific investment decisions. In the case of a short duration portfolio, this range can be between one and three years.



Duration is a key measure of risk for fixed income investors and captures the price sensitivity of a bond or a portfolio to changes in interest rates. Duration depicts a negative relationship between interest rates and price and depending on how large the duration figure is, a rise in interest rates can have a significant negative impact on the return of a fixed income portfolio.

So, when an investor decides on investing in an active short duration strategy, it is done on the conviction that interest rates could move in the near to medium term and the investor is unwilling to take the risk of significant interest rate changes. From a risk point of view, this investor could be seen as being risk averse or concerned about sharp near-term interest rate moves.

CONSIDERING THE SPECTRUM – ALL \$415 BILLION OF IT

In considering the spectrum of short duration funds in the U.S., we looked at the roughly 100 mutual funds in the universe of short duration funds in eVestment Alliance, an investment-manager database we used to analyze manager performance and sector allocation statistics. Upon initial inspection, the fund names are diverse and the funds vary greatly in size from \$5 million to \$38 billion. The investment focus is also wide ranging with some funds heavily invested in investment grade corporates, some in mortgage passthroughs, and one portfolio with almost half its allocation in high yield corporate bonds, contrary to what one would expect in a short duration fund. The only homogeneous factor across all funds is the low duration; consistent with expectations, duration for all funds in the universe is within 0.5 and 3.6 years.

A closer look at the assets under management and the makeup of the portfolios, reveals the average size of a short duration fund is quite large at \$4.2 billion, while the median is only \$920 million (Table 1). The large average is due to a few big funds skewing the average. In fact, we found that the 10 largest funds account for 60% of all assets under management. In line with the short duration theme, the average duration of the funds is 2.1 years and average maturity is 2.9 years (Table 1).

TABLE 1: SHORT DURATION FUND STATS

Total AUM	\$415 billion
Average Size of Fund	\$4.2 billion
Size of Median Fund	\$920 million
Size of Largest Fund	\$37.8 billion
Weighted Average (W.A.) Fees @ \$100m	24 bps
W.A. Effective Duration	2.1 years
W.A. YTM	1.9%
W.A. Maturity	2.9 years
% of Funds with Avg. AA Quality Issuer	63%

Source: eVestment Alliance & Babson Capital as of September 30, 2011

Note: For illustrative purposes only. This information is not intended as an offer or solicitation for the purchase or sale of any financial instrument and is being provided merely to illustrate a particular investment strategy.

MANY SUITABLE BENCHMARKS BUT FEW PERFECT MATCHES

The indices used as benchmarks for short duration funds fall within 1-5 years maturity but vary in terms of asset classes from governments to corporates to agencies, with 24 broadly known individual indices and a number of custom benchmarks (Table 2). Any index chosen as a benchmark should speak volumes about the strategy of the fund and give investors an idea of the standards of risk and return that the portfolio manager expects to adhere to when managing the fund. By understanding the benchmark, we should get a deeper understanding of what the portfolio manager is trying to achieve with the fund and what the investor can expect from the fund from a risk-return standpoint.

What we find, however, is that some funds do not follow the benchmark closely when it comes to asset selection, let alone return and risk standards. Consider the Bank of America/Merrill Lynch US Treasuries 1-3 Year Index¹, which is the most popular benchmark in the industry, being used by over a quarter of all short duration funds as a benchmark. In addition to Governments/Sovereigns as an asset class, the funds that use this index as the benchmark also have significant exposure to the following asset classes that are not in the index: Agencies (up to 100%),

1. The BofA Merrill Lynch 1-3 Year US Treasury Index is a subset of The BofA Merrill Lynch US Treasury Index including all securities with a remaining term to final maturity less than 3 years. The BofA Merrill Lynch US Treasury Index tracks the performance of US dollar denominated sovereign debt publicly issued by the US government in its domestic market.

**TABLE 2: THE VARIETY OF INDICES USED AS BENCHMARKS BY SHORT DURATION FUNDS**

BENCHMARK INDEX	NO. OF FUNDS
BofA ML US Treasuries 1-3 Yrs	25
Barclays Capital 1-3 Yr Govt/Credit	20
Barclays Capital 1-3 Yr Government	7
BofA ML US Corp/Gov 1-5 Yrs	5
Barclays Capital 1-5 Yr Govt/Credit	5
BofA ML US Corp/Gov 1-3 Yrs	5
BofA ML US Government 1-3 Yrs	4
Custom	3
BofA ML US Treasuries 1 Yr	3
Citigroup 1-Year T-Bill	2
Unique Benchmarks Used by Different Funds*	19

Source: eVestment Alliance & Babson Capital as of September 30, 2011

*Unique benchmarks include known indices as well as unspecified custom benchmarks. It is not possible to invest directly in an index.

Investment Grade Corporates (up to 62%), High Yield Corporates (up to 6%), Non-Agency ABS (up to 32%), Non-Agency MBS (up to 22%), Munis (up to 7%), and Private Placements (12%). This divergence of portfolio holdings from benchmark weights highlights the need to pay close attention to the fund's actual asset allocation as it could cause some variation in performance relative to the benchmark.

We also analyzed the three largest funds in the industry, which account for 26% of all assets under management, to see what their holdings by asset class look like. The three largest funds, all of which share the same benchmark, are quite different. The holdings in government/sovereign bonds range from 3% to 40%, and investment grade corporate bonds from 14% to 40% (Table 3), both wide ranges. The wide range of government/sovereign bonds is especially interesting given that the benchmark for all three funds is the Bank of America Merrill Lynch US Treasuries 1-3 Year Index.

TABLE 3: VARIED HOLDINGS OF THE TOP 3 FUNDS

PRODUCT	A	B	C
AUM (\$ mn)	37,846	36,020	35,406
Average Quality	AA	AA	AA
Benchmark	BofA ML US Treasuries 1-3 Yrs		
SIGNIFICANT ASSET CLASSES			
Governments/Sovereigns	40%	3%	28%
IG Corp	18%	40%	14%
Non-Agency ABS	12%	15%	0%
Gov Agencies/Regionals	8%	25%	3%
RMBS	7%	4%	6%
Mort.-Passthrough	13%	1%	16%

Source: eVestment Alliance & Babson Capital as of September 30, 2011

Note: For illustrative purposes only. This information is not intended as an offer or solicitation for the purchase or sale of any financial instrument and is being provided merely to illustrate a particular investment strategy.

**TABLE 4: HOLDINGS OF SHORT DURATION FUNDS – ONE-THIRD IN INVESTMENT GRADE CORPORATES**

	AUM (\$ MILLION)	%
Invt. Grade Corporates	128,300	30.9%
Govts/Sovereigns	74,839	18.0%
Agencies/Regionals	55,387	13.3%
Mort.-Passthrough	45,193	10.9%
Other	37,180	8.9%
Non-Agency ABS	32,409	7.8%
Non-Agency MBS	28,589	6.9%
High Yield Corporates	7,426	1.8%
Municipals	5,565	1.3%
Priv. Placements/144As	468	0.1%
Leveraged/Bank Loans	278	0.1%
Convertibles	202	0.0%
Total	415,837	100.0%

Source: eVestment Alliance & Babson Capital as of September 30, 2011

Next, we aggregated the holdings for all short duration funds in the eVestment universe, for which data was available, to see if we could spot trends in the aggregate. We found that when we aggregated the holdings of the funds, almost one third of assets under management are invested in investment grade corporate bonds (Table 4). Government and sovereign debt comes in second at 18% and Agencies

and Regionals come in third at 13%. Quality wise, ratings are consistent with expectations of high quality holdings, with over half invested in AAA bonds and over 96% invested in investment grade bonds (Table 5). As a result, corporate bonds are the largest holding in the aggregate and not government Treasuries as one would expect from looking at the popular benchmarks.

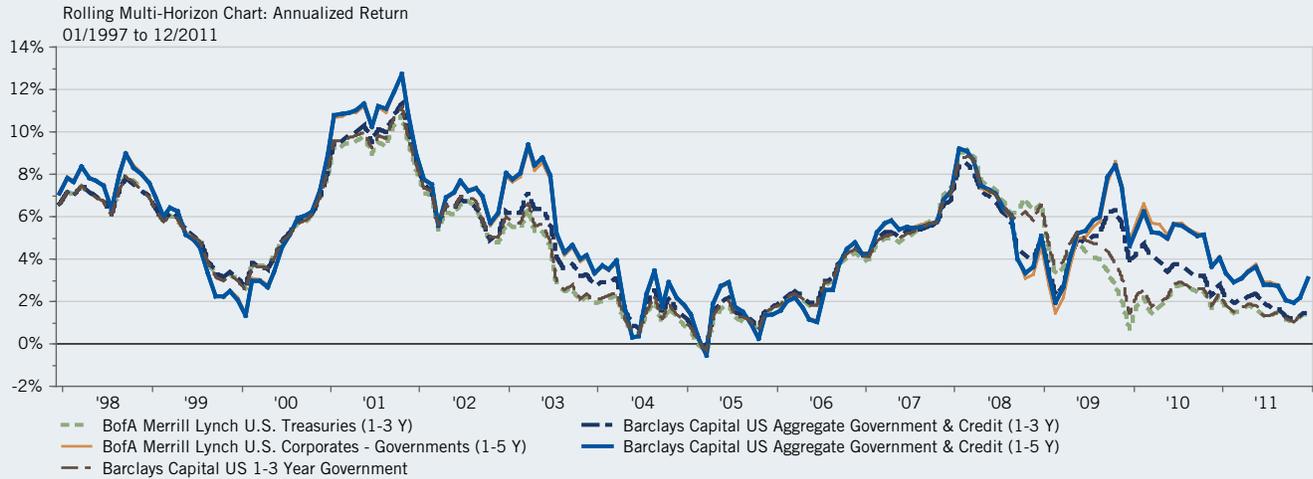
TABLE 5: HOLDINGS OF UNIVERSE OF SHORT DURATION MUTUAL FUNDS BY RATING CATEGORY

	AUM (\$ MILLION)	%
AAA	242,992	58.4%
AA	51,202	12.3%
A	60,615	14.6%
BBB	45,304	10.9%
BB	7,639	1.8%
B	3,272	0.8%
CCC	1,199	0.3%
CC	90	0.0%
C	24	0.0%
Not Rated	3,500	0.8%
Total	415,837	100.0%

Source: eVestment Alliance & Babson Capital as of September 30, 2011



CHART 2: BENCHMARK RETURNS



Source: FactSet and Babson Capital as of December 31, 2011
Rolling 12 Month Windows

RETURNS: FUND RETURNS MUCH MORE VOLATILE THAN BENCHMARKS SUGGEST

Returns of the benchmark indices have been robust over time, with returns dipping into the red only once in 2005 since 1997² (Chart 2), even though these short term benchmarks are known for low yields relative to indices of higher yielding asset classes. Considering the return and risk of these benchmarks from 1997 onwards, the annualized return of the benchmarks range from 4.4% to 5.2% and volatility³ in the low range of 1.5% to 2.2% (Table 6).

Short duration fund returns, on the other hand, have not been as steady and have been much more volatile than the benchmark returns. Chart 3 shows the performance by quartile of the universe of short duration funds over time and reveals that the returns of the bottom quartile of funds fell drastically during the last financial crisis to large double-digit negative returns. In fact, the returns for the fourth quartile ranged from the low single-digits to less than -40% (12-month rolling returns) from January to July 2010 (Chart 4). During the same time period, the top quartile ranged from the high single-digits to over 30%. As benign as benchmarks can be, actual fund performance can be more wide ranging during times of heightened volatility, making the choice of fund key to the investment decision.

TABLE 6: MID-SINGLE DIGIT RETURNS AND LOW RISK (01/1997 - 12/2011)

BENCHMARK	ANN. RETURN %	ANN. STD DEV %
BofA Merrill Lynch U.S. Treasuries (1-3 Y)	4.4	1.6
Barclays Capital US Aggregate Government & Credit (1-3 Y)	4.6	1.5
BofA Merrill Lynch U.S. Corporates - Governments (1-5 Y)	5.1	2.2
Barclays Capital US Aggregate Government & Credit (1-5 Y)	5.2	2.2
Barclays Capital US 1-3 Year Government	4.5	1.6

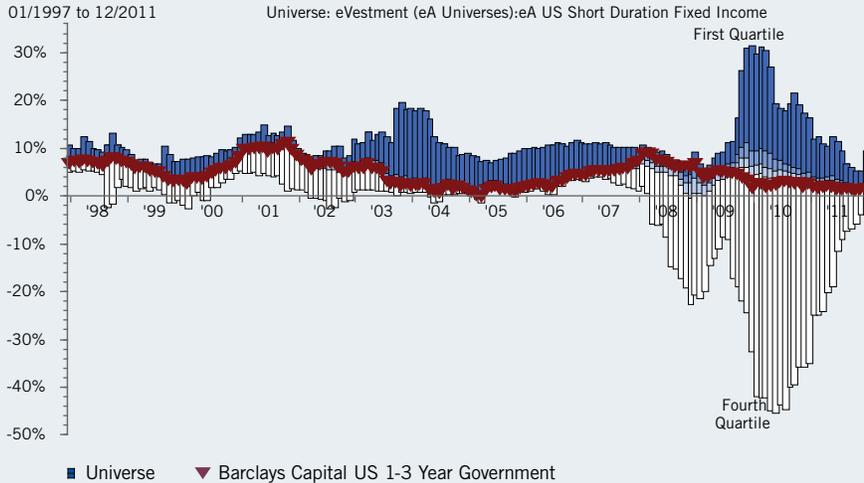
Source: FactSet and Babson Capital as of December 31, 2011

2. January 1997 was the earliest point in time for which data for all benchmarks is available.

3. Annualized standard deviation.

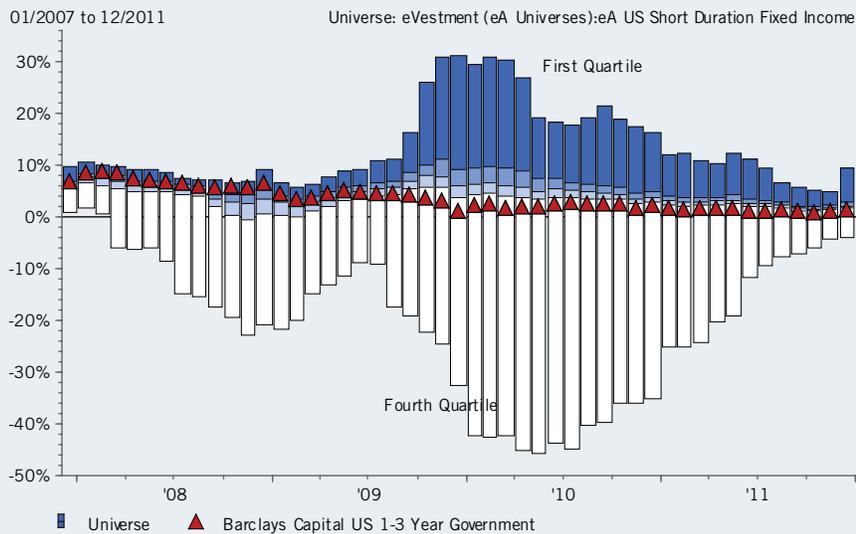


CHART 3: THE UPS AND DOWNS OF FUND RETURNS



Source: FactSet and Babson Capital as of December 31, 2011
Rolling 12 Month Windows

CHART 4: RETURNS BY QUARTILE FOR THE PAST FIVE YEARS



Source: FactSet and Babson Capital as of December 31, 2011
Rolling 12 Month Windows

CONCLUSION

Active short duration strategies are typically sought after by investors looking to invest in investment grade bonds to enhance yield but who are wary of near term interest rate movements and the follow-on impact to their fixed income portfolios. Within this set of investors, more risk-averse investors might prefer a portfolio that resembles an enhanced cash strategy, holding Treasuries and high quality commercial paper. More aggressive, yield-focused investors may seek an alternative strategy which holds higher risk, less liquid instruments to boost income.

At Babson Capital, we approach short duration as an active yield curve management strategy which overlays a short duration core bond product. We rely on our deep and seasoned credit research team and sector investment teams to generate investment ideas covering a variety of asset classes while combining a dynamic portfolio duration strategy which adjusts duration based on the current shape of the yield curve. In the context of today's low yielding environment, duration management is a key ingredient for enhancing returns, especially on the short end of the curve where Treasury bills maturing inside of three months are essentially yielding zero.



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* As of December 31, 2011. Assets include Babson Capital Management LLC and its subsidiaries

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