

FUND COMMENTARY

Navigating a rising rate environment through Thrivent Diversified Income Plus Fund

By Gene Walden, Senior Finance Editor | 05/03/2022



Investors thirsty for yield have faced a prolonged drought in recent years as yields fell to historic lows and even negative levels in some countries. With the recent rise in treasury rates, however, fixed-income yields are starting to look more attractive. Investors looking for income along with the potential for capital appreciation may find both with **Thrivent Diversified Income Plus Fund**.

“The goal of the Fund is to provide a stable, dependable stream of income through a fixed-income portfolio,” explained Grant Whitehorn, Thrivent Diversified Income Plus Fund Senior Portfolio Manager. “But it differs from other income-focused funds not only by investing in a more diverse mix of assets within fixed income, but also by offering the potential for modest capital appreciation through a conservative allocation to equities.”

While the Fund invests in a broad range of traditional income-oriented assets, such as corporate bonds, Treasuries, and mortgages, it also mixes in other securities that tend to do better in a rising rate environment. That portion of the portfolio—which includes floating-rate debt and collateralized loan obligations (packages of loans)—is intended to reduce the interest rate sensitivity of the Fund during periods of rising rates, according to Steve Lowe, Chief Investment Strategist and a co-manager of the Fund.

The Fund also broadens the diversification of the portfolio through other income-oriented investments, such as real estate investment trusts (REITs), convertible bonds, and preferred securities.

With an equity allocation of about 20%, the Fund may also generate a modest level of dividend income, although the primary purpose of the equity allocation is capital appreciation. “Depending on how we view the market, we may adjust that mix up or down slightly,” explained Whitehorn. “The fixed-income asset exposure remains the core of the Fund and may provide a high level of income while serving as an offset to the equity exposure, maintaining an overall moderately conservative risk profile for the Fund.”

Micro and macro management

Through active management of the Fund, the portfolio managers can emphasize areas of the market that may perform better during transitional periods of the economy. One advantage, said Lowe, is that the active managers can pivot to sectors that they believe are undervalued while avoiding or underweighting sectors that appear to be riskier.

“If you look back at March 2020,” Lowe recalled, “certain asset classes got completely out of sync with underlying fundamentals and value. Actively managing the Fund enabled us to underweight areas that we thought were too rich and pivot to areas that appeared to be more attractive.”

The Fund managers try to adhere to a long-term strategy to guide them through varying macro-economic environments. “The macro environment has a significant impact on how much risk we take, what our interest rate positioning is, and, particularly, what sectors we invest in,” Lowe explained.

“For example, over the past year or so, markets have done very well, but we felt that the economy and earnings were probably at a peak last year. Credit markets got quite rich, particularly high yield bonds and investment grade bonds. So, we

dialled back our allocation into those areas and shifted a little bit into more conservative areas. That has worked to our benefit so far this year. But we're always adjusting the portfolio based on macro-economic factors."

Mitigating risk

With the Federal Reserve (Fed) expected to continue to raise rates to combat inflation in the coming months, the Fund faces both the risk of declining bond prices and the possibility of a more volatile equity market if economic growth slows.

"Most likely," said Whitehorn, "this will lead to some continued volatility as the Fed tries to engineer a soft landing. One of the ways to manage risk during a period of increasing short-term interest rates is to limit duration exposure and maintain diversification among asset classes within fixed income that are less sensitive to rate increases." (Diversification can help reduce market risk but doesn't eliminate it.)

It's during volatile periods like this that the Fund's active management can offer a potential advantage. "When the Fed is raising rates," explained Lowe, "an index-oriented portfolio stays the same, but we are able to manage duration both in how we invest, and more importantly, in our ability to construct an overlay of Treasury futures so that we can get the interest rate exposure that we want where we want it."

"One specific asset allocation within our Fund that has performed well recently," added Whitehorn, "is our exposure to leveraged loans, which make up approximately 10% of the portfolio. These are limited duration assets that have a floating rate coupon, so you can still capture higher levels of income by taking credit risk, but you limit your duration risk as compared to other fixed-income assets, such as investment grade corporates."

Market challenges

"Higher interest rates in 2022 have certainly been a headwind for most fixed income-focused products," said Whitehorn. "In the Fund, we try to maintain a disciplined approach to the asset allocation mix and try to focus on long-term income potential."

"Markets have struggled early in 2022," agreed Lowe. "Most assets are off, whether it be fixed income from higher rates or wider credit spreads, and equities, which are down significantly. What's driving that weakness are higher rates and higher

inflation, which ties into concerns about the economy slowing despite a really strong job market and generally strong consumer demand.”

One other issue currently facing the markets is the inversion of the yield curve—with longer treasury rates falling below the short-term treasury rates.

“Historically, the yield curve inverts, on average, about 18 months before a recession,” said Lowe. “Asset classes tend to continue to do well for at least a year or so, although that may vary. But just because you see an inversion doesn’t mean that market returns are going to be negative. We do think that recession probabilities are increasing, but that’s a scenario that is most likely still a year or two away. In the meantime, the historically lower risk assets tend to do okay.”

Managing a changing landscape

As external forces, like rising inflation and the war in Ukraine, impact the economy and the markets, Lowe and Whitehorn believe it’s particularly important to be nimble in how they manage the Fund.

“When you’re dealing with multiple assets, some components of the Fund might be very rich while others might be particularly cheap,” said Lowe, “and you want to be able to toggle between them while maintaining your long-term strategy.”

“One of the lessons I’ve learned while managing the Fund,” added Whitehorn, “is to always maintain a healthy skepticism of your own data and analysis in the investment process. Markets are dynamic. You should stay disciplined, but you should always be questioning your inputs and your investment decision-making process.”

Part of that discipline, noted Lowe, is to continue to tweak the asset mix of the Fund to adapt to the changing dynamics. “Having that discipline to gradually reduce allocations in the richer areas and increase allocations in the areas that are cheaper can be a very, very powerful tool.

“Sometimes portfolio managers talk themselves into the idea that this time it’s different—the market’s rich, but the situation is different,” he added. “While that might hold true for a period of time, ultimately it usually doesn’t work out that way. That’s where a strong commitment to discipline can really pay off.”

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