Staying Active in Fixed Income

An unbiased side-by-side performance comparison of active and passive bond strategies may be an eye-opener for those considering index products.

by Stephen Hillebrecht, CFA, Fixed-Income Product Strategist

IN BRIEF

- Rather than debating "active versus passive," we should be asking, "Which strategy can deliver more attractive risk-adjusted returns, after expenses, to investors?"
- In certain categories, the largest passive strategies have underperformed the category averages, and done so with additional risk.
- Passive approaches may bring unintended exposures, such as increased rate sensitivity or exposure to the most indebted companies.
- Certain fixed-income indexes are not easily replicated, potentially leading to missed opportunities for passive products.
- Fixed-income markets have inefficiencies that create opportunity for active management.

The "active versus passive" debate has been well covered in the financial media and popular press. The market has weighed in on this debate, as reflected in the fund flows into passive index funds and exchange-traded funds (ETFs) versus outflows from actively managed equity mutual funds. Much of this has been driven by the recent uneven performance of active equity managers, which, we believe, is largely cyclical in nature. We also believe that active and passive strategies can play complementary roles in equity portfolios. ***In some asset classes, however, passive management is not optimal—and that is the case, particularly, in certain segments of the fixed-income market.***

DELIVERING THE BEST FIXED-INCOME SOLUTION?

If someone were to offer a mutual fund with a performance record that ranked in the bottom third of its category over the trailing three-, five-, and 10-year periods, while delivering higher volatility than the category average, one might assume that this would not be a very popular investment. In fact, however, this describes the track record of the two largest ETFs in Morningstar's High Yield Bond category. And, despite their less-than-stellar performance, these two ETFs attracted more than $6.5 billion in inflows over the three years ended December 31, 2017, and had a combined $30 billion in assets, according to Morningstar.

How can this be? Despite what a closer look at the performance of passive fixed-income strategies shows, it appears that some investors have made the assumption that a passive approach to investing is the only way to go. In fact, passive investing in the fixed-income asset class is at significant levels: of the $3.7 trillion in taxable fixed-income assets categorized by Morningstar, more than $1 trillion is invested in passive mutual funds ($559 billion) and ETFs ($515 billion) as of year-end 2017.

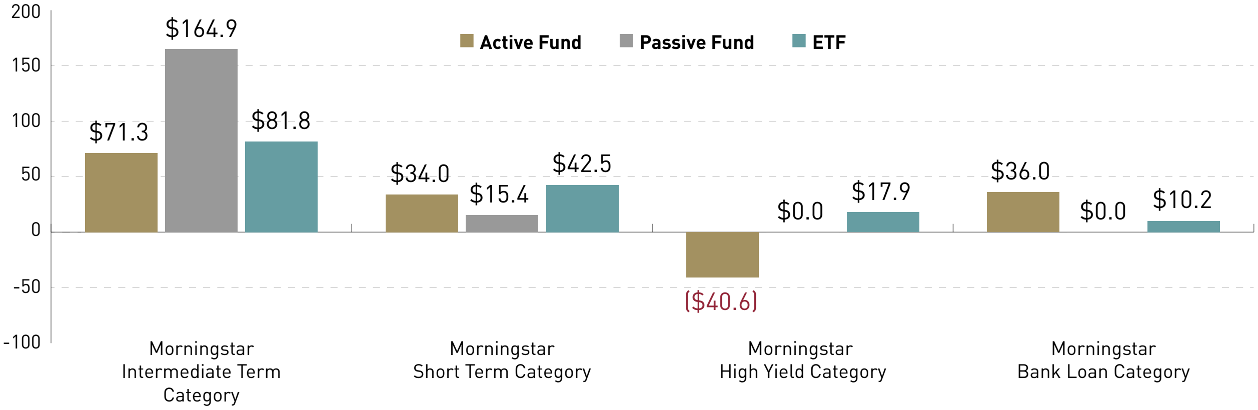
FOUR FACTORS TO CONSIDER

The adoption of passive investing has witnessed tremendous growth in recent years, driven by a desire to gain exposure to broad asset classes at a low cost and to replicate the performance of an index. As we've noted, there seems to be a common misconception that this approach would always generate a better outcome, based on an assumption that passive usually outperforms active management. Before making such an assumption, there are a few items that we might suggest investors keep in mind:

1. In certain categories, the largest passive strategies have underperformed the category averages, and have done so with additional risk.
2. Passive approaches may bring unintended exposures, such as increased rate sensitivity or exposure to the most indebted companies.

CHART 1. PASSIVE FLOWS HAVE OUTPACED ACTIVE FUND FLOWS IN LARGE FIXED-INCOME CATEGORIES

Trailing five-year fund flows in select categories, as of December 31, 2017



Source: SimFund and Morningstar.
The historical data are for illustrative purposes only and do not reflect any specific portfolio managed by Lord Abbett or any particular investment

3. Certain fixed-income indexes are not easily replicated, potentially leading to missed opportunities for passive products.
4. Fixed-income markets have inefficiencies that create opportunity for active management.

Below, we will address how some of these considerations affect four major categories of fixed income: intermediate-term bonds, short-term bonds, high-yield bonds, and bank loans.

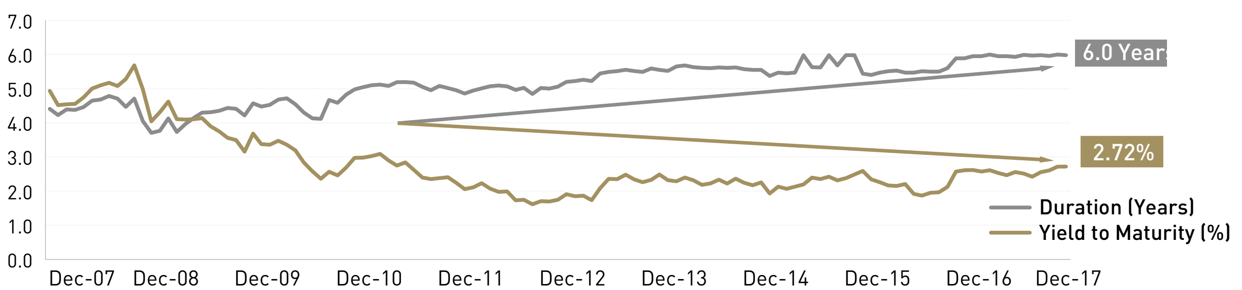
INTERMEDIATE-TERM BONDS

The intermediate-term bond category is by far the largest fixed-income category in Morningstar, with more than $1.4 trillion in assets across mutual funds and ETFs. While active funds have seen strong inflows of more than $71 billion over the past five years, passive funds have received almost $165 billion in new money, and ETFs an additional $82 billion.

Funds in this category often serve as a core bond allocation for an investor's portfolio. While the category includes a broad range of strategies, the common benchmark for the category, the Bloomberg Barclays U.S. Aggregate Bond Index, has a duration of 6.1 years, compared to the category average of 5.3 years, and is heavily weighted in U.S. Treasuries and government-related securities. As such, the index tends to perform well in stable or declining interest-rate environments, and provides valuable diversification benefits during difficult equity markets. However, the duration exposure of the index leads to significant interest-rate risk during periods of rising rates. And that risk has increased over time. Chart 2 illustrates how the average yield and duration

CHART 2. INDEX DURATION HAS EXTENDED NEARLY 50%, WHILE YIELDS HAVE DECLINED

Duration and yield for Bloomberg Barclays U.S. Aggregate Bond Index; data as of December 31, 2017



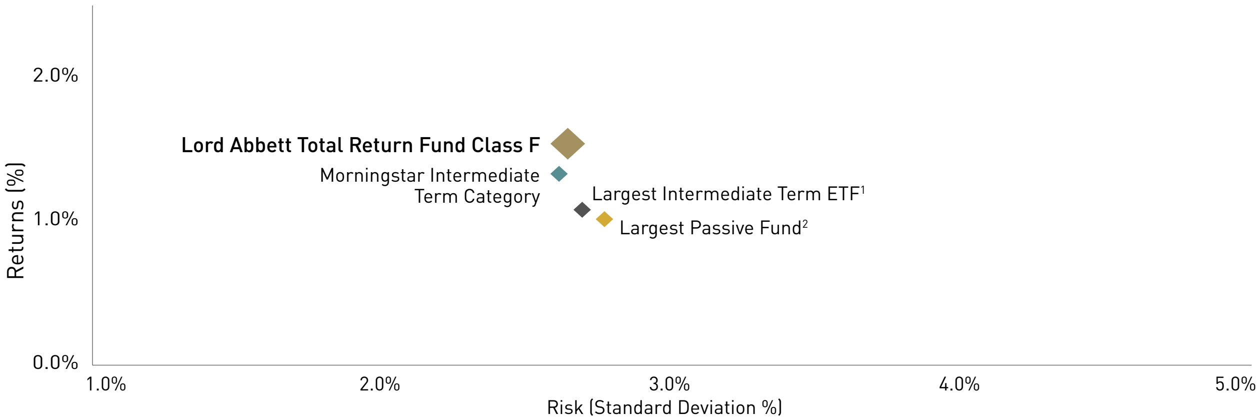
HYPOTHETICAL RETURNS FOR 6-YEAR DURATION FIXED INCOME IN RISING RATES					
RATE INCREASE	NO CHANGE	+500bps	+100bps	+150bps	+200bps
Price Return	0.00%	-3.0%	-6.0%	-9.0%	-12.0%
Yield	2.72%	2.72%	2.72%	2.72%	2.72%
TOTAL RETURN	2.72%	-0.27%	-3.26%	-6.25%	-9.24%

Source: Bloomberg Barclays. Duration as represented by modified adjusted duration in years. Yield as represented by yield to maturity. Yield to maturity is the rate of return anticipated on a bond if held until it matures. Duration is a measure of the sensitivity of the price (the value of principal) of a fixed-income investment to a change in interest rates. Bps represents basis points. One basis point equals 0.01%.

Performance quoted above is historical. Past performance is not a reliable indicator or guarantee of future results. The historical data are for illustrative purposes only, do not represent the performance of any specific portfolio managed by Lord Abbett or any particular investment, and are not intended to predict or depict future results. Investor may experience different results. Due to market volatility, the market may not perform in a similar manner in the future. Indexes are unmanaged. Do not reflect the deduction of fees or expenses, and are not available for direct investment.

CHART 3. TRAILING THREE-YEAR RETURN AND VOLATILITY—INTERMEDIATE-TERM BONDS

Data as of January 31, 2018



01/31/2018	TRAILING RETURN (%)/CATEGORY RANK (%)				3 YEAR	
	1 YEAR	3 YEAR	5 YEAR	10 YEAR	STANDARD DEVIATION (%)	SHARPE RATIO
Morningstar Intermediate Term Bond Category Average	**2.45**	**1.33**	**1.95**	**3.8**	**2.63**	**0.33**
Lord Abbett Total Return Fund, Class F Shares (NAV)	2.53	1.63	2.3	4.69	2.60	**0.45**
Lord Abbett Rank in Category	**45**	**31**	**29**	**14**	–	–
Largest Intermediate Term ETF[1]	**2.15**	**1.08**	**1.95**	**3.60**	**2.69**	**0.23**
Rank in Category	**61**	**61**	**50**	**66**	–	–
Largest Passive Fund[2]	2.13	1.03	1.95	3.66	2.84	0.20
Rank in Category[2]	**62**	**66**	**51**	**63**	–	–

Source: Morningstar performance and rankings. [1]iShares Core U.S. Aggregate Bond ETF (AGG). [2]Vanguard Total Bond Market Index Fund (VBTLX).

Percentile rankings in Morningstar Intermediate Term category (as of January 31, 2018): Lord Abbett Total Return Fund: one year, 45% (463/983); three years, 31% (265/842); five years, 29% (221/775); 10 years, 14% (67/554). iShares Core U.S. Aggregate Bond ETF rankings: one year, 61% (631/1033); three years, 61% (588/957); five years, 50% (468/928); 10 years, 66% (532/808). Vanguard Total Bond Market Index Fund rankings: one year, 62% (639/1033); three years, 66% (630/957); five years, 51% (475/928); 10 years, 63% (510/808). Morningstar rankings reflect all share classes within the category and are based on total return and do not reflect the effect of sales charges.

Morningstar Intermediate Term category average returns are based on all share classes within the category and include the reinvested dividends and capital gains, if any, and exclude sales charges. The net asset value (NAV) performance above shows the Fund's average annual total returns of Class F shares.

Past performance is not a reliable indicator or guarantee of future results.

has changed over the past decade. The index duration has increased by approximately 50%; the average yield in the index had declined to 2.7% (as of December 31, 2017), compared with approximately 5.0% a decade ago.

While the largest passive mutual fund and ETF provide very low-cost exposure to the index, they have trailed the actively managed category average with modestly higher volatility over the three years ended January 31, 2018. While the longer-duration, government-focused index generally performs well during "risk-off" periods, rising rates can provide a headwind.

SHORT-TERM BONDS

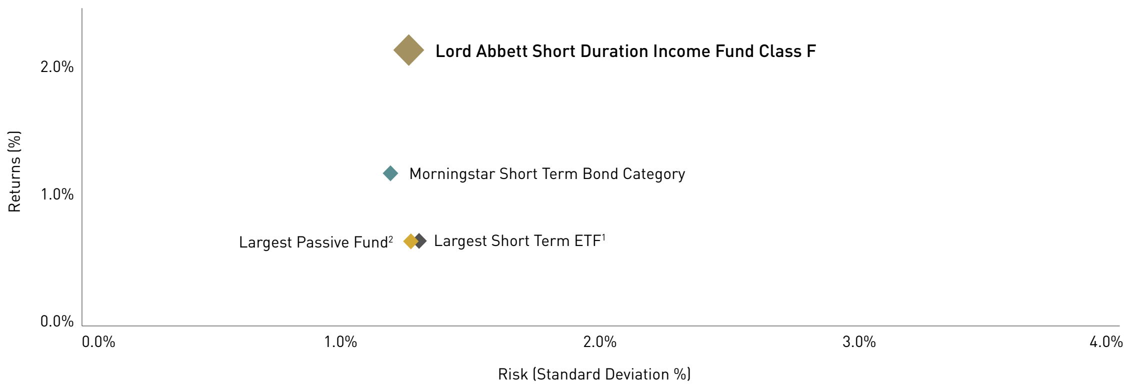
Those seeking to reduce interest-rate risk may look to shorten duration. The short-term bond category (comprised of investment-grade strategies with an effective duration between 1.0 to 3.5 years) is the second largest category in Morningstar, with $376 billion in mutual fund and ETF assets. The category average duration is approximately 2.0 years, with many funds benchmarked to a one- to three-year index. The largest passive mutual fund and ETF, however, use the Bloomberg Barclays U.S. 1-5 Year Government/Credit Float Adjusted Index as a benchmark, which now has a duration of 2.7 years. This longer-duration profile can be a challenge during a period of rising interest rates, as we have seen over past year, as the index fund and ETF have landed in bottom quartile in the short-term bond category over the trailing year and below the category average over the trailing three- and five-year periods.

Similar to the Barclays Aggregate Bond Index, the government/credit index has an emphasis on government-related securities (as of January 31, 2018, U.S. Treasuries and agencies comprised 64% of the index). However, within the short-duration arena, credit-sensitive sectors of the market (including short-maturity corporate bonds, commercial mortgage-backed securities, and asset-backed securities) historically have delivered very attractive risk-adjusted returns relative to government-related sectors.

There are a number of reasons why this might be the case, but this may be due in part to the biases of investors. For example, certain short-term mandates may be restricted by investment policy statement or regulatory factors that would prevent them from investing in securities rated below 'AAA.' Such investors may be unable to buy (or unwilling to do the proper level of credit research to buy) the lower end of investment-grade or below investment-grade securities. Likewise, they may be forced sellers of securities if their holdings are downgraded below a certain rating. This may create opportunities for active investors to uncover individual short-maturity securities with attractive risk-reward profiles.

CHART 4. TRAILING THREE-YEAR RETURN AND VOLATILITY—SHORT-TERM BONDS

Data as of January 31, 2018



01/31/2018	TRAILING RETURN (%)/CATEGORY RANK (%)				3 YEAR	
	1 YEAR	3 YEAR	5 YEAR	10 YEAR	STANDARD DEVIATION (%)	SHARPE RATIO
Morningstar Short Term Bond Category Average	1.22	1.20	1.07	2.13	1.20	0.43
Lord Abbett Short Duration Income Fund, Class F Shares (NAV)	1.89	2.17	2.06	4.11	1.27	1.30
Lord Abbett Rank in Category	**16**	**10**	**8**	**2**	–	–
Largest Short Term Bond ETF[1]	0.41	0.67	0.91	2.13	1.30	0.14
Rank in Category	**78**	**69**	**55**	**47**	–	–
Largest Passive Fund[2]	0.42	0.67	0.91	2.13	1.29	0.14
Rank in Category	**77**	**69**	**55**	**46**	–	–

Source: Morningstar performance and rankings. [1]Vanguard Short-Term Bond ETF (BSV). [2]Vanguard Short-Term Bond Index Fund (VBIRX).

Percentile rankings in Morningstar Short-Term category (as of January 31, 2018): Lord Abbett Short Duration Income Fund: one year, 16% (79/514); three years, 10% (41/463); five years, 8% (25/396); 10 years, 2% (6/256). Vanguard Short-Term Bond ETF rankings: one year, 78% (410/526); three years, 69% (344/498); five years, 55% (248/450); 10 years, 47% (184/389). Vanguard Short-Term Bond Index Fund rankings: one year, 77% (408/526); three years, 69% (345/498); five years, 55% (250/450); 10 years, 46% (180/389).Morningstar rankings reflect all share classes within the category and are based on total return and do not reflect the effect of sales charges.

Morningstar Short Term Bond category average returns are based on all share classes within the category and include the reinvested dividends and capital gains, if any, and exclude sales charges. The net asset value (NAV) performance above shows the Fund's average annual total returns of Class F shares.

Past performance is not a reliable indicator or guarantee of future results.

HIGH-YIELD BONDS

Passive investing, meanwhile, introduces a different set of issues as we move to more credit-sensitive sectors, such as high yield. Given that credit risk is a major consideration in high-yield investing, one would think an active approach that seeks fundamentally strong issuers and carefully manages risk would be most appropriate. But fund flows have suggested otherwise. The contrast in flows in this $300 billion category has been dramatic, with more than $40 billion in outflows from active funds, versus nearly $18 billion in inflows to ETFs over the five years ended December 31, 2017. These flows can be quite erratic, however, especially during periods of market volatility. For example, over the six weeks ended February 21, 2018, high-yield ETFs suffered $6.8 billion of outflows (representing 13.6% of their AUM).

Within a market cap-weighted index, when companies issue more debt, they then become a larger part of the index. As a result, a passive approach leads to larger allocations to the most indebted companies and industries, which would not seem to be ideal. An active manager can undertake rigorous fundamental credit research on individual issuers and choose to focus on the best opportunities, while avoiding those credits that pose the largest risk of default, or trade at unattractive valuations. In addition, an active portfolio can favor those industries that are better positioned for the economic environment, while adjusting overall risk exposure across the credit-rating spectrum. This especially came to light during the commodity price collapse of 2014–15, when the energy sector, which grew to become one of the largest sectors in the major high-yield indexes, suffered sharp price declines.

The data in Table 1 reveal that it is common to have a large dispersion of returns by rating and sector in each calendar year in the high-yield index. For example, in the “risk-off” environment of 2014–15, ‘CCC’ rated bonds underperformed those rated ‘BB’ by 790 basis points (bps) and 1,400 bps, respectively, only to outperform by more than 2,300 bps during the recovery of 2016. A review of returns by sector in the BAML U.S. High Yield Index reveals a spread of more than 30% in the return of the best and worst sectors in the index. This variability creates opportunity for active managers.

TABLE 1. WIDE DISPERSION OF RETURNS CREATES OPPORTUNITIES FOR ACTIVE MANAGERS

Dispersion of returns, by credit rating and industry

Index Returns by Credit Rating

ML High Yield Index*	2013	2014	2015	2016	2017
BB	5.2%	5.3%	-1.0%	13.2%	7.2%
CCC	13.0%	-2.6%	-15.0%	36.5%	10.2%
Difference CCC-BB	**7.8%**	**-7.9%**	**-14.0%**	**23.3%**	**3.0%**

Index Returns by Industry

ML High Yield Index*	2013	2014	2015	2016	2017
Top Sector	14.2%	9.9%	6.4%	38.4%	12.8%
Bottom Sector	4.5%	-7.4%	-23.6%	4.1%	1.5%
Difference Top-Bottom	**9.7%**	**17.3%**	**30.0%**	**34.3%**	**11.3%**

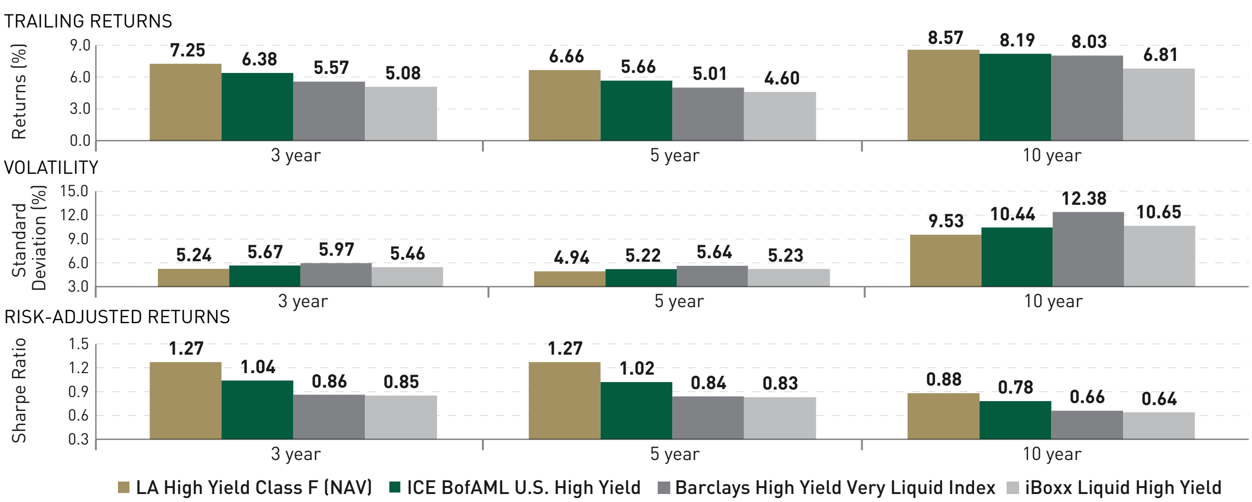
Source: Merrill Lynch. Data for calendar years (ended December 31).

Past performance is not a reliable indicator or guarantee of future results. *ICE BofAML U.S. High Yield Constrained Index. The historical data shown in the chart above are for illustrative purposes only and do not represent any specific portfolio managed by Lord Abbett or any particular investment. Indexes are unmanaged, do not reflect the deduction of fees or expenses, and are not available for direct investment.

One reason to own an index is to gain broad exposure to an asset class. But unlike the S&P 500® Index, for example, the high-yield index is not easily replicated. A common index, the ICE BofAML U.S. High Yield index, is comprised of approximately 2,000 issues representing a market value of $1.3 trillion. In the case of the two largest high-yield index ETFs, they instead attempt to track indexes that reflect just a portion of the market—the “highly liquid” market—representing the largest borrowers in high yield. An active approach provides flexibility to take advantage of all market opportunities across a broader universe, not just the largest issuers of debt, while mitigating risk.

CHART 5. HISTORICALLY, THE HIGH-YIELD MARKET HAS GENERATED HIGHER RETURNS THAN THE MORE NARROW INDEXES TRACKED BY ETFS

(Data as of January 31, 2018)



Source: Morningstar.

Past performance is not a reliable indicator or guarantee of future results. The net asset value (NAV) performance above shows the Lord Abbett Fund’s average annual total returns of Class F shares. Indexes are unmanaged, do not reflect the deduction of fees or expenses, and are not available for direct investment.

These two large ETFs have the benefit of lower expenses, but their construction has led to high opportunity cost, as both have lagged the mutual fund category average by a significant margin, placing them in the bottom third of the category over the past three-, five-, and 10-year periods. Some investors may be willing to accept lower returns if it comes with lower volatility. But in this case, these ETFs have delivered lower returns with higher volatility than the category average manager.

CHART 6. TRAILING THREE-YEAR RETURN AND VOLATILITY—HIGH-YIELD BONDS

Data as of January 31, 2018

01/31/2018	TRAILING RETURN (%)/CATEGORY RANK (%)				3 YEAR	
	1 YEAR	3 YEAR	5 YEAR	10 YEAR	STANDARD DEVIATION (%)	SHARPE RATIO
Morningstar High Yield Category Average	**5.85**	**5.07**	**4.48**	**6.70**	**5.06**	**0.97**
Lord Abbett High Yield Fund, Class F Shares (NAV)	**7.44**	**7.25**	**6.66**	**8.65**	5.24	**1.27**
Lord Abbett Rank in Category	**15**	**6**	**3**	**5**	–	–
Largest High Yield ETF[1]	**5.46**	**4.40**	**4.14**	**6.22**	**5.41**	**0.73**
Rank in Category	**65**	**80**	**70**	**70**	–	–
2nd Largest High Yield ETF[2]	5.62	4.17	3.83	6.05	6.00	0.63
Rank in Category	**60**	**85**	**81**	**78**	–	–

Source: Morningstar performance and rankings. [1]iShares iBoxx $ High Yield Corporate Bond ETF (HYG). [2]SPDR Bloomberg Barclays High Yield Bond ETF (JNK).

Percentile rankings in Morningstar High Yield category (as of January 31, 2018): Lord Abbett High Yield Fund: one year, 15% (86/698); three years, 6% (23/605); five years, 3% (11/500); 10 years, 5% (12/325). iShares iBoxx $ High Yield Corporate Bond ETF rankings: one year, 65% (464/712); three years, 80% (528/658); five years, 70% (418/594); 10 years, 70% (354/471). SPDR Bloomberg Barclays High Yield Bond ETF (JNK) rankings: one year, 60% (426/712); three years, 85% (561/658); five years, 81% (481/594); 10 years, 78% (371/471). Morningstar rankings reflect all share classes within the category and are based on total return and do not reflect the effect of sales charges.

Morningstar High Yield category average returns are based on all share classes within the category and include the reinvested dividends and capital gains, if any, and exclude sales charges. The net asset value (NAV) performance above shows the Fund's average annual total returns of Class F shares. Indexes are unmanaged, do not reflect the deduction of fees or expenses, and are not available for direct investment.

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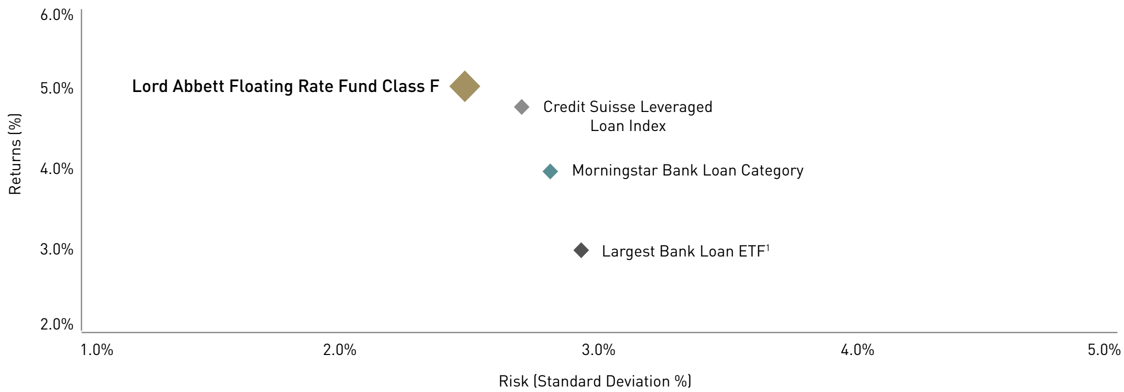
BANK LOANS

Similar to high yield, the bank loan index is not easily replicated, and, as a below investment-grade asset class, is an area where credit research should be a key focus. While ETFs are not as prevalent in this category, assets in bank loan ETFs have been growing. The biggest ETF tracks the largest 100 loans in the S&P/LSTA Leveraged Loan Index, so it is fairly concentrated in the largest borrowers in the space, and is much narrower than broad indexes maintained by Credit Suisse and J.P. Morgan (the CS Leveraged Loan Index and the J.P. Morgan Leveraged Loan Index), each of which includes more than 1,100 issues. With this approach, the ETF has had difficulty keeping up with the average peer in the group, falling in the 85th percentile or lower over the trailing one-, three-, and five-year periods, while generating higher volatility than the category average.

Over short periods of time, ETFS may be useful for a professional manager looking to manage cash flows and achieve exposure to the asset class. But over the longer term, the track record would suggest that this is an area where an active approach is superior.

CHART 7. TRAILING THREE-YEAR RETURN AND VOLATILITY—BANK LOANS

Data as of January 31, 2018



01/31/2018	TRAILING RETURN (%)/CATEGORY RANK (%)				3 YEAR	
	1 YEAR	3 YEAR	5 YEAR	10 YEAR	STANDARD DEVIATION (%)	SHARPE RATIO
Morningstar Bank Loan Category Average	**3.97**	**3.98**	**3.35**	**4.24**	**2.92**	**1.27**
Lord Abbett Floating Rate Fund, Class F Shares (NAV)	4.43	5.04	4.18	4.89	2.48	**1.81**
Lord Abbett Rank in Category	**22**	**8**	**9**	**13**	–	–
Largest Bank Loan ETF[1]	**3.21**	**3**	**2.56**	–	**2.93**	**0.86**
Rank in Category	**85**	**91**	**88**	–	–	–

Source: Morningstar performance and rankings. [1]PowerShares Senior Loan Portfolio (BKLN).

Percentile rankings in Morningstar Bank Loan category (as of January 31, 2018): Lord Abbett Floating Rate Fund: one year, 22% (65/231); three years, 8% (21/206); five years, 9% (17/165); 10 years, 13% (8/77). PowerShares Senior Loan Portfolio rankings: one year, 85% (207/242); three years, 91% (211/232); five years, 88% (175/198); 10 years, not available. Morningstar rankings reflect all share classes within the category and are based on total return and do not reflect the effect of sales charges.

Morningstar High Yield category average returns are based on all share classes within the category and include the reinvested dividends and capital gains, if any, and exclude sales charges. The net asset value (NAV) performance above shows the Fund's average annual total returns of Class F shares. Indexes are unmanaged, do not reflect the deduction of fees or expenses, and are not available for direct investment.

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FINAL THOUGHTS ON PASSIVE

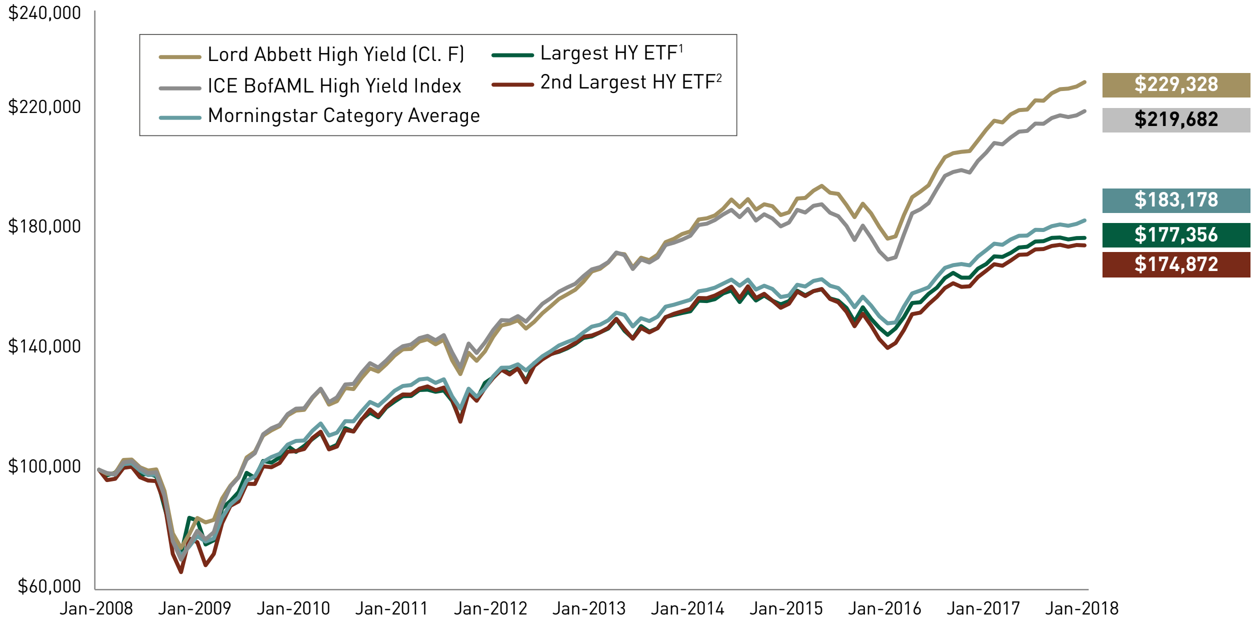
There are many nuances to consider when comparing active and passive managers in fixed income. Since there are a wide range of sectors within fixed income, and numerous indexes that can be used as benchmarks within each segment of the market, comparing rules-based ETFs to more flexible, actively managed funds isn't necessarily a straightforward exercise.

That said, we would encourage investors to undertake an unbiased, side-by-side performance comparison of active and passive strategies, just as one might analyze two active strategies, rather than defaulting to a passive approach (as fund flows suggest that many investors have done). Rather than debating "active versus passive," we should be asking, "Which strategy can deliver more attractive risk-adjusted returns, after expenses, to investors?" From the performance comparisons above, it would appear that, in many cases, an active approach to fixed income historically has delivered more attractive risk-adjusted returns—not only higher returns (after expenses) but also lower volatility and better downside capture.

Of course, investors should consider expenses when building portfolios. But in many cases (as illustrated in Chart 8), solely focusing on the lowest expense option has led to large opportunity cost (and opportunities lost) for investors. ■

CHART 8. A SOLE FOCUS ON THE LOWEST EXPENSE RATIO HAS LED TO LARGE OPPORTUNITY COSTS FOR INVESTORS

Growth of $100,000, January 31, 2008—January 31, 2018



Source: Morningstar.

[1]iShares iBoxx $ High Yield Corporate Bond ETF (HYG). [2]SPDR Bloomberg Barclays High Yield Bond ETF (JNK).

Based on a hypothetical Class F share investment of $100,000 on January 31, 2008, at net asset value and includes the reinvestment of all distributions. Data as of January 31, 2018. **Past performance is not a reliable indicator or guarantee of future results. Current performance may be higher or lower than the performance quoted.** Indexes are unmanaged, do not reflect the deduction of fees or expenses, and are not available for direct investment

TOTAL RETURN PERFORMANCE FOR LORD ABBETT FUNDS REFERENCED IN THIS COMMENTARY

As of December 31, 2017

	AVG. ANNUAL RETURN (NAV; CLASS F)				EXPENSE RATIO	
	1 YEAR	3 YEAR	5 YEARS	10 YEARS	GROSS	NET
Lord Abbett Total Return Fund (LTRFX)	3.92%	2.48%	2.45%	4.89%	0.71%	0.58%
Lord Abbett Short Duration Income Fund (LDLFX)	2.63%	2.41%	2.15%	4.23%	0.50%	0.50%
Lord Abbett High Yield Fund (LHYFX)	8.61%	7.20%	6.97%	8.35%	0.78%	0.78%
Lord Abbett Floating Rate Fund (LFRFX)	3.96%	4.69%	4.22%	4.53%	0.70%	0.70%

Performance data quoted reflect past performance and are no guarantee of future results. Current performance may be higher or lower than the performance data quoted. The investment return and principal value of an investment in the Fund will fluctuate so that shares, on any given day or when redeemed, may be worth more or less than their original cost. You can obtain performance data current to the most recent month end by calling Lord Abbett at (888) 522-2388 or referring to our website at lordabbett.com.

Total Return Fund and High Yield Fund expense ratios: The net expense ratio takes into account contractual fee waivers/expense requirements that currently are scheduled to remain in place through 03/31/2018. For periods when fees and expenses were waived and/or reimbursed, the Fund benefited by not bearing such expenses. Without such fee waivers/reimbursements, performance would have been lower.

Fund expense ratio: Reflects expenses for the Fund's fiscal year and is subject to change. Fund expenses may fluctuate with market volatility. A substantial reduction in Fund assets (since its most recently completed fiscal year), whether caused by market conditions or significant redemptions or both, will likely cause total operating expenses (as a percentage of Fund assets) to become higher those shown.

Without sales charge (NAV): the net asset value performance above shows each Fund's average annual total returns excluding sales charges. If sales charges, including any applicable contingent deferred sale charge (CDSC) had been included, performance would have been lower.

Class F shares are not subject to sales charges and available only to eligible fee-based advisory programs and certain registered investment advisers. For additional information, see the Fund's current prospectus.

A NOTE ABOUT RISK

Total Return Fund: The Fund is subject to the general risks associated with investing in debt securities, including market, credit, liquidity, and interest rate risk. The value of an investment in the Fund will change as interest rates fluctuate in response to market movements. When interest rates rise, the prices of debt securities are likely to decline, and when interest rates fall, the prices of debt securities tend to rise. The Fund may invest in high yield, lower-rated debt securities, sometimes called junk bonds and may involve greater risks than higher rated debt securities. These securities carry increased risks of price volatility, illiquidity, and the possibility of default in the timely payment of interest and principal. The Fund may invest in foreign or emerging market securities, which may be adversely affected by economic, political, or regulatory factors and subject to currency volatility and greater liquidity risk. The Fund may invest in derivatives, which are subject to greater liquidity, leverage, and counterparty risk.

Short Duration Income Fund: The Fund is subject to the general risks associated with investing in debt securities, including market, credit, liquidity, and interest rate risk. The value of an investment in the Fund will change as interest rates fluctuate in response to market movements. When interest rates rise, the prices of debt securities are likely to decline, and when interest rates fall, the prices of debt securities tend to rise. Debt securities are subject to credit risk, which is the risk that the issuer will fail to make timely payments or interest and principal to the Fund. The Fund may invest in high yield, lower-rated debt securities, sometimes called junk bonds and may involve greater risks than higher rated debt securities. These securities carry increased risks of price volatility, illiquidity, and the possibility of default in the timely payment of interest and principal. The Fund may invest in foreign or emerging market securities, which may be adversely affected by economic, political, or regulatory factors and subject to currency volatility and greater liquidity risk. The Fund may invest in derivatives, which are subject to greater liquidity, leverage, and counterparty risk. These factors can affect Fund performance.

High Yield Fund: The Fund is subject to general risks associated with investing in debt securities, including market, credit, illiquidity, and interest rate risk. The Fund invests primarily high-yield, lower-rated securities, sometimes called junk bonds. These securities carry increased risks of price volatility, illiquidity, and the possibility of default in the timely payment of interest and principal. The Fund may invest in foreign or emerging market securities, which may be adversely affected by economic, political, or regulatory factors and subject to currency volatility and greater liquidity risk. The Fund may invest in derivatives, which are subject to greater liquidity, leverage, and counterparty risk. These factors can affect Fund performance.

Floating Rate Fund: The Fund is subject to the general risks associated with investing in debt securities, including market, credit, liquidity, and interest rate risk. The value of investments in debt securities will fluctuate in response to market movements. When interest rates rise, the prices of debt securities are likely to decline, and when interest rates fall, the prices of debt securities tend to rise. The Fund may invest substantially in high yield, lower-rated debt securities. These securities carry increased risks of price volatility, illiquidity, and the possibility of default in the timely payment of interest and principal. Moreover, the specific collateral used to secure a loan may decline in value or become illiquid, which adversely affect the loan's value. The Fund may invest in foreign or emerging market securities, which may be adversely affected by economic, political, or regulatory factors and subject to currency volatility and greater liquidity risk. The Fund may invest in derivatives, which are subject to greater liquidity, leverage, and counterparty risk. Certain of the Fund's derivative transactions may give rise to leverage risk. Leverage, including borrowing for investment purposes, may increase volatility in the Fund my magnifying the effect of changes in the value of the Fund's holdings. The use of leverage may cause investors in the Fund to lose more money in adverse environments than would have been the case in the absence of leverage. These factors may affect Fund performance.

No investment recommendation is made with respect to any of the ETFs or mutual funds referenced herein. Investors should not rely on the information included in making investment decisions with respect to those funds.

Neither diversification nor asset allocation can guarantee a profit or protect against loss in declining markets.

There is no guarantee that the bond market will perform in a similar manner under similar conditions in the future.

Forecasts and projections are based on current market conditions and are subject to change without notice. Projections should not be considered a guarantee.

This article may contain assumptions that are "forward-looking statements," which are based on certain assumptions of future events. Actual events are difficult to predict and may differ from those assumed. There can be no assurance that forward-looking statements will materialize or that actual returns or results will not be materially different from those described above.

IMPORTANT INFORMATION ABOUT MORNINGSTAR

Morningstar percentile ranking for the specified periods are relative to all funds that have the same investment categories. The highest (or most favorable) percentile ranking is 1, and the lowest (or least favorable) percentile rank is 100.

The Morningstar Intermediate-Term Bond Category represents funds that focus on corporate, government, foreign, or other issues with an average duration of greater than or equal to 3.5 years, but less than or equal to six years, or an average effective maturity of more than four years, but less than 10 years.

The Morningstar Short-Term Bond Category represents funds that invest primarily in corporate and other investment-grade U.S. fixed income issues and typically have durations of 1.0 to 3.5 years. Morningstar, Inc. ©2018. All rights reserved. The information contained herein is the proprietary information of Morningstar, Inc., may not be copied or redistributed for any purpose and may only be used for non-commercial, personal purposes. The information contained herein is not represented or warranted to be accurate, correct, complete or timely. Morningstar, Inc., shall not be responsible for investment decisions, damages, or other losses resulting from the use of this information. Past performance is no guarantee of future performance. Morningstar, Inc. has not granted consent for it to be considered or deemed an "expert" under the Securities Act of 1933.

The Morningstar High Yield Bond Average represents high-yield bond portfolios that concentrate on lower-quality bonds, which are riskier than those of higher-quality companies.

The Morningstar Bank Loan category primarily invests in floating-rate loans instead of bonds. In exchange for their credit risk, these loans offer high interest payments that typically float above a common short-term benchmark such as the London Interbank Offered Rate, or LIBOR.

The ranking information shown herein reflects a fund's relative performance to other mutual funds within a fund's peer group and does not reflect the absolute performance of a fund. It is possible that during any given time frame within the periods shown herein a fund may have had negative performance.

Any examples provided are for informational purposes only and are not intended to be reflective of actual results.

INDEXES

The **Bloomberg Barclays U.S. Aggregate Bond Index** represents securities that are SEC-registered, taxable, and dollar denominated. The index covers the U.S. investment-grade fixed-rate bond market, with index components for government and corporate securities, mortgage pass-through securities, and asset-backed securities.

The **Bloomberg Barclays U.S. Corporate High Yield Bond Index** is a market value-weighted index which covers the U.S. non-investment grade fixed-rate corporate-debt market.

The **Bloomberg Barclays U.S. High Yield Very Liquid Index (VLI)** is a component of the Bloomberg Barclays U.S. Corporate High Yield Index that is designed to track a more liquid component of the U.S. dollar-denominated, high-yield, fixed-rate corporate-bond market.

The **Bloomberg Barclays U.S. 1-5 Year Government/Credit Float Adjusted Index** is a market-weighted bond index that covers investment-grade bonds with a dollar-weighted average maturity of one to five years.

The **Credit Suisse Leveraged Loan Index** is designed to mirror the investable universe of the U.S. dollar-denominated leveraged-loan market.

The **ICE BofA Merrill Lynch U.S. High Yield Constrained Index** is a capitalization-weighted index of all U.S. dollar-denominated below-investment-grade corporate debt publicly issued in the U.S. domestic market.

The **ICE BofA Merrill Lynch U.S. High Yield Index** tracks the performance of U.S. dollar-denominated below-investment-grade corporate debt publicly issued in the U.S. domestic market.

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The **J.P. Morgan Leveraged Loan Index** is designed to mirror the investable universe of U.S. dollar institutional leveraged loans, including U.S. and international borrowers.

The **Markit iBoxx USD Liquid High Yield Index** consists of liquid U.S. dollar-denominated high-yield bonds, selected to provide a balanced representation of the broad U.S. dollar-denominated high-yield corporate-bond universe. The index is used as a basis for tradable products, including ETFs.

The **S&P/LSTA U.S. Leveraged Loan 100 Index** is designed to reflect the performance of the 100 largest facilities in the leveraged loan market.

The **S&P 500® Index** is widely regarded as the standard for measuring large cap U.S. stock market performance and includes a representative sample of leading companies in leading industries.

Indexes are unmanaged, do not reflect the deduction of fees or expenses, and are not available for direct investment.

GLOSSARY OF TERMS

A **basis point (bp)** is equal to 1/100th of 1%, or 0.01%, or 0.0001, and is used to denote the percentage change in a financial instrument.

Correlation is a statistical measure of how two securities move in relation to each other.

Modified adjusted duration is a measure of the sensitivity of the price (the value of principal) of a fixed-income investment to a change in interest rates. Specifically, modified duration indicates by how much a bond's price will change if interest rates rise or fall by exactly 1 percent, or 100 basis points.

Yield to maturity is the rate of return anticipated on a bond if held until it matures.

The **Sharpe ratio** is a measure of excess return per unit of risk.

Standard deviation is a measure of volatility. Applied to an asset's return, it provides a measure of the range of those returns. A higher standard deviation means a greater range of returns.

Treasuries are debt securities issued by the U.S. government and are secured by its full faith and credit. Income from Treasury securities is exempt from state and local taxes.