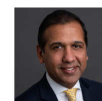
Smoothing the Ride for Credit Allocations

Dynamic Credit Strategy offers a flexible, differentiated approach.

May 2023



Saurabh Sud, CFA
Portfolio Manager, Dynamic Credit Strategy

KEY INSIGHTS

- The Dynamic Credit Strategy is well suited for those who want to take advantage of credit opportunities while also seeking a "smoother ride."
- The strategy focuses on credit selection and sector rotation to generate alpha, coupled with active duration and credit beta management.
- The composite within the Dynamic Credit Strategy posted a nearly flat return in 2022, demonstrating the value of its approach in a historically difficult year for credit markets.

The Dynamic Credit Strategy seeks to offer investors a "smoother ride" in credit investing by finding diverse alpha[1] sources in a variety of market environments. The strategy focuses on credit selection and sector rotation across the credit spectrum—high yield, investment grade, emerging markets, securitized, distressed, municipals, convertibles, and bank loans—of the global multi-asset credit (MAC) universe.

The strategy harnesses expertise across T. Rowe Price's global multi-sector research platform to deliver an actively managed, flexible portfolio with a long[2] bias. Coupled with this long bias, which is expected to deliver 80% of the strategy's returns, we employ active credit shorting[3] and duration[4] management in looking to add further alpha and dampen volatility. Our strong emphasis on finding credit dislocations, our total return perspective, and our goal of creating a differentiated portfolio are embedded in the design and the process of the strategy.

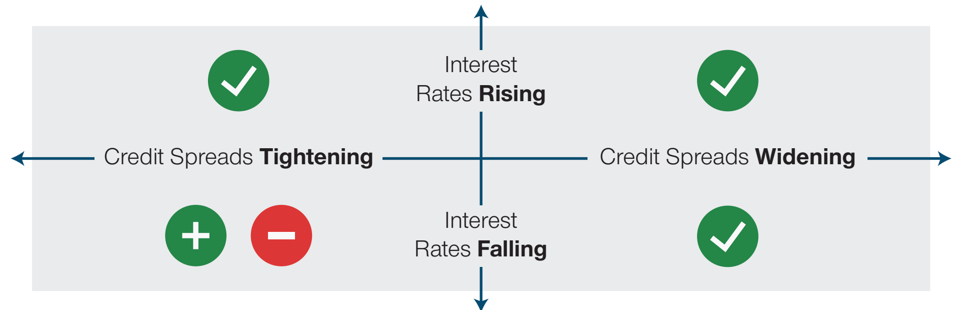
Key Source of Differentiated Returns

In addition to the strategy's goal of delivering alpha across the broad credit market, we also strive to limit undue credit beta and duration risk. We believe that our approach to portfolio construction makes the strategy a compelling and consistent credit allocation, and its differentiated returns also enable it to complement other credit allocations. The strategy's lower credit beta profile should allow it to hold up well in environments where credit spreads[5] are widening,

[1] Alpha is the excess return of an investment relative to its benchmark.
[2] Long positions benefit from credit improvement.
[3] Short positions benefit from credit deterioration.
[4] Duration measures a bond's sensitivity to changes in interest rates.
[5] Credit spreads measure the additional yield that investors demand for holding a bond with credit risk over a similar-maturity, high-quality government security.

Credit Exposure: Creating a Better Way

(Fig. 1) Strategy strives for more flexible, alpha-oriented outcomes



Source: T. Rowe Price.
Green icons represent expected outperformance versus credit beta; red icon represents expected underperformance. The expected performance for Dynamic Credit is relative to alternative credit indices such as investment grade corporates, high yield corporates, or emerging market bonds. Market environments and expected performance are based on the general strategy structure, but are not based on actual performance, nor intended as forward-looking performance projections. As with any investment, performance may vary and is subject to potential loss. Actual performance may differ significantly.
For illustrative purposes only.

SPOTLIGHT ON CREDIT RESEARCH

The strategy's repeatable process relies heavily on our global research platform of more than 300 people, who collaborate across investment strategies, asset classes, and geographies. Our team of credit analysts integrates proprietary environmental, social, and governance (ESG) factors as appropriate into the analysis. The table below provides examples of typical types of positions:

Sector	Industry	Long/Short	Description
High Yield	Automotive	Long	U.S.-based electric vehicle manufacturer positioned to compete with market leader Tesla. Bonds were secured by assets with a floating rate coupon that provided attractive risk/reward characteristics.
Investment-Grade Corporate	Utility	Long	European energy company that was remaking itself in 2022 to focus on green energy technology and was proving itself as a leader in the clean energy transition in Europe.
Convertible	Tech/Media/ Telecom	Long	A communications and media company, where the convertible bonds[6] offered exposure to an improving credit along with an attractive yield and the potential for exposure to a rising stock price.
High Yield	Health Care	Short	A U.S. health care company that was de-consolidating its businesses, leaving one entity over-leveraged and with fundamental business challenges. As a result, we anticipated that its credit spread would widen materially and shorted the credit through derivatives.

For illustrative purposes only. It s not intended to be investment advice or a recommendation to take any particular investment action.

As of March 2023. Subject to change.

[6] Holders of convertible bonds can convert the debt into equity if the stock trades at or above a predetermined price.

while its lower duration profile should be a positive in rising interest rate environments.

Three Primary Credit Evaluation Factors

When collaborating with our credit sector experts and evaluating individual credits for potential portfolio inclusion as either long or short positions, we ask three key questions:

- Is there a catalyst that could cause the credit to outperform? Depending on the type of credit, this could be a range of factors, such as a potential credit rating upgrade or downgrade for a corporate credit. For consumer-dependent credit like an asset-backed security (ABS) backed by auto loans, it could be an upturn in consumer payment trends.
- Is the position positively or negatively correlated[7] with the performance

Performing as Expected

(Fig. 2) Dynamic Credit Strategy held up in volatile 2022

	Mitigated downside in volatile 2022					Delivered a smoother ride over credit cycles	
	2022 (Calendar Year)	Three Months	One Year	Two Years	Three Years	Since Composite Inception*	
Dynamic Credit Composite (Net of fees)†	-0.13%	0.57%	3.04%	0.43%	8.79%	3.82%	
Linked Benchmark‡	1.47	1.08	2.53	1.29%	0.97	1.30	
Credit Beta Indices							
MAC Custom Index¶	-9.18	3.01	-1.75	-1.74	4.82	2.34	**Especially when compared to other credit beta risk.**
iBoxx USD Liquid High Yield Index§	-10.74	3.65	-3.25	-2.02	4.76	2.47	
J.P. Morgan EMBI Global Core§#	-18.37	1.91	-7.64	-7.25	-0.05	-1.11	
iBoxx USD Liquid Investment Grade Index§	-17.92	4.47	-6.44	-5.47	-0.96	1.60	
Bloomberg U.S. Aggregate Index§	-13.01	2.96	-4.78	-4.47	-2.77	0.47	

Past performance is not a reliable indicator of future performance.

As of March 31, 2023. Figures calculated in U.S. Dollars. All percentages for time periods greater than one year are annualized.
Sources: T. Rowe Price and Bloomberg Finance L.P.
*January 31, 2019.
† Net of fees performance reflects the deduction of the highest applicable management fee that would be charged based on the fee schedule contained within this material, without the benefit of breakpoints. Net performance returns reflect the reinvestment of dividends and are net of all non-reclaimable withholding taxes on dividends, interest income, and capital gains.
‡ Effective May 1, 2021, the benchmark for the composite changed to the ICE BofA 3-Month Treasury Bill Index. Prior to May 1, 2021, the benchmark was the 3 Month LIBOR in USD Index. Historical benchmark representations have not been restated.
§ Indexes shown represent beta credit returns and are benchmarks used by ETFs: High Yield Bond, Emerging Market Bond, US Investment Grade Index and Bloomberg US Aggregate Bond Index, respectively. The ETF benchmarks are shown for illustrative purposes to demonstrate how each of the different sectors performed for the period when looking at passive indexes (peer proxies).
¶ MAC Custom index is represented by 1/3 Bloomberg US Corporate High Yield Bond Index, 1/3 S&P/LSTA Leverage Loan Index and 1/3 Bloomberg Emerging Markets Hard Currency Aggregate Index. The MAC benchmark is a TRP proprietary benchmark that is used to compare the MAC sectors against a comparable benchmark. Please see Additional Disclosures page for information about this S&P information and this Bloomberg information.
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[7] Correlation measures how one asset class, style, or individual group may be related to another. A perfect positive correlation means that the correlation coefficient is exactly 1. This implies that as 1 security moves, either up or down, the other security moves in lockstep in the same direction. A perfect negative correlation means that 2 assets move in opposite directions, while a zero correlation implies no relationship at all.

of existing portfolio holdings? A meaningful negative correlation could indicate that the new position can provide diversification benefits by gaining when other exposures lose value.

- What is the asymmetry of the return profile? Essentially, will the price benefit more from a positive development than it suffers from a negative outcome—or vice versa? This can affect how a holding would fit into the strategy's overall positioning in terms of sizing, diversification, and potential alpha generation.

In addition to addressing these three factors, our investment process tries to ensure that we are getting paid for each position's embedded credit beta,[8] volatility, and liquidity. Our dynamic, flexible, and alpha-oriented approach has enabled the composite to deliver differentiated performance in challenging markets such as in 2022, when traditional credit sectors suffered amid rapidly rising rates.

Approach Well Suited for Unsettled Credit Environment

The strategy's alpha-seeking but risk-aware approach is well suited for a range of market conditions, but it may be even more valuable in the current unsettled credit environment. We believe that our fundamental credit analysis process that generates forward-looking insights from a global research platform with broad sector expertise can help the strategy identify and capitalize on inefficiencies ahead of the market.

WHAT WE'RE WATCHING NEXT

We have recently observed that banks are tightening their lending standards, which typically precedes the end of a credit cycle and rising defaults by two to three quarters. This changing environment may produce opportunities across the range of credit markets.

[8] Beta measures the volatility, or risk, of an investment relative to the risk of the broad market.

Risks—the following risks are materially relevant to the portfolio:
ABS and MBS—Asset-Backed Securities (ABS) and Mortgage-Backed Securities (MBS) may be subject to greater liquidity, credit, default and interest rate risk compared to other bonds. They are often exposed to extension and prepayment risk.
China Interbank Bond Market—The China Interbank Bond Market may subject the portfolio to additional liquidity, volatility, regulatory, settlement procedure and counterparty risks. The portfolio may incur significant trading and realisation costs.
Contingent convertible bond—Contingent Convertible Bonds may be subject to additional risks linked to: capital structure inversion, trigger levels, coupon cancellations, call extensions, yield/valuation, conversions, write downs, industry concentration and liquidity, among others.
Country (China)—Chinese investments may be subject to higher levels of risks such as liquidity, currency, regulatory and legal risks due to the structure of the local market.
Country (Russia and Ukraine)—Russian and Ukrainian investments may be subject to higher risks associated with custody and counterparties, liquidity, market disruptions, as well as strong or sudden political risks.
Credit—Credit risk arises when an issuer's financial health deteriorates and/or it fails to fulfill its financial obligations to the portfolio.
Currency—Currency exchange rate movements could reduce investment gains or increase investment losses.
Default—Default risk may occur if the issuers of certain bonds become unable or unwilling to make payments on their bonds.
Derivative—Derivatives may be used to create leverage which could expose the portfolio to higher volatility and/or losses that are significantly greater than the cost of the derivative.
Distressed or defaulted debt—Distressed or defaulted debt securities may bear substantially higher degree of risks linked to recovery, liquidity and valuation.
Emerging markets—Emerging markets are less established than developed markets and therefore involve higher risks.
Frontier markets—Frontier markets are less mature than emerging markets and typically have higher risks, including limited investability and liquidity.
High yield bond—High yield debt securities are generally subject to greater risk of issuer debt restructuring or default, higher liquidity risk and greater sensitivity to market conditions.
Interest rate—Interest rate risk is the potential for losses in fixed-income investments as a result of unexpected changes in interest rates.
Issuer concentration—Issuer concentration risk may result in performance being more strongly affected by any business, industry, economic, financial or market conditions affecting those issuers in which the portfolio's assets are concentrated.
Liquidity—Liquidity risk may result in securities becoming hard to value or trade within a desired timeframe at a fair price.
Prepayment and extension—Mortgage- and asset-backed securities could increase the portfolio's sensitivity to unexpected changes in interest rates.
Sector concentration—Sector concentration risk may result in performance being more strongly affected by any business, industry, economic, financial or market conditions affecting a particular sector in which the portfolio's assets are concentrated.
Total Return Swap—Total return swap contracts may expose the portfolio to additional risks, including market, counterparty and operational risks as well as risks linked to the use of collateral arrangements.

General Portfolio Risks:
Counterparty—Counterparty risk may materialise if an entity with which the portfolio does business becomes unwilling or unable to meet its obligations to the portfolio.
ESG and sustainability—ESG and Sustainability risk may result in a material negative impact on the value of an investment and performance of the portfolio.
Geographic concentration—Geographic concentration risk may result in performance being more strongly affected by any social, political, economic, environmental or market conditions affecting those countries or regions in which the portfolio's assets are concentrated.
Hedging—Hedging measures involve costs and may work imperfectly, may not be feasible at times, or may fail completely.
Investment Portfolio—Investing in portfolio's involves certain risks an investor would not face if investing in markets directly.
Management—Management risk may result in potential conflicts of interest relating to the obligations of the investment manager.
Market—Market risk may subject the portfolio to experience losses caused by unexpected changes in a wide variety of factors.
Operational—Operational risk may cause losses as a result of incidents caused by people, systems, and/or processes.

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GIPS® COMPOSITE REPORT

Dynamic Credit Composite

Period Ended December 31, 2022. Figures Shown in U.S. dollar.

	2019[2]	2020	2021	2022
Gross Annual Returns (%)	6.47	3.33	6.92	0.05
Net Annual Returns (%)[1]	5.69	2.50	6.06	-0.76
Benchmark (%)[3]	2.12	0.66	0.09	1.47
Composite 3-Yr St. Dev.	N/A	N/A	N/A	9.82
Benchmark 3-Yr St. Dev.	N/A	N/A	N/A	0.31
Composite Dispersion	N/A	N/A	N/A	N/A
Comp. Assets (Millions)	33.8	76.1	68.5	62.2
# of Accts. in Comp.	1	2	2	2
Total Firm Assets (Billions)	1,218.2	1,482.5	1,653.6	1,237.4[4]

[1]The fee rate used to calculate net returns is 0.81%. This represents the maximum fee rate applicable to all composite members. **Past performance is not a reliable indicator of future performance.**

[2]January 31, 2019 through December 31, 2019.

[3] Effective May 1, 2021, the benchmark for the composite changed to the ICE BofA US 3-Month Treasury Bill Index. Prior to this change, the benchmark was the 3 Month LIBOR in USD Index. The change was made because the firm viewed the new benchmark to be a better representation of the investment strategy of the composite. Historical benchmark representations have not been restated.

[4] Preliminary - subject to adjustment.

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Gross performance returns are presented before management and all other fees, where applicable, but after trading expenses. Net of fees performance reflects the deduction of the maximum fee rate applicable to all composite members as shown above. Gross performance returns reflect the reinvestment of dividends and are net of nonreclaimable withholding taxes on dividends, interest income, and capital gains. Gross performance returns are used to calculate presented risk measures. Effective June 30, 2013, portfolio valuation and assets under management are calculated based on the closing price of the security in its respective market. Previously portfolios holding international securities may have been adjusted for after-market events. Policies for valuing portfolios, calculating performance, and preparing compliant presentations are available upon request. Dispersion is measured by the standard deviation across asset-weighted portfolio returns represented within a composite for the full year. Dispersion is not calculated for the composites in which there are five or fewer portfolios.

The strategy utilizes on a regular basis a variety of derivative instruments such as (but not limited to) currency forwards, fixed income futures, interest rate swaps, credit default swaps, synthetic indices, and options on all mentioned instruments, primarily to hedge certain market risks associated with the strategy's objective, to express directional opportunities on specific markets and to facilitate liquidity management.

Benchmarks are taken from published sources and may have different calculation methodologies, pricing times, and foreign exchange sources from the composite.

Composite policy requires the temporary removal of any portfolio incurring a client initiated significant cash inflow or outflow greater than or equal to 15% of portfolio assets. The temporary removal of such an account occurs at the beginning of the measurement period in which the significant cash flow occurs and the account re-enters the composite on the last day of the current month after the cash flow. Additional information regarding the treatment of significant cash flows is available upon request.

The firm's list of composite descriptions, a list of limited distribution pooled fund descriptions, and a list of broad distribution pooled funds are available upon request. GIPS® is a registered trademark of CFA Institute. CFA Institute does not endorse or promote this organization, nor does it warrant the accuracy or quality of the content contained herein.

FEE SCHEDULE

Dynamic Credit Composite

As of March 31, 2023.

The Dynamic Credit Composite seeks total return through a combination of income and capital appreciation, while defensively preserving capital throughout the credit cycle. The investment approach provides the flexibility to invest across a wide variety of global credit instruments without constraints to particular benchmarks, asset classes, or sectors. The strategy may invest in corporate and sovereign bonds, leveraged loans, municipal securities, securitized instruments, and derivative instruments that are linked to, or provide investment exposure to, equity or credit instruments. (Created January 2019; incepted January 31, 2019)

First 50 million (USD)	37.5 basis points
Next 50 million (USD)	35 basis points
Above 100 million (USD)	35 basis points on all assets[1]
Above 250 million (USD)	32.5 basis points on all assets[1]
Minimum separate account size	100 million (USD)

[1] A transitional credit is applied to the fee schedule as assets approach or fall below the breakpoint.

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