Inside the portfolio

Delaware Diversified Income Fund

Learn how a veteran fixed income manager is showing that prudent flexibility can provide a steadying influence on your income outcomes.

Key fund features

- A flexible core bond strategy designed to weather market cycles
- An actively managed bond portfolio emphasizing risk control and income generation
- An experienced management team with more than 30 years average industry experience

David Hillmeyer
Portfolio Manager,
Delaware Diversified Income Fund

Delaware Diversified Income Fund portfolio manager, David Hillmeyer, discusses the evolving role of bonds in today’s portfolio and how a flexible approach can help provide current income and competitive long-term returns delivered in a risk-controlled strategy.

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Delaware Funds®
by MACQUARIE
How would you describe the Delaware Diversified Income Fund (the Fund)?
We’re managing a flexible core bond portfolio designed to deliver long-term growth with an emphasis on risk management. We characterize the portfolio as ‘looking, acting, and feeling like a bond fund investment.’

And that means….. delivering income, yes?
Yes, that is certainly part of it – but, most importantly, we believe fixed income should serve as an anchor to balance risk in investors’ portfolios. To deliver this, we focus on fundamental, bottom-up credit analysis, looking at the broad spectrum of fixed income offerings. Investment grade, high yield, developed and emerging markets -- we believe that today’s income investors can benefit from an actively-managed flexible portfolio with a goal of delivering a dependable and predictable experience for investors.

Why is flexibility so important in bond investing today?
Markets have shifted, as has the role of bonds in the portfolio, and that role is continuing to evolve. We feel that managers who have the flexibility to utilize both traditional, US investment grade fixed income securities as well as ‘plus’ sectors (think High Yield, Emerging Market, and Non-dollar bonds) are well positioned to navigate this shifting landscape and identify some of the opportunities it presents. In the Fund, we look across a number of fixed income sub-sectors that we believe can provide an optimal mix of risk and reward – with a bias toward risk management.

How does this approach compare to other diversified bond funds in the marketplace?
We believe the Fund should be a core fixed income holding for investors. Relative to other funds in the Intermediate Term Bond category, we may take on a bit more risk via our flexibility to invest in high yield, bank loans and emerging debt securities; however, investing in these bond sectors is really part of our professional wheelhouse. We understand – and seek to take advantage of – the complex relationships between interest rates, credit, maturity structures and geography.

The bond market has flexed to encompass more choices through the Multi-Sector Bond and Non-Traditional Bond categories. When you look under the hood of many multi-sector and unconstrained bond strategies today, what you find is that as managers have stretched for yield, the correlations in these products are closer to equities than many advisors might realize. It’s this added risk that we seek to avoid. When equity markets are volatile, investors can be caught off guard by concurrent volatility spikes in their bond portfolios. We believe there’s a central, core place in the world for a bond fund that behaves like a bond fund.

Do you cap the Fund’s ‘plus’ sector exposure?
Yes, the Fund can hold up to 35% in below investment grade (high yield) bonds, up to 40% in non-US bonds, including 20% from emerging markets, if the fundamentals and opportunity are there, but we won’t add high yield or non-US exposure to stretch for yield. We like to have the flexibility to be tactical and add exposure to areas of the market that domestic investors might overlook. We don’t add to our international exposure solely to increase diversification – we need to see positive fundamentals and opportunity. Today we’re holding approximately 8% in emerging market bonds and our exposure to below investment grade is 20%.

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And how do you believe a bond fund should behave today?
Credit spreads today are tight, regardless of where you look on the spectrum. Any stretch to increase income requires an asymmetric increase in your risk profile. Given this scenario, we see bonds returning to their role as mitigators of portfolio volatility – an asset class whose primary role is to act as ballast in a storm and potentially provide some income in a yield-starved world.

How do you describe the Fund’s long-term return profile?
We see this Fund as a solution to meet investor needs versus creating a problem. The Fund’s objective is to deliver an attractive total return consisting of both growth and income to investors – because we actively manage risk, we seek to maintain attractive downside capture and, over time, keep pace with, or outperform more aggressive bond funds. We say that the Fund offers a lower volatility route to the same destination.

What are the Fund’s sector exposures?
The Fund’s flexible mandate allows us to take advantage of the breadth of our fixed income capabilities. We actively manage allocations to the US investment grade, US high yield, international developed markets, and emerging markets sectors. We are normally defensively positioned, keeping duration in the intermediate range, with an objective of delivering steady long-term returns. It’s this flexibility to allocate across these bond sectors while managing portfolio volatility that we believe provides a steadying influence in the portfolio.

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Unconstrained bond funds have become popular in recent years. What are your views on portfolio constraints?

The flexibility to pursue opportunities wherever they are is a critical element of an active investment approach. In today’s market, however, there can be a place for constraints – within reason – because they let the financial advisor and client know what they’re getting and help keep surprises to a minimum. With rates at historic lows for an extended period, we’ve seen unconstrained bond managers, who have aggressively used duration as a way to anticipate rising rates, underperform and underwhelm investors. Fixed income should behave like fixed income – i.e. provide portfolio income and help dampen volatility. Investors prefer that their bond portfolios not act like equities when volatility strikes. Having some constraints in place can help manage expectations.

How do you source ideas?

This is very much a fundamental, bottom-up strategy. I have been a portfolio manager on the strategy since 2011 and have been in the industry for over 25 years. I set the direction for asset allocation as part of a team of seven portfolio managers, but it’s a collaborative effort that leverages the strength of our entire fixed income franchise, which includes more than 100 people, including specialists, in the investment grade, high yield, international, and emerging markets sectors. What you see in this portfolio is the sum of our best ideas from our research analysts, traders, and portfolio management teams. We feel the diversity of opinions represented in the Fund helps drive results over time.
For more information call us at 800 523-1918 or visit our website at delawarefunds.com

The views expressed represent the Investment Team’s assessment of the market environment and should not be considered a recommendation to buy, hold, or sell any security, and should not be relied on as research or investment advice. Views are subject to change without notice and may not reflect the Manager’s views.

Carefully consider the Fund’s investment objectives, risk factors, charges, and expenses before investing. This and other information can be found in the Fund’s prospectus and its summary prospectus, which may be obtained by visiting delawarefunds.com/literature or calling 800 523-1918. Investors should read the prospectus and the summary prospectus carefully before investing.

Investing involves risk, including the possible loss of principal.

Diversification may not protect against market risk.

Fixed income securities and bond funds can lose value, and investors can lose principal, as interest rates rise. They also may be affected by economic conditions that hinder an issuer’s ability to make interest and principal payments on its debt. The Fund may also be subject to prepayment risk, the risk that the principal of a bond that is held by a portfolio will be prepaid prior to maturity, at the time when interest rates are lower than what the bond was paying. A portfolio may then have to reinvest that money at a lower interest rate. • High yielding, non-investment-grade bonds (junk bonds) involve higher risk than investment grade bonds. The high yield secondary market is particularly susceptible to liquidity problems when institutional investors, such as mutual funds and certain other financial institutions, temporarily stop buying bonds for regulatory, financial, or other reasons. In addition, a less liquid secondary market makes it more difficult for the Fund to obtain precise valuations of the high yield securities in its portfolio. • The Fund may invest in derivatives, which may involve additional expenses and are subject to risk, including the risk that an underlying security or securities index moves in the opposite direction from what the portfolio manager anticipated. A derivatives transaction depends upon the counterparties ability to fulfill their contractual obligations. • If and when the Fund invests in forward foreign currency contracts or uses other investments to hedge against currency risks, the Fund will be subject to special risks, including counterparty risk. The Fund may experience portfolio turnover in excess of 100%, which could result in higher transaction costs and tax liability. • International investments entail risks not ordinarily associated with U.S. investments including fluctuation in currency values, differences in accounting principles, or economic or political instability in other nations. Investing in emerging markets can be riskier than investing in established foreign markets due to increased volatility and lower trading volume. • Duration is a measurement of the sensitivity of a bond’s price to a 1% change in interest rates, given the bond’s coupon rate and maturity.

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