Voya Strategic Income Opportunities Fund

Unconstrained Fixed Income

Strategy overview

Unconstrained and flexible approach, investing broadly across the global debt markets.

Key takeaways

- Rates marched higher as strong data kept the U.S. Federal Reserve in a hawkish position.
- The Strategy underperformed its benchmark, the ICE BofA USD 3M Deposit Offered Rate Constant Maturity Index (the Index), on a net asset value basis. Duration and yield curve positioning depressed returns, while sector allocation and security selection both added.
- The end of the Fed tightening is within sight, but rate cuts are still a way away.

Portfolio review

For the quarter ended September 30, 2023, the Strategy underperformed the Index. Duration and yield curve positioning depressed returns, while sector allocation and security selection both added.

Rates marched higher as strong data kept the Fed in a hawkish position. The third quarter of 2023 contained an abundance of strong data, casting aside thoughts about a recession in the near-term and the prospect of a soft landing, which seemed like a dream at the start of the year, gained credibility. Inflation continued to trend in the right direction. Core Personal Consumption and Expenditures Price Index (PCE), which peaked at a year over year rate of 5.6%, fell to 3.8% by the end of August. Meanwhile, the U.S. economy continued to add jobs at a fast pace. The combination of falling inflation and a strong labor market allowed consumers to continue spending, which is important since consumption is the largest component of U.S. gross domestic product (GDP). The Fed maintained a data dependent stance and responded to the better-than-expected data by hiking rates at their July meeting. At the same time, they continued to stress that monetary policy would need to remain in restrictive territory until the economy softens and inflation is clearly in the rearview mirror. In September, the Fed resisted delivering another hike, however their updated dot plot reinforced their “higher for longer” message. As a result, rates resumed their march higher. By quarter-end the 10-year Treasury yield had risen by 73 basis points (bp), to 4.57% as the market continued to digest the higher for longer message, with the 2-year rising modestly by 18 bp, to 5.05%. This set the stage for negative total returns across most fixed income markets, with the Bloomberg US Aggregate Bond Index falling by –2.54% for the period.

Credit sectors broadly outperformed U.S. Treasuries, mitigating some of the pain inflicted by higher rates. Responding to the economic data, higher beta sectors such as high yield (HY), senior loans and collateralized loan obligations (CLOs) were the top performing sectors in both nominal and excess returns. Non-agency residential mortgage-backed securities (RMBS) and credit risk transfer securities (CRTs) also posted strong returns, supported by the resilient economy, low unemployment and continued strength in house prices. Higher quality sectors such as investment grade (IG) corporates and asset-backed securities (ABS) also produced positive excess returns, albeit to a lesser degree. Even commercial mortgage-backed securities (CMBS) outpaced the Treasury market, however rising delinquency rates and declining property values remain a concern dogging the sector. One sector that did not follow the positive excess returns was agency RMBS. The sector lagged Treasuries and was the worst performing sector due to higher rates, continued rate volatility, a steeper yield curve (less inverted), and a lack of demand.

Duration and yield curve positioning depressed returns, while security selection and sector allocation both added. The duration profile was maintained above our 2-year central tendency and weighed on performance as the Fed maintained their hawkish tone, the economy proved resilient, and rates rose. A positive risk sentiment tone meant that our sector allocations and credit sensitive security decisions contributed meaningfully for the quarter. Sector allocations were broadly additive for the period. The largest contributor was from investments in non-agency RMBS and CRTs, buoyed by the economy, housing market and resiliency of the U.S. consumer. Allocations to bank loans also added as the sector outperformed other segments in a rising rate environment. Meanwhile, our allocations to agency RMBS was the largest detractor as the sector lagged in the wake of higher rates and rate volatility. Security selection contributed for the period, with securitized sectors outpacing corporate security selection. Agency RMBS security selection added, supported by collateralized mortgage obligations (CMOs). ABS contributed as a result of investments in off-benchmark sectors as well as high quality CLOs, driven by collateral performance and the sector's yield advantage. CMBS security selection also contributed as attractive yields helped to support outperformance. Corporate security selection across IG and HY corporates was mixed and in aggregate was a small detractor. Notable changes in our allocations included an increase in agency RMBS as relative valuations offer attractive high-quality yield. We trimmed positions in IG corporates as valuations are pricing through the cycle and emerging market (EM) local as a persistent Fed and weaker China outlook can challenge many EM countries. Overall duration ended the period at just over 3 years, above our 2-year central tendency.

Current strategy and outlook

The end of the Fed tightening is within sight, but rate cuts are still a way away. While market participants debate whether the Fed has a 'final' rate cut on the horizon, we think the discussion on rate increases has run its course and investors should focus on how long the Fed might maintain official rates. We think moderating inflation allows the Fed to pause, yet a clear downturn in labor and the economy will be required for the Fed to pivot to substantive cuts. As a result, we expect the timeline for a rate cut is further out, reflecting the robustness in labor markets. We expect growth will slow and continue to monitor threats for a possible recession. With households well supported by higher wages, moderating inflation and a liability structure that is primarily fixed rate and corporations exercising discipline with regard to balance sheet management, we see the limited scope for a sharp downturn in the U.S. economy.

Allocating in fixed income is less complicated against a backdrop of higher nominal and real yields. While the path of higher rates since the beginning of the Fed tightening cycle has been painful, investors should not fear the destination. Investors are being rewarded with attractive nominal and real yields without needing to overextend credit risk. Our preference for 'up in quality' investments is higher than it has been in the recent past, but as opportunities present themselves, we are willing to deploy capital to take advantage of these opportunities. From a sector allocation perspective, we have more capital deployed across securitized sectors, with non-agency RMBS and CRTs as well as CMBS representing our largest allocations. CMBS is another area of focus. Ongoing concerns on commercial real estate and specifically office will remain a challenge, but security selection opportunities within this sector are abundant. We prefer seasoned deals, which have gone through some degree of deleveraging, over newer vintages. Agency MBS is an area we find attractive. With market comfortable with the Fed in runoff mode (QT) and prepayment risk virtually non-existent, the market is now priced at levels that should attract buyers. On the corporate side, financials have lagged the rally, enhancing the relative value opportunity within the IG sector. While spreads are pricing through the cycle, nominal yields continue to attract buyers. Meanwhile in leveraged credit, we prefer HY corporates over senior bank loans. Borrowers in the loan market continue to be plagued by rising interest rates and the slowdown in CLO origination means refinancing maturing debt could be difficult. While an array of economic outcomes is adding volatility to interest rate markets, we believe real yields remain an anchor to valuations and duration can serve as a risk mitigant in episodes of market stress. As a result, we have a duration profile higher than our 2-year central tendency.

The **Bank of America US Dollar 3-Month Deposit Offered Rate Constant Maturity Index** represents a high-quality base rate for three-month constant maturity dollar denominated deposits. The Index does not reflect fees, brokerage commissions, taxes or other expenses of investing. **Investors cannot invest directly in an Index.**

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The strategy employs a quantitative investment process. The process is based on a collection of proprietary computer programs, or models, that calculate expected return rankings based on variables such as earnings growth prospects, valuation, and relative strength. Portfolio construction uses a traditional optimizer that maximizes expected return of the portfolio, while managing tracking error.

Data imprecision, software or other technology malfunctions, programming inaccuracies and similar circumstances may impair the performance of these systems, which may negatively affect Fund performance. Furthermore, there can be no assurance that the quantitative models used in managing the Fund will perform as anticipated or enable the Fund to achieve its objective.

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