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Morningstar's Split of the Intermediate Term Bond Category: Understanding Core vs. Core Plus

Authors

STERLING CAPITAL
FIXED INCOME TEAM

Highlights:

- On April 30, 2019, Morningstar segmented the Intermediate Term Bond category into two categories - Intermediate Core and Intermediate Core Plus[1]
- Morningstar assessed bond funds using historical holdings, performance and prospectus language to separate the new categories
- Funds with less than 5% in below investment-grade debt are now part of the Intermediate Core category and those funds above the 5% threshold are now labeled Intermediate Core Plus
- The two new categories are measured against different market benchmarks
- The Core Bond category keeps the Bloomberg Barclays U.S. Aggregate Bond Index (which holds 100% investment grade bonds), while the Core Plus category now uses the Bloomberg Barclays U.S. Universal Bond Index (which holds on average 5-8% in riskier, below-investment-grade bonds)
- Morningstar's split of the intermediate term bond category could lead investors to reallocate assets as the risks associated with various bond funds may be made clearer

> One of the key differences between the two new categories is that Intermediate Core Plus bond strategies tend to own lower-quality credit.

Why the change?

One of the key differences in delineating the categories is that Intermediate Core Plus Bond strategies tend to have portfolios with a greater amount of lower-quality credit.

The old category included a mix of portfolios that tended to cluster in one of two subgroups. The first contained funds that held U.S.-dollar-investment-grade debt with very little exposure to below-investment-grade securities.

STERLING CAPITAL TOTAL RETURN BOND FUND

Overall Morningstar Rating™

★★★★★

Overall rating based on risk-adjusted returns against 356 Intermediate Core Bond funds as of 09.30.2019, derived from a weighted average of the performance figures associated with its three-, five- and ten-year (if applicable) Morningstar Rating metrics. (BIBTX)[2]

The second included funds with more-flexible mandates; these typically held larger positions in below-investment-grade debt, with many venturing into emerging-markets debt and non-U.S.-dollar debt and currencies. Funds in these two subgroups tend to behave dissimilar in different market environments and offered investors contrasting risk/reward trade-offs. Morningstar explained that the reason for its change was to provide investors with clearer expectations for risk and performance and to create more homogeneous bond fund classifications.[1]

> Prior to the divide by Morningstar, investors may not have been aware of the different levels of risks in the intermediate bond fund category.

New Category Descriptions

Intermediate Core Bond portfolios invest primarily in investment-grade U.S. fixed-income issues, including government, corporate, and securitized debt, and typically hold less than 5% in below-investment-grade exposures. Their durations (a measure of interest-rate sensitivity) typically range between 75% and 125% of the three-year average of the effective duration of the Morningstar Core Bond Index.

Intermediate Core Plus Bond portfolios invest primarily in investment-grade U.S. fixed-income issues, including government, corporate, and securitized debt, but generally have greater flexibility than core offerings to hold noncore sectors such as corporate high yield, bank loan, emerging-markets debt, and non-U.S. currency exposures. Their durations (a measure of interest-rate sensitivity) typically range between 75% and 125% of the three-year average of the effective duration of the Morningstar Core Bond Index.

Morningstar's stated key differences between the two: By definition, funds in the Core Bond category typically hold less than 5% in below-investment-grade debt, so these funds tend to have credit-quality profiles that skew more heavily to the higher-rated tiers of the market. The categories look more similar when it comes to duration and interest-rate sensitivity. Size: The new categories include about 140 funds in the Core Bond category reflecting approximately $830 billion in assets, while the Core Plus Bond category was reported to house about 190 open-end and exchange-traded funds totaling around $720 billion in assets.[1] When viewed through the active/passive lens, active funds represent 37% of Intermediate Core Bond vs. 100% for Intermediate Core Plus.

Why does it matter and what does it mean for investors?

Prior to the divide by Morningstar, investors may not have been aware of the different levels of risks in the intermediate bond fund category.

After the reclassification of funds into these two new categories, investors may be surprised to find that they are overweight in the Core Plus category and underweight in the Core category. As a result, dividing the old category could cause investors and their advisors to reevaluate their allocations based on desired risk/return profile.

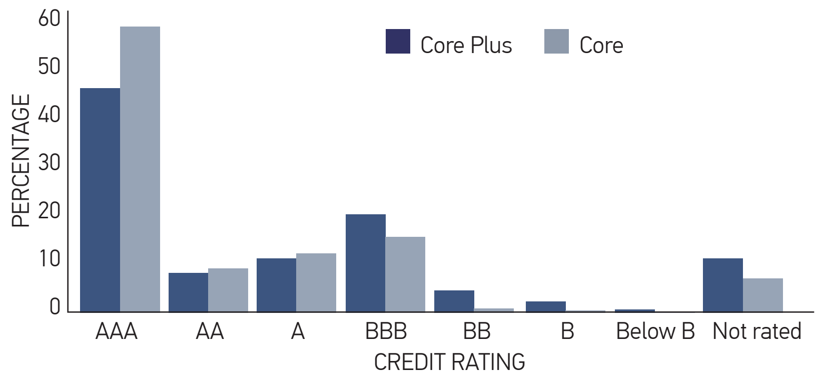
A closer look at two factors: credit quality and exposure to emerging markets.

Based on Morningstar Direct Cloud data, and illustrated in Figure 1, Intermediate Core Bond strategies have a clear bias toward AA-rated debt, which constitutes an average of 57% of their portfolios according to this calculation. In contrast, Intermediate Core Plus Bond funds average approximately 45% in AAA debt. At the same time, Core Plus funds hold an average of 19% in BBB-rated debt, compared with less than 15% for Core funds.

Figure 1

NEW MORNINGSTAR CALCULATED CREDIT QUALITY AS OF 05.01.2019

Average percentage of portfolio, calculated credit quality



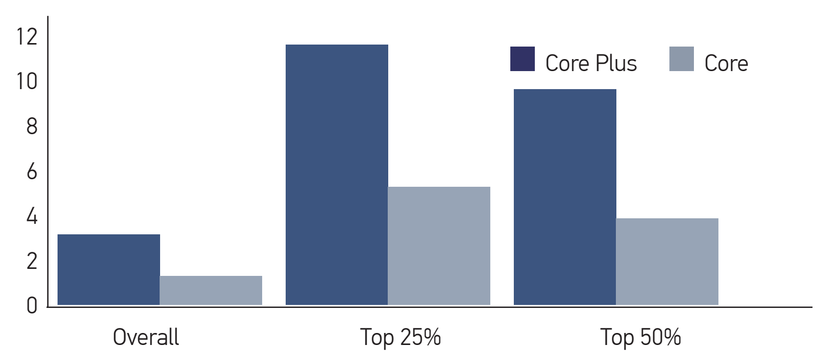
Source: Morningstar Direct

> By definition, funds in the Core Bond category typically hold less than 5% in below-investment-grade debt.

Non-U.S. debt and emerging-markets debt asset allocations can be a further differentiator between funds in these two categories. For emerging-markets bonds, the averages are not vastly different — 3.2% for Core Plus and 1.3% for Core — but the upper end of the ranges when it comes to weightings of emerging-markets bond holdings reflects the contrast. The following chart (Figure 2) shows the average weighting, plus the average for those in the top half of the group and in the top quartile.

Figure 2

AVERAGE PERCENT OF PORTFOLIO IN EMERGING-MARKET DEBT



Source: Morningstar Direct

How does the Sterling Capital Total Return Bond Fund fit into the new Morningstar categories?

The new intermediate bond categorization resulted in changes to Morningstar's ratings. Morningstar ratings were recalculated for funds reflecting their new categories based on April 30, 2019 data. As a result, the Sterling Capital Total Return Bond Fund (BIBTX, institutional share class) received an overall 5 star rating from Morningstar for the Intermediate Core Bond category based on risk-adjusted returns against 358 Intermediate Core Bond Funds as of 04.30.2019.

With almost 50 years of experience in active fixed income management, the success of the Sterling Capital Total Return Bond Fund reflects an unwavering commitment to finding the best, most durable investment opportunities for investors under any market conditions.

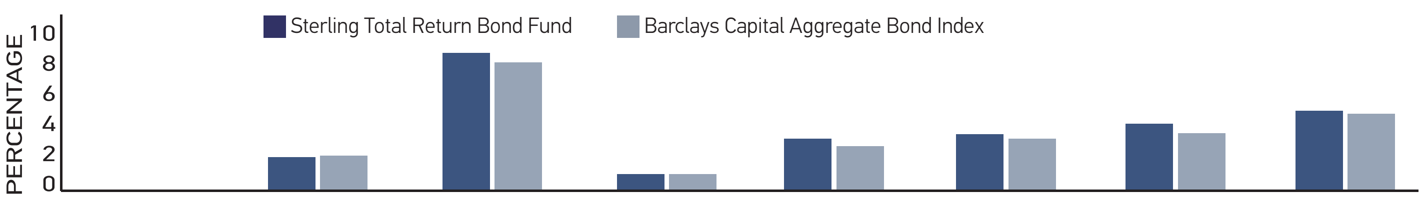
Sterling's team-managed approach employs a multi-faceted strategy that begins with a broad, top-down view of the global economy. Our projections for growth, inflation and monetary policy drive big picture decisions, while detailed qualitative and quantitative analyses of industries, companies, and security structures steer our analysts towards instruments that will outperform. Due to the inherently asymmetric risk/return profile of fixed income investing, the team places a special emphasis on risk management, whereby the potential return of any investment is considered only after a thorough assessment of the risks involved. The Sterling Capital investment team firmly believes in avoiding unintended exposures, managing towards consistent risk-adjusted performance over time and the idea that "if you cannot measure it, you cannot manage it" when it comes to risk.

The Sterling Capital Total Return Bond Fund demonstrates our unwavering commitment and consistent approach to actively managing fixed income investments (see Figure 3).

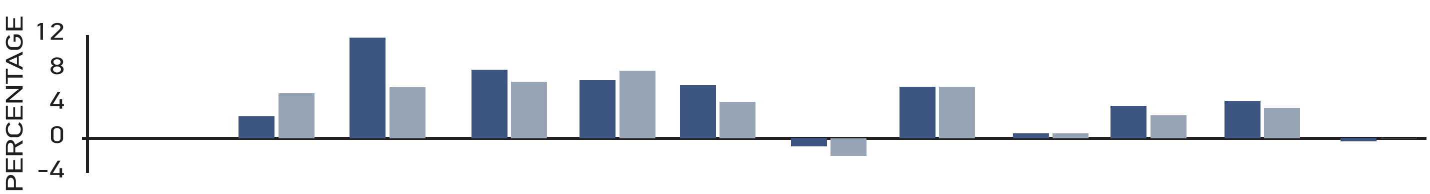
The Sterling Capital Total Return Bond Fund Seeks to Provide Consistency Where it Matters Most — In your Core Allocation

Figure 3

PERFORMANCE CONSISTENCY AS OF 09.30.2019



Performance	QTR	YTD	1 Year	3 Years	5 Years	10 Years	Since Inception
Inst'l Shares	2.16%	9.13%	10.27%	3.40%	3.71%	4.38%	5.28%
Index	2.27 %	8.52 %	10.30%	2.92%	3.38%	3.75%	5.05 %



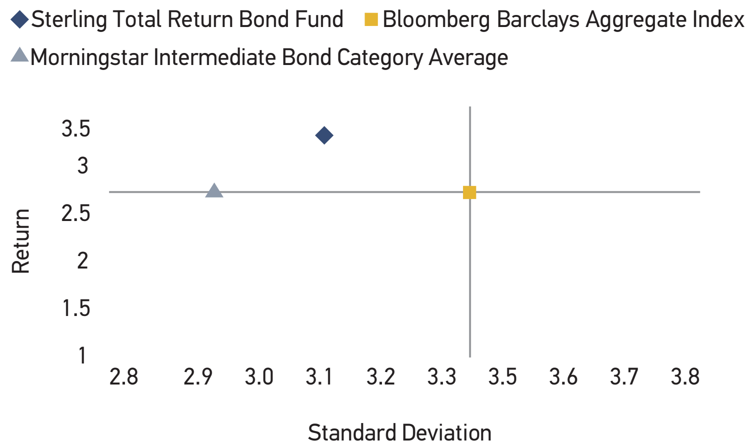
Year-End Returns	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
Inst'l Shares	2.53%	11.70%	7.98%	6.73%	6.14%	-0.97%	5.99%	0.54%	3.75%	4.34%	-0.35%
Index	5.24%	5.93%	6.54%	7.84%	4.21%	-2.02%	5.97%	0.55%	2.65%	3.54%	0.01%

As of 09.30.2019. Performance greater than 1 year is annualized. Source: BNY Mellon; Morningstar Direct; Bloomberg Barclays Capital; Sterling Capital Management Analytics. **Past performance does not guarantee future results. The performance data quoted represents past performance and current returns may be lower or higher. The investment return and principal value of an investment will fluctuate so that an investor's shares, when redeemed, may be worth more or less than the original cost. To obtain performance information current to the most recent month end, please visit www.sterlingcapital.com. The inception date for Institutional Shares is 12.02.1999. The performance shown reflects the reinvestment of all dividend and capital gains distributions.**

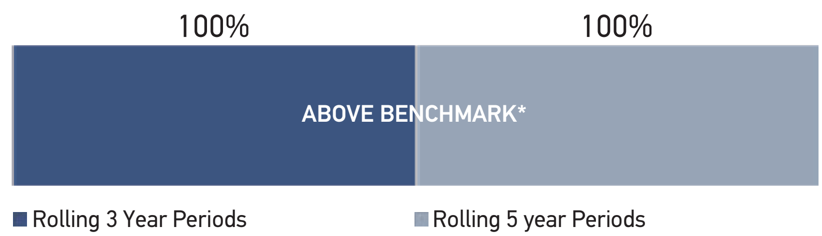
> Sterling Capital Total Return Bond Fund (BIBTX) received an overall 5 star rating from Morningstar for the Intermediate Core Bond category.

The Fund is Designed to Deliver Results Without Surprises. By Focusing on Risk Management, Diversification and Capital Preservation

3 YEAR RISK & RETURN AS OF 09.30.2019



10 YEARS ENDING 09.30.2019 ABOVE BENCHMARK



*Benchmark is Bloomberg Barclays US Agg Bond TR USD The performance consistency graph displays the "frequency" with which the portfolio outperformed the benchmark over rolling periods using quarterly data. Source: Bloomberg Barclays, Sterling Capital Management Analytics.

Morningstar US Fund Intermediate Core Bond Category Based on Risk-Adjusted Returns as of 09.30.2019	Overall Ratings	1 Year	3 Years	5 Years	10 Years
Institutional Shares Morningstar Rating™	★★★★★	—	★★★★★	★★★★★	★★★★
Morningstar Ranking/Number of Funds in Category	356	97/403	18/356	18/312	26/238
Morningstar Quartile (Percentile)		2nd (27%)	1st (7%)	1st (6%)	1st (13%)

ABOUT STERLING CAPITAL MANAGEMENT

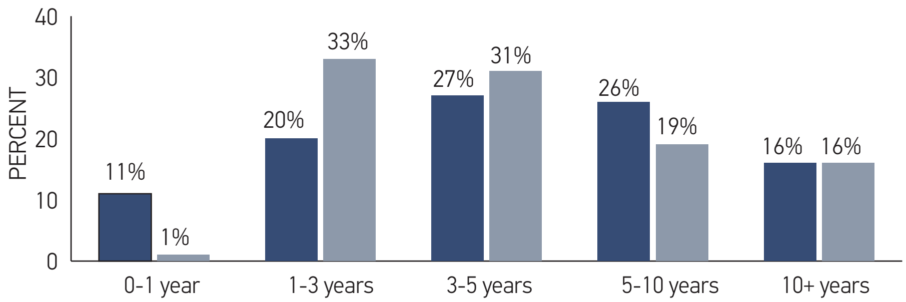
Sterling Capital Management LLC is a registered investment advisor founded in 1970, with $58 billion in assets under management. The firm is an independently operated subsidiary of BB&T Corporation, one of the nation's largest financial services holding companies. Headquartered in Charlotte, NC, Sterling Capital is comprised of more than 160 professionals located in Charlotte and Raleigh, NC; Philadelphia, PA; Richmond and Virginia Beach, VA, Washington, DC; and San Francisco, CA.[3]

With almost 50 years of experience in active management, our results and investment expertise reflect an unwavering commitment to finding the best, most durable investment opportunities for our clients in the years ahead.

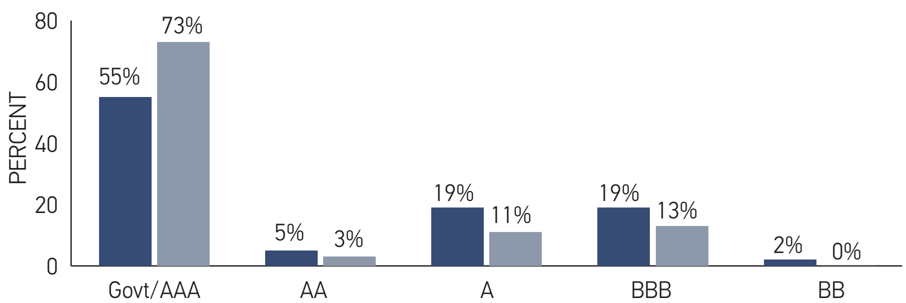
Sterling Capital offers investment services across a variety of asset classes and structures such as Fixed Income, Equity, and Multi-Asset Class solutions. At Sterling Capital, we are dedicated to providing strong risk-adjusted investment returns and exceptional client service for a diverse group of institutional and private clients. ■

> Adhering to the principle of "know what you own" is deeply embedded in Sterling's approach to active fixed income management.

DURATION COMPOSITION



CREDIT QUALITY



Charts above: Data as of 09.30.2019. Source: Sterling Capital Management Analytics, Bloomberg Barclays Capital, BNY.

Conclusion

- It is important to remember that both Core Bond funds and Core Plus Bond funds are still similar in many aspects in the new categories. In addition to understanding the new Morningstar categories, investors and their advisors should continue to take each fund's underlying sectors and exposures into consideration.
- At Sterling Capital, we deeply believe in adhering to the principle of "know what you own." We believe that investors and advisors have the opportunity to use the new Morningstar categories to further differentiate between fund offerings and potentially better calibrate their fixed income allocations.
- Sterling Capital has built a highly-collaborative team of fixed income experts and grown its reputation for its bond and credit expertise since 1970, managing over $36 billion in active fixed income assets as of September 30, 2019.
- Morningstar's stated intention to create categories containing a more homogenous set of bond funds could make it easier for investors and advisors to evaluate the performance and risk of like portfolios and select fund managers that are optimally-aligned with their objectives — owning bond funds that behave like bond funds.

[1] Source: Morningstar Inc., "Introducing Two New Morningstar Bond Categories," 05/02/2019. https://www.morningstar.com/articles/926636/introducing-two-new-morningstar-bond-categories.

[2]Ratings would have been lower for Class A shares due to fees and expenses.

Morningstar rankings are based on total return, including the reinvestment of dividends and capital gains but do not include sales charges for the periods indicated. Rankings shown are for Class I Shares and may be lower for Class A Shares due to higher fees and expenses. Mutual funds are assigned a rank within a universe of funds, relative to a peer group and similar in investment objective as determined by Lipper and Morningstar. The lower the number rank, the better the fund performed compared to other funds in the classification group. Lipper and Morningstar also calculate a percentile measure for each fund ranging from 1% (best) to 100% (worst).

The Morningstar Rating™ for funds, or "star rating", is calculated for managed products (including mutual funds, variable annuity and variable life subaccounts, exchange-traded funds, closed-end funds, and separate accounts) with at least a three-year history. Exchange-traded funds and open-ended mutual funds are considered a single population for comparative purposes. It is calculated based on a Morningstar Risk-Adjusted Return measure that accounts for variation in a managed product's monthly excess performance, placing more emphasis on downward variations and rewarding consistent performance. The top 10% of products in each product category receive 5 stars, the next 22.5% receive 4 stars, the next 35% receive 3 stars, the next 22.5% receive 2 stars, and the bottom 10% receive 1 star. The Overall Morningstar Rating for a managed product is derived from a weighted average of the performance figures associated with its three-, five-, and 10-year (if applicable) Morningstar Rating metrics. The weights are: 100% three-year rating for 36-59 months of total returns, 60% five-year rating/40% three-year rating for 60-119 months of total returns, and 50% 10-year rating/30% five-year rating/20% three-year rating for 120 or more months of total returns. While the 10-year overall star rating formula seems to give the most weight to the 10-year period, the most recent three-year period actually has the greatest impact because it is included in all three rating periods.

[3]Data as of 09.30.2019.

Investment Considerations

Investors should consider the investment objectives, risks, charges and expenses carefully before investing. For a prospectus with this and other information about the Fund, please call (888) 228-1872 or visit our website at www.sterlingcapital.com. Read the prospectus carefully before investing.

The fund is subject to the same risks as the underlying bonds in the portfolio such as credit, prepayment, call and interest rate risk. As interest rates rise the value of bond prices will decline. The fund may invest in more aggressive investments such as foreign securities which may expose the fund to currency and exchange rate fluctuations; derivatives (futures and swaps); mortgage backed securities sensitive to interest rates and high yield debt (also known as junk bonds), all of which may cause greater volatility and less liquidity. Derivatives may be more sensitive to changes in market conditions and may amplify risks.

Credit quality ratings using S&P's ratings symbols reflect the credit quality of the underlying bonds in the fund portfolio and not of the fund itself. Securities are rated by S&P's, Moody's and Fitch; when ratings vary the highest rating available for each security is applied. Credit quality ratings are measured on a scale that generally ranges from AAA (highest) to D (lowest). "NR" is used to classify securities for which a rating is not available. Bond quality ratings are subject to change. Allocations are based on the current weight to funds in the cited category. The composition of the fund's holdings is subject to change.

Technical Terms

Effective Duration: A calculation of the average life of individual bonds within a bond fund, and serves as a useful measure of the entire portfolio's sensitivity to rising and falling interest rates. An Effective Duration of 2.00 means that with a 1% decline in interest rates, the principal value should rise by 2%, and vice versa.
Standard Deviation: Standard deviation is a statistical measurement in finance that, when applied to the annual rate of return of an investment, sheds light on the historical volatility of that investment. The greater the standard deviation of securities, the greater the variance between each price and the mean, which shows a larger price range.

Bloomberg Barclays U.S. Aggregate Bond Index is an unmanaged index composed of 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. It is not possible to invest in the Bloomberg Barclays U.S. Aggregate Bond Index, which is unmanaged and does not incur fees and charges.

Barclays Capital Aggregate Bond Index, also known as "the BarCap Aggregate," is an unmanaged broad bond index covering most U.S. traded bonds and some foreign bonds traded in the U.S. The BarCap Aggregate was once known as the Lehman Brothers Aggregate Bond Index. It is not possible to invest in the Barclays Capital Aggregate Bond Index.

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WHAT MATTERS MOST TO YOU MATTERS MOST TO US

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