Getting Big through Betting Small

Believe it or not, there are bond funds that don't really care about the level of interest rates. This strategy has worked quite well for Phoenix Multi-Sector Short Term Bond Fund, which takes only small bites of risk in a diversified fashion. Achieving consistent returns in any interest rate environment, manager David Albrycht thinks the key is active sector rotation and granularity.

Q: ***Would you describe your investment philosophy?***

A: Our philosophy is grounded on active sector rotation combined with a disciplined risk management process and security selection. We believe that this is the most effective way to achieve excess returns in the fixed income market. We select holdings from a universe of up to 12 bond market sectors, which include traditional sectors in the Lehman Brothers Aggregate Bond Index. The additional ones include core plus sectors, such as high-yield bonds, emerging markets debt, and non-dollar securities.

Q: ***What is your priority when managing your clients' money? Is it preservation of capital or aggressive growth?***

A: For this short duration fund our primary objective is preservation of capital through stability of NAV. Competitive income, combined with achieving total return would be secondary objectives. The cornerstones of our philosophy are consistency, risk-adjusted returns and preservation of capital.

The most important attribute of our style probably is the duration neutral approach. We prefer sector rotation rather than interest-rate anticipation. We have similar risk to the benchmark and the peer group, adding value through the active sector rotation. Two-thirds of our attributions come from sector selection and one-third from issue selection.

Q: ***Why is being duration neutral of such of high importance in your philosophy?***

A: We've seen many funds that have great sector calls and great issue selection but lack the consistency and stability of our fund because they make duration bets. Being duration neutral has worked unbelievably well; we are recognized by Lipper for consistency of returns over the last decade.

Making huge duration bets is inconsistent with our philosophy of preservation of capital and consistency of risk adjusted returns. Our expertise is identifying sector valuations and then trying to hit singles and doubles with issue selection as opposed to trying to manage the duration based on where we think the market is going.

Q: ***Is tax efficiency part of your objectives?***

A: The short duration fund is one of the most tax-efficient products over the last decade, but that wasn't our main ob-

Phoenix Multi-Sector Short Term Bond

Fund Facts

Symbol	NARAX
Website	www.phoenixinvestments.com
Address	Phoenix Investment Partners 56 Prospect Street, Hartford, CT 06115
Tel. No.	800-243-4361
Inception	7/6/92

Portfolio

Total Net Assets *	$ 693.4
Avg Mkt Cap ($ Weighted) *	N/A
Average Price/Earnings Ratio	N/A
Average Price/Book Ratio	N/A
Turnover Ratio	95 %

Investment Information

New Investment	Open
Min Initial Investment	$ 500
Min Subsequent Investment	$ 25
Min Initial IRA Investment	$ 25

Risk (Against Lehman Aggregate Bd - 3 Years)

Alpha	0.25
Beta	0.63
R-Squared	N/A
Ann Std Deviation	3.01
Sharpe Ratio	1.46

Returns vs. Lipper Short-Interm Inv Grd

	NARAX	Index
1 Year (Cum.)	3.65 %	2.30 %
3 Year (Ann.)	6.19 %	3.68 %
5 Year (Ann.)	6.58 %	5.40 %

Returns vs. Lehman Aggregate Bd

	NARAX	Index
1 Year (Cum.)	3.65 %	4.15 %
3 Year (Ann.)	6.19 %	4.88 %
5 Year (Ann.)	6.58 %	6.98 %

Fees and Expenses

Max Sales Charge - Front	2.25 %
Max Sales Charge - Deferred	0.00 %
Max Redemption Fee	0.00 %
Total Expense Ratio	1.03 %

Portfolio Manager

David L. Albrycht	Jul-1993

* *millions*

Data through: 08/31/05

Source: Company Documents; Lipper

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jective. It is a by-product of our sell discipline. In the last four years of a volatile credit environment, when we have monitored prices on a weekly and monthly basis, we are better sellers, i.e. before bad news and downward price movement occur. This approach has generated small taxes carried forwards.

Q: ***How do you implement this philosophy in your strategy?***

A: We are value-driven, research-intensive and opportunistic. We employ active management by selecting sectors and securities which we believe represent the best value, focusing on core-like sectors to add value. We tactically use core-plus sectors to add alpha, tightly controling portfolio risk through a variety of means. Unlike a lot of our competitors, who would use 3 to 5 sectors in style management, we use all twelve.

Nimbleness and granularity are concepts that make a huge difference in this environment. In 1996 when everything went up, you could make a horrible selection of issues and still do well. From 1999 to 2003, issue selection was of utmost importance but granularity gives you the ability to have a few bad calls without blowing up your portfolio.

The focus on liquidity is of utmost importance. Purchasing benchmark issues if you are buying foreign, staying in the sovereign names, buying securities that are senior in the capital structure and have better liquidity. When you have liquidity, you can really employ sell discipline.

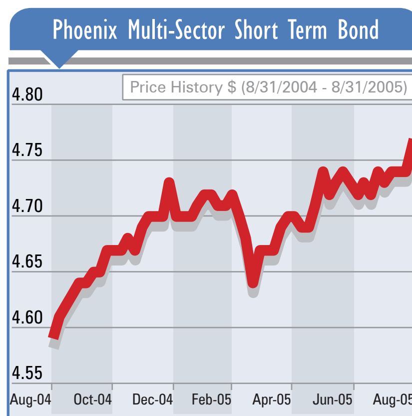
Q: ***What constitutes your core group and how do you monitor it?***

A: Our core sectors include those of the Lehman Brothers Aggregate Bond Index: US government securities, treasuries, agency mortgage-backed Ginnies and Fannies, investment grade corporate bonds, investment grade Yankee bonds, investment grade Brady US dollar-denominated foreign issuers, commercial mortgage-backed securities, asset-backed securities, and taxable munis.

There are also some securities that are not necessarily in the index, but we still feel they are core sectors. Those would include some non-corporate bonds, some non-agency mortgage securities that don't qualify for Fannie and Ginnie guarantees, munis when they make sense on a total return basis. The extended bond universe, or the enhanced core with alpha adders would include high-yield bonds, emerging markets debt and non-dollar securities.

Q: ***Could you tell us more about your research process as part of the portfolio construction process?***

A: Our investment process relies on intensive fundamental analysis and disciplined risk management. There are 4 essential steps - sector analysis and sector allocation as the primary driver of performance and fundamental research and issue selection being second. Through those steps we generate portfolio construction and risk management portfolio oversight.



We have 12 sector managers who have been with us for a decade or more and 26 investment professionals broken up by sectors. We bonus everybody on the team based on composite results rather than assets under management. In that way people do not try to push the exposure to their sector higher, because they will be paid even if they suggest zero exposure to their sector at a certain time.

Sector allocation begins with an analysis of all sectors. We try to establish relative value among the sectors and to identify where the greatest value opportunities are. Next we look at supply and demand and estimate the impact of these trends on yield spreads and prices. Then we analyze the instrument environment and its impact on various sectors of the market. Based on relative value, we establish target portfolio allocation percentages for each sector, emphasizing the sectors we believe are undervalued.

Q: ***How do you identify new investments?***

A: The new idea generation begins with the analyst or the trader and often is in some type of collaboration. The analyst who is the industry specialist becomes aware of the new issues and we begin researching them for suitability. The trades would be in part dictated by particular market opportunities and are brought to the analyst for further review and to the portfolio manager for final approval.

If we identify a prospective investment, we perform a highly detailed review to assess its suitability for individual portfolios. A lot of people are responsible for a variety of factors: credit risk, industry analysis; rating developments and daily pricing; management review; issue structure and so forth. Technical market conditions are another important aspect. They include supply and demand, mutual funds, individual hedge funds, etc. A specific issue analysis is always placed in the context of the industry and the sector in order to assess relative value.

Q: ***Would you describe your risk management process?***

A: Risk is something that we manage very tactically. We actively rotate the 12 sectors based on relative value. When we utilize the less efficient credit-like sectors, we try to avoid risk by staying in more benchmark, more liquid issues. But the cornerstone is granularity or small position sizes. Half a percent or a quarter of percent is not going to devastate your portfolio. We stay well-diversified by issuer with most positions averaging less than 1%; with those less liquid names we take even smaller positions.

We avoid interest rate risk by trying to neutralize it. We match portfolio duration to our benchmark and match yield curve distribution to the benchmark and avoid

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significant pre-payment or call risk. We use derivatives strategically, not for yield enhancement. We hedge currencies when appropriate for the shareholders and for dollar price management.

The portfolio review is another method of oversight. We have standard portfolio reviews, sector reviews & sector allocation meetings, making them formal and mandatory on a monthly basis. We review daily anything that is out of realm or has big price swings. Anytime we purchase a credit that's below AA, we have a formal review and require a full-blown write-up.

Q: ***Some fund managers start with a macro view and then construct the portfolio along those lines, others start with a bottom-up analysis. Where do you stand?***

A: It is a combination between the two. Our top-down approach is the sector analysis and allocation; our bottom-up is the fundamental research, which is issue selection. We have a macro overview, but since we don't anticipate interest rate moves, it is based on sector bets. As we construct the portfolio, both of the approaches are based on relative value.

The disciplined sell strategy is an essential part of our portfolio construction process. Our sell decisions are driven by relative value. If the fundamentals deteriorate, or the price has appreciated too greatly, the security becomes a candidate for a valuation review and possible sale.

Q: ***One of the difficulties in investing in fixed income has been relying on rating agencies. How do you handle this difficulty?***

A: We actually have set up a rating database here. When we look at a credit, we attach a score internally. We overlay relative value to better identify credits and to see if the market is already pricing based on what we found about from the rating agencies and the security. But you are right. Often you would have a credit for which there is troublesome news and the rating agencies would lag. And in the last credit cycle we saw some of them downgrading first on bad news and asking questions later. So you need your own proprietary research, which for us is about 70-80%.

Q: ***Can you give us an example of picks that have worked out and picks that haven't worked out? How did you change your process?***

A: One screen that worked out was on Fleming Companies. There was negative price movement and the credit analyst could not find any solid concrete evidence on what was going on. We looked at the credit derivatives market as a second overlay and saw that spreads were dramatically wider than the cash market, which typically means that there was some news that we weren't privy to. We sold the underlying position and a week later their main purchaser of the food wholesale business went bankrupt.

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about David Albrycht

Mr. Albrycht, CFA serves as the senior portfolio manager for the Phoenix Multi-Sector Short Term Fund and The Phoenix Low Duration Core Plus Bond Fund. In addition he manages the fixed income portions of the Phoenix Balanced Fund, Phoenix Balanced Return Fund, Phoenix Strategic Allocation Series and the Phoenix Income and Growth Fund. He is a senior managing director, fixed income and has managed fixed income portfolios since 1992.

On the other side, right now the autos are getting very cheap for their rating from a valuation perspective. Market technicals dictated change as opposed to pure fundamentals and the auto companies, which are investment grade rated, are trading as CCC credit. For our model this is a huge buy signal, however, when we set down to discuss the purchase, nobody felt comfortable adding the position, knowing that they could easily go to below investment grade. So we had to revise our process. The model said buy, but there were other factors to be considered out of our normal process.

Some of the mistakes that we've made include being too model-like or too systematic, where spreads widening 15 basis points signal that the sector is cheaper and we feel that we have to increase our position. However, sometimes we haven't been able to act on that because we couldn't find something that we liked. Just because something is cheaper doesn't mean that it is a buy.

Q: ***I may be wrong, but my experience is that the U.S. inflation rates measurements tend to be incomplete and do not include some of the major components of inflation as they would in some other countries. How do you counter this situation?***

A: I agree. I think that CPI is not a good benchmark of overall inflation. Two-thirds of the CPI is wage inflation, which because of productivity enhancements, is not existent. Healthcare, commodity inflation, and housing prices aren't truly reflected in the CPI. But there are ways to hedge yourself and take advantage of this. When we see it, we call for a sector allocation meeting and potentially allocate more to the inflation-protected securities, both government and corporate. ▮

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