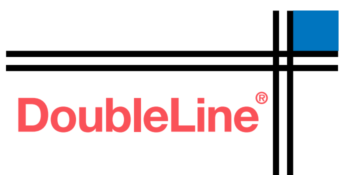


DoubleLine Income Fund:
Mining Structured Credit for Incremental Yield, Duration Management and Diversification

Ken Shinoda, DoubleLine Portfolio Manager | September 30, 2021

Fixed income investors face tough times. Not only are yields on the safest bonds, U.S. Treasuries, near historic lows, but with inflation running hotter in more than a decade, real yields are negative. Of course, this notion of safety is in the eye of the holder – of Treasuries! To earn a higher yield from Treasuries, investors must venture further out along the maturity curve and, by definition, assume more interest rate risk. Understandably, some investors might shy away from such a move. Inflation, transitory or otherwise, GDP growth and other gauges suggest yields would be higher were the Federal Reserve not scooping up bonds with both hands. As a result, income-seeking mutual fund investors have flocked into two areas of corporate credit, both of which offer incremental yield over Treasuries: high yield bonds, which historically have low interest-rate sensitivity, and bank debt, whose floating-rate nature offsets rising interest rates.

The rush into corporate credit has largely overlooked a complementary market: structured credit. This asset class includes private-label residential mortgage-backed securities (RMBS); commercial mortgage-backed securities (CMBS); other asset-backed securities (ABS), such as securitizations of aircraft leases, credit card receivables and student loans; and collateralized loan obligations (CLOs). These subsectors of structured credit offer attractive incremental yields, in particular relative to their interest rate sensitivity. Furthermore, structured credit is secured to collateral distinct from the balance sheets of single-name corporate issuers, offering meaningful diversification.

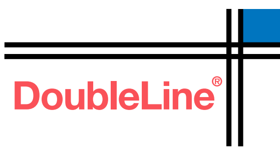
In this commentary, I'll describe the composition of the structured credit universe and the factors that make this asset class an attractive investment for incremental yield. With these factors in mind, investors can use structured credit exposure to serve in several roles: as a partner to below-investment-grade corporate credit within an allocation for incremental yield; as a stand-alone allocation for incremental yield; or as the credit-risk half of a barbell to the investment grade anchor of a diversified fixed income portfolio. Then from theory to practice, I will discuss the implementation of structured credit in the portfolio construction aimed at achieving our objectives for yield, return and risk management for the DoubleLine Income Fund (I shares DBLIX; N shares DBLNX).

Away From the Duration for Yield Trade-Off

Duration measures the sensitivity of a bond's price to changes in interest rates. A higher duration generally indicates the price of a bond will exhibit greater sensitivity to changes in interest rates. In other words, if interest rates rise, longer-duration bonds should decline more in price than shorter-duration bonds.

Unsurprisingly, given more than a decade has passed since the last default cycle, U.S. investors in search of yield, but averse to interest rate risk, have allocated to the corporate credit markets in the months since the COVID-19 pandemic took hold. Broadly speaking, the two most popular markets for U.S. investors looking for credit exposure and incremental yield are the U.S. high yield and bank loan markets. Both markets are rated below investment grade, and they have historically offered similar yields, albeit with distinct differences in interest rate sensitivity. The duration of the high yield market, whose securities bear fixed coupons, has historically ranged from three to four years. Bank loans are floating rate and thus face virtually no interest rate risk. U.S. high yield bond and bank loan mutual funds, according to estimates by the research firm Morningstar, had net inflows of $53.6 billion since the onset of the pandemic (April 2020 through August 2021).

Viewed through the rear-view mirror, below-investment corporate credit has been a good place to be in 2021. High yield bond and bank loan markets have generated positive returns year-to-date, as credit spread compression, incremental yield and low to no duration offset any price depreciation due to rising interest rates. But other fixed income markets at present offer a competitive yield-to-duration proposition and can add diversity to offset or complement investors' exposures to below-investment grade corporate credit.



DoubleLine Income Fund:
Mining Structured Credit for Incremental Yield, Duration Management and Diversification

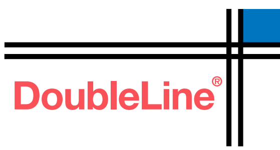
Ken Shinoda, DoubleLine Portfolio Manager | September 30, 2021

The structured credit universe includes non-Agency (aka private-label) RMBS and CMBS, ABS and CLOs, which offer attractive yields with limited interest-rate risk and can add diversification benefits to a portfolio when grouped with corporate bonds. Unlike corporate bonds, which are backed by the creditworthiness of companies, structured credits are typically backed by pools of loans (e.g., residential mortgages) with stable cash flows and often collateralized by hard assets. Moreover, these are large markets in terms of outstanding debt, and they cover a diverse universe of collateral exposed to consumer and commercial sectors of the U.S. economy. *(Figure 1)*

I should add that structured credit represents a subset of structured product, which in addition to the aforementioned securitizations of credits refers to Agency mortgage-backed securities (MBS), including both pass-throughs and collateralized mortgage obligations (CMOs). Agency pass-through MBS and Agency CMOs represent securities guaranteed by agencies of the federal government (e.g., Ginnie Mae) or by government-sponsored entities (e.g., Fannie Mae and Freddie Mac), and thus, to the extent one trusts the explicit or implicit backing of the U.S. government, pose no credit risk.

Subsector	Agency Mortgage-Backed Securities	Commercial Mortgage-Backed Securities	Asset-Backed Securities	Collateralized Loan Obligations	Non-Agency Residential Mortgage-Backed Securities
Market Size	**$6.8 Trillion**	**$1.4 Trillion**	**$0.8 Trillion**	**$0.7 Trillion**	**$0.6 Trillion**
Underlying Assets	Residential mortgage loans backed by the federal government directly in the case of GNMA or by government-sponsored entities	Mortgage loans backed by commercial real estate properties including but not limited to: office, industrial, hospitality, retail and multifamily	Receivables including secured and unsecured consumer loans, and other cash-flowing assets	Diversified portfolios of actively managed U.S. floating-rate bank loans	Single-family residential mortgage loans or other mortgage-related assets not backed by the federal government
Positive Factors	• Additional yield over U.S. Treasuries • Typically lower volatility through time than Treasuries and corporate bonds • Historically perform well amid rising rates	• Variety of subsectors to invest in to gain exposure to certain segments of the commercial real estate market • Gain exposure to nonconsumer-based assets	• Variety of sub-sectors to invest in to gain exposure to different segments of the economy • Resilient U.S. consumer • Hard-asset investments	• Active management of the collateral pool over time • Historically resilient capital structures • Alignment of interest with equity and managers	• Strong housing market driven by low supply, high demand and increased affordability • Resilient U.S. consumer

Figure 1
Source: DoubleLine



DoubleLine Income Fund:
Mining Structured Credit for Incremental Yield, Duration Management and Diversification

Ken Shinoda, DoubleLine Portfolio Manager | September 30, 2021

Evolution of Structured Credit: Underwriting of Collateral and Capital Structures

As we know, dubious underwriting of residential mortgages and inadequate structuring of the deals that securitized that collateral formed key fault lines leading to the Global Financial Crisis (GFC). More than a decade has passed since the depths of the GFC in 2008-2009. Structured products have evolved following that turmoil. The securities issued post-GFC benefit from stronger underwriting standards, stricter rating agency criteria and skin in the game for issuers under rules in place since December 2015 under the Dodd-Frank regulatory regime.

The strengthening of structured credit has occurred both at the bottom-up level of the individual loans composing the collateral pools and from the top-down perspective of the securitization structures backed by these pools. Take RMBS, for example. Post-GFC underwriting of residential mortgage loans has on average higher credit scores as well as lower loan-to-value and debt-to-income ratios relative to pre-GFC underwriting.

At the deal level, for a bond to receive a given rating (e.g., AAA, AA, A, BBB, BB) from the rating agencies, the safety, i.e., the amount of loss that the collateral pool must absorb before that bond takes a first dollar loss, has increased post-GFC. *(Figure 2)* Then there is issuer skin in the game. Pre-GFC, securitizers of loan pools could sell off all the risk upon issuing bonds. For certain types of assets, issuers must now keep at least 5% of the risk, giving them ongoing credit exposure to the deal. Together, these changes have generally increased the credit quality of the structured credit market.[1]

Hypothetical RMBS Capital Structures, Pre- and Post-Global Financial Crisis

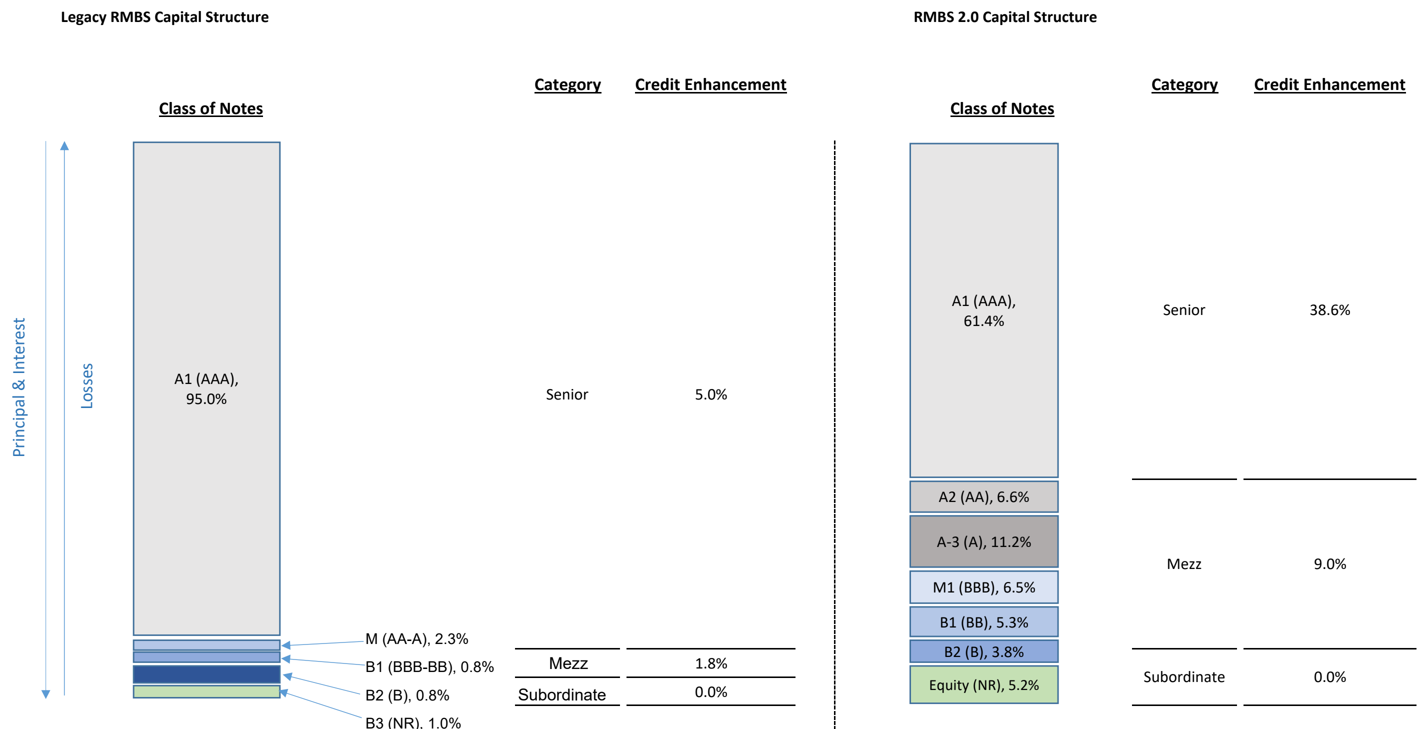
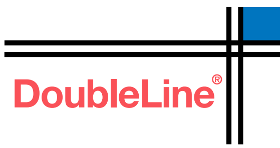


Figure 2
Source: DoubleLine



DoubleLine Income Fund: Mining Structured Credit for Incremental Yield, Duration Management and Diversification

Ken Shinoda, DoubleLine Portfolio Manager | September 30, 2021

The capital structures of CMBS deals have undergone similar credit enhancements in the wake of the GFC.[2] *(Figure 3)*

Hypothetical CMBS Capital Structures, Pre- and Post-Global Financial Crisis

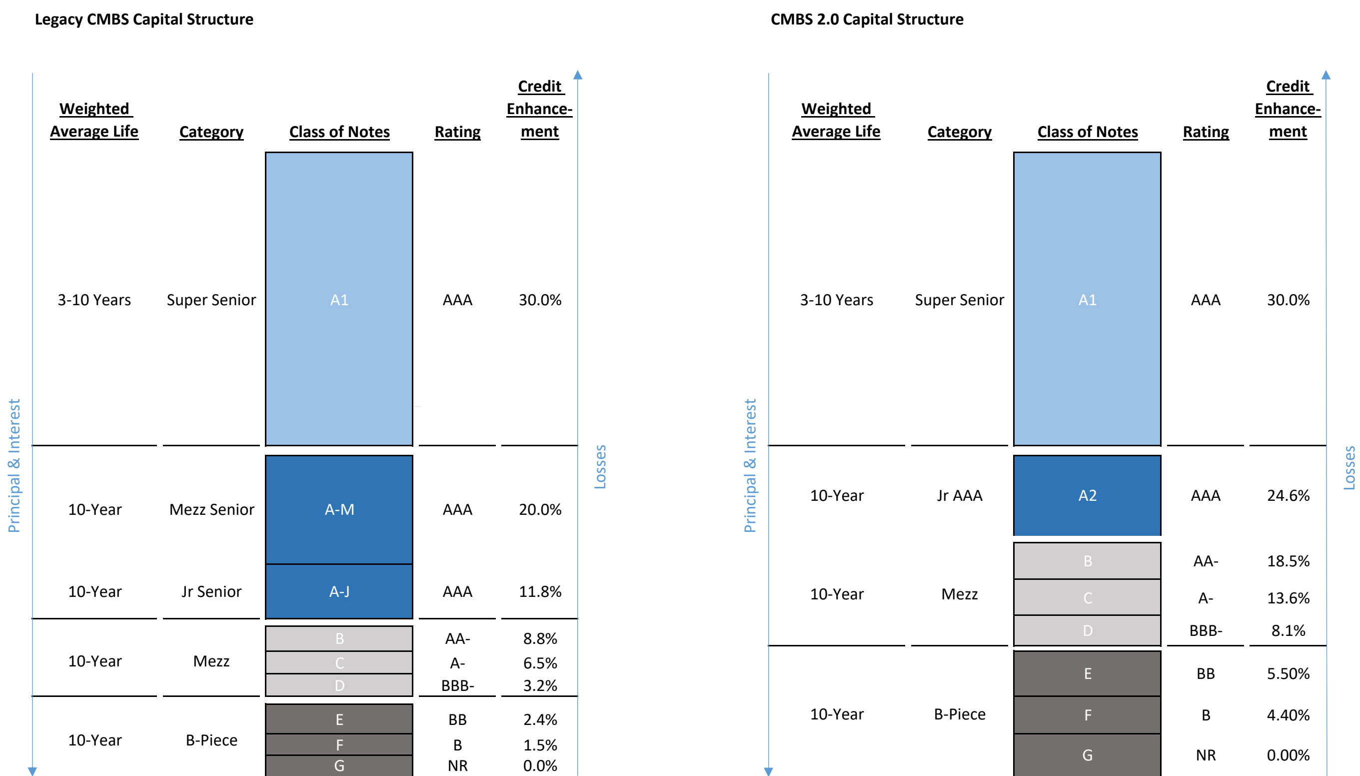
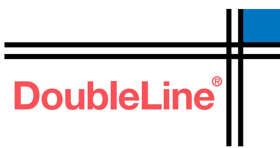


Figure 3
Source: DoubleLine

Active Management Through the DoubleLine Income Fund

The DoubleLine Income Fund provides investors with a one-stop solution to gain access to the higher-yielding parts of the structured products market. DoubleLine's seasoned investment professionals have decades of experience investing in these markets through many cycles and various interest-rate environments. Over the years, DoubleLine has developed a rigorous and time-tested investment philosophy and process, implemented by dedicated investment teams focusing on Agency and non-Agency RMBS and CMBS, ABS and CLOs.



DoubleLine Income Fund:
Mining Structured Credit for Incremental Yield, Duration Management and Diversification

Ken Shinoda, DoubleLine Portfolio Manager | September 30, 2021

Active Management Through the DoubleLine Income Fund (cont'd)

The fund's portfolio is constructed using top-down and bottom-up approaches. First, the portfolio managers and investment team utilize our firm's research and views on the economic and financial landscapes to determine the appropriate interest-rate duration and asset allocation across the various sectors of the structured products universe. From there, our specialized investment teams are responsible for fundamental research, analysis and stress testing of cash flows to determine the most attractive securities within their sectors in terms of those credits' bottom-up merits and their place within the overall portfolio construction.

The analysis of structured products is quite different from researching the credit of companies. Each deal can have a unique sponsor, type of cash-flowing asset and bond capital structure. DoubleLine's teams have developed a comprehensive underwriting process for each asset type. Once securities are analyzed and purchased, the work doesn't stop there. Ongoing and proactive asset management is critical. Each month, new data is released about the performance of the underlying assets. The investment teams gather and analyze this information and assess any changes in the market. Investments are re-underwritten on an ongoing basis with continued stress testing to determine buy, hold and sell decisions.

DoubleLine Income Fund Portfolio Composition

As of this writing, the DoubleLine Income Fund was positioned with the highest weighting in credit toward the consumer. With elevated savings rates, income payments through August 2021 from federal fiscal stimulus and a slow but steady recovery in jobs, the consumer is one of the strongest parts of the U.S. economy. The portfolio gains access to that exposure through non-Agency RMBS, multifamily CMBS and consumer-related ABS. The fund also has exposure to parts of the market that were hardest hit by pandemic lockdowns, including pockets of commercial real estate and travel-related ABS. These securities provide both higher yields and potential total return upside to a continued improvement of the economy. In seeking to provide a ballast of safety and liquidity against the portfolio's higher-yielding holdings, the portfolio holds allocations to higher-grade assets such as Treasuries and Agency MBS. *(Figure 4)*

DoubleLine Income Fund Portfolio Statistics[3] | As of September 30, 2021

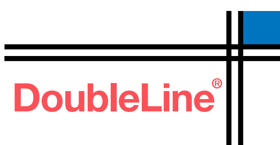
Portfolio Characteristics	
# of Issues	151
Ending Market Value	$135,039,708
Market Price	$119.32
Duration (years)	0.65
Weighted Average Life (years)	4.86

SEC 30-Day Yield (%)	I-Share	N-Share
Gross	5.60	5.35
Net*	5.64	5.38

Sector Breakdown (%)	
Non-Agency Residential MBS	29.11
Commercial MBS	22.58
Collateralized Loan Obligations	16.75
Agency Residential MBS	12.39
Asset-Backed Securities	9.21
Government	3.07
Investment Grade Corporates	0.78
Cash	6.12
Total	**100.00**

Credit Quality Distribution (%)	
Government	3.07
Agency	13.04
Investment Grade	23.03
Below Investment Grade	36.53
Unrated Securities	18.22
Cash	6.12
Total	**100.00**

Figure 4
Source: DoubleLine
* If a Fund invested in an affiliate Fund sponsored by the Adviser during the period covered by this report the Adviser agreed to not charge a management fee to the Fund in an amount equal to the investment advisory fees paid by the affiliated Fund in respect of the Fund's investment in the affiliated fund to avoid duplicate charge of the investment advisory fees to the investors.



DoubleLine Income Fund: Mining Structured Credit for Incremental Yield, Duration Management and Diversification

Ken Shinoda, DoubleLine Portfolio Manager | September 30, 2021

This diversified approach across many sectors of the structured products market combined with higher-grade assets generates attractive income, with limited interest-rate risk, and offers the potential for upside to a continued healing and reopening of the economy. This portfolio can provide investors with a complementary asset to an existing portfolio of high yield corporate bonds, a source of standalone yield or be added to a higher-grade portfolio as part of a barbell strategy.

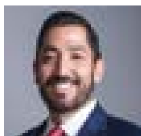
Conclusion

A carefully and thoughtfully positioned portfolio of structured products has the potential to add a diversified source of incremental income and returns to an investor's overall portfolio. The universe of assets to choose from range from high-quality exposure to government- and quasi-government-guaranteed Agency mortgages down to below investment grade, high-yielding structured credit.

While 2020 was a challenging year for parts of the structured products market acutely affected by the pandemic such as CMBS and travel-related ABS, other parts of the market proved their resilience as improving economic data and lower interest rates generated tailwinds for consumer-related assets such as auto, credit card and student loans as well as mortgage-related credit.

The markets that lagged in 2020 and were not bailed out by the Fed, which included these harder-hit CMBS and ABS, have led the charge in positive returns this year as the reopening and recovery of the economy. Further, these sectors can offer higher yield as they continue to recover from the depths of the pandemic. We believe opportunities remain to invest in these recovery trades.

For more information about DoubleLine's offerings, please visit www.doublelinefunds.com or call (213) 633-8200. ■



Ken Shinoda, CFA
Portfolio Manager

Mr. Shinoda joined DoubleLine at its inception in 2009. He is the Chairman of the Structured Products Committee and Portfolio Manager overseeing the non-Agency RMBS team which specializes in investing in non-Agency mortgage-backed securities, residential whole loans and other mortgage-related opportunities. Mr. Shinoda is co-Portfolio Manager, with fellow Portfolio Managers Morris Chen and Andrew Hsu, of the DoubleLine Income Fund. Mr. Shinoda is also a permanent member of the Fixed Income Asset Allocation and participates in the Global Asset Allocation Committee. Prior to DoubleLine, Mr. Shinoda was Vice President at TCW where he worked in portfolio management and trading from 2004-2009. He holds a BS in Business Administration from the University of Southern California and is a CFA® charterholder.

DoubleLine Income Fund Performance | Fund inception: September 3, 2019

Quarter-End Returns | September 30, 2021

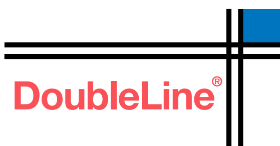
	1 Month	Third Quarter 2021	Year-to-Date	1 Year	3 Years	Since Inception	Gross/Net Expense Ratio
I Share (DBLIX)	-0.03%	0.76%	6.11%	9.66%	–	0.58%	0.75%/0.66%*
N Share (DBLNX)	0.06%	0.80%	5.91%	9.37%	–	0.45%	1.00%/0.91%*
Bloomberg Barclays US Aggregate Index	-0.87%	0.05%	-1.55%	-0.90%	–	2.51%	

* The Adviser has contractually agreed to waive fees and reimburse expenses to limit ordinary operating expenses to an amount not to exceed 0.66% for Class I shares and 0.91% for Class N shares. This contractual agreement will remain in place through July 31, 2022 and may be terminated by the Adviser, or extended or modified with approval of the Board of Directors. Net expense ratios are applicable to investors.

Performance data quoted represents past performance; past performance does not guarantee future results. 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. Current performance of the fund may be lower or higher than the performance quoted. Performance current to the most recent month-end may be obtained by calling (213) 633-8200 or by visiting www.doublelinefunds.com.

The Fund's investment objectives, risks, charges and expenses must be considered carefully before investing. The statutory and summary prospectus contain this and other important information about the investment company, and may be obtained by calling (877) 354-6311 / (877) DLINE11, or visiting www.doublelinefunds.com. Read them carefully before investing.

DoubleLine Funds are distributed by Quasar Distributors, LLC. DoubleLine® is a registered trademark of DoubleLine Capital LP.



DoubleLine Income Fund: Mining Structured Credit for Incremental Yield, Duration Management and Diversification

Ken Shinoda, DoubleLine Portfolio Manager | September 30, 2021

Citations

[1] For further information on the state of the private-label RMBS market and underlying housing market, see Ken Shinoda, "Housing Finance Post Covid-19 Is In Better Shape Than You Think," RealClearMarkets.com, May 28, 2020.

[2] For further information on the state of the CMBS market and underlying commercial real estate collateral, see Morris Chen and Mark Cho, "Evaluating the Commercial Real Estate Debt Market: Observations and Opportunities," DoubleLine.com, July 30, 2021.

[3] For more information on the DoubleLine Income Fund, please visit: https://doublelinefunds.com/income-fund/

Definitions

B-Piece – When commercial mortgage-backed security loans are pooled together to create commercial mortgage-backed securities (CMBS), these securities vary in credit quality and payment priority. Typically, they are divided into several different tranches, which can be grouped into two broad categories: investment grade and below-investment-grade securities. A-class bondholders are paid first, and "B-piece" bondholders must wait until all A-class bondholders are fully paid before they receive any compensation. Due to their higher risk, however, B-piece CMBS offer investors significantly higher returns when compared to A-class CMBS.

Below Investment Grade/Non-Investment Grade – Term indicating a security is rated below investment grade (IG). These securities are seen as having higher default risk or being prone to other adverse credit events. They typically pay higher yields than higher-quality bonds in order to make them attractive. They are less likely than IG bonds to pay back 100 cents on the dollar.

Credit Enhancement – Method through which a borrower or bond issuer seeks to improve its debt- or creditworthiness by adding protection through financial support against losses on securitized assets.

Debt-to-Income (DTI) Ratio – Personal finance measure that compares an individual's monthly debt payment to their monthly gross income. Your gross income is your pay before taxes and other deductions are taken out. The DTI ratio is the percentage of your gross monthly income that goes to paying your monthly debt payments.

Fannie Mae (FNMA) – The Federal National Mortgage Association (Fannie Mae) is a government-sponsored enterprise (GSE) chartered by Congress in 1938 during the Depression to stimulate home ownership and provide liquidity to the mortgage market. Its purpose is to help moderate- to low-income borrowers obtain financing for a home.

Freddie Mac (FHLMC) – The Federal Home Loan Mortgage Corp. (Freddie Mac) is a stockholder-owned, government-sponsored enterprise (GSE) chartered by Congress in 1970 to keep money flowing to mortgage lenders in support of homeownership and rental housing for middle-income Americans. Freddie Mac, purchases, guarantees and securitizes mortgages to form mortgage-backed securities (MBS).

Ginnie Mae (GNMA) – The Government National Mortgage Association (Ginnie Mae) is a federal government corporation that guarantees the timely payment of principal and interest on mortgage-backed securities (MBS) issued by approved lenders. Ginnie Mae's guarantee allows mortgage lenders to obtain a better price for MBS in the capital markets.

Government-Sponsored Enterprise (GSE) – Quasi-governmental entity established to enhance the flow of credit to specific sectors of the American economy. Created by acts of Congress, these agencies – although they are privately held – provide public financial services. GSEs help to facilitate borrowing for a variety of individuals, including students, farmers and homeowners.

High Yield (HY) – Bonds that pay higher interest rates because they have lower credit ratings than investment grade (IG) bonds. HY bonds are more likely to default, so they must pay a higher yield than IG bonds to compensate investors.

Investment Grade (IG) – Rating that signifies a municipal or corporate bond presents a relatively low risk of default. Bonds below this designation are considered to have a high risk of default and are commonly referred to as "junk bonds." The higher the bond rating the more likely the bond will return 100 cents on the U.S. dollar.

Legacy RMBS – Name for private-label, aka non-Agency, residential mortgage-backed securities (RMBS) issued before the shift to stricter post-Global Financial Crisis (guidelines). RMBS issued post-GFC are referred to as "RMBS 2.0."

Loan-to-Value (LTV) Ratio – Assessment of lending risk that financial institutions and other lenders examine before approving a mortgage. Typically, loan assessments with high LTV ratios are considered higher-risk loans. Therefore, if the mortgage is approved, the loan has a higher interest rate.

Mezzanine Debt – Occurs when a hybrid debt issue is subordinated to another debt issue from the same issuer. Mezzanine debt has embedded equity instruments attached, often known as warrants, which increase the value of the subordinated debt and allow greater flexibility when dealing with bondholders. Mezzanine debt is frequently associated with acquisitions and buyouts, for which it may be used to prioritize new owners ahead of existing owners in case of bankruptcy.

Pass-Through Security – Pool of fixed income securities backed by a package of assets. A servicing intermediary collects the monthly payments from issuers and, after deducting a fee, remits or passes them through to the holders of the pass-through security (that is, people or entities who have invested in it).

RMBS 2.0 – Name for private-label, aka non-Agency, residential mortgage-backed securities (RMBS) created under revised guidelines after the Global Financial Crisis (GFC). Non-Agency RMBS dating to before this shift are known as "legacy" non-Agency RMBS.

It is not possible to invest in an index.

Mutual fund investing involves risk; Principal loss is possible.

Fund Risk
Investments in debt securities typically decrease in value when interest rates rise. This risk is usually greater for longer-term debt securities. Investments in lower-rated and non-rated securities present a greater risk of loss to principal and interest than higher-rated securities. Investments in ABS and MBS include additional risks that investors should be aware of such as credit risk, prepayment risk, possible illiquidity and default, as well as increased susceptibility to adverse economic developments. The Fund may use leverage which may cause the effect of an increase or decrease in the value of the portfolio securities to be magnified and the Fund to be more volatile than if leverage was not used. Derivatives involve special risks including correlation, counterparty, liquidity, operational, accounting and tax risks. These risks, in certain cases, may be greater than the risks presented by more traditional investments. Diversification does not assure a profit, nor does it protect against a loss in a declining market.