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Looking Under the Hood of Alternative Bond Funds.

Different funds have radically different strategies and management arrangements

The nontraditional bond fund sector continues to attract inflows and new products.

These funds had net flows of almost $25 billion through Aug. 31, according to Morningstar.

Plus, the category is getting more crowded, with 22 new entrants in 2013 and 20 or more additional arrivals projected for 2014, the research group estimates.

A key reason for the appeal of many of these funds is the fact that their flexible portfolios may offer more protection and steadier total returns in a rising interest rate environment than traditional bond funds.

That benefit hasn't been strenuously tested yet, though, as bond yield increases, which were widely expected for 2014, are still on hold. The 10-year Treasury, for instance, dropped to 2% in mid-October.

Surging market volatility is making regulators increasingly concerned that bond funds have loaded up on hard-to-sell assets.

Some funds in this category focus on narrow niches and provide unique strategies, experts point out.

The Forward Credit Analysis Long/Short Fund (FLSIX) focuses on municipal bonds, which accounted for close to 80% of the portfolio as of Sept. 30. Short-term securities (13%) and corporate bonds (7.4%) comprise the balance, with a fraction of 1% in futures contracts.

What makes this fund unique is that it can use strategies to replicate short positions in municipal bonds. According to the fund's materials: "A substantial portion of assets may be invested in derivatives to seek to achieve returns and for hedging." Additionally, "The fund may engage in borrowing for investment purposes in order to increase its holdings of portfolio securities and/or to collateralize short sale positions, as well as for cash management, and short positions may equal up to 100% of the fund's net asset value."

The hedges are indirect due to the fund's inability to directly short tax-exempt municipals, according to Jim O'Donnell, Forward's chief investment officer.

Portfolio managers can work with Treasury bond futures and the Markit MCDX synthetic municipal-credit index to get around that limitation.

PIMCO is the fund's subadvisor. However, that firm's recent management shake-up doesn't concern O'Donnell, because it hasn't affected PIMCO's municipal-bond managers, who are led by Joe Deane in New York, he says.

The fund uses two benchmarks for comparison: the Barclays U.S. Municipal Bond Index and the

Barclays U.S. Corporate High Yield Bond Index.

The returns on institutional shares, from 2009 through 2013, fell between the performance of two indexes, although its 1-, 3- and 5- year performance lagged both benchmarks.

Other Strategies

The Pioneer Absolute Return Bond Fund (ABRDX) takes a different approach that incorporates two strategies.

The portfolio's core component is managed to track the fund's benchmark, the Bank of America Merrill Lynch 3-month U.S. Treasury Index. The fund then uses multiple uncorrelated alpha-generation strategies through selective use of derivatives to seek performance above the core strategy and deliver absolute returns.

These strategies include spread duration, sovereign exposure, interest rates, currency selection and inflation, among others.

The fund takes team-based portfolio management to a new level, according to Pioneer, by utilizing over a dozen analysts and managers with investment responsibility for a particular alpha generator.

For example, one manager handles inflation and Nordic yield curves; another handles volatility, and so on.

The idea behind this approach is to take small amounts of risk across many uncorrelated positions with the goal of adding incremental gains over time. It's a complex management strategy, but a team of portfolio construction-specialists monitors drawdowns and risk levels to avoid extreme positions, says the fund group.

This is the third inception of the strategy for Pioneer, which launched the euro version in December 2010, the British-pound version in December 2013 and the U.S. dollar fund in January 2014.

According to Morningstar, the fund has just under $20 million of assets, and its return has slightly trailed that of the Non-Traditional Bond index.

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