Over a 30-year period, traditional fixed income products performed extremely well and acted as a counterbalance to equity portfolio exposure due to an ultra-low interest rate environment. As interest rates continue to rise in a positive economic environment, many bond funds are now in negative territory this year. For investors that only hold a handful of traditional fixed income products in their portfolios, this may be increasingly problematic if rates continue to climb upward. We believe that now is the time for investors to consider a more diversified approach to fixed income, by reallocating a portion of their traditional fixed income allocation to actively managed satellite fixed income investments. These investments potentially offer non-correlated returns, protection against rate hikes and market volatility, while providing access to non-traditional core bonds.

We believe it is important to diversify your bond portfolio, just as you would your equity portfolio. Although there is no magic number of funds to incorporate into a portfolio, many bond portfolios are underexposed to the broader fixed income universe. This is problematic as it could lead to a lack of diversification, which could result in higher risk and lower overall returns for investors.

Although there is no magic number of funds to incorporate into a portfolio, many bond portfolios are underexposed to the broader fixed income universe.

We believe it is important to diversify your bond portfolio, like your equity portfolio.

Adding satellite fixed income funds to your portfolio can help to offer non-correlated returns with the potential of protecting against interest rate increases, while at the same time offering investors access to markets that are not contained in traditional fixed income investments.

A More Diversified Fixed Income Portfolio May Help Protect Investors Against Rate Hikes And Market Volatility.
The Problem with Traditional Bond Funds

Traditional bond funds have been declining in performance over the past years as they implement index-like strategies (e.g., replicating the AGG) and have not managed duration risk. To put things in perspective, annual returns of investment grade bonds have steadily declined over the past five years. As of October 2018, the AGG was down 2.4%. Since 1989, the duration has increased from 4.6 to 6.0.

**U.S. Barclays Aggregate Annual Total Returns Have Steadily Declined Over the Past Five Years**

Based on data from January 1990 to September 2018. Source: Bloomberg and Barclays Aggregate Index.

One reason for the AGG’s underperformance is that it does not include about two-thirds of the investable fixed income space, limiting exposure to fixed income sectors that have the potential to deliver returns for investors. Index-tracking funds, by their structure, continue to concentrate on traditional bonds that will suffer greater loss when rates rise, while many active managers have been steadily shifting toward short-term debt, which is less vulnerable to losses from rising rates and inflation.

**U.S. Barclays Aggregate Current Composition**

Based on data as of September 2018. Source: Bloomberg and Barclays Aggregate Index.

Another drawback of passive index funds like the AGG is the need to rebalance monthly because of bond maturity, new bond issuance, and rules that govern whether a particular credit can be included in the portfolio. We believe that passive strategies are “price takers” in the fixed income space. On the other hand, actively managed funds can use proprietary technology, analytics, and research to buy or sell at the better price to potentially enhance returns.
The Importance of Diversifying Fixed Income Portfolios

As shown below, fixed income sectors react differently to rising interest rates, inflation, credit risk, macro uncertainty, and market volatility. For these reasons, we believe it is important to diversify your fixed income portfolio, just as you would your equity portfolio.

Fluctuations in Fixed Income Sector Performance Over the Past 20 Years
Based on data from January 1998 to December 2017. Source: Bloomberg.

Investation Grade Bonds are represented by the U.S. Barclays Aggregate Index. Floating Rate Loans are represented by the Credit Suisse Leveraged Loan Index. Treasurys are represented by the Bloomberg Barclays U.S. Treasury Total Return Index. High Yield Bonds are represented by the Bloomberg Barclays U.S. High Yield Total Return Index. Mortgage Backed Securities are represented by the Bloomberg Barclays U.S. Mortgage Back Securities Index.
Using Floating-Rate Bank Loans to Diversify Fixed Income Portfolios

We believe that actively-managed, satellite fixed income investments, such as floating-rate bank loans, can potentially enhance a portfolio’s returns, while balancing risks and returns. These investments can help to offer non-correlated returns with the potential of protecting against interest rate increases, while at the same time offering investors access to markets that are not contained in traditional fixed income investments.

Shorter Duration Bonds Outperform During Periods of Rising Interest Rates

Based on data from January 1993 to September 2018. Source: Bank of America Merrill Lynch, Barclays, Credit Suisse, Guggenheim Investments.

Floating Bank Loans Have Outperformed Over the Past 10 Years

Based on data from October 2008 to October 2018. Source: Barclays, Credit Suisse. Floating Rate Loans are represented by the Credit Suisse Leveraged Loan Index. Floating Rate Loan funds tend to be illiquid; a fund might be unable to sell the loan in a timely manner as the secondary market is private, unregulated inter-dealer or inter-bank re-sale market. These factors may affect the value of your investment.
WHY SELECT AN ACTIVE FIXED INCOME FUND?

- Recent Morningstar research found that 70% of active managers who choose intermediate-term bonds are beating their passive peers.
- Active managers have the ability to decrease long-duration exposure.
- Active managers are more able to pursue “smart risk”.
- Active managers have a wide variety of sectors to invest, while index-tracking funds have limited exposure to non-traditional fixed income sectors.

Over the past decade, there has been much media attention over the debate between active and passive investing. Consequently, many fixed income investors have jumped on the passive investing bandwagon due to their focus on management fees and the assumption that there aren’t many idiosyncratic risks to exploit compared to equities in order to generate alpha. However, passive strategies have mostly underperformed active strategies, while exposing investors to more risk. Actively managed funds also offer investment opportunities that are not available to passive funds.

One of the main problems with passive strategies is that they cannot effectively manage duration like active strategies. In a rising rate environment this is problematic because historical data shows as the Fed raises rates, higher-duration bonds have experienced a greater risk of loss compared to shorter-duration bonds.

The Problem with High Duration Bonds During Periods of Rising Rates

Historically, if interest rates change by 1%, a fixed income fund’s price is likely to experience an inverse change by approximately 1% for each year of duration.

Passive Fixed Income Fund Duration Has Steadily Increased Since 2007

Based on data from January 2007 to June 2018.

Passive Fixed Income Exposure has Experienced Losses over the Past Year because of Increased Duration Risk and Rising Rates

Based on data from October 2017 to October 2018.

ABOUT CATALYST FUNDS

Catalyst Funds is a distinct alternative manager. Since our founding in 2006, we understood that the market did not need another traditional family of mutual funds. We strive to provide innovative strategies to support financial advisors and their clients in meeting the challenges of an ever-changing global market environment.

Catalyst offers a broad range of distinct, “intelligent alternative” funds. Our specialized strategies seek to address the needs of investors, including generating alpha, reducing volatility, limiting tail risk, mitigating interest rate risk and generating income. We strive to be “ahead of the curve” in exploiting emerging areas of opportunity to assist our clients in achieving their long-term investment goals.

IMPORTANT RISK DISCLOSURES

Investing in fixed income mutual funds carries certain risks. The value of a fund may decrease in response to the activities and financial prospects of an individual security in a fund’s portfolio. Some funds may invest in high yield or junk bonds which present a greater risk than bonds of higher quality. If a fund invests in asset-backed securities or mortgage-backed securities, the fund is subject to the risk that, if the underlying borrowers fail to pay interest or repay principal, the assets backing these securities may not be sufficient to support payments on the securities. Other risks include credit risks and interest rate risks for floating rate loan funds and other fixed income funds. Interest rate risk is the risk that bond prices overall, including the prices of securities held by a fund, will decline over short or even long periods of time due to rising interest rates. Certain funds are non-diversified and may invest a greater percentage of their assets in a particular issue and may own fewer securities than other mutual funds.

Changes in short-term market interest rates will directly affect the yield on the shares of a fund whose investments are normally invested in floating rate debt. Floating rate loan funds tend to be illiquid, a fund might be unable to sell loans in a timely manner as the secondary market is private, unregulated inter-dealer or inter-bank re-sale market. These factors may affect the value of your investment. 8548-NLD-12/11/2018

Investors should carefully consider the investment objectives, risks, charges and expenses of the Catalyst Funds. This and other important information about the Fund is contained in the prospectus, which can be obtained by calling 866-447-4228 or at www.CatalystMF.com. The prospectus should be read carefully before investing. The Catalyst Funds are distributed by Northern Lights Distributors, LLC, member FINRA/SIPC. Catalyst Capital Advisors LLC is not affiliated with Northern Lights Distributors, LLC.

GLOSSARY

**Excess Spread**: the amount an investor gets paid after expected credit losses.

**Credit Suisse Leveraged Loan Index**: a market-weighted index that tracks the performance of institutional leveraged loans.

**BAML ABS Floating Rate Index**: tracks the performance of U.S. dollar denominated investment grade asset backed securities publicly issued in the U.S. domestic market.

**Barclays TIPS Index**: the index includes all publicly issued, U.S. Treasury inflation-protected securities that have at least one year remaining to maturity, are rated investment grade, and have $250 million or more of outstanding face value.

**Barclays HY Index**: measures the USD-denominated, high yield, fixed-rate corporate bond market.

**Barclays Agg Index**: a market capitalization-weighted index, meaning the securities in the index are weighted according to the market size of each bond type. Most U.S. traded investment grade bonds are represented.

**Barclays Treasury Index**: a market-capitalization weighted index that measures the performance of public obligations of the U.S. Treasury that have a remaining maturity of one year or more.

**Barclays IG Index**: measures the investment grade, fixed-rate, taxable corporate bond market. It includes USD-denominated securities publicly issued by US and non-US industrial, utility and financial issuers.

**S&P LSTA Leverage Loan 100 TR Index**: reflects the performance of the largest facilities in the leveraged loan market.

**Bloomberg Barclays US FRN < 5 yrs Total Return Index**: a subset of the US Floating-Rate Note (FRN) Index, which measures the performance of USD denominated, investment-grade, floating-rate notes across corporate and government-related sectors.