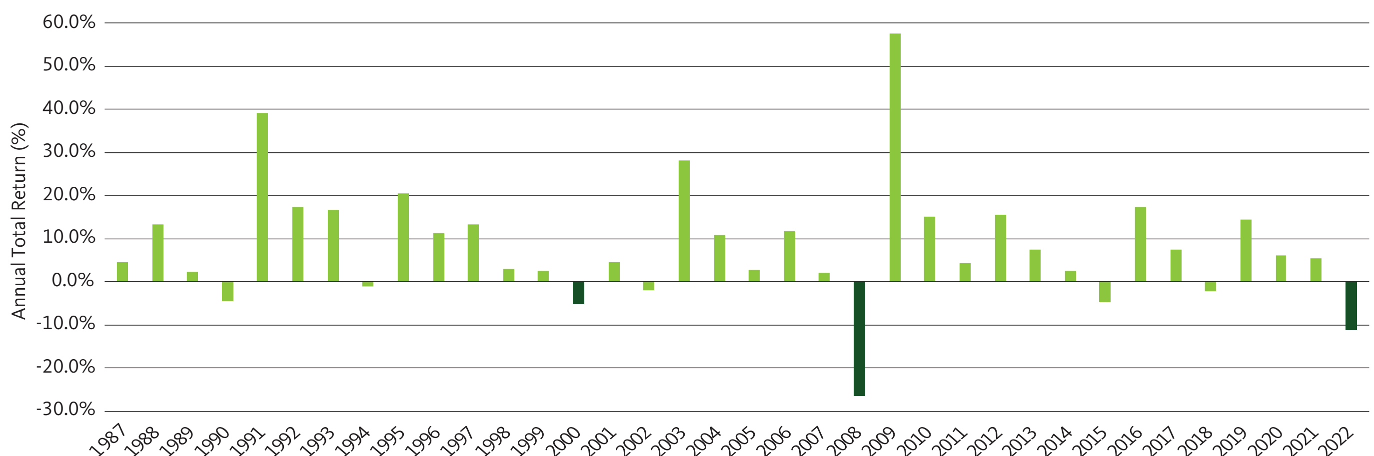
FUND SPOTLIGHT

U.S. High Yield Bond Fund.

Why high yield?

A truly diversified portfolio should have exposure to as many segments of the capital markets as possible. To that extent, we believe high yield has a place in most portfolios. High-yield debt can offer higher expected returns than investment-grade bonds as compensation for both credit and liquidity risk. On the other hand, high yield carries significantly less risk than equities and is not perfectly correlated to either investment-grade bonds or equities. While rising rates are generally a headwind for fixed income, high yield can be expected to outperform investment-grade bonds when interest rates rise since the asset class is less sensitive to interest rates due to its relatively shorter maturity and higher coupons. Further, rising rates are often accompanied by higher expectations for economic growth and inflation. As a hybrid asset with characteristics of both fixed income and equities, high yield would also be expected to benefit, as would equities, from the improved economic outlook. High yield, therefore, offers valuable diversification benefits in the context of a total portfolio. Our typical recommended exposure to high yield, while relatively modest, may contribute positively to overall expected portfolio risk-adjusted returns.

Exhibit 1: U.S. High-Yield Bonds: Only three down years in excess of 5% over past 35 years



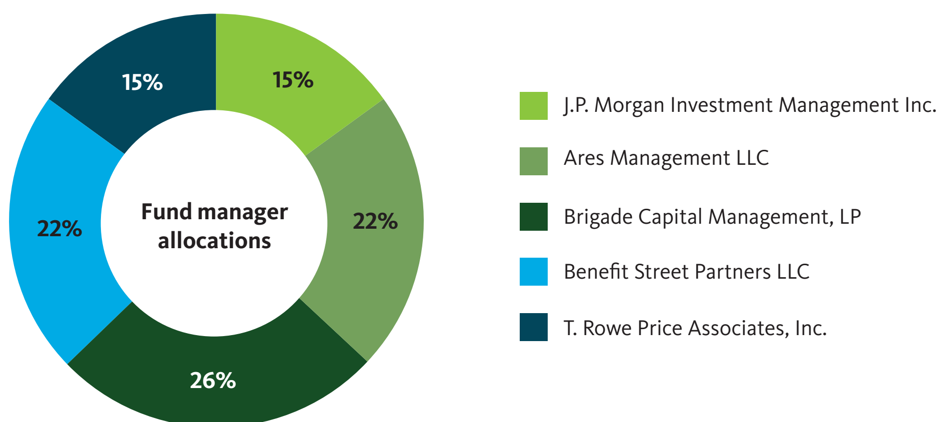
Source: SEI, Morningstar Direct. High yield is represented by the ICE BofA US High Yield Index and return data is in U.S. dollars. The Index tracks the performance of U.S. dollar-denominated below-investment-grade-rated corporate debt publicly issued in the U.S. domestic market. Index returns are for illustrative purposes only, and do not represent actual performance of an SEI Fund. Index returns do not reflect any management fees, transaction costs or expenses. Indexes are unmanaged and one cannot invest directly in an index. Past performance does not guarantee future results.

Why the SEI U.S. High Yield Bond Fund?

Manager of managers

Manager-of-managers strategies combine multiple third-party manager strategies into a single mutual fund with the expectation that specialization should have a beneficial bearing on performance. At SEI, given the varying ways to analyze an opportunity set, we seek specialists with unique expertise to work collectively under our watch to harvest opportunities. In the high-yield space, our manager-of-managers framework provides flexibility in balancing capacity constraints that larger single-manager strategies may struggle with. Our current manager lineup in our U.S. High Yield Bond Fund presents a unique offering that couples traditional long-only high-yield managers (J.P. Morgan and T. Rowe Price) with non-traditional or alternative credit strategies managers (Ares Management, Benefit Street, Brigade Capital) that may be unfamiliar to potential investors (Exhibit 2).

Exhibit 2: SEI U.S. High Yield Bond Fund manager allocation



For illustrative purposes only.
Source: SEI

Capacity-constrained asset class

U.S. high yield is a capacity-constrained asset class, as many issuers in the space are smaller and have limited trading liquidity. With single-manager funds, this may reduce accessibility for investors or lead to funds with bloated assets that must rely primarily on investing in the most liquid bonds while generally ignoring potentially profitable investments. SEI's manager-of-managers framework spreads capacity over multiple managers while also allowing for the potential addition of more managers if capacity truly becomes an issue.

Active management

We believe that active management is critical in high yield. Investors may see that common high-yield benchmarks often outperform actively managed funds and view this as reason to go passive. But the two most popular ETFs in high yield have generally lagged the benchmark.[1] This may not seem to make sense on the surface, but the most popular high-yield benchmarks are not investible indexes and, as such, are difficult to replicate. They have positions in small issues with ratings below CCC (or no rating at all) that are largely illiquid, preventing replication by ETFs. In addition, passive approaches do not offer the credit analysis that active managers provide, making them a particularly poor choice when compared to active management.

[1]Source: Morningstar Direct; Two most popular ETFs= iShares iBoxx $ High Yield Corp Bond ETF (Total Retail Annualized Performance - 3-year: 4.22%, 5-year: 2.48%, 10-year: 3.03%) and SPDR® Bloomberg Barclays High Yield Bond ETF (Total Retail Annualized Performance - 3-year: 4.61%, 5-year: 2.42%, 10-year: 2.80%); Benchmark = ICE BofA US High Yield Composite Index (Total Retail Annualized Performance - 3-year: 5.84%, 5-year: 3.06%, 10-year: 4.03%). As of 03/31/2023.

Other features

The primary risk in high yield is default risk; as such, the SEI U.S. High Yield Bond Fund has a focus on credit analysis. While this isn't necessarily unique to SEI, it's a defining part of our process. The Fund invests the vast majority of assets in BB and B rated securities—the highest-rated bonds within high yield. However, it also invests in select CCC rated bonds—which carry more risk but higher potential returns—when credit analysis indicates the risk is warranted. We also strategically allocate to bank loans, which are typically BB rated and have floating rates. Floating-rate securities help offset losses elsewhere in the Fund when rates rise as they reset with higher payments. Loans sit above bonds in the capital structure and, in the case of default, are more likely to recover a higher portion of the principal than a bond. While loans will reset with lower payments when rates are falling, we believe the benefits outweigh this disadvantage.

Suggested implementation

A hybrid asset class

We view high-yield bonds as a hybrid asset class that has features of fixed income (regular coupon payments and maturity dates) and equities (exposure to the economic cycle for which we expect to be compensated over time). High yield offers exposures and performance expected to be comparable to those provided by a blend of stocks and bonds, but also brings its own unique characteristics and diversification that can help to moderate the overall risk of a portfolio. With this in mind, we generally suggest that when investors add high yield to a portfolio, they fund the allocation from a roughly even combination of investment-grade fixed income and equities.

High yield has a place in most strategies

Some conservative investors may view high yield as too risky, while some growth-oriented investors may view it as not risky enough. Yet we believe high yield has a place in most portfolios. Our allocation to high yield does not change dramatically from conservative to growth-oriented strategies, but it can be viewed as playing a different role in one compared to the other. In conservative strategies, high yield will be one of the riskier allocations; in growth strategies, it may be one of the least risky allocations. Conservative investors typically have a higher income goal and may therefore welcome an allocation to high yield, which remains one of the best asset classes for generating current income. Meanwhile, a growth-oriented investor may be happy to hold high yield as a diversifying source of expected return within their portfolio that presumably comprises mainly equities.

To learn how to add SEI's U.S. High Yield Bond Fund to your clients' portfolios, contact your relationship manager.

130 King Street West
Suite 2810
P.O. Box 433
Toronto, ON M5X 1E3
855-734-1188

seic.ca

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