Fixed Income Strategies

QUARTERLY UPDATE

Second Quarter 2019

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Review & Outlook

Interest rates took a tumble in the second quarter. The 10-year Treasury, which started the year at 2.69%, ended the quarter at 2.00%. This came on the heels of a rapidly changing outlook for the Federal Reserve. As the quarter ended, futures markets indicated a 65% chance of three or more rate cuts by the end of 2019. That is up from just 5% at the end of March. Concerns about the pace of global growth as well as flagging inflation are responsible for driving the market to expect imminent Fed easing.

It is a concern we share, but calling a turn in the business cycle is exceedingly difficult. We can say with confidence that the risk of an economic slowdown is elevated. But it is also quite possible that the expansion continues. We want to invest portfolios in a way that maintains our bottom-up process and balances the potential macro risks that could impact performance.

In this light, several of our strategies were positioned to benefit from a more accommodative Fed at the start of 2019. Again, this was not us making a big macro call. Rather, the view that if the cycle indeed turned for the worse, the Fed would be likely to cut rates. Positioning to benefit from this would help ballast our portfolios against a period where our core credit positions could underperform. In addition to this serving as a natural hedge, we also felt that various markets were not pricing any possibility of Fed cuts. Hence, we found many micro ways to position for a macro possibility.

The municipal market is one example. In the last several quarters, there have been substantial flows into shorter-duration municipals, particularly between one to five years to maturity. While owning short-term bonds can be prudent from a risk management perspective, the market did not seem to be considering relative value between different points along the curve. Within our strategy, yield curve positioning and a modest duration overweight drove our strong relative performance this quarter. Longer-duration municipal bonds dramatically outperformed in the second quarter as the muni yield curve bull flattened.

We continue to pair these longer-duration bonds with a sizable overweight in ultra-short floating-rate and short-callable municipal bonds. We believe that these "off-the-run" short-duration structures provide some of the best risk-adjusted yields in the market, while also adding downside protection. Many of our muni floating-rate holdings are spread off of three-month LIBOR, which remains elevated compared to short-maturity municipal bonds. The beauty of this barbell is that both "wings" outyield the municipal benchmark, effectively eliminating the need (or risk) of a timing decision. We can continue to underweight bonds with poor relative valuations in the middle of the intermediate municipal yield curve—without sacrificing yield—while we wait for better opportunities.

Another example is mortgage bonds. During most of 2018, only around 5% of the mortgage universe was easily refinanceable. Now the number is probably 40% that is clearly refinanceable, with another 32% very close. We did not think the mortgage market was pricing in the possibility of mortgage rates suddenly declining by 50 basis points to 70 basis points, and thus bringing so many mortgage loans into the money. When a mortgage is refinanced, investors in that mortgage stop earning interest and just get their par amount back. This tends to cause mortgage bonds to substantially underperform during periods of falling interest rates.

Our view that interest rates could decline rapidly if the economy slowed, combined with the fact that the mortgage market did not seem to have this risk priced in at all, led us to materially underweight traditional mortgages. Instead, we bought more commercial mortgage bonds, which generally carry onerous prepayment penalties and thus perform much better during periods of falling rates. In addition, we bought asset-backed securities in sectors where changing interest rates tend not to impact payment rates, including auto loans, equipment finance and rental properties. For more about how we approach mortgage bonds, see John Henry Iucker's piece titled Late-Cycle Investing: MBS Offer Attractive Income and Downside Protection.

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INDEX PERFORMANCE AS OF 06/30/2019 (%)

INDEX NAME	3-MONTH	PAST 12 MONTHS
Bloomberg Barclays U.S. Aggregate Bond Index	3.08	7.87
Bloomberg Barclays Int. Aggregate Bond Index	2.39	6.73
Bloomberg Barclays U.S. Treasury Index	3.01	7.24
Bloomberg Barclays Long U.S. Treasury Index	6.03	12.30
Bloomberg Barclays Mortgage-Backed Sec. Index	1.96	6.22
Bloomberg Barclays U.S. Corporate Index	4.48	10.72
Bloomberg Barclays U.S. Corporate High-Yield Index	2.50	7.48
Bloomberg Barclays U.S. Municipal Bond Index	2.14	6.71

Source: Bloomberg. Please see disclosure statements on page 2 for additional information and for a complete list of terms and definitions.

Similar to the municipal example, the combination of being underweight traditional mortgages and overweight commercial mortgages and asset-backed bonds garnered more yield than a passive portfolio of just mortgages. We were not "betting" on interest rates falling at all. Rather, we were just betting on a market mispricing and could collect extra yield while we waited for the mispricing to correct itself.

Corporate bonds are probably the trickiest fixed income sector in which to invest when the cycle might be turning. Corporate bonds generally underperform other types of bonds during recessions, but they also generally offer the best yields during normal times. They are also the sector with the most differentiation from one bond to the next, which means corporates can offer the best opportunity for us to have an edge with individual bond selection. We want to preserve the good (extra income, individual bond opportunities) while at least mitigating the volatility risk should the economy slow.

In another piece on our website (Winter Is Coming: How to Invest in Late-Cycle Credit), we referred to this balance as being "long alpha, short beta." We are "long alpha, short beta," in that we are overweight corporate bonds by percentage in our taxable strategies. We are "underweight beta," in that the average duration of the corporate bonds we hold is less than that of the benchmark. Usually we think of a bond's "duration" as its exposure to changes in interest rates, but it also measures its exposure to changes in spreads. For example, in a recession, Treasury yields tend to fall. But because the recession puts pressure on company earnings, the market tends to view corporate bond risk as elevated. That tends to cause spreads (which is just a measure of the extra yield you get to take on credit risk) to increase. In our case, because our bonds are a bit shorter-term, we are less exposed to general corporate bond weakness than we would otherwise be. However, because we still have a healthy percentage in the sector, we are able to keep buying interesting bottom-up ideas.

This is one way we hope to maintain strong relative performance even if the credit markets underperform. Earlier this year, we also added some duration outright as well as overweighted the five to 10 year part of the yield curve. Both of these positions were meant to add performance in a situation where the Fed was cutting interest rates. Again, this was not a call on the macro economy but an acknowledgment of where the risks in our portfolio resided and how we could mitigate those risks.

Notably, as interest rates have fallen this year, and the fact that the five- to 10-year area has been the best-performing segment, relative performance has been strong. However, this has been only one part of our strong relative performance in 2019.

Looking forward, rates have fallen to the point that for yields to fall meaningfully from here probably requires clear signs of a real slowdown. Merely soft inflation figures probably are not enough. We believe that yields in other developed countries should serve as a warning to U.S. investors that there is no practical floor to how low yields can fall.