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THE WALL STREET TRANSCRIPT

Connecting Market Leaders with Investors

Fixed Income Manager Finds Agency MBS Attractive Right Now

AMY HAUTER, CFA, is a Partner, a member of the Executive Team and serves as a Portfolio Manager and Director of Sustainable Fixed Income at Brown Advisory. She is a Portfolio Manager on Brown Advisory's U.S. sustainable fixed income strategies, which include its Sustainable Core, Tax-Exempt Sustainable and Sustainable Short Duration strategies. In 2018, Ms. Hauter received recognition as a Rising Star from Fund Action and Fund Directions for her work in building out Brown Advisory's sustainable fixed income platform. She has held numerous speaking engagements, including the United Nations Sustainable Investing Summit in 2019. Ms. Hauter joined the firm in 2012, and previously worked in fixed income client service at Morgan Stanley. She earned her B.S. at Old Dominion University and is a CFA® charterholder.

SECTOR — GENERAL INVESTING

TWST: Let's start with an introduction to Brown Advisory, the firm's overall business and approach to its work. What would you want readers to know?

Ms. Hauter: I'll take it back to our roots, which go back to Alex. Brown, which is the oldest investment bank in America and was founded in Baltimore in the early 1800s. We brought the asset management business private, we spun off in the late 1990s, and it has remained independent and private ever since.

The firm at large manages about $160 billion in assets globally. We've expanded our global footprint significantly over the better part of the past five or six years. Within our two businesses, our private wealth, or high net worth, endowment and foundation business makes up about 55% to 60% of our overall business, and then institutional is the remainder.

I sit on the institutional side of the business within the fixed income investment team. Across our institutional business, we have over 70-plus colleagues within sales roles, research analysts, traders, and portfolio managers that help support our single strategies within equity and fixed income.

In terms of what sets us apart, I would say probably our ownership structure. Seventy percent of the firm is owned by 100% of our full-time employees, and no one person, including the CEO, owns a material position. This structure is intentional, and it really creates long-term alignment and collaboration, drives us to continually advance and improve the business together as colleagues, and it really has created an incredible work culture and environment.

TWST: As Director of Sustainable Fixed Income, what sustainability factors do you take into consideration during your investment analysis and selection process?

Ms. Hauter: We take a holistic approach. We don't screen out anything on the front end of our investment process. We look for investment opportunities across various asset classes, sectors, and industries.

I've always felt that within fixed income, we're in a unique position to help large, important sectors transition. If you think about a lot of the global sustainability challenges that our global economy faces, they're going to require a lot of capital to shift things like their operations, products and services, their supply chains, etc. Issuers are likely going to have to tap the debt markets, and we certainly embrace investing in transition stories that we think are credible and meaningful.

Also, our sustainable investment philosophy is predicated on the belief that it is important to understand the many levers that can drive economic and financial results, with a focus on two that we think transcend asset classes and sectors. Those are climate and natural capital, and community and human capital, both of which are underpinned by sound governance.

The implications are far reaching and varied, with public — which would be sovereign and municipal issuers — and private — which would be corporate and securitized sectors — facing different considerations and serving different roles within this.

With these considerations interwoven into our investment process, we believe that we're able to promote positive sustainable outcomes on both pillars alongside our investment performance. We certainly will not sacrifice one for the other.

The last thing I'll say is, it's imperative, particularly within fixed income, that we focus on mitigating risk. Our upside is capped. It's all about how we're managing downside risk. Downside risk in the event of default can be significant, and so we view integrating sustainable factors as another lens to evaluate risk.

It's not a replacement for fundamental due diligence, it adds an informational edge that helps us identify high-quality investments with lower risks and compelling opportunities that are aligned with improved sustainability outcomes.

TWST: The Sustainable Bond Fund (BASBX) and Sustainable Core Fixed Income strategy are among the portfolios you manage. Would you give us a snapshot of the strategy? And what else would you add about the attributes you look for in individual holdings?

Ms. Hauter: We believe that taking a sustainable and flexible approach to fixed income can certainly offer our investors access to a more attractive stream of income and risk-adjusted returns that really is aligned with positive sustainability outcomes. At the same time, and as I said earlier, you don't have to sacrifice one for the other.

Our core investment philosophy is based on three principles. One, we believe that dynamic asset allocation, informed by our rigorous bottom-up security selection and combined with understanding macro analysis, is the foundation of strong investment performance.

The second point is, we believe sustainable investment research adds an informational edge that helps us identify high-quality investments and lower risk.

And third, by being benchmark aware but not benchmark driven, we believe we can achieve attractive risk-adjusted returns through various economic cycles and diversify our portfolios across different sectors and themes and industries.

We believe **Carrier's** focus on HVAC positions it well to benefit from tailwinds, including regulation and policy, more extreme climate, and greater focus on energy efficiency. According to Carrier, buildings account for 40% of energy-related GHG emissions, and integrated smart building systems such as those provided by **Carrier** can reduce energy by up to 10% to 20%.

I can touch on another one, **AbbVie** (NYSE:ABBV), the global pharmaceutical company. They discover many different types of medicine and solutions that improve the lives of many different people. They maintain a leading edge in biologics and research and development, with a history of developing market-leading pharmaceuticals.

Being a global biopharmaceutical company that provides a broad range of medical solutions, they have leading positions in oncology, neuroscience, and eye care.

Their mission to discover and deliver innovative medicines and products that solve serious health issues and enhance people's lives puts them really at the front lines of tackling some of the world's most complex and serious diseases.

They also are focused on research and development, improving patient diversity in clinical trials, and they've also been able to help identify and address the medical needs of marginalized and historically underserved communities across the globe, which is something that is also important and that we look for in the investments that we're making.

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In terms of individual holdings, we really rely on a credit-focused due diligence process that includes sustainable investment research to build investment cases and mitigate risk. We look to identify securities where estimates of fair value diverge from current market pricing, and depending on which asset class we're talking about, different criteria are used for determining value.

We do invest in all sectors within our benchmark; we include supernationals, corporates, both investment grade and high yield, securitized, and taxable munis as well. As I noted, investment criteria across those may differ, but it's used to identify the best risk and return opportunities for the individual securities within the sectors.

TWST: Can you tell us about a few examples of holdings — what makes them attractive and how do they illustrate the strategy?

Ms. Hauter: Our analysts build robust sector frameworks across many different asset classes and industries in which we invest. I think a good example of one that we've looked at recently is **Carrier Global** (NYSE:CARR). It's a sector our analysts spend a lot of time thinking about.

Carrier is a global leader in residential and commercial HVAC, with a dominant share in heat pumps. Fundamentally, they are a must-buy home expense in many regions. That leads to strong pricing power. Relatively recently they acquired another company which has an installer-centric business model with stickier customers, which is also an advantage.

TWST: You just gave us two great examples from different industries. Are there certain sectors or industries or themes where you're finding the best opportunities?

Ms. Hauter: I'd say from a sector perspective, we find agency mortgages particularly attractive right now. They have strong liquidity, are high quality, offer diversification benefits versus other risk assets, and they carry no credit risk.

Average agency MBS excess returns relative to Treasuries increases when interest rate volatility decreases. If the Fed were to cut rates and banks begin investing more in MBS holdings, which we anticipate coming into play as we move into the end of 2024 and into 2025, it could make this sector particularly attractive.

The other thing that I'll note, from a sustainability perspective, is we have a robust affordable housing and environmental efficiency framework that helps us identify a broad set of mortgage pools that fit within this bucket, and we have a large enough opportunity set to invest in as we have added to this sector.

We've also been adding to asset backed securities, focusing on short, top-of-stack issuance with low impairment risk. Mostly we've been looking at auto and equipment ABS. We have, again, frameworks that help us assess sustainable risks and opportunities. Within auto ABS, the right and comfortable mix of EVs and hybrid vehicles within the respective collateral pools is important for us to understand, as well as emissions metrics.

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TWST: Are there any areas you're especially cautious about? Ms. Hauter: I wouldn't say we're overly cautious about one particular sector of the market. We are paying very close attention to where spreads are, and listening to our research analysts as they provide insight into the health of the companies we're invested in. We've not seen any alarming statistics that show us that defaults should be picking up in a big way. And while spreads continue to be anemic, we still are finding opportunities.

We're back in a world where income is going to be the dominant driver of fixed income returns, and so while we may see some spread volatility in the interim, we're really focused on trying to capture that all-in yield.

But our ability to be nimble and flexible and reallocate and add risk back to the portfolio across various sectors has allowed us to reposition the portfolio to perform in a variety of potential outcomes.

In terms of impact, we have always strived to be intentional about being very transparent in our approach to sustainability and the related outcomes. We're not naïve about sustainability meaning many different things to many different people, but we want to showcase to our clients exactly why we're invested in each security, and what are the factors that we thought were most material to the investment decision and impact to the financials.

We report in many different ways. We have quarterly reporting that highlights new investments we made that quarter, both fundamental and sustainability strengths. We also do an annual sustainability outcome report, in which we aim to report on the impact of our investment decisions.

"We take a data-driven approach by showing the carbon footprint of the portfolio when and where we have that data. We highlight engagement outcomes, how we're engaging with issuers on various topics that are important to our investment decision making."

So, I wouldn't say there's a particular area where we're cautious. We're just really looking at and understanding how those economic factors are impacting the various sectors in which we're investing, and what that may do to things like spreads or defaults.

TWST: What characterizes your approach to constructing a portfolio out of those individual holdings, as well as your ongoing portfolio monitoring and management?

Ms. Hauter: We take a dynamic approach to asset allocation, and reposition the portfolio in different market environments in an effort to help maximize return potential and mitigate risk. We leverage insights from our analysts, combined with macro analysis, to determine where we think we are in the economic cycle and implications to various sectors. That really helps us think about and think through our asset allocation decisions, and our overweights and underweights.

In that regard, we have a systematic process for monitoring portfolio performance, risks, and potential investment opportunities, reassessing key inputs into portfolios and making buy and sell decisions. We have daily, weekly, monthly and annual team meetings that include all of our analysts, traders, and portfolio managers. All of us getting together on a more frequent basis and discussing value and risk really helps inform how we're thinking about positioning the portfolio from a top-down perspective.

TWST: How has the Sustainable Bond Fund and strategy performed compared to its benchmark? And do you measure impact as well?

Ms. Hauter: The strategy has performed quite well over the almost 10 years we've been managing it — we're coming up on our 10-year track record at the end of September. Strong performance relative to the benchmark, the Bloomberg U.S. Aggregate Bond Index, for our long-term numbers.

Certainly, we've experienced some intermittent underperformance at times. One in particular, in late 2022/early 2023, we de-risked our portfolio with the view that there was going to be a more imminent slowdown in the economy. Obviously, as everyone knows, the economy continued to surprise to the upside.

We take a data-driven approach by showing the carbon footprint of the portfolio when and where we have that data. We highlight engagement outcomes, how we're engaging with issuers on various topics that are important to our investment decision making.

TWST: What are your most recent thoughts on the interest rate environment and the likelihood that the Fed will begin to lower rates? We've been talking about that happening for a year now, but it does seem like it's sooner than later. What do you anticipate in terms of market reaction or impact on fixed income in general and sustainable fixed income in particular?

Ms. Hauter: Yes, as you noted, there's been a lot of interest rate volatility over the past year or so. It's certainly more imminent now, at least one Fed cut is on the horizon in September, which we think is probable just given some recent economic figures that have come out.

We've certainly seen our fair share of the markets overreacting to certain indicators, which has impacted both fixed income and equity markets, but markets have stabilized shortly after.

I think the volatility that we've seen over the past couple of years has certainly injected more market reaction than we see in normal market environments.

But economic growth, while strong, is showing signs of weakening, and inflation is still sticky but moderating. Typically, policy easing should steepen the curve, but whether long-end yields decline in outright terms will really depend on exactly why the Fed is cutting rates. And so, more to come, but we do think that at least one rate cut that's being priced in right now is probable.

In terms of how we think about that impacting sustainable fixed income, there is no difference to how you should think about interest rate volatility in a sustainable portfolio. You shouldn't be thinking about it any differently. Those macro factors are going to impact any type of fixed income portfolio. It's really about how you're managing that interest rate risk within your investment strategy, and that's what we think is most important here.

TWST: Beyond interest rates, are there any other macro issues that are top of mind for you?

Ms. Hauter: While consumer fundamentals remain supported by a relatively strong job market and persistently low unemployment, we are mindful of the pressure that higher prices and borrowing costs are putting on many households. So, while early signals indicate that originators have responded with more conservative underwriting, we remain watchful of trends in performance, and cognizant of the impact that any weakness in labor markets would have on consumers. That's really top of mind for us right now.

TWST: What are common questions or concerns that you and your colleagues hear from clients with regard to your sustainable fixed income investing?

Ms. Hauter: I'd say in the early days of running the strategy, and we've been managing it for close to 10 years now, there was a lot of confusion around the complexity of how to think about sustainability within fixed income. We have so many different asset classes and structures within the fixed income landscape and a large/broad opportunity set.

I think there's been an evolution of understanding of various approaches, but also creating our own framework for how to think about some of these more complex asset classes. So, a lot of education early on in terms of how we approach it, the data that we're using, and the material factors within various asset classes.

Within labeled bonds, there has been an evolution of different types of labels, which has spurred criticism of some structures. They are structured and they perform and are issued pari passu to a traditional bond, they just have a green or social or sustainability label, and the use of proceeds are supposed to be earmarked for specific projects. There is no regulatory body that sits over the labeled bond market, but there is ICMA, which set out voluntary guidelines to help structure and standardize the market to create some transparency and standardization.

I think the questions and concerns around that market is, everybody has a very different approach and view to sustainability. What may be green for one investor may not be for another. There's also some scrutiny around the authenticity of some of the projects that are being funded. So, that's an area of scrutiny.

But much like any investment, whether it's for a sustainable strategy or not, that's why you have a team of analysts that have to do their own due diligence. We have a team of five sustainability analysts that sit alongside our fundamental analysts. Together they aim to look at every individual investment that goes into our portfolios, whether it's a labeled bond or not, and labeled bonds have even more scrutiny because we do a deep dive into those proceeds.

TWST: What do you think is notable about sustainable or responsible investing in the last decade or two? And if you could get out your crystal ball, what do you think the next decade or two will bring?

Ms. Hauter: It has certainly evolved tremendously over the past 10 years, both from a positive perspective but it's certainly seen challenges. The space is heavily debated, and most recently, particularly here in the U.S., has faced immense scrutiny.

On a positive note, there's been a lot of maturity in the space and in some aspects of sustainable investment. We've seen companies and governments become more transparent about the materiality and the impacts of things like climate change and the need to focus on human capital and many other areas. That provides investors more data and information to make better investment decisions with.

Unfortunately, I don't think the scrutiny and polarization is behind us, there's more to come. But my hope is that it will stop being so heavily debated, that some of these global sustainability challenges do not have investment implications or do not need to be addressed by public and private partnerships. I think it's critical and obvious that they do, and they are having impact on our day-to-day lives across the global economy.

So, I do think we still have a lot of this scrutiny ahead of us, but I think there's a little bit of a silver lining in this. We've seen such a wave of folks coming to market with sustainability strategies or integrating sustainable investing and all the various different approaches, and not a lot of clarity in approach, and I think the scrutiny has forced many to reflect on their approaches and authenticity in their investment process.

Hopefully, we're getting back to a world where we can have some more standardization around how people are doing this, and doing it in an authentic way, and are thinking about it in terms of how it's financially impacting the investments that we're making.

TWST: Thank you. (MN)

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