Caron's Corner Transcript - 9.19.2022

The Strategy for Fixed Income as Yields Rise

- The recent rise in yields may be providing an opportunity to start adding duration through core fixed income and total return strategies.
- Bond yields have risen and they are starting to reflect the realities that the Fed may need to hike policy rates toward 4.25%
- Expectations were previously too low, but I am finally comfortable with rise in yields because consensus expectations for policy rates finally reflect reality, in my opinion.
- But with the rise in rates also comes the risk that the economy may slow in 2023 and longer duration bond exposures may benefit. We can't rule this out.
- Our asset allocation strategy has been a bar-belled approach that on one side recommends owning short duration and floating rate assets to manage the risk of rising rates and on the other side owning more traditional core fixed income and total return strategies with a longer duration.

Jim Caron: "Yields continue to rise and this is creating some anxiety in the markets. But the rise in yields also provides some opportunities. What I think is that bond markets are starting to reflect the reality that the Fed may have to hike policy rates towards that 4.25%. I'm finally comfortable with the rising yields because consensus expectations for policy rates are finally reflecting reality.

But with the rise in rates also comes the risk that the economy may slow in 2023 and long duration bond exposure may actually benefit from that. Our asset allocation strategy has been a barbell approach, something I've discussed often on previous audiocasts. On one side we recommend owning short duration and floating rate assets to manage the risk of rising rates. On the other, more traditional core fixed income and total return strategies with longer duration. One of the most frequently asked questions I get is what do I mean by core fixed income and more traditional total return strategies.

The answer? I define these types of strategies as owning multi-sector investment grade fixed income assets including Treasuries, corporates, mortgages and the like, that are benchmarked against a broad U.S. Aggregate style index. But, rather than having me explain this, I'm pleased that we have Vishal Khanduja, a portfolio manager on our core fixed income and total return strategies, who will explain this type of strategy in more detail.

As someone who manages these strategies every day let me ask some questions I often get. First could you talk about the benefits of adding duration to core fixed income and total return portfolios in the midst of rising bond yields? How do you manage this risk?

Vishal Khanduja: "Good morning Jim. This is the perfect day to have this discussion as we are retesting the 3.5% ten-year U. S. treasury rate. I expect we'll probably see a lot more hikes around the globe in

the next 24 to 36 hours. But I would love to take a slight step back here. You know, I think we believe that there are three key drivers along some interest rates for a developed market: Real growth rates, realized inflation and inflation expectations. Monetary policy is solely focused on bringing down inflation, while keeping inflation expectations anchored and bringing some growth down. We believe that we are starting to see that growth slowdown. We believe that interest rates are compelling value. Now keeping that thing in mind, we strongly believe that investors should consider increasing that duration in their fixed income allocations and specifically via traditional fixed income strategies. Although volatility feels terrible while we're going through the period, it provides compelling opportunities. The most ignored or under allocated portion of traditional fixed income are core plus sectors.

Coming back to your question, throughout this year we have utilized various tools and strategies in our portfolios to manage interest rate risk. We had increased their allocation to floating rate securities at the beginning part of the year, securities that actually benefit from rate hikes, and reduced allocation to negatively convexed securities to avoid owning bonds that actually extended maturity as rates spike. Then we increased our allocation to bond structures that pay coupon and principal amortization payments monthly so that we can reinvest those higher payments and higher interest rates to cushion the negativity caused by higher or spike in interest rates. We continue to hold small allocations of these various strategies in our portfolio. But we've reduced such allocations as we are tending to believe that there is a lot more value in increasing duration.

And you know, look, rising interest rates are always something that people are going to be worried about. But aside from inflation and rising rate risks, people are also worried about the potential for recession risks because central banks are hiking rates very aggressively. This could create a slowdown in the economy, potentially a hard landing or even a recession. And when people get concerned about this, they typically focus on credit spreads and they start to worry that credit spreads may actually start to widen. I know that these types of strategies, these core fixed income and traditional strategies typically own a decent amount of credit.

Jim: So how do you think about this risk? How do you manage it?

Vishal: That's a very natural next question, Jim. Thinking back to our three key drivers of interest rates, it’s logical to think that a central bank is trying to control inflation and inflation expectations by slowing growth down. One possible outcome of that is a recession, and even though risks are elevated at the moment, we don't believe that a recession is inevitable. But honestly Jim we spend much less time trying to call a binary event like recession. Instead what we do is focus on how various corporate and household balance sheets here in the U. S. will fare in a slower growth environment. That brings back to one of our strong beliefs that the resiliency of balance sheets coming into this period is very strong. Both consumers and corporations in the U.S. have prudently utilized the low interest rate environment. Starting from the lows of May 2020 to the end of 2021 to extend the maturity of their liabilities, they have done that in very stringent underwriting environment meaning prudently underwritten loans and then they've done it mostly with fixed rate debt that cushions the balance sheets and does not bring in the unintended consequences of higher liability rates as rates go higher.

For this reason we believe that credit spreads will be a lot more resilient than in stressed episodes that we had seen in 2008 or 2020. Another point here is the adjustment in yields and spreads this year, investors do not have to compromise actually on the quality of fixed-income portfolio to get yield. Both interest rates and credit spreads this year have spiked at the same time, which is very unusual, but creates very attractive opportunities for fixed-income investors going forward. What I mean by not compromising on quality is that investors do not have to go down in ratings or capital structure to get that increased yield. Single, mid to high, single digit yields are achievable in high quality diversified fixed income portfolios. Lastly, we do humbly accept that during these inflection points, markets do tend to overshoot and in such an event and over shooting credit spreads could absolutely happen where spreads could widen. Typically these events are very short lived and traditional fixed income strategies should do better versus some of the highly leveraged ones. If you couple that with the higher duration that some of these traditional fixed income strategies bring along with it, that if growth is lower, your interest rate should react lower and that should serve as a little bit of a cushion as spreads are widening out or spiking higher again. Starting valuations are pretty compelling and they should cushion investors in such short lived events of credit stress.

Jim: So one more question for you, Vishal. Given all that you're saying in terms of how the market has been set up and the recent rise in rates that we've gotten and your outlook on the risk of recession and how you manage that, is now the right time to start adding duration to one's fixed income allocation through these core and total return strategies?

Vishal: The very short answer here Jim is absolutely, yes. You know, these strategies have been under allocated immensely since the global financial crisis in 2008, and there are a few reasons for that. Valuations have broadly been compressed by a monetary policy regime following the 2008 crisis. The risk of recession and higher inflation were very, very low given the big footprint that that the central bank had in the markets. When those two risks are low, it allows for getting out of your traditional fixed income strategies and into benchmark sectors with better risk reward. Those were a lot more favored, and we did exactly that for our investors during that time. These traditional fixed income sectors do have a high allocation to negatively convex assets and longer duration assets. Those don't bode well when you go through a treacherous spike in interest rates that we've seen over the last 9 to 12 months. I'm going to use the word pivot a little loosely here, but the significant pivot that we've seen in monetary policy here in the last 12 months to align with the inflation and growth dynamics has caused a complete reversal in all those aspects that kept investors away from traditional fixed income assets or sectors, if you will. All those aspects of traditional sectors and strategies are now in perfect unison, that negative convexity has dramatically reduced, given dollar prices of adjusted lower coupons with higher spreads. A wider and high quality speculation at this point is well compensating investors to take that risk. I would probably go out on a limb here and we are reentering into an era where high quality traditional fixed income strategies will provide the income, the diversification and the volatility hedge that an investor typically wants from these strategies. These three aspects of the income diversification and the hedge for volatility are why these traditional fixed income strategies have gained focus even prior to the financial crisis.

How do we construct these portfolios? We're taking all these macroeconomic factors and combining it with our deep understanding of expected return and risk adjusted returns for various sectors over various economic scenarios. Then we're looking at the correlations of these sectors amongst each other to build that diversified fixed income portfolios that over time, have performed on a consistent basis. One thing that we never touched on during the conversation is security selection, a key to our process. Security selection brings in a lot more consistency to our alpha within these traditional fixed income strategies, whether it's the issue of selection, whether it's the capital structure selection within an issue or stack if you will. One last item that I often stress is that environment like these where we have high valuation dispersion among sectors and industries, high dispersion in expected terms and expected risks and standard deviations of those industries, it is critical to be actively managing your fixed income allocation. When monetary policy and economic conditions are changing, it's an almost unachievable ask for passive portfolios to adjust to these economic conditions.

Jim: Thanks Vishal . One of the things that we've discussed on our audio cast in the past is really a broad allocation to fixed income. We have short duration floating rates. We've got some longer duration strategies and what's important is that we blend these things together. One point that we've advocated in the past is that we like to see somewhere around 3 to 4 years of overall duration in a fixed income asset allocation. The strategies that Vishal has been discussing are these core and traditional strategies. Thank you for listening and thank you Vishal for providing a lot of clarity on how to incorporate a longer duration strategy into a fixed income portfolio."

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CRC 4951235 Exp. 9/30/2023