Fixed Income Strategies

QUARTERLY UPDATE

First Quarter 2018

THOMAS D.D. GRAFF, CFA

Head of Fixed Income, Portfolio Manager

Review & Outlook

We heard a lot about "risk" from our clients during the first quarter of 2018. For just the second time since 2009, both the S&P 500® Index and the Bloomberg Barclays U.S. Aggregate Bond Index posted a negative return.

When most investors think about "risk" and bond portfolios, they immediately think about rising interest rates. Indeed in any given quarter, if bond portfolios fall in value, interest rates are almost always the culprit. The first quarter of 2018 was no exception. The 10-year Treasury yield rose by 0.33%, which was the main driver behind the Bloomberg Barclays U.S. Aggregate Bond Index returning a negative 1.40%. This is the second bout of rates lurching higher in the last two years, the first coming in the fourth quarter of 2016. All told, the 10-year Treasury note rose from a yield of 1.36% in July 2016 to as high as 2.95% in late February before finishing the quarter at 2.74%.

The conversation about risk can get tricky when discussing a bond portfolio. As stated above, interest rates are typically the main source of volatility for a bond portfolio. But are volatility and risk the same? That depends entirely on an investor's time horizon. From the low in rates in July of 2016 through the end of February, a 10-year Treasury bond would have lost over 8% in total return. That is definitely volatile. Of course, if the time horizon were 10 years, the realized volatility would go to zero when the bond matures.

Most clients, however, do not have neatly defined time horizons. They use portions of their portfolios for spending or rebalancing into other asset classes; this means that some of the portfolio winds up having a short time horizon. The remainder of any given portfolio is structured to be more or less permanent, and meant to provide stability and diversification over a long time horizon. This means that volatility is important, and we cannot allow our portfolios to become overly sensitive to interest rates in the pursuit of more yield. It also means that in order to serve the stability function that clients want from a bond portfolio, we have to be keenly focused on downside protection.

We use a number of tools to manage volatility and protect against downside risk, all without sacrificing yield. We will highlight some of what we are using more heavily today and what we think will help not just dampen volatility, but also produce performance.

Floating rate bonds are an obvious way to protect against rising rates and are a tool we have been heavily using in recent quarters. These are bonds where the coupon rate increases along with short-term interest rates. So as the Federal Reserve has been raising their interest rate target over the last two years, the stated rate on these floating bonds has also gone up. In turn, this means the price of these bonds has almost no sensitivity to interest rates at all.

This tool is available in various forms. There are attractive floating rate bonds in the corporate sector, tax-free municipals, asset-backed bonds, commercial mortgages and securities backed by bank loans. While we certainly make heavier use of floating rate structures in lower-duration strategies, such as strategic bond, we use them in traditional strategies as well. Tax-exempt floating rate bonds have been a major driver of outperformance for our municipal strategies during this period of rising rates. Since the low in the 10-year Treasury in July 2016 to February 2018, the floating rate bonds in our municipal strategy were up 6.8% cumulatively. Remember, the 10-year Treasury was down over 8% during that same period.

Another important tool for managing volatility is reinvesting. Owning bonds that return principal on a regular basis moderates both interest rate and credit exposure. If interest rates were to rise rapidly, the principal coming back can be reinvested at higher rates—the same goes if credit conditions deteriorate. The bond pays investors back, which limits downside, and the fresh cash provides an opportunity to invest at more attractive valuations. Auto loan asset-backed bonds are the perfect example of these types of securities. The underlying loans are relatively short term, usually around six years, and the actual bonds are structured to pay off more senior notes with all available principal first. That means that most of the auto-related bonds we buy are only one to two years in average life. For example, in July 2016, we held a AA-rated Santander

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INDEX PERFORMANCE AS OF 03/31/2018 (%)

INDEX NAME	3-MONTH
Bloomberg Barclays U.S. Aggregate Bond Index	-1.46
Bloomberg Barclays Int. Aggregate Bond Index	-1.05
Bloomberg Barclays U.S. Treasury Index	-1.18
Bloomberg Barclays Long U.S. Treasury Index	-3.29
Bloomberg Barclays Mortgage-Backed Sec. Index	-1.19
Bloomberg Barclays U.S. Corporate Index	-2.32
Bloomberg Barclays U.S. Corporate High-Yield Index	-0.86
Bloomberg Barclays U.S. Municipal Bond Index	-1.11

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

auto bond with an average life of just over two years. Between then and the end of February 2018, the two-year Treasury rate rose from 0.6% to 2.3%, but the Santander bond's return over that period was +2.6%

We should emphasize that we did not buy these types of bonds in anticipation of rates rising rapidly. We invested because, we determined that they had a favorable risk/reward profile. The bonds described above had an attractive yield even if rates had remained steady. Alternatively, one could have held more cash in mid-2016 guessing that rates would rise and present more favorable opportunities. In hindsight, this could have worked great, but it would have been a binary bet of winning if rates rise and losing if rates fall. Additionally that kind of timing also requires timing your re-entry. When have rates risen enough to buy back in? Lastly, holding excess cash means losing out on income generation. So the longer an investor would wait for rates to rise, the more precise the forecast needs to be.

Instead, we used the tools we described above, which allowed us to get a little more stability in the short term as rates rose but also gave us plenty of income generation should rates remain steady or even fall. There was no need to time anything exactly right. We should note that the benchmarks for our various strategies do not include any floating rate bonds, nor most of the auto-ABS we buy. Having the flexibility to find bonds with value regardless of their type of issue is also an important source of value-add, both in terms of return generation and stability.

We have spent most of this letter describing tools that protect against interest rate volatility, but we actually do not think of this as the most important risk for bond investors. Rather, when we talk about risk within our team, we are almost always talking about the chance that a bond becomes truly impaired. We spend more of our collective brain power analyzing that ultimate downside risk than anything else. This is not to say shorter-term volatility does not matter; in fact, we think this downside focus also helps dampen the volatility of our portfolios. Bonds with less downside potential tend to be more stable during periods of credit stress, either for the creditor specifically, or the market generally.

For clients who want a bit more interest rate protection, we have shorter duration strategies like, Limited Duration and Strategic Bond. However, we use the tools we described here for protecting against risk across all of our strategies. We believe that by remaining flexible and focused on ultimate downside protection, we can deliver portfolios that produce attractive yields while still offering stability.

Disclosures

Bloomberg Barclays U.S. Aggregate Bond Index is an unmanaged, market-value-weighted index composed of taxable U.S. investment-grade, fixed rate bond market securities, including goverrnment, government agency, corporate, asset-backed, and mortgage-backed securities between one and 10 years.

Bloomberg Barclays Intermediate Aggregate Bond Index is an unmanaged index that consists of 1-10 year governments, 1-10 year corporates, all mortgage and all asset-backed securities within the Aggregate Index.

Bloomberg Barclays U.S. Treasury Index is an unmanaged index of public obligations of the U.S. Treasury with a remaining maturity of one year or more.

Bloomberg Barclays Long U.S. Treasury Index includes all publicly issued, U.S. Treasury securities that have a remaining maturity of 10 or more years, are rated investment grade, and have $250 million or more of outstanding face value.

Bloomberg Barclays Mortgage-Backed Securities Index is a market-value-weighted index that covers the mortgage-backed securities component of the Barclays U.S. Aggregate Bond Index. The index is composed of agency mortgage-backed passthrough securities of the Government National Mortgage Association (Ginnie Mae), the Federal National Mortgage Association (Fannie Mae), and the Federal Home Loan Mortgage Corporation (Freddie Mac) with a minimum $150 million par amount outstanding and a weighted-average maturity of at least 1 year. The index includes reinvestment of income.

Bloomberg Barclays U.S. Corporate Index is a broad-based benchmark that measures the investment-grade, U.S. dollar-denominated, fixed rate, taxable corporate bond market. It includes USD-denominated securities publicly issued by U.S. and non-U.S. industrial, utility and financial issuers that meet specified maturity, liquidity and quality requirements.

Bloomberg Barclays U.S. Corporate High-Yield Index measures the market of USD-denominated, non-investment grade, fixed rate, taxable corporate bonds. Securities are classified as high yield if the middle rating of Moody's, Fitch and S&P is Ba1/BB+/BB+ or below, excluding emerging market debt. The U.S. Corporate High-Yield Index was created in 1986, with history backfilled to July 1, 1983, and rolls up into the Barclays U.S. Universal and Global High-Yield Indices. The U.S. Corporate Index rolls up to other Barclays flagship indices, such as the U.S. Aggregate and the multi-currency Global Aggregate Index.

The **Bloomberg Barclays U.S. Municipal Bond Index** covers the USD-denominated long-term tax-exempt bond market. The index has four main sectors: state and local general obligation bonds, revenue bonds, insured bonds and prerefunded bonds.

An investor cannot invest directly in an index.