Fixed Income Strategies

QUARTERLY UPDATE

Third Quarter 2018

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Review & Outlook

Brown Advisory's Fixed Income team aims to deliver performance primarily through individual bond selection. To achieve this, all of our strategies make heavy use of so-called "spread" sectors; these include corporate bonds, mortgage bonds, revenue municipals, etc. In other words, we favor sectors where our analysts can have a differentiated view on a particular bond. The "spread" moniker implies that these bonds yield more than government bonds or state-level municipals and hence can drive relative performance. Using these sectors, we believe that we can garner outperformance by either earning that extra income above government bond yields or realizing price gains as the bond's spread compresses.

However, periods like what we have seen so far in 2018 can present something of a challenge to this approach. The good news is that we view the current economic conditions as favorable for credit fundamentals. The bad news is that because of such good conditions, spreads are very tight. This means that we are getting less extra yield over government bonds than in years past. The market is rational to price credit risk as relatively low, but it leaves bond pickers with fewer opportunities to outperform.

Our approach to a market like this is to stick with our discipline. We buy bonds that make sense, and we do not compromise on our risk parameters just to boost yield. We believe that owning enough of these types of bonds to earn a reasonable return while retaining some dry powder for times when the opportunity set is more plentiful will be a successful strategy. Here are our thoughts on why:

Markets Do Not Move Without a Catalyst

As much as markets can sometimes feel like a truly random walk, they are not. The stock market is not going to fall persistently unless something happens to ding earnings. The credit market typically does not widen unless default rates are actually threatened. The yield curve typically does not steepen unless the Fed stops hiking rates. Of course, legitimate catalysts can come by surprise. There are also plausible catalysts already "out there": trade wars, China's economy, emerging markets debt, etc. We believe that the U.S. economy is in such a position of strength right now, it would take a tremendous shock for the economy to suddenly turn weaker. Even the 2008 financial crisis, which certainly had dramatic and fast-moving moments, was a really long time coming. Unemployment stopped falling more than a year before the recession hit. Indicators like the Institute for Supply Management (ISM) survey or personal consumption had been falling for two years. Robust Septembers followed by contractionary Decembers typically do not just happen—it usually takes some time.

Time Is on Our Side

Our focus on bonds with extra yield has an important benefit: it puts time on our clients' side. If indeed the economy is strong enough that a recession is some time away, having time on our side seems especially advantageous. It means that every day the economy remains robust, we are building an ever-increasing return cushion ahead of a period where the cycle turns. The passage of time is highly certain. The timing of cycles is highly uncertain. We like betting on the former.

Just Because It Feels like 2005 Does Not Mean 2007 Is Around the Corner

In many ways, this period feels a lot like 2005, which is the last time corporate and municipal spreads were this tight, the yield curve was flattening, and the Fed was hiking in a methodical fashion. But we remain cautious in making simplistic historical comparisons: just because it feels like 2005 does not mean 2007 is right around the corner. This cycle has not seen the kind of excesses of either the 2005–2007 period, or the 1996–1999 period. In both of those cases, capital flowed overwhelmingly into a narrow set of sectors, which eventually needed a painful rebalancing. While there are some excesses today to be sure, it is nothing like either the housing or dotcom bubbles, in our view.

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INDEX PERFORMANCE AS OF 06/30/2018 (%)

INDEX NAME	3-MONTH	PAST 12 MONTHS
Bloomberg Barclays U.S. Aggregate Bond Index	0.02	-1.22
Bloomberg Barclays Int. Aggregate Bond Index	0.11	-0.93
Bloomberg Barclays U.S. Treasury Index	-0.59	-1.62
Bloomberg Barclays Long U.S. Treasury Index	-2.88	-3.56
Bloomberg Barclays Mortgage-Backed Sec. Index	-0.12	-0.92
Bloomberg Barclays U.S. Corporate Index	0.97	-1.19
Bloomberg Barclays U.S. Corporate High-Yield Index	2.40	3.05
Bloomberg Barclays U.S. Municipal Bond Index	-0.15	0.35

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

So what happens if there is a "run-of-the-mill" recession sometime in 2020 or 2021? It could be a lot more mild than 2007–2009, which would likely mean benign performance from our favored spread sectors. Alternatively, we could have a nonrecession recession like 1995, where GDP slowed to about 1.3% in the first half of the year. This caused many to predict a recession was on its way, but the economy rebounded in the second half. The credit markets were a bit choppy in late 1994 but finished 1995 positive.

Putting this together with the earlier point: if the cycle takes a long time to turn, we will earn extra yield while we wait. If any coming downturn is mild, we would likely do better holding spread bonds over the period. We see these as two important ways to mitigate risks in remaining in spread bonds despite current valuations.

Despite All of the Above, Stay Focused on Downside Risks

Our individual bond analysis always focuses on downside risks, which we view as the most important protection against cyclical risk. We analyze our bonds through a cycle, meaning that we consider how the underlying company, municipality or structure will perform assuming a recession. This discipline gives us a high degree of confidence in how a credit will ultimately perform, even if we see a downturn sooner than expected.

We also stick to a strict pricing discipline, which helps us buy not only what we view as the best bonds out there but also bonds that are reasonably priced given where we are in the cycle. Because spreads are historically tight, we do own less credit risk in our strategies today than we did one or two years ago. As a result, we can be opportunistic when the cycle does turn, and our opportunity set is more attractive.

There Still Are Opportunities

Spreads are tight everywhere—in municipals, corporates and securitized bonds—but that does not mean we cannot find ways to produce attractive performance, nor does it mean we have to go outside of our standard process to find attractive bonds. The municipal team has been using floating rate bonds to add meaningful performance as short-term rates have risen. In taxable bonds, short-duration asset-backed securities and collateralized loan obligations have performed a similar purpose. In addition, we have consistently found individual corporate bonds that, as a group, have outperformed the corporates within our benchmarks.

This tight spread environment does mean that fixed income performance will not likely have the easy tailwind of an improving credit environment going forward; however, we believe that focusing on both bottom-up bond selection and downside analysis may produce attractive performance.

Disclosures

The views expressed are those of the author and Brown Advisory as of the date referenced and are subject to change at any time based on market or other conditions. These views are not intended to be and should not be relied upon as investment advice and are not intended to be a forecast of future events or a guarantee of future results. Past performance is not a guarantee of future performance and you may not get back the amount invested. The information provided in this material is not intended to be and should not be considered to be a recommendation or suggestion to engage in or refrain from a particular course of action or to make or hold a particular investment or pursue a particular investment strategy, including whether or not to buy, sell, or hold any of the securities mentioned. It should not be assumed that investments in such securities have been or will be profitable. To the extent specific securities are mentioned, they have been selected by the author on an objective basis to illustrate views expressed in the commentary and do not represent all of the securities purchased, sold or recommended for advisory clients. The information contained herein has been prepared from sources believed reliable but is not guaranteed by us as to its timeliness or accuracy, and is not a complete summary or statement of all available data. This piece is intended solely for our clients and prospective clients, is for informational purposes only, and is not individually tailored for or directed to any particular client or prospective client.

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.