TREASURY | PARTNERS

Portfolio Strategy

Prioritizing Protection

September 26, 2018

Richard Saperstein
Managing Director/Principal
+1 917-286-2777
rsaperstein@treasurypartners.com

Steven Feit
Managing Director
+1 917-286-2793
sfeit@treasurypartners.com

Daniel Beniak, CFA
Director
+1 917-286-2783
dbeniak@treasurypartners.com

treasurypartners.com

One of the biggest mysteries facing the Fed and investors alike has been the absence of inflation despite the current back drop of strong economic growth. We're also surprised and would like to update you on our latest thinking on market conditions, inflation, and fixed-income strategies.

Our Philosophy

We're opportunistic. But at the same time, our most important goal in managing client fixed income portfolios is to manage risks. Our customized portfolios prioritize principal protection while providing liquidity for unique client requirements (e.g. cash withdrawals, capital calls, changes in tax situations, etc.). Therefore, within broad asset allocations the fixed-income component serves as the primary source of safety and liquidity. As a result of these directives, portfolios typically will not match the credit and maturity characteristics of benchmarks.

In the world of fixed income there are two types of risk – default risk and inflation/interest rate risk. Default risk can be combatted with our intensive credit analysis and willingness to actively trim deteriorating credit exposures.

Inflation/interest rate risk, on the other hand, can only be managed by *deliberate positioning to minimize harm*. This is because when rates rise, all fixed-rate bond returns suffer, but longer-dated bonds are hit with greater price losses than shorter-dated bonds (as they have higher "durations," or price sensitivity to interest rate changes). As a result, tilting towards shorter maturities is an effective strategy for minimizing the "bite" of higher rates.

When making investment decisions, we combine these principles with our macro-level assessments of economic and financial market conditions to determine whether risks appear to be increasing or decreasing. In market conditions where we judge potential upside is insufficient compared to the level of risk, we will "tighten up" credit exposures and/or shorten maturity positioning.

Current Environment

Longtime readers know of our creeping concern about inflation, which has both direct and indirect impacts. Directly, rising inflation causes interest rates to increase, which brings down bond prices and hurts current bondholders. Indirectly, higher inflation also reduces the real purchasing power of bond's principal, meaning "waiting out" bond price losses by holding positions until maturity still doesn't preserve the full value of the original capital.

Long-Term Trends in Bond Risk

Rising bond price risk is a lasting consequence of the 2008 crisis that has impacted our thinking on fixed income portfolio positioning.

Pre-crisis, rates were significantly higher, and the income generated from bonds was often sufficient to offset the price declines of a rising interest rate environment. Therefore, investors often didn't have to extend maturities to capture yields that handily exceeded the rate of inflation. While inflation has been low, this has not been the case post-crisis, as rates have been significantly lower and require accepting longer maturities (and greater price risk) per unit of real return.

Maturity	Treasury Yield 8/1/2007	Treasury Yield 9/25/18
2 Year	4.60%	2.83%
5 Year	4.64%	2.98%
10 Year	4.79%	3.10%

Source: Bloomberg

The implication is that today's longer maturities (and lower yields) translate into higher duration risk. This means fixed income investing is riskier, subject to greater volatility, and comes with substantially less yield compensation.

Looking back, the 10-year Treasury yield had been in a clear multi-decade downtrend (following a multi-decade trend higher) leading to the post-crisis "trading range" of approximately 1.50-3.00%.

Source: Bloomberg

After three decades of declining rates accelerated by the Great Financial Crisis, have we hit bottom? Putting aside this longer-term question, in practice the risk for investors is asymmetric –there's more room for rates to move higher than lower. A very specific set of benign market conditions and central bank policies would be required for rates to remain at low levels. In this low-yield environment, fixed income investors have little margin for error if these conditions aren't maintained.

Given these longer-term trends, we aren't willing to invest client capital under the assumption that the world has permanently changed and rates will remain anchored near current lows.

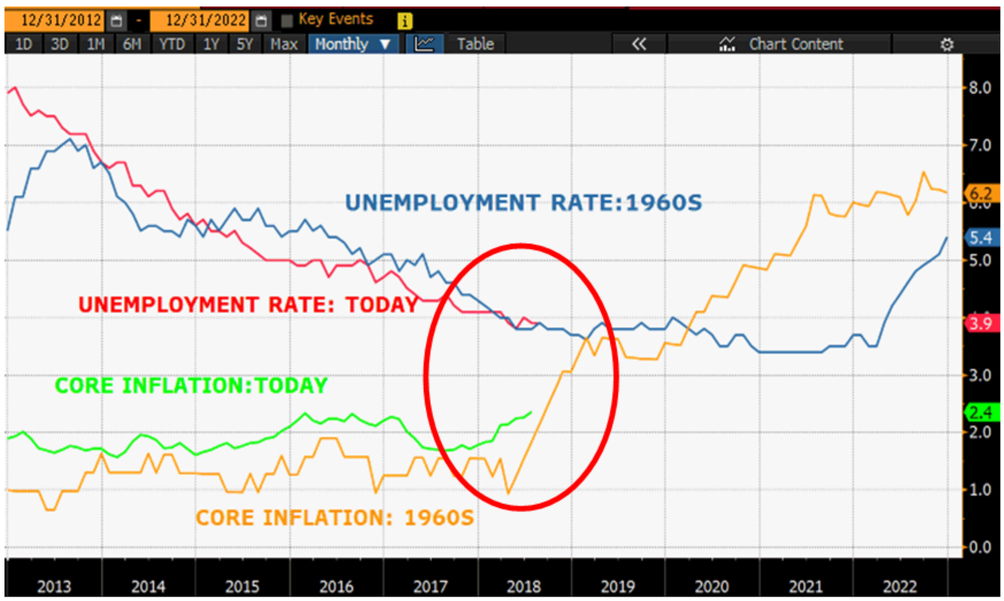
Despite the fact that inflation measures have remained benign, we've recently positioned portfolios to guard against rising inflation in 2019. Several factors inform this decision, including:

- The long-running US expansion appears to be accelerating
    - ◊ GDP growth and corporate earnings are benefiting from tax cuts
    - ◊ Unemployment remains at historic lows, with increasing evidence of worker shortages and job-hopping behavior that typically precedes wage growth
- Consumer and business confidence remain near cycle highs
- Tax reform's stimulative effects should become more powerful with time, as corporations begin to take advantage of 100% capital expensing
- The experience of the 1960s, which witnessed a long period of low unemployment before inflation took off, provides a strikingly similar analogue to today

Although we don't see a return of 1960s or 1980s levels of inflation, any significant uptick in an environment of structurally low interest rates could have harmful effects on bond portfolios. We therefore have positioned bond portfolios with shorter-maturity debt and lowered overall portfolio durations.

But every coin has two sides – if inflation fails to pick up, this strategy will underperform traditional metrics. In addition, our income return will also be reduced.

Unemployment and Inflation Comparison: Today vs. 1960s



Source: Bloomberg

We prefer to think of this strategy as buying an insurance policy which minimizes the worst effects of an inflationary spike. Nothing is free, and in this case the "premium" we're paying is the foregone additional yield available from holding longer maturities.

Summary

With short-term rates primed to keep moving higher and the curve flattening due to continuing Fed hikes, the foregone additional yield from not extending maturities has been minimal. Until the economic situation changes or longer yields reflect a more appropriate risk/reward balance compared to laddering short maturities, we don't foresee changing tactics.

As always, please feel free to reach out to us with any questions.