

Pivoting Away from Traditional Fixed Income



This is the third piece in our three-part-series on the recalibration of investment tools and portfolio design.

U.S. fixed income has been a reliable diversifying asset since the early 1980's when the Federal Funds Target Rate reached 20% to combat rising inflation. Now, forty years later, fixed income yields are at a generational low and will not provide investors the return and diversifying benefits previously enjoyed. The immediate implication is that the commonly utilized 70/30 or 60/40 portfolio construct has substantially more risk than it has had in decades. Real rates of return in U.S. government and investment grade corporate fixed income are now negative. The shifting investment landscape requires us to recalibrate our tools, it requires agility, vigilance, and it requires avoiding antiquated paradigms that have been rendered obsolete. Failing to make this adjustment is likely to lead investors clinging to old asset allocation models to undershoot their long-term return targets.

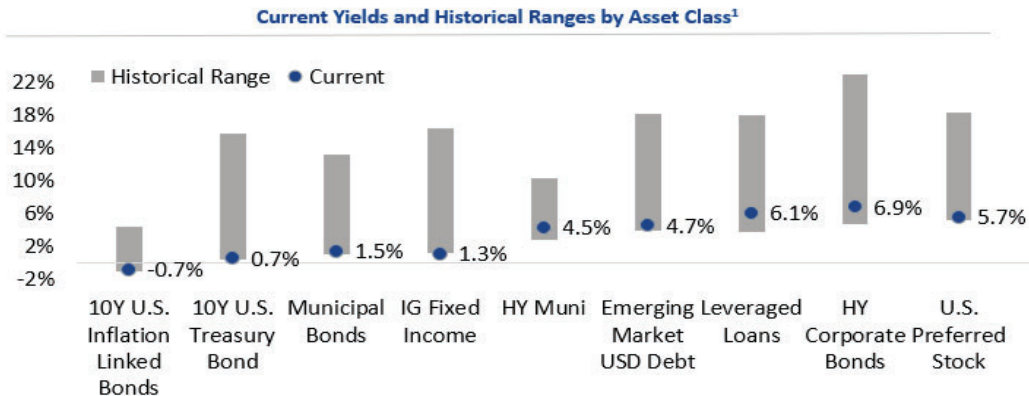
Aggressive purchases by the Federal Reserve of government, corporate, municipal and even high yield bonds further complicate the investment landscape. The adage "buyer beware" seems appropriate for many fixed

income opportunities when balancing low returns with the potential for meaningful drawdowns, either via credit deterioration, rising interest rates and potentially one day the sale of fixed income securities by the Federal Reserve. Chart 1 shows bond yields at multi decade lows and historical drawdowns on principal that are noteworthy.

Moral Hazard

The nearly limitless ability of the U.S. Treasury and the Federal Reserve to support the economy has important ramifications for allocators of capital. In addition, the hastily conceived nature of some of these emergency programs makes long-term outcomes unpredictable. It is striking to consider that the Federal Reserve is the third largest investor in the largest corporate bond ETF, owns positions in sixteen other ETFs and also owns ample amounts of municipal and high yield debt. Are these now risk-free assets or will the Fed eventually move away from them? Importantly, where does the line of solvency get drawn and how will investment managers respond?

Chart 1



Drawdown²

Asset Class	Drawdown
Inflation Linked Bonds	-12.2%
Nominal Sovereign Bonds	-19.7%
Municipal Bonds	-22.4%
IG Fixed Income	-12.7%
HY Muni	-30.2%
Emerging Market USD Debt	-32.7%
HY Bank Loans	-29.2%
HY Corporate Bonds	-33.3%
U.S. Preferred Stock	-55.1%

Source: S&P, Bloomberg. Data as of July 22, 2020.

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Do credit spreads adequately compensate investors for the underlying risks? Given these challenges facing fixed income investors, we believe the risk/reward is asymmetric to the downside.

Many pundits argue that deflation is the greatest near-term risk, while others argue inflation is nearer than many expect. Current Federal Reserve reflation policy initiatives suggest rates may stay low, but it is unknowable where rates will be in 2-4 years. If rates were to rise in response to increased inflation expectations, normalizing Fed policy, a loss of confidence, or a weakening U.S. dollar, investors could experience principal loss on their longer duration fixed income investments. After a forty year bull market in bonds complacency is likely, which means investors are not prepared for rising interest rates when it happens.

Avoid Structural Complexity

To generate bond-like income and diversification benefits, some investors have resorted to structured product solutions. Structured products are expensive derivative-based contracts priced to achieve a specific outcome, but with no guarantee that the specific outcome will happen. The imbedded investment theme can be very attractive, but it is often too dependent on timing, which is unpredictable. Importantly, while the investor owns a sub-optimal security with no guarantees, the “entity” that structures the investment will always make money.

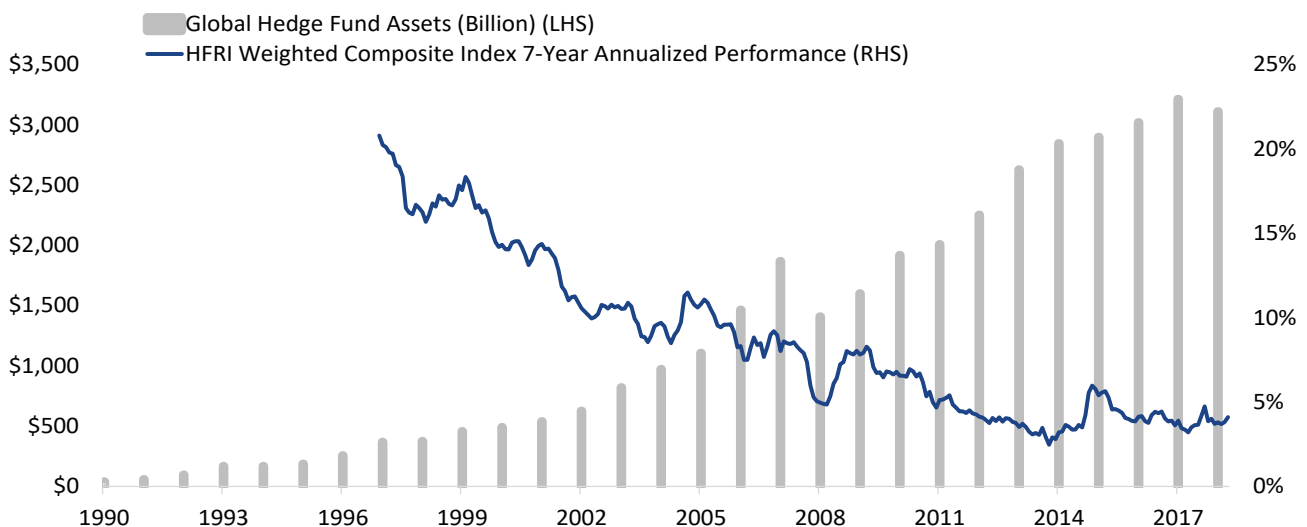
This makes structured products unattractive in our view.

The uniqueness of hedge funds has also been severely diluted. While there are some excellent managers, the structure of the funds is typically costly and has been an unreliable source of consistent risk management and return. In the past 20 years as shown in Chart 2, hedge fund net returns have experienced a noteworthy decline. In 2007-8, our client portfolios had as much as 40% deployed to hedge fund managers, today it typically is around 10%. Hedge Funds have lost much of their appeal due to too much capital chasing harder to find returns. We plan to invest in carefully selected hedge fund managers, but have a much higher threshold for deploying capital to this structure.

Our Solution

The challenge of replacing 30%-40% of a portfolio to achieve a historically consistent return target while still maintaining portfolio diversification is a major focus. The temptation for many allocators is to reach for yield, which risks permanent impairment of capital, elevated marked to market volatility, or greater drawdown risk as noted earlier. As there are no free lunches, one must assume different risks to generate necessary returns. These risks can include less liquidity, lower credit quality and/or higher volatility. Consequently, we have been utilizing several alternatives to provide an attractive combination

Chart 2: A proliferation of hedge funds globally has led to increased competition and lower returns



Source: Bloomberg, HFRI Fund Weighted Composite Index.

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of higher returns, diversification, and low correlation to equities, including managers that specialize in direct lending, music royalties, reinsurance, life insurance settlements, litigation finance³ and relative value credit. Many of these strategies are capacity constrained and have barriers to entry such as domain knowledge, and/or have an ample margin of safety that compensate investors for any additional assumed risk such as credit quality or lower liquidity. They also avoid risks found in traditional fixed income today such as being over-crowded and long(er) duration, which is susceptible to a decline in principal with an increase in future interest rates.

Examples of these niche investments include:

- *Music Royalties* – a diversified portfolio of digital music rights, supported by seasoned catalogues of mature music rights with stabilized cash flows and target net returns of 12-14%, and potential upside at exit.
- *Life Insurance Settlements* – a highly diversified portfolio of previously settled life insurance contracts, focused on healthy policy holders with target net returns of 13-15%.
- *Reinsurance* – a diversified portfolio of industry loss warranties across four primary dimensions: type of peril, geographic region, severity of loss and structure with a targeted net return of 7-9%.
- *Relative Value Credit with Hedging* – seeks to capitalize

on structural discrepancies in the credit derivatives market driven by regulatory changes in the financial sector. Strategy generates a positive carry of which half is used to buy put options on credit markets with a targeted net return of 6-10%, while maintaining optionality and material downside protection.

- *Direct Lending* – targeting a 12-15% net internal rate of return (IRR) with an average expected duration of 2-3 years. The loans are corporate, highly collateralized with an emphasis on downside protection, and focused on Asian markets where banking rules are different than the U.S., leading to notable inefficiencies and opportunities.
- *Litigation Finance* – an uncorrelated and diversified return stream that selectively partners in complex commercial litigation where there is little competition and domain knowledge is an important asset. The strategy seeks a 13-16% net IRR over a multi-year timeframe.

Our conclusion is that to generate strong risk adjusted returns investors need to recalibrate their portfolios – pivoting away from traditional fixed income and toward well researched diversifiers that are uncorrelated and uncrowded. Our focus in this area is on transparency, consistency of return and sustainability of the business model. In the meantime, we remain ever vigilant regarding the direction of interest rates and will consider fixed income investments when rates and credit spreads provide proper compensation for risk.

End Notes

¹ Start dates for the individual asset classes vary and are based on the earliest data available.

Note: Assets/indices and start dates: 10Y U.S. Inflation Linked Bonds: U.S. Generic Govt TII 10-Year (Jan-97), 10Y U.S. Treasury Bond: U.S. Generic Govt 10-Year Yield (Jan-62), Municipal Bonds: Bloomberg Barclays Municipal Bond Index (Jan-80), IG Fixed Income: Bloomberg Barclays U.S. Aggregate Bond Index (Jan-76), HY Muni: Bloomberg Barclays Municipal Custom High Yield Composite (Dec-95), Emerging Market USD Debt: Bloomberg Barclays EM USD Aggregate Bond Index (Jan-93), Leveraged Loans: S&P/LSTA U.S. Leveraged Loan 100 Index (Sep-12), HY Corporate Bonds: Bloomberg Barclays U.S. Corporate High Yield Bond Index (Jan-87) and U.S. Preferred Stock: iShares Preferred and Income Securities ETF (Mar-07).

² Maximum Drawdowns are presented on a total return basis and are based on the earliest data available for the corresponding indices.

Note: Assets/indices: 10Y U.S. Inflation Linked Bonds: Bloomberg Barclays U.S. TIPS, 10Y U.S. Treasury Bond: ICE BofAML 10+ Year U.S. Treasury, Municipal Bonds: Bloomberg Barclays Municipal Bond Index, IG Fixed Income: Bloomberg Barclays U.S. Aggregate Bond Index, HY Muni: Bloomberg Barclays Municipal Custom High Yield Composite, Emerging Market USD Debt: JPM EMBI+, Leveraged Loans: S&P/LSTA U.S. Leveraged Loan 100 Index, HY Corporate Bonds: Bloomberg Barclays U.S. Corporate High Yield Bond Index and U.S. Preferred Stock: ICE BofAML Fixed Rate Preferred Securities.

³ Research in process.