# Taxable Fixed Income Strategies

July 2016

### Overview



### 2nd Quarter 2016 Positioning

While the US economy has remained healthy, and even accelerated by some measures as the year progressed, interest rates have fallen to historic lows. This disconnect between bond yields and economic fundamentals is a function of two phenomena we have seen in recent years:

1. The global bond market has been transformed from a free market into a managed market as a result of central bank intervention. Interest rates are no longer set by free market forces. Instead, they are set by the buying patterns of price-insensitive central bankers.
2. Rising trends of panic and fear in markets have led to repeated safe-haven moves into fixed income.

These combined forces have repeatedly driven interest rates lower. Some fear a bond market bubble, but we believe that central bankers hold the needle and do not intend to prick the bubble any time soon. As such, we expect low rates for the foreseeable future as easing will keep a ceiling on rates.

Our long-term investment process has helped us look through the volatility in the first half of the year to find opportunities for our clients, as evidenced on the returns table on the right. While Brexit – Great Britain's close vote to leave the EU, surprised investors, our fully invested posture and focus on macroeconomic fundamentals kept our portfolios properly positioned. In the aftermath of Brexit, global government bond yields collapsed, credit spreads briefly widened, and stock prices fell in the classic flight to quality moves following economic turbulence. In contrast, we maintained our overweight to corporate bonds, and tracked a series of risk indicators that informed our view that the market reaction was a panic, and not a crisis[1].

Since then, stocks and corporate bonds spreads rapidly recovered and Treasury yields are now beginning to rise out of their historic lows. In our recent Investment Committee planning process, we concluded that macroeconomic data is consistent with a floor in rates. Even though the pull of negative rates overseas may help keep a lid on any rise in US rates, we do not see those rates falling meaningfully from current levels. We expect to remain fully invested in our portfolios as we believe the Fed

1. As noted in our presentation to the Annual CFA Conference in May, as well as our June and July commentaries.

### Market and Strategy Returns

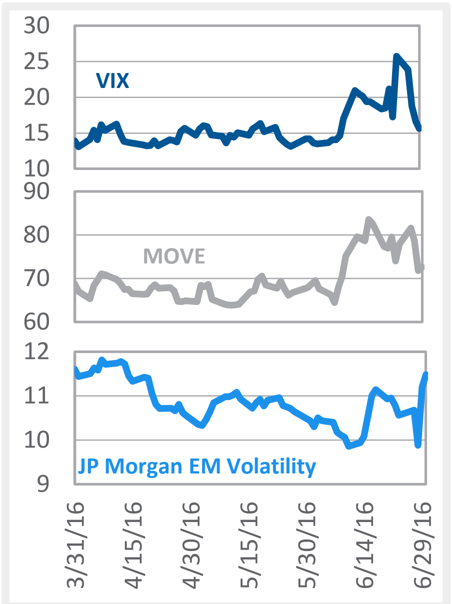
| | | 2Q16 | YTD |
|---|---|---|---|
| **HGST** | **Gross** | **0.59%** | **1.69%** |
| | Net* | 0.50% | 1.52% |
| BC US Gov/Cred 1-3Y | | 0.67% | 1.65% |
| Ex BBB | | 0.59% | 1.53% |
| **HGCI** | **Gross** | **1.31%** | **3.87%** |
| | Net* | 1.22% | 3.69% |
| BC Int. Agg | | 1.44% | 3.78% |
| Ex. BBB/CMBS/ABS | | 1.25% | 3.48% |
| **Int Gov** | **Gross** | **1.19%** | **3.64%** |
| | Net* | 1.10% | 3.46% |
| BC Int Gov | | 1.24% | 3.55% |
| **Corp 1-5** | **Gross** | **1.16%** | **3.21%** |
| | Net* | 1.10% | 3.08% |
| BC 1-5 Corp | | 1.39% | 3.17% |
| BC Int. Treasury | | 1.28% | 3.66% |
| BC Int. TIPS | | 1.71% | 6.24% |
| BC U.S. MBS | | 1.11% | 3.10% |
| BC Int. Corp | | 2.24% | 5.06% |
| Industrials | | 4.01% | 8.91% |
| Financials | | 2.45% | 4.76% |
| BC Muni 5 Year | | 1.16% | 2.32% |

*Please see important disclosures at the end of this commentary.

Sources: Barclays (BC), Bloomberg 6/30/16.

**Past performance is not a guarantee of future results. Inherent in any investment is the potential for loss.**

### Market Indicators




Source: Bloomberg 6/30/16.

is unlikely to tighten in the near future. We also continue to expect a range-bound trading environment given continuous central bank interventions in the market.

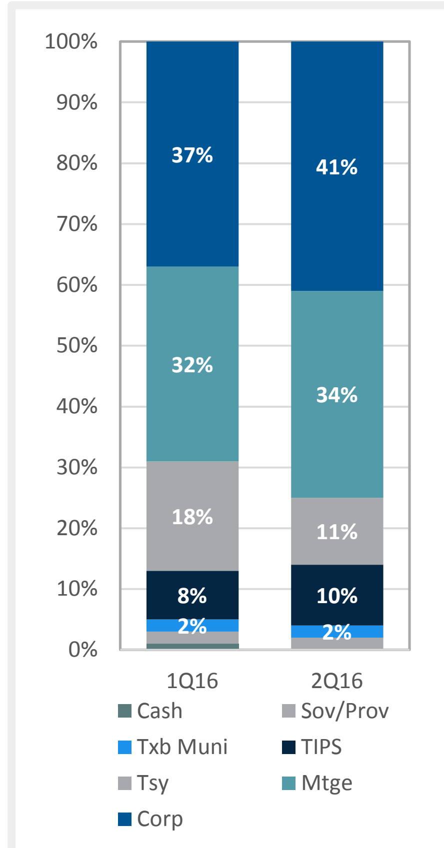
### Sector Spotlight

Our strategies have long been underweight government bonds in favor of sectors which have historically done well in periods of low growth. In March, we quickly took advantage of market dislocation when valuations of high quality corporate bonds were inconsistent with our fundamental macroeconomic views. We used waves of panic in the first quarter to add corporates at cheaper valuations, which keeps consistent with our value-oriented discipline. If fundamentals are stable to positive and valuations cheap, we will likely be buyers. This overweight is predicated on our view that the US economy will avoid recession and risk assets will benefit from the improving economic state of the US consumer (charts on wage growth, consumer confidence). The prospect of easier monetary policy globally should also be supportive of corporate bonds. In recent purchases, as a risk-management tool, we have preferred US-focused companies with strong balance sheets and dominant industry positions. We believe that these companies are likely to perform as well or better than foreign peers should global growth be further called into question.

We look not only at the taxable universe, but also include tax-exempt municipal bonds in our solution set. This makes our approach unique compared to other managers. We monitored Municipal to Treasury yield ratios at different maturities and thus far in 2016, we have deemed longer-dated maturities more attractive. We built small municipal positions at cheap valuations and sold when they returned to fair value during the quarter. We believe that municipals may offer opportunities to add yield in a defensive manner for portfolios should Treasuries remain volatile.

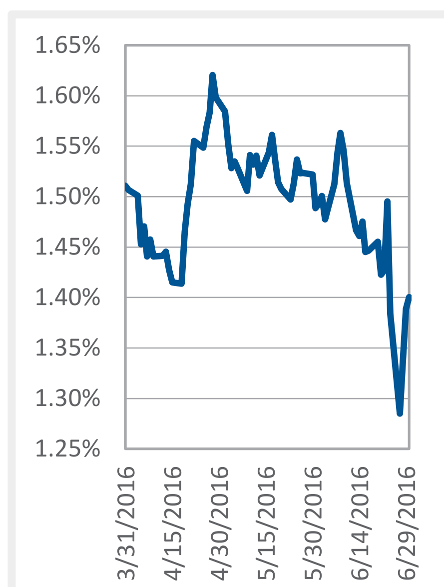
We modestly increased exposure to Treasury Inflation Protected Securities (TIPS) – an out-of-benchmark sector - throughout the quarter as market-implied inflation expectations fell. Five-year TIPS breakevens are currently pricing 1.5% inflation compared to the Fed's 2% target. We believe TIPS are likely to outperform nominal Treasuries if our thesis holds that the consumer base will strengthen and central banks will maintain their easing policies.

### HGCI Sector Rotation




Source: Fiera Capital.

### 5 Year TIPS Breakevens




Source: Bloomberg .

## Corporate Credit

In the corporate sector, our view on financials began to shift from positive to stable near the end of the 2nd quarter.

Certainly, banks remain fundamentally better-positioned today than they were pre-crisis. The results of the 2016 stress tests and the Comprehensive Capital Analysis Review are a testament to this fact, given that nearly all institutions passed. The risk of a bank failure, even in a severely adverse scenario, is small given how well-capitalized and highly liquid banks have become. Our shift in outlook looks beyond the balance sheet however, and reflects our belief that banks are likely entering a period of margin pressure, in part induced by our doubt that the Fed will raise rates in 2016, and that any increases in 2017 are likely to be small and infrequent.

While this does not directly impact the balance sheet of financial institutions, net interest income will likely continue to be under pressure. Compounding this margin pressure is the challenge of increasing new issuance. In the near term, banks will have regulatory debt issuance (TLAC) that must be funded. Once issuance for TLAC begins to increase, so will supply. This will not only pressure the spreads on bank bonds, but may contribute to an increase in bank funding costs – further impacting margin. We are also concerned that ratings pressure may increase as the global economy begins to lose stability. In fact, ratings agencies have already begun to change their outlook on certain financial institutions as a result of Brexit. As we rethink our exposure to banks, we will focus on opportunities in regional banks, which we believe may benefit from their limited global exposure. Our concern about financials is not exclusively about banks, however. We also believe that insurance companies may face pressure, given that low interest rates for a protracted period of time may similarly weigh on insurance company investment portfolios.

We remain cautious on technology companies, as we have seen increased re-leveraging activity in the sector. While credits as a whole have relatively strong balance sheets, we are seeing more aggressive financial policies like mergers and acquisitions (M&A) and shareholder-friendly activities which increase event risk. Given current tight spreads, we are likely to reduce exposure over time to this sector. With the rebound in commodity prices from the lows earlier in the year, we are slightly more positive on certain integrated, MLP, and Exploration & Production companies. We will look for opportunities in the sector in the coming months.

### Bank Capital Ratios

| Year | Median Ratio |
|---|---|
| 2015 | 11.1% |
| 2014 | 11.2% |
| 2013 | 11.2% |
| 2012 | 10.9% |
| 2011 | 10.1% |
| 2010 | 9.3% |
| 2009 | 8.0% |
| 2008 | 5.7% |
| 2007 | 6.1% |
| 2006 | 7.4% |
| 2005 | 7.9% |
| 2004 | 8.1% |

Source: Bloomberg.

### Banks Net Interest Income

| Year | Median Income |
|---|---|
| 2015 | $3,533 |
| 2014 | $4,047 |
| 2013 | $3,561 |
| 2012 | $3,880 |
| 2011 | $4,376 |
| 2010 | $4,563 |
| 2009 | $3,335 |
| 2008 | $3,646 |
| 2007 | $3,009 |
| 2006 | $2,873 |
| 2005 | $2,821 |
| 2004 | $2,804 |

Source: Bloomberg.

### Examples of Tech Company Actions

| Company | Action |
|---|---|
| Apple | Increased shareholder return program by $50bln to a size of $250bln |
| Microsoft | Announced a $26bln acquisition of LinkedIn |
| Lam Research | Announced a $11.4bln acquisition of KLA-Tencor |
| Hewlett Packard | Separated its PC and Enterprise segment |
| Dell | Acquired EMC for $67bln |

In addition to fundamental analysis, we evaluate the corporate bond market using a relative value framework that includes sector rich/cheap analysis as well as an evaluation of market technicals. The negative global rate landscape is an important technical factor that will likely contribute to greater stability in corporate spreads, despite periodic safe-haven events that may lead to momentary spread widening. We believe that US corporate bonds offer a stable alternative to low-yielding global government bonds, and the global thirst for yield creates sustained demand. As a result, the market has easily absorbed the heavy corporate supply.

We are maintaining our overweight to corporate credit, but are taking a more cautious tone and beginning to rotate toward more defensive sectors and issuers in this stage of the credit cycle. During the quarter we added high-quality utility securities to our core intermediate accounts as a way to capture exposure to more defensive, domestically-focused companies. We believe that the utility sector offers relative value compared to other traditionally defensive sectors, as noted in the relative spread to the right. The technology and consumer discretionary sectors continue to tighten to the index, while the consumer staples and cable/telecom sectors, where deleveraging is occurring, may offer a better risk/reward trade off.

## Outlook

We intend to stay fully invested as the best way for us to provide our clients with the asset allocation benefits of fixed income. We will continue to seek value by utilizing our sector relative value methodologies. Our expectation is that interest rates will remain in a trading range. We will continue to invest using our fundamentals and rich/cheap analysis with an eye to capture the benefits of roll-down. In this way, we look to harvest added return for clients in a fixed income environment that requires an increased focus on risk management and quantitative decision-making to deliver stable returns.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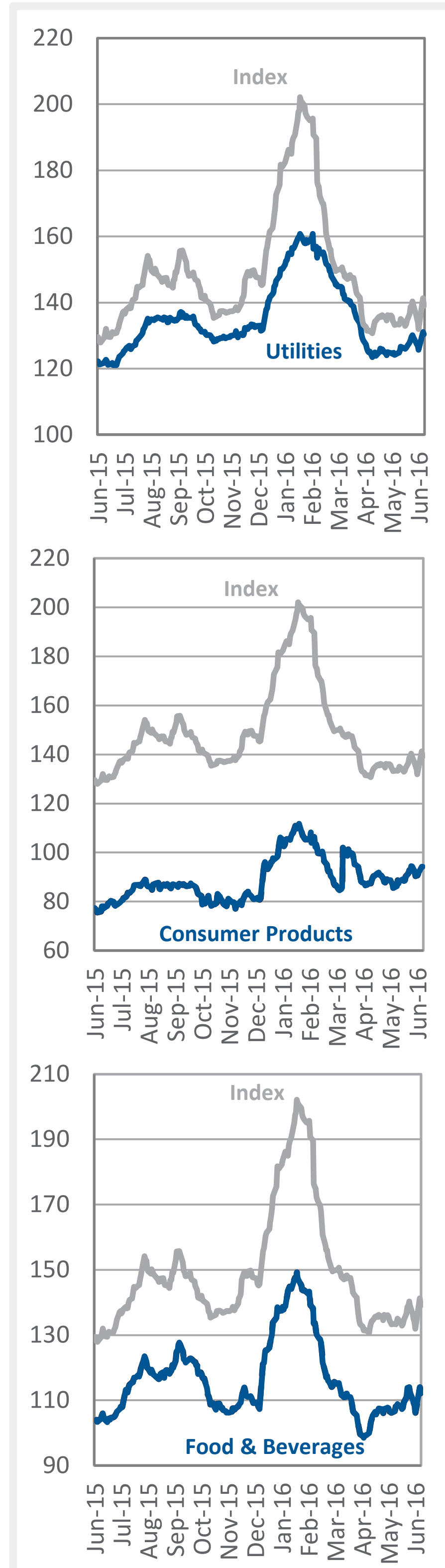
**JULI Index Relative Value Spreads**




Source: Bloomberg as of 6/30/16.

**Past performance is not a guarantee of future results. Inherent in any investment is the potential for loss.**
Net returns are net of annual fees and expenses of 0.25%, relevant for accounts with $10 million in assets. Investors in certain classes may pay a higher fee, which would have the effect of reducing net returns.
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Index Definitions:

- Barclays 1-3 Yr Gov/Credit is the 1-3 Yr component of the U.S. Government/Credit Index. The Government/Credit Index includes securities in the Government and Credit Indices. The Government Index includes treasuries (i.e., public obligations of the U.S. Treasury that have remaining maturities of more than one year) and agencies (i.e., publicly issued debt of U.S. Government agencies, quasi-federal corporations, and corporate or foreign debt guaranteed by the U.S. Government). The Credit Index includes publicly issued U.S. corporate and foreign debentures and secured notes that meet specified maturity, liquidity, and quality requirements.
- Barclays Intermediate Aggregate Index is the intermediate component of the US Aggregate Index. The Barclays U.S. Aggregate In dex represents securities that are SEC-registered, taxable, and dollar denominated. The index covers the U.S. investment grade fixed rate bond market, with index components for government and corporate securities, mortgage pass-through securities, and asset-backed securities. These major sectors are subdivided into more specific indices that are calculated and reported on a regular basis.
- Barclays U.S. Corporate Investment Grade Index is a rules-based and market value weighted index of publicly issued U.S. corporate bonds. To be included in the index, bonds must be rated investment-grade (Baa3/BBB- or higher) by at least two of the following ratings agencies: Moody's, S&P, Fitch. Bonds in the Index must have at least one year to final maturity regardless of call features and have at least $250 million par amount outstanding. Bonds in the Index must be fixed rate, although it can carry a coupon that steps up or changes according to a predetermined schedule, must be dollar-denominated and non-convertible and must be publicly issued.
- The Barclays 1-5 Corporate Index the 1-5 year component of the index.
- The Barclays Intermediate Corporate Index is the Intermediate component of the index.
- Barclays Intermediate Corporate Industrial Index is the Intermediate component of the Investment Grade Industrial Index. To b e included in the index, bonds must be rated investment-grade (Baa3/BBB- or higher) by at least two of the following ratings agencies: Moody's, S&P, Fitch. Bonds in the Index must have at least one year to final maturity regardless of call features and have at least $250 million par amount outstanding. Bonds in the Index must be fixed rate, although it can carry a coupon that steps up or changes according to a predetermined schedule, must be dollar-denominated and non-convertible and must be publicly issued. Bonds in the Index must belong to the Industrial sector.
- Barclays Intermediate Corporate Financial Institutions Index is the Intermediate component of the Investment Grade Financial Institutions Index. To be included in the index, bonds must be rated investment-grade (Baa3/BBB- or higher) by at least two of the following ratings agencies: Moody's, S&P, Fitch. Bonds in the Index must have at least one year to final maturity regardless of call features and have at least $250 million par amount outstanding. Bonds in the Index must be fixed rate, although it can carry a coupon that steps up or changes according to a predetermined schedule, must be dollar-denominated and non-convertible and must be publicly issued. Bonds in the Index must belong to the Finance sector.
- Barclays 5 Year Municipal Index is the 5 Year component of the Municipal Bond Index. The Barclays Municipal Bond Index is a r ules-based and market value weighted index engineered for the long-term tax-exempt bond market. To be included in the index, bonds must be rated investment-grade (Baa3/BBB- or higher) by at least two of the following ratings agencies: Moody's, S&P, Fitch. If only two of the three agencies rate the security, the lower rating is used to determine index eligibility. If only one of the three agencies rates a security, the rating must be investment-grade. They must have an outstanding par value of at least $7 million and be issued as part of transaction of at least $75 million. The bonds must be fixed rate, have a double date after December 31, 1990, and must be at least one year from maturity date. Remarketed issues, taxable municipal bonds, bonds with floating rates, and derivatives, are excluded from the benchmark.
- Barclays US MBS is a component of the US Aggregate Index. The MBS Index covers the mortgage -backed pass-through securities of Ginnie Mae (GNMA), Fannie Mae (FNMA), and Freddie Mac (FHLMC). The MBS Index is formed by grouping the universe of over 600,000 individual fixed rate MBS pools into approximately 3,500 generic aggregates. In other words, each aggregate is a proxy for the outstanding pools for a given agency, program, issue year, and coupon. The index maturity and liquidity criteria are then applied to these aggregates to determine which qualify for inclusion in the index. About 600 of these generic aggregates meet the criteria.
- The aggregates included in the index are priced daily using a matrix pricing routine based on trader price quotations by agency, program, coupon, and degree of seasoning.
- BofA Merrill Lynch US High Yield Index tracks the performance of US dollar denominated below investment grade corporate debt publicly issued in the US domestic market. Qualifying securities must have a below investment grade rating (based on an average of Moody's, S&P and Fitch), at least 18 months to final maturity at the time of issuance, at least one year remaining term to final maturity as of the rebalancing date, a fixed coupon schedule and a minimum amount outstanding of $100 million. In addition, qualifying securities must have risk exposure to countries that are members of the FX-G10, Western Europe or territories of the US and Western Europe. The FX-G10 includes all Euro members, the US, Japan, the UK, Canada, Australia, New Zealand, Switzerland, Norway and Sweden.
- The US 3-Year, 5-Year, 10-Year, and Intermediate Treasury Indices measure securities in their respective maturity range of the U.S. Treasury Index, which represents public obligations of the U.S. Treasury with a remaining maturity of one year or more.
- The S&P 500, or the Standard & Poor's 500, is an American stock market index based on the market capitalizations of 500 large companies having common stock listed on the NYSE or NASDAQ.
- The Barclays Intermediate TIPS Index consists of securities in the intermediate maturity range of the Inflation-Protection securities issued by the U.S. Treasury.
- The JPMorgan US Liquid Index, or JULI, provides performance comparisons and valuation metrics across a carefully defined univ erse of investment grade corporate bonds, tracking individual issuers, sectors and sub-sectors by their various ratings and maturities.
- Goldman Sachs Commodity Index (GSCI) is a composite index of commodity sector returns which represents a broadly diversified, unleveraged, long-only position in commodity futures.