Breckinridge
CAPITAL ADVISORS

MARCH 16, 2022

Discussion Summary: Investment Grade Fixed Income in Uncertain Times

Against a backdrop of rising inflation, impending Federal Reserve (Fed) interest rate increases, and the destabilizing Russian invasion of Ukraine, Breckinridge President Peter Coffin and Chief Investment Officer Oggie Sosa discussed the role of investment grade (IG) fixed income strategies in investors' overall asset-mix. This is an edited version of their discussion. You can view the full discussion here.

Authors

PETER COFFIN
PRESIDENT

OGNJEN SOSA, CAIA, FRM
CHIEF INVESTMENT OFFICER

Peter Coffin: Dealing with uncertainty is a big part of why investors have exposure to IG bond portfolios. IG bonds never have been focused on maximizing returns. Instead, they've been about stabilizing returns and historically, they have done exactly that.

Maintaining IG bond exposure helps investors cope with volatility in risk assets elsewhere in their portfolios.

Interestingly, over the last couple of decades, the Fed provided stability by stepping in time and again to support financial markets and risk assets when risk is out of favor or markets are volatile or asset prices are falling.

Fed intervention was referred to as the Greenspan Put, then the Bernanke Put, then the Yellen Put. Recently, market participants have been referring to the Powell Put.

After the global financial crisis, the Fed cut rates to zero and began successive quantitative easing programs to support asset prices.

It effectively boosted asset prices and the wealth effect, thereby stimulating the economy.

The challenge is, it can be argued, that asset prices and financial markets are more closely tied to the economy. The Fed is compelled, I believe, to step in and support financial markets.

Investors naturally and understandably responded to this pattern and, over time, embraced more risk, and accepted less liquidity in their portfolios.

One could argue that investors have seen less of a need for the stability provided by an IG bond portfolio because the Fed provided that stability.

For many investors, that may beg the question: "Is there still a role for an IG bonds in their asset mix?" Or, will the Fed perpetually provide stability and encourage risk when risk might otherwise be out of favor?

Oggie Sosa: I agree that policymakers have been exerting a tremendous amount of influence on the financial markets. Their actions, have in recent times, overshadowed macro forces and other fundamental drivers.

Reflecting back to the global financial crisis—maybe even prior to it—the Fed had the luxury of focusing almost entirely on one part of its dual mandate: maximizing employment.

It didn't have to worry about inflation.

Today, we have higher and what appears to be more persistent inflation.

In addition to maximizing employment, the Fed must also stabilize prices and maintain moderate long-term interest rates.

That means that the Fed is likely to start normalizing rates and tapering the balance sheet if it is going to be successful at keeping inflation at bay.

Their ability to curb inflationary pressures may come at a cost. The cost is that when the next major risk-off period comes, the Fed is going to be much less apt to step in and back-stop financial markets. In other words, the strike price of the Powell Put has been meaningfully lowered.

Peter: So, the takeaway is that, with the Fed's diminished ability to step in and save the day, we are likely to see more severe and prolonged periods of volatility.

Oggie: Agreed and it is the uncertainty that investors like to mitigate through diversification. In my prior role as an asset allocator, and when I speak with asset owners and intermediaries in my role now, they value, as I do, the role that IG fixed income portfolios play as diversifiers: exhibiting low or negative correlations to other asset classes.

High quality IG bonds provide stability and resilience during volatile times, and they do that through diversification by counterbalancing what many would characterize as equity-like risks.

Peter: Right, so an allocation to a bond portfolio still makes sense for most asset owners.

While many investors are motivated by capital preservation, by diversification, a lot of investors are motivated by the income a bond portfolio generates.

Yields are relatively low. Could you talk a little bit about the challenge of generating income in the current environment?

Oggie: We have seen a meaningful rise in yields off the lows of 2020, which have made IG- bonds more attractive as a source of reliable and predictable cash flow for investors seeking steady income: growing number of retirees

At Breckinridge we manage a range of maturities in all of our portfolios and our expectation is that as yields rise, so will the income generated by newly issued bonds.

We've been seeing some very nice opportunities to pick-up high-quality municipal and corporate bonds at attractive spreads and that has further enhanced income potential.

It is the high grade, IG bonds that have historically offered reliable and predictable income during uncertain and volatile times.

Peter: In addition to your responsibilities as an asset allocator, you have quite a bit of experience in examining retirement income strategies, and beyond that, also investment strategies for pension plan sponsors. Could you talk a little bit about how bonds fit into those strategies.

Oggie: Most asset owners have future financial obligations, which can be estimated using prevailing market interest rates. .In those instances, investing earmarked assets in IG bonds portfolios today would increase investors' likelihood or probability of being able to meet future liabilities.

Pensions and insurance companies that make promies in nominal terms can mitigate the risk of a shortfall on future promises by allocating assets to portfolios of IG-bonds that will hedge those liabilities.

For investors who embrace asset-liability frameworks to hedge future liabilities, there is no other instrument in the financial markets that can provide the type of hedge that high quality IG bonds can.

Peter: We established that the Fed, in our view, has diminished capacity to backstop markets as it has in the past.

Inflation is a game-changer.

We believe that there is a more meaningful risk of prolonged periods of volatility or dislocation or risk-off periods.

We know that in persistent risk-off periods, you can get bouts of illiquidity. Correct?

Oggie: True, but higher quality bonds do tend to be more liquid and when markets are distressed, bond holders are more likely to benefit from a flight to quality. That provides investors an opportunity to rebalance, to change direction, reallocate, be opportunistic.

It is also good to remember that bonds are self-liquidating. IG fixed income investors are less reliant on other parts of their investable assets for return of capital.

Peter: We also have observed the trend of investors seeking high returns, higher yields in private markets, whether it's private equity, private debt, or real estate.

They have been stepping into more esoteric instruments in an effort to improve returns by harvesting the illiquidity premium.

While that strategy has merit, we believe that residual fixed income assets could benefit from exposure to high-grade investment grade bonds providing a counterbalance, or a barbell approach.

Oggie: I've had the great benefit of sitting in a seat for many years as an asset allocator. We, as investors, understand the future is uncertain, but it's that uncertainty that we deal with on a daily basis.

Being effective requires that we practice discipline, we stick to our core beliefs, and we stay true to our investment process.

Being able to do these things has helped us and our clients.

Investors come to IG bonds for a variety of reasons. Some are seeking stability, diversification, capital preservation, others may seek income or liquidity, while a subset seeks exposure to bond portfolios to hedge a future liability.

Regardless of the motivation, we do believe that here at Breckinridge, we have the expertise and the depth and that our teams are well-equipped to be selective in our process of identifying the bonds we put in our separately managed accounts for our clients.

While it is prudent for investors to diversify their asset-mix, it is important also to pick a manager that is not going to compromise basic facets and tenets of capital preservation, diversification, and other features of bonds that investors have gotten accustomed to realizing.

Particularly if, going back to the introductory remarks, the Fed indeed may no longer be there to help, then the traditional asset allocation toolbox is back on the table.

Peter: Great points.

I like to stress that an important goal at Breckinridge is striving to achieve reliable fixed income returns when they matter most to investors.

That tends to be in periods when other asset classes are struggling because of a risk-off market where there is some dislocation and illiquidity.

We strive to do that by being disciplined and faithful to the goals and objectives that you have described so well.