Breckinridge
CAPITAL ADVISORS

PERSPECTIVES

FROM PETER COFFIN – A PERSPECTIVE ON THE CURRENT MARKET

March 16, 2020

The past week has shown intense volatility across all financial markets—including fixed income. In fact, the municipal market was particularly hard hit, as mutual funds experienced heavy redemptions, forcing managers to sell in an already distressed market. The selling pressure in both the corporate and municipal markets was heaviest in lower-quality and high-yield bonds, where spread differentials widened significantly, and liquidity was especially challenged.

On Friday, markets seemed to have found their footing, with some investors stepping in to take advantage of yields that have moved up significantly and are now, in most cases, higher than we have seen in several months. Regardless of whether conditions improve further, in light of the struggles in credit markets this week, we think it is a good time to remind investors of the merits of an investment grade fixed income allocation.

At Breckinridge, we've always believed an investment grade fixed income allocation should add stability to an investment portfolio. To this end, we have favored higher-quality bonds, which are more likely to hold their value or even benefit from a flight to quality in periods of uncertainty when risk is out of favor.

Our bias towards higher quality has grown stronger in recent years as the yield pick-up from lower-quality bonds has narrowed. Today, we remain very comfortable with the quality of all our holdings. Despite recent disorder in the investment grade bond market, we also remain very confident that the portfolios we manage will continue to offer a counterbalance to riskier assets such as equities.

It is important to note that much of the disorder in the investment grade bond market is being caused by the absence of liquidity. Last year's repo market debacle foreshadowed how illiquidity could cause huge price distortions, even for overnight borrowing with U.S. government guaranteed collateral. The wider spreads and difficulties trading off-the-run government securities and pre-refunded municipal bonds over the past week are evidence of a similar phenomenon. Certainly, there are heightened fears about the economy and credit quality, but we believe it is primarily the demand for liquidity that caused the selling pressure and drove investment grade bond prices lower during the last week.

The Fed was able to intervene directly to restore liquidity in the repo market, and its efforts were met with quick success. The Fed's recently announced rate cuts and bond buying will support other markets less directly, and thus will likely take longer to restore order. Working against the Fed are countless shareholders in mutual funds—including bond funds—who are redeeming shares and forcing managers to sell bonds into an illiquid market at prices below fair value. The potential for this dislocation has increased significantly in recent years as, in our view, bond funds have far outgrown the market's capacity to provide liquidity in an extended period of redemptions.

A portfolio of investment grade bonds owned directly through a separate account can offer a haven from this market distress. If the portfolio is managed well enough to avoid defaults, an investor who stays the course can continue to earn a steady and reliable cash flow of both income (coupons) and capital (principal) independent of the market. That independence is important to how an investment grade fixed income allocation helps an investor cope with market dislocation. Essentially, bond portfolios can be self-liquidating, so direct bond investors are inherently less beholden to the market and better able to look beyond periods of market distress.

My first experience with a distressed market was in the spring of 1987 when, as a new bond fund manager, I contended with a massive market sell-off. In struggling to sell bonds to meet redemptions, I soon realized the extent to which markets could be unreliable and investors could be terribly irrational.

I also saw how forced selling into a distressed market was never a good thing. In time, I came to believe the best solution to these problems was a well-managed portfolio of investment grade bonds owned directly through a separate account. Six years later, I started Breckinridge.

We believe Breckinridge's portfolios are well positioned relative to the current market turmoil. There will of course, be unforeseen challenges. Through them all, we hope our clients and their advisors will know, Breckinridge was built for challenging times like these. It is why we exist.