FEG INSIGHT

FEBRUARY 2021

2021 FIXED INCOME MARKET OUTLOOK

Navigating Low Yield Waters

F·E·G®
investment advisors

Readers may recall from childhood science classes that the world's oceans occupy two-thirds of the planet's real estate. Similarly, fixed income occupies the vast majority of investments available across the globe, far outpacing other investable assets in both numbers and dollars. Students asked to read *The Rhyme of the Ancient Mariner* might also remember that the mariner wore the burden of the albatross around his neck. The burden hung around the neck of investors navigating the oceans of fixed income today is quite simple: low yields.

The roughly $100 trillion ocean of global fixed income opportunities provides an abundance of low-yielding/high-priced options. The result for many fixed income investors is the burden of a portfolio with considerable interest rate risk, particularly if rates rise from current levels. This has created a conundrum for investors who are often required to hold a certain percentage of their portfolio in "safe" assets that provide interest income, with the dual expectation of acting as a ballast against higher return seeking/higher risk investments.

With the current seascape in mind, investors should consider routes and ports with access to new sources of higher income or, at the very least, those more concerned with the risk of increasing rates should consider moving portfolio duration closer to the beach to reduce that risk, lest their portfolios end up with insufficient lifeboats.

2020 RECAP

FEG's recent fixed income market outlooks have explored the steady decline of U.S. Treasury rates over the past four decades, culminating in the market's current lows. Last year's missive noted the surprisingly strong returns experienced by core fixed income investors, with the Bloomberg Barclays U.S. Aggregate Bond Index (AGG) returning 8.7% in 2019. Also noted was the negative asymmetry of U.S. Treasury rates based on the low levels witnessed at the beginning of 2020. To improve fixed income positioning, the analysis suggested shifting to an intermediate version of the Bloomberg Barclays U.S. Aggregate Bond Index (IAGG) for those concerned about interest rate risk. Such positioning would provide the benefit of limiting interest rate risk—i.e., duration—given the low yields available at the time, with a modest reduction in yield for making the swap.

Fast-forward a year and core fixed income investors were once again surprised with a return of 7.5% in 2020 for the AGG, despite the exceptionally low yields for the index at the start of the year. By comparison, the IAGG returned 5.5%. These returns took place primarily in a "flight-to-quality" environment in the first quarter of 2020, which ultimately saw the bellwether 10-year U.S. Treasury decline by 100 basis points, from just under 2% at the end of 2019 to less than 1% at the end of 2020.

Key sectors of both benchmarks are Treasuries, investment-grade corporate bonds, and mortgage-backed securities. On the heels of strong support from the Federal Reserve's (Fed's) move to backstop the corporate bond market in March 2020 and investors' confidence in the Fed's "lower for years" mantra, corporates and longer-dated Treasuries rallied. Mortgages and other areas of structured credit were generally left out of the Fed's support plans, however, with a technical dislocation that lingered throughout the year. Given this environment, the longer duration composition of the AGG relative to the IAGG held the day in 2020, which leads to the outlook for 2021.

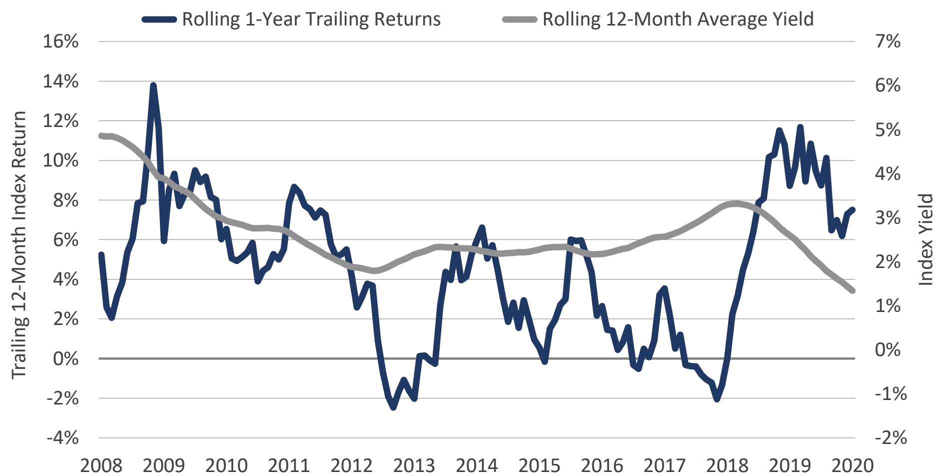
© 2021 Fund Evaluation Group, LLC

LOOKING TO THE HORIZON

While it is impossible to be 100% certain, the mathematics are not supportive of a 2021 repeat of the exceptional calendar-year performances for the AGG in 2019 and 2020. As the chart illustrates, sizeable excess returns above the yield of the AGG tend to occur with secular declines in interest rates, such as those from 2008 through 2012 and again from 2019 through 2020, and those excess returns are more limited over time and even go negative in the years that follow. Given the AGG's low starting yield of 1.1% in January 2021, a rate decline that pushed yields toward zero—and likely a negative yield on the U.S. 10-year Treasury—would be required to support exceptional AGG returns in 2021 and beyond.

STRONG RETURNS REQUIRE ANOTHER INTEREST RATE DECLINE

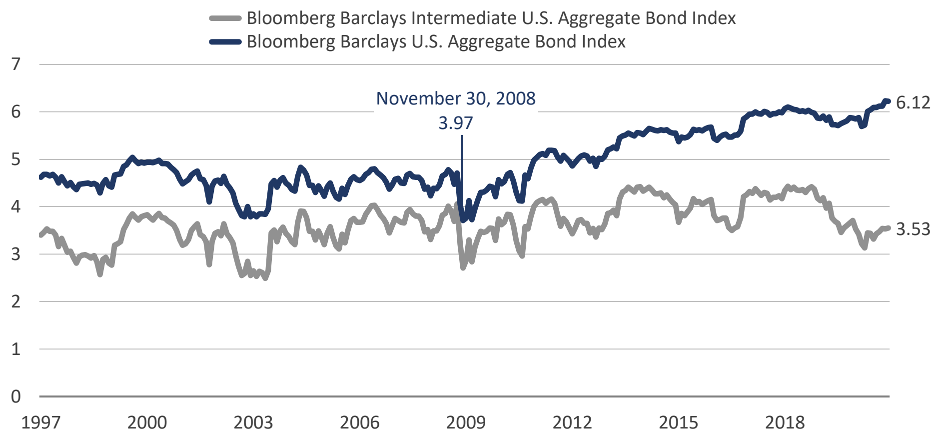
Bloomberg Barclays U.S. Aggregate Bond Index and Rolling 12-Month Average Yield



Data source: Bloomberg, L.P.

With option-adjusted spreads for investment-grade corporate bonds back to pre-2020 levels—roughly 90 basis points over Treasuries—and mortgages benefiting from less refinancing risk given the low starting point in interest rates, FEG believes the concept of swapping from an AGG to an IAGG strategy continues to have merit. Indeed, the divergence in the effective duration of the AGG over the past decade reached a high of 6.1 years at year-end versus just 3.5 years for the IAGG, with only a 30-basis point difference in yield between the indices.

EFFECTIVE DURATION OF BLOOMBERG AGGREGATE AND INTERMEDIATE AGGREGATE



Data source: Bloomberg, L.P.; Data as of November 30, 2020

© 2021 Fund Evaluation Group, LLC

IN SEARCH OF NEW ROUTES AND PORTS

1. SMOOTHER SAILING VIA REDUCING DURATION / LIMITING RATE VOLATILITY

FEG does not make explicit calls on interest rates due to an understanding, borne out by experience, that few investors have been successful over the long term in making such moves. Indeed, traditional fixed income managers typically limit themselves to duration “bands” of +/- 1 year relative to a benchmark. Managers implicitly understand that trying to predict the direction of interest rates is rarely effective. Instead, they seek to add value relative to a benchmark primarily through credit analysis/bond selection, sector rotation, and yield curve positioning.

For a fixed income portfolio benchmarked to the AGG as of December 31, 2020, the +/- 1 year band implies a duration range of 5.1 to 7.1 years. For the IAGG, the +/- 1 year band implies a duration range of 2.5 to 4.5 years. The higher end of the IAGG duration band range is more consistent with the duration experience of the AGG pre-2011. This differential is due primarily to the longer maturity issuance from the U.S. government and corporations over the past decade, locking in lower rates at longer maturities than in the past, which is captured in the composition and structure of the index.

FEG believes investors considering shifting to an IAGG mandate would stand to benefit if interest rates were to rise. However, the absolute and relative return potential for making this shift—relative to maintaining an AGG mandate—would be limited if rates declined further from current levels.

To provide some color on the numbers involved for investors considering the IAGG option, as of December 31, 2020, the coupon on the IAGG was only 30 basis points below the 2.8% coupon of the AGG. The yield tells a similar story, with the IAGG’s 0.8% yield only 30 basis points below the 1.1% yield of the AGG. While the first lesson every fixed income analyst learns is that basis points matter, FEG views the modest coupon and yield trade-off in exchange for reducing rate risk to be reasonable. For further consideration, the table highlights the negative asymmetry inherent in U.S. Treasuries—the primary risk in traditional fixed income mandates—in the event rates were to rise in various time horizons.

	INTEREST RATE DECREASE			INTEREST RATE INCREASE						
	25bp	50bp	100bp	25bp	50bp	100bp	200bp	300bp	400bp	500bp
5 YEAR NOTE										
1 Year Horizon	1.3%	2.3%	4.3%	-0.6%	-1.6%	-3.5%	-7.3%	-11.0%	-14.6%	-18.0%
3 Year Horizon	0.5%	0.7%	1.0%	0.2%	0.0%	-0.3%	-0.9%	-1.5%	-2.1%	-2.8%
4 Year Horizon	0.4%	0.5%	0.6%	0.3%	0.2%	0.1%	-0.1%	-0.3%	-0.5%	-0.8%
10 YEAR NOTE										
1 Year Horizon	3.1%	5.3%	9.6%	-1.1%	-3.2%	-7.2%	-15.0%	-22.5%	-30.1%	-36.3%
3 Year Horizon	1.5%	2.1%	3.2%	0.4%	-0.1%	-1.2%	-3.3%	-5.3%	-7.8%	-9.3%
5 Year Horizon	1.2%	1.4%	1.9%	0.7%	0.5%	0.1%	-0.8%	-1.7%	-2.5%	-3.4%
30 YEAR BOND										
1 Year Horizon	7.5%	13.4%	26.1%	-3.8%	-9.1%	-19.1%	-36.9%	-52.1%	-66.4%	-76.2%
3 Year Horizon	3.4%	5.2%	8.9%	0.0%	-1.7%	-4.9%	-11.0%	-16.5%	-21.2%	-26.1%
5 Year Horizon	2.6%	3.6%	5.6%	0.7%	-0.2%	-2.0%	-5.4%	-8.5%	-11.2%	-14.0%
10 Year Horizon	2.0%	2.4%	3.1%	1.3%	0.9%	0.2%	-1.1%	-2.4%	-3.5%	-4.7%

Data sources: Bloomberg, L.P., Fund Evaluation Group, LLC; Data as of January 18, 2021
For illustrative purposes only. Returns presented gross of fees, assuming reinvestment at 0.91%.

© 2021 Fund Evaluation Group, LLC

2. STEER TOWARD LOWER FEE OPTIONS / CONSIDER PASSIVE STRATEGIES

This advice is generally unchanged from last year, although perhaps it is even more important given the lower yield starting point for traditional fixed income in 2021 versus 2020. In line with the concept of "basis points matter," when the starting yield of an asset class is between 0.8% and 1.1%, high management fees as a percentage of the yield hoped to be earned by the investor can have a material impact on performance. In conjunction with a lower fee focus for actively managed fixed income strategies, investors may also wish to consider passive fixed income strategies to replicate the beta exposures they seek in traditional fixed income markets, as these vehicles typically have lower fees.

3. IS STRUCTURED CREDIT A WORTHY EXCURSION?

Unlike the high-yield bond and bank loan markets—i.e., corporate credit—which rallied considerably following a March 2020 sell-off on the back of Fed support, the structured credit space experienced greater liquidity pressures and has yet to fully recover. For the uninitiated, structured credit represents the "alphabet soup" of fixed income investments, with categories such as asset-backed securities (ABS), residential and commercial mortgage-backed securities (RMBS and CMBS) and collateralized loan obligations (CLOs) acting as representatives of the space. Back in March, levered buyers of higher quality structured credit were forced by their counterparties to sell collateral into a stressed market, which was not the case for corporate credit.

Due to the complexities inherent in these securities and the lack of explicit support from the Fed, demand has remained soft, although prices have improved somewhat from March lows. While nowhere close to their Great Financial Crisis highs in terms of spread to high yield—which was literally off the charts—yields on BBB-rated CMBS remain attractive versus high yield bonds. Given that delinquencies in many of these properties appear to have stabilized, a skilled manager should be able to find value in these bonds. As such, this area may offer a worthwhile excursion for investors.

BBB-RATED NON-AGENCY CMBS YIELDS REMAIN ELEVATED vs. HIGH YIELD BONDS

Data source: Bloomberg, L.P.; Data as of December 31, 2020

© 2021 Fund Evaluation Group, LLC

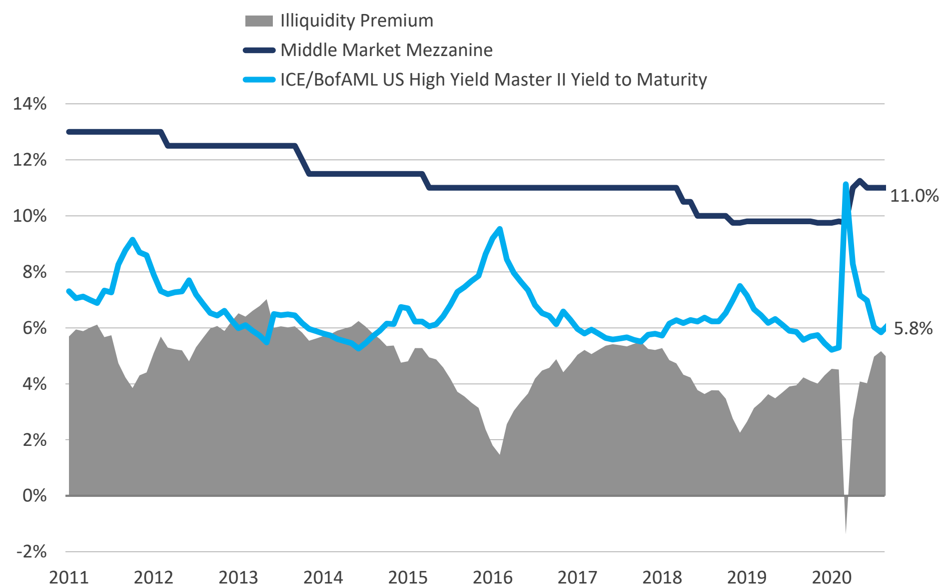
4. PRIVATE LENDING IS THE POLARIS IN A LOW YIELD WORLD

FEG has long advocated investing in private debt, emphasizing experienced cash flow-focused lenders across the corporate capital structure—e.g., senior, unitranche, and mezzanine debt. These lenders generally focus on both private equity sponsored and non-sponsored transactions and typically focus on the U.S. lower middle and middle market, which is generally defined as the approximately 200,000 private companies with annual revenues between $10 million and $1 billion.

The lower end of this market is typically unable to access capital in the public markets due to the relatively modest loan demands relative to larger companies. This has been an area of emphasis for FEG, as smaller companies are generally deemed by to be "riskier" than larger companies, which leads to attractive lending opportunities for those capable of properly analyzing these companies. As such, the illiquidity premium opportunity versus publicly traded credit tends to be wider for those companies versus their larger brethren.

Mezzanine debt yields, which FEG uses as a proxy for private lending, tend to be stable over time, generally residing in the low double-digits. The illiquidity premium—i.e., the difference between private debt and comparable public debt—has also been relatively stable. From time to time, however, the illiquidity premium shrinks, as high-yield bond yields spike to levels that provide investors with the opportunity to achieve outsized returns by allocating to public credit in lieu of making allocations to private lenders. Just such an opportunity took place in March 2020 with the onset of the pandemic, but the spike in yields was short-lived, as discussed earlier, with the rally in high-yield bonds through year-end leading to a re-emergence of the illiquidity premium for private lending. As a result, private lending has resumed its place as a strategic beacon of hope for investors thirsting for yield on the sea of low rates.

MEZZANINE YIELDS REMAIN WIDE OF PRE-COVID LEVELS



Data sources: ICE Indices, SPP Capital; Data as of November 30, 2020

© 2021 Fund Evaluation Group, LLC

5. ALTERNATIVE CREDIT STRATEGIES REPRESENT NEW ROUTES

While FEG has generally favored cash flow-focused private lending strategies in the past, alternative credit strategies have also been considered and recommended. Given the dearth of opportunities in the public credit markets today and the proliferation of direct lenders coming into the market in recent years, alternative credit strategies deserve consideration. Like cash-flow focused private lending, alternative credit strategies offer attractive coupons and cash flow streams, yet those of alternative credit strategies may be less correlated to both the public and private credit markets.

Alternative credit strategies are typically backed by various forms of collateral and are generally found in drawdown, illiquid investment vehicles. Each of these strategies incorporates varying degrees of risk and return potential, but all are fixed income-oriented in that interest income is the primary driver of return.

FEG buckets these strategies into three broad categories based on collateral: real estate, hard assets, and financial assets. Real estate strategies include, but are not limited to, asset-backed special situations, commercial real estate debt, and real estate sale-leaseback. Strategies collateralized by hard assets include areas such as aircraft and equipment leasing, asset-based loans, shipping, and infrastructure debt. Finally, strategies collateralized by financial assets include areas such as specialty finance, consumer lending, and trade finance. While FEG may or may not opt to formally support managers in all these strategies, their potential inclusion in a diversified fixed income portfolio may allow for a more robust port for investors to weather the next storm in the riskier parts of their portfolios.

CONCLUSION

During the Great Financial Crisis more than a decade ago, many investors thought yields could not go lower. Yet, the global pandemic has proven that even lower for even longer is quite possible and appears to be the new reality. For investors thirsting for yield in the shallow ocean of low-rate fixed income, there are, fortunately, still options for managing risk and finding return. In summary, FEG advises investors to consider the following:

- Assess reducing duration in portfolios to limit rate sensitivity for those concerned with rising rate risk
- Maintain focus on fee reduction for actively managed fixed income portfolios and consider passive options
- Unlike high yield bonds and bank loans, structured credit remains dislocated
- The illiquidity premium has returned for private lending strategies
- Evaluate the use of alternative credit strategies in diversified fixed income portfolios

The benefits of a zephyr tailwind in the form of declining rates from a more attractive starting point are clearly behind us, yet investors may find that there are some opportunities for fair winds and following seas.

© 2021 Fund Evaluation Group, LLC

201 East Fifth Street
Suite 1600
Cincinnati, Ohio 45202

513.977.4400
information@feg.com
www.feg.com

Cincinnati | Dallas | Indianapolis

*Subscribe to FEG's communications at **www.feg.com/subscribe.***

DISCLOSURES

This report was prepared by FEG (also known as Fund Evaluation Group, LLC), a federally registered investment adviser under the Investment Advisers Act of 1940, as amended, providing non-discretionary and discretionary investment advice to its clients on an individual basis. Registration as an investment adviser does not imply a certain level of skill or training. The oral and written communications of an adviser provide you with information about which you determine to hire or retain an adviser. Fund Evaluation Group, LLC, Form ADV Part 2A & 2B can be obtained by written request directly to: Fund Evaluation Group, LLC, 201 East Fifth Street, Suite 1600, Cincinnati, OH 45202, Attention: Compliance Department.

The information herein was obtained from various sources. FEG does not guarantee the accuracy or completeness of such information provided by third parties. The information in this report is given as of the date indicated and believed to be reliable. FEG assumes no obligation to update this information, or to advise on further developments relating to it. FEG, its affiliates, directors, officers, employees, employee benefit programs and client accounts may have a long position in any securities of issuers discussed in this report.

Neither the information nor any opinion expressed in this report constitutes an offer, or an invitation to make an offer, to buy or sell any securities.

Past performance is not indicative of future results.

This report is prepared for informational purposes only. It does not address specific investment objectives, or the financial situation and the particular needs of any person who may receive this report.

© 2021 Fund Evaluation Group, LLC