# Unconstrained Fixed Income Strategy

Portfolio and Economic Commentary – 2nd Quarter 2018

## Unconstrained Fixed Income Strategy Commentary

Based on our macroeconomic outlook over a three to five year period and our cyclical views from quarter to quarter, we employ top-down strategies that focus on yield curve positioning, volatility, and sector rotation. We then utilize bottom-up analysis to drive our security selection process and facilitate the identification of undervalued securities with the potential for above average income. We invest in securities that operate across diversified sectors in the fixed income markets of the United States, primarily those in U.S. dollar denominated high yield and investment grade bonds, including government securities, corporate bonds, and mortgage- and asset-backed. Sources of added value:

**Credit Analysis** - We emphasize independent analysis and do not rely on credit agencies.

**Duration Risk** - We avoid long, extreme duration shifts generally operating within a moderate duration range typically between two and four years.

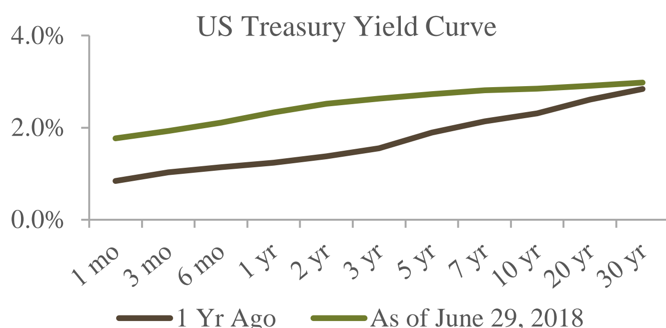
**High Income** - Our research attempts to identify issues paying above average income.

**Risk Premium Management** - We seek to attain an attractive yield/spread in relation to a five-year treasury within acceptable levels of portfolio risk.

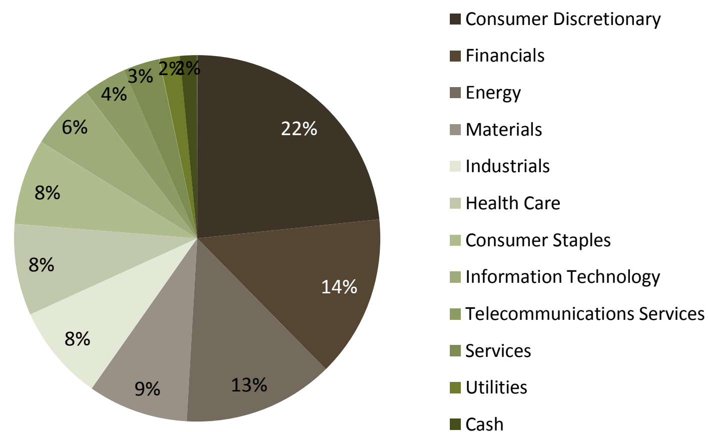
## Performance Commentary

### Market Overview

Following a rough opening quarter to the year, most all major subsectors of the broad based taxable US fixed income market generated positive returns in the second quarter of 2018, with the exception of investment grade corporate bonds, which declined approximately -1.0% as a result of rising rates. After falling -1.46% in the first quarter of the year, the Barclays US Aggregate Bond index continued to decline by -0.16% in Q2, and is now down -1.62% YTD. In its June meeting, the Fed raised rates by 0.25% for the second time this year to bring the federal funds target rate to 1.75%-2.00%. With the Fed's dual mandate of 'price stability' (low and contained inflation of around 2.0% per annum) and 'maximum employment' (US unemployment at or below 4.0%; currently approximately 3.8%) appearing stable, market consensus and Fed posturing is signaling an additional two rate hikes will likely occur before year's end.




### Sector Allocation

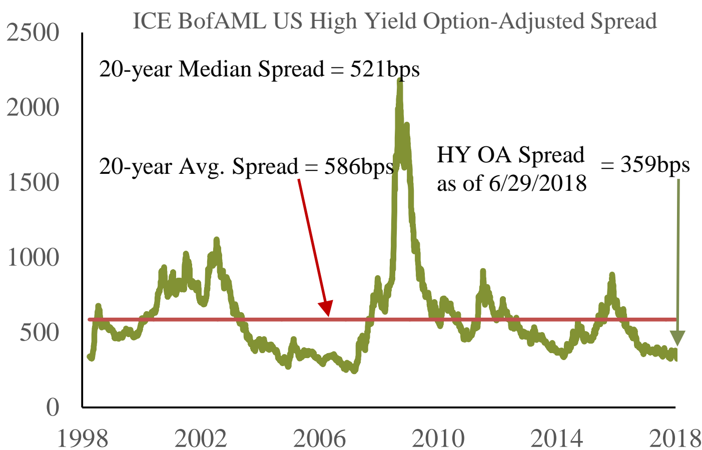



| Top Ten Holdings | Weight |
|---|---|
| Treehouse Foods | 1.28% |
| AMC Entertainment | 1.27% |
| Oppenheimer | 1.25% |
| Tempur Sealy | 1.24% |
| Lifepoint Health | 1.23% |
| Quad/Graphics | 1.22% |
| Centurylink | 1.20% |
| NCR Corporation | 1.20% |
| Infor | 1.20% |
| Coeur Mining | 1.19% |

## UNCONSTRAINED FIXED INCOME STRATEGY COMMENTARY

The US Treasury curve continued to flatten during the quarter as a result of the aforementioned rate hikes, with yields rising across all maturities and the spread between the 2-year and 10-year compressing 14bps from Q1's ending level to a differential of 33bps by quarter end.

High yield corporate bonds, specifically the lowest rated issues within the segment (B to CCC), continued to be the best performing area in the US fixed income markets producing a return of approximately +1.0% during the quarter. While the aggregate option-adjusted spread for high yield bonds contracted modestly from 372bps to 359bps by quarter end, aggregate spreads for investment grade corporate bonds expanded by roughly the same margin increasing from 117bps at the end of the first quarter to 130bps by the close of Q2.




## PERFORMANCE SUMMARY

After generating a strong +0.68% gross return for Q1 while most all other fixed income market segments and indices finished the first three months of the year in negative territory, the Unconstrained Fixed Income strategy continued to produce exceptional results posting a +1.29% gross return during the second quarter of 2018 and is up +1.97% YTD. While the Barclays US Aggregate Bond index continued to decline during the second quarter falling -0.16% and is now down -1.62% YTD, the ICE Bank of America Merrill Lynch High Yield Total Return index generated a positive return of +1.00% for Q2, essentially drawing back to even for the year with a YTD return of +0.08%.

During the second quarter, a number of the strategy's holdings in the previously distressed sectors of telecommunication services, health care, and energy experienced strong price recovery/appreciation and contributed significantly to the strategy's exceptional performance for the quarter. Telecommunication services was the strategy's best performing sector during the quarter generating a return of over +4.0% with health care, energy, and consumer discretionary each returning approximately +2.0%. Given their substantial weight of strategy assets comprising 23.2% and 13.2% respectively, the consumer discretionary and energy sectors were the most notable contributors to the strategy's Q2 results. The information technology sector was the only negatively performing sector within the strategy for the quarter declining roughly -1.7%. The tables below outline the strategy's five best and worst performing issues for the second quarter of 2018.

| Top 5 Contributors | Avg Wgt | Return | Contrib |
|---|---|---|---|
| Rent A Center 6.625% 2020 | 1.07 | 11.63 | 0.12 |
| Denbury Res. 6.375% 2021 | 0.49 | 15.37 | 0.07 |
| Supervalu 7.750% 2022 | 0.75 | 8.65 | 0.06 |
| CenturyLink 6.750% 2023 | 1.22 | 4.98 | 0.06 |
| Ensco PLC 8.000% 2024 | 0.96 | 6.13 | 0.06 |

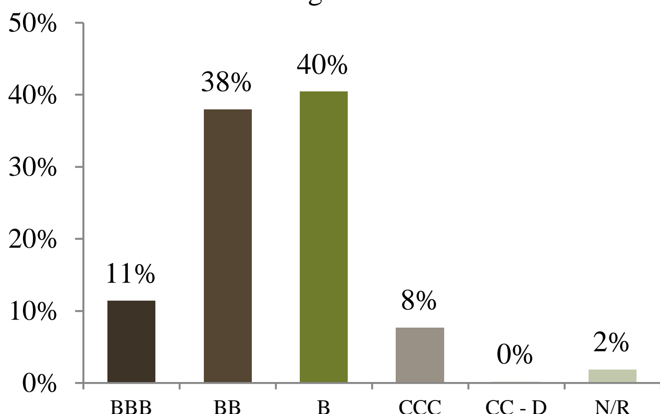
| Bottom 5 Detractors | Avg Wgt | Return | Contrib |
|---|---|---|---|
| Diebold 8.500% 2024 | 1.09 | (7.02) | (0.08) |
| Pitney Bowes 4.700% 2023 | 1.06 | (2.76) | (0.03) |
| R. Venezuela 7.000% 2018 | 0.09 | (26.39) | (0.03) |
| Coeur Mining 5.875% 2024 | 1.23 | (1.57) | (0.02) |
| Ferrellgas 6.750% 2022 | 0.65 | (2.68) | (0.02) |

## Unconstrained Fixed Income Strategy Commentary

### Strategy Characteristics

The strategy is heavily invested in the consumer discretionary, financial services, and energy sectors, with each accounting for approximately 23.2%, 14.2%, and 13.2% respectively of total strategy assets as measured by aggregate market value as of 06/29/2018. Exposure to the materials, industrials, and health care sectors is also robust with each accounting for approximately 8.8%, 8.4%, and 8.0% respectively. Despite the seemingly high degree of investment exposure to the aforementioned sectors, the strategy is always invested in an array of unaffiliated companies within each sector in order to provide broad diversification and help mitigate against issue specific credit risk.

Both the aggregate maturity and overall duration of the strategy contracted slightly relative to Q1 2018 levels, ending the quarter at 3.53 years and 3.04 respectively. The strategy's overall credit quality remained unchanged over the prior the quarter, and currently stands at 'B+'. The strategy's overall credit rating distribution is displayed in the following exhibit:




### Strategy Outlook

The carnage that investment grade corporate bonds have been experiencing thus far this year, especially those with higher durations in excess of 6.0, exhibits the importance of managing interest rate risk within a fixed income strategy. Over the prior five plus years we made the strategic decision to focus on allocating strategy assets on shorter duration high yield bonds, focusing more attentively on mitigating 'default risk' within the strategy. While in the period between 2010 and 2016 it was 'safe' to extend on longer duration bonds due to the fact that the Fed left rates unchanged at 0.00%-0.25%. We are now however in a rising rate investment environment given the two rate hikes that have already been instituted and another two which will likely occur during the latter six months of this year.

With default rates of high yield bond issuers currently at approximately 2.0% (roughly half of the 30 year average of 3.8%), and given the aforementioned rising rates, investor demand for high yield bonds is exceptionally robust right now. We anticipate that high yield bond spreads will remain largely unchanged from current levels and returns for the remainder of the year will come primarily from coupon payments alone.

Despite the strong performance of the strategy's telecommunication services positions this past quarter, issuers in the sector remain highly levered leaving us cautious of increasing the strategy's allocation to the sector. With oil prices recovering and stabilizing at and above $70/bbl, there are a number potential opportunities that are present in the energy sector, specifically in regard to 'lower duration' issues.

With the US and global economy expected to grow at approximately 2.5%-3.0% and 3.5%-4.0% respectively in 2018, the fundamentals supporting the high yield bond market appear favorable for the remainder of this year. Despite lofty valuations, we maintain that high yield remains both the most compelling and stable segment of the fixed income markets in which to be invested, especially in the face of rising interest rates.

## DISCLOSURES

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