VAN LIEW TRUST COMPANY

as we see it

Winter 2020

THOUGHTS FROM OUR CHAIRMAN

While 2019 saw S&P 500 index returns lifted over 20% , flat corporate earnings and underlying tensions surrounding trade and tariffs weighed heavily in investor's minds. We start the new year with heightened expectations of mid-single digit corporate earnings for 2020, the signing of a trade deal with Mexico and Canada and phase 1 of a trade deal with China. There appears to be little consensus on Wall Street on the extent of the impact on US GDP growth, yet most can agree the deals are a good thing for the US. The fruits of such deals may start to appear in the second half of the year.

For the last ten years, the stock market has gotten a lot of press, yet government, municipal and corporate debt continue to play a major role in funding expansion, growth, and, at times, fixing problems for corporations and individuals alike. What might investors want to know about their fixed income and bond holdings in, what seems to be, a persistently low interest rate environment? Joe Healy contributes his thoughts and concerns for bond investors in this Winter issue of As We See It.

Alfred B. Van Liew

Do My Bonds Behave Like Bonds?

Joseph J. Healy, CFA

The question, "Do my bonds behave like bonds?", may sound silly. Why wouldn't they? In recent years, the array of fixed income instruments available to investors has rapidly expanded. Thus, it's important to understand the role non-traditional fixed income investments could play in an investment portfolio. Certain investors may have an income goal they want to achieve. But is the objective for the fixed income allocation preservation of principal and a steady stream of income while serving to hedge the risk of more volatile equity investments? Or is the objective to replace declining income in a falling rate environment (while also achieving a steady total return in fixed income)? Once these questions and others like them are answered it can help guide the construction of a fixed income portfolio.

An impressive 2019 for fixed income gets minimized in light of equity market returns over the same period. Today, bond mutual funds are seeing record inflows despite historically low interest rates and yields. Are investors seeking bonds for income or because of concerns about equity prices? We believe the fixed income tailwind of declining interest rates from monetary stimulus has largely dissipated. Corporate debt issuance, rated just above or just below investment grade rated debt, has expanded unabated. The devil is in the details as some new bond issuance, commonly referred to as "covenant light", provides less protection for the bond buyer than we've seen historically. It's disingenuous on the part of the industry to create the sense you own a "so-called safe" investment when in actuality it may be something else. We fear many investors may be lulling themselves into a false sense of security.

Recognizing this changing environment, below are themes that play into Van Liew Trust Company's fixed income approach.

Interest rates have steadily fallen making income harder to find: Investors may not take comfort in receiving "steady" income if in a falling rate environment that income is also steadily declining. How can I get more income? Being realistic, the answer is simple – take on more risk. But is that what investors should do in fixed income? Lower rated bonds or longer maturities also represent more potential volatility.

Remember the core tenets of why you own bonds: At Van Liew Trust Company, we look at four main factors as to why an investor should own bonds. 1.) Diversification from equities 2.) Capital preservation 3.) Income 4.) Inflation protection. Notice I didn't say growth? Yes, total return (growth and income) in the fixed income space has been strong both last year and over the past decade while interest rates have been declining. It's harder to make the argument long term bonds will outperform and rates will continue to decline. What we call the "Plus" sectors of the fixed income space, meaning fixed income assets beyond traditional "Core" fixed income assets, have helped bolster fixed income returns. An investment research firm like Morningstar, Inc., that compiles and analyzes mutual fund data, will categorize funds as "Core" or "Core-Plus" –within their sectors- to help differentiate funds so investors can recognize how they are different in their approaches and exposures. Areas like high yield, floating rate, non-traditional bonds, emerging market, developed foreign, convertibles and preferred stock have certainly helped investors earn higher income and higher returns but it's prudent to review whether an investor is overly concentrated in such "Plus" areas, beyond the core of more traditional fixed income holdings. Our belief is that fixed income exposure and corresponding performance should be driven by the above investment grade rated component of their portfolio.

Bond proxies: A proxy by definition is a substitute to represent the value of something. Equity REITs, Utilities? Don't fool yourself. These are equities, not bonds. Their yields may be comparable or better than bonds. But don't rationalize that these investments will behave like bonds because you like their higher income.

Know what you own: Be wary of derivatives and make sure you understand them and how they behave. If your advisor can't explain what they are maybe they shouldn't own them. Recognize they may be higher risk than traditional bonds.

Individual bonds vs. bond funds: There's no interest rate risk in an individual bond if you can hold it to maturity. Certain individual bonds may have secondary market liquidity risks if there were a dramatic sell-off in bonds, though we have not witnessed a meaningful bond market sell-off in the last decade. Traditional market makers in bonds (like banks) now keep less in bond inventory, making some wonder who will be on the other side of the trade in a sell-off? With individual bonds there is also concentration risk of less diversification than with more broadly diversified mutual funds. However, with a mutual fund, whose prices changes daily, there is net asset value ("NAV") risk, the price may rise or fall. There is no set maturity, like an individual bond, where you will know what you will receive at maturity or when it's called.

Correlation matters: Historically, high yield debt has a higher correlation to equities than above investment grade rated debt. What does that mean? High yield debt while historically having roughly half the historic volatility of equities and while enjoying higher returns more in line with equities, moves more in lock-step (or is more "correlated") with equities than more traditional fixed income asset classes like above investment grade corporate debt, government bonds and agency bonds.

Bond diversification: We view bond diversification as important but make sure the drivers of your bond portfolio are investment grade credits and not the "Plus" areas I mentioned earlier (where we've seen higher returns of late). "Plus" exposure has its role but don't let the tail wag the dog, so to speak. Don't overly diversify yourself into a synthetic high yield bond portfolio. Meaning, don't assemble a diversified fixed income portfolio across various assets classes that mimics the behavior of a high yield portfolio (an asset class I discuss earlier). If that is what you desire – fine. But know the underlying risk and return potential.

At Van Liew Trust Company we view equities as the primary driver of investment returns and where risk should be centered to achieve the objective of higher long term investment returns (commensurate with the risk and return objectives and timelines of each individual client). Whereas, fixed income or bonds allow us, as portfolio managers, to temper that equity risk while "steadying" the portfolio and generating income. We do see opportunity in owning non-core fixed income assets, however, we don't want them to define our fixed income process. We will continue to think that way, especially in this current low interest rate world, and will strive to strategically and, where appropriate, deploy "Plus" exposures to benefit our clients.

This newsletter represents the opinions of Van Liew Trust Company, contains forward looking statements, is subject to alteration based upon changing market conditions, and is general and educational in nature. It should not be construed as providing investment advice. Information contained herein has been obtained from sources believed to be reliable, but not guaranteed. **Past performance is not a guarantee or a reliable indicator of future results.** Investing in the bond market is subject to certain risks including market, interest-rate, issuer, credit, and inflation risk; investments may be worth more or less than original cost when redeemed. U.S. government securities are backed by the full faith of the government; portfolios that invest in them are not guaranteed and will fluctuate in value. Mortgage and asset backed securities may be sensitive to changes in interest rates, subject to early repayment risk, and while generally supported by a government, government agency or private guarantor there is no assurance that the guarantor will meet its obligations. High yield, lower-rated, securities involve greater risk than higher-rated securities. Equities may decline in value due to both real and perceived general market, economic, and industry conditions.