TAXABLE BOND STRATEGIES

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With all the uncertainty associated with COVID-19, does the current market favor taxable bond strategies?

Mr. Repoff: During periods of heightened uncertainty such as we're experiencing now as a result of COVID-19, taxable bonds offer an appealing middle ground between cash and equities. Cash is the universal safe haven when investors fear severe market stress or price volatility, but due to accommodative monetary policy, it effectively offers no yield. At the other extreme are stocks, which offer the potential for high returns in the event of a quick economic recovery, but also the possibility of new lows if, for example, we see a second wave of infections or a flare-up in trade tensions between the U.S. and China.

Taxable bonds sit in between. They offer a relatively attractive yield and the potential for price appreciation in the event of a rebound, as well as provide a hedge against asset price depreciation. They are also likely to outperform riskier assets during a major downturn. On top of these considerations is an attractive technical environment courtesy of the Federal Reserve (Fed), which has provided a backstop for corporate credit and essentially eliminated worst-case outcomes for that market, further improving the risk/return outlook for the space.

So, would it be safe to say that despite the crisis, the current environment poses an actual investment opportunity for taxable bond investors?

Mr. Repoff: This is the kind of economic environment when taxable bonds are an ideal allocation for investors. With respect to expectations for slow growth, bonds offer stability and serve as ballast in a portfolio at a time when stocks are likely to be volatile. Corporations are also less likely to impair their credit quality during periods of low growth by issuing debt to fund capital spending or pursue M&A. Low inflation is similarly optimal, since inflation is the ultimate enemy of bond investing. This gradual erosion of principal value is a significant threat to a bond allocation, so here too the current environment supports a healthy allocation to taxable bonds.

What differentiates the firm's taxable bond strategies from others? What do you bring to the table that other investment firms do not?

Mr. Repoff: There are several areas where we distinguish ourselves from our peers. The first is that we are active, multi-sector asset allocators. This means that depending on where we are in the economic cycle or where spreads are, we actively shift among Treasuries, corporates, securitized, and governments to those sectors where we see the best relative value.

Secondly, our experienced team of analysts specializes in analyzing and investing in spread product. This means investing in sectors that offer a yield premium to Treasuries, such as corporates or mortgage-backed securities (MBS). We believe that you win with income over time and that by analyzing individual securities we can add value across the cycle relative to our benchmarks.

Finally, we exclusively invest in index-eligible cash bonds without using derivatives or obscure, illiquid structured products. This approach offers our clients transparency and liquidity compared to more arcane instruments, and we believe it reduces price volatility during periods of market instability.

ABOUT OUR STRATEGIES

GW&K offers several Taxable Bond Strategies to meet individual clients' risk tolerances and long-term portfolio objectives. We diversify portfolios across multiple bond market sectors aiming to take advantage of relative value opportunities. Our active approach combines both macroeconomic analysis and comprehensive bottom-up credit research. We look for opportunities to generate income and capital appreciation, while also limiting risk, in changing market environments. We seek out quality in all of the sectors in which we invest, including high yield bonds.

For more information on our Strategies please visit: www.gwkinvest.com

- **GW&K Taxable Bond Assets: $4,278 MM**

Assets as of 3/31/20

What should investors focus on before investing in a taxable bond strategy? For example, how important are credit quality decisions and interest rate sensitivity considerations?

Mr. Repoff: As with any asset allocation decision, this answer depends on a given investor's unique circumstances. But generally speaking, taxable bonds provide relative stability and serve as the ballast of a broader asset allocation. This means that during periods of heightened market volatility, they are likely to outperform the equity portion of a portfolio.

The other major consideration is an investor's income objective. Typically, income can be enhanced either through additional credit risk or interest rate risk. With respect to credit risk, corporate bonds offer a yield advantage over Treasuries to compensate for potential defaults. From this perspective, credit quality decisions are extremely important, because even a small number of defaults can have an outsized impact on portfolio returns. In normal markets, increased exposure to interest rate risk also commands a premium yield because investors are locking up their principal for a longer period of time. This is a risk investors must be aware of, particularly when interest rates are as low as they are right now.

As portfolio managers, we always advocate on behalf of active fixed income management, but at times like this in particular, when rates are low and defaults are likely to tick up, discerning bond selection is key.

The pandemic has plunged us into a period of roiling markets and economic uncertainty. How do you accommodate that when constructing your taxable bond portfolios?

Mr. Repoff: As obvious as it sounds, we believe one of the best approaches to managing risk is to buy undervalued assets. This means not just buying the cheapest individual bonds, but also the most mispriced asset classes or industries.

Early on in the recent crisis, this meant we were actively shedding exposure to sectors directly impacted by COVID-19, such as gaming, leisure, lodging, transports and energy. It also meant selling risk assets in general in favor of cash and Treasuries, which, as volatility began to rise, clearly offered value as safe havens and a means to preserve principal.

As the crisis advanced and the Fed stepped in to provide liquidity, it became clear to us that the cheapest assets were current coupon mortgages, which had widened significantly during the selloff, and companies that were likely to thrive in a post-recovery world, but which were still trading at crisis-level spreads. So, we used our cash and Treasury positions to fund purchases of current coupon MBS pools and high-quality, blue-chip franchises in the technology, consumer and financials sectors.

Looking forward, we continue to see value in corporates, given the historically low yields on Treasuries and encouraging signs of an eventual economic recovery. Spreads still sit well wide of their recent lows and the risk/return of the sector continues to look attractive.

Most of your taxable bond strategies are multi-sector, holding mortgage-backed securities or investment grade corporates. Some even include high yield corporates. Where are you seeing the most risk and the most opportunity?

Mr. Repoff: In light of current valuations and our expectation of a slow but steady recovery from the pandemic, we see opportunity in the credit and securitized sectors. We believe there is comparatively little value in Treasuries, which have rallied fiercely in recent months due to investor risk aversion and central bank stimulus. Treasury yields are near their lowest levels in history at the same time as interest rate risk sits near all-time highs. Consequently, we believe investors seeking to generate income must prudently move out the risk spectrum.

Within credit, we see the best value in the lower-rated segment of the investment grade (IG) market and the highest rated portion of the high yield (HY) market. These are the areas that stand to benefit the most from the Fed's credit market backstop and are best positioned to withstand another flare up in volatility should one arise. Additionally, spreads continue to sit significantly wide of pre-pandemic levels, offering not just additional income but also the potential for price appreciation as spreads continue to compress on expectations of a recovery.

In securitized, we see opportunity in fixed-rated agency MBS. These are pools of mortgages guaranteed by the U.S. government that offer an attractive spread above Treasuries. As part of our process, we analyze each individual security in order to find stories with the most compelling characteristics. The pandemic has increased mortgage forbearance, resulting in a slowdown in prepayment speeds and providing increased returns for MBS investors. In the current environment, we are seeking pools with higher coupons that should benefit the most from lower prepayment speeds and which are likely to outperform in the event of rising interest rates.

In times of crisis, focus often turns quickly to liquidity. How has the Fed's actions to bolster liquidity affected how you are positioning your portfolios?

Mr. Repoff: The Fed's announcement happened to line up well with how we were positioned coming into the crisis. We were overweight corporate credit through our exposure to both IG and, within the HY market, bonds rated BB. So the announcement of a backstop to IG *and* HY corporates that had recently fallen from IG really couldn't have been more helpful for our Strategies. After the announcement, we took further advantage of this dynamic through our active involvement in the new issue market, as a host of blue chip IG issuers came to market at levels that just a few weeks before would have been unheard of.

On the securitized side, our nimble trading allowed us to exploit the Fed's announced MBS purchases by quickly stepping into current coupon pools that had blown out. We had come into the crisis with an overweight to higher-coupon pools that typically offer better carry. However, with the Fed's announcement, it quickly became clear that there was a significant opportunity in the low-coupon cohorts, so we added aggressively to the space just as spreads tightened more than 80 basis points in less than a week.

Going forward, we remain cognizant of the support the Fed is clearly representing. This has allowed us to move a bit farther out on the risk spectrum than fundamentals alone might otherwise justify. But, of course, we're closely following this dynamic and will respond rapidly as the situation evolves.

What are you seeing in investment grade and high yield bonds?

Mr. Repoff: In IG, we've seen a few months of record new issuance as the Fed's liquidity backstop has propped up spreads and companies have rushed to lock in cheap funding. This has presented an excellent opportunity to add exposure to strong credits that are well positioned to make it through this downturn and come out stronger on the other side of it. Though it was a small window that has mostly closed by now, there were some really excellent values that we were able to take advantage of. From here, spreads across the broader market remain wide of recent tights and we believe further compression is likely as the recovery continues.

The HY picture is less clear because of how bifurcated the space has become. At the high end are recently downgraded fallen angles that present an attractive opportunity to add exposure to some large, high-quality credits at attractive valuations. On the other hand, there are some dicier credits, particularly in the energy and materials sectors, that have rallied recently that we're viewing a bit more cautiously. Should we happen to see a second wave of COVID-19, or if, for example, trade issues with China flare up, we think some of these credits might quickly retest their recent lows. Generally, we see value in HY overall, but think it's a bond picker's market and investors should be discriminating.

Most often when people talk about high yield, they're talking about junk bonds. Is this always true?

Mr. Repoff: The "haves versus have-nots" narrative is a major theme in the HY market, (i.e., bonds rated below IG). The lowest quality credits, the junky "have-nots," have struggled this year as fears of a major default wave grip investors. This segment of the market tends to grab the most headlines as a result of high-profile bankruptcies or massive price swings, but we don't traffic in credits this low on the quality spectrum. In fact, we generally believe that the risk profile of this kind of debt is more appropriate for an equity rather than a bond portfolio.

But at the higher end of the credit spectrum, where the stories tend to be less exciting, we continue to see significant opportunity. In this market, you're more likely to see higher quality credits that have temporarily fallen on hard times, but are still fundamentally solid. Often, the reason these "fallen angels" drop out of the IG universe is ill-timed M&A or a cyclical downturn that temporarily pressures their balance sheets. But these companies are typically motivated to return to IG, either for business reasons or simply for lower-cost funding. And since the factors that originally justified their inclusion in the IG universe (scale, business diversity, balance sheet strength) are often unimpaired, a return is frequently viewed as inevitable. In the meantime, our proprietary credit research allows us to identify these names in advance and earn attractive yields as we await price appreciation on their eventual migration back to IG.

High yield energy bonds have been unloved for some time and market disruption caused by the Saudi-Russia oil price war didn't help. We've seen oil contracts trade for negative amounts and production cut sharply. Do you see anything there that you like?

Mr. Repoff: HY energy is an incredibly bifurcated space right now. The last decade saw an astounding lack of capital discipline from E&Ps and the recent shocks on both the supply and demand fronts couldn't have come at a worse time. The rapid decrease in supply we've seen since prices briefly went negative is encouraging, but even at current levels many of these companies will struggle to earn a profit and, ultimately, rollover their debt.

We've been underweight the space for some time. Insofar as we've had exposure, we've concentrated on the lowest cost producers with good hedge books and strong balance sheets. Their valuations have typically reflected their high quality, but we don't believe that reaching for yield in this space is prudent.

Looking forward, we remain broadly cautious. Just as producers around the world, and shale producers in the U.S., in particular, responded quickly by shutting in production amid low prices, we expect them to ramp it back up as soon as prices recover. This will ultimately prove self-defeating and we expect volatility to be heightened going forward until the space experiences more significant rationalization.

Retail, which has been under pressure for a while now, was hit especially hard by lockdowns and layoffs across the nation. Do you worry that we will see massive credit defaults in that sector?

Mr. Repoff: The retail landscape was already challenged by intense competition, technological disruption, and rapidly changing consumer preferences prior to the pandemic. The recent crisis has only exacerbated these struggles, especially for those retailers that were in weak financial positions, as evidenced by several bankruptcy filings in just the last few weeks. Consumers' willingness and ability to return to their previous consumption habits are highly uncertain, and we anticipate additional financial challenges for companies operating in the space. Balance sheet strength, market share and e-commerce capabilities will be key to managing through this unpredictable period. We were underweight the space coming into the downturn, but recently added exposure to higher quality, well-capitalized “essential” franchises that we believe had sold off too much. Going forward we will continue to be opportunistic in this sector, but remain cautious given the challenges ahead.

GW&K has two Taxable ESG strategies. To what do you attribute the growing popularity of ESG strategies? What can you tell us about your investment expertise in this area?

Mr. Repoff: We believe ESG has become an increasingly popular approach to investing because it sits at the intersection of modern sensibilities around sustainability and best practices from a business management perspective. We don’t believe ESG is simply a values-oriented philosophy as much as it is a recognition of the significance of all of a company’s stakeholders. As such, we expect those companies that consciously engage these factors to exhibit a more attractive risk profile and generate stronger returns over time.

As an investing discipline, ESG has long been part of our investment process. We place a great deal of weight on our bottom-up, fundamental research, and as part of that process these factors play a vital role. The prominent risk factors vary by industry, but as a standard step in our analysis we identify and analyze the most salient factors. For example, we evaluate product recall histories and labor relations at major manufacturers, environmental engagement from raw materials miners, and ethics policies and lending practices at banks.

Particularly in the fixed income space, where downside risks have an outsized influence on portfolio returns, careful management of these risk factors is essential. Given our long history of engaging these areas, we believe we have a competitive advantage relative to peers who have placed less emphasis on these considerations historically.

There has been a great deal of tension for quite some time now between actively and passively managed portfolios. In times like these, how important is active management and security selection?

Mr. Repoff: The case for active management in fixed income has always been strong. There are numerous challenges inherent in replicating illiquid benchmarks. A large portion of many indices is comprised of low-yielding Treasuries. Capitalization-weighted indices introduce the undesirable quirk that the companies with the most debt are typically the largest issuers and thus the biggest holding. Furthermore, it is important to note that we’re entering a period that is likely to see an uptick in the credit default rate—so in this environment more than most, it is important to judge a borrower’s creditworthiness to avoid meaningful capital loss.

All of these factors combine to create an appealing environment for active managers and a particularly perilous one for naive bond pickers. Treasury rates are near historic lows, duration is near historic highs, and financial distress is likely to rise. The best way to successfully navigate this market is through thoughtful and active security selection.

Are you encouraged by the steps the Fed is taking?

Mr. Repoff: Yes. The Fed’s intervention was a game changer. During periods of market distress such as what we saw in mid-March, fears of market collapse begin to take on the character of a self-fulfilling prophesy. Investors panicking in their efforts to raise cash cause other investors to do the same. When this dynamic begins to stoke fears of defaults, then it goes from being a market technical to a fundamental reality for borrowers. The Fed’s backstop short-circuited this downward spiral and allowed cooler heads to prevail. And once the panic abated and order returned to markets, the narrative shifted almost immediately toward plotting a path toward recovery.

Some see a post-pandemic economic recovery as a “V.” Others see it as a “U” or even a “Nike swoosh.” How do you see recovery playing out over the rest of the year?

Mr. Repoff: Recent announcements regarding vaccine development, reinfection potential, and successful reopenings across the country have clearly provided a major boost to sentiment. As a result, investors seem more than willing to look past the near-term weakness in earnings to begin pricing in a post-recovery future. We recognize that there is still much to learn about this virus and that the path to recovery has the potential to be bumpy, but ultimately, financial markets are discounting mechanisms. In the long run, this virus will be viewed as a tragic, but nevertheless, non-recurring item in investors’ models. Of course, there will be permanent changes to consumer behavior, business investment, and government regulations, but we remain confident that growth will return before long.