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Active Insights Podcast - Finding Strategic Income Opportunities in the Midst of Market Uncertainty

Diane Merritt:

Welcome to North Square Investments Active Insights Podcast. North Square Investments is dedicated to bringing differentiated, active investment strategies to financial advisors and investors through our multi-boutique asset management platform. My name is Diane Merritt. Today, we are joined by John Cassady, Chief Investment Officer, and David Withrow, Director of Portfolio Management, with Red Cedar Investment Management. Red Cedar is a partner firm in the North Square platform, and sub-advisor to North Square Strategic Income Fund, symbol ADVNX.

Recently I spoke to John and David about their current outlook, how the Strategic Income Fund is positioned, and how the fund can be incorporated into an investor's portfolio.

John Cassady:

Thanks for having us, Diane.

Diane:

John, you look at income producing investments across world markets. Much of this year, we have experienced an unusual economic environment across many parts of the world. Where do you see the markets currently, and what is your outlook for the rest of this year and going into 2021?

John Cassady:

Yeah, certainly for the rest of the year, you're absolutely right about very unusual activity, and if we go back to the beginning signs of the pandemic, I would point out that certainly the Fed was very much spot on, very much proactive in cutting rates. Really, they cut rates before the recession officially began. So cut rates to zero, dusted off their old playbook from the quantitative easing era of the financial crisis. And they increased their balance sheet from three and a half or four trillion, and I think now they sit at about seven trillion.

So what they did in that sense, was they provided a ton of dollar liquidity, and kind of forced people, investors to look elsewhere for investment returns. So that's kind of the tailwind that we've had for most of the year. And then I'd also throw in the fiscal stimulus that we got this time around as opposed to '08/'09, a lot more fiscal stimulus as we sit here today, fiscal stimulus for the US for 2020 sits at about 14% of GDP, versus the financial crisis it was only about 6% of GDP, and in that time period it took place over two or three years. So, much different strategy this time. The other thing going on is the banks in '08/'09 caused problems, they were part of the problem.

Right now as we entered this, banks were as healthy as they've been in post-war years. So, much different situation. Lots of tailwinds. Clearly I think we're setting up for a reflationary period in the global economy. Part of that's going to depend on what's the outcome of coronavirus? How quickly do we get a vaccine and get people vaccinated, and/or a herd immunity? But I can see us as we enter into 2021, some positive news on that front, and I think that the global growth could surprise to the upside as we get into 2021.

In the short term between now and year end, all you have to do is look at the VIX curve. VIX, which is the measure of the implied volatility for the stock market. It's using volatility to price the options. The VIX curve is inverted right now. And the inflection point seems to be around a certain date in November when we have an election. That's what markets are signaling right now. They are very concerned about US election coming up in November. So I think there's a lot of things going on there. Part of it's caused by coronavirus. Part of it's caused by social unrest. And I think the mail-in ballots are going to be an issue as well. We might not know the morning after the election who the president is, and we might not even know who holds Congress.

I think those are things that the market is going to be wrestling with between now and year end, trying to get an idea of what is government policy going forward. Who's in office, in the executive branch and who controls the House and the Senate? I think once they get clarity on that, then you get some tailwinds, because as we've figured out how to deal with coronavirus, then 2021 could turn out to be very much a risk on year. But in the meantime, I think it's going to be... Probably caution is warranted as we get through the election cycle here, and we'll see where it goes. I do think that given the amount of fiscal stimulus, and I think there's more to come, I think, look, at the end of the day, we're dealing with politicians. I think they can see some of the issues we have in society, and these are all very political, but you have to take that into account in your investment analysis.

We do try to do a good job, we have people who work here who are very passionate about different things, but we do try to look at politics as dispassionately as possible. Just make the best investment decision that we can. And I think we do a pretty good job of that. I think that the government, I think we're going to have a lot of fiscal stimulus still to come no matter who's in office. I think Republicans or Democrats, I think it'll just be a matter of how much, and will it be full on modern monetary theory, or it will be not quite that much? But I think that's the direction we're headed in. I think that politically, they want to give labor more bargaining power when it comes to wages, that sort of thing, and try to help some of the social ills in the country.

I think that's where we're headed. It's a little long winded, but that is to say that I think the cat's out of the bag regarding any sort of ideas that we might practice a little fiscal austerity here. I think we're going in the opposite direction. We're probably going to have a budget deficit in 2020, to about 25%. You'd have to go back to World War II to see when it was that high, and it's certainly unsustainable.

You can deal with it for a very short period of time, but if we keep spending, then I think that's when it could get interesting in fixed income. You could see lots of treasury supply, obviously. And I think that the aim though, is for definitely fiscal stimulus to provide reflation to the global economy. And I think the Fed clearly has indicated they will tolerate inflation, and overshoot on their 2% target. I think longer term that's where we're headed. And that could mean probably, as we move throughout the year, it could get reflation globally, it's probably not good for dollar, probably US dollar that is. And it creates opportunities in other countries, they can see capital flows to other countries. And that could be a good thing.

Diane:

With central banks indicating the low rate environment may be with us for some time, do you see advantages with Red Cedar's particular style of active management?

John Cassady:

Yeah, we are definitely predicated on active management, we are a pretty nimble shop. We don't sit here and analyze things in huge committees, or anything like that. We definitely do our homework, but we're relatively small, 14 total employees, with 11 investment professionals. Then we can gather the information, bring it in, and make decisions. We tend to be rather nimble when we see things that start to change. And I think that's one of the hallmarks about what makes us really good. And one of the gentlemen that rejoined our firm, Mitch Stapley, he was the Chief Investment Officer in our old shop. We brought him out of retirement, Director of Global Macro Strategy. And so that's one of the things that he brings to the table. And we've all learned with him over the years the ability to analyze what's going on, not just in your own backyard, not just the US, but globally, which way the political winds are blowing, and what that might mean for investment indications.

So we're thrilled to have him on board here, helping us think through these complicated issues. And I haven't even spoken about China. Clearly we have, there was trade war going on for the last two years, which seems to have died down. But I think no matter who's in charge, no matter who's in the executive branch, I think that that's something that's here to stay. Maybe we gravitate towards more bipolar of worlds, with different spheres of influence. You can already see China laying the groundwork for their inclusion in world global bond indices, which they need to do, because they are not always going to run a current account surplus. At some point, they're going to run a deficit and they've got demographics not in their favor. So they need to have a very mature and functioning capital market. They're trying to do things now for inclusion in these bonds indices.

So I think that the things that are happening now with trade wars lead us down the path, China's going to be a sphere of influence, and they're going to have very investible capital markets. That could be a good thing. Once again, gives us more options out there. Chinese government bonds currently have a 10 year yield, like 3% for a 10 year, versus US about 67 or 70 basis points. That could create new opportunities. So we don't look at the changes in the political bent globally as being necessarily a bad thing. We just try to understand them, think about what are the ramifications for investments, and how can we take advantage of that for our investors? The fact that we're pretty nimble, I think plays right into our wheelhouse.

John Cassady:

Diane, I think that one of the important pieces of the puzzle here is our style and active management is exceptionally important, especially in this environment with US Treasury rates at historic lows. And as we've talked about before, international rates being negative in some cases, you have to be creative in terms of how you create income in a portfolio. Foundations and endowments, pensions are starving for income, and starving for performance. And we have to reevaluate all these marketplaces and say, "Okay, we can't do things like we've always done them." We've been in this, again, we were one of the first, I shouldn't say first, but we were early in managing this type of strategy, because we believe that looking at income traditionally was not going to solve investor's needs over the long haul. This active approach and creative ways of looking at income, we think is a better solution, given the current environment we're in.

Diane:

Where are you finding the best opportunities for income-oriented portfolios in this market?

John Cassady:

Right now I think it's a careful balance just at this very moment, as I mentioned, the potential volatility due to the upcoming election. It is a careful balance, as David mentioned, I think that you have to be creative. Clearly there's mortgage REITs, would be an example out there. The common equity of mortgage REITs, where you find lots of dividend income on that. In some cases, dividend yields approaching double digits. Now there are certainly risks with putting money in something like that. And we saw case in point of those risks back in February, when a lot of mortgage REITs had to liquidate, they went down in price, and all that kind of thing. But we had experience with this for the past 15, 18 years, and we were patient, before we got involved. We knew that there were liquidations coming. They had to restructure their portfolios. And then yes, one thing to say that their dividend yield is X. Let's just say 10% or something like that.

But is that sustainable? Can they keep doing it? Well, but they have to liquidate and de-lever, then no, that is not sustainable, and their price falls, their stock price falls. So we waited until we felt that they had restructured their portfolios. We've taken a few positions there. So that's one place. I think internationally, I think upcoming, I think coronavirus we're still having difficulty, and look, in the US, we're still having difficulty. It's very troublesome in emerging markets. I think that their time will come, however, and as soon as we see the clouds start to lift from coronavirus, I think we can see capital flowing to emerging markets. So there could certainly be opportunities there for income producing securities in EM sovereign debt, and the aforementioned China down the road, they're going to be a player. I think their government bond market is one and a half trillion or so. So they certainly have plenty of supply.

And I guess the other thing I'd say is, we discussed income producing opportunities, is we do need to exercise caution, because what we're trying to position this, it's like, "Look, this is the way that you want to own fixed income going forward." The central banks and governments globally have kind of flipped the script on fixed income. They say that used to buy equities for capital appreciation and you bought bonds for the income. And now it's seemingly the opposite with negative yielding bonds. In many cases, you're buying bonds in the hopes of capital appreciation, but there's some pretty attractive dividend yields out there on equities that you could own. So I think the idea is you have to be flexible. We're trying to position this as, this is how you want to own fixed income going forward. And I think that's where we bring value to the table.

I will say, too, that we do keep a close eye on we want to try to hedge volatility, so to speak, to the best of our ability. We've got going back for 18 years, a history of using different tools to hedge the volatility in our strategic fixed income portfolio that we have at our disposal, whether that's using VIX futures or selling emerging market currencies, versus US dollar, as a hedge against volatility. We're seeing different options strategies. Those are the things that we all have experience with. The situation warrants it, we can then go right back to the same playbook that we've seen in a different time and space.

Diane:

David, as we mentioned earlier, you sub-advise North Square Strategic Income Fund, a mutual fund with symbol ADVNX. What are the objectives of this fund?

David Withrow:

It's really pretty simple in terms of the objectives. We want to provide a high level of income with the opportunity for upside return when available. But I think the differentiator on all of this is we do it in a high quality manner. Many of our competitors in this space are using traditional high yield securities, to a large extent, or emerging market debt to a large extent, as the "value add to their portfolio."

We think there's a different way to do it. And so when you look at our securities, while we do have up to 20% of the portfolio can be in below investment grade, which would be considered high yield, largely it's through the preferred sector that we go below investment grade. So these are on balance sheets of companies where their senior debt is actually investment grade debt. So it's a very different type of quality of underlying security when you look at the credit of these individual companies than a traditional high yield manager. And what that does is it allows us to have more consistency and have more certainty around the long term income potential stream of those securities. As I mentioned before, high yield securities tend to have a high correlation with equity securities. So we've decided that really, if we're going to own a security, we'd rather own the equity of that security, as opposed to a comparable high yield security without as much upside.

Diane:

What is the current investment strategy and asset allocation for ADVNX?

David Withrow:

Currently we believe that coming out of the pandemic, we're actually coming out from a macro standpoint, and time will tell, but based upon our view, we think there's a strong tailwind, both from a macro standpoint, because of the things John mentioned earlier. Certainly monetary and fiscal policy are supporting a strong economy, and there's an old adage: don't fight the Fed. So as long as the government and the Fed are behind this growth pattern, we want to be in securities that offer, maybe take a little additional risk in the portfolio, but offer a good income stream with some upside potential. So we've actually recently upped our equity allocation, not to the high end, but a little over 6% in equities. We also have been upping our preferred allocation. We took the opportunity during the pandemic to add to preferred securities.

Largely again, we talked about before, the $25 preferreds, as those securities have richened, we've transitioned into the hybrid securities or more institutional preferred securities. Our preferred exposure is closing in on 40%, which is kind of middle of the range. But again, given the macro and the tailwind of the Fed and the fiscal policy, we think taking that risk in the portfolio, we may look to actually increase that part of the portfolio into the maybe low to mid 40%, if we continue to view the macro environment as improving.

And then as John mentioned, we do have some mortgage REITs, but the overall REIT exposure, including both traditional REITs and the mortgage REITs is just under 4% of the overall portfolio. Traditional corporate bonds are just around 11%, and we don't really... What we found is that we'd rather own, in many cases, the preferred of a company, a preferred or equity of the company, as opposed to just the senior debt of the company, because from a risk/reward standpoint, you're being compensated better. Then again, the last piece of the puzzle would be securitized, so mortgage-backed, asset-backed securities. That's about a third of the portfolio. We actually have been drawing down that a little bit to add to our preferred part of the portfolio. We added a lot of those securities during the pandemic. And so they've had a great run, and we're looking to monetize that and then move into other areas. John, why don't you speak to the non-dollar because I think it's also an important and potentially growing piece of the portfolio.

John Cassady:

Yeah, so right now we do own some non-US dollar sovereign debt, little bit of EM, and some developed market. Just looking to take advantage of some of the higher yields we can see elsewhere, and potential weakening of US dollar. So that's 5.5%, 6% currently. That's probably on the lower end, and I would look to increase that, as some of the uncertainty starts to recede into the background about global growth, and in particular the US election. For right now, we do own non-US dollar debt. It offers not only the income that is better in many cases than other things you could buy domestically, but also potential currency appreciation, being additive to the total return of that part of the portfolio.

Diane:

John, how do you see a multi-asset income strategy being best positioned in the investment portfolio of income-oriented investors?

John Cassady:

I just think going forward for the foreseeable future, they talk about how savers are being punished and financial repression. I just think it's a very creative solution to owning fixed income. And I would argue it's probably the way forward, that you do want to own fixed income. I think it's really in a nice spot right now. And I think we do it in a unique way. I do believe also that... Look, it can be in the eye of the beholder, what you want this to mean. Especially amongst institutional consultants. Some consultants might look at it as a fixed income portfolio. Some might call it simply multi-sector bond. Some might call it liquid alts. It could occupy, let's say many different spots of the box for this group, but I do think it does serve its purpose. I think it should be a part of your asset allocation if you go forward. I just think income is... We are a growth starved world, and we're income starved right now. That's the way we're going to have to look at fixed income for the foreseeable future is in products like this.

David Withrow:

I think one of the pieces that John was talking about is the fact that it can be a standalone. We firmly believe that can be a standalone piece of income producing portfolio, but also we found that many investors look at it as a complement to other more traditional ways of doing strategic income. So if they're using high yield and emerging market in a big way, then this portfolio would tend to have, for lack of a better word, a lower correlation to those returns. So high income producing portfolio, that might be a complement to other strategic income strategies.

Diane:

John and David, thank you so much for taking the time to join us today.

John Cassady:

Thank you, Diane.

David Withrow:

Thank you very much, Diane.

Diane:

And we want to thank you for tuning into our North Square Active Insights podcast. For more information on North Square Investments, our partners and investment solutions, please visit our website at www.northsquareinvest.com.

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