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Active Insights Podcast – Fixed-Income Strategies to Navigate Today's Challenging Markets

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. Today, Mark Goodwin, Chief Executive Officer of North Square Investments, will discuss the strategies Red Cedar Investment Management believes can enable income-oriented investors to navigate today's challenging markets. John Cassady, Chief Investment Officer, and David Withrow, Director of Portfolio Management with Red Cedar Investment Management, will provide us with their insights. Red Cedar is a partner firm in the North Square platform and sub-advisor to North Square Strategic Income Fund, symbol ADVNX. Mark, John, and David, we look forward to your discussion.

Mark Goodwin:

Thanks, Diane. As you mentioned, at North Square we seek out best-in-class active managers for our platform. And our partners at Red Cedar are well positioned to help income-oriented investors address the challenges presented by the current environment. John, I want to start off by looking generally at the current market environment and your outlook for the next six to 12 months. Red Cedar focuses on income solutions and has a highly experienced team. Can you tell us your view of the market right now? Do you see the pickup in inflation as transitory or perhaps more extended? And how do you see this impacting interest rates either short-term or long-term?

John Cassady:

Hi Mark and thanks for having us here. So as we look out over the horizon, six, 12 months out into the future, certainly a lot of debate over whether the inflation is transitory or not. And certainly there are elements of what we're seeing now that could be considered transitory as it relates to the bottlenecks and COVID that eventually could get worked out. But I think there's some other elements of inflation that could be a little longer lasting, for instance, the wage pressures we're starting to see now. Even prior to COVID, there were starting to be wage pressures in terms of average hourly earnings. We couldn't seem to get up off the mat after the financial crisis with 2% annualized average hourly earnings. And then right prior to COVID, that started to uptick. It got up to the 3% range and then certainly spiked during COVID.

And now we're sitting here, in fact, the reading today came in at just under 4% average hourly earnings. So we are seeing wage increases. We are seeing lots of legislation being passed in regards to minimum wage increases. And then of course, you can look across the commodity complex and some of the things that are going on there as it relates to going to greener energy, which takes a lot of commodities to make that happen. You're seeing that. I guess the other thing I'd point to would be the earnings that we've seen this earning season, certainly the commentary afterwards by the executives talking about how they are

able to pass on their increased costs to the consumer. So I think some of these price increases are certainly going to be sticky, because even if their costs go down further on down the road, I don't think you're going to see a decrease in the pricing of their goods and services.

So we do tend to think that it is not transitory. That being said, we don't think this is a '70s or early '80s style inflation, runaway, or stagflation or otherwise at this point. But we do think you can see an uptick in inflation. We're probably going to surpass that. The Feds already said they're okay with it running hot. I'll take them at their word on that. That being said, we think that rates—10- year yields down at 1.27% here this morning, as we speak—doesn’t really reflect the market's view on inflation. And that has to do with all the quantitative easing, the bloated balance sheets of central bankers globally because you have buyers that are not economic buyers. They're buying because that's their mandate for the time being and negative real yields certainly do not make any sense.

So yes, we think rates are going higher. We're not in the camp that says they're going to go to 3%, 4% or anything. But I think by year end, we're going to probably retest that 1.75% area on the 10 year, if not 2%. And that's where we stand today. So rates higher in the, we'll call it six- to 12-month timeframe. And then from there, we'll see what happens with all the fiscal stimulus, the half trillion infrastructure bill we're looking at right now and probably more to come. Where we go from that point is going to be a function of monetary as well as fiscal policy.

Mark Goodwin:

Very insightful, John. Turning to you, David. For several years, investors looking for income from their investment portfolios have had the challenge of dealing with historically low yields on traditional fixed income investments. What challenges does this type of environment present to income-oriented investors or investors seeking portfolio diversification from the fixed income component of their portfolio?

David Withrow:

Mark, I think it really goes back to the challenge is probably partially in our mind. And as much as historically—and I talked about prior to 10 years ago—the market had kind of viewed this allocation is 60/40, 70/30 split between equity and fixed income. And didn't have to think very creatively because yields in the fixed income market were higher so you were actually getting potentially real yields that were in excess of inflation. But after the great financial crisis in '08, we've seen that (real) fixed income yield disappear. And I think really what it forced us to do is to take a look at what alternatives are out there. And certainly you've seen investors looking at things outside of the traditional equity fixed income box. We think that the opportunity's been presented. We had been doing, preferreds and kind of these other alternative asset classes prior to the '08 financial crisis. But it really brought them into focus and people have started, really starting to reimagine what income looks like and why are we looking at only traditional investment grade, fixed income, or even high yield as our income producers.

There are alternative asset classes out there which can offer you income at different risk levels. But those are ways to mitigate that risk and look for opportunities to add income to a portfolio, to add lower correlations to a portfolio, but do it in a unique and different way.

Mark Goodwin:

David, we mentioned the North Square Strategic Income Fund, ticker symbol ADVNX, in our introduction. This fund, which you sub-advised has a broad range of potential investments. How do you see active management across this range of potential investments contributing to an ability to address the market challenges we're seeing?

David Withrow:

As I mentioned, we've been in this multi-asset class space as a firm for many years, and we love managing the Strategic Income Fund because it provides the opportunity. When you don't like an asset class and you're restricted to that asset class and you kind of buy the least ugly piece. You buy the least ugly security. And in this, we have an opportunity in the North Square Strategic Income Fund. We have the opportunity to say, hey, we really like preferreds right now, or maybe we want to go to our lower end of the band and we really like the equity market. We can add a little bit of equity, dividend paying equity, and we create that opportunity to go up and down the capital structure and the most senior security in the capital structure all the way down to the equity. I mean, we've found many times where you can look at a company you may like, and you may say, hey, the dividend of this stock in a low volatile environment, or maybe we view as being inexpensive, the dividend of the stock is outyielding the debt of this company.

And maybe outyielding the preferred at that same company. Now you have to weigh that against the risk and the volatility of that underlying security. But then you may say, okay, well we don't like the equity to get too volatile, even though the dividend's attractive. Well, we can go into the preferred piece and the preferred offers lower correlations than high yield out there and to traditional equity. Or perhaps if we're in a risk off environment, we can go all the way to the senior security or potentially even treasury in a dramatic situation. We're not looking to totally de-risk a portfolio and volatility picks up, but we're looking for ways to provide, up and down the capital structure, opportunities to exploit inefficiencies in the market, inefficiencies in the capital structure that provide the best opportunity for the Strategic Income Fund to perform.

Mark Goodwin:

That's great to hear, David. Having the ability to look across the cap structure for relative value is something that definitely distinguishes Red Cedar from other firms that I've worked with. Pivoting back to you, John, you and your team have particularly strong expertise in preferred securities. How would you expect preferreds to perform based upon your current market outlook?

John Cassady:

The first thing I'd like to address is that I just got through mentioning earlier is we expect Treasury yields to rise here between now and year end. We've gotten this question a lot, particularly the last 10 years, where we've managed a strategy like this. People want to always say, hey, rates are going to go up, or if rates go up, that means preferreds are just going to get killed, aren't they? And that's just not necessarily the case. And so let me explain that.

There are lots of risk factors that are involved in a preferred security. If you look at a Treasury security, that's the purest form of expressing the interest rate risk. Just the risk-free interest rate, looking at

Treasuries, right? Well that is one risk factor in a preferred security, but there are many others. There's credit risk involved there. There's the structure risk. There's callability of that deal. Other things could have an impact on the pricing of a preferred security, such as the steepness or flatness of the yield curve, particularly in the banking sector. A steeper yield curve would help improve the credit characteristics of a bank preferred for instance.

So what tends to happen is all of these other risk factors can really dilute the interest rate risk factor within a preferred security. So as a result, it's not as easy to just say, well, rates are going up, preferreds are going to perform poorly. And in fact, we've done some analysis where we looked at the correlations of preferred securities relative to Treasuries. And when I looked at the results, it was kind of astounding, in a good way, that the correlation between various Treasury indices, whether I looked short term Treasuries by themselves or medium term Treasuries where the entire Treasury index, the correlation of all those Treasury indexes relative to preferred securities was pretty close to zero.

And so that's kind of the proof point out there that says that they're not necessarily correlated to interest rates. And that's a good thing. Because that's what we're trying to accomplish here within the Strategic Income Fund.

David Withrow:

I might add, Mark, that when people talk about preferreds, they think of this homogenous perpetual security out there. And it's important to understand that the preferred market, as we view it, is made up of a lot of very nuanced securities. So you can take very different interest rate risk depending on the type of preferreds you buy. And we spend a lot of time looking at the deal structures of these preferred securities to try to make sure that we are mitigating our interest rate risk when we purchase them.

Mark Goodwin:

Great insight. When you think about other higher yielding spaces in the fixed income arena, namely high yield and emerging market debt, how would you see preferreds performing against those traditional higher yielding flavors of fixed income?

John Cassady:

So we look at preferreds as a high quality way, actually, to get income into your portfolio relative to your high yield holdings, which by definition are below investment grade. We think it definitely has a place in your portfolio. And we think that preferreds can be certainly, whether it's a multi-sector strategy or a core plus type strategy. A lot of core-plus investors tend to just put a lot of their holdings directly into high yield. And we use high yield, we don't have anything against it. We use that in several strategies, but this gives you the income without taking as much credit risk by using preferred securities.

David Withrow:

Yes, and as John has pointed out, when we look at the capital structure, the high yield security is high yield. The traditional high yield is high yield because it has a balance sheet or an income statement, which says it's not as credit worthy.

When we're looking at the preferred piece, which might fall as a high yield security. In other words, it might have a below investment grade rating. The reason it's rated below investment grade is because of where it falls in the capital structure. So in all likelihood it's part of an investment grade company. It just falls lower in the capital structure. So it's not that there's not risk with the preferred or credit risk with the preferred, but it's a very different type of credit risk when you're looking at traditional high yield.

John Cassady:

Just one other point. At certain times, high yield and emerging markets can have much higher volatility in the price action there. So in particularly when things aren't going so well, high yield tends to get more and more highly correlated to the equity market. So hence there's the potential there for higher volatility in those other sectors you mentioned high yield and emerging markets. And then of course, emerging markets comes with a whole other set of issues just in terms of central banks of those countries. You definitely have to pay attention. It's a different kind of risk, which is something to be aware of when you're looking at emerging market debts out there.

Mark Goodwin:

You've given some good background on the benefits of preferreds in general. Can you talk about the importance of active management in this space and are there nuances to the preferred arena that give an active manager particular advantage, either trading or otherwise?

John Cassady:

Yes, there's definitely a nuance. Dave mentioned a little earlier. So some of the preferred structures can be very long dated. Perpetuals out there. There's $25 preferreds, that they can be more of a retail product. And we think one of the few places in fixed income that is not as efficient anymore. It never really has been efficient, it's just not a very efficient market. And we can take advantage of those things and actively manage by rotating between maybe the $25 preferreds, maybe moving into bank hybrids when valuations look more attractive there.

An example of this would be going back to the first and second quarter of last year, when the world was coming unglued and COVID was upon us, a lot of retail investors started selling their $25 preferreds. So we were able to buy those at really, really cheap prices, high yields, just as being the provider of liquidity for that part of the preferred market. And then as things settled down and those things increase in price, then it was time to rotate maybe more, and we did, into the more institutional preferred market, which would be the bank hybrid. So it's definitely something you don't just want to buy preferreds, stick them in your portfolio and forget about it. You can actually add a lot of value by actively managing in that space.

Mark Goodwin:

Do you think it would also be fair to say that this exposure to preferred securities may provide a degree of diversification to portfolios that investors might not get from other traditional fixed income investments?

John Cassady:

Yes, absolutely. There are a low correlation benefits that you can put into your fixed income portfolio by owning preferreds. Going back to my conversation earlier about the correlation to interest rates, those sorts of things. Not as highly correlated to equities as say the high yield market. So there are absolutely diversification benefits to adding preferreds into your traditional fixed income portfolio.

Mark Goodwin:

Thank you. Back to you, David. As we mentioned earlier, you folks sub-advised ADVNX, the North Square Strategic Income Fund. Can you talk about how the current portfolio for ADVNX is positioned?

David Withrow:

Certainly. Well, coming out of COVID and into the beginning part of this year, we added risk to the portfolio and our equity positions were towards the upper end of their band around nine or 10%. We've since reduced equity a little bit, with the Delta variant, with the Fed kind of changing at least their talking points, we de-risked them slightly. But equity is now at about 7 1/4%, real estate equity's around 5% focused, a little bit more on the mortgage REIT exposure. In the fixed income space, our preferred is still at the upper end of the band, just under 50%, which is the top end of the band for our preferred exposure. We have been, in some cases, really focusing on higher quality names or lower, more low volatility names. Please understand we're not looking and saying that the sky is falling, but we do know with uncertainty, the markets become more volatile. But we also, because of that, we did reduce some of our non-dollar exposure. I think most in that zone around three to 4% right now.

I think, most interesting, is we've increased our hedging exposure in the portfolio and look to kind of hedge out some of the tail risk. Again, our long-term view or intermediate term view is not really for the sky to fall, but we do think that as the uncertainty is there in the market and it was prudent to take off a little risk and to hedge out some of the risks. And John, you might go into a little bit of that tail risk management that we've done over the last several weeks here.

John Cassady:

Definitely. It's something that is a concept that we employ within the strategy. Wanting to protect the portfolio from some of those “left tail” events, if you will. Maybe the tidal wave that could be coming by definition, they pretty much come out of nowhere. And so we always look for cheap hedges to put in the portfolio and buy that. A hedge is going to cost you money. It's going to cost the portfolio money. So we want to do it in the cheapest way possible.

And over the years, going back in all the years, we've managed this strategy together, we have several arrows in our quiver to utilize, to hedge out tail risks. Sometimes we utilize VIX futures. But no matter which method we use, it's all about having the portfolio be positioned so that if ball does spike and volatility does spike, then it'll dampen the blow to the portfolio in terms of the NAV or the draw down that you might take. So we look at that. We use risk budgeting in terms of how much we want to risk in the name of tail risk hedging, but we keep track of it. And we very finely calculate how much we're willing to risk there and what the potential upside to the portfolio would be in such a scenario.

Mark Goodwin:

Thank you, John. In the case of income-oriented investors, how would you say they should see this multi-asset income strategy best positioned in their overall investment portfolio?

David Withrow:

Well certainly, you have to take into account each individual risk profile and all those sorts of things. I think when you're talking about longer term portfolios, we mentioned earlier in the podcast, that we kind of have to re-imagine what's your allocation mix. It's no longer can you look at this 60/40, 70/30 traditional fixed to equity mix and say that's going to get you where you would like to be long-term in terms of real return, real total return in the portfolio.

I think there's a case to be made, and I look at this personally, as it replaces the core income piece of your portfolio. And I think the other place that can make a lot of sense is if you want to combine it with other managers who take maybe a re-imagined or a unique approach to fixed income, and they compliment each other. We play in spaces that a lot of other managers don't play in. And so it can compliment other fixed income type strategies. But we view it can be used in either or.

And I think the other thing it's important that we really view it as is the low rate environment certainly has made us rethink and I think has made the market rethink what does fixed income look like in the portfolio? What does an income piece of the portfolio look like? But I think even if we return to a more historically normal rate environment, I think that only serves to help the asset managers and investors to say, okay, for a long time, you do it this way. Just because income is a little easier to come by, we're still talking about what's real yield? What's real income to the portfolio over and above inflation? And I think these new strategies can play a part as a core or a complimentary piece in those portfolios because you're looking at your portfolio more holistically and saying, what's the cheapest way to get income into portfolio. And I'm not just constricted to two buckets.

Mark Goodwin:

As we sit here today, there are probably many investors that find themselves more overweight equities than they normally like, but they're still uncomfortable about reallocating into more traditional fixed income investments given the potential for rate rises. How do you see ADVNX better positioning their investment portfolios in the current market environment or something they should consider as a way to compliment their existing equity sleeve?

David Withrow:

I think there's a lot of investors out there who say, well, I want my fixed income when there's a risk-off moment. So to be the anchor to my portfolio. And I understand that desire to have that. The challenge is the other direction. So you have very little income to offset a sell-off in the fixed income market. And so that risk/reward that used to exist in fixed income, where you have income offsetting, maybe some depreciation and the market of the fixed income marketplace, doesn't really exist like it used to.

And I think again, if you take a look at the equity portfolio, as do you allocate a part of the equity portfolio—which we do—as a piece of what we do as income producing, and look at again at your portfolio more holistically and say, what happens historically in fixed income? When you look at the first quarter of

this year, the traditional fixed income market, the Bloomberg Barclays US Aggregate Bond Index had its worst performance in its history for a quarter. And I think what ADVNX says is even when fixed income underperforms, there are strategies which in those marketplaces can out perform and add incremental, not only income to the portfolio, but also total return, especially over a longer time period.

Mark Goodwin:

John, David, thank you so much for joining me today. This has been a great discussion, as always.

John Cassady:

Thank you very much for having us, Mark.

David Withrow:

Thanks, Mark. It was great to be here.

Diane Merritt:

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