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Active Insights Podcast – CS McKee's Active, Low Duration Fixed Income Strategy

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 fixed income investing for capital preservation and the investment approach of CS McKee. Brian Allen, Senior Vice President and Portfolio Manager, will provide his insights and outlook for this sector of the market. CS McKee is a partner firm in the North Square platform. Mark and Brian, 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 CS McKee have a proven, repeatable approach to fixed income investing. Brian, your firm has primarily worked with institutional investors so financial advisors and individual investors might not be as familiar with CS McKee. Can you give us some background on the firm and your investment team?

Brian Allen:

Sure. CS McKee was founded in 1931. We were happily celebrating our 90th year in business. On the fixed income side of the shop, we manage funds across the maturity spectrum, under a high quality, high liquidity, and primarily a bottom-up investment process. We are 100% investment-grade focused for all portfolios, and our goal in this approach is to deliver a consistent market outperformance with lower volatility. Behind the scenes, we have a fixed income team comprised of seven members, four portfolio managers who've been with the firm an average of 22 years, three securities analysts—including one quantitative analyst; they have been with us an average of seven years. And together we manage 250 or so primarily institutional accounts, totaling approximately $6.5 billion in assets.

Mark Goodwin:

Brian, McKee manages an array of fixed income strategies, but today I'd like to focus on the low duration fixed income strategy, particularly with CS McKee now sub-advising the AdvisorShares North Square McKee Core Reserves ETF, ticker HOLD. This strategy covers investment grade corporates, mortgage- and asset-backed and government securities that you and your team consider when building the portfolio.

Can you talk about how you develop an overall portfolio strategy with an objective to both preserve capital and maximize income given the duration limitations here?

Brian Allen:

Yes. Our low duration in this case, what we've heard is an enhanced cash strategy is really the first step up in risk versus a money market fund. It offers the investor the opportunity to earn additional income, versus the money fund, primarily by expanding the investment universe, but also maintaining low interest rate and yield curve risk. What little duration risk we take, which typically ranges from one half year to just over one year, is determined by forward curve analysis, which is a process for us to determine the break-even rate at various points along the short end of the yield curve, and determine where we should best take risk, to the extent we take any degree of interest rate or duration risk.

Holdings within the ETF fund currently include about a 20% allocation to asset-backed securities. And there we prefer the more liquid issuers, typically credit card and auto loan and lease deals, and avoid the less liquid, newer securities that have come to market. That's joined by about a 60% allocation to investment grade credit, where we maintain a fairly thorough and broad diversification among financial, industrial and utility names. And then finally about a 20% allocation to U.S. Treasuries for the most immediate liquidity needs.

Mark Goodwin:

Can you talk about the process you use to evaluate your investment universe to develop a workable set of potential investments?

Brian Allen:

Yes. Drawing from our experience and input from the entire fixed income team, we begin by developing an initial framework for portfolio structure, based on the aforementioned outlook for market interest rates and what we see as a result of our forward yield curve analysis. Now we follow that with a review of the relative value of the various sectors that we look at, both on a current and historic basis. Again, try to determine what we think is the break-even in performance for those securities versus an otherwise purely Treasury-invested portfolio. And that step leads to our sector weightings as well as informing where exactly along the short end of the yield curve we'll position ourselves.

Personally speaking, I have a particular bias towards the asset-backed sector. I'm primarily responsible for securitized assets. And frankly, those securities, especially in the short end of the curve, work in a number of ways to generate return that you structurally won't see in your typical corporate agency or even Treasury security. Asset-backed securities (ABS), even the most liquid and high-quality ones that we favor, out-yield short term corporate issues. It's not unusual to see AAA rated asset-backeds with equal or higher yield than a single-A rated credit.

And add to that the fact that when buying, for example a single or double A rated asset-backed security, as it pays down over time, there's a natural structural bias towards improving credit rating. So you've got the benefit of higher yield to begin with, you roll down the yield curve, which improves pricing on the bond in overall terms, and then you've got ever improving credit quality underneath the bond. So it really

does fuel returns and makes this sector what we think typically is the most attractive in that part of the curve.

Mark Goodwin:

Moving forward, once you have your workable investment set, how do you then make specific security selections and allocate those positions as you build portfolios? So, you don't have 100% asset-backeds, for example?

Brian Allen:

The final determination of portfolio construction, the individual security holdings and position sizes are also very important ingredients. Really incorporate all those previously mentioned factors in terms of duration, curve, interest rate risks, spread risk, and takes scenario testing to what we deem to be extreme levels. We've certainly found that when it comes to weighing the relative attractiveness of one bond or one sector versus the other, you can become a little too enamored with a particular security, or of a greater concern is the fact that you may like, on a standalone basis, you may find corporates attract, you may find TIPs attractive or callable securities, all of which based on historic measures may look attractive, but when combined in a total portfolio setting, leave you open to negative economic surprises; sharp jumps in volatility, a quick rally in Treasury rates.

So, the final step in making specific security selections really involves shocking the portfolio to what we think are relative extreme levels in terms of rates and volatility, changes in credit quality and liquidity as we've seen in the last few years, very important consideration. We do all that to really come down to a final portfolio structure.

Mark Goodwin:

So where would you say the greater impact will come onto your portfolio performance, from security selection or asset allocation over time?

Brian Allen:

Well, while both are obviously very important components, especially in the short end of a yield curve and for a portfolio such as this, I'd have to give a slight nod to sector allocation. We're operating within a sort of narrow duration window and limiting ourselves to a high quality investment universe. So most relative value will show up at the sector level, and provided we don't make any mistakes at the security selection level, we're really going to see most of performance driven from how well we've made the decision regarding the sector allocation.

Mark Goodwin:

Thanks Brian. We've seen a great deal of monetary and fiscal stimulus, investment markets at high valuations and much higher inflation. Over the past 30 days or so we've seen 10-year Treasury bonds all over the place, forward and backward. Where do you see the current economic environment and what's your outlook for the economy and fixed income markets in 2022?

Brian Allen:

Yes, we generally remain constructive on growth headed into next year, almost regardless of what the Federal Reserve does. General speaking payroll growth—as we've seen again this morning with some noise in this last report—has accelerated to well above historic averages, two to three times that you typically see in monthly gains. The participation rate is finally beginning to move up. We've got a ways to go to get to pre-pandemic levels, but nonetheless, we're on the right track there. Wage growth continues to be strong and whether we need it or not, a fair amount of fiscal stimulus is headed our way. So the demand side of the equation is certainly great from a growth point of view. As a result though, in the balance between growth and inflation, a little bit more concerned about, not only the rate of inflation, but the market's ever-changing view of inflation.

And as much as the Fed has tried to calm, there's concerns from May, June of this year up through about a month ago, early November, they are finally coming to the realization, much as the market has instructed them to do so, that inflation really isn't transitory by historic standards, and that they in fact may be a little behind the curve with respect to removing stimulus. As a result, they've talked about tapering faster than they had originally discussed. Well, we think the market now discounts at least two rate hikes in 2022, which I believe is an accurate assessment. We will see a peak in inflation early next year, and it will trail off certainly a year from now when inflation is measured month by month or even on a year over year basis, we'll have put most of what we hope, with the COVID influence on the economy in the rear view mirror.

And therefore, year-over-year numbers will become a little more digestible and comfortable, and as result, the Fed will play it slow, raising rates only twice along the way there. The only thing that's really concerning is beyond 2022. Again, the market has very fully discounted, what's likely to be the Fed response next year, but frankly has gone to sleep on what may occur should inflation prove to be a little stickier than even what I've just outlined. And a terminal Fed Fund's rate of 1.5% is still negative in real terms, and again, the market's frankly betting 100% on the fact that just a few slight adjustments from the Fed will do more than enough to correct the imbalances in place right now.

Mark Goodwin:

Given this inflationary backdrop and rising rate environment, how does this view impact the way you're positioning the portfolio strategy today?

Brian Allen:

Well, with the market discounting what we believe is the most likely scenario over the next 12 months, and given our focus on such a short part of the yield curve, we are positioned, we think, as we should be. Given the outlook, we're now beginning to move duration very gradually a little longer from its about 0.6 year level. We also have, as the opportunities present themselves, bought or added more callable and adjustable rate securities as well. So we're finding ways to improve portfolio yield without taking undue duration risk, and certainly not going beyond what the market is giving us in terms of reasonable opportunities.

Mark Goodwin:

Where would you say you're finding the best opportunities in today's market?

Brian Allen:

Definitely in the ABS market. Again, take care of my own familiarity and personal bias in that space, but certainly those securities come to market with more attractive yield profiles and risk profiles than we find in other sectors. But we've also seen an uptick to a small degree, but an uptick in corporate space with respect to floating rate offerings. And there again, we like that structure in a portfolio like this, where principal preservation in our mind is still the first priority, and then generating yield a close second. But those two areas in particular will offer us, I think the ideal tradeoff between low duration, liquidity and yield.

Mark Goodwin:

Changing gears for a minute. Many investors use passive investment strategies for portfolio exposure in fixed income. Do you see advantages from CS McKee's style of active management for investors' fixed income exposure in what could be a more volatile environment over the next 12 to 24 months?

Brian Allen:

Yes, though the trend to passive investing continues, that's true in equity and many areas in the fixed income markets, core fixed income is one area where active management can and does offer consistent benchmark out performance, lower volatility, or a combination of the two. That's really our focus across the board for all of our products, be it the very shortest maturity as out to a full aggregate one to 30-year benchmark. Now the one caveat to that is that many firms, if while the percentage of firms that outperform a core benchmark is higher in the space than in, frankly against any other fixed income or equity benchmark, many firms simply assume a greater degree of credit risk, as a means for out-performance.

Again, that tends to generate attractive long-term average returns, but within the context of a diversified portfolio, doesn't provide much by way of diversification. So, the firm's focus historically has always been fixed income as a compliment to higher-beta, higher-risk holdings. And therefore the quality bias runs through everything we do, and our pursuit of higher returns, higher yield doesn't rely on credit risk, but in uncovering other liquid securities that offer both yield and diversification.

Mark Goodwin:

Brian, a final question. How do you see an active, low duration fixed income strategy being best positioned in the diversified portfolio of an individual investor?

Brian Allen:

Yes, I think for that particular investor, a product such as HOLD is really ideally suited for that portion of their total portfolio that should be allocated to stable liquid reserves. Money markets typically fill that role, but as we all know, in the last year or plus, most money market funds offer as close to zero in terms of yield than we've ever seen. So, the cost of maintaining liquidity, already reserves is fairly high, especially

when measured in inflation adjusted terms. So, a product that offers somewhat higher yield than money marketing funds and doesn't take excessive duration or yield curve risk, really makes sense for a sort of holdings that most investors should maintain the old mantra six months' worth of expenses or a year's worth of expenses in a stable performing fund sounds... those are the ideal types of investments that investors will find are met in the HOLD product.

Mark Goodwin:

Makes a lot of sense. Brian, thank you for joining me again today. It's been a great discussion as always.

Brian Allen:

Thank you. All was a pleasure to discuss our growing suite of products.

Diane Merrick:

Thank you for tuning in to 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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