

Tortoise QuickTake Credit Podcast



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Welcome to the Tortoise QuickTake podcast. Thank you for joining us. Today, a senior member of Tortoise provides a timely update on trending topics in the market.

Welcome to the weekly Tortoise credit podcast. I'm Greg Haendel, Senior Portfolio Manager at Tortoise. It's been an interesting month thus far with interest rates rising, wage inflation fears increasing, equity market volatility spiking, mutual fund flows reversing course and ETF redemptions abound. While equity volatility can be unsettling, this volatility is typically much more contained within fixed income credit spread products while in our opinion it can also create investment opportunities for the actively managed fixed income manager. In today's podcast we will briefly discuss the linkage or correlation between equities versus investment grade corporate credit spreads, interest rates versus investment grade corporate credit spreads, and the advantages of actively managed fixed income as opposed to passive fixed income strategies such as ETFs.

Month-to-date through February 16th, the S&P 500® Index declined by 3.24% despite being down 8.6% by February 8th then rebounding from the lows. Investment grade credit spreads took the volatility in stride and only widened by 6 basis points over the same time period resulting in an excess return (return only attributable to credit spread changes) of -0.40% and a total return of -1.46 % (return inclusive of Treasury rate moves) as measured by the Bloomberg Barclays Credit Index. In fact, over a 10-year period, the changes in investment grade credit spreads versus the changes in the S&P 500® Equity Index have a beta of roughly -0.30 (meaning as equity prices decline credit spreads increase, but only by a fraction). This in turn provides some much desired relative stability versus equities in times of volatility. Further, while rising interest rates typically mean lower dollar prices on bonds (coupon, structure and maturity dependent) they also typically result in tighter credit spreads. This inverse relationship typically occurs given that rising interest rates are often a sign of an improving economy which is a positive for corporate fundamentals. In addition, from a supply demand technical standpoint, rising interest rates typically increase buyer interest in fixed income, particularly from pension funds and insurance companies as yield targets are met or exceeded. As such over a 10-year period, changes in investment grade credit spreads versus changes in the yield on the 10-year Treasury have a beta of approximately -0.40. This means that historically on average, as treasury rates increase, credit spreads narrow by a fraction of the increase thereby providing some cushion to the effects of rising interest rates.

As discussed in our podcast dated Oct. 10th, 2017, growth in financially innovative products, like exchange-traded funds (ETFs) and exchange traded products (ETPs) post the financial crisis has been remarkable. The global AUM of exchange-traded products has grown from around \$800 billion in 2008 to over \$4 trillion today. While ETFs offer some attractive attributes such as low costs, transparency, liquidity and potential index replication, these could also exacerbate the liquidity gap and the velocity of the price movements during periods of heavy redemptions similar to what has been experienced this February. In periods of balanced flows, the daily volumes for larger ETFs can reflect shares in those ETFs changing hands with no new shares created or dissolved thereby eliminating the need for an underlying transaction. However, in a time of heavy one-way redemptions, ETF managers are forced to indiscriminately sell the underlying securities. When this occurs in less liquid assets classes such as high yield bonds it has the potential to vastly compound the selloff as well as diminish the effectiveness of the ETF replication strategy.

During turbulent times within the markets or times of significantly rising or falling interest rates an actively managed fixed income product can decrease or increase its interest rate sensitivity to take advantage of declining interest rates or protect investments against rising interest rates (similar to what recently occurred). Alternatively an index or ETF is relatively static and thus is unable to adjust for the new market conditions. Further, investment opportunities tend to arise during times of turbulence when the market doesn't always work efficiently thereby over-shooting or under-shooting fair value. In fact, while this turbulence may not be caused by the ETF or index seller, it can be perpetuated by them, similar to what we believe has occurred this month. Luckily, what could be one manager's loss, in this case the ETF, could also be another manager's gain, in this case the active manager given their ability to invest in the dislocation and not be bound by the exact specifications of an index.

Within fixed income ETFs and index replication strategies, the ETF, or index, exposure to a specific issuer or industry is determined by the amount of debt that issuer or industry has outstanding. As the issuer or industry becomes more indebted they often become a larger and larger part of that ETF or index whereas within equity ETFs and their associated indices the percentage composition is often determined by the equity market cap of the issuer or industry. While a higher total amount of debt outstanding doesn't necessarily mean an industry or issuer is more risky given it also depends upon their ability to pay those debts through operating income, it can signal potential problems for that issuer or industry down the road should their fortunes change. In essence today's easy money can turn into tomorrow's problems. For example, history is littered with examples of industries that experienced extremely easy and plentiful borrowing one year or years with solvency problems occurring a couple of years later. This includes the technology bubble of the late 1990's, the telecom bust of the early 2000's, the mortgage and housing crisis in mid to late 2000's and the energy downturn of 2015 and 2016. In most of these cases, the percentage of exposure of debt from these industries in fixed income ETFs and indexes grew significantly in the years leading up to the problems. While many debt indices and ETFs are forced to own more of an indebted issuer or industry, an actively managed fixed income strategy can avoid this common pitfall by owning less or none at all. Alternately, there are also some issuers or industries that have minimal amounts of debt outstanding and hence have little representation in the index or ETF although they may still represent strong investment opportunities. While all active bond managers can theoretically invest in these unique opportunities, this particular advantage is best afforded to smaller active managers that can amass reasonable exposure.

We believe that fixed income can be both a source of stability for a diversified portfolio during times of market instability as well as a source of opportunity at the same time. While ETFs and index replication does provide some benefits, we believe their effectiveness within various fixed income asset classes can be questionable during times of volatility and can even perpetuate that volatility. In addition, the debt-weighted construction of such fixed income ETFs can cause future problems. We believe that actively managed fixed income strategies are not only removed from some of the structural problems plaguing ETFs, but they can also take advantage of the dislocations caused by these fixed income ETFs.

Thank you for listening, we'll talk to you again next week.

Thank you for joining us. And stay tuned for our next cast. Have topics you want covered or other feedback to share? Write us at info@tortoiseinvest.com.

The **S&P 500® Index** is an unmanaged, market-value weighted index of stocks that is widely regarded as the standard for measuring large-cap U.S. stock market performance.

The **Bloomberg Barclays U.S. Credit Index** measures the investment grade, U.S. dollar-denominated, fixed-rate, taxable corporate and government-related bond markets. It is composed of the U.S. Corporate Index and a non-corporate component that includes non-U.S. agencies, sovereigns, supranationals and local authorities. The U.S. Credit Index was called the U.S. Corporate Index until July 2000, when it was renamed to reflect its inclusion of both corporate and non-corporate issuers. The U.S. Credit Index is a subset of the U.S. Government/Credit Index and U.S. Aggregate Index.

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