Tortoise QuickTake Credit Podcast

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Welcome to the Tortoise QuickTake podcast. Thank you for joining us. Today, senior members of Tortoise provide 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. Halloween apparently came early this year in the markets and frightened investors resulting in the S&P 500 equity index down 5.04% month-to-date through October 12th, the VIX volatility index rising to 21.31, and the 10-year U.S. Treasury interest rate increasing to 3.16%. What proverbial Halloween costumes frightened investors enough to cause this volatility? Was it the ghost of tough year-over-year earnings comps haunting forward earnings guidance? Was it the frightening Smoot-Hawley Tariff reaper reappearing after an almost 90 year hiatus? Was it the scary hawk costume sported by Fed Chairman Jay Powell? Was it the terrifying Italian werewolf howling again? Was it fears of the inflation monster finally emerging from a long period of hibernation? Was it interest rates riding the witches' broomstick higher and higher? Or was it the invisible man costume startling people with the unknown? Regardless of what may have been the root cause of the scare, in today's podcast we will discuss a fixed income strategy that can thrive in this volatile and uncertain rising interest rate environment, specifically short duration or short-term bond strategies.

An investment grade short duration portfolio can be best defined as a relatively high quality diversified portfolio of fixed income securities with the majority of those securities maturing in less than three years. On the maturity/duration spectrum, short duration falls just beyond money markets and well short of many other intermediate fixed income strategies. This means that short duration prices are much less sensitive to changes in interest rates than longer duration strategies and are only marginally more sensitive to changes in interest rates than money markets. Investment grade short duration portfolios typically maintain a relatively conservative credit quality whereby they have significantly less credit-related price volatility than many other lower credit quality strategies.

The primary objective of the typical investment grade short duration portfolio is principal preservation, stable current income, strong liquidity, minimal interest rate risk and minimal credit risk by investing in a high quality diversified portfolio of short duration fixed income securities. In general this means the average portfolio duration is less than two years. Further, most if not all securities are typically rated investment grade while often the average credit quality within the portfolio is A- or higher.

Investments within a short duration mandate typically include corporate bonds, mortgage-backed securities, asset-backed securities and U.S. government and government agency securities. These securities, excluding U.S. Treasuries, generally offer a yield enhancement over similar duration U.S. Treasuries thereby offering the potential for higher returns than Treasuries as well as providing some yield cushion in a rising rate environment. In addition, due to the short duration of these securities (excluding U.S. Treasuries) they can often withstand significant increases in risk premiums over a one-year investment horizon while still outperforming the similar duration U.S. Treasury security. Taking this concept one step further, short duration strategies by nature enjoy some of the most compelling break-evens of any fixed income asset. This means that they can generally withstand a significantly larger interest rate or credit spread shock versus other fixed income strategies and still retain a positive yearly return. The simple math here looks at the yield over a one-year horizon less the bond's price decline which can be approximated by multiplying the bond's duration by the yield shock. For example, over a one-year time horizon, a two-year duration bond yielding 3.5% can withstand up to a 175 basis point yield shock higher (through credit spreads or Treasury rates) and still generate a positive total return, while an eight-year duration bond yielding 4% can only withstand a 50 basis point shock without generating a negative yearly return.

Within the corporate bond side of the short duration equation, the short maturity can also provide some structural protections during periods of leveraging M&A and leveraging recapitalization events. Often a secured bank credit line or loan will have a five year or shorter term and although these lenders are secured, they also prefer not to have unsecured bonds temporally senior to them. As such, in a leveraging corporate transaction the bank lenders will often require the company to tender for these shorter maturity bonds at attractive make-whole prices.

The current business cycle and economic expansion has lasted for almost 10 years, which marks one of the longest expansions in U.S. history. As is typical in the late stages of an expansion, the Fed tightens monetary policy by using various tools such as increasing short-term interest rates in order to prevent the economy from overheating. As a result and as the case exists today, the relatively flat yield curve makes it possible to earn similar yields when moving to short-term investments from intermediate or longer-term bonds without incurring similar interest rate risk. In fact, as of October 12th, 2018, the ICE BofAML 1-3 Year Corporate Index yielded 3.42%, while the Bloomberg Barclays U.S. Aggregate Index and the Bloomberg Barclays U.S. Long Government / Credit Index yielded 3.54% and 4.18%, respectively. Further, by definition short term bonds strategies have a substantial amount of bonds maturing each year thereby allowing for reinvestment at potentially higher interest rates (if rates are indeed rising).

Rising interest rates don't necessarily mean negative returns for all fixed income products. The investment horizon, the pace and magnitude of the rate increase, the duration of the portfolio and the yield on the portfolio are just some of the factors that will affect your returns during a rising rate environment. While past performance is not indicative of future returns, the ICE BofAML1-3 Year U.S. Corporate & Government Index, which is a common short duration index, has never recorded a negative calendar year return since inception in 1986. Even during an extreme year in 1994 when the Federal Reserve increased the Fed Funds rate by 250 basis points and the 10-year Treasury rate increased by over 200 basis points, the short duration index was one of the only fixed income indices which still generated a positive total return.

All investments must be evaluated based upon both potential returns as well as potential risks, specifically return volatility associated with achieving those returns. A common method of evaluating the risk return trade-off is to compare Sharpe ratios, which measure a portfolio's excess return relative to the total variability of the returns for that portfolio. In comparing the historical Sharpe ratios for the various fixed income indices along the duration and credit quality spectrum, the Sharpe ratio of investment grade short duration indices exceeds that of longer duration and lower credit quality indices over almost all trailing time periods.

Last, but not least, short duration investment grade strategies typically provide investors significant flexibility regardless of where you are within the business and economic cycle. Short-term investment grade bonds are generally more liquid than longer-term bonds and more liquid than lower quality bonds. As such, this can offer investors the flexibility to reinvest relatively quickly in other asset classes if or when they become more attractive or to easily meet other cash needs.

We are not forecasting the imminent end of the current economic and business cycle although we do believe we are in the late stages of the cycle. As is typical with late stage market behavior, volatility remains elevated, interest rates creep higher and financial conditions begin to tighten. Given this backdrop and the increased attractiveness of short duration yields, we believe short duration fixed income strategies can provide a potentially stable and liquid source of income with minimal price exposure to rising interest rates yet the ability to also capture higher reinvestment yields as interest rates trend higher.

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@tortoiseadvisors.com.

The S&P 500 Index is a market-capitalization-weighted index of the 500 largest U.S. publicly traded companies by market value.

VIX = The CBOE Volatility Index, known by its ticker symbol VIX, is a popular measure of the stock market's expectation of volatility implied by S&P 500 index options, calculated and published by the Chicago Board Options Exchange. It is colloquially referred to as the fear index or the fear gauge.

ICE BofAML 1-3 Year Corporate Index is an unmanaged index that tracks the performance of the U.S. dollar-denominated investment-grade public debt issued in the U.S. domestic bond market. Qualifying bonds must have at least one year but less than three years remaining term to maturity, a fixed coupon schedule and a minimum amount outstanding of $150 million

ICE BofAML 1-3 Year US Corporate & Government Index is a subset of the BofA Merrill Lynch US Corporate & Government Index, including all securities with a remaining term to final maturity less than three years. The BofA Merrill Lynch US Corporate & Government Index tracks the performance of US dollar-denominated investment grade debt publicly issued in the US domestic market, including US Treasury, US agency, foreign government, supranational and corporate securities.

Bloomberg Barclays U.S. Aggregate Index is a broad-based flagship benchmark that measures the investment grade, US dollar-denominated, fixed-rate taxable bond market. The index includes Treasuries, government-related and corporate securities, MBS (agency fixed-rate and hybrid ARM pass-throughs), ABS and CMBS (agency and non-agency).

Bloomberg Barclays U.S. Long Government / Credit Index is a broad-based flagship benchmark that measures the non-securitized component of the U.S. Aggregate Index and only including bonds maturing in 10 years or greater. The index includes investment grade, U.S. dollar-denominated, fixed-rate Treasuries, government-related and corporate securities maturing in 10 years or greater.

