4Q 2018 Commentary

ANDY KAUFMAN
CHIEF INVESTMENT OFFICER

KRISTIN FAFARD, CFA
CHIEF INVESTMENT STRATEGIST

ELLIOT GILFARB, CFA
HEAD OF FIXED INCOME

ANDREW COWEN
HEAD OF EQUITIES

JULIE EGAN
PORTFOLIO MANAGER

THOMAS LOTT
PORTFOLIO MANAGER

DAVID SAND
CHIEF IMPACT STRATEGIST

JESSICA BOTELHO
DIRECTOR OF CRA AND IMPACT RESEARCH

RICKY FERNANDEZ, CFA
JUNIOR PORTFOLIO MANAGER

MARKET COMMENTARY

If nothing else, the fourth quarter proved redeeming for disciplined asset allocators who were finally rewarded for rebalancing their clients' portfolios. Investment-grade bonds reversed course and posted positive results while stocks fell broadly. Despite U.S. economic growth indicators remaining strong, concerns grew about negative trends overseas, particularly in China and Europe, causing equity market sentiment to abruptly flip and end the upward momentum that persisted in the prior two quarters.

Commodities quickly responded to the news, particularly oil prices, which plummeted almost 40% from their October peak. The S&P 500 Index lost over 13%, more-than erasing the impressive gains posted in the first nine months of the year. In classic "risk-off" fashion, the money headed into U.S. Treasuries, pushing the 10-year yield down from its 7-year high in early November of 3.24%, to not far from where it started the year at 2.69%. The Bloomberg Barclays Aggregate Bond Index rose 1.64%, partially offsetting the price declines from earlier in the year. With income proving the reliable contributor to total return, the Index avoided a negative year, posting a flat, yet positive .01% return for 2018.

From the start of the year until early November, yields had increased by 60-100 basis points across the yield curve. In the fourth quarter, the combination of these higher yields and the slightest hint of a potential U.S. economic slowdown was enough to shift the risk/reward equation toward bonds, driving yields down to levels not seen since January. Dynamics within the bond market were also pointing to a cautious outlook. The yield curve was mostly flat coming into the fourth quarter so when the Federal Reserve showed no interest in listening to the signals coming from the equity markets and stated their intentions to move forward with their fourth planned Fed Funds rate rise of the year, the yield curve inverted and the 1-year Treasury yield ended the year higher than the 7-year yield. While investors sought the safety of bonds, they demanded more yield to take on risk, causing spreads to widen across most sectors of the bond market, particularly in lower quality corporate bonds where the BBB segment of the Bloomberg Barclays Aggregate Bond Index declined by 0.9% and the Barclays U.S. Corporate High Yield Index declined by just over 4.5%. Municipal bonds, which remained relatively insulated from the wild swings that Exchange-Traded Funds (ETFs) and quantitative trading have gifted the equity and bond markets, posted an impressive 1.69% return for the quarter.

While the equity markets were down overall for the quarter, the volatility seems to be the bigger story. The October sell-off was severe, but seemingly rational as investors focused their selling on the expensive stocks in cyclical areas of the market that are most vulnerable to slowing global growth. November saw positive results, particularly in the more defensive and less expensive areas of the market. December's grand finale was hardly a holiday bonus. Stocks were sold in an indiscriminate fashion, reminiscent of what we have seen in other periods of massive deleveraging with wild daily swings up until the last trading day of the year. On a brighter note, many of the active managers who led the way in the first nine months of the year maintained their leadership despite the wholesale market sell-off. And with seemingly lower valuations and pricing inefficiencies that so often follow such periods of de-risking, those successful active managers can further expand their 2018 leadership as markets recover.

Core Fixed Income Composite

PORTFOLIO COMMENTARY

In the fourth quarter of 2018, the Core Fixed Income Composite was up 1.85% (gross of fees) and up 1.77% (net of fees). The Intermediate Component of the Bloomberg Barclays Aggregate Bond Index ("Benchmark") was up 1.80%.

The Composite's largest sector, agency commercial mortgage-backed securities (CMBS) was up 1.92%. On a stand-alone basis, the sector contributed 27 basis points of income return – the Composite generated a total income return of 82 bps. Swap rates rallied across most of the curve and outperformed their Treasury counterparts, which helped relative returns to other agency sectors in the Benchmark. Unfortunately, spreads widened on our Ginnie Mae Project Loan real estate mortgage investment conduit (REMIC) positions.

The composite's second largest sector, agency mortgage-backed securities (MBS), was up 2.05% during the quarter, underperforming the Benchmark's U.S. MBS sector return of 2.08%. The Composite's MBS had similar paydowns vs. the benchmark while generating 5 basis points of additional income. Unfortunately, the relative price return was negative given our underweight allocation to 3% and 3.5% coupons, which were the best performing bonds in the MBS sector during the quarter.

The third largest sector in the Composite, taxable municipal bonds, was up 1.63%. Most of the performance came from the price return given the rally across the Treasury curve, while income contributed 84 basis points out of the 1.63% total return. Spreads widened across our pass-through municipals having a negative impact to price returns, while paydowns across the pass-through municipals also had a negative impact to performance.

The Benchmark was up 1.80% in December. Treasuries were the best performing major sector in the bond market during the quarter, generating a 2.24% total return. As referenced above, the MBS sector of the Benchmark was up 2.08% while corporate bonds were only up 0.58% as spreads widened in the space.

As of December 31, 2018, the Composite's Yield-to-Worst (YTW) is 3.47%, which is higher than the Benchmark's YTW of 3.28%; and exhibited 11% longer duration (interest rate risk) to the Benchmark (4.66 vs. 4.18). Overall, the composite's higher income profile contributed 7 bps to relative returns, while the exposure to swap rates positively impacted returns given swaps outperformed Treasuries. In addition, the exposure across the longer-end of the curve positively impacted returns given the move in rates.

Going forward, the portfolio management team does not anticipate any changes to its asset allocation weightings.

Effective April 1, 2018, the benchmark for the Core Fixed Income Composite changed from Bloomberg Barclays U.S. Aggregate Bond Index to the Bloomberg Barclays Intermediate U.S. Aggregate Index.

Data sources: Barclays Live, Bloomberg PORT, and eVestment Alliance.

As of 12/31/18, the average annual gross returns for the Core Fixed Income Composite for 1-year, 5-year, 10-year and since inception (8/30/99) were 1.06%, 2.75%, 3.49% and 4.83%. As of 12/31/18, the average annual net returns for the Core Fixed Income Composite for the same time periods were 0.76%, 2.44%, 3.18% and 4.43%.