An Unsettled Bond Market

Rising interest rates, high inflation, and geopolitical risks are contributing to uncertainty in the U.S. economy with the bond market, in particular, being impacted. The Bloomberg Aggregate Bond Index (the Index), which is considered the proxy for the U.S. investment-grade bond market, was down 5.93% in the first quarter of 2022, one of its worst quarterly returns in 40 years. While the volatility paled in comparison to that of the stock market, the negative 7.70% drawdown that has occurred since rates started to rise in August 2020 has been a painful surprise to investors who look to bonds for principal protection, steady returns, and overall portfolio ballast. This perspective highlights how risk has grown in the overall bond market and how the universe of core bond mutual funds carries varying degrees of credit and interest rate risk. We also share details on how our flagship impact investing mutual fund — the CCM Community Impact Bond Institutional Shares (Ticker: CRANX) — has performed in the recent environment and in other unsettled environments over the last 15 years.

Interest Rates and Credit Quality

Two important factors responsible for fluctuations in the price of a bond are its interest rate sensitivity and credit quality. As shown in **Figure 1**, since the start of 2007, the interest rate sensitivity of the Index, as measured by duration, has grown by 45%, and the lowest credit-quality segment of the Index (BBB-rated bonds) has almost doubled. Core bond strategies that benchmark to the Index and manage within a relatively tight tracking error range have experienced a similar, proportional growth in the level of interest rate and credit risk. While the bond market and many core bond mutual funds have become riskier over the last 15 years, these two major risk factors have changed little in CRANX.

Figure 1

	Bloomberg Aggregate Index	CRANX
% BBB-rated bonds as of 1/1/07	7.50%	0.00%
% BBB-rated bonds as of 3/31/22	13.60%	0.10%
Duration (yrs.) 1/1/07	4.46	4.78
Duration (yrs.) 3/31/22	6.58	4.15

Sources: CCM, Morningstar Direct

Bond Market Risk and Returns: The Last 15 Years

Even though bond market risk has been growing since the start of 2007, the environment for most of the last 15 years has been favorable for risk taking — inflation was low, interest rates were generally downward trending, and with a few exceptions, bond prices were relatively stable. Against this backdrop, riskier, lower-quality, and longer-duration bond funds generally outperformed lower risk, higher-quality, and shorter-duration bond funds. Volatility in bond prices primarily occurred because of the fear of an economic downturn rather than from inflation woes and rising interest rate concerns. Over the same time frame, there were five periods when stocks, as measured by the S&P 500 Index, declined by more than 15% and corporate bonds, specifically those rated BBB, also declined. Given the wide range of credit risk taken among core bond funds, the range of returns was also vast. **Figure 2** shows performance during those five periods for the highest credit quality segment of the investment-grade market (U.S. Treasurys) and the excess returns over U.S. Treasurys for the lowest-quality segment, BBB-rated bonds. We also show the range of returns for mutual funds in the Morningstar Intermediate Term Core Bond Category and returns for CRANX.

Figure 2

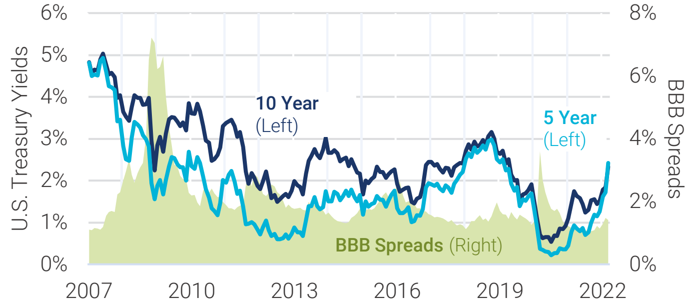
	Returns				
Date Range	S&P 500	U.S. Treasurys (UST)	BBB-Rated Excess Over UST	Range of Returns for Mutual Funds in the Morningstar Intermediate Term Core Bond Category	CRANX
10/10/07 to 3/9/09	-55.25%	15.38%	-24.62%	-44.98% to 14.65%	8.98%
4/26/10 to 7/2/10	-15.63%	4.36%	-3.88%	-1.72% to 4.53%	2.31%
7/25/11 to 10/3/11	-17.91%	6.17%	-7.12%	-5.63% to 5.59%	3.06%
11/8/18 to 12/24/18	-16.16%	3.00%	-3.09%	-0.39% to 3.04%	2.23%
2/20/20 to 3/23/20	-33.79%	5.40%	-22.16%	-12.58% to 2.09%	-0.82%

Sources: CCM, Morningstar Direct

During these five tumultuous periods, the lowest quality segment of investment-grade bonds posted the worst results with U.S. Treasurys posting the strongest returns. While these five periods were painful for those fixed income investors carrying higher weights to lower-quality bonds, particularly if they needed liquidity, price declines generally recovered. This was typically a result of interest rates declining, investor sentiment improving, and credit spreads (i.e., the higher yield that investors require for taking on credit risk) tightening.

As shown in **Figure 3**, interest rates and BBB spreads bounced around over the last 15 years but were generally on an overall downward trajectory until hitting their respective record lows in 2020 and 2021.

Figure 3 5- and 10-Year U.S. Treasury Yields and BBB Spreads
1/1/2007 – 3/31/2022



Sources: Barclays LIVE, U.S. Department of Treasury

Rising Rates

While interest rates started rising in August 2020, spreads continued to tighten, benefiting the lowest-quality bond managers, and helping to offset the negative impact of rising rates. After hitting a 14-year low, however, spreads started rising in October 2021, and with the headwinds of both rising rates and widening credit spreads, there were subsequent declines across the bond market and core bond mutual funds (**Figure 4**). Lower duration and higher credit quality core bond funds like CRANX held up better than longer-duration and lower-quality bond funds, many of which were the largest recipients of fund inflows after posting market-leading performance in the prior era of declining interest rates and credit spreads.

Figure 4

Date Range	Bloomberg Aggregate Index	U.S. Treasurys	BBB	Range of Returns for Mutual Funds in the Morningstar Intermediate Term Core Bond Category	CRANX
10/20/21 to 3/31/22	-5.74%	-5.19%	-7.54%	-9.29% to -3.14%	-4.39%

Sources: CCM, Morningstar Direct

While these returns may cause concern for some, particularly when considering returns that include the entire period of rising rates, we still have not seen a period of significant spread widening while interest rates are rising. Credit spreads have widened, particularly after Russia's invasion of Ukraine, but continue to remain tight even in BBB-rated bonds. If investors seek the same level of compensation for taking on such credit risk vs. what they have looked for in the past, we could see much larger movements in BBB spreads and larger negative returns from these higher-risk bonds.

Conclusion

For most of the last 15 years, declining interest rates and low inflation buoyed most core bond funds, particularly those carrying the highest risks. In the few instances when declining credit markets rattled bond funds carrying higher credit risks, U.S. Treasurys helped offset some or all of the credit losses and recoveries were generally swift. In an environment when inflation expectations are high and rates are rising, U.S. Treasurys have not been able to provide that same level of historical defense. Unless interest rates reverse course and decline, we may not experience the same swift recoveries we had in prior periods of bond market stress. Considering a strategy like CRANX, which has carried a consistently lower level of credit and interest rate risk, could be a way to preserve income while minimizing the potential for large losses in today's uncertain environment.

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Sources: CCM, Morningstar Direct, Barclays LIVE, U.S. Department of Treasury

As of 03/31/2022, the average annual returns for CRAIX for 1-year, 5-year, 10-year, and since inception (8/30/1999) were -4.70%, 0.95%, 1.16%, and 3.41%. The average annual returns for CRANX for 1-year, 5-year, 10-year, and since CRANX inception (3/2/2007) were -4.18%, 1.42%, 1.62%, and 2.88%. The average annual returns for CRATX for the same periods were -4.61%, 1.05%, 1.26%, and 2.52%. As of 03/31/2022, the 30-Day SEC yield for the CRA Shares, Institutional Shares, and Retail Shares was 1.17%, 1.62%, and 1.27%, respectively. Performance quoted is past performance and does not guarantee future results. Current performance may be lower or higher than the performance data quoted. An investor's investment return and principal value will fluctuate so that your shares, when redeemed, may be worth more or less than your initial cost. To obtain the most recent month-end performance, call 877-272-1977. The annual operating expenses for the CCM Community Impact Bond Fund's CRA Shares, Institutional Shares, and Retail Shares is 0.90%, 0.45%, and 0.80%, respectively.

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