COMMUNITY CAPITAL MANAGEMENT

The Rebalancing Conundrum

Key Takeaways

- Rebalancing is not a binary decision and cheap equities are not the only phenomenon at play
- The current market environment presents an opportunity for investors to take a closer look at the role bonds play in their portfolio
- There is heightened concern given the increased level of risk in the corporate credit sector but there are ways to avoid this vulnerable area

We have heard a common dilemma over the last few weeks – when, and how, to rebalance portfolios in the face of continued uncertainty and volatility. Below we discuss the heightened concern given the increased level of risk in the corporate credit sector concluding with ideas for a more thoughtful risk-adjusted rebalanced portfolio.

Understanding Your Portfolio's Exposure to the Corporate Capital Structure

To fully understand your portfolio's exposure to the vulnerable corporate capital structure, we bring attention to the fact that rebalancing is not a binary decision and cheap equities are not the only phenomenon at play. Interest rates are at record low levels, we are facing an imminent recession, and the risk in the bond market continues to grow, much of which has been driven by the growth of BBB rated corporate debt. The table below illustrates changes that have transpired in the bond market (as measured by the Bloomberg Barclays U.S. Aggregate Index (the Index)) over the last 12 years (the start of the financial crisis to the last quarter prior to the most recent market volatility) unless otherwise stated:

	12/31/2007	12/31/2019	Change
Effective Duration	4.40 years	5.87 years	Up 33%
% of Corporates	19%	25%	Up 32%
% BBB Rated Corporates	7.25%	13.8%	Up 90%
Total Leverage in BBB Rated Companies	$750 billion	$2 trillion[1]	Up 167%
Leverage as a Percent of EBITDA in BBB Rated Companies	2.22	3.08[2]	Up 39%

The Index is the most commonly used benchmark by active and passive investment-grade bond strategies. As of 12/31/19, core bond fund managers held approximately 38 percent more BBB rated, or below, corporate bonds versus the Index [3], indicating the actual risk of investors' bond portfolios could be even greater than that of the Index.

In a recession, downgrades are more likely. The increase in BBB rated corporates and leverage levels in the investment grade bond market signals the likelihood for more bonds to become non-investment grade. These downgrades could force some active managers and many passive bond strategies to sell, leading to price declines that could spread throughout the entire corporate bond market. Even if price declines were contained to the downgraded bonds, the larger percentage of such bonds in the portfolio could have a disproportionate impact on the portfolio. Additionally, if this occurs while equities are declining, the diversification benefits of an investor's bond portfolio could be diminished, as experienced in 2008.

> We recently wrote a piece on the topic of Fallen Angels which are bonds initially given an investment-grade rating but have since been reduced to high yield – or junk bond – status by at least two of the three major ratings firms. The perspective is available here.

Conclusion

This is an opportunity to take a closer look at the role bonds play in your portfolio. Income, liquidity, stability, attractive yields, and low correlation to equities can be found in non-Index sectors of the investment grade bond market such as taxable municipal bonds, high-quality commercial mortgage-backed securities, and asset-backed securities. Rebalancing is an evaluation of the risks versus the rewards. If you rebalance too early, you could be subjecting the portfolio to further losses. If you wait too long, you could be forgoing return. Replacing some of the portfolio's exposure to corporates with bonds from sectors that are historically less correlated to equities can reduce exposure to the corporate capital structure. This can reduce the timing risk of rebalancing amidst deteriorating economic and market conditions.

[1] As of October 2019, measured by the amount of leverage in the S&P Global Ratings' U.S. 'BBB' bond composite
[2] Source: S&P Dow Jones Indices LLC, Factset. Data as of December 31, 2018 measured by the net debt/EDITDA ratio for U.S. issuers of investment-grade bonds
[3] Source: Morningstar and CCM. The average allocation to bonds rated BBB, or below, within the actively managed mutual funds in the Morningstar Intermediate Core Bond category that reported their holdings as of 12/31/19 was 19 percent compared to 13.8 percent for the Index

Community Capital Management, Inc. ("CCM") is an investment adviser registered with the Securities and Exchange Commission under the Investment Advisers Act of 1940. Registration as an investment adviser does not imply a certain level of skill or training. The verbal and written communications of an investment adviser provide you with information you need to determine whether to hire or retain the adviser. Past performance is not indicative of future results. CCM has distinct investment processes and procedures relating to the management of investment portfolios for institutional clients. The firm's strategies are customized, rather than model-based, and utilize an innovative approach to fixed income and equity by combining the positive outcomes of impact and environmental, social, and governance ("ESG") investing with rigorous financial analysis, an inherent focus on risk management, and transparent research. Bonds are subject to interest rate risk and will decline in value as interest rates rise. Stocks will fluctuate in response to factors that may affect a single company, industry, sector, or the market as a whole and may perform worse than the market. A sustainable investment strategy which incorporates ESG criteria may result in lower or higher returns than an investment strategy that does not include such criteria.