Roosevelt Current Income Portfolio | Third Quarter Commentary

Thoughts from our Domestic Fixed Income Team

Market Overview

While US credit markets experienced slightly wider price swings this past calendar quarter, domestic interest rates still linger just about where they started at summer's beginning. Serving as a safe haven for many investors from disconcerting global political risks, the US Treasury 10-year note closed out September at 2.33%, one of the highest levels of the quarter, despite having posted its lowest yield of the year (2.04%) only a few weeks prior. More directly influenced by Federal Reserve monetary policy, the US Treasury 2-year note similarly waffled, ending the quarter at its highest level of the year (1.48%), unseen since the onset of the financial crisis. ***Ongoing positive economic data and official statements have strengthened expectations of short-term rate target increases by the Federal Reserve in order to re-normalize interest rate levels.*** Expectations are high for the next federal funds rate hike to occur in December, with several incremental rises to follow in 2018, provided current economic trends continue.

This slow and steady market mentality toward future interest rate hikes has worked to compress yields along the US Treasury maturity curve, as well as yield differences between government and investment grade corporate debt. ***Domestic interest rates remain very low by historical standards, and as a result, the hunt for additional yield persistently dominates credit market activities – as it has since the financial crisis prompted strong monetary policy response***. If interest rate increases are believed to occur only sporadically, then market participants will likely become increasingly content with making the best of their steadily shrinking options. Nevertheless, even at low interest rates, the time value of money is too great to stay in cash and hope for better opportunities to become available. As a result, the ongoing relative outperformance of higher yielding market sectors continues to reflect fundamental dynamics of a global hunt for yield.

For instance, the BofA Merrill Lynch 1-10 Year US Treasury and Agency Index returned 0.34% over the third quarter, evidencing a relatively weaker total return than earlier this year, as interest rates began to slowly discount external stressors and refocus on monetary policy changes ahead. Similar performance was noted in the investment grade corporate markets, but with attractive improvements, as the BofA Merrill Lynch 1-10 Year US Corporate Index returned 1.07% and the BofA Merrill Lynch Fixed Rate Preferred Securities Index returned 1.27%. Year to date performance, however, more forcefully demonstrates the power of enhanced corporate bond yields and the competitive pricing environment forged by the hunt for yield. The BofA Merrill Lynch 1-10 Year US Treasury and Agency Index returned 1.47%, versus the BofA Merrill Lynch 1-10 Year US Corporate Index returning 3.87%, while the BofA Merrill Lynch Fixed Rate Preferred Securities Index returned a dramatic 10.11% year to date. This wide performance variance demonstrates the importance of a well-diversified portfolio for income-oriented investors.

The Current Income Portfolio combines corporate bonds and preferred securities into a single portfolio – actively managing the sector allocation process much like a traditional balanced strategy manages the mix of stocks and bonds. Through a benchmark-agnostic approach, the portfolio is diversified across major market industries, with the flexibility to overweight or avoid specific areas. As such, the portfolio is designed to provide high income without taking excessive risk during low rate periods, while positioned to benefit when rates start to rise. ***We are increasingly cognizant of the risks of rising interest rate scenarios, and the growing possibility of re-inflationary patterns appearing across the US economic environment.*** We anticipate price inflation beyond targeted levels is likely to replace employment levels as the market's key harbinger as to the pace of future interest rate rises—offering new challenges as well as opportunities.

Outlook

One opportunity we are seeing is a new type of preferred security issuance. The inclusion of preferred securities into a well-diversified income-oriented, intermediate-term investment grade portfolio is the most significant aspect of the Roosevelt Current Income Portfolio style. Historically, preferred securities have produced the highest current income in the investment grade fixed income market, and as such, the product has benefited on both a total rate of return and income basis. ***The preferred security market has evolved to include non-traditional hybrid and fixed-to-floating rate issuances, which we believe offer potential new opportunities for income-oriented investors.*** A fixed-to-floating rate structure is available in both the traditional $25 par format and newly issued $1,000 par offerings, but dominates the latter. Similar to traditional bonds, these newer $1,000 par securities trade primarily over-the-counter.

As we deem appropriate, we are transitioning a portion of the portfolio's overall preferred security allocation from traditional structured preferred securities to hybrids. ***These $1,000 par securities offer a number of advantages, in our opinion, given the Strategy's fundamental objectives of current yield enhancement and principal safety. The hybrid variety offers coupon rates that will switch from their current fixed levels at the initial call dates to floating rates at spreads to short-term interest rates.*** While there are no guarantees to future performance, the hybrid varieties have demonstrated less volatile market price sensitivity while the preferred securities market has been under pressure. In any case, we view both varieties of fixed-to-float preferred security structures as a potentially valuable way to enhance income generation while attempting to preserve future reinvestment flexibility, as we look forward to shifts in Federal Reserve policy and inflation expectations.

Roosevelt Investments

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BofA Merrill Lynch Fixed Rate Preferred Securities Index tracks the performance of fixed rate U.S. dollar denominated preferred securities issued in the U.S. domestic market. Securities must have an investment grade rating (based on an average of Moody's, S&P, and Fitch) and must have an investment grade rated country of risk (based on an average of Moody's, S&P, and Fitch foreign currency long term sovereign debt ratings).

BofA Merrill Lynch 1-10 Year US Corporate Bond Index is a subset of the BofA Merrill Lynch U.S. Corporate Index including all securities with a remaining term to final maturity less than 10 years.

BofA Merrill Lynch 1-10 Year U.S. Treasury & Agency Index is a subset of the BofA Merrill Lynch U.S. Treasury & Agency Index including all securities with a remaining term to final maturity less than 10 years.

Barclays Capital U.S. Intermediate Government/Credit Index is composed of approximately 3,500 publicly issued corporate and U.S. government debt issues rated Baa or better, with at least one year to maturity and at least $1 million par outstanding.

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