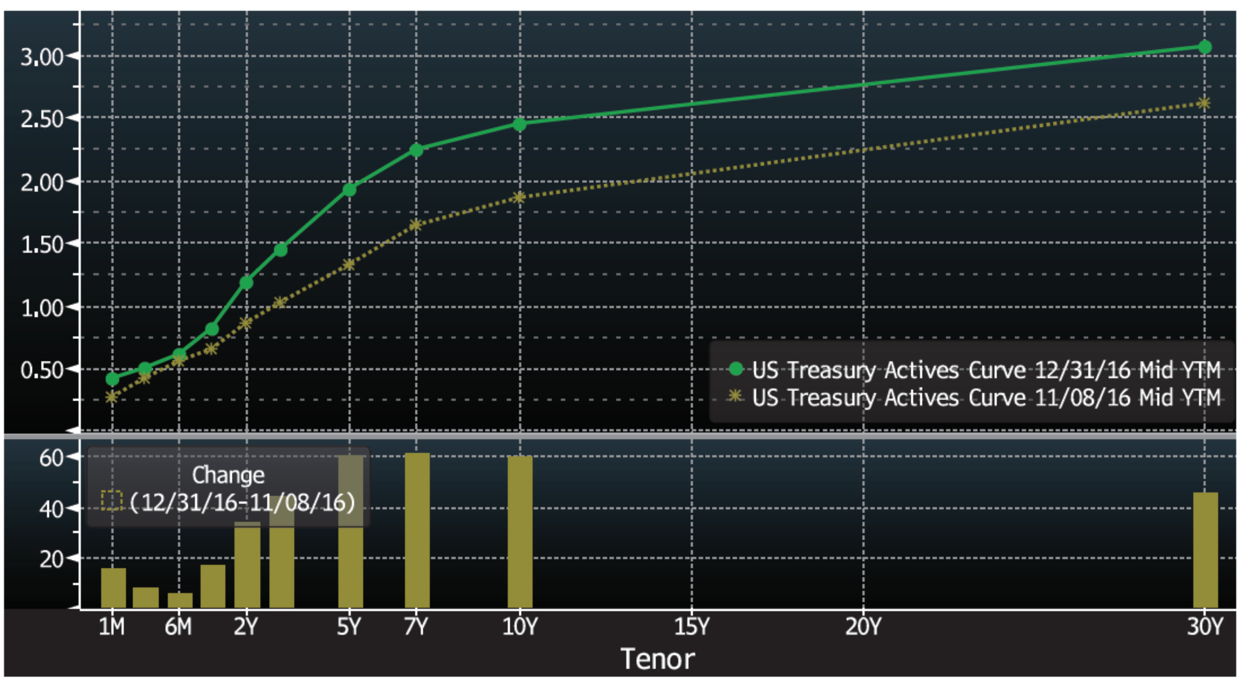
KOVITZ INVESTMENT GROUP
Intrinsic Values®

Fixed Income/Closed-End Fund Commentary
Winter 2017

Financial news outlets focused on rallying stocks after Election Day, but arguably the largest changes in the investment landscape were actually seen in the bond market. As discussed earlier in the newsletter, interest rates around the world pushed higher post-election due to perceptions that the new administration will produce faster economic growth, higher inflation and steeper short-term interest rate increases. All of these factors have historically led to increasing bond yields.

Exhibit 1 shows the US Treasury yield curve (the yields of US Treasury securities across varying key maturities) on the day before the election and at year-end. The yield on Treasuries with ten years until maturity increased from 1.86% on November 8th to 2.45% by the end of the year. While an increase of this magnitude in absolute terms is not unprecedented, it still represents a 32% increase in less than two months and the highest yield on the ten-year Treasury in over two years. The Treasury yield curve also steepened, erasing a period of historically flat curves – meaning the yield on longer dated maturities increased more than shorter maturities. For example, the yield on a one-year Treasury only increased 0.2% versus 0.6% for ten-year maturities.



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In the market for municipal bonds, the change in interest rates was notable for another reason. In addition to the factors influencing Treasuries, the increased probability that personal income tax rates will decline under the next administration put downward pressure on the prices of municipal bonds versus taxable bonds of similar credit quality because lower tax rates reduce the value of the tax-exempt status of these bonds. Between the election and year-end, the yield on ten-year AA-rated general obligation bonds (a typical benchmark in the municipal bond market) increased 29% from 2.04% to 2.64% while the yield on ten-year AA-rated corporate bonds only increased 19% from 2.76% to 3.28%.

What does this mean for Kovitz bond portfolios? After a period of overweighting our bond ladders with shorter maturities in response to the relatively meager incremental yield offered by the market on intermediate-term maturities, we believe the higher and steeper yield curve now available compensates us more fairly for investing in longer-dated maturities. As a result, clients may begin to notice an increase in the concentration of bond purchases maturing in 2023 through 2025 in the new year as we attempt to take advantage of the new interest rate environment and normalize our bond ladder maturity years. Our focus in shorter maturities allowed us to weather the uptick in rates better than we otherwise would have (shorter bonds decrease in price less than longer bonds when rates rise, all else equal) and it now provides plenty of bonds coming due in the next year or two that will be reinvested at higher yields. This of course assumes that interest rates do not return to their pre-November 8th levels anytime soon, which is something we have no way of knowing.

Closed-End Fund Commentary

We first started buying closed-end funds in December 2015, and the strategy has outperformed our expectations over the last year. Even though we avoided, and even discouraged, closed-end funds in the past, we thought the market for closed-end funds that invest in high-yield corporate debt presented a unique opportunity at the time.

For background, closed-end funds have a fixed amount of capital and a fixed number of shares that trade on an exchange in the same fashion as common stocks. Unlike typical open-end mutual funds and ETFs, their market prices can vary – sometimes significantly so – from their net asset value. Because of their fixed capital base, these funds also typically employ leverage, although the amount of leverage varies among individual funds depending on the underlying assets owned by the fund and the discretion of the manager.

While many closed-end funds regularly trade at some discount to their net asset value, we observed unusually large discounts for closed-end funds that invest in high-yield debt. The dislocation seemed to stem from a combination of two factors: 1) the perception that rising short-term interest rates would increase borrowing costs for leveraged funds, and 2) expanding credit spreads[1] for fixed

[1] Credit spreads are the difference in yield between bonds of differing credit quality. As credit spreads expand, bond yields increase and high yield bond prices decrease.

income instruments caused a decline in the net asset value of many funds. Because of these factors, investors in closed-end funds, who were traditionally individuals attracted solely by the leverage-enhanced distribution rates offered by these funds, began abandoning the space. This sustained selling pressure expanded the difference between market price and net asset value to levels not seen since shortly after the financial crisis of 2008.

Similar to most of our successful investments, our decision to buy was made when everyone else seemed to be selling. Despite our prior aversion to the asset class, we ultimately determined that the combination of closed-end funds trading at discounts to NAV approaching 15% in many cases, and high yield bonds trading on the cheap end of historical norms, had stacked the odds in our favor. We selected funds that were invested in high yield corporate bonds, bank loans[2], and asset-backed securities that we felt offered the best risk-return profile. We also used a diversified portfolio approach to minimize the risk to the portfolio of any single fund performing substantially worse than the asset class as a whole.

Flash-forward to today and our thesis has proved correct thus far. High yield bond prices have rallied throughout most of 2016 as investors have become less concerned about credit risk. This has increased the net asset values of most of our funds markedly. The market price discount of our closed-end funds also narrowed. Some sectors of the closed-end fund market are more in vogue than others, such as floating-rate bank loan funds, which has afforded us the ability to exit a few funds at narrow discounts, while the rest of our portfolio has remained relatively cheap to net asset values.

We've continued to search for opportunities to add to our portfolio, but the narrowed discounts and pricier valuations of the underlying assets that drove the performance of this strategy throughout the year has also limited our ability to deploy new capital. It would likely take another significant expansion of credit spreads or fund discounts for us to see a sufficient margin of safety to commit new capital. In the meantime, we are content wait until the right risk/return profile presents itself – whether that is in the closed-end fund market or an alternative.

[2] Bank loans, sometimes referred to as leveraged loans, are typically made to businesses that are too small to attract enough demand to float a typical bond issue. In terms of risk, these securities are similar to high yield bonds and they typically have floating-rate coupons.