CONSUELO MACK | WEALTHTRACK

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The advantage of active management in bond investing with two top performing mutual fund managers from Thornburg Investment Management.

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CONSUELO MACK: This week on WEALTHTRACK: a status report on bonds: the potential risks and rewards in corporates, treasuries and munis with two highly rated fund managers. Next on Consuelo Mack WEALTHTRACK.

Hello and welcome to this edition of WEALTHTRACK, I'm Consuelo Mack. Just about everywhere you look America is awash in debt. U.S. households recently set a new record of indebtedness, $12.7 trillion more than they owed at the height of the credit bubble in 2008. But context is everything. As recent WEALTHTRACK guest, Cornerstone Macro's top ranked economist, Nancy Lazar told us, consumer debt is down significantly relative to disposable personal income at 88% of income vs. 115% in 2008. And savings rates are up.

Corporate debt is another story. It too has been growing significantly in recent years, but unlike more thrifty consumers it is accelerating at a faster rate than revenues.
Corporate debt is more than 90% of revenues, that's a record during an expansion. And despite historically low interest rates, corporate interest expense is barely off its all-time high.
What about government debt? In 2016 total U.S. national debt was estimated at $22.5 trillion. The Federal government accounted for the lion's share, about $19.5 trillion, while states had a little over one trillion and local governments nearly $2 trillion.
Again, context is everything. The last 10 years have seen federal debt skyrocket from about 60% of GDP in 2005 to over 100% of GDP, while state debt has held steady at 6% and local government indebtedness has increased to a little over 10%.

There are always outliers. One of the biggest is in the municipal bond market. The largest issuer of tax-free muni bonds by far is the U.S. territory of Puerto Rico.
With over $70 billion in bond obligations and $50 billion in unfunded pensions Puerto Rico cannot meet its obligations and has gone to bankruptcy court. Outcome to be determined.
What is the state of all of these bond markets and how best to invest in them?
This week's guests each manage several top rated mutual funds in different types of bonds and they work together on the Fixed Income Team at Thornburg Investment Management.
Thornburg is a WEALTHTRACK sponsor but their collective performance speaks for itself.

Jeff Klingelhofer is a Portfolio Manager on several Thornburg funds including its 5-star rated, Limited Term Income Fund which uses a laddered strategy, investing in bonds with staggered maturities so that a portion matures every year and is reinvested in a new issue. He also manages the 4-star rated Strategic Income Fund, which has a flexible mandate to invest anywhere in the world and in any kind of income producing security.
Nicholos Venditti is Portfolio Manager for several municipal bonds funds including the 5- star Thornburg Limited Term Municipal Fund, again using a laddered portfolio, and the 4-star Thornburg Strategic Municipal Income Fund which also has a broad, flexible approach.
I began the interview by asking Klingelhofer for his assessment of the overall state of the bond market. How expensive is it?

JEFF KLINGELHOFER: I think for investors honestly, if you were to paint the entire fixed income universe with a broad brush, it's pretty expensive. Investors just aren't being paid to take a lot of risk these days. So while securities are priced nearly to perfection, there's still a lot of risk out there in the world. Right? We have a lot of geopolitical risk with whether it be China slowing down or North Korea issues. We have questions over how the U.S. is actually performing at this point. We are printing kind of one and a half to two percent GDP growth, and that might be about the best that we can get in today's environment. So one sector we have liked has been the U.S. consumer, but even within the U.S. consumer sector, credit card delinquencies are beginning to tick up. Auto loan delinquencies are beginning to tick up. There is some signs of wage growth, but the U.S. consumer perhaps isn't quite as on the upturn as a lot of investors believe. So yields have come down. Income has come down, and at the end of the day the asymmetric return of fixed income really means that investors are having to take a lot of risk in search of that very marginal incremental piece of yield.

CONSUELO MACK: How does the municipal bond market fit into this, Nick? Is it kind of a universe unto itself with municipal issuers, or is it affected by the trends that Jeff is talking about?

NICK VENDITTI: Well, to some extent the municipal bond market holds kind of a special place in the investment universe, but a lot of the trends that Jeff has mentioned are flowing over. Valuations don't look very attractive. If you think about it kind of from a 35,000-foot level, we're fixed income portfolio managers. Right? Basically we have two levers we can pull to try to juice returns. We can do credit. Hey, let's take a bunch of credit risk and try to get the yield of our portfolios up. The problem with that is that credit spreads in both our markets are basically as tight as they've ever been.

CONSUELO MACK: That means that the difference in yields between very high quality bonds and lower quality bonds is very narrow.

NICK VENDITTI: Exactly.

CONSUELO MACK: So you're not getting a lot more to buy riskier bonds. You're not being paid to do that.

NICK VENDITTI: Exactly. So again if you aren't being compensated for that risk, then probably you shouldn't be taking it. The other lever we have is obviously duration. We can buy longer bonds and try to get more income that way. The problem we have with sort of that is that absolute yields even after the run-up we saw after the Trump election are still, relatively to any recent long-dated history, really low. You knock inflation off of that. Get real yields and they're even worse. So investors really aren't being compensated to buy ten-year bonds as opposed to nine or nine as opposed to eight and, again, why take that risk when you're not being adequately compensated for it?

CONSUELO MACK: How big is the risk of a correction?

JEFF KLINGELHOFER: Honestly at this point in the point in the cycle I don't think there's a huge risk that a correction is imminently coming. But the problem is if you ask investors that honest question at any point in the cycle, the answer's almost always no. We're sitting at record low unemployment rates. Some of the feedback that I hear from people that suggest people should be reaching for yield right now is that unemployment rates are very low. 4.5-ish type percent, the last time we were at that was in mid 2007, and so you can point ...

CONSUELO MACK: Before the financial crisis.

JEFF KLINGELHOFER: Before, exactly. Everything always feels great until it doesn't.

CONSUELO MACK: Municipal bond correction. What do you think that the likelihood or how concerned are you about a major correction in the municipal bond market?

NICK VENDITTI: Somewhat. I don't know.

CONSUELO MACK: That's okay, Nick. Somewhat.

NICK VENDITTI: Similar to Jeff, I don't know that a major correction is imminent, but again I think it depends on where you're invested and what you're invested in. Let me give you an example. So tobacco bonds in the municipal space have gotten a lot of press over the last couple of years because they performed very, very well. If you bought tobacco bonds, you deserve a cookie. The problem you have with tobacco bonds are that they are going to default. These are deeply, deeply non-investment grade issuers. They are drawing on their debt service reserve funds right now to make debt service payments, and they are trading in this market above par.

CONSUELO MACK: Tell me. What are tobacco bonds? This is not Philip Morris bonds.

NICK VENDITTI: Not Philip Morris bonds. So essentially what happened is in 1998 the states got together and sued the tobacco company and said, "Hey, you're making everyone sick. Most of them are Medicaid payers. We're paying for it. You're killing us. You got to give us some money." They won that suit. What they won was the tobacco company said, "We will send you money every year based on roughly how many cartons of cigarettes we ship to your area." The state said, "That's fantastic." You know what's better than some money over time? A lot of money right now.

CONSUELO MACK: So where do the bonds come in?

NICK VENDITTI: So they securitized that revenue stream. So they got all the money upfront, and they passed the revenue stream through. What they didn't foresee is that smoking has actually declined and declined dramatically in the United States.

CONSUELO MACK: So therefore the revenues are much less than they had anticipated.

NICK VENDITTI: Much, much less. So now you have investors who are holding these bonds that are secured by lower and lower revenue that gets lower every year as more and more people quit smoking. All right, so these bonds are going to default. The revenue is going to run out, and they're trading in the market above par.

CONSUELO MACK: Wow.

NICK VENDITTI: So look. In any market – throw out fixed income, real estate, equities – at any time when sort of the price of a security is as divorced from the fundamental value as we're seeing in some sectors in the municipal bond world, as Jeff is seeing in some sectors of the global fixed income world, there's a correction. Those two things have to be reckoned, and generally that's a painful reckoning for investors.

CONSUELO MACK: Now the other big thing that's happening in the municipal bond market is Puerto Rico, and I remember talking to your colleague, Chris Ryon, a couple of years ago, and Thornburg did not own Puerto Rican bonds, but it's the largest municipal bond issuer in the country. It's got serious problems. How has that affected the market? Are there any opportunities in Puerto Rican bonds?

NICK VENDITTI: So Puerto Rico is – to put it bluntly – an absolute nightmare.
Those bonds are trading in the market right now give or take 65, 68 cents on the dollar.

CONSUELO MACK: Oh, so they're still that high actually.

NICK VENDITTI: They are still that high. I will tell you in my mind the ultimate recovery value on most Puerto Rico debt is going to be closer to 25 cents on the dollar. So again there is still significant pain to be had for anyone who's playing in those securities.

CONSUELO MACK: So what we do as investors? I know that each of you, you run several different types of portfolios, and one of them which I guess is considered kind of a core at Thornburg is your limited term portfolios. So explain, Jeff, the limited term income portfolios that you run and how they work and why they're considered to be safer than some other types of portfolios.

JEFF KLINGELHOFER: Absolutely. I mean you're correct. Our Limited Term Income Fund is designed to be kind of an average bondholder's core bond portfolio. So one of the core competencies of our portfolios I believe is the ability to search deep and far for relative value but only within the safer parts of fixed income. So it's 100 percent investment grade at time of purchase. It's U.S. dollar only.

CONSUELO MACK: These are the limited term funds.

JEFF KLINGELHOFER: That’s correct. These are the limited term funds, but they’re also designed to have a pretty significant income stream, although in the relatively low income world today, still preserving an income stream for our end clients.

CONSUELO MACK: So how do you invest the limited term? You use a laddering strategy.

JEFF KLINGELHOFER: Absolutely. The laddering strategy has been a core of our approach to fixed income investing since the very beginnings of Thornburg. What that allows us to do is to take away the need in order to look at the Federal Reserve and have a very distinct forecast of what they’re going to do. At the end of the day, making a direct call on interest rates is very difficult, and the market prices that in relatively quickly. By having a bond laddered portfolio, what it allows us to do is always have an exposure to the zero to ten-year part of the curve.

CONSUELO MACK: You start with the very low maturity, and then you move up. Just explain how it works.

JEFF KLINGELHOFER: So having exposure from zero to ten years allows roughly on average every single year about ten percent of your portfolio is rolling off. So in the world we live today with the fear of rates beginning to rise, next year we have ten percent of our portfolio that we can take from the very front end and reinvest into those higher rates. That really does help us to preserve and grow an income stream over time and mute volatility. Kind of give our average shareholder a better ride, a better experience even in a relatively possible tumultuous time for fixed income.

NICK VENDITTI: So think about that kind of just from a very basic standpoint. You have a portfolio that’s roughly ten, ten, ten, ten, ten. Ten percent of the assets in each rung of the ladder for the limited term, muni for the limited term income. What happens is interest rates go up and bond prices go down. That’s kind of the universal fixed income equation. There’s very little any of us can do about that. So rates go up. You lose NAV on the fund. Principal decreases but, as Jeff said, you’re getting this free flow of cash as these bonds mature. We are de facto dollar cost averaging back into the market in now higher yielding bonds because we saw rates go down or go up. So now what you have is you have the dividend yield on those portfolios starting to tick up which helps offset the decline in the NAV. In my world, in the muni world, the dividend yield is why we’re all here. Right? That’s the part that’s tax-exempt. So we have always been big believers of the ladder. We’ve run them at Thornburg for well over 30 years, but I think we’re even more of a believer in that structure today because of the uncertainty we’re seeing, because of that rolling mechanism which is very, very powerful. Look. Our Thornburg Limited Term Muni Fund has never had a negative two-year rolling return.

CONSUELO MACK: So the other strategy, one of the other strategies is what you call strategic which is a lot more flexible and, again, you are a portfolio manager in the Strategic Income Fund, Jeff, and so what you're doing ... explain how that mandate works, and it is taking on more risk for a higher return. Right? Is that the deal there?

JEFF KLINGELHOFER: That's correct. It absolutely is taking on more risk than our core Limited Term Income Fund. What that fund really is designed to do is allow us the most flexibility to find relative value wherever it may lie. As Nick said earlier, when you're being paid attractively to take risk, we're happy to take it within the portfolios, now always within the context of what the portfolio is designed to do, and at the same time when we're not being paid to take risk, we simply choose to take a lot less of it..

CONSUELO MACK: And at one point dividend-paying stocks were definitely a part of your strategy. What role do stocks have now in the Strategic Income?

JEFF KLINGELHOFER: In today's world, given the high level of potential volatility for fixed income, dividend-paying stocks in our current bond portfolio are a very small portion of that portfolio simply because there's one absolute truth about stocks is they're more volatile than bonds broadly
.

CONSUELO MACK: What about high-yield bonds which also have been terrific performers over the last several years? Which I think Larry Summers called equity in drag. What's your view about the high-yield space?

JEFF KLINGELHOFER: If I had to paint again any space of fixed income with a broad brush, unfortunately high-yield today is actually relatively low yield and very expensively priced. We are willing to roll up our sleeves and do a lot of deep dive diligence and fundamental valuation, and there are some pockets that do look interesting to us, but broadly across the board it's pretty expensive.

CONSUELO MACK: What are the pockets? So where are you investing given the very expensive and risky market?

JEFF KLINGELHOFER: If I had to kind of classify what the Thornburg Strategic Income Fund looks like today, it would be defensive focused on consumer less cyclical spaces of the consumer space, defensive carry, defensive income. We continue to hold a relatively high balance of cash to allow us to be opportunistic when and if the market does turn and reinvest that cash into a more attractive market in the future.

CONSUELO MACK: Strategic income in the municipal space. You can't have the kind of flexibility that Jeff does. Right? You've got to be in municipals.

NICK VENDITTI: Let me tell you about why I like Thornburg Strategic Muni Fund by telling you why I hate municipal high-yield. I think that's the best way to sort of get there. You're absolutely right. The municipal high-yield market is nowhere near as diversified as the market that Jeff gets to play in every day. In fact, if you look at some of the major indexes sort of as a proxy for the high-yield market, 80, eight zero percent of the income in those indexes historically has come from two things: Puerto Rico and tobacco.

CONSUELO MACK: Wow.

NICK VENDITTI: So just by virtue of that, you know there's no diversification, and both of those issuers in my mind at least are going to default. So they're beyond high-yield and do something else. Throw that away. Let's say I'm a hypothetical high-yield municipal bond manager who has managed to avoid Puerto Rico and tobacco entirely. I've bought single-site hospitals, dirt deals in Florida, charter schools, whatever. I've had an unbelievable track record for the last couple of years. Here's my problem even knowing that.
By prospectus as this hypothetical high-yield manager, I am forced to take at least 50 cents of every dollar that comes into my portfolio and invest it in low investment grade or non investment grade credits. We talked about how credit spreads, the incremental yield I get from buying triple Bs as opposed to triple As are as tight as they've ever been which means as this hypothetical high-yield manager, I am forced to buy the worst stuff at the most expensive it's ever been, and that seems like a terrible, terrible investment strategy to me.

CONSUELO MACK: Right. So where are you investing, therefore?

NICK VENDITTI: So that fund again, it looks much, much lower on its risk spectrum. A fund that can go up to 50 percent below investment grade is running at about two percent below investment grade.

CONSUELO MACK: Wow.

NICK VENDITTI: If I'm not getting paid to take the risk, don't take the risk.

CONSUELO MACK: You're not going to do it..

NICK VENDITTI: I think the mistakes that people are likely to make in this market are stretching too far, are getting way, way, way outside of their risk bubble searching for that extra five, that extra ten basis points.

CONSUELO MACK: Which has worked actually so far. It really has.

NICK VENDITTI: It absolutely has.

CONSUELO MACK: So it's really difficult if you are a responsible manager who doesn't want to lose principal to not go that route.

NICK VENDITTI: It absolutely is. Look. The key word is discipline. We believe that again that valuations are divorced from prices, and you have to have the discipline to do the boring, the un sexy thing because in the long run we feel like that's going to be the right thing to do.

CONSUELO MACK: Tough market, challenging market. One investment for a long-term diversified portfolio. Given how you just described and characterized the markets, what would it be, Jeff? What should we all own some of in a long-term diversified bond portfolio?

JEFF KLINGELHOFER: I'll give you a little bit of a nuanced answer. I honestly think it is a diversified portfolio where you believe the manager really is managing risks well. One space in particular that we have found some value is still anything tied to the U.S. consumer. The U.S. consumer remains the bright spot of the global economy. So directly accessing the consumer balance sheet is one of the places we're finding value. Asset-backed securities in particular are a source of where we see relative value within our portfolios. They tend to be relatively short. Often times they're floating, so they protect you from that gradual rise in interest rates. Most of them are still very, very liquid, and it's a core portion of our portfolio today.

CONSUELO MACK: Nick, in the municipal space.

NICK VENDITTI: Sure. So I think anyone looking for a municipal tax-exempt income, the right place to be is one in a laddered strategy. I think the laddered portfolios have proven themselves to outperform over a long period of time, and in a period like this where there's so much uncertainty, I really do believe the ladder is going to protect investors. In addition to that, I think being able to play in the sort of one to 20-year space, particularly that 12 to 15, kind of that elbow of the curve over a long period has been the right place to be in municipal finance in most fixed income investment. So that's where I would guide investors.

CONSUELO MACK: So is there a role for passive in fixed income, global fixed income?

JEFF KLINGELHOFER: The problem with passive is it generally forces an investor to take a very, very narrow view across a very short timeframe. One of the biggest benefits of hiring a manager who has a long history of managing risk and reward in various cycles is the ability to be diversified. When I look at the world of passive today, there've been significant flows into high-yield passive for instance. But generally most of those passive high-yield managers are forced to buy the very same security. So fundamentals and valuations get disconnected within that small space that they're playing versus an active manager has the ability to assess relative value by looking outside and beyond where the passive players are looking to find that relative value, to find actual sources of better risk and return for their shareholders.

CONSUELO MACK: Nick? Does passive have any role in municipal bond investing?

NICK VENDITTI: No. It absolutely doesn't for a couple of reasons. One, the municipal bond indexes aren't real. They're just an idea. So in the equity markets an investor can invest in the S&P 500 or a value fund. They have those two decisions. An investor can't invest in the municipal bond index. They can invest in something that's trying to mimic the index but not the index directly. So that's a little tenuous right off the bat.

CONSUELO MACK: You're saying they can't duplicate the issues that are in the index? It just is not possible in the municipal bond world?

NICK VENDITTI: It's not possible. So think about it from this perspective. The S&P 500 there are 500 stocks. There are almost 90,000 municipal issuers. There are over one million CUSIPs. Every maturity gets its own fingerprint that's called a CUSIP. There are just too many. The market is too broad to ever mimic any one strategy directly. So throw that aside. Even ignoring that, what you have is you have an index who is buying up or fake buying up things that are generally issuers that generally issue the most debt.

CONSUELO MACK: Puerto Rico.

NICK VENDITTI: Puerto Rico. So think about that as a fixed income investor. Throw Thornburg out. Throw Jeff and I out. Do you always want to be investing in the thing with the most debt? Probably not. Probably not, and so again the idea is that if you have someone sitting in a chair like Jeff and I are that's looking for relative value on a daily basis, on a long-term basis, we are much more capable of finding the right bond on the right day at the right price.

CONSUELO MACK: All right. Thank you both so much for joining us and discussing municipal bonds, Nick Venditti, and also the corporate space and the global space, Jeff Klingelhofer. Thank you very much.

NICK VENDITTI: Thank you.

JEFF KLINGELHOFER: Thank you.

CONSUELO MACK: At the close of every WEALTHTRACK we try to give you one suggestion to help you build and protect your wealth over the long term. This week's Action Point is: Seriously consider sticking with active management in your bond portfolio.
This week's guests gave their reasons for doing so but there is other evidence as well. According to a recent analysis by PIMCO, which we will have on our website, unlike stocks, the majority of actively managed bond mutual funds and ETFs have outperformed their passive peers, after fees, over the last 1, 3, 5, 7, and 10 year periods. Over the last 5 years for instance, 63% outperformed. The same cannot be said for stock funds, where the majority of funds have

underperformed their passive equivalents in recent years. PIMCO cites the unique structure of the bond market for giving the advantage to active managers. 47% of the $102 trillion global bond market is made up of non economic investors like central banks and insurance companies who frequently have different objectives than beating the market. Bonds mature and the indexes change frequently. Active managers can anticipate these changes and act accordingly.
As PIMCO's report concludes: Bonds are different.

To see this program again and other WEALTHTRACK interviews, on your own schedule, please go to our website WEALTHTRACK.com. Also feel free to reach out to us on Facebook and Twitter. Thank you for joining us on this Memorial Day weekend. And while you enjoy your Monday off, please take a moment to remember those who have lost their lives in military service to our country, so we could celebrate a holiday in freedom and peace with our loved ones. Make the week ahead a profitable and a productive one.