MITCHELL CAPITAL MANAGEMENT

Taxable Bond Strategy

Philosophy

MCM's fixed income investment strategies pursue the belief that fixed income portfolios represent the foundational portion of an overall investment allocation, acting as the ballast to the risker allocations. Therefore, it is our practice to avoid the riskier, or less liquid corners of the fixed income market in search of every last bit of yield. Rather, we employ a time-tested, diligent investment process to build high quality, fixed income portfolios that are suitable for a given market environment.

Objective

MCM's Taxable Bond strategy seeks to deliver total returns, on a risk-adjusted basis, that exceed the Bloomberg 1-3 year Government/Credit Index.

Strategy

MCM's fixed income strategies employ three stages in constructing bond portfolios. We start with a top-down viewpoint, evaluating the current economic environment, monetary and fiscal policies, and secular trends to identify the pressure on monetary authorities towards future interest rate moves. These factors inform the Fixed Income Investment Committee in determining how portfolio duration will be established. Portfolio duration can range from 1.5 – 6.0 years. We then utilize our proprietary credit analysis model to determine which candidates we would consider applying to the portfolio construction, favoring those we believe to be in an improving credit position and avoiding those moving in the opposite direction. Then we determine valuation and trading strategies, the final and most impactful step in the process on the strategy returns.

Team

Ken Green, CFA - PM, Principal
with Mitchell since 1991
analyzing fixed income since 1986

Phil Kernen, CFA - PM, Principal
with Mitchell since 2005
analyzing fixed income since 1992

Christen Dusselier - PM, Principal
with Mitchell since 2001
analyzing fixed income since 2001

What sets this strategy apart?

Long-term management team with ownership in the firm

Close working relationship with MCM's equity team to ensure the Fixed Income strategies benefit from equity research and expertise

Flexibility allowing for responsiveness to changes in the economic environment.

MCM Fixed Income

The **MCM Taxable Bond** and **MCM Tax-Exempt Bond** strategies were positive for the quarter and for the year, while most fixed income benchmarks were flat or negative.

The risk of a yield curve inversion is getting more attention. Does inversion matter? History says it can, acting as a predictor of recession in 12-18 months. But it doesn't always work, and isn't a good predictor now.

The slope of a yield curve is usually measured by comparing the yields between a 2-year note and a 10-year note, or the 2-10 spread. At quarter end, that spread was 0.24%. When you can get a better yield on a 2-year note than a 10-year note, then your curve is inverted. As spreads contract, the curve becomes flatter. For reference, at Dec 2017, it was 0.52%.

The 2-year point on the curve is highly influenced by Fed policy. Since they have raised rates eight times, the 2-year U.S. Treasury note yield has moved up in sync. Not so much with the 10-year note, because there remains such a huge demand for longer-dated U.S. Treasury notes from some big buyers. which keeps yields lower than they might otherwise be.

Start with the Fed itself. It may be reducing the size of its balance sheet, but it remains a huge buyer using a large portion of maturities. Foreign central bank and other foreign buyers need a safe place to park their US currency holdings. And banks purchase U.S. Treasuries to meet regulatory requirements. These groups are price-insensitive, meaning they will buy U.S. Treasuries regardless of their price, or yield. These factors artificially suppress the long rates and give a false impression of the dangers of an inverted yield curve in today's environment.

Things are different with municipal curves, which have actually steepened. At Dec, 2017, the AAA municipal spread was 0.45%. By the end of Q3, that had actually widened to 0.64%. Why the difference from taxable bonds?

It stems from the same three buyer groups. 1) the Federal Reserve does not buy municipal bonds with any maturities from its slow balance sheet reduction. 2) Foreign investors do not enjoy tax benefits from the interest earnings on such debt.

3) Banks buy municipal bonds, but do so for their own account, unlike purchases of U.S. Treasury notes which are done to meet regulatory requirements. That leaves the municipal market much more heavily exposed to relatively price sensitive retail investors, and less to institutional investors that may be making their decisions more heavily based on business, policy, or regulatory rules.

What are we seeing?

The Wall Street Journal recently printed an article stating that, for the first time ever, more than 40% of the value of U.S. corporate bonds was rated BBB, just above the investment grade line. In 2007, only 26% of U.S. corporate bonds was rated BBB.

Last quarter we noted that junk bond issuance doubled since 2007, and this BBB growth is part of the same trend.

This matters because credit markets are where investors usually see the first signs of market troubles in the form of wider spreads (lower bond prices) and possible downgrades. The long expansion has allowed issuers of all types to encounter little resistance to taking on new debt. When economic growth becomes challenged, as it eventually will, there is now a much larger body of examples from which to draw evidence of a turning point.

Your portfolios hold an allocation of BBB bonds. Our interest, first and foremost, is the safety and security of our holdings. We conduct our own credit analysis on each to help avoid names that will be part of that 'early-warning system'.

Taxable Bond Strategy

September 30, 2018

Strategy Characteristics

Characteristic	Portfolio
Yield to maturity	2.53%
Average coupon	2.33%
Average maturity	1.97
Duration	1.84
Average rating	A1/A+

Ratings Distribution

Moody/S&P	Portfolio %
Aaa/AAA	38.2
Aa/AA	11.7
A/A	33.5
Baa/BBB	16.6

Sector Weightings

Sector	Portfolio %
U.S. Treasury Notes	224.6
U.S. Agency Notes	11.6
Corporates:	62.9
Banking/Finance	12.3
Energy	1.1
Industrials	38.5
Telecom	2.3
Transportation	4.5
Utilities	4.7
Other	0.1
Cash	0.8

Maturity Distribution

	Portfolio %
< 1 year	21.1
1 - 3 year	59.5
3 - 5 year	19.2
5 - 7 year	0.2
7 - 10 year	0.0
> 10 year	0.0

About Mitchell Capital Management

Mitchell Capital Management (MCM) was founded in 1987 and is an SEC Registered Investment Advisor. The firm manages portfolios and provides investment solutions for an array of investors nationwide, including individuals, foundations, union pension plans, retirement plans, endowments and associations. MCM has always been employee owned and intends to stay that way. Our fiduciary culture means our clients are the first priority in each decision we make.