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 superior total returns, on a risk-adjusted basis, over a market cycle. We strive to effectively balance incorporating best opportunities and the avoiding a negative credit event.

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.

Mitchell Capital Fixed Income

The **Taxable Bond** and **Tax-Exempt Bond** strategies both turned in solidly positive returns for the year. Both results are very satisfactory given the rising rate environment and volatility presented in 2018.

In early February, we initiated a position in U.S. Treasury TIPS bonds in both portfolios, which benefit in a period of rising inflation. By September, when reported inflation had moved solidly towards the 2.0% target and economic growth was picking up, TIPS bonds were performing better than their non-inflation adjusted peers. That began to change in the fourth quarter as reported inflation data appeared to peak and the shine towards economic sentiment began to dim. We sold our positions and reallocated the proceeds towards nominal U.S. Treasury notes and Treasury Bills as we expect inflation data to soften, but the contribution to portfolio returns was positive.

In taxable bonds, we reduced the allocation to corporate bonds from the 55-60% range, to something closer to 50%, increasing our allocation to government securities such as U.S. Treasury notes at the same time. In previous letters, we have discussed corporate credit and the growing debt load that non-financial corporate borrowers have undertaken. They have done so both for the purpose of investing in capital projects (a good use of credit) as well as to buy back their own stock (a not so good use of credit). Our credit work showed that, in aggregate, these debt loads were getting to a point that made us uncomfortable having such a large allocation to the asset class. At some point, investors would more widely recognize the challenges of managing such high debt loads, even under benign economic conditions. We wanted to be less exposed when that time came. It should come as no coincidence that intermediate corporate bonds turned in the weakest performance for fourth quarter and one of the few negative returns in fixed income.

In tax-exempt bonds, the update is more about supply and the slope of the yield curve. Total tax-exempt bond issuance in 2018 was $338 billion, down by $45 billion from 2017, and marks the first negative net issuance in three years. Compounding the issue, surveys suggest no change for 2019. Such dwindling supply, and unchanging demand, creates benefits and challenges. Challenges in finding sufficient supply at acceptable prices from sellers who know supply is limited. Benefits because the value of existing holdings are less exposed to external economic conditions than they might otherwise be.

Which explains why the municipal bond yield curves are still positively sloped, while the taxable bond curves are flirting with a possible inversion. In 2018 investors sold their long bonds in favor of short bonds, conditions we expect to continue into 2019.

When bond deals go wrong

To experience the 1.1 million square Zona Rosa shopping center in North Kansas City, MO, you would probably never know of the financial distress that lurks in the background. But the bond holders that financed the expansion of the shopping center in 2007 are now sweating bullets wondering if they will be paid what they are due.

That fate lies in the hands of the elected commissioners for Platte County, who so far have failed to make good on their obligation to act as a backstop to cover bond payments for bond holders, after proceeds from the shopping center came up short.

In the fourth quarter, the county commissioners elected to not appropriate funds to cover the December 1, 2018 bond payment. This triggered significant credit rating downgrades for the 2007 Zona Rosa deal, as well as the county's debt liabilities totaling more than $50 million in outstanding bonds.

This speaks to the importance of understanding a bonds underlying structure. Zona Rosa is in our backyard, so we had plenty of chance to buy them. We can't say we predicted this outcome, but we didn't like the structure, so we passed each time. The story isn't over yet.

Taxable Bond Strategy
December 30, 2018

Strategy Characteristics

Characteristic	Portfolio
Yield to maturity	2.96%
Average coupon	2.54%
Average maturity	1.99
Duration	1.87
Average rating	A1/A+

Ratings Distribution

Moody/S&P	Portfolio %
Aaa/AAA	40.5
Aa/AA	9.3
A/A	32.2
Baa/BBB	18.0

Sector Weightings

Sector	Portfolio %
U.S. Treasury Notes	28.6
U.S. Agency Notes	9.7
Corporates:	60.7
Banking/Finance	10.3
Energy	1.0
Industrials	37.6
Telecom	2.2
Transportation	4.2
Utilities	5.4
Other	0.0
Cash	0.7

Maturity Distribution

	Portfolio %
< 1 year	21.2
1 - 3 year	56.8
3 - 5 year	21.9
5 - 7 year	0.1
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.