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 Intermediate 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.

## Mitchell Capital Fixed Income

Fixed income markets provided positive returns for the quarter. The FOMC left overnight rates unchanged and downgraded their economic forecasts in March. These combined actions led to mixed signals from the fixed income marketplace.

Taxable bond markets are reflecting a two-sided face regarding economic optimism. In the first instance, yield curves are threatening to invert and some points on the curve have already done so. Yield curve inversions do not cause recessions, but they have been observed to preceed recessions by as much as 12-18 months based on expected FOMC policy changes. It is for this reason that market observers place so much importance on an inversion and its duration.

The predictive nature of inversion is itself debateable. Making it more confusing is just which inversion is the most precient. Is it the spread between the 10-year and the 2-year U.S. Treasury Notes? Or between the 10-year U.S. Treasury Note and the 3-month U.S. Treasury T-bill rate? These are only two and there is no agreement on which is the most reliable. In our view, the yield curve is already so manipulated by FOMC monetary policy that an inversion holds little meaningful relevance right now.

In the second instance are credit spreads, which widen when bond markets fear economic contraction. Especially in the non-investment grade levels of fixed income markets. So what are credit spreads doing now? They are contracting, giving little indication of concern.

In tax-exempt bond markets, there is no threat of inversion, but the story remains too much demand and too little supply. 2019 issuance is running similar to 2018, which was itself lower than average after a great deal of issuance was pushed forward to December 2017 to take advantage of expiring tax benefits.

At the same time, more investors are coming into the tax-exempt market for their own tax benefits, and finding some of the lowest tax-equivalent yields available, compounding the crunch. Partial relief may come in the form of BAB's bond refunding.

Build American Bonds (BAB) are relics of the post-recession years when Congress sought ways to support infrastructure spending. BABs are issued by municipalities, but their coupon income is taxable. This was expected to make them more attractive to a broader group of tax-exempt investors such as foundations or pension plans, who see little value in tax-exempt income.

Most BAB's are callable, meaning the issuer can buy them back at a preset price. Many of these callable BAB's bonds will face ther first call dates in 2019. The view is that with tax-exempt rates so low, issuers are very incented to call their BAB's bonds and issue new tax-exempt debt. Estimates suggest as much as $20 billion could switch in 2019. This could be a helpful source of supply in a new issue market expected to reach $300 billion this year. Anything will help.

## You are doing what with my retirement?

The funding strength of municipal and state pension plans has received more press over the last several years. Through financial markets cycles, the message only changes by a matter of degrees; there is not enough money to fulfill the promises that were made.

The problem is not new, and there have been plenty of attempts to fix it. Some states have issued bonds, delivered the proceeds to the plan and hope plan returns exceed interest expense. Plan funding looks better, but the municipality still owes the money. Some states have adjusted benefit levels for new participants to reduce the expected benefits. Such changes take too long to make a material dent. Other states ramp up their risk-taking in the portfolio in the hopes of ramping up their returns as well.

Such decision-making was in mind as we reviewed the latest from the State of Kansas. which has allocated 11% of their assets to commodities. By point of reference, in 2016, the average public pension fund allocated less than 1% to commodities. Less-well-funded plans often take steps like that to try and catch up when nothing else has worked.

# Bond Strategies
March 31, 2019

## Strategy Characteristics

| Characteristic | Taxable Bond | Tax-Exempt Bond |
|---|---|---|
| Yield to maturity | 2.59% | 1.77% |
| Average coupon | 2.45% | 3.95% |
| Average maturity | 1.78 | 1.99 |
| Duration | 1.68 | 1.87 |
| Average rating | A1/A+ | Aa2/AA |

## Ratings Distribution

| Moody/S&P | Taxable Bond % | Tax-Exempt Bond % |
|---|---|---|
| Aaa/AAA | 40.9 | 30.8 |
| Aa/AA | 9.5 | 57.9 |
| A/A | 32.9 | 11.3 |
| Baa/BBB | 16.7 | 0.0 |

## Sector Weightings

| Sector | Taxable Bond % | Tax-Exempt Bond % |
|---|---|---|
| U.S. Treasury Notes | 29.8 | 6.5 |
| U.S. Agency Notes | 9.3 | 0.0 |
| Corporates: | 59.6 | 0.0 |
| Banking/Finance | 12.1 | 0.0 |
| Energy | 1.0 | 0.0 |
| Industrials | 36.5 | 0.0 |
| Telecom | 1.6 | 0.0 |
| Transportation | 4.5 | 0.0 |
| Utilities | 3.9 | 0.0 |
| Muni Bonds: | 0.1 | 91.0 |
| Other | 0.0 | 0.0 |
| Cash | 1.2 | 2.5 |

## Maturity Distribution

| | Taxable Bond % | Tax-Exempt Bond % |
|---|---|---|
| < 1 year | 29.0 | 29.9 |
| 1 - 3 year | 53.4 | 45.6 |
| 3 - 5 year | 17.4 | 22.4 |
| 5 - 7 year | 0.2 | 2.1 |
| 7 - 10 year | 0.0 | 0.0 |
| > 10 year | 0.0 | 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.