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 left their economic forecasts largely the same. Worldwide, rates continued their decline as investors sought out safety to protect portfolios from perceived risks of a slowing world economy.

The slide in global bond yields has exacerbated a problem we thought was moving behind us; negative yields. $13 trillion worth of government bonds worldwide currently trade at negative yields, guaranteeing a loss. Contrast that with the 2.0% yield on the 10-year U.S. Treasury notes, which feel miles away. Even still, investors are looking outside their usual refuges as they hunt for stable assets that provide at a better return.

Everybody has their own definition of safe haven and it seems people are, again, loosening that definition in search of yield. We have seen this before. Go back to before 2008 when investors threw billions of dollars at U.S. mortgages thinking they were all rock solid. They weren't. Then, coming out of 2008 when interest rates were zero, investors sought out returns from places they didn't typically go, such as junk bonds whose issuance has exploded. We haven't seen the end of this story yet. The unhappiest investors will be those who should not have been there in the first place.

One recent quote from a fixed income portfolio manager caught our attention, that the challenge is "not falling into the trap of changing strategy too much." How about not changing strategy at all? Safe is safe, and like any market, if a lot of people want safety, you are going to have to pay for it. You can't buy something else and confer a reflection of safety through sheer will. Our clients ask us to invest their fixed income assets responsibly and safely given the current environment. They already take risks elsewhere and bond portfolios are the ballast, the stable part of your portfolio, not the place to stretch for extra return. It explains why we have increased our allocation to obligations of the U.S. Government and reduced our allocations to corporate notes. And why we have become more discerning in our credit analysis towards both corporate issuer and municipal issuers.

In tax-exempt markets, conditions are mostly unchanged from the prior quarter. An unbroken flow of cash into the municipal-bond market since early January has supported the best start since 2014. At the same time, the pace of new debt sales, $164 billion, has barely begun to rebound from the depressed levels of 2018, rising about 6% year-over-year.

This mismatch between supply and demand helped push prices to record highs relative to U.S. Treasuries until last month, when Treasuries rallied on the belief the FOMC will soon cut interest rates.

We expect the trend of new issuance will not change materially through year-end and returns will largely be driven by coupon returns instead of additional price appreciation.

There is no excess here.

The low interest rates engineered over the last decade by the Federal Reserve achieved the desired outcome; more borrowing to spend or invest. From student loans, to corporate loans across the credit spectrum to the U.S. Treasury, outstanding borrowings are up. In some cases, way up. Each are usually included on investors list of possible catalysts for the next recession, much like mortgage borrowings drove the last.

But when we look at America's states and cities, we see the opposite. The decade-long economic expansion has left surpluses where there were once deficits. The paradox is that interest rates are veering back towards more than half-century lows and there are of billions of dollars of spending needed to refurbish roads, sewers and public transportation systems. Yet governments around the country are showing little interest in borrowing money. In fact, they collectively owe $143 billion less than they did nine years ago.

This is the same infrastructure problem Washington believes to be one of the few solvable problems in the current environment. Just don't wait around for cities and state to lead the charge.

Bond Strategies

June 30, 2019

Strategy Characteristics

Characteristic	Taxable Bond	Tax-Exempt Bond
Yield to maturity	2.28%	1.54%
Average coupon	2.51%	3.96%
Average maturity	1.92	1.95
Duration	1.80	1.83
Average rating	A1/A+	Aa2/AA

Ratings Distribution

Moody/S&P	Taxable Bond %	Tax-Exempt Bond %
Aaa/AAA	37.9	28.9
Aa/AA	15.9	60.0
A/A	30.1	10.8
Baa/BBB	16.1	0.3

Sector Weightings

Sector	Taxable Bond %	Tax-Exempt Bond %
U.S. Treasury Notes	26.5	5.0
U.S. Agency Notes	10.3	0.0
Corporates:	61.7	0.0
Banking/Finance	11.4	0.0
Energy	1.3	0.0
Industrials	39.4	0.0
Telecom	0.8	0.0
Transportation	5.5	0.0
Utilities	3.4	0.0
Muni Bonds:	0.4	93.7
Other	0.0	0.0
Cash	1.1	1.2

Maturity Distribution

	Taxable Bond %	Tax-Exempt Bond %
< 1 year	32.3	34.6
1 - 3 year	47.6	38.4
3 - 5 year	16.9	23.8
5 - 7 year	3.1	3.2
7 - 10 year	0.1	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.