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 even after giving back some of the gain in September. The FOMC moved for a second time to lower interest rates, purportedly to insure against any further economic slowdown, but actually to keep our currency competitive.

During the quarter, between the first and second rate cut from the FOMC, long bond yields moved downward on economic concerns. This led to the yield curve inversion that so many had expected, which provides a case study in why yield curve inversion may not possess the ability to predict recession that is often associated with its appearance. Here's the thing, a fair amount of that yield decline stemmed from hedging activities, sometimes called 'forced buying'.

This refers to institutional investors like banks or insurance companies. They either desire, or are required by investment policies, to hedge their portfolios and minimize their exposures. As markets move, they are required to trade in order to leave their net exposure unchanged. As rates declined rapidly in August, they were forced to buy more U.S. Treasuries just to maintain their position.

Here is how just one example works. Falling rates leads to homeowners refinancing home loans. That means mortgage-backed bonds get paid off faster. Institutions who own these bonds are pushed into buying longer dated Treasuries or interest rate swaps as the fastest and cheapest way to replace that income that disappeared with the mortgage-backed bond was paid off. One sign that this hedging activity has been important is that yields in the derivatives markets where hedging is done have fallen faster than those on bonds.

The lower we go in long-term bond yields, the more demand starts to increase for certain products. You end up with a market that is all buyers and all sellers. None of these activities kick off a market move, but they can help it gather pace. And it can work in both directions when rates start to rise again. Without these flows, the U.S. yield curve wouldn't have inverted and there would be much less chatter about a coming recession.

With U.S. Treasury yields falling so low, the world-wide demand for municipals is growing. During the quarter, municipal bond yields reached multi-year lows before rebounding in the September when supply came in higher than expected to take advantage of the lower rates. The whole curve moved upward, but longer dated bonds were off more than 1%.

Issuers responded to the rates drops by increasing their issuance towards the end of the quarter as offerings increased 10% over the prior year. In an effort to take advantage of historically low rates, more than a few even came to market with century bonds, or those that will mature in 100 years. In fact, nearly $1.3 billion in century bonds have been issued through September, the highest in more than five years.

Taxable municipal bonds?

You read that right. Taxable municipal bonds have a always been around, but were relegated to a very small corner of the municipal market due to small issuance volume and even smaller investor demand. However the juxtaposition of new tax laws and interest rate levels have led to a surge in taxable municipal bond issuance.

The Tax Cuts and Job Act of 2017 prohibited a long-standing practice for municipalities wanting to take advantage of lower market rates; refinancing tax-exempt notes with new tax-exempt issuance. Going forward, they could only refinance with new bonds that lacked the tax-exempt, or taxable municipal bonds, costing more for the issuer.

As interest rates declined again in the third quarter, the numbers started to make sense for issuers. They could place taxable debt and still find themselves with savings after retiring their tax-exempt notes at the call date.

The upshot comes for investors who are indifferent to the tax-exemption, such as retirement accounts, foundations, or overseas investors. They now have an option that may offer diversification and incremental yield relative to typical taxable fixed-income investments.

Bond Strategies
September 30, 2019

Strategy Characteristics

Characteristic	Taxable Bond	Tax-Exempt Bond
Yield to maturity	1.95%	1.61%
Average coupon	2.55%	3.92%
Average maturity	1.94	2.01
Duration	1.82	1.89
Average rating	A1/A+	Aa2/AA

Ratings Distribution

Moody/S&P	Taxable Bond %	Tax-Exempt Bond %
Aaa/AAA	37.7	28.0
Aa/AA	16.0	59.1
A/A	31.0	12.4
Baa/BBB	15.3	0.5

Sector Weightings

Sector	Taxable Bond %	Tax-Exempt Bond %
U.S. Treasury Notes	26.3	4.9
U.S. Agency Notes	10.0	0.0
Corporates:	61.4	0.0
Banking/Finance	10.6	0.0
Energy	1.5	0.0
Industrials	39.1	0.0
Telecom	0.8	0.0
Transportation	5.5	0.0
Utilities	4.0	0.0
Muni Bonds:	0.3	92.5
Other	0.0	0.0
Cash	2.0	2.6

Maturity Distribution

	Taxable Bond %	Tax-Exempt Bond %
< 1 year	29.6	31.0
1 - 3 year	48.2	43.0
3 - 5 year	18.7	22.6
5 - 7 year	3.3	3.4
7 - 10 year	0.2	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.