RMB CAPITAL

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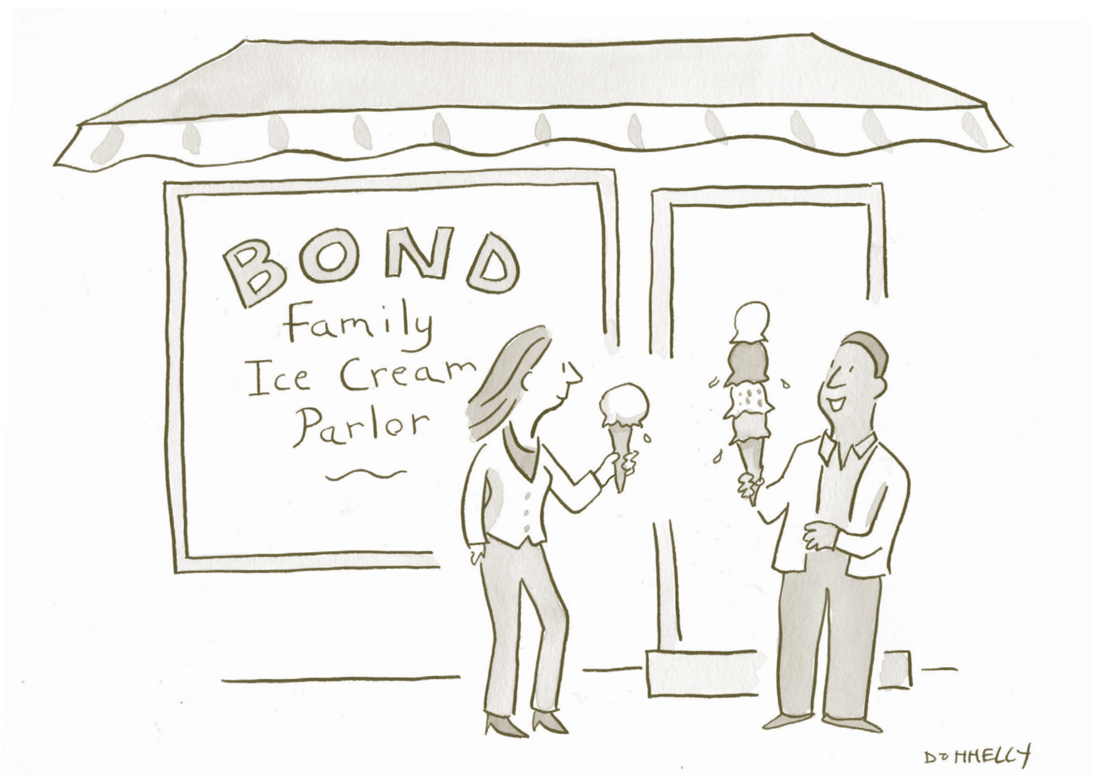
LOW INTEREST RATES PUT Opportunistic Fixed Income IN THE SPOTLIGHT

A core tenet of investing is diversification. Nobel Prize winner Harry Markowitz said diversification is "the only free lunch," meaning that, through diversification, an investor can reduce risk without a commensurate loss in return. U.S. Treasuries and high-quality corporate and municipal bonds, which we refer to as "core" fixed income, have historically played a key role in providing diversification against higher-risk equity investments. »



"There are a lot of interesting flavors to try today."

Core bonds continue to provide diversification today; however, because we are now mired in a low-interest-rate environment, the forward-looking returns for core bonds are at all-time lows. While some investors may simply accept those lower returns, others require higher returns to meet their financial goals. RMB is committed to helping investors navigate the changing market landscape, and we believe "opportunistic" fixed income can be instrumental.

RMB's core/opportunistic framework draws a clear distinction between these two categories of bonds and the role they play in a portfolio. Core fixed income is characterized by high-quality issuers such as government entities and highly rated corporate borrowers. These bonds tend to be extremely liquid and have a very low probability of default. The risk of not being paid back at maturity is remote, and they generally provide stability in equity market drawdowns. Core bonds' main risk is interest rate changes: as interest rates go up, bond prices go down. Because interest rates tend to fall during periods of economic and market stress, which typically coincide with falling equity prices, core bonds tend to perform well in those periods. But, while predicting the future direction of interest rates is notoriously difficult, with today's rates at all-time lows, there is certainly more room for them to rise than fall.

Bonds that we categorize as "opportunistic" also have a promise to pay at maturity, but the credit quality of these issuers is less sound. Because of the lower certitude of principal repayment, opportunistic fixed income tends to be more volatile, as well as less liquid and more susceptible to loss during times of stress. Exhibit 1 shows some basic metrics on a few opportunistic fixed income sectors, and the following examples can help illustrate.

High-yield bonds[1] and leveraged loans[2] make up a large part of the opportunistic fixed income universe.[3] Both are issued by companies that have levered balance sheets and may be facing some type of stress, either due to poor management, outdated business models, or industry headwinds. Because of these blemishes in quality, ratings agencies assign credit ratings below investment grade, signifying an increased likelihood of default relative to investment-grade core bonds.

Structured credit is another sizeable part of the opportunistic fixed income universe. Structured credit products are created through a securitization process in which financial assets are packaged into interest-bearing securities backed by those assets, and then issued to investors. By assigning different rights to different levels ("tranches") of the securitization, such as a descending priority order to the cash flow from the assets, »

EXHIBIT 1 KEY CHARACTERISTICS OF OPPORTUNISTIC FIXED INCOME

	Yield	Duration	Rating	Annualized Return	Standard Deviation
Bank Loans	4.9%	0.3	B	4.1%	5.0%
High Yield	5.8%	3.7	B	6.5%	7.0%
Commercial Mortgage-Backed Securities	6.5%	5.1	BBB	6.4%	8.6%
Emerging Markets	4.5%	5.4	BBB	0.5%	11.8%
Core Bonds	1.2%	6.1	AA	3.6%	3.0%

Sources: Bloomberg, Barclays Live
Yield, duration, and rating are as of 9/30/20. Annualized return and standard deviation are based on the 10 years ending 9/30/20. Bank Loans = S&P/LSTA U.S. Leveraged Loan 100 Index; High Yield = Bloomberg Barclays U.S. Corporate High Yield Index; Commercial Mortgage-Backed Securities = Bloomberg Barclays CMBS BBB Index; Emerging Markets = JPMorgan GBI-EM Global Div Traded Index Yield Index; Core Bonds = Bloomberg Barclays U.S. Aggregate Bond Index.

this in effect reallocates the risks and return potential involved in owning the underlying assets. Many types of assets are securitized, including residential and commercial mortgages, corporate loans, student loans, auto loans, and credit card receivables. Payments from the underlying collateral run through a "waterfall" and are paid out to the top tranche first, with the bottom tranche receiving what is left at the end. This means that different securities, though backed by the same assets, can have very different risk-reward characteristics.

A third example of opportunistic fixed income is emerging market debt. Emerging market debt is often categorized into three subsectors: sovereign bonds denominated in U.S. dollars, sovereign bonds denominated in their local currency, and bonds issued by corporations based in emerging markets. The average credit rating of emerging market debt is BBB (still considered investment grade), but credit ratings and associated risk vary substantially from country to country, as do the macro factors that drive risk and the yield available.

These three examples demonstrate the heterogeneity of the opportunistic fixed income universe. And that variety is a good thing for investors in diversified, opportunistic fixed income portfolios, as the risks associated with owning a bond issued by a levered energy company versus a pool of residential mortgages versus the government debt of Indonesia is quite different. Said another way, whereas the main risk to core fixed income is rising interest rates, opportunistic fixed income investors take different risks such as credit, illiquidity, and currency fluctuations.

So why would investors want to take these additional risks? Because they are compensated to do so in the form of higher yields, at times dramatically so. And because the risks are different than in core bonds, some of the risk is diversified away, providing a bit of the free lunch Markowitz proclaims. So, while in isolation we expect the risk and return of opportunistic fixed income to fall in between core bonds and stocks, when included in a broader portfolio we believe returns can be increased without a commensurate increase in risk.

Over the last 10 years, stocks returned 13.7% per year[4] while core bonds returned 3.6%.[5] In a simplified analysis, the return on a typical 60/40 portfolio was therefore 9.7%. There is good reason to believe that level of return will be difficult to achieve over the next 10 years. First, stocks' long-term average return is more like 10%.[6] Second, core bonds yield 1.2% today,[7] making it hard to earn much more than that over the next 10 years. As shown in Exhibit 2, by adding just 10% to »

EXHIBIT 2 HYPOTHETICAL 10-YEAR RETURNS WITH AND WITHOUT OPPORTUNISTIC FIXED INCOME

	Last 10 Years		Next 10 Years		Next 10 Years with Opportunistic Fixed Income	
	WEIGHT	RETURN	WEIGHT	RETURN	WEIGHT	RETURN
S&P 500 Index	60%	14%	60%	10%	60%	10%
Barclays Aggregate Bond Index	40%	4%	40%	1%	30%	1%
Opportunistic Fixed Income	0%	0%	0%	0%	10%	5%
Portfolio		9.7%		6.4%		6.8%

Source: RMB Capital
The percentages in this table are estimates of what returns could be based upon opinions and analyses derived from RMB Capital's research and professional experience. These are hypothetical in nature and not intended to speak to any future periods or forecasts.

opportunistic fixed income, we can increase the expected return by 40 basis points per year without taking on excessive risk. While 40 basis points may not sound like a lot, when factoring in the effects of compounding, it can add significant excess return over time.

In today's world of ultra-low interest rates, core bonds are now priced to provide negative returns after adjusting for inflation. While their diversification characteristics can still add value to a portfolio, investors who require the higher returns they've earned historically must look elsewhere to re-create them going forward.

To help clients meet their risk and return objectives, we are committed to identifying creative investment opportunities, and we believe opportunistic fixed income warrants consideration in a diversified portfolio. ■

1 *For more on this topic, see "High-Yield: Opportunity in a Low-Growth, Low-Yield Environment" from the Summer 2012 issue of INVESTED.*
2 *For more on this topic, see "Floating-rate Bank Loans" from the Summer 2011 issue of INVESTED.*
3 *We also include convertible bonds and preferred stock, whose characteristics are a hybrid between stocks and bonds.*
4 *S&P 500 Index as of 9/30/20.*
5 *Bloomberg Barclays U.S. Aggregate Bond Index.*
6 *As of 9/30/20, the P/E ratio of the S&P 500 is 26x; we find that, on average, stocks have returned closer to 7% over the following 10 years when starting at that level.*
7 *Bloomberg Barclays U.S. Aggregate Bond Index yield as of 9/30/20.*

Index Definitions

- The S&P 500® is widely regarded as the best single gauge of large-cap U.S. equities. There is over USD 7.8 trillion benchmarked to the index, with index assets composing approximately USD 2.2 trillion of this total. The index includes 500 leading companies and captures approximately 80% coverage of available market capitalization.
- The S&P/LSTA U.S. Leveraged Loan 100 Index is designated to reflect the performance of the largest facilities in the leveraged loan market.
- The Bloomberg Barclays U.S. Corporate High Yield Index is an unmanaged index that is composed of issues meeting the following criteria: at least $150 million par value outstanding, maximum credit rating of Ba1 (including defaulted issues), and at least one year to maturity.
- The Bloomberg Barclays CMBS BBB Index measures the market of conduit and fusion CMBS deals with a minimum current deal size of $300 million and a credit rating of BB (using the middle rating of Moody's, S&P, and Fitch).
- The JPMorgan GBI-EM Global Div Traded Index Yield Index is an index in the JP Morgan GBI EM series that provides a comprehensive measure of local currency denominated, fixed rate, and government debt issued in Emerging Markets. The three main composite indices are GBI-EM, GBI-EM Global, and GBI-EM Broad, each having a Diversified version. The series is available in a number of different segments and breakouts including maturity sectors, regions, and individual countries, as well as hedged and unhedged in certain currencies.
- The Bloomberg Barclays U.S. Aggregate Bond Index is an unmanaged index composed of securities from the Bloomberg Barclays Government/Corporate Bond Index, Mortgage Backed Securities Index, and the Asset Backed Securities Index. Total return comprises price appreciation/depreciation and income as a percentage of the original investment. Indices are rebalanced monthly by market capitalization.