Fixed Income Insights

April 8, 2019

Dear Fellow Investor,

If the Federal Reserve was the market's "boogie man" in 2018 for raising short-term interest rates, it didn't take long for it to become the "Candy Man" (a la Sammy Davis Jr.) in 2019. On January 4, Fed Chairman Jerome Powell told a conference for economists that the central bank would be patient in deciding whether to continue raising short-term interest rates. This message, which signaled at least a pause in any further rate increases, was an immediate balm (like "a groovy lemon pie" from the famous crooner's lyrics) to jittery investors fresh off a tough 2018. Equity markets jumped over 3 percent on that day, and fixed income credit markets firmed up (lower credit spreads and higher prices). That set the stage for what became further gains for both stock and bond investors in this year's first quarter. The S&P 500, for example, closed out its best quarter in nearly a decade. And fixed income investors experienced meaningful price gains as a result of declining U.S. Treasury interest rates and shrinking credit spreads.

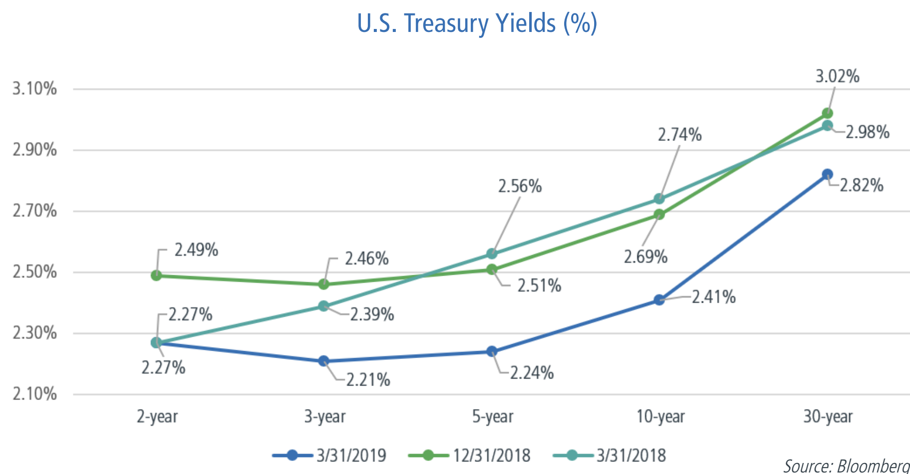
Weitz equity and balanced funds delivered particularly strong first quarter results. Please see Wally and Brad's **Value Matters Letter** and the equity and balanced funds' Quarterly Commentaries for detailed analysis of results.

Weitz fixed income funds also delivered good results in the year's first quarter and during the past twelve months. Further detail about contributors to performance can be found in the fixed income funds' Quarterly Commentaries.

The only gray cloud to the quarter's otherwise silver lining was precipitated by late March manufacturing reports out of Germany that dealt a blow to Europe's economic outlook, triggering fresh concerns about the global economy and tripping the alarm on one of the market's more reliable recession indicators. The news reverberated through markets, sending Germany's 10-year bund yield below zero for the first time since 2016. In the U.S., investors drove the yield for the 10-year Treasury lower than the 3-month Treasury bill for the first time since just before the Great Recession. Such an inversion of the yield curve, where interest rates on 3-month Treasury bills are higher than 10-year Treasury bonds, has historically been a reasonably reliable recession indicator if it persists long enough. While not a perfect indicator, a consecutive 10-day inversion of the 3-month/10-year Treasury yield has preceded, by a year or two, each of the last seven recessions. The first quarter's inversion lasted for five days before ending slightly positive and has remained positive into early April.

The graph below shows the changes of select Treasury rates over the past quarter and year.

U.S. Treasury Yields (%)



Source: Bloomberg

A distinct outcome in the first quarter as evidenced in the graph above has been an inversion of a portion of the U.S. Treasury yield curve, particularly between 2-year and 5-year bond rates. Time will tell whether this flat-to-inverted yield curve is the "canary in the coal mine" signaling recession risk. At present, though, domestic economic signals continue to appear sound (e.g., consumer and business confidence, and employment and wage growth, to name a few). Some to much of the Treasury rate reaction/progression in the first quarter can be traced to the surprisingly dovish, or neutral, stance on interest rates by the Federal Reserve and by market participants' anticipation of when/if the Fed may start *cutting/lowering* short-term interest rates.

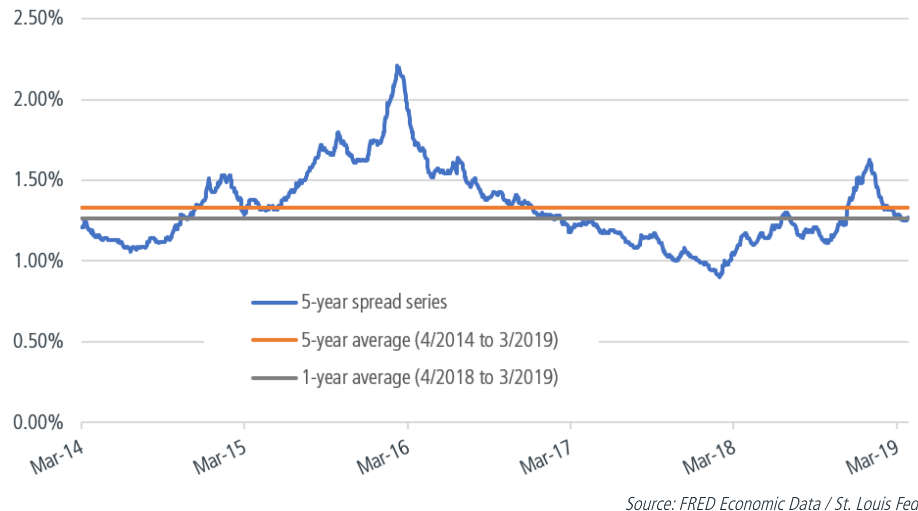
As mentioned, corporate bonds and other credit-sensitive securities had strong quarterly performance and outperformed Treasury bonds as credit spreads narrowed, particularly for non-investment-grade or high-yield bonds. A broad measure of investment-grade[1] corporate bond spreads, compiled by ICE BofAML, decreased to 127 basis points as of March 31, down 32 basis points in the quarter. Spreads remain marginally higher (10 basis points) than they were a year ago.

The charts that follow highlight a couple variables that we use to help inform our investment process. The core of that process is to do fundamental credit work, one security at a time, identifying those companies/credits that we believe provide reasonable-to-good risk adjusted returns for any incremental risk assumed. However, those potential returns are ebbing and flowing based on whether a company/credit is becoming more or less credit

worthy—and based on investor *perceptions* (i.e., the behavioral aspects of fear and greed).

The first chart graphs broad investment grade spreads over the past five years as well as the one- and five-year average. Besides identifying favorable credit opportunities one at a time by fundamental credit analysis, our future/forward returns are enhanced when we can invest when others are more fearful (i.e., when credit spreads are above a 5-year average, for example). Our credit investments in 2015/16 are the most recent example of overlaying deep fundamental work, when credit spreads were at the high end of a historical range. Conversely, our caution in 2017/18, which resulted in shrinking corporate credit exposure in 2017/18, was the result of the marketplace being greedier/less fearful. We again took advantage of a more favorable investment environment in late 2018, but the duration of the dislocation was too short to make meaningful headway. Overall, we believe this macro data, in conjunction with our fundamental credit work, will help enhance long-term returns by taking advantage of what the market presents us.

Investment Grade Credit Spreads



Source: FRED Economic Data / St. Louis Fed

The next chart graphs the relative attractiveness of investing in corporate credit as compared to the "risk free" alternative, again using the past five years as a baseline. Since our investment mandate is not predicated on mimicking a particular index, we have the flexibility either to own a high percentage of credit investments (such as corporate bonds) or none at all. The graph below provides a framework to help inform that decision by depicting the incremental return an investor receives for taking credit risk—in this case across the broad investment-grade corporate universe. Like with investment *spreads*, our goal is to invest more heavily in credit when our incremental unit of return is high, or at least higher than a longer-term average, so the prospects for outsized forward returns are enhanced. Again, the graph helps explain why we were more constructive on credit investments in 2015/16 and less so in 2017/18.

U.S. Investment Grade: Spread as a % of Yield to Worst[1] (Spread/YTW)

Source: CreditSights, ICE BofAML Indices

Structured/Asset-Backed Securities (ABS): A Growing Area of Expertise

One area in which we have meaningfully exercised our willingness to be index agnostic is in the approximately $1.7 trillion asset-backed securities market. This segment of the nearly $43 trillion fixed income marketplace is not represented in most fixed income indexes yet includes a broad array of investment opportunities secured by autos, credit cards, fleet equipment, commercial mortgages, student loans, mobile phones, cellular towers,

other consumer loans and many other assets.

We have spent nearly 10 years becoming more familiar with this segment of the bond market, particularly since the arrival of teammate Nolan Anderson. Our approach to this asset class has been no different than any other credit investment—namely, developing a thorough understanding of the asset class backing each security *before* making any investment, whether its autos, fleet equipment, etc. Additionally, we have spent significant time conducting due diligence with the sponsors/issuers of each investment (either by phone or shoe-leather contact). To date, this work has culminated in due diligence on nearly 50 different sponsors/issuers, with current investments across approximately two dozen in our taxable fixed income funds.

Asset-backed securities, by their nature, are constructed with a senior-to-subordinate structure. A significant majority of this roughly $1.7 trillion segment is rated the highest (AAA) by one of the independent rating agencies and has been the primary area in which we have focused our investment efforts to date. We purposefully started at the top (the most structurally protected) to enhance/ensure capital preservation, but our aperture to accept properly priced credit risk further down the capital structure has improved over the years.

Why invest in this segment? The short answer is we believe ABS presents opportunities to deploy capital on behalf of our shareholders in assets and cash flows that we understand and that enhance returns over comparable corporate bond alternatives. Stay tuned for the long answer, as we plan to produce white papers on various segments of this asset class in the coming quarters.

Please see all the fund commentaries on our website for additional information regarding first quarter 2019 portfolio activity and current positioning. Our fixed income investment philosophy is straightforward. We believe the key to winning is not losing. Permanent losses of capital are a bane to long-term compounding—and *especially* so in fixed income investing. We avoid making bold or specific predictions about the direction and pace at which interest rates or credit spreads might move in the future. Caution has arguably always been our calling card in managing fixed income assets on behalf of clients—we want to be properly compensated for any risks we assume. We are index agnostic and prefer to individually select assets. We concentrate in the ideas that we believe best represent attractive risk-adjusted returns, taking into consideration the general level of interest rates and the credit quality of each investment.

This year has certainly started off strong for equity and fixed income investors. It seems plausible that the first quarter's robust returns have been partly borrowed from the future. And time will tell whether the Fed's dovish tilt on interest rates coupled with progress on the trade dispute between the U.S. and China may help the global outlook: "make the world taste good" (to continue the Candy Man theme). In the meantime, we intend to stick to our knitting and welcome any volatility that may ensue, particularly when it results in a disconnect between price and value. We look forward to taking advantage of any valuation disparities that may develop in 2019 and hope to continue to earn your investing trust.

Sincerely,

Tom Carney **Nolan Anderson**

Performance data represents past performance, which does not guarantee future results. *The investment return and the principal value of an investment in the Funds will fluctuate so that an investor's shares, when redeemed, may be worth more or less than the original cost. Current performance may be higher or lower than the performance data quoted. Performance data current to the most recent month end may be obtained at* ***weitzinvestments.com****.*

[1]**Definitions: Investment Grade:** We consider investment grade to be those securities rated at least BBB- by one or more credit ratings agencies. **Yield-to-worst (YTW):** The lowest potential yield (most conservative yield) that can be received on a bond without the issuer actually defaulting. YTW is calculated by using worst-case scenario provisions, including prepayments, calls and sinking funds. Furthermore, YTW is a forward-looking estimate that ignores capital gains.

Investors should consider carefully the investment objectives, risks, and charges and expenses of the Funds before investing. The Funds' Prospectus contains this and other information about the Funds and should be read carefully before investing. The Prospectus is available from Weitz Investment Management, Inc. Weitz Securities, Inc. is the distributor of the Weitz Funds.