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INVESTING BEYOND THE INDEX

A Fixed Income Q&A with Weitz Investment Management

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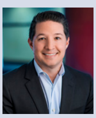

NOLAN ANDERSON
PORTFOLIO MANAGER

Perhaps the most important lesson of the COVID-19 pandemic for fixed income investors is just how critical it is to be flexible. Specifically, to have the flexibility to invest in fixed income sectors outside of broad fixed income indexes.

Two portfolio managers who have long embraced this notion of "investing beyond the index" are Weitz Investment Management's fixed income portfolio managers Tom Carney, CFA, and Nolan Anderson. Tom has been managing fixed income funds at Weitz for 25 years and was joined by Nolan in 2014.

THE FEDERAL RESERVE HAS INDICATED IT WILL LOOK PAST INFLATION AND KEEP INTEREST RATES LOW. BUT AS THE ECONOMY CONTINUES TO SHOW SIGNS OF STRENGTH, DO YOU SEE THE FED STICKING TO ITS STATED PLAN?

TOM: The short answer is yes. We've been down this path of 'zero interest rate policy,' or ZIRP, before. From December 2008 to December 2015, the Fed kept short-term interest rates at zero. Today, we're seeing a sequel of sorts, and it seems this could just be the start of another long run. We think this is especially likely given the Fed's new average inflation targeting directive to allow inflation to run moderately above 2% for some time.

NOLAN: I think it's clear that we've seen fiscal and monetary policy shift in a way that could drive inflation above that target. One quote that I think tells the story is from San Francisco Fed president Mary Daly, who said in February 2020 about the coming Fed regime shift "We've exercised the muscle of pushing inflation down for so long that changing direction feels unnatural. But that is exactly what we will need to do."

2021 BEGAN WITH THE WORST FIRST QUARTER FOR INVESTMENT-GRADE BONDS SINCE 1980. HOW ARE YOU FINDING OPPORTUNITIES FOR THE WEITZ FIXED INCOME PORTFOLIOS?

TOM: To backtrack a bit, the broad corporate bond market ended 2020 with duration – or interest rate sensitivity – at a 20-year high. At the same time, forward returns, as measured by yield-to-worst, were at an all-time low of 1.75%. So, it didn't come as a big surprise to us that corporate bond investors had a rough quarter.

But the real culprit was Treasuries. As the economy showed signs of growth, 10-year Treasury rates doubled, and 30-year rates increased by nearly a full percent. With such a large price impact to Treasuries, all sectors – including corporate bonds – took a hit.

NOLAN: The first quarter of 2021 was a great example of why we embrace an active, flexible approach to fixed income investing. Our portfolios invest in a wide variety of assets, including securitized assets like asset-backed securities as well as an area we have been intently focused on during the past year – corporate collateralized loan obligations, or CLOs. These are typically shorter-duration or floating-rate products, and in the current bond market environment, CLOs have typically offered higher yield than similarly rated corporate bonds. Securitized assets aren't particularly well-represented in indexes because many don't meet the criteria for inclusion. This is why it can be beneficial to have the flexibility to search for opportunities beyond the index.

Our investing approach is to construct portfolios one security at a time, sector by sector, based on what we believe are the best risk/reward opportunities available at the time. We believe that a disciplined approach to balancing risk and return is how active managers can help investors navigate through a rising rate environment.

YOU MENTIONED CLOS. CAN YOU ELABORATE MORE ON YOUR INTEREST IN THIS AREA?

TOM: CLOs are portfolios of senior secured, typically first lien, floating rate bank loans to businesses of all sizes. These portfolios of loans are securitized and sold to investors across senior to junior to equity segments.

The CLO market is divided into two parts: broadly syndicated loans – generally companies with annual cash flow above $75 million – and the middle-market, companies with less than $75 million in annual cash flow.

We're primarily interested in middle-market CLOs. The middle-market and the smaller companies it includes require a granular, rigorous, company-level investing process. This lends itself to our overall investing approach.

Furthermore, the full U.S. middle market is vast – if it were an economy in and of itself, it's estimated that it would be the third largest in the world. The market represents more than 200,000 companies, covers a third of U.S. GDP, and employs roughly 50 million people. While not every inch of the middle market falls within our investible purview, the CLOs in this segment represent an important opportunity set for us.

The CLOs we invest in add three primary benefits for our shareholders. First is diversification. Typically, underlying each CLO is 50 to 100 companies diversified across various industries. Second, we believe they are very well structured from a risk-of-loss standpoint. And third, middle-market CLOs in particular tend to generate higher coupon income than a comparably rated broadly syndicated loan CLO.

STICKING WITH THE FLEXIBILITY ASPECT, WHAT TYPES OF MARKET CONDITIONS WOULD HAVE YOU STEERING AWAY FROM CLOS?

NOLAN: When we think of investing broadly, it all comes down to the idea that price is what you pay and value is what you receive. As active managers, it's our job to be mindful of that and to constantly be on the lookout for the best risk/reward opportunities available to us. And right now, CLOs are exhibiting better spreads than similarly rated corporates. But if we saw valuations shift and CLOs became unfavorable relative to other fixed income sectors, or if our view of the underlying risk within the loans changed significantly, then we would adjust our positioning. This all harkens back to the benefits of being flexible.

FINALLY, WHAT WOULD INCREASED INFLATION MEAN FOR THE FIXED INCOME MARKETS, AND SHOULD INVESTORS TAKE A DEFENSIVE APPROACH?

NOLAN: At Weitz, we often say the best offense is a good defense – so we will continue to focus on downside protection, while assessing the probability of being adequately compensated for any risk exposure in the portfolio. By way of example, currently the entire U.S. Treasury curve has a negative yield after accounting for inflation. Even if you assume inflation doesn't go materially higher from where we are now, we don't think we're getting compensated to take significant interest rate risk at current yield levels. On the other hand, Treasuries provide diversification, liquidity, and downside benefits.

TOM: I'm reminded of a quote by President Reagan, "Inflation is as violent as a mugger, as frightening as an armed robber, and as deadly as a hitman." I sometimes think about inflation like toothpaste – it's hard to put back in the tube once it has been squeezed out.

Lastly, to echo the sentiments of Baupost's Seth Klarman – our job as active managers has always been and will always be to worry top-down on issues like inflation, but to invest bottom-up, one security, one sector at a time.