Managing Risks vs. Managing Returns

TOM CARNEY, CFA
Director of Fixed Income Research & Portfolio Manager

NOLAN ANDERSON
Portfolio Manager & Research Analyst

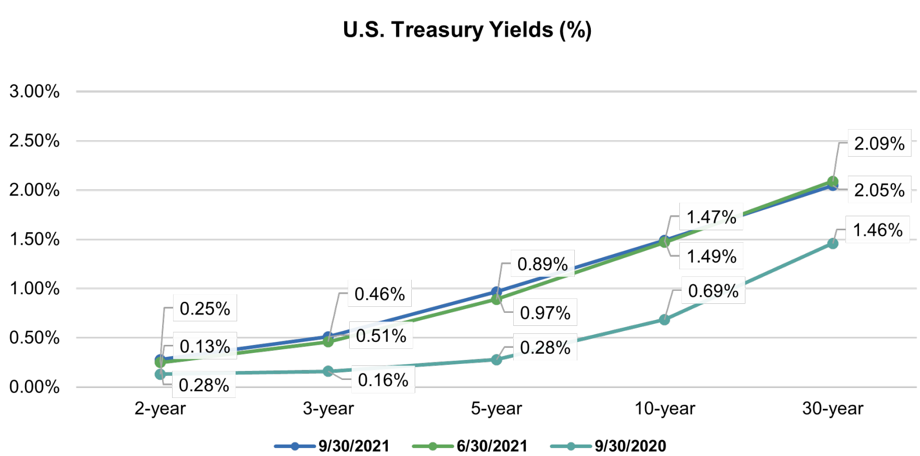
Opportunities in the marketplace are shrinking as credit spreads remain near all-time lows. The Federal Reserve (Fed) is indicating potential changes to its quantitative easing (QE) program. Inflation concerns are growing and could end up *biting* American consumers. Millions remain unemployed, and counterintuitively, the nation faces a labor shortage with many business owners reporting a lack of qualified job applicants. The business landscape is challenged by an escalating global supply chain disruption with the potential to impede an economic recovery. And a developing debt crisis in China could soon be felt around the world. Indeed, it is an interesting time to be a fixed income investor.

Against this backdrop, Weitz taxable fixed-income funds generated modestly positive overall returns as well as good relative results in the third quarter. Security and sector selection along with reasonably defensive duration metrics drove performance. Each fund's quarterly commentary contains additional details about contributors to performance. Also, please see the latest *Value Matters* from Wally and Brad and the portfolio managers' commentaries for detailed analysis of the Weitz equity and conservative allocation funds.

Fixed-Income Market Update

Most bond market segments were little changed in the third quarter as modest (unrealized) price declines offset income returns. Fixed-income indices were generally higher through mid-September as investors rotated to safety amid the rise in cases of the COVID-19 Delta variant in July and August. But in late September, the Fed confirmed that they will likely begin tapering their $120 billion-per-month QE program later this year. That, combined with still-high inflation statistics, weighed on fixed income markets during the final days of the third quarter, erasing most of the quarter-to-date returns for many bond indices. So far, the "taper tantrum" that occurred in 2013 when the Fed last announced a reduction in its monetary life support has not repeated itself to the same degree. More will be known in the coming weeks and months whether history does repeat itself, or if this potential QE reduction proves to be a tantrum-less taper.

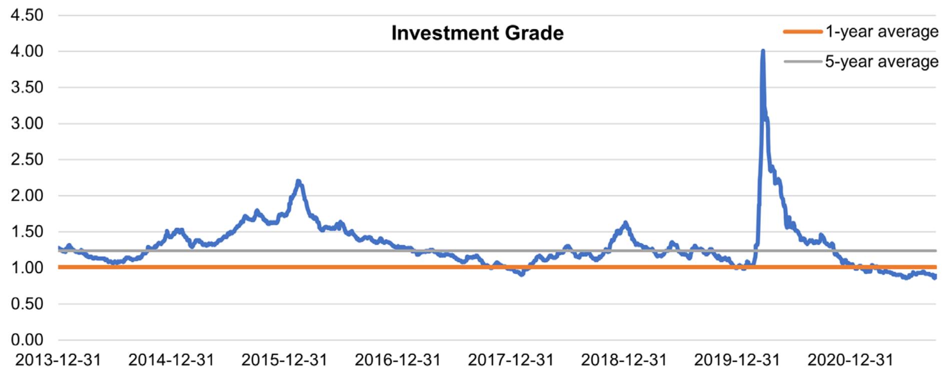
The graph below shows the changes of select Treasury rates over the past quarter and year.



Source: Bloomberg

The Treasury curve was mostly unchanged in the third quarter, with 3- and 5-year Treasury rates rising the most (5 and 8 basis points, respectively) while the 30-year Treasury rate declined 4 basis points. The result was a modest flattening of the curve, with the difference between 2- and 30-year Treasury rates declining to 177 basis points on September 30, 2021, from 184 on June 30, 2021.

Spreads on corporate bonds changed little in the quarter. A broad measure of investment-grade corporate bond spreads, compiled by ICE BofA, increased to 89 basis points on September 30, 2021, from 86 basis points on June 30, 2021. The chart below depicts the path of investment-grade credit spreads for the past five years (blue line) against the 1- (orange) and 5-year (gray) averages.



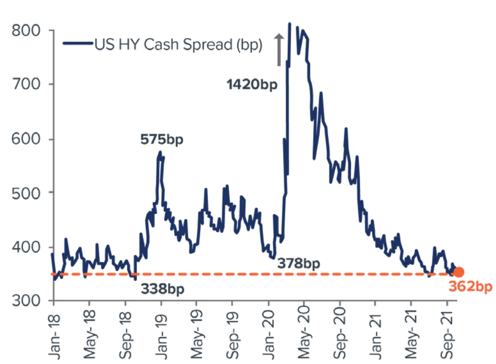
Source: Federal Reserve Economic Data (FRED) – St. Louis Fed

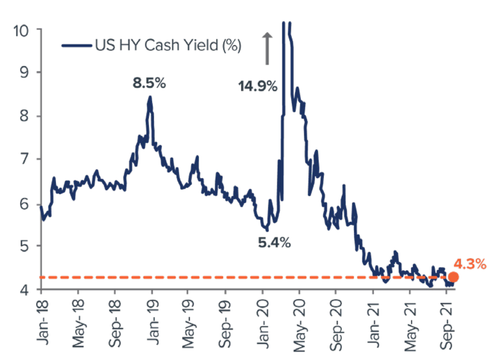
Overall, investment-grade corporate bond spreads remain below their 1- and 5-year averages. The charts below, from Credit Suisse, provide more perspective on the declining investment opportunity set for fixed-income investors. Credit spreads and overall nominal returns in both investment-grade and high-yield remain at, or near, all-time lows. It's certainly not a target rich environment for forward returns.

Investment-Grade (IG)

Source: Credit Suisse

High-Yield (HY)





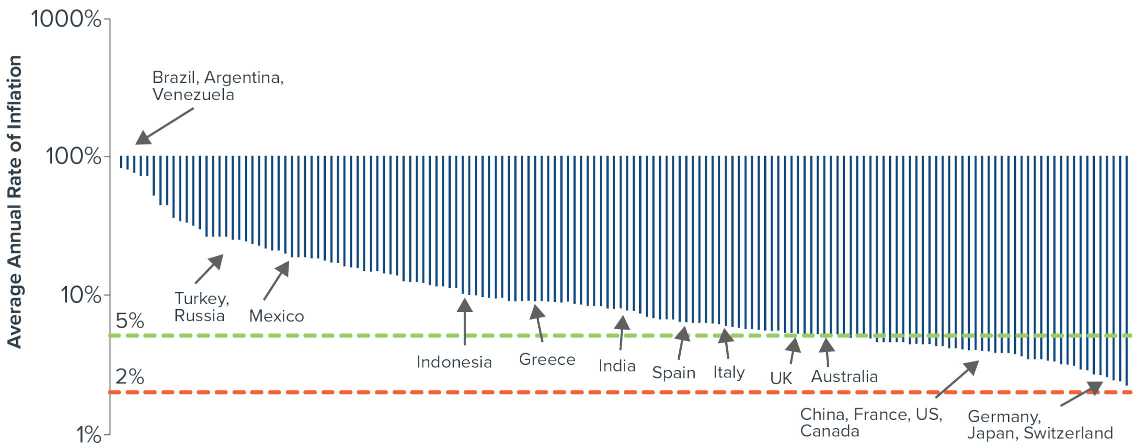
Source: Credit Suisse

Inflation

For the past decade, inflation could be described as the dog that didn't bite (i.e., rarely rising much above the Fed's long-term 2% target). That dog (inflation) seems to have grown teeth with the Consumer Price Index (CPI) having persisted above 5% on an annualized basis for nearly half of 2021. Oil prices at seven-year highs and rising food and lodging costs are eating into Americans' disposable incomes – especially those at the lower end of the economic ladder.

The chart below provides a history lesson on inflation. It represents 50 years of data on 152 economies going back to August 1971 when the U.S. decided to scrap the Bretton Woods Agreement – a multi-national monetary management system that tied the value of currencies to a commodity (namely gold). The end of the agreement led to the introduction of 'fiat' currencies that are not supported by a commodity but rather have value based solely on the support of the government that issues them.

Average Annual Inflation Since 1971 for 152 economies



Source: Ha, Jongrim, M. Ayhan Kose, and Franziska Ohnsorge (2021). "One-Stop Source: A Global Database of Inflation." Policy Research Working Paper 9737. World Bank, Washington DC., Deutsche Bank

As the above chart depicts, no economy saw annual inflation average below 2% during the past 50 years. In the U.S., the inflation experience was 3.9% per year during this time span. And while the last decade has witnessed relatively low inflation for the most part, fiat money has been highly inflationary in aggregate through history. The Fed may need to do more than talk about inflation being 'transitory' to keep today's inflation 'dog' from further biting American consumers and the economy.

Other challenges – employment, supply chains, and bears in the China shop

Despite job openings at record highs (11 million as of July), recent results from the National Federation of Independent Business (NFIB), which has been conducting a monthly survey of small business owners since 1974, were disconcerting. A 48-year record high – 50% – reported job openings that could not be filled. Of those owners hiring or trying to hire, 91% reported there were few or no qualified applicants. A record high 29% reporting no – zero – qualified applicants. All this despite a record high 41% reporting that they had increased compensation. As a result, another record high – 28% – identified labor quality as their top business problem. Quite a conundrum considering there are approximately 8 million people still unemployed.

Stories continue to mount of supply chain challenges. Rising demand, continued concerns and responses to COVID, and residual trade disputes have led to shortages in essential ingredients to the overall economy -- from semiconductors, new cars, chicken wings, toilet paper, paper towels and more. Record numbers of shipping vessels off the west coast await the opportunity to unload their cargo. This has led to a joint open letter by the International Chamber of Shipping, whose industries account for more than $20 trillion of world trade annually and represent 65 million transport workers, calling on world leaders to secure global supply chains.

Finally, a regulatory crackdown in China has wiped trillions of market value from its markets, while property developer Evergrande, one of the world's biggest high-yield debt issuers, is on the brink of default. Evergrande, with total debt of approximately $300 billion, failed to make an interest payment at the end of September – but have 30 days to cure the payment default. Given China's property sector represents about a quarter of the country's GDP (versus an average of 15-18% in the U.S.) and comprises the single largest category of total household assets (60%), a lot appears at stake for China with the possibility that trouble gets exported beyond its borders.

"The essence of investment management is the management of risks, not the management of returns".

— Benjamin Graham

As long as the Federal Reserve continues to influence markets via its twin-barreled monetary bazooka of zero interest rate policy (ZIRP) and QE, coupled with the myriad of issues above, Ben Graham's quote seems to particularly apply – especially in an environment with seemingly high levels of complacency. The successful management of risks (e.g., credit, interest-rate, liquidity) is arguably key in generating future returns.

We believe the flexible mandates of our fixed income funds will continue to allow us to navigate challenging environments by enabling us to identify the most favorable investment opportunities at any given time, wherever we can find them. With credit spreads, particularly investment grade, that are at or near 10-year lows and low overall forward return prospects, we continue to believe it prudent to remain defensive, especially with respect to interest rate risk (i.e., maintain lower than index duration).

Our overarching investment goals are to preserve capital, maintain a strong liquidity position, understand evolving risks and opportunities, conduct consistent/thorough credit surveillance, and selectively take advantage of favorable risk/reward opportunities.

Disclosures:

The opinions expressed are those of Weitz Investment Management and are not meant as investment advice or to predict or project the future performance of any investment product. The opinions are current through 10/19/2021, are subject to change at any time based on market and other current conditions, and no forecasts can be guaranteed. This commentary is being provided as a general source of information and is not intended as a recommendation to purchase, sell, or hold any specific security or to engage in any investment strategy. Investment decisions should always be made based on an investor's specific objectives, financial needs, risk tolerance and time horizon.

Portfolio composition is subject to change at any time. Current and future portfolio holdings are subject to risk.

Definitions: Investment-Grade Bonds are 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. This and other important information is contained in the prospectus and summary prospectus, which may be obtained at weitzinvestments.com.

Weitz Securities, Inc. is the distributor of the Weitz Funds.