

Fixed Income Investment Philosophy

The Confluence fixed income strategy utilizes fixed income Exchange Traded Funds (ETFs) to deliver the income and lower volatility traditionally available from a diversified bond portfolio. Shares of fixed income ETFs are not bonds, but are pro-rata interests in publicly traded bond funds. The number of ETFs focused on the fixed income market has grown substantially over the past decade, allowing Confluence the experience to construct fixed income ETF portfolios that have characteristics similar to a traditional bond ladder or mirror a diversified bond index like the BofA Merrill Lynch U.S. Corporate, Government & Mortgage Index. By investing in certain ETFs we have the ability to shorten or lengthen the combined average maturity, and we can also adjust the exposure to corporate, government agency and U.S. Treasury sectors depending on our viewpoints regarding Fed policy, the shape of the yield curve, relative yields, credit spreads, default rates and other market factors.

Our focus is on fixed income ETFs following investment grade benchmarks with a domestic orientation. We continually monitor the allocations, rebalancing at least annually, but may elect to rebalance over shorter time frames at our discretion. Confluence offers its fixed income strategy as a stand-alone portfolio, and also in balanced accounts combined with equity portfolios.

Benefits Relative to Traditional Fixed Income Portfolios

In the fixed income markets, bigger tends to be better. This rule generally holds true because larger blocks of bonds tend to have better liquidity and pricing relative to smaller block transactions. Oftentimes, a smaller trade is penalized as an odd lot, in which traders incorporate extra costs into purchases and sales to accommodate these smaller transactions. Over time, these additional costs may substantially weigh on returns, particularly for investors making frequent deposits and withdrawals.

These size requirements pose challenges to investors using individual bonds. On the one hand, position sizes need to be large enough to maintain liquidity; on the other, proper diversification requires many positions, with varying maturities and sector exposures. So unless an account is very large, the tradeoff between liquidity and diversification might need to be weighed, creating a less than optimal portfolio. Commingled securities, like mutual funds, are one way to help address these issues. Unfortunately, there are often a number of drawbacks to the commingled approach, including tax inefficiencies, a lack of transparency and less precision with regard to maturities and sector exposures.

As an alternative, Confluence offers a portfolio of fixed income exchange traded funds. We believe these securities help address the need for liquidity, diversification and transparency, while avoiding some of the limitations of mutual funds.

A relatively newer fixed income ETF structure, the maturity date ETF, has recently become more available. In this structure, the fixed income ETF has a finite life, one that is completed by returning capital back to shareholders on a specific date through a final cash distribution. This structure replicates the cash flow pattern of an individual bond, because the ETF “matures” by distributing all of its cash. The following table summarizes differences between the various fixed income securities.

Fixed Income Security Comparison

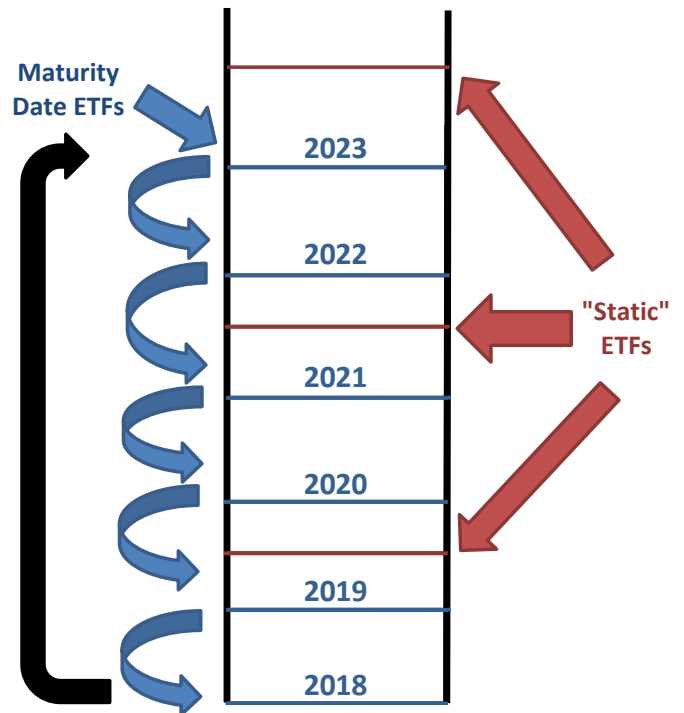
	Maturity	Diversification	Transparency	Liquidity
Individual Bonds	Yes	Low	High	Poor
Mutual Funds	No	High	Low	Good
Fixed Income ETFs	No	High	High	Good
Maturity Date ETFs	Replicated	High	High	Good

Of course, investors should be aware there are limitations in utilizing fixed income ETFs, too. There may be times when an ETF’s performance may vary relative to its targeted benchmark. And while ETFs generally trade very close to their net asset values, during times of market disruption they can trade at discounts or premiums, directly affecting performance. Liquidity is generally good, but can vary depending upon market conditions.

We utilize maturity date ETFs to construct a “bond ladder,” one that is similar to those often utilized by investors who invest in individual bonds. Over time, the allocations “roll down the ladder” (illustrated in blue) as the portfolio progresses toward the maturity dates. We may decide to hold the ETF to its maturity date, or rebalance the position into a new “rung,” depending upon our market views.

There are several maturity date ETFs in the 1-10 year range, and the portfolio is positioned to utilize a variety of them to create a diversified exposure, one that targets particular maturities as well as different industries of the bond market.

We complement the maturity date ETFs with traditional fixed income ETFs (illustrated in red), which have a more “static” maturity profile. These ETFs allow for more precise exposures to sectors of the bond market, including corporates, mortgages, commercial mortgage backed securities (CMBS) and Treasuries. In addition, these ETFs can be efficiently adjusted, allowing for portfolio changes that don’t necessarily disturb the maturity date ETF ladder.



The combination of maturity date ETFs and traditional “static” fixed income ETFs forms a portfolio with many of the familiar characteristics of an individual bond ladder, while avoiding some of the related illiquidity and non-diversification issues. At the same time, the sector exposures and maturity profile can be efficiently managed, all in a highly transparent portfolio.

Current Viewpoints

Our experience investing in the financial markets spans across several decades, including time frames when interest rates were multiples of what they are today. Interest rates were much higher during the late '70s and early '80s. As illustrated on the chart, the 10-year Treasury yield was often above 10%. We'll take a look at what caused that interest rate environment and why we think it's worth revisiting today.

We've often referenced the equality/efficiency cycle in our work and in this report we'll review how it affects inflation, which is of paramount importance to bond investors. High inflation is not a friend to lenders as the dollars repaid are worth less than the dollars lent. So, as inflation rises, so too do interest rates as lenders demand higher returns to compensate for the risk.

Why was inflation in the late '70s so high? We believe it was in part the result of a multi-decade period of economic equality. During periods of equality, high levels of regulation result in stability, while innovation and global trade are low. In this part of the cycle, the economy is less open with more of a domestic focus. Inflation tends to rise during the equality cycle, particularly when supply cannot efficiently adjust to growing demand. The oil embargos of the 1970s are good examples of this phenomenon. Not only did they contribute to inflation, but they also harmed economic growth. The inflation and low growth of the '70s fostered sentiment that ushered in a change in the cycle from equality to efficiency. As noted on the chart, during the late '80s the economy was shifting from a period of equality (in yellow) to one of efficiency (in blue).



During this efficiency phase (in blue), many industries were deregulated, opening the door to competition and innovation. Telecom, transportation and the financial services industries were able to adjust prices to market rates as opposed to regulated ones. Efficient, innovative companies displaced the inefficient. Global trade rapidly increased, creating new means of supply, and technology gained prominence from living rooms to board rooms.

The all-important consumer was a big winner during this time frame as new products and declining inflation increased the utility of spending. Lower inflation also greatly benefited the owners of capital, also known as stock and bond investors, while the losers were the suppliers of labor, especially workers who struggled to operate in a highly technological, globalized environment. The efficiency cycle remained in place for several decades, pushing forward as most people in society benefited, including political leaders.

However, after the great recession of 2008, conditions began to change. The stock and bond markets resumed their upward path, supported by accommodative monetary policy, even as economic growth was far below average. The recovery in housing didn't benefit those who had lost their homes, labor participation was low and wage growth was anemic. As our country worked through these doldrums, a growing number of people began to question policies supporting efficiency. Establishment political leaders failed to develop policies to support those who struggled during the efficiency cycle and consequently voters moved to give control to new leaders, most notably Donald Trump. His policies, along with many non-establishment politicians, embrace equality more than efficiency. We don't know how far these policies may go, but we believe new trade policies are likely to foster inflation.

This isn't to say that we expect inflation or regulation to reach the levels seen in the 1970s. We can see from the equality/efficiency chart that it takes a very long time for trends to develop. Still, if we are entering a period of growing equality, interest rates are likely to move higher. For this reason, we are trimming some of the exposure to longer maturities in the Fixed Income portfolio. We are also continuing to deploy target-dated bond ETFs that mimic a bond ladder, which should be an appropriate policy in an environment of steadily rising rates. At the same time, the nature of the long cycle indicates that our focus on intermediate maturities is still appropriate, even as we move the average portfolio maturity a bit shorter than the broad market benchmark.

Illustrative Portfolio Construction

<i>Selected Positions from Fixed Income ETF Portfolio</i> ⁽¹⁾ As of December 2016			
Name	ETF Average Maturity	ETF Portfolio Yield to Maturity	ETF Number of Holdings
MATURITY DATE ETFs			
iShares iBonds Corporate ex-Financials Bond ETF 2023	5.7	3.0%	180
Guggenheim BulletShares Corporate Bond ETF 2024	7.8	3.6%	201
iShares iBonds Corporate ex-Financials Bond ETF 2018	0.9	1.4%	202
iShares iBonds Corporate Bond ETF 2023	5.7	3.2%	276
iShares iBonds Corporate ex-Financials Bond ETF 2020	2.8	2.2%	220
Guggenheim BulletShares Corporate Bond ETF 2018	1.7	1.8%	373
TRADITIONAL FIXED INCOME ETFs			
iShares 7-10 Year Treasury Bond ETF	8.3	2.5%	14
iShares MBS ETF	6.6	2.9%	357
SPDR Bloomberg Barclays Intermediate Term Corporate Bond ETF	5.0	3.0%	3,495
iShares 20+ Year Treasury Bond ETF	26.2	3.1%	34
iShares Intermediate Credit Bond ETF	4.2	2.8%	3,678
Vanguard Intermediate Term Corporate Bond ETF	7.5	3.5%	1,806
Weighted Average ETF Yield to Maturity	2.7%		
Weighted Average ETF Maturity	6.4 years		
Number of Portfolio Positions	16		

⁽¹⁾The illustration of maturity date ETFs and static traditional fixed income ETFs is not a complete list of ETFs in the portfolio or which Confluence may be currently recommending. Furthermore, application of the investment strategy as of a later date will likely result in changes to the listing. The illustrative portfolio attributes do not represent actual trading as actual investment results may vary from the illustration due to inherent limitations in ETF securities that do not perfectly replicate a selected fixed income asset class. Fixed income allocations in client accounts may vary based on individual client considerations and market fluctuations. The allocation of assets in the illustrative portfolio may be changed from time to time due to market conditions and other factors. The investments held by the portfolios are not guaranteed and do carry a risk of loss of principal. Each asset class has specific risks associated with it and no specific asset class can prevent a loss of capital in market downturns.

The above ETFs are utilized in creating a separately managed account (SMA) portfolio. There are investment risks in investing in this strategy, including credit and interest risks. Besides Confluence fees for investment management, clients may be charged brokerage commissions, transaction fees, and other related costs and expenses. Clients may incur certain charges imposed by custodians, brokers, third party investment and other third parties such as fees charged by managers, custodial fees, deferred sales charges, odd-lot differentials, transfer taxes, wire transfer and electronic fund fees, and other fees and taxes on brokerage accounts and securities transactions. Mutual funds and exchange traded funds also charge internal management fees, which are disclosed in a fund's prospectus.

About Confluence Investment Management LLC

Confluence Investment Management LLC is an independent, SEC Registered Investment Adviser located in St. Louis, Missouri. Confluence provides professional portfolio management and advisory services to institutional and individual clients. Our portfolio management philosophy begins by addressing risk, and follows through by positioning clients to achieve income and growth objectives.