Confluence
INVESTMENT MANAGEMENT

Fixed Income Strategy
September 2016

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.

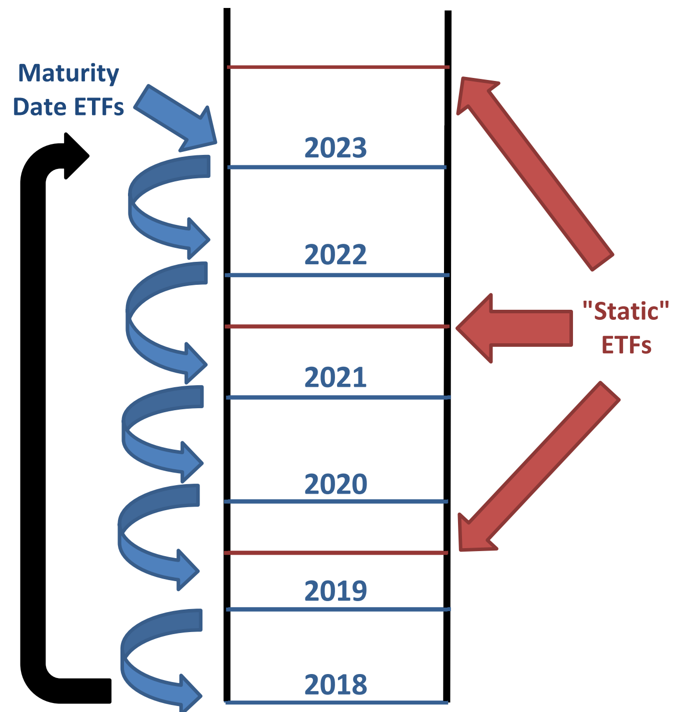
A relatively newer fixed income ETF structure, the maturity date ETF, has recently become more available. In this structure, the fixed income ETF has a finite life, one that is completed by returning capital back to shareholders on a specific date through a final cash distribution. This structure replicates 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.

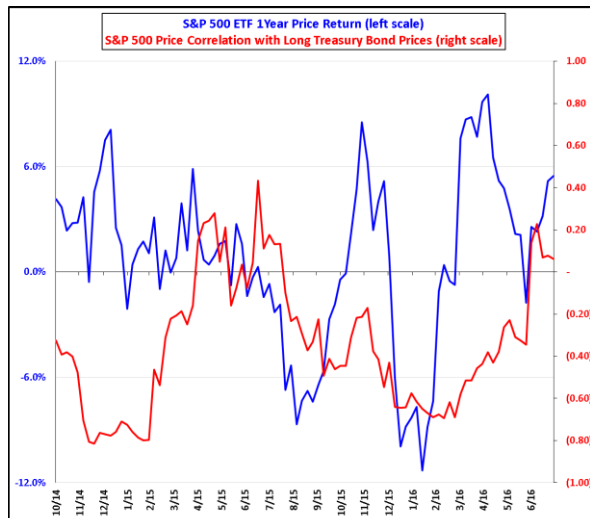
We complement the maturity date ETFs with traditional fixed income ETFs (illustrated in red), which have a more "static" maturity profile. These ETFs allow for more precise exposures to sectors of the bond market, including corporates, mortgages, commercial mortgage backed securities (CMBS) and Treasuries. 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

For several years, bond investors have had to deal with low and declining interest rates. With each successive new low in bond yields, investors have questioned whether the utility of owning bonds is worth the risk. While it is true that income from bonds is one of the most important considerations among bond investors, there is another aspect that is often forgotten or overlooked: diversification. In recent quarters, bonds have provided significant diversification—among the most of all asset classes—by performing in an opposite direction relative to stocks. By doing so, investors holding both bonds and stocks have traveled through periods of high volatility with relative calm.

In this chart, we compare the 12-month rolling price returns of the S&P 500 (in blue), with the correlation between the S&P 500 and long Treasury bond prices (in red). Over the past two years, the S&P rolling returns have experienced meaningful swings. This chart shows how the correlation with bonds declined during periods of falling equity returns. That is to say, when the S&P 500 declined, bonds oftentimes did the opposite. In statistical parlance, this is called a negative correlation. When managing a portfolio, combining asset classes with negative correlations is often very useful in addressing overall risk.

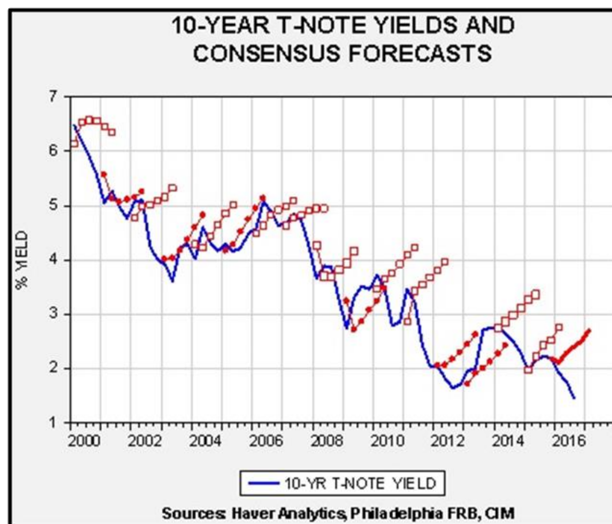


Data source: Bloomberg. S&P 500 price returns derived from the iShares Core S&P 500 ETF (IVV). Correlation between the S&P 500 and Long Treasury Bond price returns are calculated by comparing IVV with the iShares 20+ Year Treasury Bond ETF (TLT).

Many asset classes have correlations that tend to rise during times of market stress. This can be a bit like learning your flood insurance policy isn't valid when it rains. But longer maturity bonds have often zigged when equities zagged, providing diversification and lower volatility for investors holding both. For this reason, we continue to include longer maturity exposure in our fixed income portfolio.

A common view among bond investors is that with rates as low as they are, there is really only one way to go, and that is up. This thesis has actually been around for quite some time…and it has been wrong! In this bottom chart we see the yield on the 10-year Treasury note since 2000. Each year, we can see the consensus forecast for where professional economists expect the 10-year yield to go, represented by the red points. The filled red circles show when the consensus was correct, the open red squares show when the consensus was wrong and the solid red line for 2016 shows the current forecast.

A couple items are noteworthy. First, this professional consensus tends to be wrong (10 times) more often than correct (six times). Second, most of the time the consensus expects rates to rise (it is actually this latter point that has made the consensus wrong so often). So why is it that the pros are wrong so often? We believe it is because inflation has persistently declined and fallen faster than expected. Global trade, deregulation and technology have improved productive capacity during a time frame of declining global growth.



So, our view is that although rates are historically low, so too are inflation and growth. Until these conditions change, low rates may be quite appropriate. However, we continuously monitor the landscape for changing conditions. What could cause inflation to return? Forces against global trade, like protectionism, are definitely on the list. Also included are rising regulations that prevent technological innovation, currency wars and dramatic changes in fiscal policies around the world. Currently, we believe inflation is likely to remain low and we believe a variety of maturities is appropriate in bond portfolios. We will revisit this posture if conditions change.

Illustrative Portfolio Construction

Selected Positions from Fixed Income ETF Portfolio [(1)] *As of September 2016*			
Name	**ETF Average Maturity**	**ETF Portfolio Yield to Maturity**	**ETF Number of Holdings**
MATURITY DATE ETFs			
iShares iBonds Invest Grade Corp Bond ETF 2023 (ex-Financials)	5.9	2.2%	172
iShares iBonds Invest Grade Corp Bond ETF 2018	1.1	1.2%	195
iShares iBonds Corporate Bond ETF 2023	5.9	2.5%	274
iShares iBonds Invest Grade Corp Bond ETF 2020 (ex-Financials)	3.0	1.6%	207
Guggenheim BulletShares Invest Grade Corp Bond ETF 2018	1.9	1.5%	365
Guggenheim BulletShares Invest Grade Corp Bond ETF 2019	2.9	1.7%	320
TRADITIONAL FIXED INCOME ETFs			
iShares 7-10 Year Treasury Bond ETF	8.5	1.6%	13
iShares 20+ Year Treasury Bond ETF	26.5	2.3%	33
SPDR Barclays Intermediate Term Invest Grade Corp Bond ETF	5.0	2.3%	3,401
iShares MBS Bond ETF	4.3	1.9%	366
iShares Intermediate Invest Grade Corp Bond ETF	4.8	2.1%	3,629
iShares Treasury 3-7 Year Treasury Bond ETF	4.8	1.2%	70
Weighted Average ETF Yield to Maturity	1.9%		
Weighted Average ETF Maturity	7.8 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.