Confluence
INVESTMENT MANAGEMENT

Fixed Income Strategy
September 2017

Fixed Income Investment Philosophy

The Confluence fixed income strategy utilizes fixed income Exchange Traded Funds (ETFs) to deliver the income 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 for trading. 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.

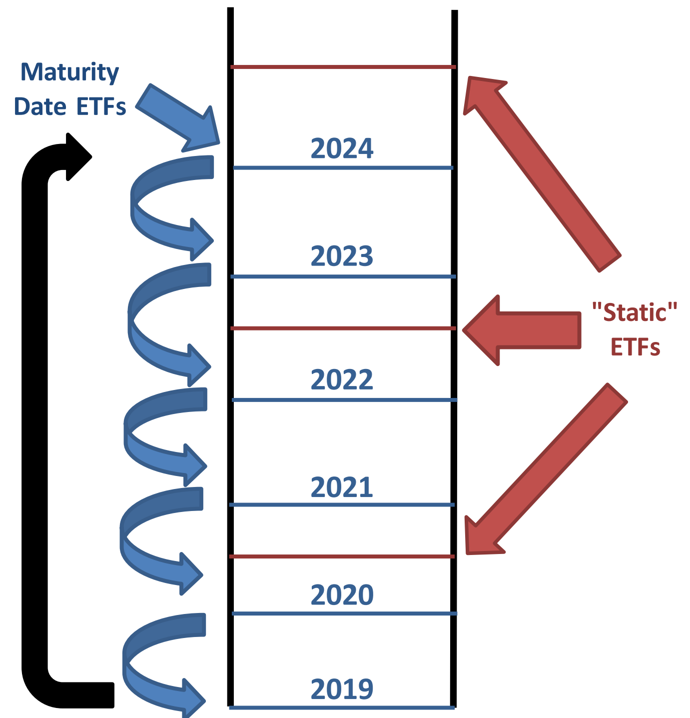
A relatively newer fixed income ETF structure, the maturity date ETF, has recently become more available. In this structure, the fixed income ETF has a finite life, one that is completed by returning capital back to shareholders on a specific date through a final cash distribution. This structure replicates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



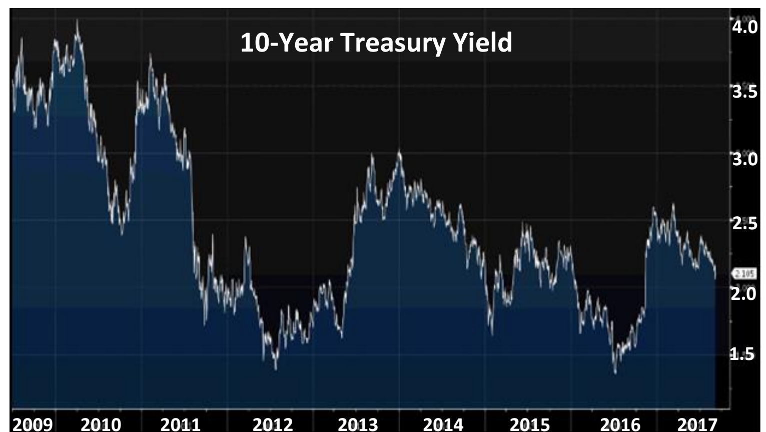
There are several maturity date ETFs in the 1-10 year range, and the portfolio is positioned to utilize a variety of them to create a diversified exposure, one that targets particular maturities as well as different industries of the bond market.

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 bond investors, the time frame following the Great Recession has been not just unusual, but also somewhat confusing. It's been unusual because economic growth rates typically rise to high levels after a recession, reflecting progress as the economy recovers. However, since 2009, growth remained below average, along with inflation and interest rates. This chart shows how the yield of the 10-year U.S. Treasury Note actually declined after the recession. Normally, we would expect high growth, rising inflation and higher interest rates.

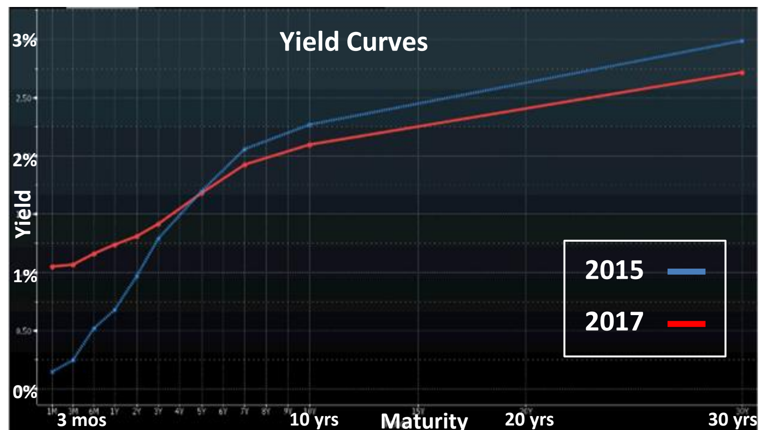


Source: Bloomberg

What was the cause of this environment? We believe it's a combination of factors. On the growth side, widespread consumer deleveraging in the U.S. weighed on consumption. The resulting low growth combined with excess global capacity kept inflation very low. Low inflation, along with massive amounts of capital injected by central banks around world, fostered an environment in which interest rates could remain low.

Of course these circumstances have created a fair amount of confusion for bond investors who saw historically low rates and believed rates could only move higher. This belief became particularly widespread when the Federal Reserve began raising rates in December 2015. Initially, bond investors backed away from longer maturities, following the age-old mantra, "Don't Fight the Fed." But, as the Fed applied its tighter policy very gradually, and as inflation remained low, interest rates stabilized without a strong bias to spike upward.

On our second chart we share what is called a yield curve, which shows yields for U.S. Treasuries across maturities, ranging from three months to 30 years. The blue line is the yield curve from December 2015, when the Fed first began raising short-term rates, and the red line is the yield curve from September 2017. We can see that three-month yields have followed Fed policy and moved higher by almost 1%. At the same time, intermediate rates are largely unchanged, while 10- and 30-year yields have actually declined! This "flat" yield curve is indicating the expectation that growth and inflation are likely to remain low.



Source: Bloomberg

We, too, expect inflation and growth to remain relatively low, but at the same time don't foresee a recession on the near horizon. Accordingly, we apply certain principles to the portfolio. The first incorporates a significant allocation to investment grade corporate bonds. This exposure provides incremental yields relative to Treasuries that we believe offer good value. Our expectation is for low inflation and relatively stable economic conditions to foster a fairly benign default environment, making our overweight allocation to corporate credit appropriate. We also include a range of maturities in the portfolio. This strategy allows us to utilize shortening "rungs" from our maturity series ETF "ladders," which can be reinvested as short-term interest rates rise. At the same time, the longer maturity exposure allows us to include higher yields associated with longer maturities.

One other very important aspect of the fixed income portfolio is the inclusion of long-maturity Treasury bonds. We have observed a negative correlation between long-maturity Treasuries and stocks during times of market dislocation, which indicates that long-maturity Treasuries may increase in price at times when the stock market declines. This phenomenon may not always take place; however, we find its frequency high enough to merit the allocation, particularly in balanced accounts where investors have exposure to both equities and bonds.

Illustrative Portfolio Construction

Selected Positions from Fixed Income ETF Portfolio [1] As of September 2017			
Name	**ETF Average Maturity**	**ETF Portfolio Yield to Maturity**	**ETF Number of Holdings**
MATURITY DATE ETFs			
Guggenheim BulletShares Corporate Bond ETF 2019	1.7	1.8%	379
iShares iBonds Corporate ex-Financials Bond ETF 2020	2.0	1.8%	225
Guggenheim BulletShares Invest Grade Corp. Bond ETF 2021	3.7	2.4%	368
Guggenheim BulletShares Invest Grade Corp. Bond ETF 2022	4.7	2.6%	333
iShares iBonds Corporate Bond ETF 2023	4.9	2.7%	284
Guggenheim BulletShares Invest Grade Corp. Bond ETF 2024	6.7	3.1%	214
TRADITIONAL FIXED INCOME ETFs			
iShares MBS Bond ETF	4.8	2.7%	465
iShares Intermediate Term Corporate Bond ETF	4.8	2.8%	3,574
SPDR Bloomberg Barclays Intermediate Term Corporate Bond ETF	5.1	2.9%	3,448
iShares 7-10 Year Treasury Bond ETF	8.5	2.2%	18
iShares Barclays 20+ Year Treasury Bond ETF	26.6	2.8%	34
Weighted Average ETF Yield to Maturity	2.6%		
Weighted Average ETF Maturity	7.3 years		
Number of Portfolio Positions	15		

[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. 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.