

THE "PLUS" AT OUR CORE

September 30, 2020

In an effort to mitigate the disastrous effect of shutting down the U.S. economy to slow the spread of COVID-19, the Federal Reserve Board (FRB) significantly increased its presence in the U.S. bond market. With its tentacles reaching into the bulk of the largest and most liquid sectors of the investment grade space, its effects are felt **almost** everywhere. Alongside the 10-Year Treasury yield at 0.66% and high-grade corporate bond spreads quickly returning to their cyclical nadir, it would seem all the value has been squeezed out of the U.S. investment grade space, yet the traditional risks associated with bond investing are still present. Besides seemingly limited upside and all the risk, why would anyone still find the need to allocate assets to actively managed Core Fixed Income?

We believe now may be one of the best times to allocate assets to an active, meaningfully contrarian approach to domestic U.S. Core fixed income portfolio management. We intentionally bolded and italicized the word "almost" in the paragraph above because, while the FRB can have a dramatic effect on the pricing of risk in large swaths of the bond market, it runs into the same problem all large asset managers do—its size. The FRB is now one of the largest buyers of domestic credit, which puts downward pressure on yields that's felt primarily in the largest sectors/issuers in the market. Because of the size of its purchases, like all large bond buyers, the FRB must concentrate its buying in the Treasury, Corporate and Mortgage-Backed Securities (MBS) sectors. It's no coincidence that these are, by far, the largest sectors within the market and they collectively make up over 90% of the Bloomberg Barclays Aggregate index! ***We believe investing in what the Fed can't own better preserves the traditionally low correlation core bonds have had versus a client's riskier allocation silos, and provides exposure to fixed income assets that seem to have the highest potential return for the amount of risk accepted.***

The word "Plus" has traditionally described the ownership of bonds that are not represented, or are underrepresented, in a broad market index. Inclusion in an index tends to concentrate investor demand in the largest issuers that are found in popular benchmarks like the Bloomberg Barclays Aggregate index. Unlike the stock market, however, the bond market is a collection of non-standardized, idiosyncratic markets of oftentimes inefficiently priced securities. ***We feel investment in smaller, high-quality, niche areas of the bond market where one can avoid directly competing against the FRB and the market's largest asset gatherers can support a sustainable competitive advantage.*** At WEDGE Capital Management, we believe our relatively small size is a significant advantage in that it allows us to more meaningfully invest client assets in small, niche areas of the investment grade space that the FRB and large investors have difficulty trafficking in. By doing this, we think it's possible to find high-quality issues at spread levels ***greater*** than their more popular, and in some cases, lower-rated peers. ***This is our Core "Plus" and for us "Plus" doesn't have to mean taking more risk!***

In addition to the duration of the bond market being near a record high, and the majority of the Treasury market trading at sub-1% yields, 17% of all Baa/Baa3-rated bonds are on rating agency negative outlook. With the default rate expected to peak at around 12.5% by March 2021 (higher than the 12% default rate witnessed at the peak in the Great Recession) consideration should be given to how one can best manage these risks. Is it time for clients to seek a more contrarian approach to their Core Fixed Income allocation?

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