Innealta
CAPITAL

COMMENTARY: FEBRUARY 3, 2015

FIXED INCOME IN 2014

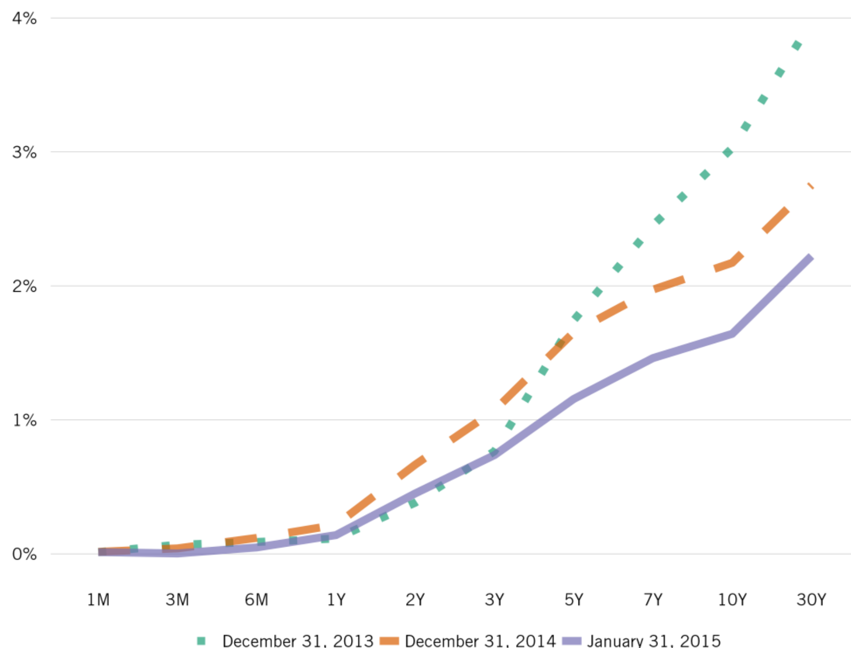
Following up on our commentary last month, in which we detailed the significant pressures faced by the Fixed Income Portfolio during the final months of 2014, we wanted this month to expand the review to include the whole year, emphasizing both those decisions that positively contributed to portfolio return and those that did not, all in the context of the drivers of total return for the benchmark.

As we noted last month, the Investment Committee expected yields on U.S. Treasury bonds to prove rather narrowly range-bound in 2014. On the contrary, of substantial impact through the year was the progressive downtrend in interest rates in the U.S. As we show in Figure 1, the yield curve flattened substantially last year and even further in 2015. From a medium-term peak of 3.97% on 12.31.13, the 30-year bond yield closed out January at a record low 2.22%. And the 10-year Treasury, which also saw a medium-term peak of 3.03% at the end of 2013, finished last month at 1.64%.

FIGURE 1

U.S. Yield Curve

SOURCE: Innealta Capital using data from Bloomberg



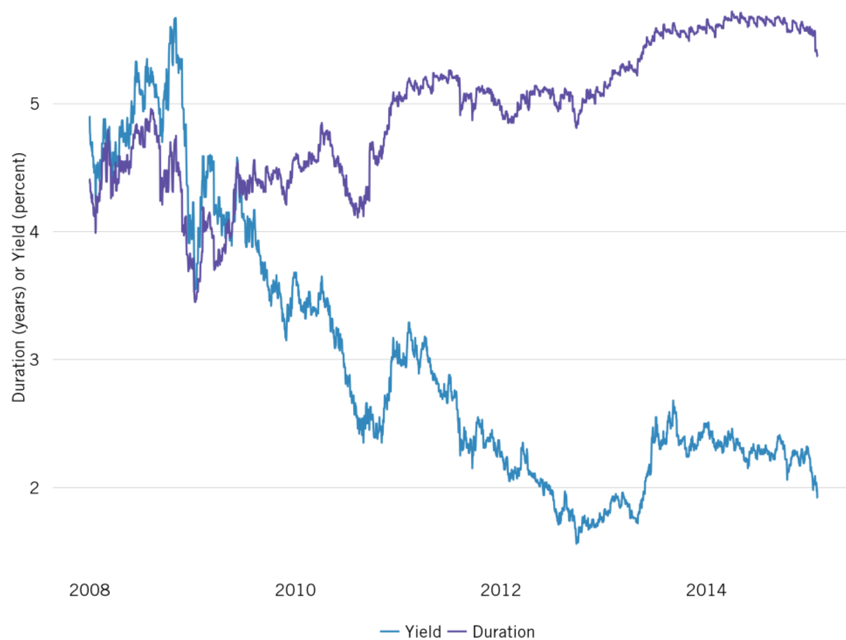
There are obvious reasons—in hindsight, anyway—for investors to have flocked to the long bonds in the U.S. First came Putin's march on Crimea, an initial volley in a battle with Ukraine that continues to this day and seems, once again, to be intensifying. The threats presented and confirmed by ISIS and ongoing instability in the Middle East also weakened appetites for risk in most places outside of U.S. equities. Meantime, global macroeconomic growth trends seem to have added further pressure to interest rates. And the yearend brought a commodity rout, global currency volatility, renewed uncertainty in regard to central bank policy motivations and expectations, and a dramatic shift in Eurozone stability.

Core to the positioning of the Fixed Income Portfolio in 2014 was the Committee's belief that many domestic exposures—Treasuries in particular—had become unattractive from a valuation standpoint. To show at a very high level what we mean, we chart the post-Great Recession trend in yield and duration for the Portfolio's benchmark, the Barclays Capital U.S. Aggregate (BarCap Agg) in Figure 2.

FIGURE 2

Barclays Capital U.S. Aggregate Yield and Duration

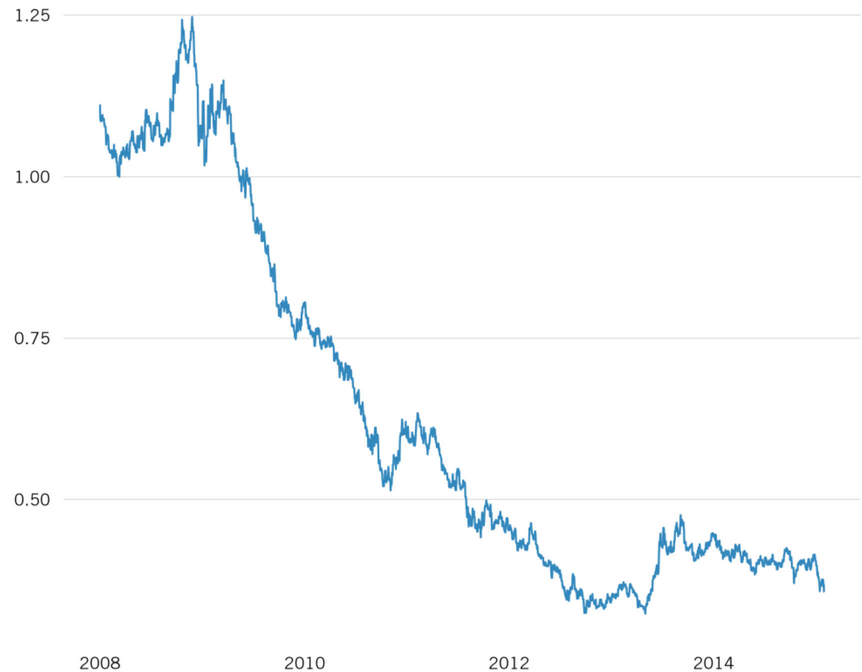
From 12.31.07 to 01.31.15.
SOURCE: Innealta Capital using data from Bloomberg



Combining those two series, we show the ratio of yield and duration for the benchmark in Figure 3. A bit of the “meat” of the positioning thesis, the cost in terms of duration for incremental yield in a large swath of the U.S. fixed income space had grown uncomfortably dear.

FIGURE 3

Barclays Capital U.S. Yield per Unit of Duration



From 12.31.07 to 01.31.15.
SOURCE: Innealta Capital using data from Bloomberg

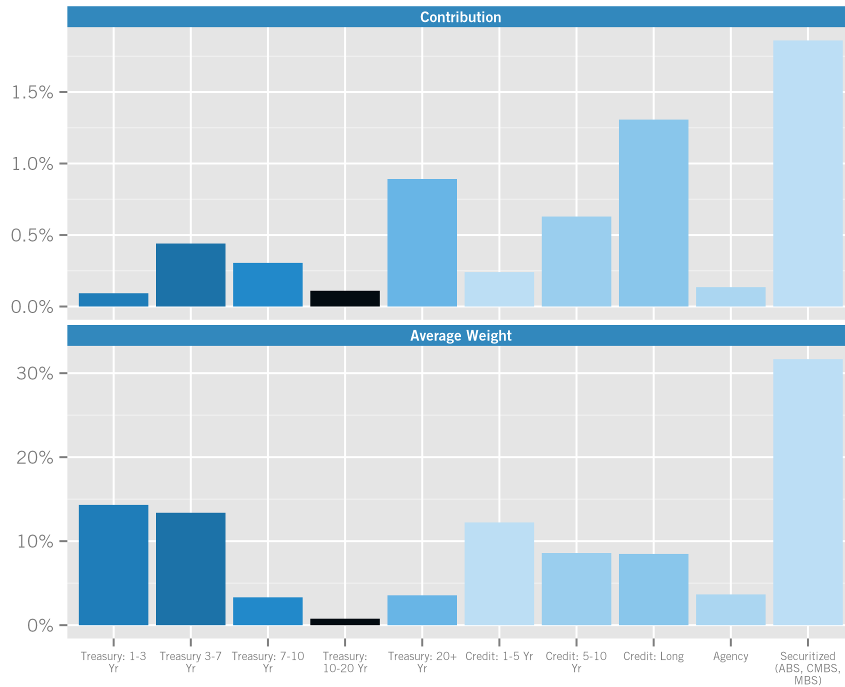
RATES A THEME, BUT NOT THE WHOLE STORY

As already mentioned, however, there were more than enough folks who thought otherwise, and the effects of the shift in the term structure can be seen clearly in the contribution to return for the various segments of the BarCap Agg, detailed in Figure 4. Together comprising just about 12% of the overall index, the long ends of both the Treasury and the credit groups comprise well more than a third of the Aggregate’s total return in 2014. Not as much discussed in regard to the performance of the Aggregate last year, though, is the total return contribution from the securitized market. The largest component of that group is the mortgage-backed securities (MBS) sector, constituting 90% of the total securitized market and a bit under 30% of the BarCap Agg; MBS gained more than 6% last year. Not surprising, then, the substantial addition to total return from that group.

FIGURE 4

Barclays Capital U.S. Aggregate Performance Contribution

From 12.31.13 to 12.31.14.
SOURCE: Innealta Capital using data from Bloomberg

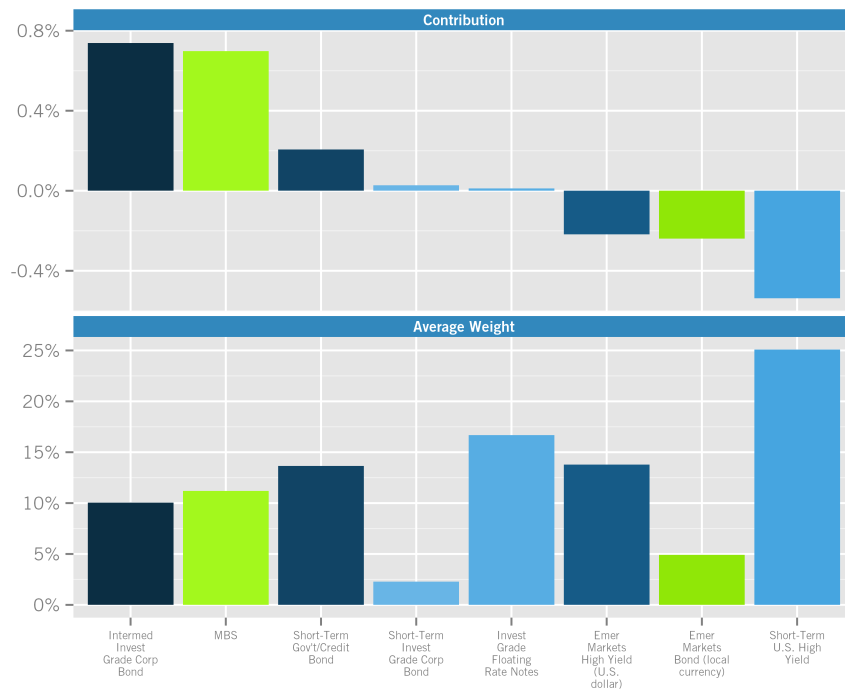


Turning to the Fixed Income Portfolio, we see in Figure 5 among the primary contributors to total return that the portfolio captured the shift in rates (and the relatively stable spreads in that sector) via the decision to invest in the U.S. intermediate investment-grade corporate sector. So, too, did the portfolio partake in gains from mortgage-backed securities.

FIGURE 5

Innealta Fixed Income Portfolio Performance Contribution

From 12.31.13 to 12.31.14.
SOURCE: Innealta Capital. Performance data based upon Innealta Capital composites.



At the midpoint of the year, however, risk appetites began to shrink, with a particular disdain shown for several of the exposures from which the Committee sought more attractive yield/duration tradeoffs. While each had augmented return through 06.30.14, contributions from investments in emerging markets and in U.S. short-term high yield turned south through the second half of the year, with the final two months of 2014 seeing particularly negative sentiment and return.

STILL BETTER PLACES TO BE

The risks we assume at the individual exposure and total portfolio levels…always…are top-of-mind for the Innealta Investment Committee. These risks, in turn, are weighed against the opportunities for income and capital gain the Committee believes presented by each potential decision the Team may make. Though the prior year proved a tough one from a performance comparison basis, the Team continues to believe that the collective decisions we have made in regard to the balancing of potential risk and return will prove themselves for our partners and clients as we progress further into 2015.

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Sector ETFs, such as Real Estate Investment Trusts ("REITs") are subject to industry concentration risk, which is the chance that stocks comprising the sector ETF will decline due to adverse developments in the respective industry.

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Country/Regional risk is the chance that world events such as political upheaval or natural disaster will adversely affect the value of securities issued by companies in foreign countries or regions. Country/Regional risk is especially high in emerging markets.

Emerging markets risk is that chance that stocks of companies located in emerging markets will be substantially more volatile, and substantially less liquid, than the stocks of companies located in more developed foreign markets.

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