Hutchinson
CAPITAL MANAGEMENT

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INVESTMENT PERSPECTIVES

Balance with Bonds

A core element of our culture at Hutchinson Capital Management is personalized attention to each client's unique needs. We don't believe that one-size-fits-all when it comes to either financial planning or investing. In our previous Investment Perspectives, we discussed the importance of diversification, with an emphasis on individual security selection. We discussed our preference for human thought-based processes versus automated, rules-based systems. In this piece, we extend the topic of diversification with a focus on aspects of the asset allocation decision. Specifically, we will explore the role that bonds play in most client portfolios. While we select the same individual stocks and bonds across most client accounts, the asset allocation decision (the mix of stocks, bonds, and cash), is personalized. It's personal because the key considerations in developing the asset allocation strategy depend on the individual's investment horizon (when is the money needed?), the stability of any earned income, potential liquidity needs, and willingness to take risk. Risk tolerance is the fortitude and discipline to stick with the investment plan through rough markets. A trade-off comes in balancing growth with safety; equities provide higher growth, but with higher volatility. Even though we shun formulaic decision making, we'll concede that certain mathematical formulas are useful in evaluating the proper mix of assets. That said, it is only with genuine knowledge of a client's specific needs and risk tolerances that we can use analytical tools to design a suitable mix of assets. We know there will be times when a blended portfolio of stocks and bonds will underperform an all-stock portfolio but adding bonds lowers the portfolio risk more than it sacrifices returns.

As we write this, there is tremendous tumult occurring in the bond markets so we will explore the ways these changing circumstances are factoring into our bond portfolio management strategy. Because it's been a while since we've talked about bonds, we'll begin with a brief review of the most important terminology and some of the basic formulas that make bonds work. So we're sorry, there will be math, but there won't be a test.

Large but Largely Unappreciated

The value of all the securities making up the global bond market is estimated to exceed $100 trillion while global equity markets total a mere $65 trillion; bond trading volumes dwarf equities at $700 billion compared to $200 billion. Bonds finance our government, underpin our infrastructure, and for most of us, facilitate home-ownership. The flow of credit lubricates the gears of free markets, and bonds are the foundation of long-term investment. Despite the size and importance of bond markets, stocks usually attract more media attention. Stocks can offer multiples of price appreciation when the right narrative takes hold. Even though bonds don't have the same lottery-ticket excitement available with stocks, they can exhibit price volatility. The same mathematical truisms that anchor bonds with stability, also act as governors on price appreciation. Despite this, we are not taking the last ten years of bond price placidity for granted. Change is in the air, as markets confront the normalization of interest rates and the unwinding of central bank balance sheets. This change will have profound effects on economies and financial markets around the world, so media attention and investor interest are shifting toward bonds.

The size and significance of the global bond market became even more pronounced following the Great Financial Crisis (GFC). Central banks' Quantitative Easing programs (QE), added $30 trillion of tradable debt into the market. In less than ten years, a market that has evolved over decades was more than doubled. The reason the fixed-income markets grew so much and so fast was through government intervention. Rational market participants would not behave this way. The central banks had unlimited capital with the intention of paying prices over market value. The distortions they created were so considerable that we questioned the market pricing mechanism. Before the crisis, there was $27 trillion of tradable debt, now that stands at $57 trillion. To put that in perspective, $57 trillion amounts to more than three years of total US

economic output[1]. The turmoil we are seeing in the bond markets now is the reassertion of price discipline. Ten years of market dysfunction has made attentiveness to quality and credit more important than ever.

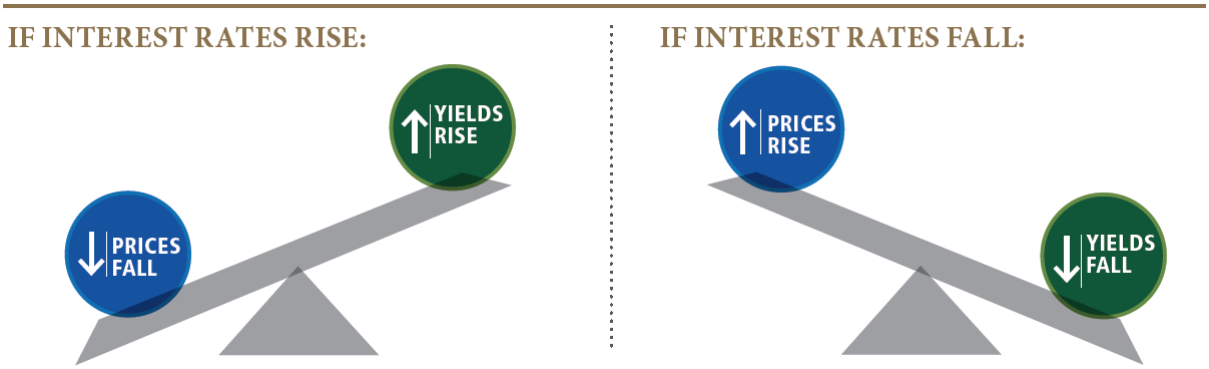
As the monetary authorities fought debt deflation, they coaxed investors into riskier areas of the markets. One outcome of their efforts has been investor propensity to lengthen the maturities of their bond holdings to get higher yields. Longer-term bonds usually carry more risk and pay higher coupons, but are also more volatile. With market interest rates on the rise, there is growing concern that many investors have taken too much risk in chasing yields.

> *"As the corporate-bond market has grown, credit quality has declined. There has been notable growth in noninvestment-grade "junk" bonds. Even investment-grade quality has deteriorated. Of corporate bonds outstanding in the United States, 40 percent have BBB ratings, one notch above junk status. We calculate that one-quarter of corporate issuers in emerging markets are at risk of default today—and that share could rise to 40 percent if interest rates rise by 200 basis points.*
>
> *Over the next five years, a record amount of corporate bonds worldwide will come due, and annual refinancing needs will hit $1.6 trillion to $2.1 trillion. Given that interest rates are rising and some borrowers already have shaky finances, it is reasonable to expect more defaults in the years ahead."*[2]

Bond Basics[3]

If equities are expected to provide growth, bonds are favored for income, stability, and diversification. They offer contractual terms that do not change over the life of a bond. A bond's life begins at issuance and ends at maturity or redemption. Newly issued bonds are priced at face value or par and, at maturity, the bondholder presents the bond to the issuer who redeems it at that same face value. Face value is usually $1,000 per bond. Bonds trading in the open market are quoted as a percentage of face/par value; a bond price of $90, translates into 90% of par or $900/$1,000. Said bond has declined by 10%, but it is quoted as a percentage of par because the holder will receive the full $1,000 par value at maturity.

Even though their market prices will fluctuate with changes in market interest rates, a bond held to maturity has a value anchored by math and concrete terms. The return on a bond investment is comprised of two distinct cash flow streams: return ***on*** capital (coupon payments) and return ***of*** capital (principal redemption). The coupon rate[4] is set at the time of issuance based upon the issuer's credit, time to maturity, and comparable rates offered in the marketplace. An investor can easily calculate the cash flow and return on a bond by using some fairly simple equations. Most bonds offer periodic cash flows (semi-annually) based on the coupon rate determined at issue.



Outside of bonds issued by large sovereign governments, most bond prices embed the risk of default. Investors often rely on credit rating agencies to rate the quality of a bond issuer as to default risk. The agencies assign a score to the bond to help the investor rank it relative to other bonds in the market. Issuers with higher credit scores will generally receive more favorable terms from investors.

[1] US GDP is approximately $18.5 trillion p.a.
[2] *"A Decade after the Global Financial Crisis: What has Changed (and hasn't) Changed?"* McKinsey & Co. August 2018
[3] Bonds come in myriad shapes and structures, so for simplicity's sake, throughout this paper we will refer to the most generic bonds (corporate, non-callable, coupon bond sold and redeemed at par or face value, and paying semi-annual coupons).
[4] The coupon rate (=) the dollar amount of annual coupon payments divided by bond's face value.

Over its life, a 4% coupon, 20-year bond, issued at par (100%), will pay 40 coupons of $20 each. At the end of the 20-year holding period (maturity/redemption), we get back the original $1,000 we invested, plus the $800 in coupon interest income. Valuing a bond investment means calculating and totaling its three cash flow components:

1. The sum of its coupon payments
2. The interest-on-interest received from the reinvestment of the coupon payments
3. The return of the $1,000 principal at redemption or maturity

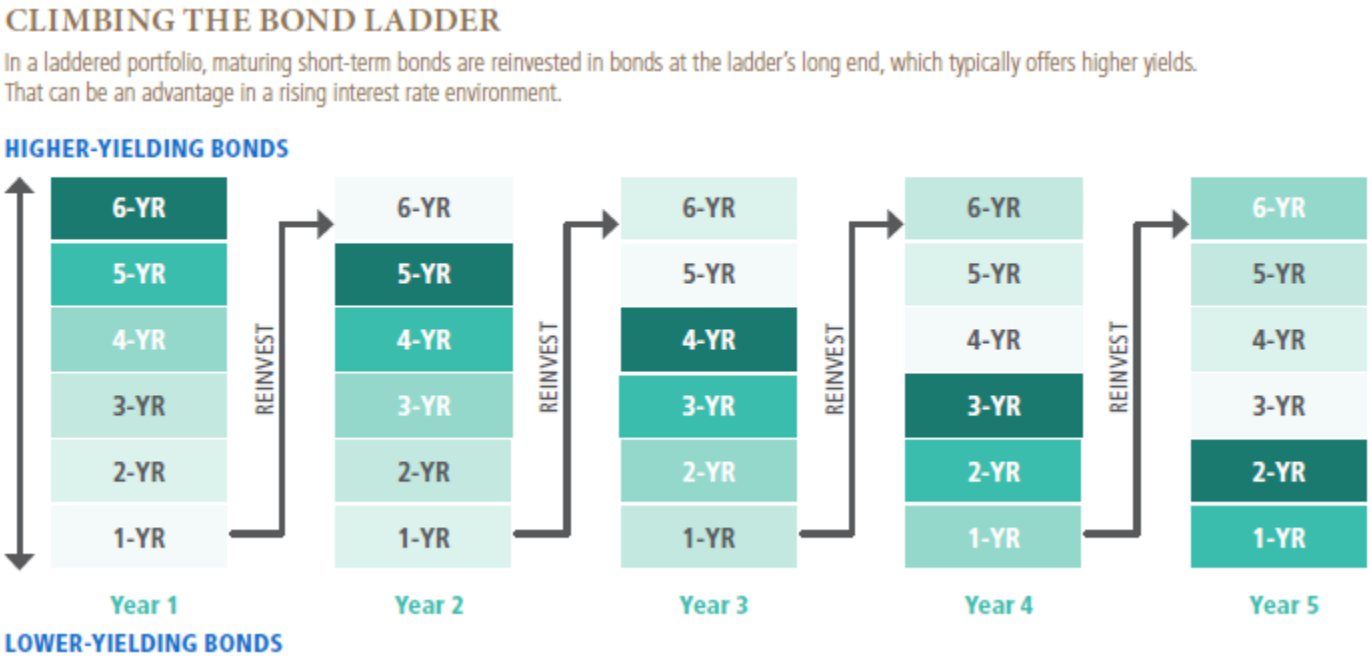
Credit Quality: the company issuing the bond must pay us 4% per year to use our money; that 4% is determined by the markets based on that company's creditworthiness and must be competitive with comparable issues in the marketplace. If investors believe there's a chance the company may have trouble paying back this loan, they will demand a higher coupon rate; in this way, investors get both a higher return for assuming more risk and also get that cash flow faster. If over the course of a bond's life, the company's financial condition worsens, the bond's price may fall, but the company cannot be compelled to pay any more than the 4% coupon agreed to at issuance.

Interest Rate Volatility: We get our $20 coupon payment every six months, and it is assumed that we can reinvest those coupons at 4%. But market interest rates are not static, so there's a risk that, if rates go lower, our reinvestments will be made at lower rates. The flipside of this is that our bond will rise in price because the 4% coupon will be attractive relative to newly issued bonds at currently lower rates. If rates go higher, our 4% bond will be unattractive relative to new issues, and our bond will decline in price.

Time Value: Based on our view of the market, how long do we want to commit our money at a given rate of interest? These three factors are all inter-related and must be considered for each bond we purchase.

Bond Portfolio Management

Just as we do with our equity portfolio, we build our bond portfolio with individual bonds. This includes corporate bonds, government bonds, municipals, and TIPs[5]. For each bond we own, we will have a view on credit quality, but we do not speculate on the direction of interest rates. We seek to lower our vulnerability to interest rate risk by staggering our bond purchases across various maturities out to ten years. This strategy, called "Laddering," means we always have a portion of our bond portfolio maturing, and the proceeds reinvested.



Source: PIMCO

By evaluating each individual holding, we know what we own, and we monitor the issuer's credit quality. We emphasize the protection of principal, and we do not chase yield; if we're wrong about a company's credit and the quality of a bond deteriorates, we are not averse to selling it regardless of its yield. We analyze each client's financial situation and tax status as part of our portfolio structuring process. This includes planning, well in advance, for cash flow needs so as to

[5] TIPs are Treasury Inflation-Protected Securities; most bond prices decline with increases in inflation, but TIPs are structured to increase in price as the Consumer Price Index (CPI) rises.

match bond maturities with those needs. By always maximizing the after-tax yield[6], we ensure that the right type of bond goes into the right type of account; for example, tax-free municipals will generally have a lower stated yield than a taxable bond, and we would not place a tax-free bond in a tax-exempt account.

Why Bonds?

Even though bonds are the topic of this piece, our investment process focuses on the overall portfolio strategy. In that sense, bonds are intended to act as a hedge against equity risk while also providing stable income. This diversification provides higher risk-adjusted returns[7]. This lower risk comes not just from decreased volatility but also through the preservation of capital. Provided we own bonds of good credit quality, we can expect to get our principal back at maturity. Stocks can exhibit high volatility over short periods of time, and while bonds are not completely immune to price volatility, by laddering our maturities, we can reduce interest rate risk while also matching client cash needs with maturing bonds. Whether an investor's view of risk is volatility or permanent loss of capital, bonds are risk-dampening instruments. A portfolio with a mix of stocks and bonds is more risk efficient than a 100% stock portfolio. Asset allocation strategies that blend stock and bond portfolios may experience periods of underperformance vs. an all-stock portfolio, but adding the bonds lowers the portfolio risk more than it sacrifices returns.

Asset Mix	Cumulative Returns during 2000-2002 Bear Market	Projected Cumulative Returns Over 10Yrs using Long-Term Averages
100% Stock	-55.3%	62%
80% Stock / 20% Bond	-34.4%	52%
70% Stock / 30% Bond	-25.8%	47%
60% Stock / 40% Bond	-20.0%	42%
50% Stock / 50% Bond	-13.9%	38%
40% Stock / 60% Bond	-7.5%	33%
30% Stock / 70% Bond	-0.75%	29%
20% Stock / 80% Bond	+6.3%	24%
Long-term average annual returns used in the data are: stocks +8.0%, bonds +4.5%, inflation 3.0% Wilshire 5000 index fund, Barclays Capital Aggregate Bond Index Fund, US Treasury inflation rate.		

Shifting from 100% stocks to 80% stocks / 20% bonds can be expected to shave 10 percentage points off an investor's ten-year returns, but in the 2000-2002 bear market, the investor who had made that shift would have saved nearly 21 percentage points. Simplifying greatly, a conversation with a client might run along the lines of, *"What returns do you expect to earn from your investment portfolio?"* Once we have that in mind, we might ask, *"How much downside risk can you tolerate before you begin to lose sleep?"* Matching those growth and security needs will frame the asset allocation decision, and the table above is a starting point for that discussion.

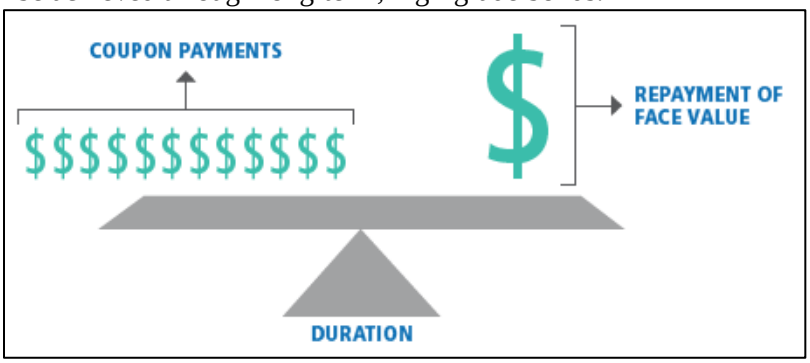
Bonds may have less price volatility than stocks, but there are other risks to which we must be attentive; one is reinvestment risk. Reinvestment risk occurs when market interest rates are lower than the coupon rate on a maturing bond. This risk contributes to bond price volatility and is particularly disruptive when market interest rates move dramatically over short time frames. When rates move lower, bond prices go up because coupon rates on outstanding bonds are worth more than newly issued bonds offering lower rates. One measure of a bond's sensitivity to changes in market interest rates is called *Duration*. Duration is always measured in years. The greater the duration of a bond, the longer an investor must wait for the full payment of coupons and return of principal. For a given increase in market interest rates, the prices of two bonds with different durations will respond differently; a bond with a duration of 10 years will have twice the price sensitivity of a bond with a 5-year duration. As a rule of thumb, the price of a bond with a duration of 10 years, will decline 10% for each 1% increase in interest rates, while the price of a bond with a 5-year duration will decline 5%. When investors believe that long-term interest rates are going lower, they will lengthen the duration of their bond portfolio to gain greater sensitivity to that rate move.

Credit, duration, and interest rates are all inter-connected. The lower a company's credit quality, the higher the coupon interest rate it must pay investors to attract capital. Higher coupon interest implies not just a higher yield to the investor, but also a shorter duration, as the investor recaptures the cash flow faster than would be the case for a lower coupon bond.

[6] Bonds trade on a tax-equivalent yield basis; the calculation of the TEY goes as follows: (1) Determine the reciprocal of your tax rate, (1 – your tax rate). If that rate is 40 percent, the reciprocal would be (1 - .40) = .60, or 60 percent; (2) Divide the yield on the tax-free bond by this tax rate reciprocal to estimate the tax-equivalent yield. If a tax-free bond yields 3.0%, use the equation (3.0%/.60) = 5.0% to estimate what that bond would have to yield in order to provide a return equivalent to a taxable bond.

[7] Risk-adjusted returns consider the units of risk taken to generate a unit of return.

High yield bonds have shorter durations, making them less sensitive to changes in rates than long-duration bonds. In fact, HY bonds trade with a much higher correlation to stocks than to high-grade bonds, making them a less effective hedge for an equity portfolio than can be achieved through long-term, high-grade bonds.



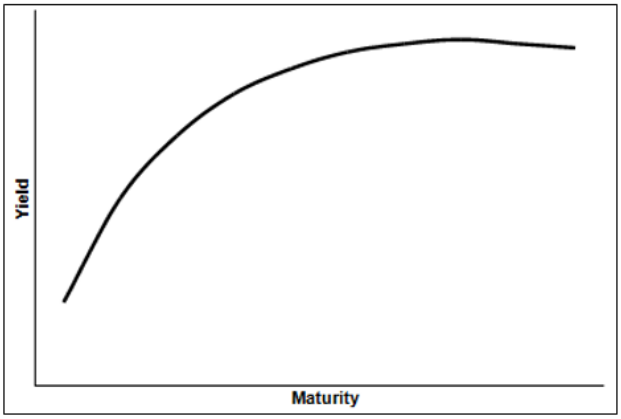
Source: PIMCO

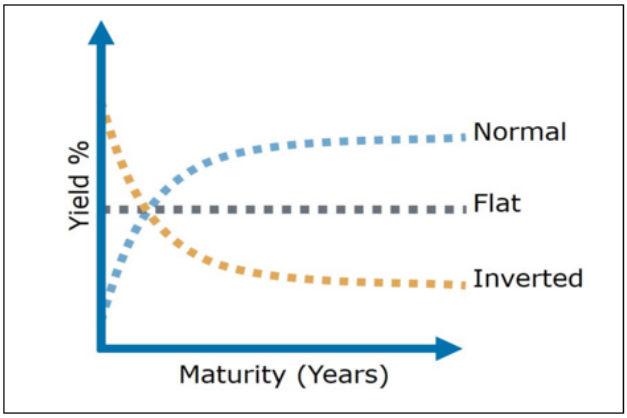
Bonds can also offer tax advantages. When held outside of a tax-exempt account, the income earned on cash deposits, money market funds, and equity dividends are taxed at ordinary income rates. However, the interest income from municipal bonds is tax-free at the federal level and also at the state level when held by an investor residing in the same state as the issuer. The income from U.S. Treasuries is taxable at the federal level, but exempt from state and local tax. In high-tax states like California, demand for tax-exempt municipal bonds can be intense among upper-income investors. The prices of tax-advantaged securities may fluctuate wildly with changes in tax rates, so proper diversification is sensible.

The Yield Curve

Because bonds are acutely sensitive to growth and inflation expectations, fixed-income investors pay very close attention to macroeconomic data. When investors translate those views into investment decisions, it is reflected across the spectrum of bond instruments. Stocks perform well when the economy is growing, and companies have pricing power. When economic conditions are inflationary, a bond's fixed income payment stream can look less attractive, as its fixed coupon payments support diminishing purchases of goods and services. During periods of slower economic growth and deflation, companies experience declining profits and returns, making bond coupon streams more attractive. This is one reason bonds offer a diversified portfolio some hedge value against economic weakness and/or deflationary conditions that hamper equity prices.

Normal market conditions mean positive economic growth and reasonable inflation. These circumstances support what is called a "Normal" yield curve; one in which maturity juxtaposed to yield is upward sloping. It's not just inflation but also the uncertainty of future cash flows that causes investors to demand higher returns for higher risk. As price and yield are inverses of each other, declining prices mean higher yields. This preference for lower duration bonds relative to higher duration causes what is called a "steepening of the yield curve." When bond investors have low expectations for future economic growth and do not fear inflation, they will extend the duration of their bond portfolios by buying long-term bonds. Currently, with the Fed raising short-term rates, and bond investors pessimistic about the longevity of the current economic cycle, we see the yield curve flattening. Investors pay attention to these signals from the bond market because they have proven prescient in estimating future economic conditions. In past cycles, when long-term rates have moved below short-term rates (yield curve inversion), the economy has been on the precipice of recession. The two charts below are yield curves, depicting the relationship between bond yield and time.





Individual Bond Selection

How do we synthesize this market knowledge into a diversified portfolio of bonds? Starting at the highest level, each client's portfolio is structured to meet their unique needs for growth, income, and stability. While we buy the same individual securities across all client portfolios, the allocation between stocks and bonds often varies. Additionally, the bond allocation must consider the account's tax status. As we discussed earlier, companies with higher credit risk must pay higher rates of interest to compensate investors for that risk. Some bond investors willingly take this credit risk as they can become seduced by temptingly high yields. This yield chasing behavior is akin to picking up nickels in front of a steamroller; it looks like easy money—who can't outrun a plodding steamroller? But if one gets too greedy, trying to clutch too many coins, the outcome can be disastrous. Recall that a bond investment is a return ***on*** capital as well as a return ***of*** capital. The collection of high coupons, for a while, cannot offset the losses associated with a credit default and failure to receive the return of principal at redemption. Along with high quality, we require that our bonds have ample trading liquidity; high-quality liquid bonds are the instruments to which investors turn when risk aversion rises.

We may not speculate on interest rates, but we do focus on the shape of the yield curve and on credit spreads to ensure that we are receiving fair yields for the risk we take. At various points in the rate cycle, different areas of the yield curve will offer more or less relative value. In response to this, we may shift the final maturity of our bond ladders to add or reduce duration. This is a reflection of our market view but not a speculative endeavor.

The Power of Compounding and the Time Value of Money

There are a few simple truths critical to understanding bond investing:

- Money received today is worth more than money received tomorrow
- *"Compound interest is the eighth wonder of the world"* - Albert Einstein

Disregarding taxes, capital invested at semi-annual compound interest rate of 4% would double every 17.5 years, at 6%, every 11.7 years, at 8% every 8.8 years, and at 10% rates, money doubles every 7.1 years.

The present value of money is higher than its future value due, in large part, to the power of compounding and the effects of inflation. When we buy a 4% coupon bond, we know the simple yield to be 4%; however, our total return on the investment may vary depending on the range of market interest rates over the course of our investment. The 4% coupon on a newly issued bond, priced at par value, has a purchase yield of 4%, but there's no guarantee that the realized compound yield over the life of the bond will deliver that 4% return. For buy-and-hold investors, the realized compound yield is critical; if market interest rates decline, our bond price will go up, but if we hold onto it until redemption, our realized compound yield will decline since our reinvestment options for that coupon income are at rates lower than our purchase yield. The longer the life of the bond, the more important becomes the reinvestment of coupon income—or the interest-on-interest (I-o-I) portion of our return.

The time-value-of-money principle has a Yin and Yang effect on bond investments. Coupon payments received today are worth more than they will be tomorrow because they can be invested to generate compound interest. At the same time, normal inflationary factors mean today's coupon income can buy more goods and services now than it will in the future. Spending the coupons when received equates to a 0% return for the I-o-I component of total return. Doing this over the lifetime of the bond ensures that the total realized compound yield will fall short of the purchase yield.

Reinvestment Rate	I-o-I % of Total Return	I-o-I $ Amount	Coupon Income	Total Return	Total Realized Compound Yield
0%	0%	$0	$800	$800	2.9%
2%	18%	$178	$800	$978	3.4%
4%	**34%**	**$400**	**$800**	**$1,200**	**4.0%**
5%	41%	$548	$800	$1,348	4.3%
6%	47%	$708	$800	$1,508	4.7%
7%	53%	$891	$800	$1,691	5.0%
8%	58%	$1,101	$800	$1,901	5.4%

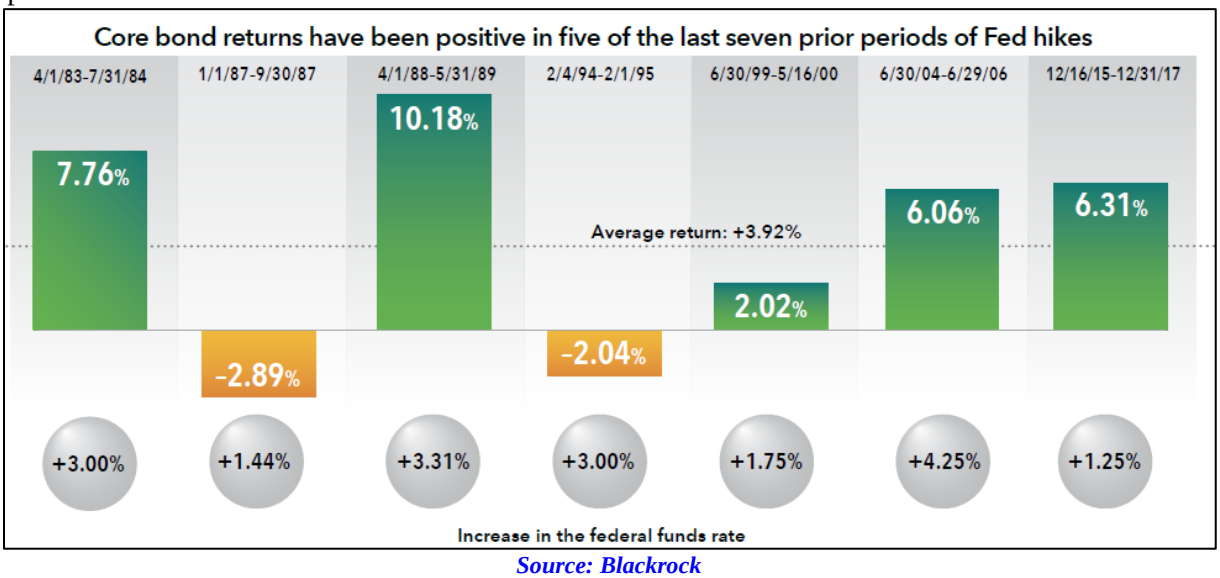
In the case of our hypothetical 4%, 20-year bond, the total coupon income paid to us by the issuer is $800, regardless of market interest rates. By reinvesting each of the 40 coupon payments of $20 at 4% over 20 years, the interest compounds for us. Our total income on this bond investment can end up being higher than $800. At 4% interest, over 20 years, the interest-on-interest is $400 per $1,000 or 34% of the total return. Interest rate sensitivity is also affected by a bond's duration. It's now October 2018; imagine we've owned the 4%, 20-year bond since December 1998 and it's maturing in two months. This means that on 12/31/2018 we will receive our final $20 coupon payment plus the return of $1,000 principal or par value. What would happen to the price of this bond if interest rates rose by 200bps between now and the day we receive our principal? The answer is, not much—the price might drop by $4.00. However, if that bond had matured on 9/30/2018 and we had rolled the proceeds into a new 4%, 20-year bond (duration ~14 years), that same 200bps rate increase would drive our bond price down 23% to $770.

The Normalization Process

"For every action, there is an equal and opposite reaction." - Sir Isaac Newton

All of the actions taken by the central banks to ease us through the Great Financial Crisis of 2008 (GFC) are now in reverse as quantitative easing has become quantitative tightening. It's true that the US economy is on solid footing, but the Federal Reserve is not raising interest rates to put a damper on growth. The economic recovery has been long and shallow, only recently becoming self-sustaining. Inflation is under control and wage growth tepid. These current economic conditions do not necessitate an aggressive rate-raising policy stance, but rates are going up nonetheless. Rates are going up because they have been too low for too long. The economic recovery looks tired, and with rates so low, the central banks have few arrows in the quiver to combat the next recession. The idea is to get rates up to a normalized level so that they can then be reduced when future stimulus is needed. It seems silly, and may not even be effective, but central bankers are painted into a corner.

These central bank actions were so massive that it's important for us to discuss how they have impacted our bond portfolio management strategies over the past ten years and will shape our views going forward. Not all bonds will behave similarly to these tightening financial conditions, and we believe we are well-positioned for normalization. Credit quality plays a significant role in the price sensitivity of bonds to rising Fed Funds rates. We buy high-quality bonds primarily to preserve capital, but this also means that our bond portfolio should provide the support we expect it to during this painful transition period.



Source: Blackrock

- In five of the past seven rate-rising cycles, investment grade (BBB/Baa) bonds provided positive returns
- Lower quality bonds are highly correlated to equity prices, so they have worked during this prolonged equity rally, but they may not provide downside protection once the equity bull market ends
- The immense supply of low-quality bonds issued during the post-GFC period will magnify the market tensions that will arise during the adjustment to normalized rates

Why Bonds Now?

We all know rates are going higher. We know that when interest rates rise, bond prices decline. So why buy bonds at this point in the rate cycle? Firstly, it matters that we are buy-and-hold investors and not traders. This, coupled with our laddering strategy means that we always have a constant stream of low coupon bonds maturing which we can reinvest into new bonds with higher coupons. So, over the longer term, our bond portfolio's return can rise as market interest rates rise.

Over the ten years following the GFC, our skepticism about the market's price discovery mechanism amid central bank intervention kept us in shorter duration bonds. This hampered our returns as rates declined over this period, but it was a conscious decision to sacrifice short-term returns in exchange for lower risk to our clients. Now that rates are rising, we are finding more value across the yield curve. As money market conditions tighten, securities such as mortgages, lower-quality credit, and momentum equities grow increasingly vulnerable. Our conservative stance on duration, coupled with our insistence on holding higher quality assets, should dampen portfolio volatility as rates increase.

Conclusion

Changes in market interest rates do not affect bond investors uniformly. Just because bond prices go up when interest rates decline, does not guarantee higher profits to a bond holder. Many factors influence bond profitability; such factors include bond duration and holding period. Holding bonds to maturity, rather than trading them, means using tactics such as laddering. Short term rates are now rising, but this has the potential to increase the long-term returns on our bond portfolio.

- As it pertains to our bond portfolio, we are not afraid of higher rates; over the long term, higher rates should enhance the overall yield of our portfolio
- We focus on the aggregate portfolio value and risk, of which bonds make up a meaningful component
- Under most market conditions, with the exception of high yield, bond prices are inversely correlated to stock prices
    - We only buy high-quality bonds, so we expect our bond portfolio to dampen total volatility during this period of rising rates
- We purchase individual bonds, assessing the credit of each and constantly monitoring them for risk
- Each client account is evaluated individually to determine the suitability of bond types for inclusion
    - Tax-free bonds would never go in a tax-exempt account
    - Bond purchases are laddered to reduce interest rate risk and to match principal redemption with client cash flow needs
- Over the past ten years, the investment climate for bonds has been complicated by government intervention
    - With that now changing, we see new opportunities along with the challenges
    - Investors have chased yield during this period
    - Issuers have taken advantage of the mispriced yield curve and investor desperation for yield to sell bonds at advantageous prices
        - The market is flooded with low-quality bonds
        - This makes the market more vulnerable to rate normalization
        - Bond prices will likely be more volatile than we are accustomed to

For a complete list of holdings, please see our most recent 13F filing on the following SEC website:
http://www.sec.gov/edgar/searchedgar/companysearch.html
HCM's investment decision making process involves a number of different factors, not just those discussed in this document. The views expressed in this material are subject to ongoing evaluation and could change at any time.
Past performance is not indicative of future results, which may vary. The value of investments and the income derived from investments can go down as well as up. It shall not be assumed that recommendations made in the future will be profitable or will equal the performance of the securities mentioned here. While HCM seeks to design a portfolio which reflects appropriate risk and return features, portfolio characteristics may deviate from those of the benchmark.
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