The Continuing Fat Pitch: Non-Traditional Bonds

While we like the protection that traditional bonds provide, their yields have been paltry for years. Our return expectations for the asset class have been in the low single digits under a wide range of economic and interest rate scenarios. Our analysis also indicated that if interest rates were to rise sharply, traditional bonds would be susceptible to potentially large short-term downside, which clients are not prepared for. So in the years following the financial crisis, we moved a significant portion of our fixed-income exposure into flexible bond funds and then later added an allocation to floating-rate loans:

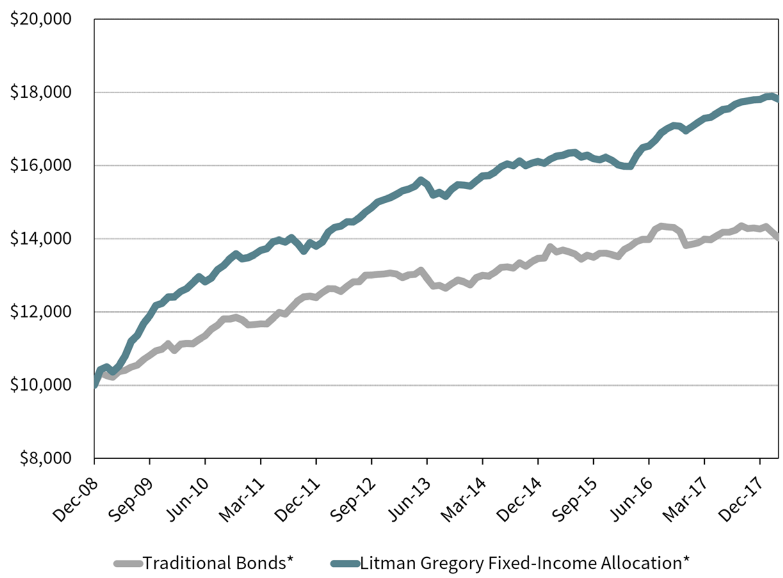
- The flexible bond funds we selected are distinctive, actively managed strategies with a history of success, run by experienced portfolio managers. Generally, they have unconstrained mandates and possess the flexibility to take on higher credit risk, invest in floating-rate versus fixed-rate securities, or even hold cash if opportunities are scarce.

- The actively managed floating-rate loan funds we own should generate returns that are comparable to the passive leveraged loan options over a full credit cycle, despite being more conservatively positioned. Floating-rate loans are attractive to us because of their higher yields compared to traditional bonds and their structural advantages over high-yield bonds: Their seniority in the capital structure leads to lower defaults and higher recovery rates, and their coupons adjust upward with rising rates, resulting in next to no interest rate risk.

The motivation behind this move away from traditional bonds was to lower our risk to rising interest rates, while also increasing returns in most plausible scenarios. The tradeoff is that we took on increased credit risk. But by combining traditional bonds with more credit-oriented strategies—each exposed to a different *uncorrelated* primary risk—we believe we've built a balanced fixed-income allocation. Our positive view of the prospective performance of our bond portfolios is reinforced by the fact that they have an overall higher yield *and* lower duration than our benchmark (the Vanguard Total Bond Market Index).

Let's look at the results. Since we initiated our move away from traditional bonds in December 2008, our fixed-income portfolios have far and away outperformed the traditional bond market index fund, with nearly identical volatility.

Our Bond Portfolios Have Strongly Outperformed



*Source: Litman Gregory Analytics, Morningstar Direct. Data 12/1/08 through 3/31/18. * Litman Gregory Fixed-Income Allocation is a proxy of the active bond allocation Litman Gregory AdvisorIntelligence recommended over this period. Traditional Bonds is the Vanguard Total Bond Market Index (VBMFX).*

Clearly, “safer” traditional bonds are not without risk, they are simply exposed to *different* risks, namely interest rate risk. The last three years are very illustrative:

1. At the start of 2016, credit-oriented bonds fell along with equity indexes, but the impact on our portfolios was muted.

2. Later in the fall of that year, traditional bonds suffered a drawdown of their own on expectations of a pro-growth Trump presidency, during which our non-traditional bond holdings protected the portfolios.

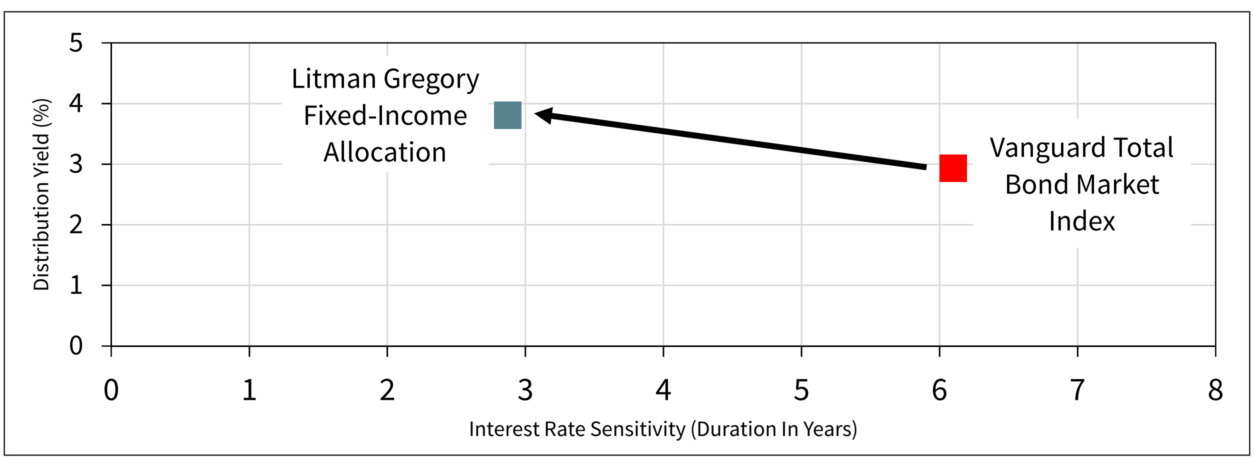
3. More recently, in 2018, the 10-year Treasury yield jumped close to 3% through March, likely due to inflation concerns, leading stocks *and* bonds to decline at the same time. Yet our flexible bond fund holdings produced a positive return in aggregate. And unlike high-yield bonds, floating-rate loans generated positive returns as well.

	Annualized Return	Cumulative Return	Standard Deviation	Max Drawdown	Upside/ Downside Capture	Sharpe Ratio	Equity Correlation	Equity Beta
Litman Gregory Fixed-Income Allocation*	6.41%	78.65%	3.27%	-2.85%	105.05%/ 12.71%	1.84	0.54	0.13
Traditional Bonds*	3.76%	41.17%	3.10%	-3.76%	-	1.12	-0.06	-0.01

*Source: Litman Gregory Analytics, Morningstar Direct. Data 12/1/08 through 3/31/18. *Litman Gregory Fixed-Income Allocation is a proxy of our active Balanced fixed-income allocation over this period. Fund holdings and performance may vary depending on platform availability. Traditional Bonds is the Vanguard Total Bond Market Index (VBMFX). Standard deviation is annualized. Max drawdown is based on monthly returns.*

From the table of metrics above, one can see from the moderately higher equity correlation that we've been willing to accept some additional credit risk in exchange for higher long-term returns and less interest rate sensitivity. Still, the equity beta of our bond portfolios in this market cycle has been less than 0.14, implying that if relationships hold, their downside during equity selloffs should be a fraction of what stocks would experience. In addition, we have high conviction in our active managers’ bottom-up security selection. We continue to believe the added credit risk of our non-traditional holdings is more than offset by the protection they provide against the prospect of rising interest rates. It's telling that despite the higher credit risk, our bond allocation has captured over 100% of the updside of the core bond index fund, while avoiding the vast majority of the downside.

We want to specifically highlight the maximum drawdown of our bond allocation over this time, because we believe that metric approximates how many clients “experience” risk. This period encompassed market dislocations related to rising rates and to declines in risk assets—our portfolios held up well through each. The max drawdown of our bond allocation was much lower than the benchmark’s, despite the higher equity correlation and beta. This



lower drawdown was not surprising to us; it was the intentional goal of our portfolio construction. Our exposure to non-traditional bonds protected the portfolio against declines in traditional bonds, and vice versa, leading to a superior Sharpe ratio, a measure of risk-adjusted return.

The insight and conviction to execute this portfolio decision derived from the intersection of Litman Gregory's asset class analysis and fund research capabilities. Our work on expected returns—both long-term returns and 12-month downside—and the various stress tests we run identified the risk of rising rates, while our due diligence experience in selecting successful managers allowed us to take advantage of the opportunity presented by more flexible strategies and floating-rate loans.

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925 254-8999

research@advisorintelligence.com

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