TELOS Gram

"The market is a pendulum that forever swings between unsustainable optimism and unjustified pessimism. The intelligent investor is a realist who sells to optimists and buys from pessimists."
& Benjamin Graham, 1894 – 1976, American economist, professor and investor; known as the "father of value investing"

MEETING THE CHALLENGES OF A LOW YIELD ENVIRONMENT

From the start, the project looked impossible. Many engineering and construction experts said it couldn't be built. The structure would need to span more than 6,700 feet across one of the most unforgiving stretches of water in the world. It would be broadside to ferocious winds and would often be surrounded by blinding fog. It would also be located at the intersection of two of the most dangerous fault lines in the country and therefore needed to be strong enough to withstand a major earthquake. It was a daunting challenge.

Yet on April 19, 1937, *'the bridge that couldn't be built'* was completed and officially opened to the public on May 27, 1937. Painted a bright *'International Orange'* and spanning almost two miles across the narrow strait, the iconic Golden Gate Bridge was the longest and tallest single-span suspension bridge in the world, a position it retained for more than 25 years. More than eight decades later, it still has the second longest main span (distance between the towers) of any suspension bridge in the United States. The American Society of Civil Engineers named it one of the 'Seven Wonders of the Modern World' and it remains one of the most recognizable architectural structures in the world to this day.

With its tremendous towers, sweeping main cables, and great span, the iconic Art Deco masterpiece is not only vast and beautiful in design, but also highly functional. It is a suspension bridge, which means that it relies on cables and suspenders under tension along with towers under compression to cross a long distance without any intermediate supports. As such, the bridge was designed to be flexible enough to withstand the weight of traffic and avoid damage during earthquakes or sustained winds by swinging up to 27 feet laterally.

Thanks to its *flexibility*, it can absorb the energy coming from wind or seismic forces that more rigid structures cannot.

In the same way, *maintaining a flexible mindset is a must for fixed income investors* hoping to successfully navigate the ill winds blowing from central banks.

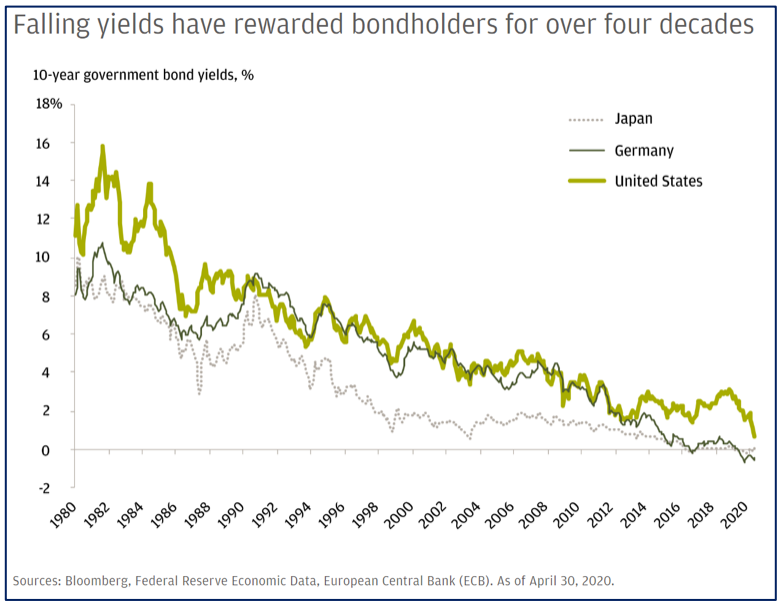
As we discussed in last quarter's newsletter (https://telosinc.com/july-2020-the-great-wall-street-main-street-disconnect/), in response to the Covid-19 pandemic and its potential impact on the global economy, the world's major central banks deployed their 'full range of crisis tools' to stimulate growth and stabilize financial markets.

One of the Federal Reserve's (Fed) most prominent tools is termed 'zero interest rate policy,' or ZIRP, which generally means that a central bank has set its target short-term interest rate at or close to 0%. In the U.S., the main short-term rate for monetary policy is the Federal funds (Fed funds) rate, which is used as a benchmark for short-term lending for financial institutions and is currently targeted at 0% to 0.25%.

The Fed first adopted ZIRP during the Global Financial Crisis in 2008 and held rates near zero until 2015 before the economy was deemed healthy enough to warrant gradually higher rates. Last summer, the lower bound of the Fed funds rate was 2.25%

before the Fed abruptly slashed rates back to near 0% in March this year as part of sweeping crisis measures to combat the economic fallout from the coronavirus pandemic (see top graph on this page). With its traditional policy instrument set as low as reasonably possible, the Fed launched a number of facilities to relieve financial strains, committed to purchasing substantial amounts of financial assets under its quantitative easing (QE) measures and vowed to keep interest rates near zero through 2023 to support the nation's economic recovery.

The upshot is that bond yields, which were already low before the pandemic hit, have become even more depressed and are expected to remain exceptionally low for the foreseeable future. This has created a great quandary for fixed income investors: how to earn an acceptable return when risk-free bonds yield next to nothing? They either have to accept a much lower income, or they have to take more risk as ZIRP is forcing them higher on the risk spectrum to earn a return on their capital.



The days when investors could rely on traditional bonds for income, capital preservation and a hedge against inflation are over. In this zero and negative interest rate world, it has become a lot more challenging to prudently allocate capital since an investor's risk assets now need to make up the difference for the loss of earnings on the safe assets. And the longer ZIRP lasts, the greater risks investors will have to take, especially the ones who have to meet certain required rates of return.

Indeed, the Fed's policies have already paved the way for billions of dollars to flow into high-yield (junk) debt as investors are eagerly searching for yield. U.S. high-yield bond issuance reached an annual record of $329.8 billion, eclipsing the prior annual sales record of $329.6 billion set in 2012, amid a surge in issuance from high-yield borrowers seeking to reap the benefits from the central bank's liquidity-boosting policies. The junk market's record year follows the U.S. investment-grade bond market, which reached a new annual issuance high in mid-August. And Europe's high-yield bond sales surged in July, the busiest for that month since 2009, according to data compiled by Bloomberg.

Unquestionably, today's ultra-low yields, which are without precedent in U.S. history, are challenging the traditional role of income and stability that bonds have played in the past. Because bonds can serve as a buffer during periods of equity market turbulence, we believe that maintaining a bond allocation befitting one's age and risk tolerance is still a sound decision for most investors. However, given the subdued yield environment and the Fed's commitment to keep the benchmark interest rate near zero for several years, *investors need to look beyond traditional bonds to generate steady streams of income.* This means investing flexibly across the fixed income universe for potential yield opportunities, focusing on quality without overstretching for yield, and reducing risk through diversification.

The Russian novelist Leo Tolstoy wrote that *"all happy families are alike, but each unhappy family is unhappy in its own way."* Had he applied this to the fixed income universe, he might have written that changes in interest rates affect all areas of the bond market to varying degrees, but that other factors can have an impact on the return and income of a bond portfolio that far outweigh any effect from interest rate changes. In other words, interest rates are just one factor that can drive bond prices. Other variables that can influence returns include *economic growth*, *inflation*, *credit quality*, *credit spreads* and *currency fluctuations*, each of which can serve as a driver of returns. To generate some additional yield, such securities can be added to a portfolio in a manner that is consistent with the investor's risk tolerance.

Typically, these segments include **high-yield bonds**, **emerging market bonds**, **agency mortgage-backed securities (MBS)**, and **lower-rated corporate bonds** (see chart next page, courtesy Charles Schwab). Investors with a higher tolerance for risk can also find opportunities in select **preferred stocks** that pay a high dividend and are viewed as more steady than common stocks. With about

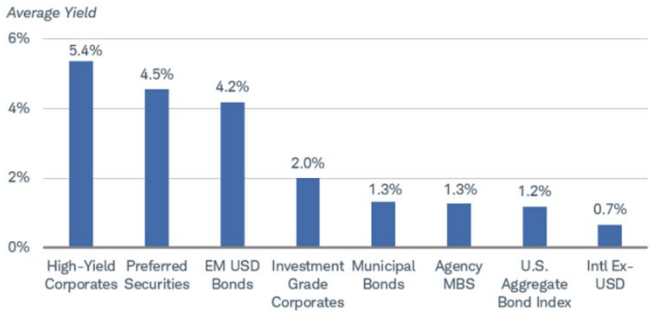
80% of stocks in the U.S. offering a higher dividend yield than the 10-year Treasury bond, **stocks that have sustainable and growing dividends** could present a compelling investment opportunity in this low yield environment.

Income generation continues to be a top priority for many investors. Used judiciously, adding some higher yielding investments may provide an opportunity to enhance a portfolio's income and total return potential. *Regardless, investors need to be aware of the additional risks associated with such investments, and we suggest they add them in moderation and limit their allocation to avoid too much risk.*

Risk comes in several forms however, and even the so-called safest investments carry some degree of it. While risk can mean that investors have a greater chance of losing money, the amount of risk they take can also determine how quickly they meet their investment goals…or whether they meet them at all. Sometimes, the biggest risk is not taking enough risk.

As a repercussion of the Fed's ultra-low interest rates, investors are forced toward riskier assets with higher yields and return potential. As traditional fixed income securities fail to provide an adequate amount of yield, investors are required to be more creative about how they invest to meet their longer-term needs and commitments.

Riskier fixed income investments currently offer higher yields



Source: Bloomberg, as of 8/28/2020. Yield represents yield-to-worst for all investments except preferred securities which represents yield-to-maturity. Indexes representing the investment types are: **High-Yield Corporates** = Bloomberg Barclays U.S. Corporate High-Yield Bond Index; **Preferred Securities** = ICE BofA Fixed Rate Preferred Securities Index; **EM USD Debt** = Bloomberg Barclays Emerging Market USD Aggregate Bond Index; **Investment Grade Corporates** = Bloomberg Barclays U.S. Corporate Bond Index; **Municipal** = Bloomberg Barclays Municipal Bond Index; **Agency MBS** = Bloomberg Barclays U.S. MBS Index; **U.S. Aggregate Bond Index** = Bloomberg Barclays U.S. Aggregate Bond Index; **Intl Ex-USD** = Bloomberg Barclays Global Aggregate ex-US Bond Index. **Past performance is no guarantee of future results.**

That's why we believe investors can benefit from the knowledge and expertise of an active investment manager, such as ***Telos***, who has the flexibility to choose from a broad spectrum of potential investments and tailor investors' exposure to their unique objectives, risk tolerance and time horizon. We encourage you to have a conversation with your ***Telos*** representative.

QUARTERLY MARKET UPDATE

The U.S. economy continued its slow and steady recovery from the deep declines seen in the spring as both demand and output strengthened. Jobless claims have eased from their peak, consumer confidence has improved, and new home sales jumped to their highest level since September 2006 due to record low mortgage rates. Although the pandemic is far from over, corporate profits proved more resilient than feared and stock markets posted one of the strongest July-August rallies in history to reclaim the record highs they surrendered in February when Covid-19 rocked the markets. Lasting just 126 trading days from peak-to-peak, it was the S&P 500 index's fastest-ever recovery from a bear market (see graph on front page, courtesy WSJ). Volatility returned to Wall Street in September when stocks tumbled amid a long list of investor concerns. The benchmark S&P 500 posted its first four-week losing streak in more than a year, putting it on the cusp of a 10% decline that would have been considered a correction. Despite that September stretch of volatility, the **S&P 500** and **Dow Jones Industrial Average** gained 8.5% and 7.6%, respectively, for the quarter. It was the second consecutive quarter of powerful gains and the benchmark's best six-month performance since 2009, continuing a historic stock market recovery from the depths of the March selloff.

The yield on the **10-year U.S. Treasury note** ticked down for the third consecutive quarter, settling a 0.677%. The **U.S. dollar index** against a basket of foreign currencies recorded its worst quarter since the spring of 2017 with a 3.3% decline, largely due to the Fed's exceptionally easy monetary policy and the public's worries about the country's ballooning debt. **Gold** has been a prime beneficiary of central bank largesse, up almost 24% for the year after hitting an all-time high in August.

Now that September has lived up to its reputation as a poor month for stocks, will October live up to its reputation as a notoriously volatile month? For stocks, short-term risks remain high and volatility is likely to continue. Mounting concerns over a contested election outcome and a second wave of coronavirus infections, particularly in Europe, present near-term headwinds for financial markets. Signs that additional fiscal support may not be immediately forthcoming might further weigh on investor sentiment. With the economy likely to continue improving in fits and starts, a likely uptick in corporate earnings, and an extended period of low interest rates, our outlook for risk assets remains cautiously optimistic, despite equity valuations that generally are far from cheap and some troubling pockets of froth in the market.

In such an environment, we recommend that investors remain focused on the underlying fundamentals supporting the economy and their investment holdings, while making sure their portfolio is adequately diversified based on their objectives, risk tolerance and time horizon. It is important not to miss the forest for the trees by getting caught up in day-to-day headlines and market volatility. Over the long-run, the stock market tends to follow the path of corporate earnings, which in turn follows economic trends. In the meantime, our financial advisors at ***Telos*** are here for you - ready to listen, provide guidance and help you achieve your desired investment goals.