Specialized Asset Management

Total Return Investing in a Low Yield World

BAIRD

Baird Equity Asset Management

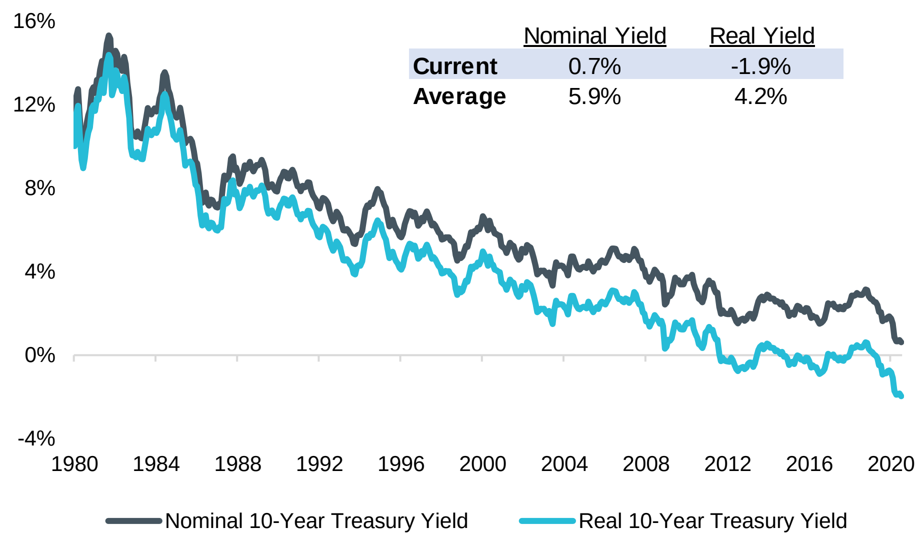
Total Return Investing in a Low Yield World

One of the hardest concepts for investors to grasp is how to generate sufficient income from an investment portfolio in today's low interest rate environment. SAM often gets asked about portfolio yield in isolation when, in reality, income needs to be thought of differently and in conjunction with other portfolio attributes. **We firmly believe in the concept of total-return investing, which uses a combination of income and price appreciation to achieve any required future distributions.** Ultimately, we think a total return investment philosophy aligns better with meeting clients' long-term financial goals compared to just focusing on portfolio yield in isolation.

THE PROBLEM

In past decades when Treasury yields were much higher, it was easy to generate enough income for clients through interest payments and equity dividends. However, that is nearly impossible today given the low interest rate regime that has persisted since the Global Financial Crisis. In fact, when normalized for inflation, real yields are actually negative currently.

Nominal and Real 10 Year Yields



Source: FRED Data; monthly 1/1980-8/2020.
A nominal interest rates is an interest rate before taking into account inflation. A real interest rate is an interest rate that has been adjusted to remove the effects of inflation.

Specialized Asset Management (SAM) is a multi-asset class solution within Baird Equity Asset Management. The portfolios consist of high quality companies surrounded by complementary mutual funds and ETFs. The solution is easy to understand, customizable, tax efficient and built to weather tough markets.

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Trying to create a high-income portfolio can be a risky endeavor as investors stray to riskier asset classes like junk bonds, lower credit quality issue, long-dated bonds, or perhaps just concentration in higher yielding sectors. Each compromise brings its own unique risks, but they are generally magnified during periods of heightened market volatility. We highlight a few examples in the table below and as you can see, yield premium typically coincides with higher price volatility in difficult market environments. This tradeoff is most prominent in the 2020 COVID recession when credit markets froze, and companies could not access the capital markets. High yield bonds underperformed investment grade bonds by 20% in four short weeks. Higher yielding equity sectors similarly underperformed the broader index.

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Reaching for Yield Introduces Other Risks

Asset Class	Current Yield (%)	Peak-to-Trough Returns	
		2018 Selloff	2020 Selloff
Fixed Income			
BBG Barc Agg	**2.3%**	**1%**	**-2%**
High Yield Bonds	**5.0%**	-7%	-22%
Emerging Market Debt	**4.1%**	-4%	-22%
Bank Loans	**4.0%**	-7%	-24%
Equities			
S&P 500	**1.7%**	**-20%**	**-34%**
MLPs	**17.1%**	-24%	-60%
BDCs	**12.1%**	-15%	-55%
Energy	**7.4%**	-31%	-57%
Banks	**3.8%**	-24%	-49%
Utilities	**3.3%**	-2%	-36%
Real Estate	**3.1%**	-7%	-38%
Financials	**2.5%**	-20%	-43%
Industrials	**1.8%**	-24%	-42%

Source: Factset; Aggregate Bond Index is the Bloomberg Barclays Aggregate Bond Index. Yield as of 9/30/20. 2018 selloff is 10/3/18-12/24/18; 2020 selloff is 2/19/20-3/23/20.

SAM views Fixed Income as the part of a portfolio that should return your principal and not lose money. We will not take undue risk to achieve a higher level of yield or return. We invest in only investment grade corporate, municipal, and Treasury bonds and/or funds and ETFs that have a similar high-quality philosophy. Although the focus on quality results in a lower absolute yield than in the past, we are completely comfortable with this tradeoff as fixed income should anchor a portfolio in times of market stress instead of amplify it. An allocation to high-quality Fixed Income is still critical for an effective asset allocation as it still acts as an effective volatility reducer and performance diversifier as seen in the table above even though its yield is relatively low.

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THE SOLUTION

A total-return investment philosophy considers income generation, but perhaps more importantly in today's low interest rate environment, the price appreciation potential of the portfolio to achieve any necessary future distributions. It does not distinguish between interest, dividend, or the sale of a security, which allows us to instead focus on constructing the best possible portfolio to achieve the client's long-term financial objectives.

Total return investing is paramount to the SAM investment philosophy.

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Key to this is first determining the correct asset allocation for the client, a realistic and durable allocation to withstand bouts of market volatility. SAM works closely with Baird Financial Advisors to understand the client's current financial situation, long-term objectives, risk appetite, and any unique considerations.

Secondarily we focus on populating the portfolio with only the highest quality companies, regardless of their dividend yield. In fact, many of the best companies in the world have such great growth prospects that they do not pay dividends, instead reinvesting their capital to grow the business and strengthen their competitive advantages. If one uses dividend yield alone as an investment criterion, it negatively screens out some companies with the best estimated future growth prospects.

For example, the table below shows the highest returning companies in the S&P 500 over the past five years. These companies' returns were multiples higher than the S&P 500's 12%, but only three pay a dividend and each yield well below the index. This underscores the importance of fundamental analysis and understanding the vision and long-term growth potential of a company. We try to identify and own these businesses, allowing their high returns to compound over time.

Highest Returning S&P 500 Companies

	Ticker	Market Cap (Billion)	5-Yr Return: Annualized	Dividend Yield
S&P 500			**12%**	**1.7%**
TOP PERFORMERS				
Advanced Micro Devices, Inc.	AMD	$100	**117%**	
NVIDIA Corporation	NVDA	$337	**86%**	**0.1%**
Paycom Software, Inc.	PAYC	$19	**54%**	
ServiceNow, Inc.	NOW	$95	**47%**	
Copart, Inc.	CPRT	$25	**45%**	
PayPal Holdings Inc	PYPL	$233	**45%**	
MSCI Inc. Class A	MSCI	$30	**44%**	**0.9%**
Amazon.com, Inc.	AMZN	$1,611	**44%**	
Adobe Inc.	ADBE	$240	**43%**	
Align Technology, Inc.	ALGN	$25	**42%**	
Take-Two Interactive Software, Inc.	TTWO	$19	**42%**	
Lam Research Corporation	LRCX	$49	**40%**	**1.6%**
IDEXX Laboratories, Inc.	IDXX	$34	**40%**	

Source: Factset; data as of 9/30/20.

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When assessing dividend paying companies we focus on the growth of the dividend over time, knowing that a company that has the financial flexibility (typically high returns, high free cash flow, low asset intensity) to rapidly and consistently grow its dividend will likely be a good investment over time.

THE OUTCOME

A well-constructed total return portfolio will generally not only hold value in difficult market environments but should also show growth over time. Ultimately SAM portfolios are a mix of long-time dividend paying companies supplemented with those companies we think are the next wave of great growth businesses. This results in a portfolio of high-quality companies we believe are positioned to capitalize on the major secular growth trends of the next decade. From a performance standpoint, SAM portfolios are designed first and foremost to weather tough markets, while participating on the upside.

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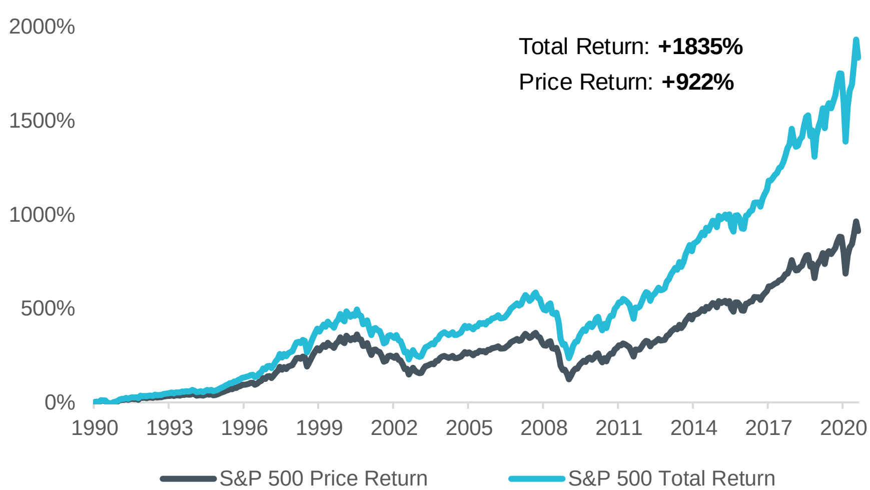
S&P 500 vs. S&P 500 Total Return: 1990 to Present



Source: Factset; data through 9/30/20.

Past Performance does not guarantee future results.

The S&P 500 index is an unmanaged, market capitalization weighted index of 500 common stocks widely regarded to be representative of the US market in general

The Bloomberg Barclays U.S. Aggregate Bond Index is a fixed income, market-value index generally representative of investment-grade fixed-rate debt issues, including government, corporate, asset-backed, and mortgage-backed securities with maturities of at least one year.

Investors should consider the investment objectives, risks, charges and expenses of the strategy before investing. For additional important information about the fees, expenses, risks and terms of investment advisory accounts at Baird, please review Baird's Form ADV Brochure which should be read carefully before opening an investment advisory account.

Diversification does not ensure a profit or protect against loss. All investments carry some level of risk, including loss of principal. An investment cannot be made directly in an index. SAM investments do not track the index and index performance does not reflect SAM portfolio performance. SAM does not invest in all companies in the index.

This is not a complete analysis of every material fact regarding any company, industry or security. The information has been obtained from sources we consider to be reliable, but we cannot guarantee the accuracy.

Fixed income is generally considered to be a more conservative investment than stocks, but bonds and other fixed income investments still carry a variety of risk such as interest rate risk, regulatory risk, reinvestment risk, credit risk, inflation risk, call risk, default risk, political risk, tax policy risk and liquidity risk. In a rising interest rate environment, the value of fixed-income securities generally decline and conversely, in a falling interest rate environment, the value of fixed income securities generally increase. Municipal securities investments are not appropriate for all investors, especially those taxed at lower rates.

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