GMO
EVENT HIGHLIGHTS

WHAT TO DO ABOUT LOW RATES?

Two actionable ideas for filling today's fixed income void

Matt Kadnar and Joe Auth | December 10, 2020

> ***"Munis have an average beta of zero but in times that you really care about, the beta increases substantially. In '08, '10, '13, '20, their beta, because of the lack of liquidity in the asset class, skyrockets at exactly the wrong time. You are getting the beta when you don't want it, and when you want it, you are not getting it. So again, it's heads I win as the issuer, tails you lose as the investor.***

OVERVIEW

On December 10, Matt Kadnar and Joe Auth sat down to discuss why Treasuries and municipal bonds give them concern (high valuations, low yields, and duration/convexity sensitivity), and why structured products and liquid alternatives are attractive substitutes.

You may access the replay here.

KEY POINTS

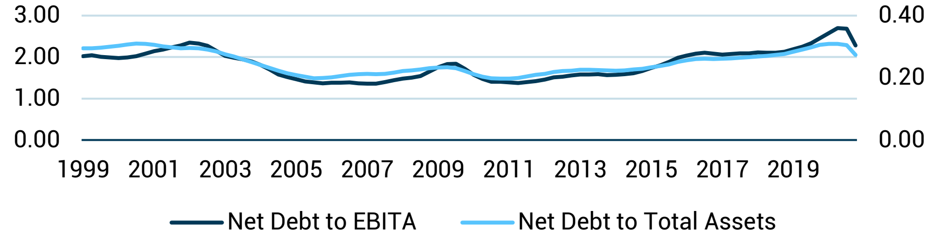
- Government bonds are in a position where they cannot provide two of the basic investment services they have traditionally provided in portfolios – meaningful income and a hedge against an economic disaster. **This leaves almost all investment portfolios with both a lower expected return and more risk in the event of a depression-like event than they used to have.**
- **Yields on munis are at or well below all-time lows – to us, it doesn't look like you are getting much of anything in income or tax benefits.** If we look back at the financial crisis in 2009, or the COVID crisis in March and April 2020, spreads blew out in the muni market and you didn't get the same portfolio shock absorber as you did owning Treasuries. Adding insult to injury, munis can be very negatively convex in a large rate sell off – most trade assuming a call, but if that call becomes uneconomical for the issuer, you have a much longer duration bond on your hands.
- **There are numerous options available to investors to lower their overall exposure to duration in a portfolio.** You can move to floating rates: we have a strong preference to structured products (especially amid concerns over bank loans due to the re-emergence of covenant-lite loans and deterioration in credit quality). Other plays include opportunistic credit, like high yield or emerging debt, rotating to value equities, and liquid alternatives, which are inherently short duration.
- We like the securitized area of the market, or structured products, for two reasons: (1) Many bonds have low interest rate and spread duration at a time when rates and spreads are low and tight, and (2) the sector provides **diverse ways to get exposure to the U.S. consumer – auto loans, residential mortgage loans, student loans – where the ultimate recoupment is dependent on the credit of the U.S. consumer, and we like that profile.** Our Opportunistic Income Strategy provides significant exposure to the U.S. consumer through very seasoned loans and the Strategy often takes more idiosyncratic rather than market beta risk. Historically the Strategy has operated with low interest rate and spread duration.

- Although **liquid alternatives** have generally disappointed in recent years (fees, commoditized strategies, lack of toughness in times of stress), we think they **are an attractive area today as a "bond replacement."** For example, some are making the trade-off from munis to liquid alts given the stability of their relative betas – **munis have an average beta of zero but skyrocketed at exactly the wrong time ('08, '10, '13, '20) and liquid alts' average beta of 0.2/0.3 has been much better behaved in times of stress.** Within GMO's Alternative Allocation Strategy, we like the combination of experienced teams in alpha and fundamental risk premia (or insurance-like activities) strategies because we believe that provides a more durable pattern of returns over time.

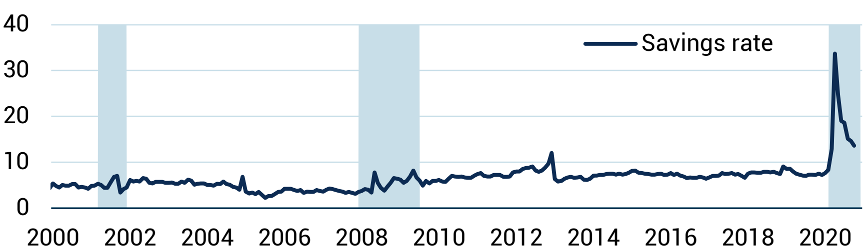
CORPORATE BALANCE SHEETS HAVE DETERIORATED…

While consumer balance sheets have improved

NORTH AMERICA IG



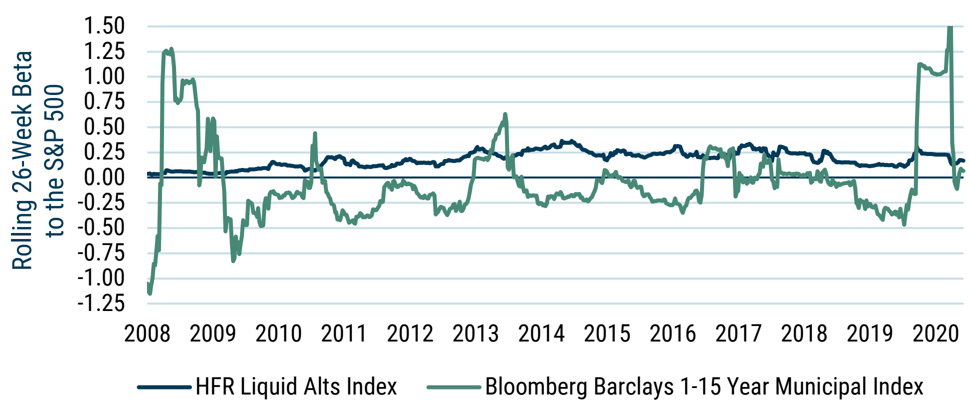
PERSONAL SAVINGS RATE



Source: Goldman Sachs, Bank of America Merrill Lynch

LIQUID ALTS ARE NOT MUNIS…

But they do have interesting relative characteristics



Source: GMO, Bloomberg

Matt Kadnar

Mr. Kadnar is a member of GMO's Asset Allocation team. Prior to joining GMO in 2004, he was an investment specialist and consultant relations manager at Putnam Investments. Previously, he served as in-house counsel for LPL Financial Services and as a senior associate at Melick & Porter, LLP. Mr. Kadnar has a B.S. from Boston College majoring in Finance and Philosophy and a J.D. from St. Louis University School of Law. He is a CFA charterholder

Joe Auth

Mr. Auth is engaged in portfolio management for GMO's Structured Products team. Prior to joining GMO in 2014, he was a Portfolio Manager for the Harvard Management Company. Previously, he was a Research Director at Standish Mellon Asset Management. Mr. Auth earned his B.A. in government and history from the Connecticut College and his M.B.A. from the University of Connecticut. He is a CFA Charterholder.

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- Opportunistic Income Strategy
- Alternative Allocation Strategy
- 2Q 2020 GMO Quarterly Letter: A Roadmap for Navigating Today's Low Rates