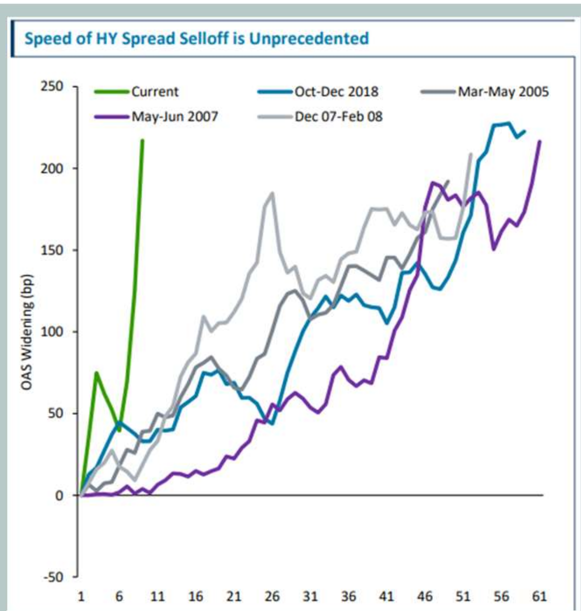
A FRAMEWORK FOR RECOVERY

As the coronavirus pandemic sweeps through the world, we are experiencing massive waves of stock and bond volatility. The speed of the dislocation is breathtaking. While the stock market sell-off generates much publicity, the fixed income sell-off is unprecedented. In only six days, high yield bonds have sold off to levels that took nearly 60 days to reach during the global financial crisis. The same is true across fixed income, without regard to credit quality: investment grade, agency mortgage, and even treasuries have all seen unprecedented selling.



Source: Citi Research, Bloomberg. Data as of Mar 10, 2020.

Fortunately, the government has responded with unprecedented monetary and fiscal stimulus. The Federal Reserve stepped in as an unlimited buyer for mortgage bonds and corporate debt, while extending loans to small businesses and investment grade borrowers. Today Congress passed a $2t fiscal stimulus with around $750b in direct assistance to households, firms and state governments. This figure also includes $350b in forgivable small business loans. The bill also provides households 6 – 12 months of mortgage relief, 6 months of unemployment assistance, and emergency aid for large impacted business. It appears that Congress is working on an additional round of relief, as well. As a reminder, all of this happened in the last thirty days.

We'd like to say that the investment team anticipated these events, but we cannot. The team did, however, plan for volatility and market dislocation; this has been evident in our asset allocation. As we wrote in our most recent commentary, we're looking for three indicators for the market to bottom: monetary action from the Federal Reserve, fiscal action from Congress, and clarity around the timing and severity of the coronavirus. While the future impact of the coronavirus is still unclear, the actions of the Fed and of Congress are supporting a bottoming process in markets. Given the speed and severity of the downturn along with the nature of a pandemic dislocation, we believe the markets will see a sharp upturn once the virus is resolved. The country will be different. Many industries may take years to recover, while others will recover quickly. Some areas of the economy will grow even faster than before the crisis.

Now is the time to position for recovery. First and foremost, we invest to protect capital. Within that framework, we strive to make the most of an opportunity. This conservative approach is evidenced in our process-driven investment philosophy. Over the past three weeks, we've engaged in repeated conversations with our underlying portfolio managers seeking to understand the current market dynamics. Our portfolio managers have been hard at work modeling portfolios across a variety of scenarios. Coming together, we've created a plan to reposition portfolios with a focus on both capital protection and opportunity.

Stage I: Portfolio Rebalancing and Tax Loss Harvesting

As we've seen the volatility begin to abate this week, markets are beginning to function again. Over the coming weeks, portfolio managers will rebalance portfolios and harvest tax losses. At this stage, the bottom of the market is being tested. Now that Congress and the Federal Reserve have begun their significant stimulus, we expect to see the daily stock market volatility settle into an elevated range as more rational trading resumes.

Our Portfolio Managers will rebalance portfolios adjusting allocations to target weightings. Investments in U.S. Treasuries, investment grade bonds and municipals can be sold at reasonable values to reallocate towards attractive opportunities. Gains in our gold investments may serve as another source of funds for rebalancing. At the end of 2019, gold allocations were increased to provide a hedge against volatility.

This downturn also presents an opportunity for tax loss harvesting. Clients can realize losses by selling one investment and moving into a new one with similar exposure. For example, two different ETF's offer investors exposure to the attractive Fintech sector. Both have sold off equally. By exchanging one ETF for the other, clients can maintain a long-term view on Fintech while realizing the tax-loss benefits.

Stage II: Opportunistic Investing

As the recovery cycle progresses, we expect markets to normalize. Daily equity market volatility will see further moderation on normal trading volume. Stocks, bonds, commodities, and currencies will re-establish their traditional intermarket relationships. Quarantine policies across the country may still be in place leaving the economy in limbo; however, we will settle into a new normal. Light may be appearing at the end of the coronavirus tunnel. Fear is subsiding, but economic uncertainty provides the chance to invest opportunistically. During this stage, early allocations will go towards assets and strategies less affected by the crisis. As we gain more clarity, allocations will move towards those strategies more directly impacted.

Less Affected Strategies/Assets – BFO will target strategies and assets least effected by the drawdown. Many of these strategies benefit from heightened volatility. These trading strategies include convertible bond arbitrage and municipal bond trading. Some thematic positions are priced at attractive entry points. These are themes poised to thrive in the post-coronavirus world: automation, fintech and aging demographics. Some discounted assets are available due to forced selling by highly levered owners. The discounts available in quality mortgage backed securities offer an historic buying opportunity. When the market offers big discounts on high quality stocks and bonds due to forced selling, we are buyers.

More Affected Strategies/Assets – These strategies were hardest hit by the drawdown and may have a longer road to recovery; but offer substantial returns. Biotech, high yield bonds, and lower rated asset-backed debt require a high-risk tolerance in normal markets. However, these heavily beaten up sectors may ultimately benefit most from the upswing.

Stage III: Distressed Opportunity

Looking forward, once the blanket quarantines and lockdowns are over, the economy should be in a good position for recovery. Given pent up consumer demand, low gas prices, and 0% interest rates, many businesses will see a quick return to profitability. BFO will look to investments most adversely impacted by the recession. While these assets are likely to be illiquid and deeply discounted, we would project expected returns at a multiple of the cost. Heavily impacted sectors such as airlines, hospitality, casinos, restaurants, and energy will be fertile ground. It's still unclear where the best distressed opportunity will be, some likely candidates include distressed municipal bonds, illiquid collateralized credit, middle market loans, and real estate.

This three-stage plan provides an overall framework for reallocating portfolios towards the post-coronavirus world. We do not know the length and severity of the coronavirus. We do not know whether we will see a second wave returning in the Fall. Given the unknowns today, we plan to move deliberately through the stages of recovery. As from past crises, we will emerge a different country with a different set of priorities, but we will emerge. Through process and research, we will patiently allocate capital towards this new world.

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