

The House View: TFG's Monthly Investment Update (February 2021)

These markets continue to shock and awe. Aside from the entertainment value, there is plenty to keep an eye on. With that in mind, see below four themes we are watching closely for the remainder of February, as well as our current asset allocation tilts.

1. The Yield Curve Is Steepening Which Spells Trouble for Government Bonds

A steepening yield curve is an indicator that bond investors see strong economic growth and increased inflation on the horizon, eventually leading to increased interest rates. Rising interest rates have historically caused bond prices to decrease, putting downward pressure on those investments. Additionally, the Federal Reserve has already cut the Federal Funds Rate to near-zero, limiting their ability to provide aid via another rate cut.

The consequences of a steepening yield curve are clear when reviewing the performance of the Barclay's Aggregate Bond Index, a broad market "Core Bond" index made up mainly of government and investment-grade bonds. This index has returned **-1.68%** so far in 2021 (as of 2/16/2021).

Our solution to the challenges faced by core bonds is to take a **multi-sector approach** to fixed income investing, which includes non-traditional areas of fixed income such as High-Yield, Bank Loans, Asset-backed Securities (ABS) and Emerging Markets Debt. We believe these sectors will be less sensitive to interest-rate risk. We also believe the fund managers we work with will be active in making any necessary rotations, which can't normally be said for passively-managed Bond ETFs. So far in 2021, the Bank of America High-Yield Index has returned **+1.41%** and the Morningstar Multisector Bond Category has returned **+0.78%** (as of 2/16/2021), significantly outperforming the broader fixed income indices.

2. The Case for Convertible Bonds

Given that rates will likely remain low for the foreseeable future, it has become imperative to identify opportunities outside of the traditional stock/bond portfolio to generate growth and income. Among several other alternative-style strategies, we have been utilizing Convertible Bonds widely across our in-house investment models.

Convertible Bonds are securities **issued as bonds** by corporations with the potential to be **converted to shares of stock** of the corporation at a later date. This conversion normally occurs when the stock price of the corporation exceeds the redeemable bond amount or at the bond's call date. This structure is important as it provides an opportunity for equity-like returns (conversion to stock) with built-in downside protection from the bond component of the convertible (the coupon).

Convertibles have seen a long-term period of outperformance over equities in the US, and have done so with less volatility. Over the past 5-years, the Bank of America Convertible Bond Index has averaged **annual returns of +25.69%**. By comparison, the S&P 500 averaged +16.12% for the same period of time. We believe the unique structure of convertibles will remain beneficial in the current investment landscape.

3. US Small & Mid Cap Continue to Shine

In the equity markets, the forecast for a strong economic recovery has continued to benefit Small & Mid Cap companies more than Large Cap companies. We have been tilting towards these asset classes in our Investment Models since mid-October 2020, which has played out nicely so far. We believe this trend of outperformance will continue for the next 12-18 months as the US economy continues to recover.

Since October 15th, 2020, The Russell 2000 Index (US Small Cap) has returned **+38.65%**, the Morningstar Mid Cap Category Benchmark has returned **+20.26%**, and the S&P 500 Index has returned only **+12.90%**. Again, we believe this trend will continue over the next 12-18 months as the US economy continues to recover.

performance data as of 2/16/2021

4. Emerging Markets are a Bright Spot

Coming into 2021, the combination of a softening dollar and global economic improvement provided a favorable environment for Emerging Markets companies. We have seen this narrative continue to play out so far in 2021,

with the MSCI Emerging Markets Index returning **+10.32%** year to date, versus only +4.09% for the S&P 500 (returns as of 2/10/2021).

Even with this outperformance, Emerging Markets still trade at a significant discount to the S&P 500 (MSCI EM trades at about a **25%** discount to the S&P 500 from a Price/Earnings Ratio perspective). We continue to believe there will be excellent opportunities within Emerging Markets.

Pulling It Together: Asset Allocation Recommendations

- **Overall:** Overweight stocks relative to bonds when risk tolerance allows
- **Equities**
 - Balanced between the US and Global
 - Overweight US Small & Mid Cap relative to Large Cap
 - Overweight Emerging Markets relative to International
- **Fixed Income**
 - Overweight Multisector and Convertible bonds
 - Underweight "Core" bonds, including Treasuries
 - Balanced Investment Grade and High-Yield

We will continue to frequently review portfolios to ensure that they reflect our best and most current ideas. As always, if you have any questions or would like to discuss the above topics further, please do not hesitate to contact us.