The Investment Landscape: Bumpy or Smooth Road Ahead?

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Los Angeles, California

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Treasurer, City of St. Paul, MN

Vishal Thacker
Chief Investment Officer, Alameda County
THE INVESTMENT LANDSCAPE: BUMPY OR SMOOTH ROAD AHEAD?
Moderator:
- Michael Solomon, Treasurer, City of St. Paul, MN

Speakers:
- Kenton McCarthy, CEO, Vulcan Consultants
- Vishal Thacker, Chief Investment Officer, Alameda County
- Michelle Durgy, Senior Portfolio Manager, KCM Investment Advisors
OVERVIEW

- Safekeeping of funds at ALL times
- GFOA Resources
  - GFOA BP: Investment Policy
  - GFOA BP: Diversification in an Investment Portfolio
  - GFOA BP: Managing Market risk in Investment Portfolios
- Market Resources
  - Investment adviser
  - Broker/dealers
  - Market information
INVESTMENT LANDSCAPE
ECONOMIC OUTLOOK
Massive Expansion of Fed’s Balance Sheet Adds to Monetary Base

Federal Reserve Balance Sheet (Quarterly)

Fed Balance Sheet in Trillions - Shrinking started October 2017
S&P 500 - Left Scale

KCM/Bloomberg Data
U.S. Macro Trends

Low Unemployment & Negative "Real" Rates Stimulate the Economy, Pushing up Inflation (CPI). Fed Raises "Real" Rate, Slowing the Economy, Eventually Causing...
U.S. Macro Trends

Fed Funds Greater than Unemployment Before Every Recession

- Recessions
- Unemployment Rate
- Fed Funds

KCM/Bloomberg Data
STRATEGY AND IMPLEMENTATION
Steps to Building An Appropriate Bond Portfolio

Develop Interest Rate Outlook
Establish Portfolio Maturity Structure
Establish Sector Strategy
Select Individual Bonds
Evaluate Existing Holdings

Where are interest rates going?
Which bond market maturities represent the greatest yield at the best price with the least risk?
Which bond market sectors represent the greatest yield at the best price with the least risk?
Which bonds are best suited given the need for income and/or capital preservation?
Are there any bonds that represent better opportunities based on changes in interest rates and sector fundamentals?

KCM/Bloomberg Data

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Establishing A Maturity Structure

KCM/Bloomberg Data

KCM Expected Total Return Between Two Treasury Bond Curves

- Tsy Bonds 05/05/21
- Tsy Bonds 05/08/19
- 2 YEAR HORIZON
- TOTAL RETURN

Bond Yields on Left Axis
Total Return on Right Axis

KCM/Bloomberg Data
Establishing A Maturity Structure

KCM Corporate Bond Investment Optimizer

Bond Yields on Left Axis
Total Return on Right Axis

KCM/Bloomberg Data
The ubiquitous and profligate callable agency.

It’s necessary companions are negative convexity (greater downside than upside) and illiquidity.

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The 'free' yield of agencies. What free really costs. Safety, liquidity and yield. Or, rather, yield, safety and, then, liquidity?

Establishing A Sector Strategy

Treasury vs Agency Liquidity (billions)

Federal Reserve New York
Establishing A Sector Strategy

Corporates – where things can get really murky.

FRED

ICE BofAML US High Yield Master II Option-Adjusted Spread

Shaded areas indicate U.S. recessions

Source: ICE Benchmark Administration Limited (IBA)

Federal Reserve St. Louis

myf.red/gfnOcn
Aligning Your Strategy With Your IPS

• Security Types and Risk
  1. Treasuries - utmost in safety and liquidity, lowest in nominal yield
  2. Agencies – high safety, illiquidity risk, option risk (negative convexity), higher incremental nominal yield
  3. Corporates – lowest safety, very low liquidity, higher incremental yield, high price volatility
  4. MBS and ABS – proceed with caution

• Duration and Cash Flow
  1. Establish an effective cash forecast based on your agency’s needs.
  2. Purchase securities that meet essential draws and leave a cushion for unexpected items.
  3. Manage price change with duration targets – be careful with options.

• Maturity Lengths
  1. Typically, longest final maturity is limited to 5 years (some are shorter)
  2. Evaluate the yield curve. Flat, inverted or normal will drive maturity targets (and total returns)
Adjusting Your IPS When Necessary

Adapting Your Policy To Meet:

- **Changing Market Conditions**
  1. Adding another security type
  2. Changing credit quality guidelines

- **Capitalize on Market Opportunities**
  1. Changing maximum duration targets
  2. Adjusting allocation maximums or minimums
Communicating Your Strategy

- County of Alameda
- City and County of San Francisco
- County of San Diego
Evaluating Your Existing Holdings

$11 Trillion globally is negative.
Evaluating Existing Holdings

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- 8M: 2.59
- 9M: 2.60
- 1Y: 2.60
Evaluating Existing Holdings

![Graph showing Medium-Term Corporate, Treasury Curves]

- "BAA" Corp Bonds: 2.91, 2.99, 3.05, 3.16, 3.30
- "A" Corp Bonds: 2.67, 2.69, 2.72, 2.78, 2.88
- Government: 2.42, 2.42, 2.42, 2.42, 2.43, 2.44, 2.42, 2.41, 2.40, 2.37, 2.29, 2.26, 2.28, 2.29
Strategy going forward. Context is key.

- Be flexible, patient and aware
- Don’t add bumpiness to a smooth road
- Be cognizant of your costs
- Understand your investments
CASE STUDY: ALAMEDA COUNTY

• Investment Policy
• Using Outside Professionals
• Market Resources Used In House
• Diversification Strategies
• Managing Risk
• Benchmarking
• Communicating with Elected Officials and Public about Changes to the County’s Investment Portfolio
QUESTIONS
Thank You!

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