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Topic: Fixed Income Investing, featuring DoubleLine Capital

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Transcript

This is an auto-generated transcript that has been lightly edited for ease in reading.

Ken Kozlowski: Hello, everyone. I'm Ken Kozlowski, Chief Investment Officer at Equitable Investment Management.

And I wanted to start by thanking our listeners. You've all been tuning into these interviews for over three years now, and we're so happy to see our audience continue to grow. Thank you for your interest in our portfolios and taking the time to hear our views.

And today, from the excellent group of around 40 investment firms hired to sub-advise Equitable investment management portfolios, we bring you Jeffrey Sherman, Deputy Chief Investment Officer of DoubleLine Capital.

Jeffrey overseas and administers DoubleLine's investment management subcommittee, implementing an investment process across the investment teams. He also serves as lead portfolio manager for multi-sector and derivative-based strategies. Mr. Sherman is a member of DoubleLine's executive management and fixed-income asset allocation committees and is also known for his podcast, *The Sherman Show*, which was named one of the 10 Must Listen podcasts by *Business Insider* in 2020. Mr. Sherman has taught statistics, mathematics and quantitative methods for rising financial professionals. He's also a CFA charterholder.

Jeffrey, last time we met, you presented to our independent Board of Trustees earlier this Spring, and I'm thrilled to share this stage with you today. Welcome.

Jeffrey Sherman: Well, thanks for having me, Ken and thanks to all your listeners for tuning in. Hopefully, we make it worth their while today.

Ken Kozlowski: Thank you, and I'm sure we will.

So for today, I thought we could start broadly. And if you could tell me a bit about your investment process and specifically what is the DoubleLine-controlled risk approach?

Jeffrey Sherman: Yeah, so the way we approach portfolio management is that we try to integrate, kind of holistically, every piece of the puzzle together. And what I mean by that is we start with the basis, especially on a fixed-income portfolio, the basis thinking about the macroeconomic landscape.

And, you know, the road of macro is fraught with all kinds of land mines out there. And so part of the risk management approach is to try to avoid the land mines. Now, sometimes you're going to get hit by one, every once in a while. So, what you need to have is a portfolio that allows you to weather that land mine, and it doesn't take you out of business, right? And from the standpoint of thinking about the macro landscape, it's a good guide. But as we sit here and record this podcast today, I don't think today's market, the activity we see out there is driven by macroeconomics, right? There tend to be, you know, kind of stories that take place.

There's also the fundamentals which are taking place. And you have to marry these things together. And when I think about the tool kit used it, it starts with the macro backdrop. You're trying to identify where you see burgeoning opportunities. You also want to see where risks you think are developing or are you're just right in the middle of the risks that that are out there. But then you have to go back to, you know, we talked about the CFA Charter, right? You've got to go back to fundamentals. And you've got to marry the two things together. You can have a positive macro backdrop and deteriorating fundamentals, which actually lead to something where you may want to be a little more risk averse, right? You're kind of looking for those sweet spot of things to work together. But also in the tool kit has to be a technical analysis, as well. There are times where you want to enter a trade. You know, just think about the AI craze that we have experienced—or at least maybe I'll be crazy to say the word craze—but the AI boom we've seen, right? Is AI innovative? Yes. Is it part of our future? Yes. But, if you look at the charts, are the stocks high? Yes, right.

So even though the thesis and the fundamentals may underpin [an investment] and valuation may look good over the cycle, maybe the technicals are in your favor as well. The way we think about risk management, and to bring this full circle and the question, is that we kind of think of it as risk integration. And what I mean by that is that in markets you should be rewarded for the risk you take, right? That's one of the basic tenants of Finance 101. And so, if you're being rewarded for that, that's great, but you have to identify what risks are in that position.

So, if we could find something else that, say, also has risk, and maybe it has a risk that occurs in a different environment than “security A” that we just described, then those two things somewhat integrate together. And if you can find multiple types of these trades and mathematically people say you'll talk about low correlation or things like that. But if you find things that can somewhat offset one another, that don't fire in the same environments, that don't exactly sell off in the same environments, then you can potentially have a portfolio that can weather a better storm. And one of the nice mathematical properties of that is that it can actually boost your return over time.

You have two assets that have similar rates return, but if you can dampen that volatility, that actually can lead to a better outcome. And the philosophy behind the portfolio management or the portfolio construction process, is to try to do this across all of our portfolios.

Now, nothing's impervious. What works for a day may not work for a week or work for a month. But the goal is to think with a horizon that you think gives you a better chance of success. And what we try to think about is try to identify opportunities over the next 12 to 24 months when it's a return opportunity or mounting risk over those periods. And that kind of forms the cornerstone of the macroeconomic outlook.

Then you get saddled with things, Ken, like an election, you get thrown off by some, you know, spurious event or some exogenous shock out there. And those are things that you have to say, “Was I, adequately protected against that?” And what we find in a lot of instances, even when there's elevated volatility, we feel like the portfolios were in good place because we tend to be a bit more risk averse by nature.

Ken Kozlowski: Thanks for that. And let's pivot a bit into something my team and I have been discussing a lot this year. Duration. How does duration play into how you select and monitor the securities you invest in?

Jeffrey Sherman: Yeah, well, duration was a dirty word a couple years ago, right, Ken? A lot of people forgot about duration. I actually gave a presentation internally and said, “Don't forget about duration out there, what it can actually do to you.” And it's a double-edged sword. It cuts both ways. Duration is just a fancy bond word to say how sensitive is your portfolio to movements and interest rates. And duration can be a tool, and it's something that you need to think about when analyzing an investment. And the longer the duration of security, the more sensitive it is to the interest rate. And it is one component of volatility.

Now if you're buying a very credit-sensitive asset that has duration, now you have both risks embedded in there, right? So in general, I don't like to buy very long duration, highly credit-sensitive assets because then I don't get that integration approach that we just discussed, right? Talking about how things can zig and zag together, because bad credit, duration rallies. Well, a bad credit environment, probably isn’t good in that highly risky security, even though it does have that duration. So, I try to separate the two things, although, we're building the portfolio, what we're going to start with is thinking about the attractiveness of the overall security for the environment. And so, the credit environment's important, the interest rate sensitivity is important, but if it's something we think is somewhat optimal, we want to do that.

So, I separate duration into kind of two pieces. One is let's find the securities that work well in this environment, that work for the outlook we have. Now start to think about, “OK, if we add these things together, what does it do to the overall duration of one's portfolio?” So, for instance, you could buy—which has been a very popular trade since 2022—you can buy floating-rate assets, right? Floating rate assets, by definition, typically only have the duration is until they reset. So they tend to be quarterly in duration. So very low sensitivity of the asset to interest-rate moves.

But if I have that, and it has a meaningful amount of credit risk, maybe I want to cobble something back together to add more duration. Well, one of the cleanest and easiest ways to add duration is through a Treasury position.

So, just if you play along with me, all of a sudden, I could take, let's say, a floating-rate asset such as bank loans, bank loans tend to be below-investment grade. They tend to have very low duration because of the floating-rate component. And I could buy a 10-year treasury and put those two pieces together. Now I have credit risk coming from a credit security; my interest-rate risk is coming from truly the interest rate, with no credit risk in it. And if you put that back together, maybe that yield looks a little bit better than buying an investment-rate corporate bond portfolio, right?

You're trying to make sure that as you pull these pieces together, the duration component, the credit component, that these things integrate in a manner that are you better off doing those two pieces separate or do you want the package deal, right? And again, there's a difference in credit quality and the likes, and you're trying to assess that.

But today, duration is one of those areas where, you know, it looks like the Federal Reserve is about to embark on its cutting campaign. Jay Powell's been alluding to it since November of 2023. And it looks like duration is something you do want to own for some of this potential softening that we've been seeing in the economic data over the course of the summer. Again, I don't know when this actually gets released, but ultimately, you know, from the Fed meeting to the jobs report, we've seen big movements in interest rates downward.

All of a sudden now it seems like OK, maybe the world isn't ending. So, bond traders are just like equity traders. They get excited, and bond traders have been had this Pavlovian response that we all want to buy duration because: “The Fed's cutting! The Fed's cutting!” So, I think it belongs in your portfolio, Ken. You and I have talked about this in the past, but it's just one of the overall tools. And I don't think that the recession is imminent. I don't think creating, you know, 110+ thousand jobs in a month is recessionary. Yes, it was below expectations. Yes, we've been spoiled. But I think the Fed cuts, right?

And so maybe this is all part of the soft-landing type scenario. Maybe we end up with the hard landing because the Fed is reticent or slower to do so. So, in general, it's a long-winded way to say duration is one of the tools you can use. It was an underappreciated risk, I think, in that whole like pre-pandemic to the pandemic era, thinking rates would be low forever. Obviously coming off of one of the lowest rates in history in the US markets, the reset hurt in duration. But just because something, you know, hurts you at one point doesn't mean you should avoid it. And we do think that duration can help you navigate at least this stage of the cycle.

Ken Kozlowski: And Jeffrey, I'd love to hear you talk about the yield curve and what if any implications have the inverted yield curve and movements in U.S. Treasury spreads had on the type of securities and asset classes you see opportunity in right now?

Jeffrey Sherman: Yeah, no, that's the great question I get from a lot of people, Ken.

And for your listeners out there, the yield curve has been inverted for the longest it's ever been. I might look at “twos” (two-year) and tens” (10-year maturities). That's kind of the traditional measure. The Fed has talked about comparing the 3-month T-bill to the tens. But that being said, twos and 10s have remained inverted, at least on a closing basis, for the longest tenor of time since the World War II era.

So is there an economic rationale? And I heard this from Professor Claudia Sahm when she was talking about the Sahm rule (an early signal of recession that she developed). And again, some of your listeners may need to Google that, but it's talking about unemployment rate. But what she said I thought was a very interesting phrase and I'll use it here. If you look at the inversion of the curve, it's kind of a statistical measure. It's not inherently an economic measure. Now, you can argue that, OK, there is economics embedded in it. I would agree with that. But this idea that the yield curve inversion leads to a recession, it's more of a statistical phenomenon than anything else. And we come up with, you know, stories and narratives to corroborate that view.

But what it tells me is that, I think a simplistic way of thinking about it, at least that's, in my little brain, how it works, is that if I see an inverted curve, especially the front end, like policy rates and/or T bill rates, relative to kind of the belly of the curve being inverted, that tells me policy is tight relative to bond market expectations. Now what I mean by that, it just says that the bond market thinks over the course of the life of that security that interest rates will come down. Otherwise, there's just no economic rationale for that.

Now, you could say that bond traders have been waiting for that for a long time. And a lot of it was because of the rapid raise of interest rates or how quick they moved up and the magnitude they moved up. I mean, this hiking cycle, 525 basis points occurred over 18 months. Well, one thing is, that usually, that kind of magnitude of rate rises causes economic stress. But in this cycle things are a little different, like they are in every cycle, right? No two cycles are the same. And a lot of people, smart people, have posited the idea (and it’s something we've been professing the last couple years) is that it's probably because of the “term structure” of debt out there—the fact that we issued so much debt to corporate America in 2020 and 2021 on a fixed-rate basis. That means those bonds, until they roll over, the issuers don't have to pay market rates. So even though the current yields are 500 basis points higher, if your coupon is still 1½%, that's the cost of your debt.

So, what most people recognize this, is if they think about their mortgage, right? If you refinanced your mortgage in ’20 and ’21—I think almost everybody did because, everybody's calling you, emailing you, texting you, whatever they do—there was the ability to do so. And so, think about your mortgage. If you refinanced or you originated a mortgage in that period of time, it probably has a “2” in front of it, right? It's like a 2% number, maybe it's 2.5%, something like that. And so, does it matter that mortgage rates are north of 6? today? No, unless you need to buy another house, right?

So, I think that's important to really assess when we think about the inversion of the curve is because I think there's this Pavlovian response that these rate rises are really going to crush the economy. But the debt structure was in such a way that people, unless you have to borrow something at the margin, it didn't get impacted. And so, as I think through the inversion, what does it tell us?

It tells me that [interest-rate] policies are tight. And I think also you have a structure where a lot of the defined benefit plans in the U.S. buy a lot of corporate bonds, and they buy long-duration corporate bonds. And so that inherently puts some pressure kind of on these, back into the curve as well. So just like in the U.K., this is something, it's just liability hedging. Well, what I grew up with was, used to be called, a bond immunization, right? That's usually what they used to call it.

But you asked me a question. I went on a rant about the inversion. What do you do with it? Well, you obviously like to buy some securities at the front end because they have more the inversion of the curve means they have more base yield. It's kind of how you think about it, that is the Treasury rate, the rate you build on before you add the credit premium on there.

And so, what we've been doing to take advantage of this over the last couple years was to buy more credit that was shorter on the curve. So, things like CLO that are floating rate, bank loans, which I kind of alluded to a little bit. We also bought some fixed-rate securities, but they have 1, 2, 3 years of duration. So, they're keyed off this part of the curve, which means you get a better base yield.

And some of the most attractive securities in those markets were things that were in the securitized market, things like non-government guaranteed mortgages, things like commercial mortgage-backed securities, which scares everyone to death, when you use that phrase, asset-backed securities. So even some high-yield bonds sit in that part of the market, high-yield corporates. So, buying these types of securities was very helpful. I like that part of it too, that part of the curve because look we are taking advantage of the shape of the curve. Also, if you have assets that have shorter lives, they tend to also have a little bit lower volatility. And if you're buying a high-quality credit, they have lower sensitivity to spread changes, what we call spread duration. So, all these things were super accretive, we thought, in managing risk at that point in time.

However, you still need to own other pieces of the curve. And so, what we did in the belly of the curve, you know, just that's kind of jargon for saying 3- to 7-year part of the curve.That part was things like corporate bonds, right? Stable, high-quality, the big names you would think of, and not taking a lot of credit risk there. But understanding that spreads got a little tight. They did until we got some of this volatility as of late. But with that, spread tightening, if rates come down, many feel like it has over a few trading sessions, even though the spreads widen, you still didn't lose money because that Treasury base shield helped you somewhat.

I don't like owning corporate bonds for the simple fact to say, “Duration is going to help you.” But in this environment, it made sense to us. Then you have agency mortgages in the belly of the curve that are government guaranteed. They've been a cheap asset class. They've worked wonderfully at this part of the cycle. Finally. It's taken a while to play out. And then we own some Treasuries there, so going back to your previous question as well, then what we would do is we say, OK, these are the mix of assets we like. We assess our portfolio and say, “Wait, that doesn't get us exactly to the right duration we want to own at this part of the cycle, because we want to have some risk-off [positioning] in the portfolio.” And so that's what led us to owning some longer-duration Treasuries. So, the inversion of the curve led us to build this credit portfolio that we liked a lot. It's worked out, if you look at the trailing standard deviation stuff, it's been had lower volatility than the Bloomberg U.S. Aggregate Bond Index.

So all of this played out like we were expecting it to, and then we have these other augmentations. So, I've really kind of brought all three questions together there with that response and trying to think about what it does. Now the question becomes, when the Fed embarks on the cutting cycle, now we have to think about, “OK, what are the implications there? Do I want to own as much floating-rate debt? Because I know my coupons are going to reset down.”

So, we're kind of at this inflection point in the cycle where this portfolio has done very well, but we're looking at, should we be changing certain pieces of it.

Ken Kozlowski: Yeah. And that's a great perspective, and it's, I think, it's a great segue into my next question.

If we take a moment to talk about the Fed's decision to hold interest rates steady earlier this year at the end of the first quarter and again at the end of June, DoubleLine's positioning and outlook saw a higher risk for recession than the consensus view. And if you could talk about that view and what you and your teams are thinking about right now?

Jeffrey Sherman: Yeah. Well, so in statistics like anything else, you can't just look at averages, right? Or you can't just look in the aggregates, which we do a lot when we talk about aggregate earnings on the S&P right, or aggregate, you know, savings, you got to distill it down into pieces.

And so, and now I'll talk about the distribution of the data. What we've been seeing over the last, I'd say 12 months or so, is some degradation in the consumer (spending levels). Now it doesn't show up in retail sales, right? It's not showing up in the personal consumption expenditure, because those are aggregate numbers. But what you've seen is some degradation at the lower income and the lower credit cohorts and strata.

So what I mean by that is, if you segment into like quintiles or deciles, it's those bottom areas that have been more challenged. So, we see this in delinquency rates. And pick the credit, the type of credit product you want—whether you want credit cards, you want autos, you want student loans (student loans have been OK, actually), mortgages—anything that is financed by the consumer, that lower cohort or strata is the one that is struggling the most. Now there has been a little bit of improvement in it but also, that lower income strata is the paycheck-to-paycheck person, right?

By definition, they're not the savers. It's not their fault. It's just the income they generate. And so inherently, if you think about what's happened in our economy in the last few years, is that who does inflation hit the most, or impact the most? I mean, we all feel the impact of it, right? We all bellyache and we say, "Oh, this used to be a lot cheaper," but you're still surviving, Ken. We're still having dinners. We're still the roof over our heads. Fine. But it's that lower income cohort that gets the regressive tax is what we call it — a regressive tax [which has proportionally higher impact at lower income levels]. And inflation has done that to them. And so this is where the struggle is. But that's the economic cycle.

Now, it either stems from the inflation that we've seen here, which kind of impacts everyone, or it extends to credit and that's also Fed raising rates. That's what it's done there. So, what we've noticed there is that the employment data has been mixed. And I say mixed because depends on the series you use, you can construct, you know, a narrative around it. And at the end of it, I think some of the data is being obscured by the immigration policies or the immigration that we've seen in the last couple of years. But it's not showing up in the household survey [series of the data collection process]. It's showing up in the [data collected on retail] establishments, which is non-farm payrolls. The retail employer says, "I have a job for these people. I hired somebody." Whereas the household survey is going through the traditional mechanism, maybe not catching that.

Why is that important, Ken? It's important because the unemployment rate is calculated on that latter series, on the household [data]. And even though there were a hundred and some thousand jobs created last month, the unemployment rate ticked up 2 tenths, right? And that was rounding, it was like 1½ tenths, but whatever. My point in all this is, that there is some weakening in the labor market, or there's at least balance. So that's something that's causing it, and you're seeing wage growth start to decelerate.

So all of these things show that maybe there's a little bit more stress on the ultimate consumer.
Now, if you look at the lowest quality of borrowers in the capital markets, things like triple-C high-yield bonds, triple-C loans, they've done quite well until the last month or so.

And this is kind of the risk-on kind of mentality that was in markets and the fervor that was going around. But when I look at what's going on (the consumer, my key metrics) I don't think we're in recession now. I don't think one's happening probably, between now and year end. But the risks are becoming a little more elevated because time is the enemy of all these theses, right? If you're living paycheck to paycheck, you have a hiccup, and you lose a job: that's what really crushes people. And so I think what we have to really focus on heavily is the labor market. And as long as people stay employed, the consumption will stay there. But the thing is that, we've noticed unemployment rate ticking up, it's kind of spooked the market a little bit, but you only get the jobs data once a month. So, it becomes this big play for the next four weeks.

However, Ken, as I've told you, and I think at our last review, is that I watch the weekly unemployment claims. And one thing I like about unemployment claims — and it has its own issues — but I don't think that it's rampant with under-reporting. I think at the end, if there's fraud, it's going to be the other way, people saying they're unemployed but they're really working.

The unemployment rate to me is our unemployment insurance. When those claims come through, people are actually receiving a benefit. They've proven that they're not working, and they need to do that, and they're looking for work. So, that measure has really started to tick up meaningfully in the last few reports, so let's say over the last six weeks. So that's something we're definitely watching, especially coupled with the non-farm payrolls on that side. It's a steady trend. We've seen the job openings come down a fair amount. There's better balance in the labor market. And I just think that what you're finding out here on the recessionary risk is that these ideas of the bankruptcies, the defaults, they take a while to materialize and the weakness that you see in credit markets as of late, has been at the lower rating area.

And I think that right now, it's not that we're pounding the table for some recession, it's that I think the borrowing costs need to come down a little bit. I also think that we need to get relief to these lower income and lower credit quality borrowers because that's the ones who are really suffering. And so those are the things that kind of manifest there when you start to dig beneath the surface of the data, you start to get a little bit different picture. But by no means am I ringing the alarm bell for the “recession is imminent” camp today.

So I feel like this cycle, it's been prolonged, but it doesn't mean that the recession risk goes away. And all we've been pointing out is that, if inflation's coming down to 2½-3% and I can buy Treasuries north of 4%, that's a good positive real yield. So even if we're delayed on this recession idea, we're getting paid to wait. And by the way, when you get this exogenous thing that just happened to us in August, it, it works in your favor.

Ken Kozlowski: Great insights and you and your colleagues at DoubleLine make frequent appearances and offer investors great insights into the market.

So final question, what's one important reminder for investors as we move through the next 12 to 18 months?

Jeffrey Sherman: The reminder, if we're "reminding" that means you already know it, right? So, I'm going to key on that word. The "reminder" is there are no free lunches except for diversification, right?

Ken Kozlowski: Great.

Jeffrey Sherman: So don't get caught up in the frenzy. Don't get caught up in the, the hot trade. If you need to trade it, take the small little account you have. Don't make it as a big piece of your portfolio. And make sure you stick to your discipline. Remember, you've got to rebalance, you've got to reallocate. And those are very important. And given that we're in an election cycle, I like to remind people that typically the election doesn't matter to most investors, right?

So, no matter what tribe you get into and, and you want to pick sides and think the world's ending if the other side wins, or it's only going to be great if your team wins. Historically that's been a horrible way to invest. And so from that standpoint, you know, you got to have cool heads in there when you get volatility.

But the thing is, is that if you're patient, you have discipline, reassess your portfolio, look at it. Hey: stocks down; Nasdaq's down 10%, 12%. Hey, it's up a lot still [for the year], but maybe it requires a little rebalance here. Bonds have done well recently.

So it's going back to, you know, kind of blocking and tackling, the basics of investing. And you got to be reminded of that because we've lived in a, a very strange capital market since November of 2023, it rarely went down, right? I mean, stocks up, credit up, there's been so many good things. And so, the hardest thing to do is when you have a winning trade is to try to trim it. And I think that's the thing that people need to look at right now, and just remember that it's a long game of investing. Investing over the next, you know, two months or for the election is just a futile exercise.

And what we got to do is be disciplined. We've got to have a process that works through a full cycle. And that's what we're trying to do for you and your clients too, Ken, and the products we run at Equitable and follow up with other clients across DoubleLine.

Ken Kozlowski: That's a great point, Jeffrey. You know, rebalancing, it's very disciplined. It takes the emotion out of investing. And I think that's a great reminder for people to do.

And, and I just want to say thank you for your time. Thanks for joining us and being such a great partner.

Jeffrey Sherman: And I thank you.

Ken Kozlowski: And to our listeners: Stay tuned to the EQ site for more news about markets and investing. Thank you so much and thank you, Jeffrey.

Jeffrey Sherman: Appreciate it. It was my pleasure.

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