REAMS ASSET MANAGEMENT
A Division of Scout Investments

July 6, 2023

Dear Clients and Friends:

The annals of human endeavor are replete with instances of unforeseen consequences born of misguided pursuits. The infamous Charge of the Light Brigade during the Battle of Balaclava in 1854, immortalized by Tennyson's stirring verse, provides one such cautionary tale. The Light Brigade, misunderstanding orders, charged headlong into a heavily fortified Russian position, resulting in heavy casualties. Their bravery was legendary, but their mission was a complete disaster. Their saga stands as a stark reminder that charging blindly, without understanding the objective, can lead to dire consequences.

The tragic miscommunication that led the Light Brigade into the valley of death is an apt metaphor for a pernicious fallacy that, at times, grips even the most seasoned investors – the mistaken belief that the index IS the strategy, the goal unto itself, not merely its yardstick. Indeed, even those who label themselves as 'absolute return' investors are not entirely immune to this seduction. Motivated by both past success and professional pressures that encourage risk aversion, index-centric investors charge confidently into the maelstrom of market and macroeconomic uncertainties. Although indices are invaluable tools for refining portfolio construction and evaluating the performance of various components, they pose a potential hazard when investors mistake the index for the destination, rather than the roadmap.

The reality is that each pool of assets serves a distinct purpose. Be it funding retirements, supporting ongoing operations, financing future projects, or simply creating a bulwark against economic turbulence, the mission of portfolio stewards is to put in place strategies that navigate towards the stated goals with a high degree of certainty. Outperforming an index by a certain number of basis points may shine in quarterly reports, but it is, at best, an abstraction from achieving the portfolio's true underlying objectives.

Within the realm of real yields, the recent differences between an index-based approach and an objectives-based approach are considerable. Two years ago, real yields were deeply negative. An index-based approach would have led unwary investors into a financial cul-de-sac that all but guaranteed negative returns and underperformance. An objectives-based approach, on the other hand, would have led investors to limit exposure to real rates and maintain below-index durations in their bond portfolios. The magnitude of the rise in rates was unpredictable, but the direction of travel and likely outcomes were not.

Fast forward to today, and the real yield landscape has transformed. Real yields are now significantly positive, the highest they have been in more than a decade. Nominal rates continued to press higher during the second quarter, causing palpable fear, or at the very least some amount of anxiety, about maintaining long duration in the current environment. This concern may prove justified in the short term. Notwithstanding, investors who are focused on achieving their long-term objectives will understand the importance of having significant exposure to real rates at current levels.

Interest rate volatility has also reached historically elevated levels, which has made the mortgage-backed sector more attractive than it has been in many, many years. The yield curve, after steepening in March following the regional banking turmoil, has once again become deeply inverted, guiding us towards curve positioning that will benefit from the inevitable normalization. In contrast, we find valuations within the corporate sector to be less compelling on a relative basis and have rotated our exposures accordingly.

We do not claim – and have never claimed – that we can accurately predict the vicissitudes of financial markets, even within the realm of our specific expertise as bond managers. Our simple yet vital goal, as stewards of your capital, is to gain exposure to attractive risk premia and avoid exposure to unattractive risk premia. If we can do this in a disciplined and consistent manner, then the long-term results will bear out, even if the short-term fluctuations are unpredictable and, at times, uncomfortable. What is certain, however, is that we will not follow in the footsteps of the Light Brigade, blindly adhering to the often-myopic consensus approach.

Sincerely,

Mark M. Egan, CFA
Managing Director