PAPERS

**Pennsylvania Association of Public Employee Retirement Systems**
**PO Box 61543, Harrisburg, PA 17106-1543**
**Website:** ***www.pa-pers.org***

# Winter 2025

## *In This Issue*



## Upcoming Conferences

***@ Harrisburg Hilton Hotel***

**Spring Forum**
**May 28-29, 2025**

**Fall Workshop**
**Nov. 18-19, 2025**

**Current PAPERS Associate and Affiliate Member firms may become a corporate sponsor for either or both conferences.**

Choose from one of three levels of sponsorship:

- ***Platinum - $6,000***
- ***Gold - $4,000***
- ***Silver - $3,000***

# PAPERS Spring Forum Agenda Shaping Up

The PAPERS Education Committee and staff are busy developing topics, engaging speakers and firming up plans for a fabulous agenda at the Spring Forum, scheduled to take place at the Harrisburg Hilton, May 28-29, 2025.

Registration opens soon for this conference, the premier public employee pension system event in Pennsylvania, providing an essential platform for trustees, administrators, and industry professionals to gain insights, exchange ideas, and network with peers.

**Key Topics:**

- **A day in the life of a TRUSTEE:** Focusing on the basic responsibilities of trustees and understanding the core duties they must fulfill.
- **Understanding Risk as a Plan Trustee:** Discussion on the various types of risk trustees are faced with as fiduciaries
- **Exploring one of the specific risks - Investment:** A panel discussion on due diligence, understanding the process and how to follow it and a quick look at emerging themes in investment trends
- **Regulatory and Legislative Updates:** Key changes impacting public pension
- **Federal policy Update**: A look at the new administration's policy agenda and how these changes could potentially impact the economy and markets
- **Actuarial Insights:** Understanding mortality tables and assumptions
- **Technology & Innovation:** How AI is operating in the public sector

Whether you're a trustee, administrator, or service provider, this event will offer valuable knowledge and tools to help you address the challenges and opportunities facing public pension funds.

**Who Should Attend:**

- Pension Trustees
- Plan Administrators
- Investment Professionals
- Consultants
- Actuaries
- Attorneys
- Service Providers to Public Employee Retirement Systems

**Registration is now easier than ever by using PAPERS' new on-line process. Look for additional conference information coming soon.**

## *From the PAPERS Board President*

**Happy New Year!**

I hope everyone had a joyous and healthy holiday season.

First off, I want to thank Karen, Doug, and Lori for the great job they did on the Fall Forum. I also want to take the time to thank the Education Committee for setting up the informative topics, the presenters for sharing their insights and talents, and a big thank you to our Sponsors, without whose support we could not conduct the forums.

Our Education Committee is already hard at work planning session presentations for the May Forum which will be upon us before we know it.

With the ever-changing landscape in Washington, it is more important than ever for Pension Plan Trustees to keep educated on changes affecting Pension Plans.

The primary mission of PAPERS is trustee Education, something we do well. If you know of any plans that would benefit from our Trustee Education, please feel free to send their names to either Karen or myself to follow up. In that way we can grow the organization and spread training to more Trustees to help them function in their capacity better.

In closing, have a great rest of winter and spring and see you in Harrisburg in May.

*Bob Mettley*

## PAPERS Membership Categories

- **Participating** ($125/year early bird rate; $150/year after 3/31/2025) - *Public employee retirement systems (pension funds)*
- **Associate** ($1,500/year) - *Corporate providers of legal and investment services to pension plans*
- **Affiliate** ($750/year) - *Corporate providers of other services, exclusive of legal and investment services, to pension funds.*
- **Sustaining** ($75/year) - *Individual membership open only to those persons with an interest in public pensions but not affiliated with an organization which qualifies for group membership pin any other category above*

# The FLATION Complication

**David Aspell, Co-Chief Investment Officer, Mt. Lucas**

We speak with a diverse range of investors—domestic and international, institutional and retail, alternatives-focused and equity-centric. Typically, they have a variety of questions and concerns driving their current thinking. However, in recent weeks, there's been a singular focus: the return of President Trump. It's remarkable how much of a Rorschach test he has become.

For macro topics like inflation or growth, we usually see a fairly narrow range of opinions—around 10-15% of people expecting slightly lower inflation, 10-15% anticipating it to be a bit higher, with most clustered near the target, expecting the status quo. Currently, not a single person thinks we are in a state of equilibrium. On one side, 50% believe we're headed for runaway inflation fueled by exploding deficits, Fed pressure, eroding confidence in the USD, and soaring commodity prices due to global turmoil. The other 50% foresee a deflationary crisis spurred by the deportation of 10 million immigrants, a $2 trillion reduction in the federal budget, and a rampant USD disrupting emerging markets and driving commodity prices down. Adding to this uncertainty, President Trump, the world's largest one-man volatility machine, has teamed up with perhaps the only person who could rival him, Elon Musk. Volatility squared.

These factors, among others, have realigned market assumptions, significantly increasing the likelihood of problematic inflation or deflation over the next twelve months. Investors face a FLATION complication.

Successful portfolios will account for this when evaluating current asset allocations. Managed Futures might be the only investment strategy that has thrived in both of these scenarios, thanks to its ability to go long and short on commodities, currencies, and global bonds. Historically, adding Managed Futures to traditional stocks and bonds has increased a portfolio's annualized return and lowered its standard deviation. Importantly, it is completely detached from the emotional aspects of analysis, which is crucial in volatile and tense times. No value judgments here—it plays the hand it is dealt. A powerful diversifier for uncertain times.

***Let's dig deeper…***

For the first set of fears—runaway inflation, exploding deficits, a collapsing dollar, and high commodity prices—trend strategies would likely be shorting the long end of the bond market, shorting the USD against major currencies, and holding long positions in hard assets like gold and crude oil.

For deflationary disaster fears—trend strategies would likely be long on the USD, short on commodities such as copper and oil due to declining global demand, and long on bonds as rates return to lower bounds.

We've always believed that portfolios are generally overexposed to the current state of the world. Equity and credit markets usually favor stability. If you're unsure how things will unfold, consider the investment approaches and tools in your portfolio. Managed Futures provide exposure to shifts in the world that you can't easily predict or access, as most portfolios are long-only and lack the tools to engage in currency and commodity markets. With credit spreads tight and equity markets at relatively high valuations, adding some diversification and exposure to significant moves seems prudent.

# Risk Mitigating Strategies

**Submitted by: Wilshire**

Over the last several years, Wilshire has observed increased appetite from institutional investors for Crisis Risk Offset, also referenced as Risk Mitigating Strategies (“RMS”). These programs tend to capture several strategies which have in common a low to negative correlation to equity markets. Most are systematic and capitalize on well-documented and researched risk premia and factors.

Each underlying strategy has a different response function to financial market shocks and behaviors. As a result, they can be assembled in multiple ways, depending on the level of expected protection to a prolonged equity market sell-off that is needed by the investor.

| Strategy | Key Characteristics |
|---|---|
| Trend Following (“Trend”) | • Low to negative correlation to most asset classes with an implicit long volatility bias.<br>• May be challenged in non-trending environments or around abrupt market reversals. |
| Global Macro (“Macro”) | • Seeks to capture large macro disruptions across most asset classes (primarily fixed income and currencies) and expected to exhibit diversifying behavior around market inflection points.<br>• Implemented in a discretionary or systematic approach. |
| Alternative Risk Premia (“ARP”) | • Seeks to capture traditional and alternative risk premia.<br>• Can be used tactically to enhance returns or provide defensive benefits in stretched markets. |

There are multiple ways to construct RMS programs, with key considerations highlighted below for investors who are in the process of building and running these programs:

- Establish the program as a strategic allocation before the actual downturn occurs, while also being prepared to be tactical/active when relevant.
- RMS building blocks need to have defensive strategies (Trend Following) to provide convexity, which should be complemented with income-generating elements (Risk Premia) to offset the negative carry associated with the defensive components. Other components that are more dynamic can play both defensive and income-generating roles (Global Macro).
- Allocate to underlying strategies with low correlations to increase the probability of performing well at different points in the cycle.
- Manager selection is key to implementing these programs, with the goal of ensuring that the managers perform in line with their desired role – defensive, income-generating or both.
- Active rebalancing is essential.
- Maintain the ability to implement tactical tilts to some of the core components in stretch environments.
- Remain disciplined in the allocation to the program during equity bull markets.
- Furthermore, given the challenges that these programs may face in certain market environments, we believe that RMS programs can be enhanced by incorporating additional elements to the core components of Trend, Global Macro and Risk Premia, which may include:

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# Risk Mitigating Strategies

***(continued from page 4)***

- Actively-managed tail risk strategies to enhance the convexity with managers and/or solutions
- that actively seek to minimize the negative carry and have systematic monetization rules in periods of strong performance.
- Complement these programs with uncorrelated strategies to improve overall performance when markets rally.

Markets have provided us with numerous shocks during the last five years, which provide a relatively robust set of observations for analysis: Covid in March 2020 and the following extraordinary monetary and fiscal stimulus, rising inflation – exacerbated by the Ukraine-Russia war and associated supply chain disruptions, and the fastest hiking cycle in decades. The U.S. financial markets responded accordingly to these events, all of which have coincided with historical moves in most asset classes.

We believe that RMS programs represent a compelling source of diversification to traditional multi-asset portfolios.

***To read more about Wilshire's approach on building an RMS program, please contact us at AltsMAP.ClientServices@wilshire.com.***

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# With the New Year Comes the Start of a New Real Estate Cycle

**By: Sabrina Unger, American Realty Advisors**

***Sabrina Unger,** Managing Director, is the Head of Research & Strategy at American Realty Advisors and is responsible for leading the firm's research initiatives and developing investment analysis in support of new acquisitions and strategy implementation. She has been published in leading industry publications, including Real Assets Adviser, and the research publications of ANREV, NCREIF, and AFIRE, and was named a 2022 Woman of Influence by GlobeSt. She holds a bachelor's degree from SIU Carbondale and a master's degree from DePaul University and has completed certificate coursework at New York University and the London School of Economics.*

**Progress towards a policy soft landing continued through the latter half of 2024, setting the stage for renewed optimism heading into 2025.**

While that's not to say today's environment is without risk, we feel confident that the glidepath charted by the Fed back in 2020 has been largely successful, and that 2025 will represent the beginning stage of a new macroeconomic and real estate cycle, marking a departure from pandemic-era inflation and policy conditions. We believe the benefit of hindsight will show investors would have wished they'd "gotten back in sooner" when we look back in a few years' time to today's buying opportunities.

**<u>Cyclical Opportunity</u>**

The saying goes "history may not repeat itself, but it often rhymes". For real estate, that has tended to manifest in a predictable set of phases (Figure 1). Today, most would probably agree we have begun

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# With the New Year Comes the Start of a New Real Estate Cycle
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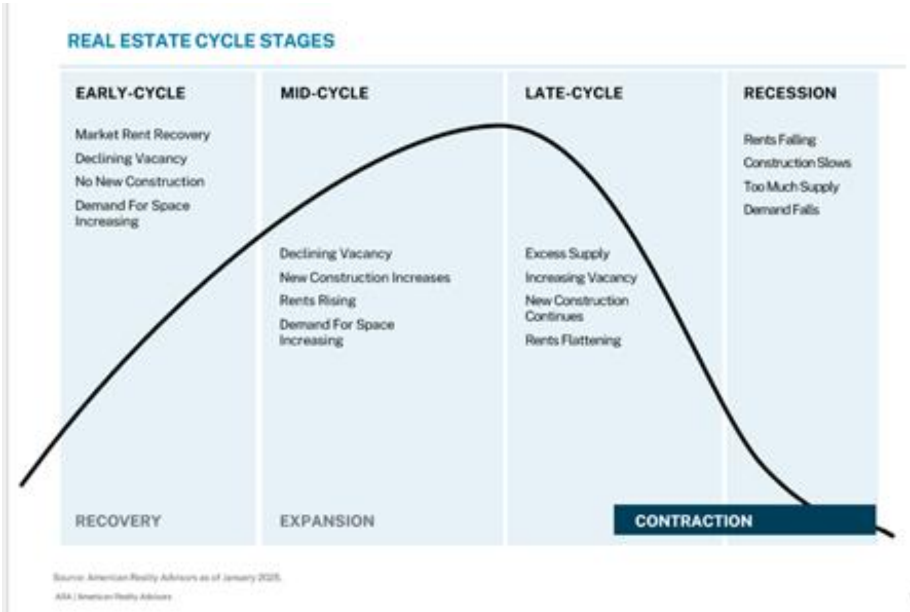
to move past the trough, as real estate fundamentals and capital markets forces both have become more supportive.




Though there are compelling returns to be had throughout market stages (yes, even contractions), history suggests that it is in the early quarters of the recovery where the highest returns are often achieved. We need only look back to what was arguably one of the worst real estate recessions in modern history during the Global Financial Crisis to see this play out.

Though the economic recession ended in 2009, real estate fundamentals did not arguably begin to turn the corner to recovery until 2010. Funds that anticipated and identified these turning points and got out of the gates earlier in the recovery provided stronger returns than those whose deployment didn't start until improvement was well under way and generally firmer. The difference in average IRR – that is, the internal rate of return, or a measure of profitability of an investment that accounts for the time value of money – between an investment made in 2011-2014 vs. 2015-2018 was 910 basis points, or nearly 10 percent.[1]

Valuations continue to be a key question for real estate investors, as few want to reenter while the proverbial knife is still falling. But for pension plans who may not be able to pivot and deploy capital quickly in the event a bottom is identified given the amount of time it can take to get new investments approved and funded, we believe a more practical and advantageous approach is to start exploring new or add-on commitments when things move into their last leg down, so that when fundamentals and capital markets start to turn, funds can be invested earlier.

But how can you determine whether the market is turning? We believe there are three areas that provide a barometer of the state of the market at any given time (Figure 2[2]).

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[1] Source: American Realty Advisors based on data from NCREIF dated 30 September 2024, the latest the series was available. Value-add real estate fund performance reflects the NCREIF Fund Index – Closed-End Equity Value-Add Strategies (NFI-CEVA) equally weighted as of the reporting date.

[2] Source: American Realty Advisors based on data from Macrobond, MSCI Real Capital Analytics, FRED St. Louis, CBRE-EA and CoStar as of January 2025. Note that data points are through Q3 and Q4 2024 depending on data availability as of January 24, 2025.

# Strapped to the Mast

**By Stephen Auth, Federated Hermes**

***Stephen Auth, CFA, Chief Investment Officer-Equities, is responsible for overseeing all of Federated Hermes equity and asset allocation products globally. He joined Federated Hermes in 2000 and has 41 years of investment experience.***

With the market so pumped up for all things Trump, some near-term rocks could be out there that could lead to some volatility ahead.

1. **Ugly sausage making process now ahead.** While the President can implement quickly parts of his supply-side agenda, he needs Congress and federal agencies for other critical parts, especially tax cuts.
2. **Earnings and guidance will matter.** We are in the early stages of earnings season now and see two important risks. Ironically, the miss is not so likely to be in fourth-quarter profits, which we expect on balance to be solid and modestly better than expected.
3. **The Federal Reserve could keep pontificating from their Econ 101 playbook, unsettling markets.** Several members seem unusually inclined to weigh in on parts of the president's agenda. If these siren calls keep up, markets may overreact.
4. **Bond market vigilantes might also overreact.** This market is also more short-term oriented, and with the Fed, could easily overreact to the sausage-making process upcoming. If bond yields cross 5%, that would be difficult for equity markets.

The upside risks to this market, on the other hand, tend to be longer term in nature and keep us positive on the outlook for equities, which, after all, are a call on the overall long-term trajectory of the global economy.

1. **"Tariff Chess" could work out better than anyone forecasts.** Given the aggressive positions Trump has laid out, he could easily come home from his various forthcoming trade negotiations with, on balance, a package of more domestic production and inbound investment, greater US exports, cheaper energy and more (tariff) revenue for the US economy paid for in part by foreign partners.
2. **Inflation could come down, not rise.** We've made the case before that the balance of Trump's policy agenda is deflationary, not inflationary. When you lower the costs of doing business in the US, those costs normally get passed through, at least in part, to consumer prices.
3. **Animal spirits could pick up.** With all the new optimism in the air, and the positive "tone at the top" coming out of Washington, we expect the Initial Public Offering /Mergers and Acquisitions market to really start to heat up.
4. **Geopolitical risks could decline.** Trump has a lot of pieces to move and is pretty skilled at doing so. If the global backdrop improves, that would be growth-positive and probably deflationary to boot.

We think there's plenty of upside ahead, even if the path there may be rocky. In the meantime, we're braced for volatility in the near term, as the balance of risks plays out, with money market cash on the sidelines if a buying opportunity emerges. We're keeping our ears tuned for the siren calls that may be coming from both sides of the straits—the bulls and the bears. But we're not going to lose focus on the prize.

***We're strapped to the mast.***

# Solving for 2025

**BY: Jeff Blazek and Erik L. Knutzen, Neuberger Berman**

As we transition into 2025, it's crucial to reflect on the past year's developments and prepare for the challenges and opportunities ahead. At the close of 2024, Neuberger Berman's investment leaders convened to discuss how the investing environment has evolved throughout the year and to identify the key themes they foresee for 2025. In this document, we present their insights on macroeconomics and their expectations for equities, fixed income and alternative investments. We believe there are five key themes for investors to consider as they evaluate risk and opportunity in the new year.

## MACRO: GOING FOR GOLDILOCKS

### 1. A Year of Above-Trend Growth

While the politics may change, industrial policy aimed at influencing domestic production patterns will continue, whether achieved via government spending and investment, tax policy, trade policy, deregulation or other means. If inflation can be contained—and we think it can—central banks can stand aside and allow economies to run a little warm. That is a recipe for above-trend U.S. GDP growth, which could drag some of the world's other economies with it. The debt and deficit implications, and the question of whether capital is being well allocated, may surprise investors by being manageable concerns in 2025.

### 2. Expanding the Soft Landing by Broadening Real Income Growth

The detrimental impact of high inflation on lower-income consumers and small businesses has been an important driver of this year's political uncertainty. Countries and governments that deliver moderate inflation and broader participation in positive real wage growth and positive real revenue growth will increasingly come to define success, visible in data points such as higher consumer confidence, political approval ratings and GDP growth rates. While it remains to be seen whether specific policy mixes can achieve this, we see evidence that the incoming U.S. administration at least recognizes the objective, and active industrial policy is evidence of growing recognition elsewhere.

## EQUITIES: THE MARKET OPPORTUNITY IS MORE THAN SEVEN STOCKS

### 3. The Stage is Set for Broadening Equity Market Performance

Deregulation, business-friendly policies, moderating inflation and lower rates may allow a broadening of earnings growth and price performance. At the same time, mega-cap technology growth rates are likely to decelerate and normalize as capital expenditure ramps up. Value and small-cap stocks, and sectors such as financials and industrials, could begin to catch up with mega-cap technology. Non-U.S. markets could perform more strongly on higher global growth and lower commodity prices. Relative valuations, as well as fundamentals, should provide support for this theme.

## FIXED INCOME: FED UP WITH FED-WATCHING

### 4. Bond Markets Will Focus on Fiscal Rather than Monetary Policy

For more than two years, bond markets have been dominated by inflation data and the responses of central banks. We think a reacceleration of inflation can be avoided next year, and that central banks will settle into the dull routine of debating where the neutral rate sits. Bond investors will likely shift focus to the growth outlook through most of 2025, and possibly deficits and the term-premium question late in the year and into 2026. The result will be moderately steeper yield curves and a migration of bond market volatility from the short end of the curve to the intermediate and long parts.

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# Solving for 2025

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## ALTERNATIVES: THE ART OF THE DEAL

### 5. Mergers and Acquisitions Are Set to Surge

Numerous factors are aligning to release a pent-up torrent of corporate dealmaking: above-trend growth; buoyant public equity market valuations; a more stable inflation and central bank outlook; the return of banks to the leveraged lending market; declining rates and tight credit spreads; and, perhaps most importantly, an expected change in regulatory stance in the U.S. That said, private equity secondaries and co-investments will continue to flourish as liquidity is still required to work through a huge backlog of mature investments, and it will remain challenging to raise new primary funds. Event-driven hedge fund strategies will benefit from a big new opportunity set.

**Link to entire article here: Neuberger Berman – Solving for 2025**

About the Authors:

**Jeff Blazek, CFA** and Managing Director, is Multi-Asset Co-Chief Investment Officer. Jeff joined Neuberger Berman in 2024 and, along with Multi-Asset Co-CIO, Erik Knutzen, is responsible for co-leading the firm's multi-asset investment activity, driving portfolio construction and developing investment outlooks. He serves as co-chair of the firm's Asset Allocation Committee and Public Private Investment Committee, and he is also a member of the Investment Risk Committee. Previously, Jeff spent over 12 years at Cambridge Associates, having founded and led the firm's New York City office, and serving as co-leader of the Endowment & Foundation practice and as Head of the Healthcare practice. Jeff has also worked in-house at two investment offices: Managing Director at New York-Presbyterian Hospital for three years, and Portfolio Manager at Teacher Retirement System of Texas for five years. Jeff has over 25 years of investment experience. Jeff holds a Bachelor of Business Administration and Master of Professional Accounting from University of Texas at Austin. Jeff serves on the BBA Advisory Board for UT's McComb School of Business.

**Erik L. Knutzen, CFA, CAIA** and Managing Director, is Multi-Asset Co-Chief Investment Officer. Erik joined in 2014 and, along with Co-Chief Investment Officer of Multi-Asset Jeff Blazek, is responsible for leading the management of multi-asset portfolios, driving the asset allocation process on a firm-wide level, as well as engaging with clients on strategic partnerships and customized multi-asset solutions. Erik Co-Chairs the firm's Asset Allocation Committee and Public-Private Investment Committee and is a member of the firm's ESG Committee. Previously, Erik was with NEPC, LLC where he served as Chief Investment Officer since 2008. As CIO, he oversaw dedicated research teams focused on Alternative Investments, Traditional Strategies and Asset Allocation for NEPC's client base with, collectively, more than $800 billion in assets under advisement. He has over 30 years of experience in the financial services industry. Erik holds an MBA from Harvard Business School and a BA from Williams College. He has been awarded the Chartered Financial Analyst and Chartered Alternative Investment Analyst designations. Erik is an Associate Editor of the Journal of Investing, is on the Investment Committee of the Massachusetts Audubon Society, and on the Board of Directors of the charity Start Small Think Big.

# 2025 Outlook: Themes for a New Economic Landing

**Authors: Saira Malik, Anders Persson, Biff Ourso - Nuveen**

**Economic landing scenarios are subjective. And from our perspective, it feels like the post-pandemic global economy has fundamentally changed. Swings in consumer behavior, technological advancements, political shifts, global trade and capital flows have created a world where inflation and monetary policy rates have settled into a new, higher-than-2020 equilibrium. This new, higher landing zone has significant implications in 2025 and beyond for how investors approach portfolio construction and find opportunities across asset classes.**

## Investment positioning: fixed income

The global macroeconomic backdrop continues to favor fixed income investments. Most global central banks are in a slow easing mode. According to our upcoming EQuilibrium global institutional investor survey, only 28% of U.S. public pensions are planning to increase inflation mitigation strategies in 2025 as compared with 41% who were planning increases in 2024. We expect long-end interest rates to remain relatively elevated and largely range-bound over the course of 2025. But, critically, even if rates remain elevated, current yields still offer compelling income.

Given this backdrop, we think it makes sense to stick with an overall neutral duration stance. While the U.S. Federal Reserve and other central banks are cutting rates, we don’t anticipate quick or dramatic declines.

Consistent with our views on duration, we have a generally unfavorable view toward U.S. Treasuries and investment-grade bonds. In contrast, we favor high yield securitized assets and senior loans. We are moving toward a more neutral view on preferred securities given recent strong performance, although we see value in $1,000 par securities where spreads offer value.

Municipal bonds enjoy strong and stable credit quality. State and local governments have solid balance sheets and ample liquidity; and the municipal market features attractive supply/demand dynamics. We see broad opportunities in tax-backed areas of the traditional tax-exempt market, as well as in taxable municipals for non-U.S. investors. We are focused on the high yield and specialty- and property-tax-backed areas.

We remain constructive toward private credit markets, especially if we only experience a mild economic slowdown.

## Investment positioning: real assets

We see value in public infrastructure, but the combination of recent strong performance and the potential for changes in U.S. regulatory and tax policies cause us to approach this area with increased caution. Within infrastructure, we see significant opportunities in data centers and investments associated with electrification, given increased demand for power.

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# 2025 Outlook: Themes for a New Economic Landing

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For public real estate, we think fundamentals and earnings prospects look solid, and this area should benefit from still-solid economic growth. We see particular value in senior housing, where supply is limited and demand is growing.

We also see compelling opportunities across private real assets. Our infrastructure investment themes remain focused on ongoing digitization and clean energy transition. We also see opportunities in agribusiness investments, including investments that focus on food ingredient processing that can reduce in-store labor at quick-serve restaurants.

**To read out full outlook, visit**
**https://www.nuveen.com/global/insights/investment-outlook/annual-2025-outlook.**

## Authors

**Saira Malik, CFA** is Head of Nuveen Equities and Fixed Income, Chief Investment Officer and a member of the Executive Management Team. She leads a business with more than $1 trillion in assets under management across equities, global fixed income, EIC, municipal bonds, multi-asset strategies, private placements, public real assets and C-PACE lending, along with driving weekly market and investment insights and delivering client asset allocation views from across the firm's investment teams. Saira also leads Nuveen's Global Investment Committee, bringing together the firm's most senior investment leaders to deliver actionable portfolio allocation ideas for our clients.

**Anders Persson, CFA** is the fixed income chief investment officer and a member of the Nuveen Senior Leadership Team. He oversees all public and private global fixed income activities, including portfolio management, research, trading and investment risk management activities. Anders is also member of the Global Investment Committee and chairs the Global Fixed Income Investment Council. Before joining the firm, he was a founding member of the team that established Société Générale's European high yield effort in London, and later worked to establish the high-yield research effort within Schroders Investment Management.

**Biff Ourso, CFA** is Global Head of Infrastructure for Nuveen. In this role he leads the strategic direction and execution of investment activities and funds in the agribusiness, clean energy, and diversified infrastructure sectors. Additionally, he is a member of Nuveen's Global Investment Committee. Since joining Nuveen's parent company TIAA in 2005, Biff has led several of the firm's businesses and has been a member of the firm's investment committees across real assets. In his most recent role, as Head of Nuveen Real Assets, he led the real assets business strategies across private infrastructure, agribusiness, timberland, farmland, commodities and impact investing.

# Short Duration Bonds: Opportune Time for Investing

*Submitted by: Palisade Capital Management*

**With the Federal Reserve's long-awaited rate-cutting cycle now underway, multiple factors are converging that we believe makes this an opportune time to "go long" short duration bonds.**

Authored By:

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With the Federal Reserve's long-awaited rate-cutting cycle now underway, multiple factors are converging that we believe makes this an opportune time to "go long" short duration bonds.

Financial markets had priced in a 50-basis point cut by the Federal Reserve and on September 18th the Fed delivered on expectations. This may finally force investors in money market funds to confront the reinvestment risk inherent in their portfolios. With elevated yields on the short end of the curve and the uncertain pace of further rate cuts, we believe investors can take advantage of opportunities in short duration corporate bonds, rather than endure the risk of longer duration fixed income. In particular, short duration corporate bonds with convertible features can potentially achieve attractive yields with limited interest-rate risk.

As of September 24, 2024, the Federal Fund futures are forecasting an additional 150 bps of rate cuts by March 2025. We expect that the front end of the curve will rally as expectations grow that short-term yields will fall more than long-term yields. Short duration debt may also gain as lower rates could spur proactive liability management as issuers seek to refinance nearer-dated issues to extend maturities and lower costs. In the case of Palisade's Short Duration Bond strategy (the "Strategy"), the holdings could further benefit from equity upside.

A newly funded portfolio comprised of bonds within the Strategy meeting the purchase criteria on August 31, 2024 (a "Palisade NFP") would have a median yield of 5.27% and a duration of 0.96 years. This is 85 bps greater than the weighted average yield of core fixed income as of August 31, 2024 with significantly less duration exposure.

| AS OF 8/31/2024 | YIELD | DURATION |
|---|---|---|
| Palisade NFP | 5.27% | 0.96 |
| Bloomberg U.S. Aggregate | 4.42% | 6.16 |

Source: Palisade, Bloomberg, LP

Given the differentiated nature of the holdings, the Strategy can provide diversification from a traditional core fixed income allocation. The Strategy has historically produced higher returns compared to the Bloomberg U.S. Aggregate Bond Index, while maintaining lower interest rate risk (duration).

| PERFORMANCE AS OF 8/31/2024 | Year To Date | 1 Year Trailing | 3 Year Trailing | 5 Year Trailing | 7 Year Trailing | Inception To Date (2/29/16) |
|---|---|---|---|---|---|---|
| Short Duration Bond Composite (Gross) | 3.83% | 6.70% | 2.37% | 5.32% | 5.00% | 5.63% |
| Short Duration Bond Composite (Model Net) | 3.27% | 5.84% | 1.56% | 4.49% | 4.18% | 4.80% |
| Bloomberg U.S. Aggregate Bond Index | 3.07% | 7.30% | -2.11% | -0.04% | 1.21% | 1.49% |
| Variance (Gross) | +0.76% | -0.60% | +4.48% | +5.36% | +3.79% | +4.14% |

Source: Palisade. Short Duration Bond Composite net performance is reduced by a model fee of 0.78% annually. Actual investment advisory fees incurred by clients may vary.

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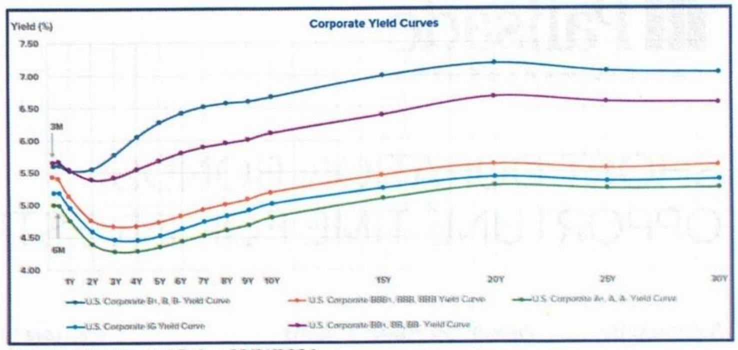
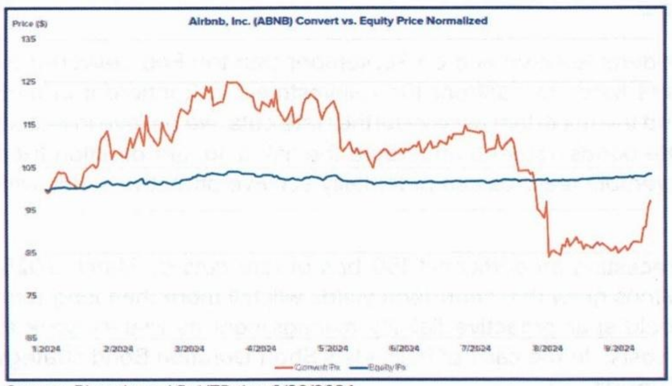
We believe longer duration bonds within the Bloomberg U.S. Aggregate Index may not offer adequate incremental yield given macroeconomic uncertainty and recent interest rate volatility. The chart to the right shows various rate curves by ratings for corporate debt. For investment grade credits, there does not appear to be an incentive to invest further out on the curve because no incremental yield is generated until maturities exceed 10 years. We do not believe the higher return offered in the longer tenors adequately compensates investors for the uncertain macroeconomic environment over such a long time period.

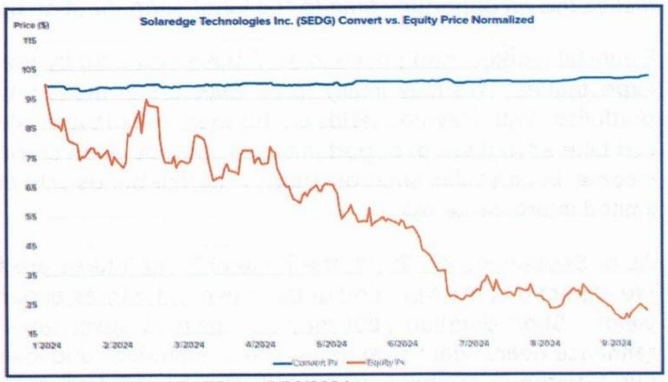



Source: Bloomberg, LP. As of 8/31/2024.

Potential downside scenarios involving higher interest rates and/or weak equity markets should have less impact on the Strategy due to its focus on maturities or put dates of three-years or less and the focus on companies with liquid balance sheets and visible credit profiles. The graphs below show the top two issuers by weight in the Strategy. In both cases, equity performance had a minimal impact on the bond price.




Source: Bloomberg, LP. YTD thru 9/20/2024.




Source: Bloomberg, LP. YTD thru 9/20/2024.

While we believe the current period provides an opportune time for consideration of Palisade's Short Duration Bond strategy, we recommend investors consider the Strategy as an active allocation and diversifier from traditional core fixed income, high yield, or less liquid fixed income investments. Palisade's Short Duration Bond strategy holds larger, publicly traded issues. If history is a guide, any weakness in credit markets could benefit the Strategy as investors tend to shorten duration and corporations attempt to opportunistically buy back bond issues that are next to mature.

As shown in the table below, Palisade's Short Duration Bond strategy has generated strong returns with lower risk (standard deviation), along with strong Sharpe and Alpha ratios relative to traditional core fixed income and high yield.

| | Annualized | | | | | |
|---|---|---|---|---|---|---|
| **STATISTICS (2/29/2016 - 8/31/2024)** | **Return** | **Standard Deviation** | **Sharpe Ratio** | **Alpha** | **Upside Capture** | **Downside Capture** |
| **Short Duration Bond Composite (Gross)** | 5.63% | 4.59% | 0.81% | - | - | - |
| **Bloomberg Barclays U.S. Aggregate** | 1.49% | 5.19% | -0.08% | 5.31% | 59.65% | -13.07% |
| **Bloomberg Barclays U.S. Agg. Corp. High Yield** | 6.59% | 7.76% | 0.60% | 2.52% | 45.67% | 36.14% |

Source: FactSet Research Systems, Inc.

Palisade's Short Duration Bond strategy deploys capital in short duration debt instruments priced between 90% to 106% of par value. This subset of the convertible bond market may mitigate interest rate risk by focusing on the shortest dated bonds. From a credit perspective, companies prepare for maturing bonds over a year in advance by raising new debt or equity capital. This can limit the credit risk of these bonds for investors. Companies may also buy back their shortest dated bonds in a tender or through open market purchases which can put a floor on the price of the bonds.

Finally, the advantage of these instruments is that they are convertible into the underlying equity of the issuer. This "out of the money" call option is often overlooked, but if the issuer's stock appreciates sufficiently, the Strategy can benefit by potentially selling the bonds above par value. These bonds effectively act like straight debt with similar yield and spread dynamics – except when the issuer's stock price rises, at which point the fixed income securities could exhibit some equity-like upside. This potential equity upside, which plays no role in the security selection, can provide additional return, which is a key differentiating feature from other debt strategies.