DIAMOND HILL

INVESTED IN THE LONG RUN

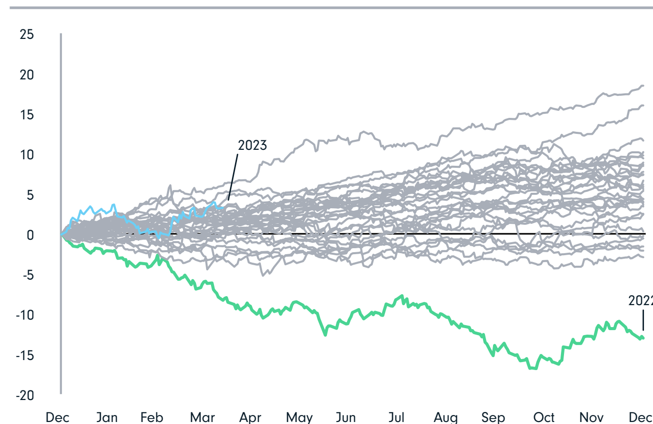
Short Duration Securitized Bond Strategy

As of 31 Mar 2023

Market Commentary

Fixed income markets moved on from what was likely the most difficult year ever for the asset class by delivering an up and down quarter that, thankfully, was more up than down. The Bloomberg US Aggregate Bond Index was up +2.96% in Q1, which is the best quarterly performance since Q1 2020 (+3.15%). Exhibit 1 is an update to a chart we shared last quarter, illustrating the historic calendar year returns since the turn of the century as well as the first quarter progression for comparison purposes.

Exhibit 1 – Bloomberg Aggregate Total Return, Year to Date (%)



Source: Bloomberg.

The year started on a positive note with strong employment news (+517k jobs added), rising consumer confidence, China reopening and continued disinflation (decrease in the level of inflation). Despite the solid economic news, which would entail further Fed tightening, the markets continued to disagree with the Fed and projected a lower terminal rate and eventual cuts. This divergence between the Fed and markets slowly broke down as continued strong employment news in February (+311k jobs added) coupled with slower disinflation brought the markets nearly in line with the Federal Reserve's tightening schedule. And then we reached March 9, and the markets were upended as Signature Bank and Silicon Valley Bank failed, and Credit Suisse was rescued by the Swiss government and UBS. The subsequent dislocation in the market and upheaval abruptly shifted market expectations for Fed action.

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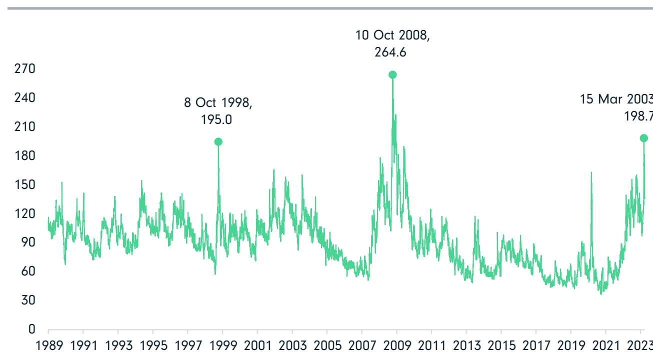
How shaky did things get in the fixed income markets during the final month of the quarter? The MOVE Index, which measures Treasury rate volatility through options pricing, experienced its wildest daily shifts and highest level since the 2008 global financial crisis. As shown in Exhibit 2, the index peaked the Monday following the collapse of Signature Bank and Silicon Valley Bank, surpassing the level reached during the 1998 Long Term Capital Management crisis and ranks as the highest level reached second only to the levels seen during the 2008 crisis. As the market moved past the unrest associated with regional banks, and concerns ebbed on widespread contagion, the MOVE index settled back into familiar territory, ending the month at 135.93.

Exhibit 2 – MOVE Index (1989-2023)



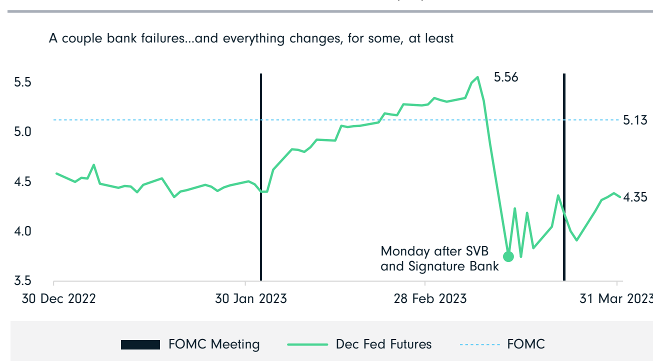
Source: Bloomberg.

Fed vs Market Expectations, Part Deux

It appeared as though the Fed's stalwart reinforcement of its much-publicized terminal rate (5.125% in both the December and March Statement of Economic Projections or SEP) had finally convinced the markets of its commitment to its tightening plan. The markets, as measured by fed funds futures, had stubbornly refused to accept both the aforementioned terminal rate and the well communicated pause through year-end 2023, instead pricing in a lower terminal rate and subsequent cuts by year end.

Stronger economic news and a slowdown in the pace of disinflation prompted the market to finally get on board with the Fed's plan of a terminal rate north of 5% and holding the line until at least the end of the year. Exhibit 3 illustrates market expectations for the fed funds rate in December 2023, which by mid-February had finally fallen in line with the Fed — even exceeding the FOMC estimate for the terminal rate (5.62% priced on March 7) though still projecting a potential cut by year end.

Exhibit 3 – Fed Funds Rate Futures (%)



Source: Bloomberg.

All of that changed on the Monday following the Signature Bank and Silicon Valley Bank failures. Expectations for Fed action plunged on March 13 as concerns around potential contagion and a redux of the 2008 global financial crisis reverberated throughout the economy. The volatility that plagued the equity and fixed income markets came to a head with the most anticipated and uncertain FOMC meeting since the 2008 crisis.

Given the stronger economic data and stubbornly resilient labor market, pre-regional bank crisis expectations had been growing for a 50 basis-point (bps) hike at the March 22 meeting, but on the heels of the mid-March events, uncertainty loomed. Fed Chairman Jerome Powell announced the 25-bps hike and, despite the SEP showing a terminal rate for 2023 holding fast at 5.125%, the market continued to show a lower terminal rate as well as rate cuts before year end.

We've returned to a period similar to earlier this year, with the Fed holding the line and the markets expecting something different. Economic data is beginning to show the impact of the Fed's tightening cycle and the regional bank crisis has served to slow aspects of the economy, so we could be near the end of this tightening cycle. But if we've learned nothing else from Q1 of this year, it's that the best laid plans are also susceptible to the unknown.

Portfolio Performance & Positioning

It is important to note our portfolio works to provide yield for investors while focusing on the shorter end of fixed income markets. We believe there are opportunities to add incremental yield over the benchmark by investing in structured products across the quality spectrum. The portfolio strives to maintain an average credit quality rating of A/BBB while taking advantage of mispriced opportunities in unrated securities and an allocation to below investment grade securities.

As of March 31, the portfolio had a yield-to-worst (YTW) of 8.84% with an effective duration of 1.11 years, compared to a YTW of 9.20% and effective duration of 1.35 years at the end of the previous quarter. The decrease in yield is reflective of the dramatic shifts the market experienced near the end of the quarter, as well as the strategy's higher allocation to cash than in the past, a result of strong flows into the strategy in Q1 2023.

All areas of the portfolio generated positive returns during the quarter, a welcome change from the prior year's challenges. The portfolio's underweight to credit detracted from relative performance though absolute performance was strong. The securitized sector remains the largest allocation in the portfolio and was the largest contributor to performance during the quarter. Specifically, strong performance from consumer related positions such as consumer unsecured, auto loans and more esoteric areas of the asset-backed securities (ABS) market contributed to relative and absolute performance.

The portfolio continued to reduce its exposure to areas in the commercial mortgage-backed securities (CMBS) sector that have shown stress, specifically the office and retail components, while focusing on stronger parts of that market such as multifamily. The Treasury allocation in the portfolio performed better than the benchmark allocation, but the significant underweight in Treasury securities in favor of the securitized sector minimized the impact.

We continue to search for opportunities in the marketplace while maintaining an attractive yield relative to the benchmark.

ICE BAML MOVE Index is a measure of US interest rate volatility that tracks the movement in US Treasury yield volatility implied by current prices of one-month over-the-counter options on 2-year, 5-year, 10-year and 30-year Treasuries. **ICE BofA US Agency Collateralized Mortgage Obligation (CMO) Index** measures the performance of US dollar-denominated, fixed-rate Agency CMOs publicly issued in the US domestic market.

Period and Annualized Total Returns (%)

	Since Inception (31 Jul 2016)	5Y	3Y	1Y	YTD	1Q23
Gross of Fees	3.12	2.86	4.68	1.17	2.09	2.09
Net of Fees	2.66	2.39	4.21	0.72	1.97	1.97
Bloomberg US 1-3 Yr. Gov./Credit Index	0.99	1.26	-0.38	0.26	1.51	1.51

Calendar Year Returns (%)

	31 Jul 2016 - 31 Dec 2016	2017	2018	2019	2020	2021	2022
Gross of Fees	0.87	4.89	3.77	5.34	3.65	3.27	-2.88
Net of Fees	0.68	4.42	3.31	4.87	3.18	2.80	-3.31
Bloomberg US 1-3 Yr. Gov./Credit Index	-0.38	0.84	1.60	4.03	3.33	-0.47	-3.69

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