Yield Growth Strategy Q1 2023

Portfolio Manager: Howard Chin, CFA
Investment Style: Income Growth

The Yield Growth strategy seeks to generate both income and growth with volatility lower than that of the equity markets by utilizing a diverse set of asset classes (Equities, REITs, Fixed Income, Closed-End Bond Funds, etc.).

Outlook and Positioning:
The Fed's fight to bring down inflation spilled over to the banking sector, resulting in several bank failures and concerns over the financial health of the regional banks. The Fed's liquidity and funding programs should mitigate further fall-out from this mini-financial crisis, but the recent episode highlights the lagged impact of aggressive monetary tightening. We have concerns about slower bank credit creation and the likelihood that this will hinder economic growth by straining the willingness of businesses and households to borrow and spend. Inflation remains well above the Fed's 2% target, particularly in the services sector. The pace of disinflation has not been as fast as the Fed had expected, and the path ahead is also unlikely to be linear. So far, the U.S. consumer spending and job growth economy has been resilient. Europe is benefiting from a warmer winter and improved energy supplies. China's growth is reemerging after three years of Covid lockdowns.

As interest rate policy normalizes, a higher cost of capital environment may influence the market backdrop in the years ahead. Higher interest expenses could inevitably be a strain on cash flows. Companies with more debt and weaker cash flows could experience downgrades by rating agencies. However, companies with pristine balance sheets and the ability to self-fund their businesses should have an edge. In the near term, we remain cautious in the portfolio's equity portion as lower earnings expectations may not be reflected in the stock prices. After years of underperformance, valuations abroad look attractive compared to U.S. stocks. The valuation backdrop and an improved earnings outlook in Europe and Asia led us to increase the exposure to international equities. With bonds offering more attractive yields, the fixed-income allocation should dampen portfolio volatility. We will look to add to duration and credit exposure as opportunities arise.

Contributors and Detractors:
Apple and Microsoft, two of our largest holdings, contributed to performance in the first quarter. Large technology companies were the beneficiaries of the recent volatility and were treated as more defensive due to their cash-rich balance sheets and secular growth profile. Pfizer and Bank of America were our biggest detractors this quarter. Pfizer was among the biggest beneficiaries of the pandemic, but it currently faces skepticism on its aggressive plan to launch new products to compensate for the lost Covid revenue. The current earnings multiple reflects a healthy dose of skepticism. While Bank of America has been a beneficiary of the deposits fleeing regional banks, it could not escape the panic that began with Silicon Valley Bank. Nevertheless, we still consider it one of the best run banks among its peers, with a balance sheet and revenue base to navigate a challenging economic environment.

Portfolio Activity:
We bought four new international stocks in the quarter: CNH Industrial, Verallia, Daifuku, and ASM Pacific Technology. CNH, the second largest global agriculture equipment company, should benefit from long-term secular demand for farmers to upgrade equipment with new precision agriculture technology. Based in France, Verallia is the world's third-largest producer of glass packaging for beverages and food products and operates in an oligopolistic market. We think Daifuku can capitalize on the secular market growth for warehouse automation and the reshoring of manufacturing facilities. Finally, ASM Pacific is a leading semiconductor packaging, bonding, surface mounting, placement, and inspection equipment manufacturer. ASM Pacific is 25% held by the Dutch semiconductor wafer processing equipment maker ASM International but is headquartered in Singapore and listed in Hong Kong.

We sold Crown Castle due to the high valuation relative to the current interest rate environment and reduced growth expectations from the cell tower business. We also trimmed Lowe's and Home Depot to lower our exposure to consumer discretionary spending in the home improvement market. We still like these home retailers but wanted to manage overall exposure to the industry. We bought Insight Select Income Fund, a no-leverage closed-end fund. It holds investment grades debt, yields about 5%, and trades at an attractive discount compared to its net asset value.