Yield Growth Strategy Q3 2022

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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 third quarter began with a rally in risk assets with the idea that the Federal Reserve (Fed) would stop hiking interest rates by year-end and start to cut rates by the middle of 2023. This market rally fizzled quickly in mid-August as stubbornly high inflation elicited a very hawkish commitment from the Fed to increase interest rates further. We believe that the Fed is committed to using monetary policy to slow down the economy to lower inflation meaningfully, making for volatile and challenging markets. Both equity and fixed-income markets went down to reflect higher rates. The S&P 500 and U.S. Aggregate Bond Index decreased by 4.9% and 4.8% in the quarter.

We remain cautious in the equity markets as lower earnings expectations may not be reflected in the stock prices. There are concerns about how higher wages, rising interest rates, less available capital, and a potential decline in consumer spending will affect earnings. We have been light on our fixed-income allocation but are beginning to find value in this market as yields have repriced to multi-year highs. During the quarter, we reallocated approximately 25% of the portfolio to government and high-quality investment-grade bonds while extending the duration. However, bond prices could decline further if rates continue to rise in the near term. With bonds offering more attractive yields, we believe bonds should again serve to dampen portfolio volatility in the Yield Growth portfolios.

Contributors and Detractors:

Lowe's, Stryker, and Apple were the stocks that contributed to performance. The general sentiment around housing is downbeat as mortgage rates are weighing on home affordability, but Lowe's positive performance in the quarter likely reflects the market's appetite for home improvement stocks. Stryker's supply challenges have been weighing on the company's ability to drive operating margins, but sales from its diversified product mix in surgical and medical devices have been meeting growth expectations. Finally, Apple has held up well in a challenging consumer environment. Still, recent news concerning lower demand for its recently launched iPhone lineup in Europe and Asia offset some of the gains in the quarter.

Taiwan Semiconductor (TSMC), Crown Castle, and W.P. Carey detracted from performance. TMSC has a dominant market share in the foundry market, but key customers have been scaling their chip orders to adjust to a slower economic environment. Both Crown Castle and W.P. Carey are REITs that were impacted by the upward moves in interest rates. Crown Castle and W.P. Carey are carrying 4% and 6% dividend yields, which we find attractive in this environment.

Portfolio Activity:

We eliminated three positions in the quarter. Carlyle was sold after an abrupt resignation from the CEO reduced our confidence in the company. Carlyle is an alternative asset manager diversifying into other asset classes beyond traditional private equity. The CEO's plan to develop new sources of revenue polarized executives and caused friction with the founders. We eliminated our position in Comcast after broadband growth was disappointing in the last two quarterly reports. The company needs new growth drivers in a very competitive industry to drive the stock in the future. Finally, B&M Retail, a discount store chain in the U.K., was eliminated as we expect weak discretionary spending to impact the top-line growth.

At the beginning of the quarter, our bond composition was tilted toward low duration and high quality, which helped shield it from the rapid rise in interest rates. With rates now meaningfully higher across the curve and the markets beginning to price in a slowing economic environment, we increased the portfolio's duration by adding to U.S. treasuries and high-quality investment-grade bonds. The reallocation may dampen a growth shock in the equity portion of the portfolios. We are still light on exposure to high-yield and leveraged loans due to concerns about widening credit spreads. However, we are looking closely at opportunities in closed-end funds as the discounts to net asset values are beginning to widen meaningfully from historical averages. Closed-end bond funds have historically been a good source of yield and diversifier for our strategy.