Westwood®

Multi-Asset – Portfolio Update

As of March 23, 2020

Income Opportunity Strategy

Our Income Opportunity strategy continues to be grounded in bottom-up, fundamental security selection and tactical asset allocation process. The sharp contraction in the markets and liquidity have created numerous market dislocations across a number of asset classes. This has created an enormous unrealized upside, we believe, in our existing holdings as well as new opportunities which we are evaluating. Given the unique current environment, we believe fundamentally analyzed companies across the capital structure can provide extraordinary value for investors as we look through the current dislocated markets into the future. We are witnessing valuations and opportunities not seen since the great financial crisis of 2008–2009; sellers are selling what they can, not necessarily what they want, creating the indiscriminate pressure in certain markets.

We have continued to take actions within the portfolio to protect client capital and position for the future. Our portfolio liquidity remains high with enough “dry powder” to take advantage of market opportunities. This includes adding a nearly 9% position in highly liquid agency mortgage-backed securities to complement a 3.5% position currently in cash with another 11% position in highly liquid U.S. Treasury securities. As well, given the challenges in the Energy markets and more specifically, the MLP market, we have exited those securities completely. Our common equity holdings remain in attractively valued, high-quality businesses that we believe are well positioned for the current and future environment. Within fixed income, our interest rate duration has been a headwind most recently, though we expect the portfolio to benefit in the future. However, we remain cognizant that a large fiscal program funded by increased debt issuance could be negative for long rates. This may lead to a reduction in exposure to the long end of the rate curve, even as near-to-intermediate term rates could be anchored at or below current levels. Our current interest rate duration has come down to approximately 3.6 years as a result of all the portfolio actions taken.

Preferred stock represents 15% of the current portfolio. This market has become dislocated from fundamental value with lower liquidity adversely impacting market pricing for both those attempting to buy or sell. While we are reducing some exposure here with minimal cost, the opportunity and fundamental value remains compelling particularly where expectations are to realize full par value, or more, in addition to their attractive yield. This remains one of the most exciting allocations within the portfolio. Overall, the preferred market has been one of the weakest asset classes since the end of February underperforming virtually all areas of credit given their less liquid nature and severity of the market correction. Our positioning in high-quality bank preferreds has been a tailwind relative to other industries and sectors, though that has been offset given the fixed to floating nature of some of our securities. Similarly, convertible bonds have also seen dislocations. While a smaller part of the overall portfolio, 7% currently, we continue to evaluate several opportunities in order to gain equity upside while dampening further downside in markets. Our current exposure is heavily weighted toward Information Technology and Health Care.

On a year-to-date basis, one our largest contributors has been a global pharmaceutical leader working on a COVID-19 solution. In addition, contributors have included long dated treasuries, convertible bonds in a content delivery provider and a global leader in the production of lithium. The largest detractors have been high quality banks and energy equities given the sharp decline in interest rates and energy commodity prices.

Valuations will eventually overly succumb to fear rather than intellectual evaluation of earnings models and sustainability. Our mantra of deep fundamental analysis and our process of continually assessing risk/reward will lead us to opportunities for outperformance as rationality prevails in a fearful environment. The recent volatility is a powerful indication for why we believe the new theme in the market and the way forward is to think and invest more tactically by utilizing dynamic and strategic multi-asset portfolios. Our flexible and tactical approach across equities, bonds and rates is designed to take advantage of attractive opportunities while emphasizing downside management through every step of the process.

Alternative Income Strategy

Our market neutral strategy, Alternative Income, is focused on combining convertible bonds, which we believe can generate a modest level of income and price appreciation, with a levered convertible arbitrage strategy to take advantage of attractive credits, mispriced volatility and potential price catalysts.

We continue to be pleased with absolute return performance as a fixed income alternative relative to performance we are seeing in the credit markets which have declined 10-20% this year (i.e., Bloomberg Barclays Aggregate Credit and US High Yield). Liquidity issues in some corners of the corporate bond market including convertible bonds has moderately impacted pricing, which negatively affected the portfolio last week. Please note, YTD the strategy is down in the low single digits as of Friday, March 20.

We have moved from seeing “pockets of opportunity” in short duration convertible bonds to new “opportunities across the board” as credit spreads gap out due to the lack of liquidity in the market. We remain confident in our market neutral approach as credit spreads widen out and are well positioned to take advantage of arbitrage opportunities globally, which we see increasing as pricing dislocations persist. Our convertible arbitrage book continues to perform well, as equity volatility levels increased significantly. The convertibles market has moved to trading at a healthy discount from fair value providing ample opportunities in our respective view to generate absolute returns (levered/unlevered). Our tail risk macro hedging strategy continues to be accretive to investors as implied volatility remains elevated.

Consistent with our strategy, duration remains low at roughly one year with the portfolio yielding roughly 1.50% which now exceeds a 10-Year and 30-Year U.S. Treasury Bonds.

We continue to be well positioned, as we have been maintaining higher cash levels at 15% in addition to having a number of bonds maturing over the coming months to take advantage of higher yields.