In Investing, **Planning** and **Patience** Pay Off in Performance

It's easy to chase after the next big thing when investing.

Written by Peggy O'Farrell
Photography provided by Wes Battoclette

Success requires patience and a well-thought out plan for strategic growth, say Stephen R. Mullin and Brendan M. White, CFA, of Fort Washington Investment Advisors, Inc. Mullin is managing director of Fort Washington's private client group; White is managing director and senior portfolio manager for the downtown investment firm, which is a member of the Western & Southern Financial Group. The firm and its subsidiaries oversee $47.2 billion in total assets under management. Its diverse client base includes high-net-worth individuals, corporate and ERISA, sub-advisory and Taft-Hartley entities, as well as endowments, foundations, insurance and public plans.

Investors need to know where they want to go, and figure out how much risk they're willing to put up with on the way from Point A to Point B, Mullin and White say. It's their job to help their clients map out the most successful route.

They shared their financial insights with LEAD Magazine:

LEAD MAGAZINE: With interest rates expected to gradually increase, how is your firm preparing for that type of economic environment? In anticipation of this event, what adjustments are you making in your money management strategy?

FORT WASHINGTON: The prospect of rising interest rates merits the attention of all investors. Although interest rates have risen in 2015, real interest rates are still historically low. Additionally, nominal interest rates could be poised to move higher with any hint of inflation. In anticipation of interest rates, potentially moving higher, our fixed income portfolios are of modestly short duration.

We advocate the allocation to certain "spread" fixed-income asset classes that essentially exchange credit risk for interest rate risk. We like corporate bonds (both investment grade and high yield) and asset-backed securities.

Additionally, an ultra-short duration strategy, comprised of high quality corporate and asset-backed securities can provide incremental yield and flexibility in a rising interest rate environment. Our ultra-short duration strategy, which is characterized by low spread duration and high cash flow orientation, should perform well in a rising rate scenario. We expect this strategy to benefit from both short duration and the positive credit fundamentals that accompany growth-oriented interest rate increases.

As for stocks, the prospect of higher interest rates does not necessarily negatively impact our outlook for equities. Equities have historically performed well when interest rates rise. An increase in interest rates normally correlates with an expanding economy, which is good for corporate profits. While higher interest rates can affect the rate at which corporate profits are discounted, the key consideration is whether or not interest rates are restrictive.

Even with the prospect for tightening by the Fed, we continue to think that financial conditions are accommodative. Real interest rates are very low, the yield curve is steep and lending conditions remain adequate. Given

Pictured left to right: Maribeth S. Rahe, President & CEO, Brendan M. White, CFA, Managing Director & Senior Portfolio Manager, Kate C. Brown, CFP, Vice President, Senior Wealth Planner, Stephen R. Mullin, Managing Director, Private Client Group

these favorable financial conditions, we think equities remain attractive. Coupled with potentially unimpressive returns in fixed income, we would advocate a balanced account skew more toward equities than fixed income.

LM: Can you give us some insight into the investment income advice you're giving your clients in anticipation of rising rates?

FW: We are encouraging our clients to maintain flexibility within their fixed-income portfolios with a modestly short duration position. Additionally, we advocate exchanging spread risk (corporate bonds and asset backed securities) for interest rate risk. While we think interest rates are likely to increase in the next 18 to 24 months, we think credit spreads can tighten, partially offsetting the increase in interest rates. For those clients with a longer-term time horizon that don't need liquidity, we encourage the capture of an illiquidity premium. An allocation to income-oriented alternative investments and/or strategic income vehicles can generate attractive returns on both an absolute and a risk-adjusted basis. While income can be realized in the near-term, an investor should have an intermediate time horizon to overcome the potential impact from illiquidity.

LM: As rates rise, shorter-term debt and eventually cash will become more attractive versus long-term bonds. Does this mean investors should be particularly wary of chasing higher returns with high yield and junk bonds due to their non-risk averse nature?

FW: Investors should always be wary of "chasing returns." Additionally, an investor should always be sure that their portfolios are consistent with their risk tolerance. That being said, a combination of ultra-short duration fixed income and high yield bonds can provide an attractive return profile in a rising rate environment. The ultra-short strategy should benefit from its short duration character while high yield bonds can experience spread tightening that results from an improving economy. This combination has historically performed well in a rising interest rate environment while generating attractive risk adjusted returns. While higher interest rates are generally challenging for fixed-income securities, increasing interest rates are not necessarily bad for high yield bonds. High yield bonds are considerably less sensitive to interest rates when compared to other fixed income securities for two reasons primarily. First, high yield bonds tend to be shorter in duration due to a larger component of return coming from current income which can reduce the overall volatility of returns. Note that principal can remain volatile but the income component is current and can be reinvested at higher interest rates. Secondly, and perhaps more importantly, high yield securities often experience significant spread tightening when interest rates rise, which can more than offset the impact of higher interest rates. Higher interest rates generally result from inflationary pressures that usually coincide with an expanding economy. In such an environment, companies can increase revenues, increase earnings and improve their credit profile resulting in credit upgrades. In such an expanding economy, default rates also tend to decline as a result of earnings growth. As a result, the risk profile of high yield securities improves and the risk premium of high yield securities (i.e. spreads) contracts reflecting such. Often, the amount by which spreads contract is greater than the rise in interest rates, potentially resulting in capital appreciation and attractive relative returns. The primary risk for high yield bonds is default risk. Given the favorable financial conditions that are currently present, we think default risk is manageable.

LM: Since the Fed isn't expected to aggressively raise rates, does this mean income-oriented investors are going to be at a disadvantage for some time yet? If so, what is your firm's advice on how to increase investors' returns without a large degree of risk?

FW: We are at the tail end of a 30-year bull market for bonds. The prospective returns for fixed income are unlikely to match the last 30 years. Although interest rates may be poised to increase, it is likely that the increase will be gradual and modest. Regardless, it may be challenging for income-oriented investors to meet their goals. In this environment, it is important that investors adhere to their risk guidelines and not stretch for yield. That being said, there are creative strategies that investors can employ to assist with this challenge. We advocate the allocation to certain "spread" fixed-income asset classes that can enhance income while moderating interest rate risk. We like corporate bonds (both investment grade and high yield) and asset-backed securities.

LM: What are your thoughts on the importance of having liquidity in a crisis and do you believe indifference to the need for liquidity exists in today's market for such a potential outcome?

FW: Liquidity can be extremely important in a crisis. However, liquidity often evaporates in a crisis. Positions thought to be liquid today could become completely illiquid in a crisis. We believe it is important to have a portion of your portfolio liquid to take advantage of opportunities that are presented in a crisis. Additionally a value-oriented fundamental process and robust risk management process are equally important. We stress test our positions and portfolios for flexibility and adequacy for their capital level. In other words, while we value liquidity, we will rely on fundamental analysis and risk management to manage through a crisis. We would hope to use liquidity to take advantage of opportunities rather than to facilitate forced selling. As for indifference to the need for liquidity, we think it is more a function of acceptance than indifference. Liquidity is a common topic of concern and everyone wants more. The reality is that illiquidity is here to stay. For that reason, fundamental analysis and risk management are more important than ever.

AT A GLANCE

Fort Washington and its Private Equity Division

- Founded in 1990 as the primary investment arm of Western & Southern Financial Group
- Expertise across fixed income, public equity, and private equity*
- $47.2 billion in total assets under management[1]
- 121 full-time employees, 83 experienced investment professionals
- Diverse client base: High net-worth-individuals Corporate & ERISA, Endowments & Foundations, Insurance, Public Plans, Sub- Advisory, Taft-Hartley

Core Values

- Interest alignment
- Risk-focused
- Valuation-driven

Source: Fort Washington Investment Advisors, Inc.

*Managed by FW Capital, a division of Fort Washington

[1] Assets as of 06/30/15. Includes assets under management by Fort Washington Investment Advisors, Inc. (Fort Washington) of $44.4 billion and $2.8 billion in commitments managed by Fort Washington Capital Partners Group (FW Capital), a division, and Peppertree Partners LLC, a subsidiary

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