Fort Washington Investment Advisors, Inc.

Ultra Short Duration Quarterly Commentary

4Q16

Philosophy

Fort Washington views the Ultra Short Duration strategy as an extension of the money market sector, offering the potential for additional returns in exchange for a modest degree of price volatility. Management's buy and hold approach produces a portfolio with significant first-year cash flows, and an overriding goal to maximize reinvestment opportunities and reduce price volatility.

Process

Fort Washington employs a disciplined investment process designed to maximize risk-adjusted returns using a broad range of fixed income strategies. Management maintains a strategic sector allocation model which is updated over a period of years (3-5 years). Tactical sector allocations are updated monthly using a data-driven approach combined with strong inter-sector communication to uncover relative value opportunities over the short term in a variety of asset classes. A proprietary risk budget model is also used to assist in determining investment strategy.

Investment Professionals

Scott D. Weston
Managing Director
Senior Portfolio Manager
24 Years Experience

Brent A. Miller, CFA
Senior Portfolio Manager
Co-Portfolio Manager – Ultra Short Duration
17 Years Experience

Performance

The last quarter of 2016 was an eventful one for markets. Following the surprising results of the U.S. presidential election and a Republican sweep of Congress, a “risk-on” sentiment led to tightening risk premiums (spreads) and a sharp selloff in bond yields. Investors began to price in higher economic growth and inflation, which are expected to result from tax reform and other fiscal policies proposed by President-elect Trump. The Federal Reserve raised its target rate 0.25%, to 0.75% in December and also noted its expectation for further rate hikes in 2017.

By quarter end, interest rates increased 20-25 basis points for tenors inside of 2 years and 80-85 basis points for longer maturities. Spreads were 5-10 basis points tighter in most short duration sectors. Strong positive carry and tighter spreads were not enough to offset the effect of higher interest rates and a steeper yield curve. Intermediate corporate bonds, CMBS, MBS, and ABS returned -2.88%, -1.98%, -2.27%, and -0.33% for the quarter.

Market technicals and investor sentiment are very positive. Demand remains strong but could experience short-term weakness associated with higher interest rates. Yield sensitive buyers will likely contain any rate-driven spread widening. Expectations for improving growth, heightened inflation, and a strong U.S. dollar could reduce the attractiveness of U.S. Treasuries for non-U.S. investors.

Factors Contributing to Performance

The Ultra Short Duration Composite outperformed its benchmark for the three months ended December 31, 2016, as the Merrill Lynch 3-month Treasury bill index returned 0.09% and the Merrill Lynch 1-year Treasury note index returned 0.08%. For the year, the composite has significantly outperformed the 0.33% and 0.81% returns of the 3-month index and 1-year index, respectively.

The sharp selloff and steepening of the yield curve left maturities of 1-year and shorter 20-25 basis points higher while rates farther out the curve (2+ years) rose 40-80 basis points. Spreads tightened 5-10 basis points following the November 8th U.S. elections. Despite higher front end rates, the combination of yield and tighter spreads more than offset the negative yield curve effects. As a result the Morningstar Ultra Short Bond category produced positive performance, returning 0.26% for the quarter and 1.42% for the year.

Composite performance was enhanced by positive security selection within individual sectors. CMBS was the best performing sector, and the Corporate, CMBS, ABS, and Agency MBS sectors outperformed their respective Merrill Lynch short duration indices. Only Municipal Bonds, a relatively light exposure for the Composite, underperformed.

The Ultra Short Duration Composite employs a strategy that emphasizes structured securities. The strategy seeks to generate alpha by investing a portion of its assets in high quality, higher yielding spread sectors with higher liquidity premiums. The focus on low spread duration (or low price sensitivity to changes in spreads) helps to mitigate the higher beta of these alpha-generating sectors. Given the positive environment for spreads and the selloff in rates, the Composite performed well during the fourth quarter.

Portfolio Outlook

Quarter-end portfolio duration is near the midpoint of the operating range, and moderately longer than the prior quarter. Duration has been below the midpoint for the last several quarters as Management has been wary of rising short rates in the face of an improving economy.

Longer key-rate duration exposure performed very poorly. The movement in the yield curve had a negative, but small impact on performance – positive carry and spread tightening likely trumped the rate move. Management intends to maintain low exposure to intermediate duration buckets given that those rates are still susceptible to heightened volatility. We are also concerned that inflation expectations and the term premium on U.S Treasuries remain too low and could normalize throughout 2017, resulting in a continued steepening of the curve and higher rates overall.

Management still prefers an overweight to risk assets. This view is driven by increased economic growth expectations, a solid labor market, accommodative global central bank policy, and supportive financial conditions. In particular, consumer credit fundamentals appear favorable for much of the composite's exposure to structured products. We remain most comfortable adding exposure in securities higher in the capital structure, but in off-the-run sectors – the credit curve is relatively flat but tertiary markets appear to still offer attractive spreads relative to their fundamental credit risk. We are constructive on spreads overall, but may pare back risk if consumer confidence falls, the jobs and wages picture fades, or the new administration appears unable to execute on its policies.

Duration positioning should help to buffer the effects of rate volatility on the front end. The market's expectation for better near-term fundamentals and tangible progress on fiscal policy seems warranted – this is likely to support credit fundamentals in the non-government sectors and help keep the liquidity premiums associated with off-the-run sectors well-contained.

The biggest concerns surrounding risk assets are the execution risks related to the expected fiscal policy boost to be provided by the new administration and Republican Congress, tightening financial conditions brought on by Fed rate hikes, and fully-valued spreads. However, given the resilience exhibited by the U.S. economy, we believe any widening in spreads is likely to be transient.

Management is also concerned about the prospects for higher interest rates as a result of rising inflation expectations and term premiums. This remains the more serious risk in our view.

Given these risks, we believe taking liquidity risk in securities maturing in less than one year remains a superior strategy compared to taking credit risk in a similar duration security. Liquidity risk is transient, especially in short duration securities with significant near-term cash flows, while credit risk can be permanent.

While management finds it difficult to predict changes in the level of interest rates, the groundwork has been laid by the Fed to continue to raise interest rates. We expect the front end of the yield curve will continue to rise and experience greater volatility than in prior quarters. We also expect the yield curve to continue to steepen.

Consumer and commercial real estate fundamentals remain positive – as such, ABS and CMBS spreads are likely to remain stable. Prospects for the Corporate sector have improved given expectations for better underlying economic growth. Given the likelihood of increased rate volatility and tight spreads, we are unlikely to increase interest rate risk or credit risk unless there is a repricing, but are comfortable with a modest amount of risk given strong fundamentals.

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