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2024 Annual U.S. Fixed Income Review

JANUARY 2025

Alex: Welcome to Dodge & Cox's 2024 U.S. Fixed Income Investment Review. I'm Alex Chartz, I'm a Vice President and Client Portfolio Manager. It is my pleasure to introduce Lucy Johns, Senior Vice President, Director of Fixed Income, and member of our U.S. and Global Fixed Income Investment Committees. Thanks for joining me, Lucy.

Lucy: My pleasure.

Alex: Over the next 20 minutes, we'll review last year's market developments, the Income Fund's performance, and how we adjusted portfolio positioning in last year's environment. Lucy, before we jump into specifics, what are the high-level takeaways?

Lucy: I'd share three. First of all, despite the fact that returns were a little lackluster in 2024 for fixed income in general, the Fund strongly outperformed its benchmark. Second, I'd share that the Credit sector was the best-performing sector. We saw spreads tightening throughout the course of the year, now ending at multi-decade tight levels. So, this was great in hindsight but does potentially set us up for a more challenging outlook going forward. Third, that our Investment Committee remains optimistic about fixed income returns in general, driven largely by the higher starting real and nominal yield levels, as well as the potential for volatility to create opportunities for us as an active manager.

Alex: Turning to the market backdrop on slide five, U.S. bond market yields and sector returns, you can see rate markets were quite volatile in 2024. If you look to the upper-right chart, the U.S. 10-year Treasury yield is in light blue. You can see it was quite volatile over the year, ultimately ending up 70 basis points. Shorter-term yields were either down or flat, which caused the yield curve to uninvert. Credit markets, on the other hand, gradually tightened over the period. Starting with rates, Lucy, can you walk through what drove markets?

Lucy: Yes, it was another exciting and volatile year for rates markets, and that was really reflecting an evolution in what was happening in the United States and global economies, geopolitical events, as well as political events in the United States, especially in the fourth quarter. So, as we look at that upper-right graph, we saw that over the course of the year, some of the key economic variables were inflation, growth, and unemployment. Inflation we saw generally getting lower over the course of the year, but maybe not as much as some expected nor in a totally even path. There's still some uncertainty as we look forward, especially given potential policies under Trump, and that caused some of this widening and these higher yield levels that we saw in the fourth quarter. Also, we really saw more economic resilience in the United States than many anticipated.

For example, third-quarter GDP was around 3%, and as much as the labor market has weakened somewhat, it remains quite strong. Unemployment ticked up incrementally to [a high of] 4.2% [in the fourth quarter], but that really remains a healthy level and so this concept of a soft landing really has gained momentum. The likelihood of recession has gone down over time according to most forecasters. If we think about this rise in rates, it's those factors as well as thinking prospectively about what the new administration may bring. Tariffs could have some at least short-term inflationary impact. [Given] some of the plans with regards to tax cuts and spending, what happens with the fiscal deficit, [and] what happens with debt? All of these things are unknowns and have contributed to a bit of a rise in yields.

Alex: You mentioned a strong performance from Credit. What has been behind that?

Lucy: Yeah, the bottom left that you pointed to with credit spreads, and I referenced earlier, really reflects that same theme of economic resilience. Growth is strong, corporate fundamentals are strong, and all of that has driven investors to be very comfortable investing in this part of the bond market. Also, just in general, fixed income—given higher levels of yield that we like—other people like them too. And so, there's just been really robust demand for the asset class, for the sector, and we think that that's driven some of these tight levels that we're seeing for spreads.

Alex: Let's transition to Income Fund performance. On slide six, the Income Fund, which we'll use as a proxy for our core fixed income strategy, returned 2.3% last year,[1] outperforming the Bloomberg U.S. Agg (Bloomberg U.S. Aggregate Bond Index) by 100 basis points. I think it's worth looking at 2023 and 2024 together, really the two-year number that you see on this page, which was a healthy 4.9% annualized. If you recall, in 2023, the fourth quarter really boosted returns for that year, whereas in 2024, the fourth quarter was a headwind for calendar-year returns. So, looking at the two-year period helps account for some of the volatility. We're pleased with relative performance over that stretch, but as you all know, we have a long-term investment horizon, so we focus on building a portfolio that can outperform over three to five years. Looking at drivers of attribution on the lower portion

Returns represent past performance and do not guarantee future results. Investment return and share price will fluctuate with market conditions, and investors may have a gain or loss when shares are sold. Fund performance changes over time and currently may be significantly lower than stated above. Performance is updated and published monthly. Current month-end performance can be obtained at dodgeandcox.com or call 800-621-3973.

of this page, the two main factors that contributed to the portfolio's outperformance last year were security selection in the blue bar and asset allocation in the gray bar. On the security-selection front, several higher beta, higher spread issuers performed well, including Pemex, Prosus, TC Energy, and Charter Communications.[2] The Fund's underweight position[3] to U.S. Treasuries and overweight position in corporate bonds also benefited returns, as did compositional selection within Agency[4] MBS (mortgage-backed securities) pass throughs. Lucy, how does this breakdown of attribution compare to longer-term periods, say over the past five years?

Lucy: There's a lot of similarities looking at the period you just described, 2024, as well as if we look across this bottom chart at the longer-time periods, including the five-year period. What you see as generally the common theme is that that dark blue bar that you referenced—security selection—tends to be the largest driver of relative returns. That's really consistent with our investment approach being bottom up in nature and spending a lot of time on each idea in the portfolio and benefiting from that level of research and our long-term horizon in terms of compounding the additional yield on those securities over time. You also see that the gray bar—the asset allocation—is a persistent driver of returns. We do typically have an underweight in Treasuries and overweight to spread product, both Securitized and Credit, although the magnitude varies over time, but overall, you see that adding to returns over time. And then lastly, you see duration, especially in recent years, the two-, three-, and five-year periods you see it adding but being a smaller, less even factor in that. We're certainly happy that that has served us well over recent history, but it's been the third most important factor over our long-term time horizon.

Alex: Moving to portfolio changes, can you walk through the adjustments we made last year?

Lucy: Of course. Looking at slide seven in the top-left box, I'd highlight that the largest change in terms of sectors was to the Credit sector. And so, if we look at that top-left box, we started the year near 40% in credit securities, and we ended the year around 31%, which, for perspective, is as low as we've had since about 2007. So, quite differentiated versus much of recent history. In fact, I'd point out that at the end of 2022, we had 48% in Credit. So over that two-year time horizon, there's really been quite a change in the portfolio. That's really related to that tightening of credit spreads that we've seen, meaning valuations are high. We tend to have a valuation discipline in the way that we approach the market in balancing what we're getting paid for an investment versus what the fundamentals are.

Alex: Where have we invested the proceeds of those Credit trims?

Lucy: To think about that, it's useful to look at this bottom-left chart. As we've been talking about, you see parts of the credit market like Industrials and Financials coming down, but on the left side, you see a couple of things that are going up. What we've invested most of the proceeds into are U.S. Treasuries, and you see that on the left. We find, in general across the bond market, attractive, nominal yield returns, including in the Treasury space. As we build a larger position in U.S. Treasuries, that gives us more flexibility to deploy into more interesting parts of the market as volatility may come in the future. And so, that's where a lot of the proceeds have gone. We've also incrementally increased our holdings in the securitized part of the market. Mainly what we own within that securitized portion is Agency mortgage-backed securities, and that is the area that we've added to over the course of the year by about 2%. We continue to find value there. If you look at the risk/reward mix within those securities, spread levels in general are at fairly average levels over time, but the risks in that part of the market we think are lower than they've been for much of history because you have less cash flow variability, less negative convexity in the areas of the market that we are, which is mainly lower coupon mortgage-backed securities.

Alex: Given the significant reduction in the Fund's credit holdings during 2024, let's walk through our view on the sector.

Lucy: We can turn to page eight, which addresses fundamentals within the credit space as well as valuations. Starting with the top part of the page, which shows views of credit fundamentals, you see that while there's been a little bit of deterioration in leverage[5] and interest coverage[6] for companies in recent years, in the broader historical context, the levels are very normal, and we're really not seeing signs of stress on a broad basis. This is, again, related to the resilience of the economy and the healthy environment in which we're operating. So, fundamentally, things look quite good. The challenge is that things are priced for perfection. And so, if we look and focus in on that bottom-left chart, we see corporate valuations, which I've referenced a few times in this presentation already, but this is giving you perspective on the last 20 years. These blue bars show the range of spreads or valuations that we've seen over that time period for different parts of the credit market through different lenses. And then, the light-colored, white-type dots show where we are today, and you see the percentile at the bottom. You can see that in several cases, we're in the first percentile. So these are relatively extreme valuations, and again, this goes back to the large reductions that we've made to our holdings in this sector.

Alex: Even with the large reduction in Credit last year, the portfolio remains overweight Credit, although that margin is lower now. You can see in the table in the lower right, the bottom row shows the Income Fund weighting in Credit of 30.6% versus just under 28.0% for the U.S. Agg. One question that we've been receiving from clients is why maintain a higher weighting in Credit with broad valuations so unappealing?

Lucy: It's an important question and a real opportunity to talk about the value of being an active manager in the bond market. There are so many CUSIPs and issuers, but as an active manager, we can pick and choose our spots, and we—through our team process, through the fundamental research that we do, through thinking about the valuation discipline—we really carefully curate a set of holdings to own within the Credit sector. And you can see on the bottom-right chart that we own just 59 issuers at this point versus over a thousand in the [Bloomberg U.S] Credit Index. So [the holdings] just look very different. It's also important to think about the characteristics of those issuers. So I'd highlight on the next row you see the OAS (option-adjusted spread), which is a spread measure in terms of incremental yield, and it's notable that the OAS on our holdings is significantly higher than those of the general benchmark.

At the same time on the next row, you see the duration, which is price sensitivity to spreads, is lower than that of the benchmark. We've intentionally, over time, sold longer-duration securities that have more price risk and left more of the portfolio in shorter-duration credits, and so that if spreads widen, we don't have as much price exposure. Overall, we have more yield but less price sensitivity, and we think that's a more attractive proposition than you would find just through a passive ownership of the benchmark. It's also important to notice that we're not constrained to just the Investment-Grade Index that you see here. We opportunistically buy some below investment grade or parts of the market that aren't included in the benchmark, and we think this is another great part of being an active manager.

Alex: Zooming out from Credit, let's look at current positioning across all dimensions on slide nine, Portfolio Structure. With the recent adjustments, the portfolio is positioned as you see in the upper left, with the Income Fund in brown and the U.S. Agg in light blue. The portfolio is underweight Treasuries, although we added to that exposure over the course of last year. The portfolio is meaningfully overweight to Securitized, mostly in Agency MBS, and the portfolio is modestly overweight to Corporate. Lucy, we focused mainly on sector and issuer changes. Can you share what adjustments we made to duration in 2024 and how the Committee is thinking about it prospectively?

Lucy: Of course. From a duration standpoint, you can see here that the Fund's duration, as of the end of 2024, was 6.3 years. Over the course of the year, I'd characterize our changes as both valuation-disciplined and incremental, which is generally how we operate. We started 2024 with the duration of six years in the Fund and in the second quarter, which was one of the periods during the year as I mentioned, it was up and down. But in the second quarter, yields rose. At that point in time, our Committee met and decided that given starting real and nominal yields and given a view that yields were likely to decline over our investment horizon and decline more than what's priced into the market, that it made sense to extend duration. We extended at that time from 6.0 to 6.25 years, which is essentially where we ended the year. So, we held that positioning steady from April through the end of the year.

At this point, that's slightly longer than the benchmark that you see here, 6.1 years. I would say that even though our interest rates are evolving, just like I mentioned with news flow on the economy and the political outlook, we still believe over our investment horizon that inflation will continue to cool, that there will be some challenges to growth from the current high levels we're at, and that the Fed (Federal Reserve) will likely continue its cycle, even if a bit slower than some anticipated or a bit shallower, and all those things are likely to drive a decline in yield levels that, again, we think will benefit this longer-duration position. I'll also mention that we see the yield on this page of the portfolio of 5.3%. We think this is a relatively attractive starting point, and it's important in our minds that we have a yield advantage versus the Index.

Alex: Thanks, Lucy. Are there any closing thoughts you'd like to share?

Lucy: I would just end by saying that the Committee remains optimistic about the outlook for fixed income given where we're starting and given that we think the potential for volatility is high. It's easy to maybe look at the market on the credit side and feel complacent, but if history is a guide, we often see periods of volatility. As an active manager, those are the periods that we get excited about, and we're looking forward to see what the future brings.

Alex: Thank you all for your interest in our Investment Review, and thanks for your continued confidence in Dodge & Cox.

Dodge & Cox Income Fund — Class I SEC Standardized Average Annual Total Returns as of December 31, 2024: 1 Year 2.26%, 5 Years 1.26%, 10 Years 2.47%. Fund and Index standardized performance is available on our website.

Income Fund's Ten Largest Positions (as of December 31, 2024): Fannie Mae (21.0% of the Fund), U.S. Treasury Note/Bond (19.7%), Freddie Mac (18.1%), Ginnie Mae (4.4%), Navient Student Loan Trust (2.5%), Petroleos Mexicanos (1.9%), Charter Communications, Inc. (1.8%), Prosus NV (1.5%), Imperial Brands PLC (1.4%), and JPMorgan Chase & Co. (1.4%).

1. All Fund performance results are for the Income Fund's Class I shares.
2. The use of specific examples does not imply that they are more or less attractive investments than the Fund's other holdings.
3. Unless otherwise specified, all weightings and characteristics are as of December 31, 2024.
4. The U.S. Government does not guarantee the Fund's shares, yield, or net asset value. The agency guarantee (by, for example, Ginnie Mae, Fannie Mae, or Freddie Mac) does not eliminate market risk.
5. Net leverage is calculated as net debt (total debt minus cash and cash equivalents) divided by EBITDA (earnings before interest, depreciation, and amortization). This ratio shows how many years it would take for a company to pay back its debt if net debt and EBITDA are held constant.
6. The interest coverage ratio is a debt and profitability ratio that shows how easily a company can pay interest on its outstanding debt.

See Disclosures for a full list of financial terms and Index definitions.