Dodge & Cox Funds®

# 2016 Fixed Income Review

**Tom Dugan:** Hi and thanks for joining us today. My name is Tom Dugan, the Associate Director of Fixed Income at Dodge & Cox and with me today is Dana Emery, our CEO, President and Director of Fixed Income.

**Dana Emery:** Nice to be here.

**Tom Dugan:** 2016 was a really eventful year in financial markets and our core bond strategies, as proxied by the Dodge & Cox Income Fund, had very strong absolute and relative performance. Today we're going to talk about four areas. First, the macroeconomic and market background for 2016. Second, a discussion of the major factors that influenced our portfolio's performance. And third and fourth, two areas of interest, as reflected by our clients and other folks, which are basically what can we expect from Washington, D.C., policy changes from both the Trump administration as well as the Federal Reserve, and second, what's the status of credit markets, given potential policy changes as well as a significant change in valuations. So Dana, how would you describe the macroeconomic and financial market environment of 2016?

**Dana Emery:** 2016 was an incredibly volatile year in terms of market sentiment, and there were four distinct events that really impacted that. Early in the year there was a lot of concern about China's slowdown. We saw energy and commodity prices decline significantly and there was concern about European Union and European bank strength and this all led to concerns about overall economic growth, and this led to a flight to quality of U.S. Treasuries and a significant widening in credit spreads. There seemed to be kind of a thawing of those concerns in the spring, but then Brexit occurred in June and the markets were very surprised by that. That's Britain's decision to leave the European Union. And there's a tremendous amount of uncertainty around the form it will take and the timing and the pace, and that led to a significant flight to quality, and actually, global interest rates met record lows during that period. Later in the year, the world was surprised by the Trump victory in the U.S. presidential election and the markets quickly turned to pricing in the potential policy changes-` corporate tax reforms or deregulation, and that led to significant narrowing of credit spreads, a big rise in Treasury rates due to some of these policies could be inflationary, and a very strong equity market finish, especially in financials and pharma and other areas that may be impacted by these policies. So I'd say the last point was really that the Fed made a decision to raise interest rates at their December meeting and the market quickly moved to reprice the forward curve and expects more rate increases in 2017 and '18. This is up from zero expectation of rate increases over the next year post the Brexit era, so it was a big repricing and a reassessment of that impact over time. So 2016 was quite a topsy-turvy year in terms of risk sentiment and now we have uncertainty going into 2017 about Trump policies and when they'll be implemented and what form they'll take. So it continues into '17 as well.

**Tom Dugan:** In terms of the bond market, 2016 net-net, year-over-year, there was only a slight rise in Treasury yields using the ten-year as an example. Its yield was only up 18 basis points from the beginning of 2016 to the end of 2016, though that masked a lot of interim volatility and in fact, yields spent most of 2016 lower than the beginning of period levels, only to spike after the election. U.S. corporates were the real superstar in fixed income markets in 2016, returning 6% overall, which was about a five-percentage point outperformance of Treasuries. Within the corporate sector there were a couple of industries that really stood out in terms of performance. Recovering from poor 2014 and 2015s, the energy and metals and mining industries rebounded significantly in 2016 in response to some of those industrial commodity price increases that you mentioned earlier. Another area of strength within the corporate bond markets was below-investment grade. That area generally had a double-digit return in 2016. All these factors combined to really favor the strategies that we had in place in 2016, and the net effect of these changes in the bond market was really quite favorable to our strategy.

**Dana Emery:** Yes, we had a really strong 2016 on both an absolute and a relative basis. The key factors that contributed to this were one, that we were overweight credit and we actually added to credit in the first quarter, when the markets were significantly weaker, and that led to a strong performance as those credit spreads narrowed throughout the year. In addition, security selection was strong, especially in the energy and commodity area, so names such as Kinder Morgan, Pemex, Rio

Oil, Teck Resources all performed very well. Some industrials such as Cemex and Time Warner performed well, as well as Navient contributed to results. In addition, we have a nice yield advantage in the Income Fund and we have a defensive duration position, which really helped mitigate the effect of rising rates during the fourth quarter.

**Tom Dugan:** We're now going to pivot to two areas of interest that come up frequently in our interactions with our clients, specifically policy changes out of Washington, inclusive of both the new Trump administration, as well as potential Federal Reserve policy changes. And second, the credit markets and specifically, given policy outlook and different valuations, what is the likely evolution of credit markets going forward. So speaking about Washington first, as we discussed the election made significant changes to financial markets. We saw equity markets move higher, we saw interest rates spike by almost 40 basis points in the days following the election, we saw the U.S. dollar move higher and we saw credit spreads narrow appreciably. The market has baked in expectations for policy changes on the tax, regulatory, fiscal, and trade fronts that on balance will be advantageous economic growth, corporate profitability, and inflation outlook, and advantageous as in higher. We would urge a little bit of caution in terms of extrapolating from campaign ideas to actual policy implementation. There's often a significant lag in Washington between policy ideas, implementation and effect on the economy. And so while we think the net effect of some of these policy changes is likely to be positive and think that the net effect on inflation and interest rates will be higher, we are somewhat cautious about the ultimate effect. Pivoting to the Federal Reserve, they find themselves, having moved rates higher in December, in an interesting position coming into 2017. Their twin mandates have basically been met at this point in time. The unemployment rate is below 5% and very close to full employment, and inflation is very, very close to their targets, at or around 2%. Nevertheless, their policy rate remains quite low and they've indicated that they're likely to raise rates several times in 2017. The interaction between the Trump policies and the Federal Reserve is quite interesting to think about. If the Trump policies are effected and start having an effect on the economy quickly, that could cause the Federal Reserve to have to be more aggressive in hiking rates going forward. Net-net, our view of all of this is that a tremendous amount of uncertainty remains, but on balance, we think the outlook for rates is higher, the outlook for inflation is somewhat higher, and we've added a modest increase in our Fed monetary rate expectations as well. So let's turn to our second topic of interest, which is the state of credit markets as we enter 2017.

**Dana Emery:** Yeah, the credit market was really strong in 2016. As we talked about earlier, credit spreads narrowed and despite that they still remain near long-term averages. When we compare that spread to the base Treasury rate, we still think that the relative return opportunities of credit are there, especially in carefully selected securities. Before I turn to talking about the credit cycle, I think it's important to emphasize that we focus on bottom-up fundamental research and look at how we think issuers can perform in a variety of economic scenarios, and we invest with a long horizon, which allows us to find credits that we think can do well even in the later stages of a credit cycle. And we do think that we're at the later stages of a credit cycle. It's been going on for – the cycle's been going on for quite a long time. There's increasing gross leverage, more share buybacks, more M&A activity, and also weaker covenants when you look at the leverage, loan and high-yield area, all are signs of later stage, but we do think there's many opportunities for security selection within that. And we don't think that the leverage numbers are especially alarming. Much of the leverage is associated with M&A activity that's been done in an investment grade area, where the resulting combination of companies, once they're financed, are still investment grade. And many of those companies have a strategic rationale for that M&A transaction, have cash flow generation ability that we believe can help reduce leverage going forward, and a management stated commitment to reducing leverage. That gives us some confidence. It doesn't mean that every transaction is attractive to us, but it does create an attractive entry point for very selective investments within M&A transactions. In addition, the financials to us look very strong, especially given their stronger capital ratios, strong liquidity and asset quality. And in addition, we do think credit can benefit from tailwinds from potential Trump policy changes, albeit likely more at the end of '17 and into '18: tax policy, which may lower corporate tax rates and incentivize lower leverage, a repatriation tax holiday that would allow companies to bring cash back into the U.S., as well as other policies that could help encourage GDP growth and improve the overall state of the U.S. economy.

**Tom Dugan:** Well their outlook for credit is a sanguine one. The significant change in valuation over the course of 2016 certainly prompted some changes. For example, at the beginning of 2016 in February, investment grade corporate spreads were well over 200 basis points. They ended 2016 at about 120. So a significant decline in those, and given how important valuation is to our strategy, there were ramifications. Over the course of the last three quarters of 2016, we lowered the overall credit exposure in our Income Fund from 57% of the fund to 49%. A couple of examples might be illustrative of our thinking there. The first, one of the securities we sold is Allergan, the global pharmaceuticals company. We sold that because the valuation had risen to a point that we didn't think there was adequate compensation for the risks that the company faces, and a potential catalyst for Allergan's credit worthiness, their merger with Pfizer, ended up being taken off the table. A second security that we sold over the course of 2016 was Teck Resources, the largest Canadian mining company. A very, very strong performer in 2016, as it recovered from the challenges for all mining companies of 2014

and 2015, and the valuation reached a point where we didn't think we were being appropriately compensated for what remained volatile end markets for its products, coupled with the fact that they sold debt that is senior to the debt that we held. And those two factors combined to make us less comfortable with the security and so we parted ways with Tech Resources. A third example is HP Enterprise, which is one of the two successor entities to Hewlett-Packard, focusing on their server and storage business. Over the -- This was initially purchased in the fall of 2015 and over the course of 2016, HP Enterprise announced several transactions that would reduce the scale and diversification of their operating businesses. That reduced scale and diversification left us somewhat less comfortable and a higher valuation as well, and so we parted ways with HP Enterprise as well.

**Dana Emery:** So despite that reduction in credit, we still remain significantly overweight. The areas that we're comfortable holding at these levels of valuation are companies that we think have some oligopolistic characteristics such as cable and telecom companies, companies that are in the energy and commodity area, where we think that they have the balance sheet and cash position fallback options to be able to weather a range of prices of oil and other commodity prices. In addition, we ran overweight to financials. Due to reasons stated earlier, they – you know, many of these are global banks that we think are in much, much stronger positions and still offer an attractive valuation. And lastly, M&A related transactions such as Dell and Imperial Tobacco are examples of M&A transactions where we felt that the strategic rationale, as well as the cash flow ability to reduce debt that was used to finance the transaction, is there. So when you add it all up, you can see that the bottom-up fundamentals and combined with valuation we think create attractive opportunities, albeit we're more cautious than we were earlier in the year about where we are in the credit cycle.

**Tom Dugan:** I'd like to conclude by emphasizing the vital role fixed income plays in a diversified investment portfolio. It provides income generation, liquidity, downside protection, and low correlation with riskier asset classes, such as equities. As we look forward, we continue to believe the likely trajectory of interest rates is going to be higher and we've continued to position our portfolios with a defensive duration position to help mitigate the risks associated with rising rates. Despite the rise in yields over the course of the fourth quarter, particularly after the election, bond yields remain relatively low on an historical basis, and we think that should temper expectations over the intermediate term for returns from the fixed income sector. So thank you for joining me today.

**Dana Emery:** Thank you.

**Tom Dugan:** And thank you for joining us.

*Dodge & Cox Funds SEC Standardized Average Annual Total Returns as of December 31, 2016: 1 Year 5.62%; 5 Years 3.77%; 10 Years 5.05%.*

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