Dodge & Cox Funds®

Video Transcript
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Dodge & Cox on Today's Bond Market

Cara Esser: I'm Cara Esser for Morningstar. Today, I'm joined by Dana Emery, President, CEO, and Director of Fixed Income at Dodge & Cox. She is here to talk about Gold-rated Dodge & Cox Income. Dana, thanks for joining me today.

Dana Emery: Thank you for having me.

Cara Esser: I want to start by talking about the credit exposure in the portfolio. The fund tends to be overweight compared to peers and the benchmark. Can you talk a little bit about the recent underperformance in the credit portfolio and also the long-term view for holding so much credit in such a portfolio?

Dana Emery: Yes. Thank you. We tend to overweight credit and we have throughout our history, but the degree to which we overweight really varies on the market environment and we're looking at a combination of fundamentals, valuations, and in combination what type of long-term return we can generate from each investment that we are making. We're in an environment now where we think the fundamentals in many cases are getting a little bit more strained. But when we are looking at companies, we are looking at their balance sheet, their cash flow generation ability, and their fallback options, so their ability to withstand a prolonged period of downturn in their business or industry. In the case of valuations, we are looking at the current yield premium that we're earning over a Treasury and that translates into what type of total return we can earn over a three- to five-year investment horizon. We've been increasing credit since about June of [2014]. We've been gradually increasing our credit and we accelerated that in the summer of [2015] when valuations got very stressed in our opinion, and created some new opportunities in credit. So, we increased our credit weight last year about 8% up to about 55% of our portfolio. So, we do have a significant exposure to credit. That has underperformed recently. The biggest problem areas in credit have been in the energy area, in metals and mining, as well as anything associated with emerging markets. All the securities in our portfolio are U.S. dollar, but those areas in particular led to our underperformance last year. But given the starting valuations we think that the math is in your favor. The yield premium that you are earning in corporates right now is substantial—about 175 basis points for investment-grade corporates over that of Treasuries. And that math starts to work in your favor if you have a longer-term investment horizon. You have a high probability of outperforming Treasuries, assuming you are doing your credit work right, and you have a high probability of producing above-Treasury type of return over a coming three-year period.

Cara Esser: OK, great. I want to touch a little bit on that emerging-markets stake that you talked about, particularly the non-U.S. issue stake. That's been increasing over the year. It's also been a rough spot for the fund in the last year or so. Can you talk a little bit about those holdings and then also what the long-term view is for adding that to a core bond portfolio?

Dana Emery: Yeah. So, right now, we have about just under 19% in non-U.S. issuers. They are all U.S. dollar. So, we are not taking the local currency risk directly in those investments. And about 6% is invested in emerging-markets issuers that are domiciled in an emerging market. We've been increasing that gradually over the last 10 years or so and accelerated more recently for a combination of factors. One is that the capital markets are opening up. More issuers are issuing in dollars to diversify their funding sources. Many of those issuers that we invest in have a reason to issue in dollars. They've either got assets in the U.S. or assets tied to the U.S. dollar. And we are doing the same approach we do with our domestic issuers, which is looking at the bottom-up fundamentals and looking at their ability to withstand a downturn. But the added factor when you are investing outside the U.S. is looking at macro factors in that given region in terms of their economic outlook, inflation rates, the currency movement that might impact their ability to service debt, and then governance factors, making sure that we feel that we have good protection as a debt investor when we are investing outside the U.S.

Cara Esser: Switching gears, I'd like to talk about interest rates. Dodge & Cox Income has been short its benchmark for a while and currently is short the benchmark in terms of duration. Can you talk about your outlook for rates?

Dana Emery: Yes. Our duration is running about 4 years in our Income fund versus about 5.6 for the Barclays Aggregate. We've stayed pretty constant but the index itself has lengthened as there has been more longer-term issuance, and at lower rates the duration of fixed income investments is longer. So, we've stayed pretty steady and the index has lengthened. And we don't believe we should lengthen into the index just to match the index. We're really trying to think about what type of portfolio can produce an attractive real rate of return over the coming three to five years. And getting out longer in this environment where we don't think you're well paid for taking interest-rate risk and the market we're starting to embark on a Fed tightening cycle, we don't think it makes sense to take on a lot more interest-rate risk in the portfolio. And we think the market-based measures of what the Fed movements are going to be are expecting very minimal tightening and also market-based measures of inflation are very low. So, we think there is room for a negative surprise there. It wouldn't take much to get the market off these what we think are very rich valuations. And that movement would cause a price impact that could overwhelm the income you are earning. So, being shorter causes us to have less price exposure to interest-rate risk, which we think is warranted given the low yields we are operating in.

Cara Esser: Finally, I want to talk about liquidity. Dodge & Cox Income is a large bond fund and investors can redeem their money whenever they want on a daily basis. So, how do you think about and manage liquidity in the fund?

Dana Emery: Yes. It's an important topic. There has been a lot of changes in market structure since the financial crisis. One of the biggest that people point out is that dealers are not able to hold as much inventory as they have in the past and so they aren't able to play that intermediary role to as great of an extent. The biggest focus area in fixed income has been on corporate bonds and we would contend that the corporate bond inventory at dealers has actually stayed pretty steady. So, we aren't counting on that liquidity from the dealers in a more adverse scenario. We think about liquidity with our fund in terms of layers of liquidity and we're a broad-based fund that has a combination of cash and Treasuries, mortgages, asset-backeds, and corporate bonds, and we think that the degree that we have the higher-quality and more liquid instruments provide very adequate protection to our underlying investors. Our underlying investors are comprised predominantly of institutionally oriented entities and entities or individuals investing for retirement. So, we don't see a likelihood of a scenario with a significant outflow simultaneous. So, we think that we've got adequate protections in how the fund is structured. There are other protections that exist we have not had to draw upon, but there are lines of credit. There is also a cross-fund borrowing. Then for institutional clients that would request it, we could have an in-kind distribution.

Cara Esser: Dana, thank you so much for joining me today.

Dana Emery: Thank you for having me.

Cara Esser: For Morningstar, I'm Cara Esser.

Dodge & Cox Income Fund SEC Standardized Average Annual Total Returns as of March 31, 2016: 1 Year 0.47%; 5 Years 3.80%; 10 Years 5.25%.