Fiducient Advisors, Nonprofit Investment Stewards Podcast
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The New and Important Role Bonds Can Play in Your Portfolio - Including Endowments, with Wesly Pate

[00:00:00] Welcome to Nonprofit Investment Stewards with Bob DiMeo and Devon Francis from Fiduciary Advisors. Bob and Devon are passionate about helping nonprofit organizations prosper. Whether you oversee endowment foundation or retirement plan investments, this podcast exists to help stewards improve performance, reduce costs, and discover strategies that enable your charitable organization to prosper and advance its mission.

[00:00:26] Now onto the show. Hello, and welcome back to the Nonprofit Investment Stewards podcast. I'm Bob DiMeo. Always great to be joined by co-host Devon Francis. I'm excited about today's guest. He and his firm are experts in their field. It's an area of investing that should be very important to all of you nonprofit leaders.

[00:00:46] I recently heard him on a podcast for the Family Office Exchange and felt like we had to get him on the show. So again, very pleased we could make this happen. Devon, I hope you're doing well today and may I ask you to introduce our guest? [00:01:00] Absolutely happy to be here, and I'm very eager to glean insights from today's guest.

[00:01:04] Wesly Pate, Senior Portfolio Manager at Income Research and Management. We also call them IR and M. So for over 35 years, IR and M has been singularly focused on managing fixed income portfolios for clients. Today they oversee about a hundred billion in assets. Our guest, Wesly Pate, joined IR and M in January of 2011, and in his role as a senior portfolio manager, Wesley is focused on portfolio construction, sector analysis and more. Wesly's undergraduate degree in finances from Georgia State University.

[00:01:37] He has an MBA from Boston University and an MS in accounting from UMass Amherst. So Wesly, welcome to the show. We're thrilled that you're here. Thank you for having me. Looking forward to the discussion. So, Wesly, why don't you share with us your career path and how you got to your current role and what your day-to-day looks like?

[00:01:56] Happy to. So, uh, so as you mentioned, studied [00:02:00] finance, which was not the long-term plan. Uh, actually initially was always planning a military career, um, and was planning to go to North Georgia Military Academy and then go into the army afterwards. And my senior year economics teacher sort of pulled me to the side and said, let's talk finance.

[00:02:15] Uh, and, you know, so I still look back on, uh, Mr. Jones and, and thank him with a very large amount of gratitude. So went and studied finance, uh, shortly after graduation, uh, took a job, uh, with a firm actually focused on the equity side. And shortly after being there, we had a, uh, an analyst and a portfolio manager that departed.

[00:02:35] And so an opportunity arose. And so it's sort of the classic area of investments where sort of chaos can create opportunity both within one's job prospects, but also just sort of within market. So, did that and was there for a few years and then opportunity arose here at Income Research and Management.

[00:02:51] I always wanted to pursue everything on the fixed income side, so was happy to jump at that opportunity. Started as a credit analyst, did a little bit of trading and moved into the portfolio manager role [00:03:00] maybe about a half, a little over a half decade ago. That's terrific, Wesly. We know that you and your firm do a great amount of work with nonprofit organizations.

[00:03:08] So, with that in mind, maybe you could start by just providing high level thoughts on the fixed income markets today, and maybe contrast that to just a few years ago. Absolutely, I mean, day and night, you know, it's sort of thinking about both in terms of the markets, but also the interest from nonprofits and endowments.

[00:03:26] In fact, it's uh, most recently it's been one of the fastest growing areas of the, the assets that we manage just 'cause this sort of reinvigorated interest in the asset class. So, you know, if we go back just a couple of years ago, we think about where yields were. And let's be honest, they were in many ways depressing.

[00:03:43] Nothing like being a bond manager with sub 1% yields, uh, it makes you a very unpopular person oftentimes at the party. Uh, but here we are today, and it's certainly changed. So, renewed interest and, you know, not only from the appeal of the asset class, but you think about where yields are [00:04:00] today, both in the context of history.

[00:04:02] But also relative to other asset classes. And so, you know, it's not surprising that we're starting to see that interest come back to the asset class and, you know, and it's really, that interest is spread across the curve as well. So, you know, thinking about where we are, we're seeing an inverted yield curve very different than what we saw just a few years ago.

[00:04:20] We're seeing meaningfully higher yields. Much different than what we were a couple of years ago. So overall, it's a new asset class, if you will, in many ways. And if you think about the average investor's, uh, tenure, in many ways, they haven't even seen this structure of the yield curve or the asset class in its today's form.

[00:04:39] So, you know, we're finally in an area where not only is it important once again, but also sort of re-educating a lot of investors to, hey, think about fixed income. Because in the past it was many ways just seen as the liquidity provider or just sort of that buffer against adverse scenarios. Well, today it's much different.

[00:04:57] Not only does it continue to serve all those [00:05:00] appealing factors of the past. But it does it with yield today. And so, you know, you're, you're really sort of starting ahead of the mark. Uh, so it certainly continues to garner more in a growing interest. So, so we'll delve in, uh, in just a bit into how that might translate into portfolio construction and things of that nature.

[00:05:17] But I can imagine whether it be the investment committee member or, or just anybody who's an investor in bonds kind of scratching their head and saying, okay, I hear you, but what are your thoughts about inflation and interest rates over the next three to five years and, and how might that ultimately impact what I do?

[00:05:34] Yeah. So, it's a wonderful question. Sort of thinking about what it looks like in the historical context and, and all the potential tailwinds that it's now starting to create. You know, we would definitely say that we're over the hump. You know, inflation is certainly coming down. You think about the supply chain pressures, uh, and everything that really got built up, especially during Covid.

[00:05:52] Also think about where we are in terms of monetary policy and fiscal policy, inflation will be lower in the future than what we've [00:06:00] experienced over the last couple of years, which also results in, you're starting to see the Fed, you know, talk more and more about the potential for cutting interest rates from here.

[00:06:08] So moving into a different policy, uh, from a monetary policy perspective. If you look throughout history, you know, following the Fed's last rate hike, and you look at forward looking returns for fixed income, very appealing. And we truly think that that's likely the scenario we're in today, where, you know, even though we have built our firm around being duration neutral, so we're not saying, you know, extend or shorten necessarily within your fixed income asset class, but rather think about fixed income in its totality.

[00:06:38] Very appealing. You know, we're entering in a period of likely seeing the Fed cut rates, and so as a result you likely have a nice attractive tailwind, especially for a risk-adjusted asset class. And I think it's important to think about what, what is yield and, and I'd actually love to start there for just a quick second.

[00:06:55] Yield is your, in many ways, your insurance against an adverse scenario. And [00:07:00] so let's put that into both the sort of the risk and the return, uh, spectrum there. So, if yield is designed to be that buffer, that insurance against an adverse scenario and sort of comparing that to a couple years ago, A, it's higher, so you're already starting in a much better position.

[00:07:17] But also the headwinds versus tailwinds have completely shifted. So, you know, we were in an environment of low inflation that was moving higher. At the exact same time, we were in a low yield environment. Now, we're in a higher yield environment with inflation moving lower. So, your risk and your reward are the exact opposite where they were just a couple years ago, which is the reason that we're saying investment committees are starting to look at the asset class once again and say, okay, this makes sense.

[00:07:44] Once again, let me build that insurance back into my portfolio because it's something that we're probably gonna need. So as we think about how, um, endowment or foundation pools have been positioned over the past several years, how should investment committees be thinking about [00:08:00] potentially modifying their allocation or their exposure to bonds?

[00:08:04] It's both probably modifying and monetizing, you know, so, you know, a lot has gone well for, for foundations and endowments. We've seen, you know, the, the returns on a lot of risk assets do exceptionally well, at least over a longer time period. You know, 22 was definitely a setback, but 23 came roaring back. And so as a result, they're looking at a lot of these asset classes and starting to feel like maybe returns have gotten a bit stretched.

[00:08:30] And so what is fixed income supposed to do? Well, it's supposed to be a core part of your portfolio. It's designed to absorb, it's designed to absorb the adverse scenarios that are more likely to negatively impact those risk assets. And so, what do you really want in your overall investment pool? You want diversification.

[00:08:50] You want something that can absorb the down, you know, the downside. You know, so if everything's going right, it's there and it's gonna give you a nice little tailwind, but if everything's going wrong, the liquidity's [00:09:00] still there. So, the one thing we would say is thinking about fixed income, A, is emphasized liquidity because within the broader investment portfolio, it is going to be the asset class that's likely to hold up in that next.

[00:09:12] Scenario that's going to provide either a buffer against the broader sort of downturn in returns, but also allow for that liquidity in order to potentially fund the same asset classes that might have been a little bit more impaired. So it, once again, it is, it's changed, but it's changed and definitely making the asset class more appealing, especially for endowments and foundations.

[00:09:34] That's helpful and, and you mentioned diversification with regard to overall portfolio structure. What are your thoughts on diversification within fixed income allocations? And specifically, how do you think about credit risk when you're investing in bonds? And do you have any special concerns about credit today?

[00:09:52] Absolutely. So when we approach a bond, we always say credit structure and price, and there's a reason credit comes first. Um, you know, you, [00:10:00] you'll hear a lot of people say, oh, there's no bad bonds, only bad prices. No, you know, there are bad bonds. You know, so credit has to come first. You know, I mean, a credit impairment is something that can really read havoc on your portfolio.

[00:10:14] So credit analysis is the start of bond analysis. And so, you know, and when we sort of take a step back and think about, you know, credit risk and where they stand, it's impossible not to at least say okay, you have to have some concerns. Anytime a manager says, oh, we have no concerns about credit risk.

[00:10:32] They're either, they're either sort of putting their head in the sand or they're, they're just being a little bit dishonest. You know, the ultimate, there are risks out there. I mean, look at the overall levels of leverage that exist in the system. It's continued to grow over the last several years. You know, today's Triple B's were, most of them were single A's, uh, back before the crisis.

[00:10:51] And so leverage has continued to grow. Um, you know, you've had, uh, continued M&A which results in greater levels of concentration. And so yes, [00:11:00] we would say, especially within sort of the more cyclical, highly levered industrial areas of the market, you know, that's where some of our concerns are specifically growing.

[00:11:10] Thinking about that on the next level. You know, there's other areas of the market where you're also seeing, uh, sort of new asset classes evolve and, and new sort of subordinated tranches getting created there. So, in the very parts of the market that are likely at the most risk is also where we continue to sort of see this ballooning of more and more credit, uh, if you will.

[00:11:29] So, but credit analysis, if, if you don't start there, ultimately the end, the end game usually doesn't end well. It's usually not a question of if, but rather than when. So, when you think about nonprofit organizations with this in perpetuity time horizon for many of them, and then the remarks you just.

[00:11:48] Made with respect to ballooning overall debt and, and such. Maybe you can drill down a little bit more on how and why bonds have a place in portfolios over the long haul. Uh, in [00:12:00] addition to the good points you, you made, but I guess you're, you're almost prompting the question of, it opportunistic now and how long might that last for an in-perpetuity investor?

[00:12:12] So, so what I would say is it, in order to exist into perpetuity, you, you have a lot to go through over that time, right? You know, perpetuity isn't a straight line of, of upward markets, but rather is, is a lot of waves, you know, along the way. And so, in order to exist into perpetuity, you have to survive the next downturn and the next one and the one after that.

[00:12:33] And so, how do you do that? Well, diversification we would say is rule number one to that. And what is the asset class that sort of allows that level of survival? And it's high-quality fixed income. And so, you know, and that hopefully comes back to that earlier question of, of why now and why does it exist?

[00:12:52] Well, the key reason that it exists within a broader portfolio for endowments and foundations is to see through the downturn. [00:13:00] And so if you're thinking about, okay, A, we have a, maybe a spending goal, you know, four or five, six plus percent. Well, the nice thing is that's close to where yields are right now for a high-quality asset.

[00:13:10] So you're approaching that level at the exact same time you're allowing your portfolio to get through the, through the lows. And so, you know, fixed income is ultimately there to make sure that that diversified portfolio can get through, can sort of get over the hump. And so that's really what we want to really, you know, what we hope resonates because it is important to know that, you know, you can't see five years out if you can't get past two years.

[00:13:37] And so from that perspective, if you do see that ballooning in sort of a pop elsewhere, it's not gonna be in high-quality fixed income. It's gonna be in those asset classes that have gotten much more stretched and, and you know, those are some of the very areas that we've seen the most issuance in. And also, areas where endowments and foundations have really increased their overall allocations in the last couple of years.

[00:13:58] And, and how [00:14:00] concerned are you with overall debt levels over the intermediate to longer term? It's growing every day. Um, you know, so, and, and I think about not only from my seat, but also it's sort of my kid's seat. And, and what does that mean? What does that mean two, five and 50 years out? It's impossible to not have at least a level of concern that you know that.

[00:14:22] And we're already starting to feel it. And, you know, we would point to a couple of different scenarios in terms of, oh, let's take a step back and think about what does this growing level of debt mean? Well, growing levels of debt at the exact same time when rates are higher also means growing levels of, of expense or interest expense.

[00:14:41] Well, if the federal government, for example, has, has to, um, shoulder the burden of more and more interest expense over the next several years and probably decades, it ultimately has a crowding out effect. You know, there, there is only so many dollars to go around. Even though we can continue to print more, there are effects.

[00:14:58] I mean, may, you know, maybe it's a [00:15:00] little bit old school. I still believe in supply side economics and monetary policy and, and the M two matters, uh, even though it seems to not have for the last, for the better part of the last two decades, it will come back. And so every single, you know, dollar of debt that's issued has a diminishing marginal utility.

[00:15:17] You know, as if you think about the first billion will, you know, has a much greater impact to the economy than the second billion of debt that's issued. Well now we're talking trillions. And so, each trillion that gets issued from here is gonna have slightly less positive, uh, economic impact and is also gonna have a greater burden.

[00:15:33] So you're really sort of pulling it from both sides of an adverse scenario, and so it's really important to sort of take a step back and think about, okay, more debt in the system also means probably less monetary and physical support going forward. All the more reason to sort of create this more diversified and defensive portfolio in order to make sure that you can see through to the next inning.

[00:15:58] That's super helpful. [00:16:00] And if, if someone were to try to translate that into really portfolio construction, be it for an endowment, a foundation, or, you know, even a wealthy investment committee member, what, what might that mean? So the first thing we'd say is, is it means you need liquidity.

[00:16:18] You know, and we cannot stress that enough. If we think about all of those various investment entities you just talked about. And, but whether it's private clients and wealthy investors, endowments and foundations, you name it. Over the better part of the last 10 to 15 years, they have all stretched more and more into less liquid asset classes.

[00:16:37] So what does that mean? Well, you need liquidity somewhere. You need liquidity in one of two, uh, scenarios. You need it either just simply to survive. Or you're gonna need it in order to sort of monetize, you know, if we do see a adverse scenario in those less liquid, more risky investments, there could be a great opportunity at some point to add to [00:17:00] them.

[00:17:00] You can't add to them if you don't have liquidity somewhere. So again, it really comes back to fixed income needs to be thought of as a tool in your toolkit. Your toolkit is not sufficient and it's not full. You're not ready to tackle every single task if you do not have liquidity somewhere in your portfolio.

[00:17:16] And so we would very much emphasize that US dollar, you know, denominated, high grade liquidity is a great area to do it 'cause A, the yields are attractive. So you're getting paid to actually carry that tool today. So, you know, definitely don't overlook it. So speaking of liquidity, there's been a swell of interest in private credit, so an illiquid asset class, and a lot of that it has been driven recently from retail investors.

[00:17:42] I know IR and M doesn't play in the private credit space, but do you have any high-level thoughts on private credit? Does the space seem a bit frothy to you? Very frothy. Uh, yeah. There, there, there's a lot of great programs out there. There's a lot of great lenders out there that have done, you know.

[00:17:59] [00:18:00] Really have done their homework. But as you can imagine, and we've seen this time and time again, is that ultimately, as various asset classes get long in the tooth, it starts to bring about that next level of lending. And usually that next level of lending is not gonna be the first tier or the second tier.

[00:18:15] And ultimately, we're starting to get there where, you know, it sort of, everyone gets a loan, you know? Uh, I always kind of come back to the thinking about Oprah. You get a car, you get a car. Well now it's, you get a loan, you get a loan. And that's sort of where we stand today in private credit. And, and I don't wanna make light of it, but.

[00:18:31] It is certainly creating an environment where, where sort of money's become too easy to access and when money becomes too easy to access, defaults ultimately follow. You know, and this is becoming increasingly concerning because really over every time in the last 20 years when we enter into sort of these adverse economic scenarios, we've either been able to see.

[00:18:51] The federal government or the Fed, someone come in to serve as a backstop, we don't think that's gonna be nearly the case in the future. And so, we're talking about lacking a [00:19:00] backstop at the exact same time where things have gotten a little bit frothier. And so, in that regards, yes, we definitely have some, some growing concerns around private credit.

[00:19:09] We think a lot of those programs have done well. But as you start sort of thinking about those tertiary type approaches, we would say caution should be warranted. And so, or caution should be exercised. And at the exact same time, there will be opportunities. But at this, at this juncture where we are, we think those opportunities have mostly been captured.

[00:19:30] Wesly, I like your Oprah comparison there. Everybody gets a loan and, uh, I'll be sure to footnote you when I use that in a client meeting. I just came up with it, so hopefully it works. I like it. So, we've covered a lot to this point and there's probably a lot more to cover, but what would you add or underscore at this point?

[00:19:50] Yeah, so you know what, what I would really know is, you know, there are two things I would come back to. One is liquidity because we talk about this [00:20:00] all the time as, as senior investors here at the firm. You know, one of the questions we get all the time is what keeps you up at night? And the answer for almost all of us is always liquidity.

[00:20:10] It's liquidity in the markets where we, uh, operate, but it's also in other markets. So, you know, liquidity is typically the most mispriced risk that exists across all asset classes. You know, uh, I come back to, you know, uh, Devon, one of your very first questions around credit. You know, markets tend to do a good job of sort of thinking about credit over a cycle, and then it gets a little stretched.

[00:20:33] Liquidity almost never gets fully and accurately priced. And so that's the one thing we would certainly add is that take a step back, think about liquidity. If we go into, you know, a repeat of 07, 08, 09, which isn't our base case by any means, what are you gonna want? You're going to want liquidity.

[00:20:51] You know, how are you gonna survive that next inning? And so that's the first thing we would talk about. And the second is, again, why? Why fixed income? And what is it [00:21:00] serving? So, it's serving as a yield, it's serving to actually allow you to meet those spending requirements. But even more so, it's also providing you that insurance against adverse scenarios.

[00:21:09] And maybe the, the one other thing I would note, my apologies there, is that there are opportunities. And so, you know, a couple of things that we would talk about is that sort of bond level differentiation right now is growing. And when bond level differentiation grows, pricing discrepancies can grow and opportunities get created.

[00:21:27] So I go back to that very first question of thinking about, you know, sort of how my career went. Volatility created a little bit of opportunity, and that's what we're seeing today. Every little bit of volatility is bringing about a little bit of an expansion of bond level diversification and differentiation, which is also creating a spread opportunity and a new level of opportunity in terms of bond entrance.

[00:21:48] So, so Wesly, as you've emphasized liquidity and quality, and we've talked a little bit about private credit and such. It sounds as though you're putting, you're [00:22:00] sort of de-emphasizing let's say high yield and, and other sectors, uh, at this point, uh, relative to your focus on liquidity and quality.

[00:22:09] Is that fair? That's fair. And you know, I think about some of the strategies that we run across the firm that are able to utilize high quality. So, or sorry, they're able to use, uh, high yield. So Core Plus is a great example where, you know, one really attractive thing today is that there are many areas to add yield without going down into high yield.

[00:22:28] You know, you think about the basis right now between investment grade and high yield has gotten exceptionally compressed. But the good thing is, is that you can still capture the overwhelming majority of the yield without necessarily having to stretch into the, the sort of lowest rated elements of the market.

[00:22:42] This is in many ways this sort of euphoria for fixed income. When you're able to capture the majority of the yield without taking on the majority of the risk, that's exactly what you want, right? As investors, we're always trying to balance risk and reward, and so when we look across the portfolios that we manage really over the better part [00:23:00] of the last couple months.

[00:23:01] An emphasis on going up in quality. And the good thing within fixed income that we would always come back to is when spreads get tighter, going up in quality costs you less, right? You, you think about, you know, the spread basis times the percentage of your portfolio would be, the reduction in yield was the spread basis comes in, you know, the, the cost of insurance, this is the beautiful thing about, about fixed income, is right now the cost of insurance is low, at the exact same time when its value is high.

[00:23:30] And so going up in quality makes a lot of sense in today's spread environment. Excellent. Those insights are very helpful, uh, and I think our listeners will find them helpful as well. So, Wesly, before we let you go, we'd love to learn a little bit more about you on a personal level. So why don't you describe your ideal Saturday to us?

[00:23:51] So I have two, uh, boys, uh, ages 10 and 6. So, for me, the perfect Saturday is anything outside with them. You know, [00:24:00] so I love being outside, whether it's coaching little league, uh, running around with them. Um, sitting on the, a dock fishing with them is just something that I will cherish forever.

[00:24:09] So anything that puts me outside with a little sunshine next to my two kids is absolute heaven for me. So, I, I, that's truly always my happy place. So wherever they wanna run around, as long as I can be somewhere in tow, I'm more than happy to be there. That's great. And the weather is turning. So here, uh, us New Englanders will soon be welcoming the spring, and then those opportunities to enjoy the sunshine outdoors.

[00:24:32] So thank you so much for joining us. It's been a pleasure. If folks want to learn more about you, to get in contact with you or to learn more about IR and M, where should they go? Sure. So, uh, so Income Research and Management, we have our website, uh, where, you know, you can access us. You know, one of the things we really pride ourselves on is the ability to connect with us.

[00:24:53] Um, so, you know, if you see someone on the website that you wanna have a discussion with, pick up the phone. You know, we're, we're, we will [00:25:00] always take the opportunity to talk bonds, uh, you know, truly a passion. So, by all means, you know, reach out, you know, our partners here at Fiducient, you know, we, you know, talk bonds all day, every day with, with you all.

[00:25:11] So always something that we're happy to. So, you know, either connecting with us directly or through you all, we'll, we're always gonna welcome that opportunity. Great. Well, thank you very much for joining us. It's been a real pleasure and we appreciate your expertise and your time. So, thanks so much. Yeah.

[00:25:27] Thanks, Wesly. It's been great to have you on the show. I couldn't echo more the, uh, or agree more with your points about time with your son. I've got two sons as well, and, uh, that's just terrific. So, thank you. To our listeners at Fiducient, we also believe it's an entirely new landscape when it comes to bond allocations in your endowment or your foundation.

[00:25:45] And we emphasize this in our 2024 Outlook, which folks can find at fiducient.com. So if this episode has made you curious, or if it's time to evaluate not only the amount, but maybe the type of fixed income allocations you have, feel free to reach out to me or to [00:26:00] Devon on LinkedIn or at the email address in the show notes.

[00:26:03] We'd be happy to chat and, and thanks again to Wesly and to all you good stewards. Thanks for investing time to help your nonprofits prosper. We'll connect with you soon on the next episode. Thank you for listening to the Nonprofit Investment Stewards podcast. Click the subscribe button below to be notified of new episodes and visit fiducientadvisors.com for more information.

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