

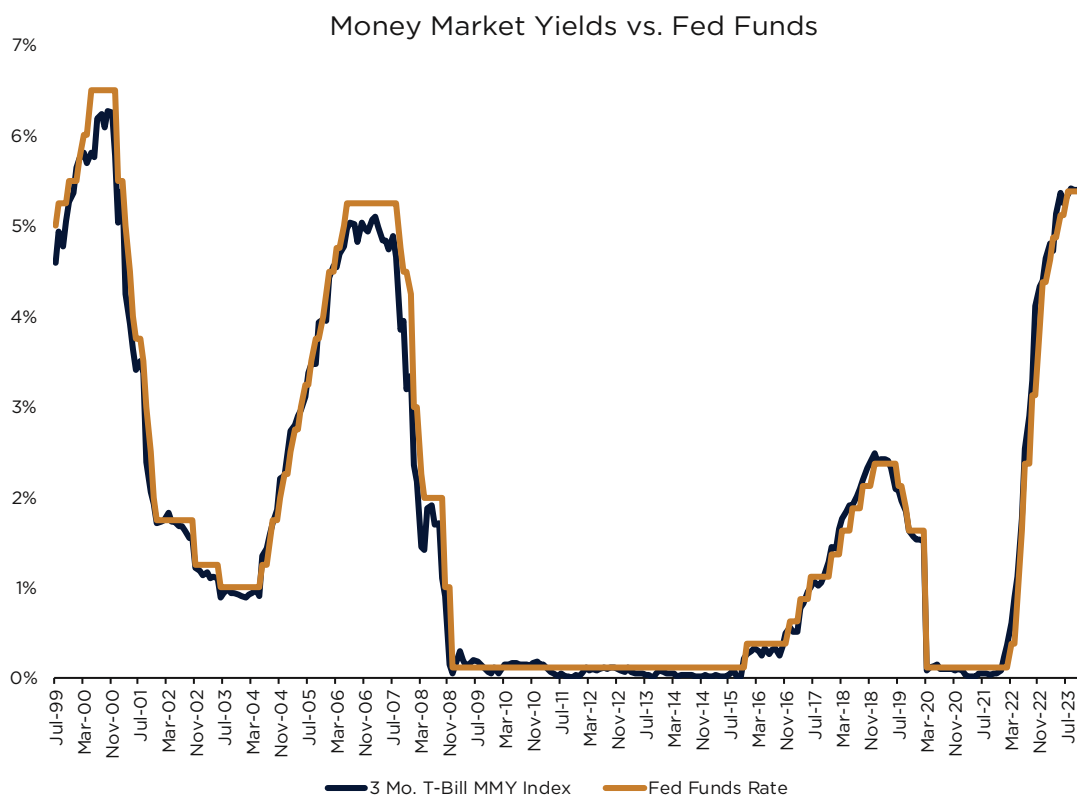
MOVING FROM CASH: THE RIGHT TIME FOR SHORT DURATION FIXED INCOME

Brandon A. Zureick, CFA | Managing Director, Portfolio Manager, Principal

Landon J. Peterson | Portfolio Analyst

The historically challenging bond market of recent years has led many investors to seek the safety and stability of cash as interest rates moved dramatically higher. The outstanding balance of money market funds and other cash-like instruments has swelled to over \$10 Trillion. However, there's been an important shift in tone from the Federal Reserve as of late. Not only have they signaled that they are likely done hiking rates, but they've also made clear that the majority of Fed members are comfortable cutting rates as soon as this year. As a result, there is an opportunity for investors to shift from cash to a short duration strategy in order to lock in today's elevated yields, reduce reinvestment risk, and position portfolios to benefit from attractive total returns should rates fall.

There's no doubt that cash vehicles have benefited from rising rates over the past two years. Aside from providing shelter from deeply negative bond returns, yields on money market funds or cash equivalents have traced the path of Fed Funds higher. The chart below illustrates the closeness of this relationship. With the Federal Reserve continuing to signal its intention to cut rates as early as this year, investors with large cash stockpiles must understand that money market yields will also trace the Fed's path downward, lowering returns.



Money market funds are extremely limited in what they buy in terms of maturity and credit quality. The typical money market fund is limited to the highest-rated securities with maturities of 397 days or less, while the portfolio itself can have a weighted average maturity of no more than 60 days.

These limitations restrict the money market portfolio and limit their ability to generate total returns when interest rates fall. Investors that remain in cash will both experience reduced yields and miss out on the total return benefits of duration.

On the other hand, a customized short duration portfolio is well-positioned to provide investors with the safety of cash-like investments while benefitting from a modest amount of duration to generate positive total returns should interest rates fall. To demonstrate this, we performed a simple interest rate scenario analysis on the ICE 1-3 Year Government/Credit Index, which has a duration of just under two years. In this analysis, we observe index total returns based solely on changes in interest rates up or down 100 bps, assuming a parallel shift in the yield curve and no additional changes in market conditions. Interest rates falling by 100 bps results in total returns above 6%, illustrating the beneficial impact of duration. At the same time, elevated yields help to offset the impact of duration if rates rise by 100 bps, resulting in positive total returns of over 2.5%. In fact, at current yield levels, interest rates would have to rise by close to 300 bps for the index to experience negative total returns, holding all else constant.

Over time, short duration bonds have historically outperformed cash vehicles, particularly following periods of Fed hiking cycles. With the Fed continuing to signal its intention to cut rates, including reiterating that stance at the recent March meeting, the likelihood remains high that we have seen the last rate hike. With that in mind, we looked at performance following the previous Fed hike in prior cycles for the Bloomberg 1-3 Year G/C index and 3-Month T-Bills. As you can see below, the short duration bond portfolio outperforms cash over 1, 3, and 5-year periods following the last hike by over 200 bps in each period. History suggests that adding some duration by moving from cash into short duration fixed income can provide meaningful outperformance.

	Total Returns Following Month of Last Fed Hike					
	Bloomberg 1-3 Year G/C			3-Month T-Bills		
	1-Year	3-Year	5-Year	1-Year	3-Year	5-Year
10/31/1979	10.18%	14.61%	13.22%	12.36%	14.18%	12.52%
5/29/1981	16.89%	14.06%	14.54%	15.92%	12.21%	11.00%
1/29/1982	21.82%	14.99%	13.71%	12.79%	11.08%	9.65%
2/28/1989	10.74%	10.60%	8.67%	8.91%	7.67%	5.97%
2/28/1995	8.47%	6.96%	6.11%	5.89%	5.50%	5.32%
5/31/2000	10.31%	7.72%	5.18%	6.03%	3.43%	2.66%
6/30/2006	5.34%	5.66%	4.52%	5.21%	3.25%	2.00%
12/31/2018	4.03%	2.28%	1.03%	2.28%	0.99%	1.69%
Avg.	10.97%	9.61%	8.37%	8.67%	7.29%	6.35%
vs. T-Bills	+2.30%	+2.32%	+2.02%			

Finally, with the importance of safety for the cash sleeve of a portfolio in mind, a high-quality focus within this short duration allocation ensures that undue risks are not being taken to generate these returns. A short duration bond portfolio from Johnson Asset Management does just that. Adhering to our Quality Yield investment discipline, our investment-grade-only portfolios are built around a high-quality approach to credit selection. In addition, we can work closely with clients to build customized portfolios to meet specific cash flow or regulatory/compliance-related needs. If you would like to learn more about how a customized Johnson Asset Management short duration bond portfolio can help you reduce risk and position your portfolio for the next stage of the economic cycle, please don't hesitate to reach out.

Any expectations presented should not be taken as a guarantee or other assurance as to future results. Our opinions are a reflection of our best judgment at the time this presentation was created, and we disclaim any obligation to update or alter forward-looking statements as a result of new information, future events or otherwise. The material contained herein is based upon proprietary information and is provided purely for reference and as such is confidential and intended solely for those to whom it was provided by Johnson Investment Counsel. If you have any questions about our fixed income strategies and how we might tailor them to fit your investment objectives, please call 513.389.2770 or via email at info@johnsonasset.com.