



# Bond Fund Intelligence

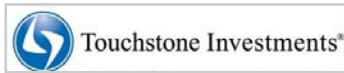
November 2016

Reprinted w/Permission

ISSN 2381-2273

## Touchstone Ultra Short Duration's Weston & Miller

This month, *Bond Fund Intelligence* interviews **Fort Washington Investment Advisors' Scott Weston**, MD & Senior PM, and **Brent Miller**, Asst. VP & Senior PM. **Fort Washington**, a subsidiary of **Western & Southern Financial Group**, is the sub-advisor for several **Touchstone** funds and the **Touchstone Ultra-Short Duration**



Fixed  
Income  
Fund,

which was started in 1994. Our interview, which discusses the ultra-short bond fund space, the Fed, and "inside-out" investors, follows.

**MFI:** Tell us briefly about your history.

**Miller:** Fort Washington has been managing in the ultra-short space since 1995. Scott and I took over management of the ultra-short duration composite in 2001. At that time the composite was corporate credit oriented, and we re-oriented the strategy with a securitized products emphasis. **We've always been students of the ultra-short space.** An attribution study we completed on our peer group confirmed what we've long suspected — securitized products have traditionally provided the best risk-adjusted returns among short duration fixed income assets. **We took over the sub-advisory role with the Touchstone Ultra-Short Duration Fixed Income fund in October of 2008.**

**MFI:** Tell us about Touchstone's lineup.

**Miller:** In addition to the **Touchstone Ultra Short Duration Fixed Income Fund**, Fort Washington serves as sub-advisor to a number of Touchstone fixed income funds including **Touchstone Active Bond Fund**, **Touchstone High Yield Fund**, and **Touchstone Ohio Tax-Free Bond Fund**.

**MFI:** How did the Ultra-Short come about?

**Weston:** We've had a strong heritage in the money market fund space. A group of

us came over from **Midwest Group of Funds**, which was one of the first money market fund complexes in the country. **So we had a strong lineage in ... short duration....** An acquisition in 2006 brought the current fund into the stable of offerings.

I think the ultra-short space was a more difficult sell back in the pre-crisis era. Our experience was that banks had strong relationships with their clients and most cash accounts and short duration monies were managed by the banks internally. **But with yields on money market funds and deposit accounts near zero, we believe this has driven a new segment of retail and institutional investors into ultra-short duration.** These are what we refer to as "inside-out" investors, those who are invested in cash and looking to move out on the curve to earn a higher yield. At times, with the specter of higher rates, we've also seen investors moving from core bonds into ultra-short ... what we term "outside-in" investors. **Since the crisis, most of our interest has been of the inside-out variety,** and those are the investors that we cater to with our strategy. We believe it's been a popular strategy because of the low interest rate environment engineered by the Fed, the regulatory environment for money market funds and the challenges that banks face with Basel III.

**MFI:** What's the biggest challenge for these funds?

**Miller:** I think for the ultra-short fund, there's always the temptation in our space to extend out the curve or take additional risk to try to get more yield and return potential. But our investors, who we've found are looking for a modest risk premium over cash, prefer the limited volatility of a true ultra-short strategy. They don't want the volatility of a longer duration fund.

**As the curve has flattened, it simply hasn't paid for us to extend duration.** Also, spreads have reached very tight levels when viewed historically, so it doesn't

really pay for us to take a lot of credit risk either. Right now you're picking up about 20 basis points to go from the half-year part of the curve to the two-year part of the curve. Break-evens are very low. If rates rise just 13 basis points, that wipes out the extra carry that you get. We watch our peer group closely... and we're seeing returns compress among our peers. **In that kind of environment, you've got to be really careful as to how much risk you take.** What we've always said is that we're happy to take "second quartile" returns in a flat relative value environment. **It's really not part of our DNA to radically shift the risk profile of the portfolio ... we're happy with middle of the pack returns during "risk on" periods because where we've tended to outperform is in the flat rate and credit environments and risk-off environments.**

This is evidenced in our upside-downside capture statistics. Historically, we have generally tended to produce returns in line with, or better than the peer group during periods of positive returns, but capture almost none of the downside when the peer group has negative returns.

**MFI:** What can and can't you buy?

**Weston:** It's an investment grade only fixed income portfolio. We do have a one year portfolio option-adjusted duration limit, and we tend to target securities with three year option-adjusted duration, or shorter. Our [duration] operating range historically has been 0.6 to 0.9 years, and we're at the low end of that range right now. We're also targeting higher-quality securities, averaging AA-minus or single-A plus for the overall portfolio rating. **So it's definitely**



Scott Weston

(Continued on page 2)

(Touchstone Weston & Miller from p.1)

a high quality focus. We're not limited by SEC Rule 2a-7, which allows us to pursue securitized products which tend to have longer legal final maturities, but very short option-adjusted durations. We don't use leverage.

**Miller:** We have very talented investment professionals, including our front end trader who manages liquidity needs and the corporate bond sector within the portfolio. **The spike in LIBOR has created some opportunities for us.** It's had a positive impact on the fund. There's been a "bulging" around the one year part of the curve that has made it attractive for us to stay relatively short. **Effectively, we're getting the same yield on one year paper as we are on two to three year paper right now.**

Yields on VRDNs and commercial paper, the more traditional money market instruments, are very attractive

relative to recent history. **So it hasn't been painful to carry a high cash allocation and to stay short as compared to what it has been in the past.** LIBOR being elevated is a phenomenon that we think is going to persist for a while. As a result, we've shifted the portfolio somewhat into more floating-rate instruments.... Again, it's been a positive for us.

**MFI:** Any other comments on the regulatory environment?

**Weston:** We feel like the pendulum may have swung a bit too far in the direction of more regulation. We believe the intention is right, to reduce risks in the fi-

ancial system. But the magnitude and the extent of the reform, we do feel is unduly burdensome. **What we have now is a dealer community that's less willing and able to position risk.** We also have more onerous reporting and compliance requirements, which increases the cost of doing business. **As a result, we're seeing less liquidity and higher volatility in all sectors of the market.** Ultimately, this manifests itself in the form of a higher cost of capital. We are confident that the markets will adapt and we'll likely see another wave of financial engineering in an effort to optimize business execution within this new framework. **Wall Street has an uncanny way of always figuring out the best way to get things done.**

**MFI:** What's your outlook on the Fed?

**Weston:** The Fed's important. We're very sensitive to potentially rising rates. **We don't want to be caught with a long duration when the Fed's in an aggressive tightening mode.** I was managing bond funds back in 1994 when short-term rates were up 300+ basis points, and that was a painful period. **But, with that in mind, our outlook for the Fed is pretty benign.** Because of our emphasis on consumer related assets we tend to keep close tabs on consumer fundamentals, which remain very sound, if not strong.

**We feel that there is upside risk to economic growth and inflation, and we think the Fed is in agreement.** For the past 6 months, the Fed has been telegraphing its desire to raise rates, market conditions permitting. Considering recent growth and employment trends, and

what appears to be firming in the inflation indices, you can build a case for higher rates over the next couple of years. The Fed has had more a hawkish bias recently, and I think because of our focus on the consumer we understand that bias.

**MFI:** What about the future of ultra-short bond funds?

**Weston:** Gradually rising rates is a 'Goldilocks' scenario, where you've got enough economic growth to support credit fundamentals but not enough growth to trigger aggressively increasing rates. **So it does seem like an ideal time for short-duration bonds.**

That said, we are concerned about the upside risk to the market's growth and inflation expectations. We're pretty much consensus in our forecast for Fed Funds — our base case is for a move in December and another move next year. **However, we do believe there's increasing risk that the Fed could move more aggressively in 2017 with multiple rate hikes.**

If we see continued improvement in employment, wages and inflation over the next year, **we believe core bond investors are going to begin looking for the "outside-in" trade — out of longer duration bonds and into ultra-short duration funds.** If, by chance, the credit cycle turns, we could also see investors moving out of high yield bonds and loan funds and into safer fixed income alternatives such as money market funds and ultra short bond funds. **So, I think ultra short duration funds are poised to benefit from changes in either the rate cycle or the credit cycle — a safer place when volatility returns to the markets.** ♦



Brent Miller

*"There's been a "bulging" right around the one year part of the curve that has made it attractive for us to stay relatively short."*

- Brent Miller

**Reprinted with permission of Crane Data LLC.** The opinions expressed are those of Scott Weston and Brent Miller and are current through Nov. 14, 2016. Their views are subject to change at any time based on market and other conditions, and no forecasts can be guaranteed. Past performance is no guarantee of future results.

Investors should consider the investment objectives, risks, charges and expenses of a fund carefully before investing. For a prospectus or summary prospectus, containing this and other information for the mutual funds call your financial advisor or visit [touchstonefunds.com](http://touchstonefunds.com). Please read the prospectus or summary prospectus carefully before investing. Low duration strategies may lose money when interest rates rise. An investment in a money market fund is neither insured nor guaranteed by the FDIC or any other governmental agency. Although money market funds seek to preserve the value of your investment at \$1.00 per share, it is possible to lose money by investing in a money market fund. ♦