Markets Enter Panic Mode

- Some financial markets are not functioning properly right now, similar to periods during the financial crisis in 2008.
- The disruption has been particularly sharp for parts of the bond market and high-dividend stocks.
- In addition to the historic level of uncertainty surrounding COVID-19, investors started today with news that **Boeing (BA: ~$102)** is seeking a $60 billion+ infusion from the government.[1]
- We suspect the Boeing news may have caused a similar reaction among investors as a different bombshell during the financial crisis in 2008…that Bear Stearns had been sold to JP Morgan for $2 per share (Bear stock had been trading over $30 the previous day, and over $160 just one year prior).[2]
- Both events triggered substantial anxiety for investors, who logically asked, "If I can be this wrong about the value of Bear Stearns (or Boeing), what else am I missing?!"
- Today, like in 2008, bids disappeared from important sectors of the credit markets.
- When we say "bids disappeared," we mean traders seeking a bid on certain bonds they were trying to sell either received no bids, or a deeply discounted bid.
- When markets are behaving like they are now, it is easy to make a big mistake by worrying about what something might be worth tomorrow, or next week, rather than focusing on what it might be worth in one year, and three years.
- The investment grade (IG) bond market, and particularly exchange traded funds (ETFs) in the IG bond market, illustrates the level of stress in the marketplace right now.
- On March 18th, the closing price for the **iShares iBonds December 2024 ETF (IBDP: $22.67)** represented 5.03% *discount* to the market value of the underlying bonds within the fund (This ETF is comprised of approximately 480 investment-grade corporate bonds that all mature during 2024).[3]
- Approximately 50% of the individual bonds within IBDP are rated A- or better by the major ratings agencies, and the other half are rated BBB, the last rating level that is still considered investment-grade.
- If we pretend that 50% of all of the BBB bonds within IBDP get downgraded to sub-investment-grade (i.e. "junk bonds"), which would be double the percentage of BBB bonds, as a category, that got downgraded during the financial crisis; and we assume 13% of these downgraded bonds eventually default, which is the same default rate as the financial crisis for *all* junk bonds, including Bs, CCCs and worse; and we assume the same recovery rate on defaulted bonds as the financial crisis, which was roughly 40 cents on the dollar…then the hit to the intrinsic value of the underlying bonds within IBDP would be -3.9% (not the current 5.03% discount).[4]
- In other words, the recent price of IBDP is already discounting a materially worse outcome for the underlying bonds in the ETF than the actual experience of BBB rated bonds during the

[1] Source: CNBC
[2] Source: Wall Street Journal
[3] Source: Bloomberg
[4] Source: Moody's

financial crisis (note from above: we assumed *double* the downgrade rate and still got a better value for IBDP than the latest quote).

- Many investors are justifiably puzzled by the recent weakness in their bond portfolios, particularly among portfolios that hold fixed income ETFs like IBDP.
- The dynamic described above for IBDP is typical of most fixed income ETFs right now.
- We estimate this dynamic is responsible for approximately 4.0 percentage points of negative performance for Capital Advisors' *Aggregate Bond ETF* strategy year-to-date, and 1.8 percentage points of negative performance for the *Income Bond ETF* strategy year-to-date.[5]
- Importantly, we expect these discounts to close in time, just like they did during the financial crisis 11 years ago.
- Yet we must be realistic about the possibility that conditions in the credit markets could get worse before they get better.
- For example, during the financial crisis the **iShares U.S. Aggregate Bond Index ETF (AGG: ~$107)** dropped to a discount of -8.8% briefly in the aftermath of the Lehman Brothers bankruptcy, only to return to parity with its net asset value within two months.[6]
- Selling high quality bond ETFs during a market panic can relieve anxiety about the possibilities for tomorrow, or next week, but it also crystalizes a loss of principal value unnecessarily, in our opinion.
- Unless the future for corporate bonds turns out to be substantially worse than the global financial crisis, many investment grade bond ETFs are materially mispriced today, in our view.
- The unsettled state of the bond market is also wreaking havoc on high-dividend stocks.
- The connection to dividend stocks is access to credit.
- Many companies that pay generous dividends operate in business lines that either provide credit, utilize credit, or both – i.e. banks, real estate investment trusts (REITs), alternative asset managers and mortgage REITs.
- Other generous dividend payers come from a who's who of industries you don't want to be in when half the global population stops socializing – energy, machinery, autos, hotels, restaurants, and any industrial company that supports commercial aviation, autos, or both.
- We have been re-focusing Capital Advisors' *Managed Equity Dividend* strategy toward stronger balance sheets and higher dividend coverage since well before the word, "Coronavirus" was ever spoken.
- We have taken multiple actions since the COVID-19 outbreak to de-risk the strategy further by eliminating two mortgage REITs, a hotel operator, energy stocks, and a global bank.
- Yet it has not been enough to prevent a substantial drawdown in the strategy during a financial panic.
- We can't help but worry about what is possible tomorrow, or next week.
- But we also believe the stocks in the *Managed Equity Dividend* strategy are significantly underpriced for any version of the future that includes mankind's ability to adapt to a world that includes COVID-19.
- We believe society's ability to cope with COVID-19 will be well established by this time next year.
- When we focus our expectations toward this longer time horizon we feel much better about the likely range of outcomes for all of our investment strategies, including *Managed Equity Dividend*.

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[5] Source: Bloomberg
[6] Source: Bloomberg

- We strongly encourage all investors to try to do the same.

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