CROSSMARK
GLOBAL INVESTMENTS

MAKING THE SWITCH

Funds vs. Individual Bonds

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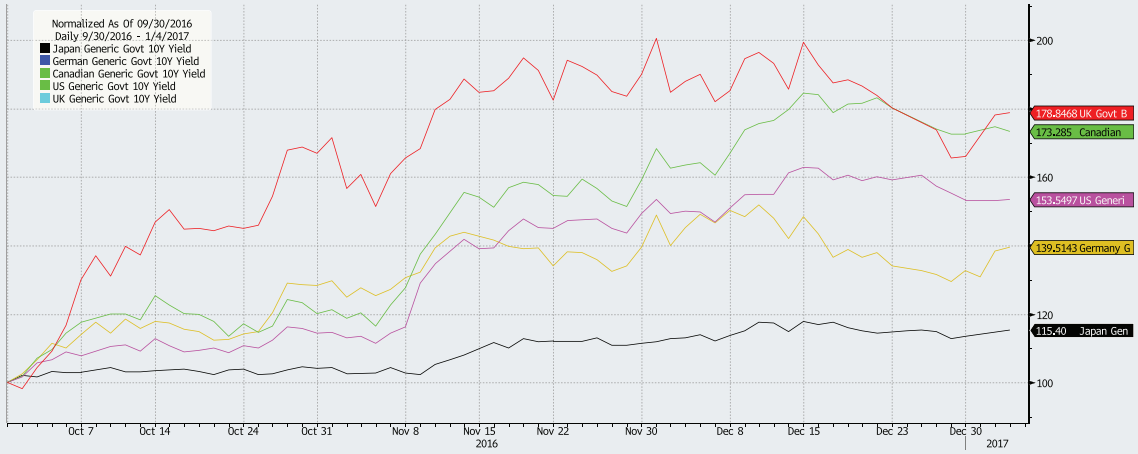
2017

After almost ten years of falling rates, the bond market is making a shift that many felt unprepared for even though warning lights have been signaling a change was nigh. From the summer of 2007 through the 2016 Presidential election, bond yields have remained in a downward trend with only a few interruptions such as the "taper tantrum" in May 2013. Investors were accustomed to falling yields and rising market values, coupled with steady income flows, as central banks around the world provided a safety net of easy monetary policy and stimulus programs to support the economy. Even as the domestic economy began to improve from recessionary levels, the markets grew dependent on easy policies and even the mention of removing some of the policies led to sharp reversals in the markets.

The fixed income markets, based on central bank projections and a "muddle-through" growth economy, anticipated more of the slow and steady rate hike movement that we have seen over the past couple of years. One rate hike in December 2015, a second hike in December 2016, followed by one or two possible hikes as we move through 2017 appeared to be the consensus. However, following the Donald Trump victory on November 8th, the markets re-evaluated their stance and we have seen a historic shift in yields with the U.S. 10yr Treasury Note climbing over 80 bps higher during the quarter, with higher trends in global markets as well, although not by quite the same magnitude.

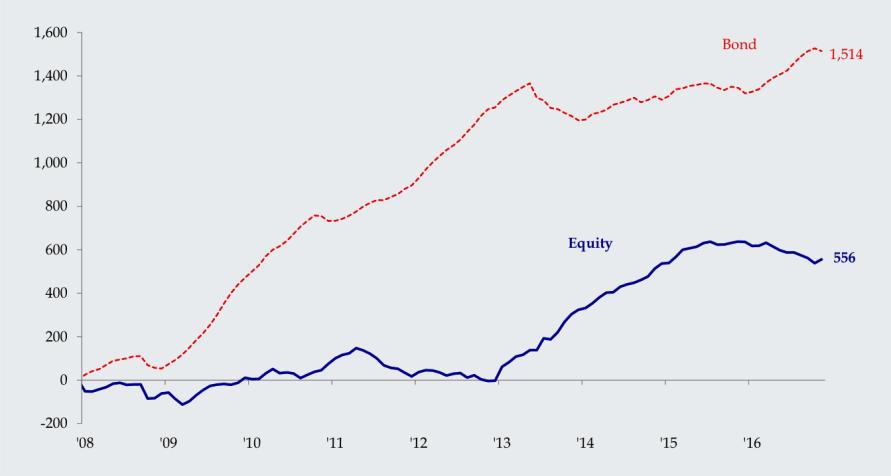
Global 10yr Bond Yields
9/30/16 – 1/4/17



Source: Bloomberg

As investors begin to see losses in their "safe-haven" assets due to higher rates, the risks associated with bond funds becomes more apparent and these investors begin to look for alternatives. We have seen a tremendous inflow to bond funds and ETFs over the past ten years as yields have steadily fallen and central banks continued to support lower yields for an extended period of time. However, as yields begin to move higher, there is anticipation that this trend may reverse and data is showing the first signs of outflows during the month of November.

Cumulative Net Flows into Equity vs. Bond Mutual Funds & ETFs $BN, 1/1/08 through 11/30/16



Source: Strategas

This is where we must look at the difference between bond funds and individually owned bonds to see where the advantage lies. Total return is comprised of two components – price return and income return. As rates rise and market values decline, your price return will be negative. If your income component is not high enough to counter the price decline, then you will have a negative total return. If your income is larger than your price decline, then you have a positive return, hence the important focus on income for our fixed income portfolios.

The key is that this negative return is only realized if you sell your asset. If you are holding individual bonds, you can make the decision to hold your security until maturity, which negates the activity due to market volatility and rising rates. Individual bond holdings have an obligation to provide the scheduled cash flows as determined by the coupon and will return a pre-specified amount of principal at maturity. These flows are unaffected by volatility in the market value of the security. Bond funds, however, do not have this obligation and are at the mercy of its investors to sell bonds as liquidations are requested, as we have seen recently. As market values decline, the NAV or value of the bond fund decreases as well, with no guarantee of future payments. Unfortunately, when investors see such market movements, this is normally the time they begin to liquidate. The high level of turnover in bond funds automatically sets them up for capturing losses as market values decline, which can then lead to additional liquidations and the vicious cycle continues.

None of us has a crystal ball or can forecast when and how quickly rates may rise in the future. And not very many of those that did have their crystal balls saw the treasury yield movement over the past weeks taking on the magnitude that it did. However, with steady, even if non-compelling, growth and the anticipation that new policies will be put in place to enhance domestic growth and increase inflation over the coming years, bond investors are embarking on territory that many have never experienced – rising yields. At Crossmark, we have been positioned for a rising rate environment with a shorter duration than comparable indices coupled with higher coupon securities to buffer some of the negative effects of higher interest rate movements. Individual bonds, such as those in a separately managed account, have a distinct advantage over bond funds as the funds are subject to greater risks without guarantees of cash flows or principal payments. This advantage allows individual bonds to be a positive alternative to bond funds during this rising rate environment, protecting your clients' investments during a difficult part of the cycle for the fixed income markets and its investors.

About Crossmark's 30 Year History

Crossmark, previously Capstone Asset Management Company, is an independent investment advisor headquartered in Houston, Texas. Founded in 1987, Crossmark is in its 30th year of providing portfolio solutions for financial advisors and institutional investors with values-based, SRI and ESG values and factor-based strategies. Additionally, Crossmark is the exclusive manager of the Crossmark Steward Funds, which is a fund family that applies an overarching values-based screening methodology to its suite of equity and fixed income funds, including its award-winning Global Equity Income Fund- named Lipper's "Best Global Equity Income Fund" for the last three consecutive years. Crossmark manages approximately $5 billion in assets with clients nationwide.

Crossmark Global Investments
3700 W. Sam Houston Parkway S., Suite 250, Houston, Texas 77042
800.262.6631 info@crossmarkglobal.com
crossmarkglobal.com