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THE WALL STREET TRANSCRIPT
Connecting Market Leaders with Investors

The Importance of Diversification and Discipline When Investing

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SECTOR — GENERAL INVESTING

TWST: Could you please identify yourself?

Mr. Abella: Yes, I am Gregg Abella from Investment Partners Asset Management.

TWST: And what's your title, Gregg?

Mr. Abella: I am a Co-Principal.

TWST: Could you tell me a little bit about the firm?

Mr. Abella: Sure, we are a money management firm that specializes in value and special situation investing. We also develop diversified portfolios to accomplish a number of objectives for high net worth individuals, families, not-for-profit and other institutions, and we try to diversify across a lot of different asset classes and assets.

TWST: And given with what's going on in the market, in the economy now, why is it important to be diversified?

Mr. Abella: Well, because if you're trying to spread risk over a lot of different types of assets in different parts of the globe, you never know when one asset class that has been a poor performer in previous years is going to be the best performer in the coming year. And you also don't know from one year to the next, how correlated one asset class might be to another. So, through broad diversification, you tend to participate and spread your bets around so that you can participate and, hopefully, improve your returns over time and have lower standard deviation than just investing in one type of investment or asset class.

TWST: And does the firm have an overall unique investment philosophy or is it different for each fund?

Mr. Abella: We do invest in funds and ETFs, for sure, and we also invest directly in individual companies. Within fund sleeves, we try to specialize in unique streams of income through MLPs and business development companies and then we also like to invest in large, mid and small cap value and special situation investments. We like closed end funds when they trade at discounts-to-asset value and then we use open ends and ETFs to get access to a lot of other different asset classes that we might not have expertise internally, but we do a lot of deep-dive diligence into the funds and fund families, to try to get what we feel are best in breed.

TWST: And did you want to talk about one of the funds; I believe there's one that's a fixed income fund.

Mr. Abella: Sure. With the market currently, at least domestically, trading at the high-end of the valuation curve – as we sit here in mid-December - the S&P is trading at roughly 20 times forward earnings and about 25 times trailing earnings. That's historically a pretty lofty valuation when you consider that over a long period of time, the S&P tends to trade at around 15 times earnings. So, the reason that we are not just going full bore into straight equities here or anywhere is that we also have to employ some risk-mitigating strategies, given that, if the global economy is going to grow at a healthier clip, accommodative monetary policy is probably going to have to be ratcheted back not just here but also abroad. That would mean higher rates. So, one way to participate in fixed income but also have a way to keep your principal relatively protected is to participate in a strategic-satellite investment called bank loans.

Bank loan funds are exactly as they sound, they are funds that buy corporate senior-secured loans that are variable-rate like working capital loans. And as rates go up, the income that you receive off of that stream of investments goes up. So, in a rising-rate environment, if we have inflation, while long-dated bonds might recede in principal, hopefully, by being senior in the capital structure and having a variable rate, you'd maintain principal and possibly even get capital appreciation.

The one fund, in particular, that does this strategy is the **Oppenheimer Senior Floating Rate Fund, the symbol is OOSYX**. It's about a $14 billion fund, it's been around a good long time, the fund's annualized return through a couple of cycles is about 4.3%, it pays about that level in income now – about 74% of the fund participates in bank loans that are a $1 billion in size or larger. So, as a broad diversification, it has about 500 different holdings of various size, with the largest one being under 2%, and the smallest being 1% or less. And, the fund managers can be tactical and move in and out of different sectors that they feel might have loans that are more attractive at a particular time and sell off loans that they think are in less attractive or industries that may be approaching full value for their bank loans.

TWST: And with the possibility that rates are going to increase, why does this fund make sense now?

Mr. Abella: Well, currently the market seems to be pricing in about two rate increases next year. If the economy does grow, though, at a pace of more than 3% next year and you have inflation in excess of 2%, I think the Fed could be more aggressive and I think that would take people by surprise on the long end. You could see 10-year rates move into the threes and if you don't keep your durations very tight, you could actually see capital depreciation on an asset, in the case of core fixed income, that is supposed to be risk mitigating.

So, the way to counter balance that, at least to some extent, is to also participate in satellite investments like this one, where you would potentially have more income as rates go up and it would continue to increase as rates go up. On traditional bonds and bond funds, you have to wait for those bonds in the portfolio to mature and roll off before the manager can reapply them and get higher rates, so, that's why this would be a good component of a diversified portfolio.

Highlights

Gregg Abella is a Co-Principal in a money management firm that specializes in value and special situation investing. Mr. Abella discusses the importance of diversification in a portfolio. He says that through broad diversification, investors can participate and spread their bets around to hopefully improve returns over time. He says the reason to stay diversified and disciplined is that a number of things anywhere in the world geopolitically could happen, and suddenly equity prices could retreat. He says investors need to have space in a lot of different parts of the market, not just the U.S.

One is what is referred to as a convertible arbitrage strategy, which aims to hedge equity risk by investing in convertible securities, and then shorting the underlying issuers' equity with the goal of hedging the equity risk. And through this process, it attempts to lock in a decent return on the fixed income component but also hedge downside risk from the potential for those underlying companies to not perform on the equity side as well. And they can move around from one company to another or de-emphasize - maybe shorting the equity on one side or short the equity more aggressively in companies that they feel that the bonds may represent value but the equity has downside.

And the secondary thing that they do is via a portfolio of diversified stocks, usually dividend paying stocks, by writing covered calls to get extra income and using that premium to buy a protective put. So, in concert with one another, these strategies tends to produce over a long period of time mid-single digit returns pretty consistently, in fact, over a couple of decades of operating history of this type of portfolio, they have had only three down years. And this is a type of fund that you use, again, maybe not as the main event, but it is a good flavor-enhancer if you think that rates possibly could go up and that equity prices may not give you the same level of return in next 12 months as they have over the previous.

TWST: If there were to be a correction in the market, not a huge one but a minor one, it would be useful in that situation?

Mr. Abella: I think that it would, and again this is a type of a strategy that you use in a very broad and diversified portfolio because pretty traditionally convertible arbitrage has had lower vulnerability to duration and credit through diversification in a rising rate environment. And it's also outperformed investment grade bonds during rising rates because you get greater resilience when there is a high yield spread blow out by using this particular strategy.

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TWST: And did you want to mention another fund? I believe there's one with fixed income and equities?

Mr. Abella: Yes, it's a strategy that is more of a diversified alternative, when you are possibly concerned that the equity markets may not have the same level of capital appreciation going forward and when you are also concerned about rising rates. It's a fund from **Calamos Investments called the Market Neutral Income Fund and the symbol is CMNIX**. It uses two simultaneous strategies and is tactical between them.

On the equity side because of the protective puts that you are hedging some of the down side, so you tend not to get a year if the market is down, this should be either flat or down not as much on the equity side and in a rising rate environment, you should still get sort of bond-like returns but hopefully with less volatility than you might have in the Barclays Agg. Generally, the reason that I mentioned these two particular styles is that we are concerned that with the low volatility in the market currently on both the equity side and in the fixed income side. It doesn't seem to be pricing in any sort of shock. And if you don't have

cash, core fixed income, and some alternatives and strategic satellites in your portfolio, we're worried that in a very rapid rising-rate environment you could have a corrrection, where traditional fixed income bonds and equities, which have historically moved in opposite directions from one another, could actually be correlated more highly. That's why we're using some of these types of strategies to round-out the portfolio.

TWST: And when you talk with investors now, what are some of their concerns as they look to 2018 and 2019? And how do these funds relate to some of those concerns?

Mr. Abella: Well, I think it goes along the lines of risk mitigation and capital preservation and that's always a concern to our clients, that we've lived through a number of different cycles. We've seen the late 90s with the internet bubble, and then subsequently the 2000 through 2002 where you had a bear market for an extended period. And 2008, obviously, is still not far enough in the rearview mirror for people to have forgotten it, I think. So, our clients are wondering – are we basically in a 1999 or 2007 scenario where we need to protect ourselves a little bit more on the downside while we still have some participation in traditional asset classes. That's some of what we've been speaking about with clients.

The other side of it is that we've had very low rates for a very long time and I think that if some of the mania in things like Bitcoin continues - I think the Fed is going to have to probably be a little more aggressive in raising rates not just because of inflation but also because you're starting to see a disconnect between valuation and traditional metrics. There's a point at which you want to avoid a boom- bust kind of economic cycle. The way to do that is to cool off asset prices. And if that were to occur, I think that we're going to have to adjust ourselves to a reality that we haven't had to deal with them in a number of years, which is that we have very modest returns for equities going forward and you're going to have to get return from other types of strategies.

Unfortunately, in the short-term, you probably keep your maturities tight because you don't want to go through a period where you're all in on fixed income and then rates go up and you wind up losing more in principal than you will make in the coming year on income. So, it's a tight rope. The reason that funds like these tend to work is because they – or at least they attempt to work – is that they are strategies that hopefully can do well and preserve principal, while still providing an income return, albeit modest.

Then, later down the road when rates are higher you can re-evaluate a portfolio and say, okay, maybe if the Fed has – at some point the Fed will stop raising rates, I don't know when that might be, but let's assume in two years, all the rate increases they're going to do in the intermediate term have ceased - well then it might be time to look at the long end of the curve and invest retirees in a broader fixed income portfolio and de-emphasize some of the other asset classes they've been in that have had more risk exposure to try to get them the same level of total return.

TWST: And is it a challenge sometimes with investors, that you have to convince them that to have a diversified portfolio is important for them to meet their needs? You know, sometimes they might just want to have something that they read about or hear about on the news?

Mr. Abella: It can be very frustrating at times, particularly when you have a year like this, while people including ourselves predicted that this would be a decent year for the stock market and that international investments would finally start to work out. It can be frustrating when you see a year like this in the S&P and the clients feel like well, if I had just been all in on equities this year, I would have had a phenomenal return and I wouldn't have to be diversified across a lot of different things or worry about income.

The flipside of that obviously is, no one rings a bell when the market is going to go the other way. And so, the reason that you stay diversified and you stay disciplined is that a number of things anywhere in the world geopolitically could happen and suddenly equity prices retreat. We tend to forget after we've had a number of years like this that wealth can be destroyed a lot quicker than it is created. And I still recall 2008 as a memory in my career and I don't think I or my clients want to re-live that time when risk assets were re-priced in the extreme. So, I think we stay diversified and you stay disciplined because you really don't know when you might go back to more historical valuations of 15 times earnings down from 20, which would mean a significant correction. It's times like that then you tend to remember why you are doing what you are doing in the first place.

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TWST: And as we talk about the Fed and interest rates, for those people that are in retirement years or nearing retirement, increasing rates would probably help them, if they wanted to have a new diverse portfolio? So maybe you could talk about their situation with what's going on with the Fed and also how maybe these funds would be helpful for people in retirement years as part of a diversified portfolio.

Mr. Abella: Yeah, sure. Well, raising rates back to normal kind of pre-2008 levels would be healthy for retirees because up until this point, people have had to take more risk to get return than they traditionally would. And if you look back at like 1995, for example, you could have a fixed income portfolio that would have produced a 7% return with very low standard deviation by just being in bonds. Now to get the same type of 7% annualized return, you have to be more exposed to risk assets than you would have back then. So, if rates rise on the short end, and ultimately move up on the long end, retirees could maybe de-emphasize their participation in the higher risk type of investments and invest more in just traditional fixed income.

TWST: We have news about Bitcoin and projections about other digital currencies that are just all over the place, and that's another factor that if somebody saw it on television and might want to invest in it, but there's a great deal of risk if suddenly it all turns down the other way. Has that been an issue too?

Mr. Abella: Well, it is now in what I believe to be in mania phase. It doesn't mean it can't continue to go up and perhaps cryptocurrencies in one form or another might be a more accepted means of commerce in

conducting transactions. But in the short-term, these are currencies that are backed by no government, there is no underlying asset, they are not part of the traditional banking system, and investors need to be aware that as quickly as these things go up, it's not too dissimilar to what occurred in a number of other mania-type investments like tulip bulbs.

As quickly as they went up, when the last dollar goes in it signals the top and then they tend to crash. I don't know if that will happen or not and for those who invest in that type of asset, I hope that it doesn't anytime soon, but it's certainly right now a distraction from what I perceive to be part of a diversified effort to build portfolios that accomplish people's long-term objectives of capital appreciation, income, and being part of the long-term plan.

TWST: And I would think it could be particularly harmful for someone in retirement years, if suddenly your digital currency suddenly were to drop and it might take a while for them to work their way up again if at all — a lot of retirees need to get income in their retirement years. They simply can't wait, and that could be a problem for them too?

Mr. Abella: Of course, and you're starting to read in some of these articles that people are taking out mortgages to buy Bitcoin and borrowing on credit cards to buy Bitcoin and this has all the sort of makings of a speculative mania and bubble. You never tell that something is a bubble until you look at it in hindsight and it proves to be, but it doesn't seem to bear any fundamental reason other than an absence of supply as to why the price keeps moving up. That goes on as long as it goes on and then, like I said, when that last dollar is in, it's over.

TWST: So for you, with your clients, it's important to stress to them diversification, but the right kind of diversification that meets their long-term needs?

Mr. Abella: Yes, I would agree that you need to stay disciplined; you're always going to need to have your risk mitigating portion of your portfolio just because it's critical particularly for retirees, you need to have space in a lot of different parts of the market not just U.S. There are also wonderful companies all over the world - that are solid companies and dividend payers and there are even investments in emerging markets if you have the risk tolerance for it that are attractive as long-term investments. You can't really rely on going full bore into any one particular asset class either because of the risk or because of the opportunity cost.

TWST: Thank you. (ES)

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