VANDERBILT ASSET MANAGEMENT Ave.

Short Duration (0-3 years) is a Sensible Investment in a Rising Interest Rate Environment

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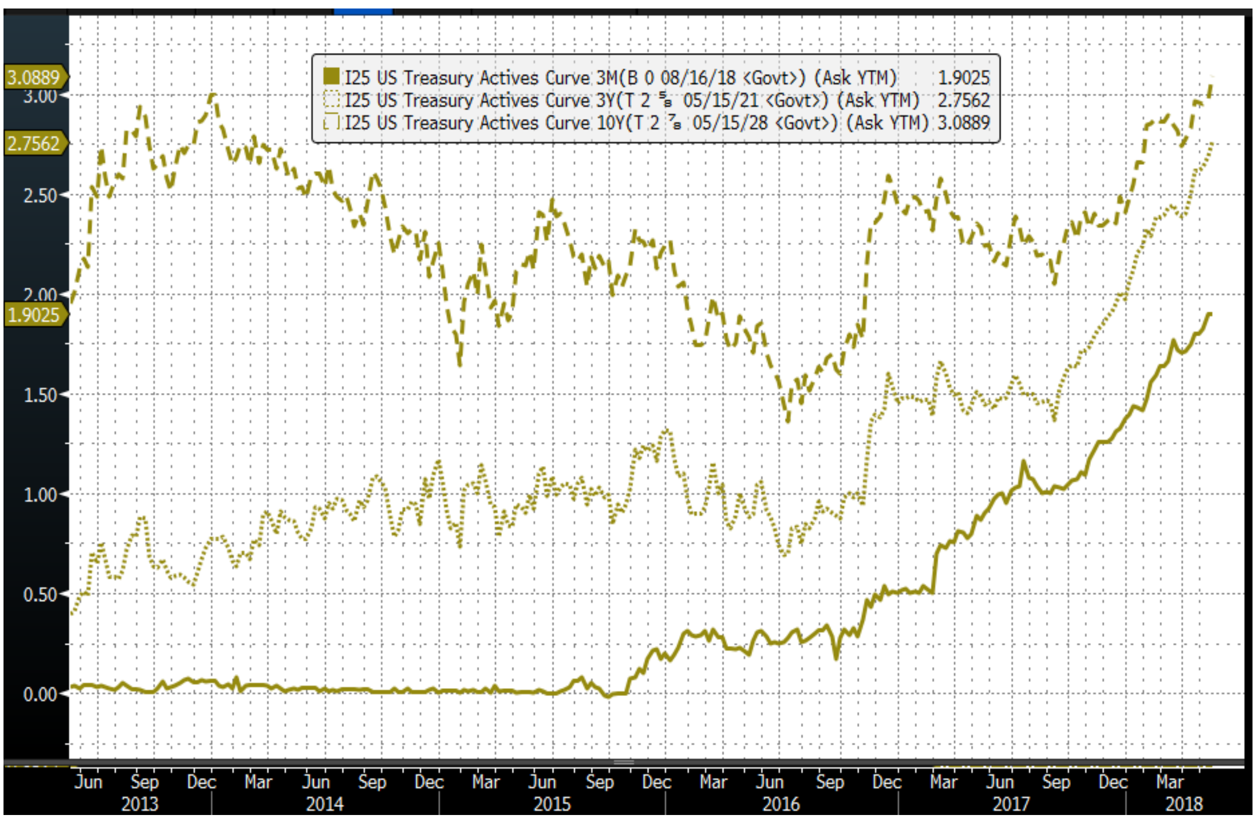
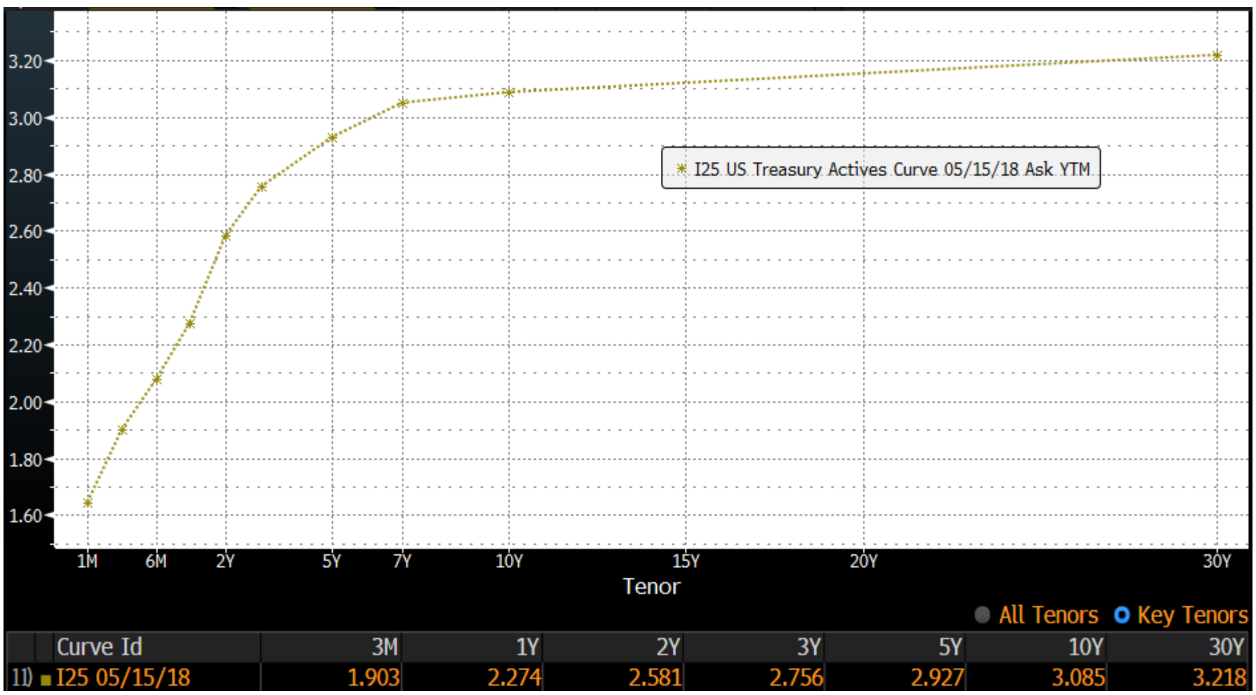
In an interest rate market characterized by rising rates, and a stock market engulfed in high, fluctuating volatility, an allocation to short duration fixed income securities is a thoughtful investment choice. Until 2017, the short end of the yield curve was at historically low levels as the Fed was holding rates unchanged. However, with the gradual increases in the Fed Funds rate, other short term benchmarks between 3 months and 3 years have also risen, creating investment opportunities on this part of the yield curve. The chart below illustrates, from top to bottom, the level of the 10-year treasury, 3-year treasury, and 3-month T-bill over a five year period. One can deduce that the 3-month through 3-year parts of the curve are now offering yields closer to those offered by the longer 10-year treasury. Therefore, with rates between 1.90% (3 month yield to maturity or "YTM") and 2.75% (3 year YTM), the short end of the yield curve can now offer considerable returns for investors with lower duration risk tolerance.



A short duration portfolio is attractive to investors who are not willing or able to risk the price fluctuations associated with locking into long-term assets. Securities in a short term portfolio have maturities ranging between 0 and 3 years. Therefore, on a monthly basis as securities come due, proceeds are reinvested into the markets. When rates are on an upward trajectory, this strategy permits investors to regularly reinvest at higher, more attractive rates.

Currently, we find that the short end of the curve also poses the most attractive relative returns, as it is also the steepest part. The differential between the 3 year treasury YTM and the 3-month T-bill YTM is 0.85%, while the YTM differential for the curve in its entirety, 30 years to 3 months, is 1.18%. The rate steepness at the short end of the curve allows securities with this maturity to "roll down" and are revalued at lower rates, with each passing month. This is in contrast to securities on the higher end, where the curve is flatter and therefore securities are valued at close to similar rates from month to month. When securities are marked to market, they appreciate faster when they are priced at continuously lower rates. The figure below illustrates the current treasury curve, depicting a steep short end and a relatively flat longer end.



With the current strength in the economy, fixed income assets that provide additional spread over short term treasuries are a wise investment. Agency, Corporate, MBS, and ABS spreads are tight, but their fundamentals are strong and stable. By investing in investment-grade Corporate securities (BBB-rated and above), and in AAA-rated ABS and MBS, we are able to reap the benefits of the strength of these sectors, while taking advantage of the pricing on the steep short portion of the treasury curve.

By diversifying into spread products, we can also invest a portion of the portfolio in floating rate coupon bonds. In a rising rate environment, floating rate bonds present an additional benefit to investors because their coupons reset monthly/quarterly. If rates are rising, floaters offer a constantly increasing yield to the fixed income portfolio.

The economy has reached an interesting cross-roads. The long end of the curve has remained relatively unchanged over the course of the last several years. In the meantime, the 3 years and shorter part of the treasury curve has risen, but is still comparatively steep. This short end of the curve has three to four Fed rate cuts priced in, suggesting that it should linger at these rates. Conversely, the longer part (greater than 10 years), yields could increase if the Treasury issues more debt to pay for revenue shortfalls resulting from the tax cut. This would hurt new investments at these longer rates. Therefore, we would recommend an investment in the short end of the treasury curve, in a diversified portfolio of investment grade fixed and floating rate securities.

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