Fixed-Income Fund Ups Exposure to Convertibles, Mortgage REITs, and BDCs

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JORDAN KAHN, CFA, is President and CIO of ACM Funds. Mr. Kahn has 25 years of experience in the investment industry serving as a senior portfolio manager, equity research analyst, and investment consultant. Before forming ACM, Mr. Kahn founded his own RIA called KAM Advisors. Prior, Mr. Kahn was a Managing Partner with Beverly Investment Advisors, and before that a senior portfolio manager for Summit Wealth Management (formerly Berger & Associates). Prior to that, Mr. Kahn ran a technology-focused fund at Kahn Asset Management. He has also worked as the Assistant Director of Equity Research at Feldman Securities Group in Chicago. Prior to Feldman Securities Group, Mr. Kahn was an investment analyst at The Chicago Trust Company. He is a frequent market commentator for numerous investment publications, and has appeared on CNBC, TD Ameritrade Network and KNBC-Los Angeles. He has been a columnist for Wall Street All-Stars and RealMoney.com. Mr. Kahn has also been featured in MarketWatch, TheStreet.com, Seeking Alpha, *Technology Investor* magazine, and *Barron's.* Mr. Kahn wrote a daily blog called *In The Money* for 10 years. Mr. Kahn received his Master's of Science in Financial Markets and Trading from the Stuart School of Business at the Illinois Institute of Technology. His studies included derivative strategies in corporate finance, trading strategies involving options and futures, and Value-at-Risk (VAR) management. He is also a Chartered Financial Analyst. Mr. Kahn graduated cum laude in Economics with a concentration in Finance from the University of Colorado.

SECTOR — GENERAL INVESTING

(AHT555) TWST: What fund would you like to discuss today and can you describe it briefly?

Mr. Kahn: Today, I'm going to talk about the ACM Tactical Income Fund. This is a diversified income fund for investors who are seeking current income plus capital appreciation.

TWST: Is it actively managed?

Mr. Kahn: It is an actively managed mutual fund that focuses on tactically allocating amongst 16 different underlying fixed-income sectors using ETFs.

TWST: Are all of the holdings ETFs?

Mr. Kahn: The underlying portfolio is built by using ETFs that represent the different fixed-income sectors we are targeting.

TWST: How do you determine the composition?

Mr. Kahn: We have fully backtested this strategy. What we use is a tactical strategy that uses a technical overlay. For each of the 16 different underlying ETFs that we follow, we have a methodology whereby we track each of them and overlay a series of moving averages on each of these ETFs. When the ETFs are in an uptrend, trending above these moving averages, that's when we start to allocate and build a position in those ETFs. Then when they start trending down and breaking back down below these respective moving averages that were overlaid, we start legging out of the positions.

The goal is to have exposure and have positions in the ones that are experiencing an uptrend, while trying to avoid and have no exposure to the areas of the market that are experiencing a downtrend.

The advantage of this is that, for the average bond fund manager out there, nobody can predict in advance which sectors are going to be the outperformers in every given cycle. What we try to do is listen to the market and let it tell us where leadership is coming from and which areas to stay away from.

TWST: What is the market telling you at this time?

Mr. Kahn: The market is telling us to avoid the areas of the fixed-income market that are more interest rate sensitive, as in areas like Treasuries and mortgage-backed securities. Even, for a while, to move away from investment-grade corporates to focus more on allocating towards areas of the fixed-income market that are more credit sensitive. Those areas do better as the economy is improving, and credit quality is improving, so things like high yield, mortgage REITs, business development companies, and convertibles. Those have been areas that are outperforming.

This year has been a good example. Because the traditional bond fund that uses the aggregate bond index or what they call the Agg as the benchmark, let's say, it is down around 200 or 240 basis points this year. Our fund is up almost 200 basis points so we have been able to stay defensive in a rising rate environment, while adding some value and outperforming the benchmark by over 400 basis points just year to date.

TWST: Is there any kind of credit type you stay away from?

Mr. Kahn: No. There's no credit type that we stay away from. We allocate to all of the areas of the fixed-income market that have ETFs that trade in a liquid fashion, representing or giving exposure to those areas. One area is government and Treasuries and mortgage-backed securities as well as muni bonds. We can allocate to regular munis, taxable munis, and high-yield munis — those all have good ETF exposure. Within international we can allocate to traditional global bonds or also emerging market bonds. On the corporate side, we can allocate to high yield, investment grade, and also bank loans.

Then we have another bucket that we call our hybrid that includes things like convertibles, preferred stock, mortgage REITs, and business development companies. These are all areas that have liquid ETFs that can give the investor easy exposure in or out to get to those underlying sectors. So, as an actively managed fund, our goal is to participate in the up-trending areas of the market, while trying to avoid the down-trending areas and also give investors some sort of consistent yield.

TWST: What are some of the trends in the marketplace you're examining most closely right now, and how is this examination impacting how you are managing the fund?

Mr. Kahn: The trends are, as we're coming out of a recession, that the economy continues to improve. Some of the areas that were hit the hardest last year might be business development companies that we talked about, which is kind of a more esoteric part of the market. These are companies that lend to smaller- and middle-market companies. Those are doing quite well. Those offer investors higher yields. They typically do better, though, only when the economy is improving. So, right now, we've seen them do quite well.

Highlights

Jordan Kahn discusses the ACM Tactical Income Fund, which he describes as a diversified income fund for investors who are seeking current income plus capital appreciation. The fund focuses on tactically allocating among 16 different underlying fixed-income sectors using ETFs. Mr. Kahn says that as an actively managed fund, their goal is to participate in the up-trending areas of the market, while trying to avoid the down-trending areas, and also to give investors a fairly consistent yield. He says the fund pays a monthly distribution and that its average yield over the past 12 months, according to Morningstar, has been 3.8%. Currently, they are allocating away from areas of the fixed-income market that are more interest rate sensitive, such as Treasuries, mortgage-backed securities and investment-grade corporates to focus more on areas that are more credit sensitive, such as high yield, mortgage REITs, business development companies, and convertibles. He notes that yields in the mortgage REITs space are probably 6% to 8%, on average, and are getting some price appreciation along the way.

Mortgage REITs are another area that took a big hit last year. Now, with the Fed coming in and backstopping the market with liquidity, and since long-term rates are starting to move higher reflecting a stronger economy and a bit of firming inflation, while the short end of the yield curve is being held down low by the Fed, the yield curve is getting steeper, and that is really benefiting mortgage REITs. This is another area that offers good yields. Yields in the mortgage REITs space are probably 6% to 8%, on average, and we are getting some price appreciation along the way.

TWST: Do you have any concerns about interest rates or inflation rising, and how that might impact some of the investments that you have in your ETFs?

Mr. Kahn: Yes, and no. We do have concern. Our forecast is that we think interest rates are going to continue to rise. Inflation is going to continue to firm. Some of it is just the simple computation that when you look at inflation rates on a year-over-year basis, compared to last year, when the economy was shut down, you are having some very easy comparisons that make those year-over-year rates look high.

But you also have a number of things that are occurring with just traditional supply and demand. Right now, demand is beginning to surge. Coming out of any recession, you have this pent-up demand that has built up from consumers who have been deferring purchases and traveling, etc. Last year, given the extent of the lockdown around the globe, you kind of have the mother of all pent-up demand scenarios being unleashed right now.

In many cases, the supply chains just aren't ready to match that demand, so you have demand outstripping supply, at least in the near to intermediate term. That's one of the reasons why we think that inflation is going to continue to run hot here for a while, to use the Fed's terminology. But at some point, one of the cures for high prices is always high prices, so supply will catch up at some point.

But in terms of the second part of your question — how does that concern impact how we're managing the fund — our concern about inflation will continue to be something that makes us want to continue to operate the fund in a defensive manner towards rising interest rates, so the areas that typically get hurt in rising rates, like we mentioned, are Treasuries, Tips, agencies, mortgage backed, those are areas that we'll probably want to continue to limit exposure to, while continuing to increase exposure to the areas that are benefiting from the recovery, whether that's convertibles, mortgage REITs, business development companies, etc. We've even started to see emerging market bonds start to come back and do well as the rest of the global economy catches up to the U.S. in terms of economic recovery.

"We don't really have to be correct in predicting things in advance. We just have to be correct in terms of catching these trends early and taking advantage of them by participating in the ones that are emerging to the upside and to minimize our exposure to the ones that are looking like they're moving to the downside."

But the beauty of our tactical-based approach is how we monitor all of these ETFs, and we kind of overlay the moving averages on them. We don't really have to be correct in predicting things in advance. We just have to be correct in terms of catching these trends early and taking advantage of them by participating in the ones that are emerging to the upside and to minimize our exposure to the ones that are looking like they're moving to the downside.

TWST: What is your turnover annually? And can you elaborate a little bit on your process beyond what you've already mentioned?

Mr. Kahn: Our fund is only in its third year of live performance. In a year like last year, the turnover was obviously higher. When so many of these areas started trending down, we had to raise a lot of cash. In general, we trade around our positions, trimming certain ones when they've had run ups and adding to other ones that have pulled back. The overall turnover is probably less than 50% in a "normal" year, but obviously much higher in a year like 2020.

TWST: When you're making a change, what are some of the criteria you're using that determine when and how the change should be made?

Mr. Kahn: In total, for our universe, we have 16 of these ETFs that target different sectors of the fixed-income markets. On a daily basis, we are monitoring all 16 of these ETFs. For each one, we have overlaid on their charts a series of moving averages. For each one, depending on the characteristics of the underlying sector, we may have a different set of moving averages that have worked the best in the past. As one of these ETFs starts to break up through their moving averages and it shows like it may be embarking on an uptrend, that's when we'll start allocating a position to that given ETF.

When I say multiple moving averages, what we have here is, each one has about three moving averages associated with it. We have both short-term, intermediate-term and longer-term moving averages. We have this kind of variation of timeframes to work with. What that helps us to do is that sometimes any one of these given sectors may go through just a shallow correction, maybe they only breach one of these moving averages. In that scenario, our exposure gets trimmed a little, but we don't get entirely out of it, and then maybe it comes out of its correction and breaks back above these short-term moving averages and then it gets a full position again.

When we have multiple areas, or ETFs, that are all signaling getting full allocation, then our second criteria, since everybody can't get a full position, will be sorted by the highest-yielding ones. A full position is 12%, as I just mentioned, moving in in thirds. So when one of these ETFs starts to break above its first moving average, we will start with a 4% position in that one. Then if it builds all the way up to a full position, a full position is 12% for us.

So we never have the fund fully concentrated in any one area; it's always at least fairly diversified. As opposed to some tactical funds out there — there's some high-yield tactical funds where they'll go 100% high yield or 100% in cash. That's not really how we're managing things.

TWST: What has most surprised you about the tactical income fund or its areas of investment over the last year?

Mr. Kahn: What has surprised us most is just that sometimes there are these violent short-term reactions to news in a given day. The surprising thing is how quickly they turn around. They don't last very long, such as last month when the above average CPI report came out. It was big news that day and it caused some disruption in the market. We saw some of these areas that we've been allocating recently to — convertibles and mortgage REITs and BDCs — we saw really poor action that day. They sold off really, really hard. But it was just a one-day event.

TWST: Can you distinguish more about how this fixed-income fund is perhaps different from another one of its type?

Mr. Kahn: In our case, the big differentiating factor is the opposite; it's that rather than focusing our expertise in one narrow area, we allocate to 16 different sectors of the market. Bond fund managers may focus on emerging market bonds, and that's their entire portfolio, or they focus on high-yield bonds, and that's their entire portfolio. It is rare to find a bond fund that can be managed by managers with the depth and expertise in all of the areas we allocate to.

The Callan table shows all of the performance over the last decade for all of these different 16 areas. From year to year, there can be great variation. One year, mortgage REITs are at the top of the list, and the next year they were at the bottom. As I mentioned, no one individual can really predict all of those things in advance. So having this tactical and quantitative methodology really helps us to gain exposure to the areas that are winners in a given year, while minimizing exposure to the other areas.

So that's one big differentiating factor that we can allocate to all of these 16 different underlying sectors of the market, whereas most funds would never try to do that.

TWST: I'm looking at the information about the tactical fund on your website. It says here, the portfolio can be invested anywhere between 100% fully invested and 0% fully in cash. What exactly do you mean by that?

Mr. Kahn: Because we are monitoring all these ETFs, and if an ETF starts to break down below those moving averages that we're following, we will start decreasing exposure to said ETF. Again, a full position is a 12% position, so it will get cut to 8%, and if it starts to break down further, then it gets cut to 4% if it breaches another moving average. Ultimately, it goes to 0%.

A year like last year, let's say in March, when we had that big sell off that was widespread across the market, a lot of these ETFs starting trending lower, so we'll start moving out of them and zeroing out our positions, and that money will just go to cash. It's not like we have to reallocate it somewhere. We have the flexibility to take our fund anywhere from being 100% invested, when we're fully invested, all the way down to 0% when we're fully in cash.

As we've seen, in practice, we never actually fully get to 0%, because even when the market is in kind of like "risk off" mode, and a lot of things are selling off, there's other areas that been usually benefit from that flight to safety. Like when everybody is selling out of high yield and preferreds and corporates, they're usually going into Treasuries for safety. So it's usually pretty rare that we would be out of everything.

Even in a year like last year in March, when things were selling off, we had big positions in Treasuries and mortgage backed. The maximum cash that we have seen, which was last spring, was during that heavy sell off. We were about 70% in cash, and 30% invested. Then, as the market started to recover, and a lot of those ETFs that we're following started to turn higher, and break back above the series of moving averages that we're following, we started to allocate back to those areas.

So last year was a good example. The category that Morningstar puts us in which is called the non-traditional bond category, the drawdown last year, the average drawdown for the category at large was over 10% or about 10.25%. Our fund, since we moved to cash and got defensive, our max drawdown last year was only 2.5%.

TWST: What are your current assets under management?

Mr. Kahn: This fund is in its third year of performance. It has about $60 million in it. Then we also have an equity fund that's in its seventh year of live performance that has about $110 million in it. We are about $170 to $175 million assets under management.

TWST: Does it pay out distributions to investors, and if so, how often?

Mr. Kahn: This fund pays a monthly distribution. Our average yield over the past 12 months, according to Morningstar, has been 3.8%. It does fluctuate a little bit from month to month, depending on which of these underlying ETFs are paying their dividend that month. But we do aim to consistently pay a monthly income distribution to our investors. We have a lot of investors who use the fund for their retirees that needs monthly income.

TWST: OK. It appears as though the fund captures some of the essence of the passive nature of investing through being invested in ETFs, but has the active management side as well.

Mr. Kahn: We are active managers so, yes, it captures the passive aspect on a sector level. Instead of us picking individual bonds within the preferred space, or the convertible space, we are using the ETFs to get broad exposure to that sector. But then we are active on a tactical basis in terms of how we adjust our asset allocation. We are constantly managing risk and adjusting our asset allocation between the percent that we have allocated to all these different sectors.

TWST: What do you think is most misunderstood currently about sort of the fixed-income investing side of the market?

Mr. Kahn: What's most misunderstood is how the average traditional bond fund or bond portfolio is going to behave in a rising rate environment. It's been a long, long time, since we've been in a sustained rising rate environment — 30 years, or since the 1980s, when rates started coming down from 20% or the high double-digits, and all the way down to the last year when they got near 1% or 50 basis points.

Over the next three years to five years, the person who's in the average bond portfolio that has an allocation that's similar to the Agg index is going to have a difficult time making money. You are going to have to have more specialized bond funds, or you are going to have to have differentiated exposure to some of the areas that we talked about that can provide some performance in a rising rate environment.

TWST: In summary, why should an investor choose to invest in this particular fund, and to use your company versus, say, another company and another fund?

Mr. Kahn: There is nobody that we've seen out there that is doing this same sort of tactical strategy that can give investors exposure to all these different 16 areas in the market, and have the flexibility to get defensive when certain areas aren't working. In that sense, we provide investors with a diversified exposure to these different areas of the fixed-income market. We provide a monthly income and very good managed risk.

As I mentioned to you, last year we had a drawdown of only 2.5%; most of the underlying asset classes that we could have had exposure to had drawdowns much farther than that. So if a client were trying to get exposure to the high yield and using just the high-yield ETFs, or just the convertible ETFs, they're going to be susceptible to a lot more volatilities than in our fund where we're managing risk on a day-to-day basis.

TWST: Is there anything else you wanted to mention that we haven't covered before we end?

Mr. Kahn: Just to recap, we allocate to a portfolio of ETFs. We could have anywhere between one to 16 positions. We have no position concentration greater than 12%. By contrast, most bond funds either have to choose between credit risk and interest rate risk. We are completely agnostic. We are just running our screens and focusing on where the market is telling us value is being added. We are always focusing on trying to minimize drawdowns in adverse market conditions.

TWST: What is the minimum investment level?

Mr. Kahn: It really depends on the custodian. In most cases, you could get into the A shares for $1,000.

TWST: Thank you. (KJL)

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