

# Strategic Income Commentary

March 31, 2024

## MARKET REVIEW

The financial markets spent much of 1Q24 undoing most of the Goldilocks scenario it had priced in during the last quarter of 2023. By the time the quarter ended, the Bureau of Labor Statistics (BLS) had reported three consecutive months of material upside surprises in non-farm payrolls. Additionally, the BLS reported three consecutive months of upside surprises to consumer prices. With these new datapoints, it is clear that job growth in the U.S. shows no signs of abating. During the quarter, the price of West Texas intermediate crude oil shot up 16.1% and March's headline Consumer Price Index (CPI) came in at 3.5% year over year (YoY), non-seasonally adjusted (NSA). March Core CPI, which excludes food and energy prices, increased 3.8% YoY, NSA. These factors and other strong economic data led the market to reconsider the bond rally that occurred during the last two months of 2023.

With the economy running hotter than most had expected, the market went from pricing in nearly seven rate cuts from the Federal Reserve (Fed) during 2024 to just a little more than 2.5 rate cuts by the time the quarter ended. As a result, the Bloomberg U.S. Aggregate Bond Index returned -0.78% during the quarter. Stocks were able to shrug off the lack of rate cuts based on strong underlying economic data to return 10.6% for the S&P 500® Index. Gains in stocks were not limited to just the mega-cap tech stocks as the rally broadened out to include other sectors of the economy. The KBW Bank Index, for example, returned 10.2% for the quarter.

As the rest of the year unfolds, U.S. fiscal stimulus remains in the pipeline, which should help to juice the economy. Additionally, China's economy appears to be showing signs of life after struggling in the post-pandemic world. This could help buoy the German and broader European economies that benefit from exports. Strong global growth could keep risky assets well bid and further broaden out the rally in equities, while geopolitical risks—i.e., war in the Middle East and Ukraine—as well as a U.S. election could potentially cause that rally to stall. The markets will also be looking for signs that the U.S. economy and markets can withstand interest rates that are higher for longer without breaking anything.

## PORTFOLIO REVIEW

The Strategic Income Composite (Composite) began the year on strong footing by outperforming the benchmark by 386 basis points (bps) on a net-of-fees basis; the Composite returned 3.08%, while the benchmark posted a return of -0.78%. The Composite was positioned for an economy that was too strong for the near seven rate cuts implied by market pricing in mid-January and was able to capitalize on that adjustment process.

Relative outperformance during the first quarter was driven by the maximum allocation to preferred securities. Specifically, regional and super-regional banks outperformed in the institutional preferred space despite the volatility around New York Community Bank (NYCB). The investment team views this as an isolated event due to NYCB's unique and concentrated commercial real estate portfolio compounded by rapid growth and the consequent increased regulatory attention. Furthermore, NYCB's ability to access equity capital as a going concern is a credit positive for the regional banking system. The fourth quarter commentary mentioned that these sectors appear attractive, which remains true, and the Composite continues to position with an aggressive allocation to additional tier 1s (AT1s), U.S. regional banks, and hybrid securities overall. At the same time, the Composite began to harvest some of the accrued gains in the U.S. regional banks while still maintaining the overweight.

The biggest performance detractor came from the covered call writing program as the strong equity market caused several stocks to get called away as the options traded in the money. Despite this headwind, the overall equity book still experienced strong results that more than outweighed the drag from call writing. Infrastructure plays, information technology, and energy all contributed substantially to results. In addition, the REIT positions outperformed with data centers and retail leading the way. The volatility hedge was marginally negative with a 12-bps drag on the strategy's return during the quarter.

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## PORTFOLIO MANAGEMENT TEAM



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## INVESTMENT PHILOSOPHY

“Strategic Income seeks current income, across global markets, in any capital structure where we find relative value. The strategy provides reduced correlations to both stocks and bonds in a high quality portfolio.”

—John Cassady

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Duration added 62 bps of alpha relative to the benchmark as the Composite remains at the short end of the duration range with a target of 3.50 years. As the market adjusted to strong incoming economic data and a reversal of the downtrend in inflation, rates rebounded roughly 30 bps across the curve and the 10-year yield ended the quarter at 4.20%.

Securitized products added to relative performance primarily through security selection. Interest-only positions in Ginnie Mae securities backed by multi-family performed extremely well. Investors sought securities with specific characteristics held by the Composite. Specifically, low coupon collateral issued shortly after COVID outperformed as it is expected to prepay slowly with minimal defaults, thereby maintaining an uninterrupted stream of interest payments to the bondholder. Also, prices on specified pools within agency mortgage-backed securities held by the strategy increased relative to generic, to-be-announced securities and drove outperformance of the mortgage book.

### PERFORMANCE

ANNUAL PERFORMANCE [%]	2023	2022	2021	2020 <sup>†</sup>	
Composite Gross	6.04	-7.58	6.22	14.75	
Composite Net	5.67	-7.90	5.86	14.46	
Index*	5.53	-13.01	-1.54	4.23	
	1Q24	YTD	1 Year	3 Year	ITD <sup>†</sup>
Composite Gross [%]	3.17	3.17	9.59	2.31	5.36
Composite Net [%]	3.08	3.08	9.21	1.95	5.00
Index* [%]	-0.78	-0.78	1.70	-2.45	-1.67
<b>Outperformance** [%]</b>	<b>3.86</b>	<b>3.86</b>	<b>7.51</b>	<b>4.41</b>	<b>6.67</b>

\*Bloomberg U.S. Aggregate Bond Index

\*\*Outperformance=Composite Net-Index

<sup>†</sup>Performance calculated from inception date 4/1/2020

Periods greater than 12 months are annualized

Source: Bloomberg, Clearwater Analytics

### PORTFOLIO OUTLOOK AND POSITIONING

The market continues to beg the Fed for rate cuts despite an economy that shows few obvious signs of imminent recession risk. One could be forgiven for asking if monetary policy is as tight as widely believed after all. Regardless, the market could potentially get what it wants. Sometimes described as political but not partisan, the Fed may want to avoid changing policy course as the election draws near and, therefore, could provide a token rate cut in advance of the November election to remain unbiased. The strategy is therefore positioned for an economy that will continue to be “juiced” on a nominal basis via both fiscal and monetary policy.

The Composite maintains a maximum allocation of 50% to hybrid securities with a focus on discount dollar price, low coupon, low back-end spread structures that are trading to perpetuity that could, in reality, be called. AT1s look attractive based on those characteristics as we continue to believe that most of the space will be called at the first opportunity. Consequently, the allocation to AT1s is just shy of 17% of the Composite. Select regional bank structures trade cheap on these metrics as well, and the portfolio has substantial exposure to regional and super-regional banks. As spreads continue to normalize and prices gravitate toward our expectations, it is anticipated that the maximum overweight to preferred securities will be reduced.

The equity market is likely to be supported by ample liquidity, therefore, the Composite maintains a risk on bias with maximum allocation to common stocks and a substantial allocation to REITs. The common stock positions are focused on energy, infrastructure, semiconductors, and metals/mining. The covered call writing book was downsized by closing options positions in the energy and gold space to allow those names further room to run whether induced by geopolitics or sticky inflation. The remainder of the equity book continues to be overwritten by calls roughly 5% out of the money primarily for income generation but also risk reduction. Finally, the volatility hedge was increased due to the tranquility currently priced into the equity market as represented by a 13-handle VIX and a 10-handle implied call option volatility on the S&P 500.

The Composite’s duration remains anchored at the short end of its trading range, hovering around 3.50 years, with a preference for a steepening yield curve. Long positions are strategically focused on the front and belly of the curve, while the portfolio maintains a deliberate short position on 10- and 30-year maturities.

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## DISCLOSURES

Red Cedar Investment Management, LLC (RCIM) is an investment adviser registered under the Investment Advisers Act of 1940, founded in 2013. Registration as an investment adviser does not imply any level of skill or training. The oral and written communications of an adviser provide you with information about which you determine to hire or retain an adviser. For more information please visit: [www.adviserinfo.sec.gov](http://www.adviserinfo.sec.gov) and search for our firm name. Neither the information nor any opinion expressed herein should be construed as personalized investment, tax, or legal advice, or a recommendation of any particular security or strategy.

The securities discussed do not represent the Composite's entire portfolio. Actual holdings will vary depending on the size of the account, cash flows, and restrictions. It should not be assumed that any of the securities transactions or holdings discussed will prove to be profitable, or that the investment recommendations or decisions we make in the future will be profitable or will equal the investment performance of the securities discussed herein.

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All information and performance are reported in U.S. dollars.

The "Net" returns presented are net of fees. Investing involves the risk of loss and investors should be prepared to bear potential losses. Past performance is not indicative of future results.

The "Gross" returns presented are gross of fees. The results do not reflect the deduction of investment management fees. The client's return will be reduced by the management fees and any other expenses incurred in the management of the account. For example, a U.S. \$100 million account, paying a 0.50% annual fee, with a given rate of 10% compounded over a 10-year period would result in a net of fee return of 9.5%. Management fees are described in Part 2A of RCIM's Form ADV Part 2A. Investing involves the risk of loss and investors should be prepared to bear potential losses. Past performance is not indicative of future results.

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The Strategic Income Composite (Composite) includes a broad distribution pooled fund (North Square Strategic Income Fund) that invests in Treasury and agency bonds, investment grade and non-investment grade corporate bonds, municipal bonds, asset-backed securities, agency, and non-agency mortgage-backed securities, collateralized mortgage obligations, preferred securities, equity REITs and equity securities. The strategy may use derivatives, including forward contracts, futures contracts, swap contracts and options in implementing its strategy. The use of derivative instruments allows the strategy to achieve its investment objectives, reduce risks, or manage the strategy more efficiently. The strategy also invests in international securities, foreign exchange, and non-U.S. dollar denominated securities. The Strategic Income Composite was created on April 1, 2020. The inception date of the Composite was April 1, 2020.

The benchmark is the Bloomberg U.S. Aggregate Bond Index. The index is a broad-based benchmark that measures the investment grade, U.S. dollar-denominated, fixed-rate taxable bond market. The index includes Treasuries, government-related and corporate securities, mortgage backed securities, asset-backed securities and commercial mortgage-backed securities.

### Benchmark Definitions:

- The S&P 500 is widely regarded as the best single gauge of the U.S. equities market. The index includes a representative sample of 500 leading companies in industries of the U.S. economy.
- The Bloomberg U.S. Aggregate Bond Index represents securities that are SEC-registered, taxable, and dollar denominated. The index covers the U.S. investment grade fixed rate bond market, with index components for government and corporate securities, mortgage pass-through securities, and asset-backed securities.
- The KBW Index is a modified cap-weighted index consisting of 24 exchange-listed National Market System stocks, representing national money center banks and leading regional institutions.
- The Consumer Price Index (CPI) measures the overall change in consumer prices based on a representative basket of goods and services over time.
- The Core CPI measures the overall change in consumer prices based on a representative basket of goods and services over time, excluding food and energy prices.
- The VIX Index is a financial benchmark designed to be an up-to-the-minute market estimate of the expected volatility of the S&P 500 Index and is calculated by using the midpoint of real-time S&P 500 Index (SPX) option bid/ask quotes.

An index is an unmanaged portfolio of specific securities, the performance of which is often used as a benchmark in judging the relative performance of certain asset classes. Investors cannot invest directly in an index. An index does not charge management fees or brokerage expenses, and no such fees or expenses were deducted from the performance shown.

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