INVESTMENT MEMO

STARTED FROM THE BOTTOM, NOW WE'RE HERE

SPRING 2023

MERGANSER CAPITAL MANAGEMENT

MERGANSER TODAY

The Merganser team has been investing in short duration fixed income securities since the firm's founding over 35 years ago. Today, 70% of our AUM has a duration of two years or less.

Short duration fixed income, often thought of as the sleepiest corner of public markets, surged to the forefront of discussions in 2022. The dramatic rise in short term interest rates to offset the round of quantitative easing during the pandemic drove bond returns to their worst annual performance in modern markets. The result is that many institutional investors remain invested in money markets and cash alternatives, fearing that future rate increases could lead to more negative returns in bonds. While we recognize this strategy has worked up until now, we believe that cash alternatives and short duration play complementary roles in serving the liquidity needs of dynamic investment programs. This whitepaper makes the case that now may be an important inflection point, where modestly extending duration from cash alternatives to short duration bonds can offer several distinct advantages:

- ***Higher return potential**: short duration outperforms cash alternatives over the long term, particularly following large drawdowns.*
- ***Income cushion**: due to the magnitude of rate increases during 2022, bonds now offer substantial cushion which can protect investors against future price declines.*
- ***Less reinvestment risk**: money markets and other cash alternatives face reinvestment risk when rates fall, and it could make sense to lock in higher rates now.*
- ***Downside protection**: with an economic downturn widely expected later this year, owning some duration could be beneficial.*

STRONG RETURN POTENTIAL AND UPSIDE FROM HERE

Notwithstanding a 2022 type market event, short duration offers greater return potential versus cash and cash equivalents over the long term. This is primarily driven by the incremental income or compensation that an investor is paid by moving along the efficient frontier. While the yield curve is currently inverted due to the Fed aggressively hiking rates, investors should typically expect to be paid a premium for lending for longer. Broadly examining returns of ultrashort (a reasonable proxy for Money Market Funds) utilizing US Treasury Bills 1-3 Month Index, and short duration utilizing Bloomberg US Treasury 1-3 Year Index, from the last 30 years (Exhibit 1), some clear trends emerge. While short duration has more instances of negative months/quarters/years than ultrashort, in exchange for the risk of a negative return in a given period, short duration dramatically outperforms ultrashort with average annual returns of 3.16%, 83 basis points (bps) ahead of ultrashort.

The average trough during a drawdown of six months or greater was 75 bps, while returns for the next 12 months average more than four times the bottom, up 334 bps.

Over the course of an average 5-year horizon, this results in returns 36% higher than ultrashort. This is the relationship you would expect from a traditional risk-return framework.

EXHIBIT 1: ULTRASHORT VS. SHORT DURATION RETURNS LAST 30 YEARS

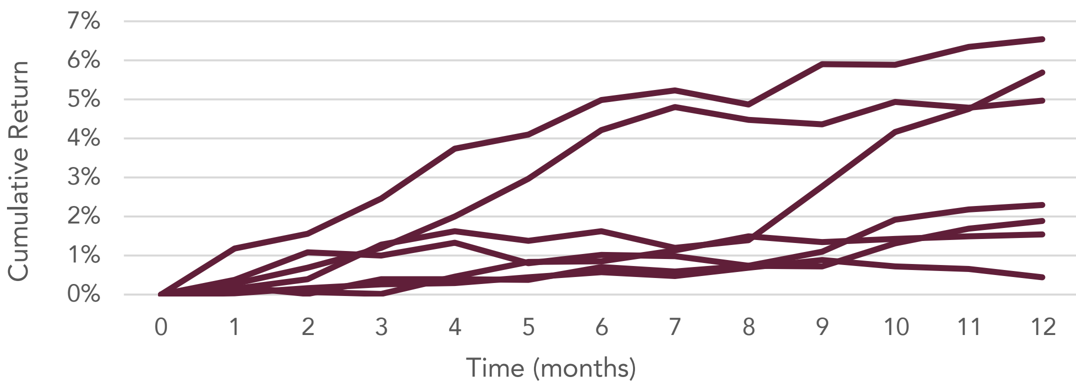
	% of Positive Returns			
Index	**Months**	**Quarters**	**Years**	**Annual Returns**
Short Duration	72.5%	83.3%	93.3%	3.16%
Ultrashort	99.4%	100.0%	100.0%	2.33%

Date range of March 31, 1993, through March 31, 2023.
References to Short Duration reflect the returns of the Bloomberg US Treasury 1-3 Year Index.
References to Ultrashort reflect the returns of the US Treasury Bills 1-3 Month Index.

While the drawdown in short duration during 2021/2022 was historic in terms of its depth and its time to recovery, history shows an encouraging outlook following similar events. The average trough during a drawdown of six months or greater was 75 bps, while returns for the next 12 months average more than four times the bottom, up 334 bps (see Exhibit 2). This is encouraging from the standpoint of both existing short duration investors and those looking to allocate a portion of their cash and extend duration.

EXHIBIT 2: SHORT DURATION PERFORMANCE FOLLOWING DRAWDOWN TROUGH

With significantly higher yields than 12 months ago, short-duration bonds can better withstand further price declines should rates continue to rise.

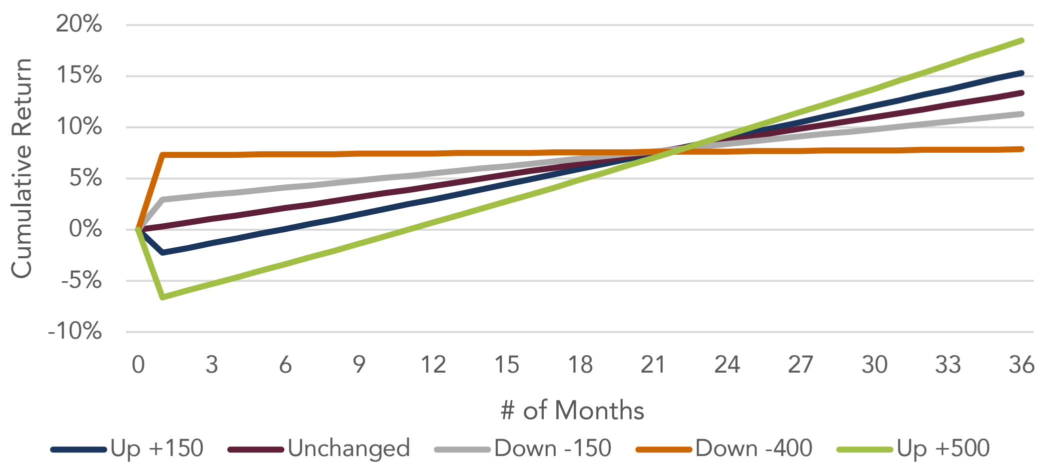


Source: Bloomberg

HIGHER RATES LEADS TO GREATER CUSHION

With significantly higher yields than 12 months ago, short-duration bonds can better withstand further price declines should rates continue to rise. For illustrative purposes, we apply a rate shock analysis to the Bloomberg US Treasury 1-3 Year Index. If rates immediately rose by 150 bps from current rates, the index would experience a price decline of 270 bps; however, the income cushion would offset that loss over the subsequent 6 months and result in a positive total return of 2.96% for the year. If the opposite occurred and rates immediately fell by 150 bps, the index would benefit from an increase in price, resulting in an annual return of 5.50%. If rates remain unchanged for one year, the index would earn 4.18%, which is essentially the yield to maturity. Short duration returns are positive in each of these three scenarios. In fact, rates could increase by more than 400 bps and total returns for the 12 months would remain positive, with significant subsequent benefits from higher income. See Exhibit 3 for the outcomes across 5 different rate shock scenarios.

EXHIBIT 3: SCENARIO ANALYSIS



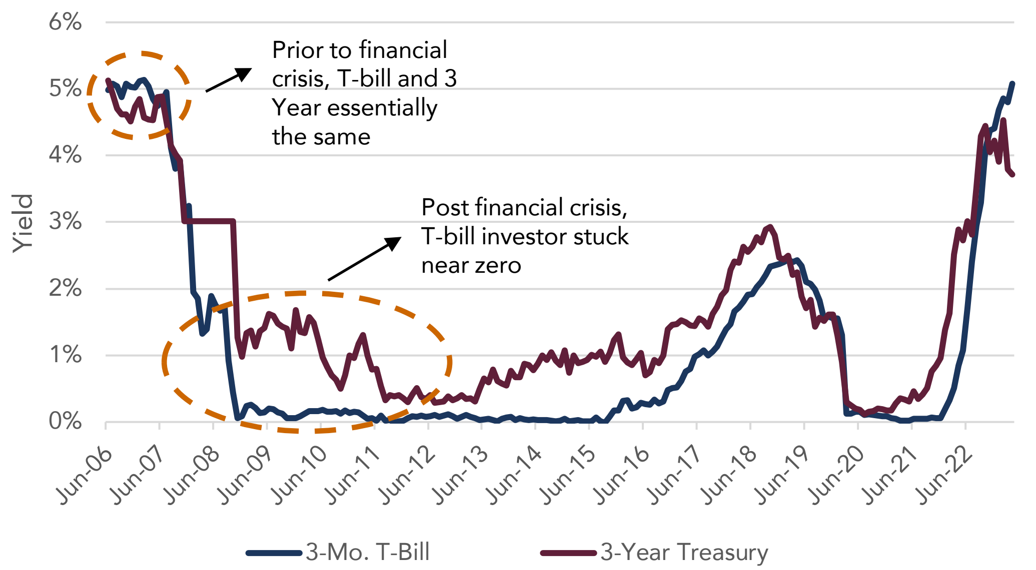
Source: Bloomberg index data, Merganser scenario analysis. All curve data as of March 31, 2023. The Bloomberg 1-3 Year Treasury index had a duration of 1.8 and a yield to maturity of 4.18 as of March 31, 2023. The performance of an index is not an exact representation of any specific investment.

If rates fall, particularly the overnight or Fed Funds rate, then investors positioned in money markets or cash equivalents will be faced with immediately deploying capital at reduced rates.

REINVESTMENT RISK IS REAL

With the shape of the curve today, investors have been wondering why they should extend duration and potentially accept less yield? The answer is simple: reinvestment risk. If rates fall, particularly the overnight or Fed Funds rate, then investors positioned in money markets or cash equivalents will be faced with immediately deploying capital at reduced rates. To bring this to life, we show a historical chart of the 3 Month T-Bill Index and the 3 Year Treasury leading up to and directly following the great financial crisis. In June of 2007, both instruments yielded approximately 4.80%. As the crisis accelerated and yields began to fall in late 2007 and early 2008, the T-bill investor would need to continually reinvest their maturing principal at lower and lower rates. Meanwhile, the investor in the 3 Year Treasury would have locked in the higher yield and would not need to reinvest principal until June of 2010.

EXHIBIT 4: HISTORICAL YIELDS



Source: Bloomberg

We believe the path to maximizing long run fixed income returns in short duration is through matching the investment horizon with the liability/expected duration of the portfolio.

DOWNSIDE PROTECTION

With an economic downturn widely anticipated by markets, it could be a good time to re-examine the duration profile of your fixed income holdings. Short duration dramatically outperforms ultrashort in this context as policy responses to economic stress often result in lower rates that immediately reduce income in ultrashort. In the 12 quarters during which the S&P 500 Index declined more than 10% in the last 30 years, short duration outperformed ultrashort by 137 bps on average and in all but one instance (you guessed it, 2022), provided positive returns. The moment in which investors look to fixed income for downside protection, short duration delivers while ultrashort quickly rolls off, now at lower yields.

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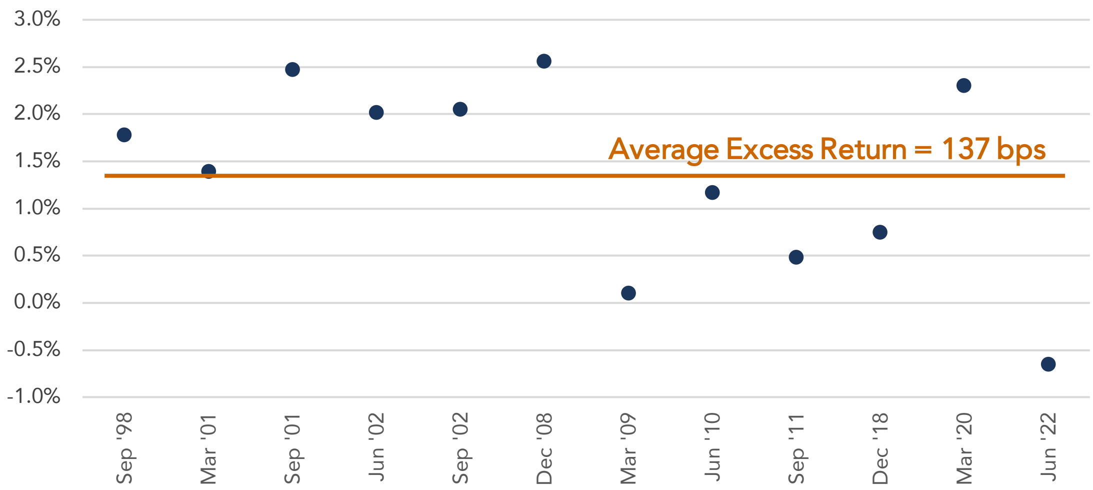
EXHIBIT 5: EXCESS RETURNS OF SHORT DURATION OVER ULTRASHORT



Source: Bloomberg

IMPLICATIONS FOR ASSET ALLOCATION

While it might be tempting to conclude from the above that short duration is superior to cash alternatives or money markets, particularly given the backdrop today, the actual conclusion is somewhat complicated. We believe the path to maximizing long run fixed income returns in short duration is through matching the investment horizon with the liability/expected duration of the portfolio. Because this is often not binary (e.g., 100% of the portfolio is required on a given date), we see money markets and cash alternatives playing an important role for liabilities inside of one year. The attractive long-term returns, lower reinvestment risk and downside protection that comes with short duration pairs well with the on-demand liquidity of cash, and both can benefit from an investment program with dynamic needs.

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Charts may not foot due to rounding.