RED CEDAR
INVESTMENT MANAGEMENT

FIRST QUARTER 2023

Short Term Bond Commentary

March 31, 2023

1Q MARKET REVIEW

It appeared the markets continued to ask the same question during the first quarter of 2023 that it had been asking for several months: Can the Federal Reserve (Fed) get inflation under control without causing the economy to fall into a deep recession? Some market participants felt the Fed could avoid any recession at all and find the perfect balance to ease inflation with minimal impact to employment and economic growth. As market yields declined during January, equity markets rallied from their December retreat and then began to favor growth stocks over value.

The debate over soft versus hard landings took a backseat in March with the collapse of Silicon Valley Bank due to a run of uninsured depositors. The contagion spread to other banks with similar characteristics and forced the government to respond with depositor guarantees and FDIC intervention. The concerns spread to Europe as Credit Suisse financials were called into question, ultimately resulting in an arranged takeover by UBS. These events had a significant impact on the banking sector's equity, fixed income, and preferred securities, negatively impacting prices. The broader markets remained surprisingly resilient with the Russell 1000® Index returning +7.45% for the quarter. Digging deeper, the Russell 1000 Growth Index returned +14.36% and Russell 1000 Value Index +0.99%. Reflective of the turmoil in the banking industry, the Russell 1000 Bank subsector returned -12.35% for the quarter.

Once the banking sector experienced some sense of stability near the close of the quarter, focus returned to inflation, the economy, and how aggressive the Fed could be in light of new banking revelations. The Fed did continue to tighten policy, ending the quarter with a total of two 25-basis point (bps) increases in the Fed Funds target rate. Expectations that banks would tighten lending standards to protect balance sheets and liquidity added to concerns that the economy may be more at risk than initially thought. The 10-Year U.S. Treasury ended the quarter approximately 41 bps lower than the end of 2022 with a 3.47% yield. The rally in yields led the Bloomberg U.S. Aggregate Bond Index to return +2.96% for the first quarter. This was the second quarter in a row of positive performance for the benchmark.

The first quarter of 2023 only added to the questions surrounding inflation and the broader economy. Employment remains stronger than anticipated, frustrating economic bears and the Fed as they try to tamp down inflation. The banking system challenges could also create a headwind for lending and economic growth. While the worst may be over for banks, the outlook for growth in the near term is probably limited due to the increased likelihood of further regulation and self-imposed balance sheet building. Equities remain resilient but likely have limited significant upside as valuations are stretched and fundamentals will probably not help in the near future. The fixed income markets have repriced over the past 18 months to a point where risk has become more symmetrical, and volatility will create challenges along with opportunities.

SHORT TERM BOND PORTFOLIO REVIEW

The Red Cedar Short Term Bond Composite (Composite) underperformed its benchmark, the Bloomberg 1-3 Year U.S. Government/Credit Index, by 0.25% (net of fees) in what was a turbulent period of historic proportions for the bond market. The first quarter of 2023 produced both the largest three-day drop in the 2-year Treasury yield since 1987 and the failure of two of the three largest banks in United States history. These events have created attractive valuations for which the strategy is positioned to take advantage.

Relative underperformance was led by the portfolio's underweight duration relative to the benchmark. The strategy was positioned for the Fed to remain active in its rate hiking campaign to tame inflation. However, the market panic caused yields to fall with multiple rate cuts now priced into the front end of the yield curve. The 2-year Treasury rate fell by 40 bps. The portfolio was positioned for a flattening of the yield curve, which partially offset the underperformance as intermediate maturity bonds rallied in price by more than short maturities.

Relative outperformance was realized by the Composite's strategic overweight to securitized products. Specifically, gains were experienced by subordinate positions in bonds backed by multi-family properties issued by Freddie Mac's K program. While headwinds in the office sector have received most of the media attention via incessant negative headlines, the multi-family sector has quietly outperformed.

STRATEGY INFORMATION

Benchmark	Bloomberg 1-3 Yr U.S. Gov/Credit
Business Minimum	$10M
Number of Holdings	85
Assets	$69.6M

PORTFOLIO MANAGEMENT TEAM

Jason M. Schwartz, CFA
Senior Portfolio Manager
Industry start date: 2004
Joined Red Cedar: 2018

Michael J. Martin, CFA
Senior Portfolio Manager
Industry start date: 1994
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Patricia S. Younker
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Chief Investment Officer
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Joined Red Cedar: 2018

INVESTMENT PHILOSOPHY

"We seek income producing opportunities while preserving capital by focusing on securities that have demonstrated superior risk-adjusted returns over time."
—Jason Schwartz

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The overweight to financials proved to be a drag on results relative to the benchmark as bonds of all banks sold off in sympathy with the issues at Silicon Valley, Signature, Silvergate, and Credit Suisse.

SHORT TERM BOND POSITIONING & OUTLOOK

It was an extraordinary quarter, as the world contended with four bank collapses. While much different in depth and breadth, the banking crisis experienced in the first quarter of 2023 had echoes of the 2008-09 Global Financial Crisis. The soundness of the banking system was questioned daily for a two-week period. In the end, actions taken by domestic and Swiss regulators re-established a level of calm and confidence that stemmed the velocity and amount of depositor outflows from regional and community banks. The strategy has always been vigilant about the credit quality of its holdings and did not own any bonds of the failed banking institutions.

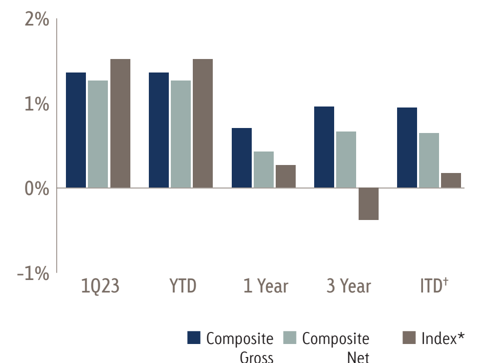
Consistent with the relative value approach, the strategy seized the opportunity to increase exposure to senior bank paper of sound institutions at attractive levels given the significant cheapening of the entire sector. The Composite sought exposure of nearly double that of the benchmark as measured by duration times spread by adding names like Capital One, Morgan Stanley, Toronto Dominion, and Wells Fargo.

Exposure to commercial mortgage-backed securities (CMBS) increased during the period. With a sizable allocation to CMBS in the strategy, care has been taken to avoid maturity default risk in the office sector. This was accomplished, first, though the sale of a single office property in Manhattan. Also, new purchases were focused either in tranches guaranteed by a government agency or structures that significantly reduced credit risk given high levels of defeasance.

The strategy sold the position in 2-year TIPS at a profit when inflation breakevens exceeded 3%. This proved to be a timely sale as subsequent issues in the banking sector caused investors to ratchet down their inflation expectations over the next two years, back to 2.68% by the end of the quarter.

Given the persistence of near record levels of interest rate volatility, the duration was increased to be equal with the benchmark. While the investment team believes that the number of rate cuts priced into the market are overdone and short-term interest rates are likely to move higher, it was viewed as prudent from a risk management perspective until more clarity on the economic outlook emerges.

PERFORMANCE



	Composite Gross	Composite Net	Index*
1Q23	1.35%	1.26%	1.51%
YTD	1.35%	1.26%	1.51%
1 year	0.70%	0.42%	0.26%
3 year	0.95%	0.66%	-0.38%
ITD†	0.94%	0.64%	0.17%

†Inception Date 1/1/2020
Periods greater than 12 months are annualized
*Bloomberg 1-3 Yr U.S. Gov/Credit Index
Source: Bloomberg, Clearwater Analytics

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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 Short Term Bond Composite includes all fully discretionary institutional portfolios that invest in Treasury and agency bonds, U.S. dollar denominated investment grade corporate bonds, municipal bonds, asset-backed securities, agency and non-agency mortgage-backed securities and collateralized mortgage obligations. The strategy also invests in derivatives such as Treasury futures and CDX for hedging purposes. The weighted average portfolio effective duration range will be 80% - 120% of the benchmark effective duration during normal market conditions. The Composite was created January 1, 2020. The inception date of the Composite was January 1, 2020. Prior to November 1, 2021, the name of the Composite was RCIM Short Term Bond Composite.

Benchmark Definition: The Bloomberg 1-3 Year U.S. Government/Credit Index measures Treasuries, government-related issues, and corporates with maturity between 1-3 years.

Index Definitions: The Russell 1000 is a stock market index that tracks the highest-ranking 1,000 stocks in the Russell 3000® Index, which represent about 90% of the total market capitalization of that index. The Russell 1000 Growth measures the performance of those Russell 1000 companies with higher price-to-book ratios and higher forecasted growth values. The Bloomberg U.S. Aggregate Bond 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 Russell 1000 Value measures the performance of those Russell 1000 companies with lower price-to-book ratios and lower forecasted growth values.

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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