Osterweis Strategic Income (OSTIX)

"Yearning for the good old days is not an investment strategy"

by David Snowball

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Mutual Fund Observer

We look at each investment as if it were the only investment we are going to make.

Objective and strategy The strategy is to preserve capital and attain long-term total returns through a combination of current income and moderate capital appreciation. The managers invest in income producing securities, primarily high yield bonds, but will shift the allocation to managing a changing risk and opportunity set. Such changes might include shifting toward higher quality or shorter duration securities and increasing the fund's cash stake. As of February 28, 2023, 76% of the portfolio is invested in high yield bonds with an average duration of about 2.5 and 13% is held in cash. The 30-day yield is 6.9%.

Adviser Osterweis Capital Management. Headquartered in San Francisco, the firm was founded in 1983 by John Osterweis. Their firm-wide ethos is "the avoidance of major losses in falling markets and the compounding of reasonable gains in rising markets." They provide investment management for individuals, families, endowments, and institutions. In 2022, the Zeo Capital Advisors team joined Osterweis, bringing their two mutual funds under the Osterweis moniker after shareholder approval. The firm advises seven mutual funds and, as of 12/31/22, assets under management were $6.4 billion.

Managers Carl Kaufman, Bradley Kane and Craig Manchuck.

Mr. Kaufman is the co-president and co-CEO for Osterweis Capital, as well as the CIO for the strategic income strategy. He has managed the fund since 2002 and co-manages Osterweis Growth & Income. Mr. Kane joined the team in 2013. Prior to joining the Osterweis Capital Management, LLC in 2013, Mr. Kane was a Portfolio Manager and Analyst at Newfleet Asset Management, where he managed both high yield and leveraged loan portfolios.

And Mr. Manchuck came on board in 2017. Prior to joining Osterweis Capital Management in 2017, Mr. Manchuck was a Managing Director of Fixed Income at Stifel Nicolaus from 2013 to 2016 and Knight Capital from 2008-2013, where he was responsible for sales and origination of high yield bonds, leveraged loans and post reorg equities.

Collectively the team has 100 years of investment experience and manages about $5 billion in fixed-income assets.

Strategy capacity and closure Mr. Kaufman notes that $7.3 billion, the fund's previous asset peak, "was not a strain" and they're billions below that. His recommendation is that we "ask again at $10 billion."

From left: Bradley Kane, Carl Kaufman, Craig Manchuck

Management's stake in the fund Mr. Kaufman has invested over $1 million in the fund, Mr. Kane is north of $500,000 and Mr. Manchuck has over $100,000. In total, eight of the firm's managers and three of its trustees are invested in the fund. The source for all of that is the 3/31/2022 Statement of Additional Information.

Opening date August 30, 2002.

Minimum investment $5,000, reduced to $1,500 for IRAs and other tax-advantaged accounts. Individual brokerages, e.g., Schwab, can set other limits.

Expense ratio 0.84% on assets of $4.7 billion

Comments Remember all the homely bits of the good old days? A roll of freshly churned butter and milk that had to be shaken to distribute the cream. The evening paper on the coffee table. Pa reading aloud from his favorite feature in the latest *Reader's Digest*, "Laughter is the best medicine." Ma working on the pan gravy that went with her fried chicken. Global admiration for America's three greatest generals: General Electric, General Mills and General Motors. Single-digit P/Es, 14% interest on passbook savings accounts, and interest rates just beginning to drift down from the stratosphere. To paraphrase Mr. Banks in Mary Poppins, "money is sound, credit rates are going up, up, up and the American dollar is the admiration of the world!"

Osterweis has a three-part plan. It's a clean, simple plan which reduces the risk of having it outsmart itself.

All of which are wonderful memories but dismal grounds for constructing an investment portfolio for 2023 and beyond. The cold reality is that the stock market remains near historic highs, making P/E contraction more likely than expansion, and interest rates seem on track for "higher for longer." Both raise the prospect for dismal returns for traditional strategies using indexed or index-like approaches. Layered onto that is that non-zero prospect of politicians doing something staggeringly stupid in pursuit of political gain or a moment's notoriety.

Osterweis has a three-part plan. It's a clean, simple plan which reduces the risk of having it outsmart itself.

Part One: Avoid panic.

Most of today's investors have never had to navigate markets marked by high inflation, rising interest rates, contracting P/E multiples or the absence of "the Fed put." If you grew up thinking that flat prices, zero interest rates, high P/E ratios and Alan Greenspan were all your entitlements, it's understandable that their sudden disappearance would be unsettling…and unsettled investors are prone to do stupid things.

As befitting guys who've seen many markets and styles and fads come and go, the Osterweis folks seem somewhere between sanguine and positively upbeat. In their early 2023 review, they write:

> Once the markets have adjusted for the absence of free money (or in the case of Europe, "pay you to take it" money), what comes next? Barring a black swan event, life will continue, coping mechanisms will take hold, and markets for financial and real assets will find their equilibrium. Sometimes it helps to take a step back to have a broader view of what markets are offering today versus what we have gotten accustomed to in the past decade or so in order to find the right path to better returns.
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> The adjustments the markets have seen in the past year are painful, but they are presenting us with better opportunities for rational investing such as getting paid a decent return to lend money. What an old-fashioned concept! Selectivity and flexibility should be winning gambits.

Part Two: Maintain a long-term stock-bond balance.

They believe that long-term investors should maintain a 60/40 portfolio, though in individual cases that might mean 50/50 or 65/35 but the goal is something in the direction of a stock-bond balance. The vexing question is "what exactly goes into the 60? What's the 40?" Their answer is 60% dividend-paying equities and 40% Strategic Income.

Over a period of decades, the fund has managed to nearly double the returns of the bond aggregate with scarcely any greater volatility.

Dividend-paying stocks, in particular the stocks of companies growing their dividends, offer the prospect of capturing much of the stock market's upside while adding a stream of income and some downside buffer.

The Strategic Income strategy focuses on investments in high-yield securities. Fixed income investments face risk, a fact masked by 30 years of declining interest rates. For investment grade fixed income, especially with passive strategies, the risk comes from rising interest rates that can lead to catastrophic mark-to-market losses. Osterweis believes that investors are better served by looking at securities that carry credit risk. "Credit risk" is the notion that an issuer might not be able to meet their debt payment obligations fully and promptly. That risk is controllable through a combination of good fundamental research (don't invest in people who can't pay their bills) and flexibility in choosing how to invest in companies:

> Your readers need to understand we're afraid of our own shadows. We don't take a lot of risk. We look at each investment as if it were the only investment we are going to make. One question forms our lens: "if you could only own one bond, is this the one?"
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> … we do a significant amount of work to determine the company's business prospects, as well as the positive and negative levers in its financial model, which influence the company's ability to generate cash flow …our ideal investments are in companies that have great products, a competitive advantage that gives them pricing power in the market, a consistent operating history, and management that operate the company as if they own it. Finally, we determine what we believe to be the appreciation potential versus the downside risk to gauge the attractiveness of the security versus other available investment opportunities.
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> We're invested in around 115 companies, far fewer than the 300-500 that are common in fund portfolios. We engage in rigorous testing, try to find the most attractive parts of the market then the least risky ways to play it. And we're not afraid to keep cash, all of which means that the ride with us will be much smoother.

Part Three: Stay flexible.

Their research allows them to understand the risks each position poses. They have the freedom to mitigate those risks by shifting higher in the credit structure, shortening durations, shifting sector focus or holding more cash.

> … our research has shown that the various sectors of the bond market behave differently under different economic conditions.
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> We believe that by avoiding the "style box" trap and having the flexibility to invest in multiple classes of bonds, we can manage each portfolio in such a way as to emphasize the most attractive sector at any given time. By strategically shifting out of overvalued assets, we strive to minimize potential risk and produce better returns over time.

All of which has worked exceptionally well.

Since inception, the Osterweis Strategic Income Fund has outperformed its Lipper peers by 104 basis points annually and the U.S. bond aggregate by 268 basis points. Both their "normal" volatility (measured by standard deviation) and their "bad" volatility (measured by downside deviation) are *far* lower than the average multi-sector income fund and only marginally higher than an investment grade fund's. In consequence, their risk-return metrics—the Ulcer Index plus Sharpe, Sortino and Martin ratios—are all far higher.

Comparison of Lifetime Performance (Since 200209)

Symbol	Name	Category	Return %	APR	MAXDD %	Date MAXDD	Recvry mo	STDEV %/yr	DSDEV %/yr	Ulcer Index	MFO Risk	Sharpe Ratio	Sortino Ratio	Martin Ratio	MFO Rating	APR Beats	APR Rating
OSTIX	Osterweis Strategic Income	Multi-Sector Income	223.03	5.89	-9.64	202209	14+	4.28	2.84	2.11	2	1.09	1.64	2.21	5	-	5
AV-MSI	Category Average	Multi-Sector Income	177.89	5.0	-19.5	-	19	6.1	4.3	4.1	2	0.63	0.89	1.00	3	0.9	3
TBILL	US 3-Month Treasury Bill TR USD	U.S. Treasury Short	28.35	1.23	0.00	-	-	0.43	0.00	0.00	1	0.00	-	-	-	4.66	-
USBOND	Bloomberg U.S. Aggregate Bond TR (Modified)	-	90.97	3.21	-17.20	202210	31+	3.97	2.71	3.09	2	0.50	0.73	0.64	-	2.68	-

Osterweis captures that same dynamic in a series of scatterplots that compare their fund's 20-year returns and volatility against a series of Lipper peer groups: their native peer group, Multi-sector Income, plus High Yield Bond and Alternative Credit. In each case the pattern is the same: OSTIX is one of the least volatile options with some of the highest returns. Another way of putting it: if you wanted somewhat better returns, you had to endure vastly higher volatility.

For those worried about bear markets: since inception, OSTIX has captured 14% of the S&P 500's downside and 21% of the downside of a traditional 60/40 portfolio…and has a negative downside capture against the U.S. bond market. That is, when traditional bonds have fallen, OSTIX has risen a bit.

Bottom Line The record is clear. Osterweis is one of the two or three best strategic income funds available to investors. Over a period of decades, the fund has managed to nearly double the returns of the bond aggregate—even during a long, rate-driven bull market for investment grade bonds—with scarcely any greater volatility. Over the past decade, when the market has favored less prudent strategies, Osterweis has managed 4.0% annual returns as both their three-year and five-year rolling average. Over the long term, the fund's three- and five-year rolling average has been around 5.8%. Mr. Kaufman believes that, with a macro environment more favorable to their style, returns of that higher magnitude remain plausible.

Investors who recognize that the era of easy, riskless returns in investment grade bonds has likely ended, at least for this generation, but who still need to prospect of steady income and ballast for a stock-heavy portfolio, have an outstanding option here. They ought to explore it soon and carefully.

Fund website **Osterweis Funds**

OSTERWEIS STRATEGIC INCOME FUND

Mutual Fund Observer

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The Fund's average annual total return for the one year, three year, five year, ten year, and since-inception periods ending 12/31/23 were as follows:

	1 Yr.	3 Yr.	5 Yr.	10 Yr.	Since Inception (8/30/2002)
Osterweis Strategic Income Fund	*12.30%*	*3.67%*	*5.06%*	*4.14%*	*6.12%*
Bloomberg U.S. Aggregate Bond Index	*5.53%*	*-3.31%*	*1.10%*	*1.81%*	*3.32%*

Expense Ratio as of 3/31/2023: 0.86% / 30-Day SEC Yield as of 12/31/23 is 6.64%.
Performance data quoted represents past performance and does not guarantee future results. The investment return and principal value of an investment will fluctuate so that an investor's shares, when redeemed, may be worth more or less than their original cost. Current performance of the Fund may be lower or higher than the performance quoted above. Performance data current to the most recent month end may be obtained by calling toll-free (866) 236-0050.

The Osterweis Funds are available by prospectus only. The Funds' investment objectives, risks, charges and expenses must be considered carefully before investing. The summary and statutory prospectuses contain this and other important information about the Funds. You may obtain a summary or statutory prospectus by calling toll free at (866) 236-0050, or by visiting www.osterweis.com/statpro. Please read the prospectus carefully before investing to ensure the Fund is appropriate for your goals and risk tolerance.

Investing involves risk, principal loss is possible.

The Osterweis Strategic Income Fund (the Fund) may invest in debt securities that are un-rated or rated below investment grade. Lower-rated securities may present an increased possibility of default, price volatility or illiquidity compared to higher-rated securities. The Fund may invest in foreign and emerging market securities, which involve greater volatility and political, economic and currency risks and differences in accounting methods. These risks may increase for emerging markets. Investments in debt securities typically decrease in value when interest rates rise. This risk is usually greater for longer-term debt securities. Small- and mid-capitalization companies tend to have limited liquidity and greater price volatility than large-capitalization companies. Higher turnover rates may result in increased transaction costs, which could impact performance. From time to time, the Fund may have concentrated positions in one or more sectors subjecting the Fund to sector emphasis risk. The Fund may invest in municipal securities which are subject to the risk of default.

While the fund is no-load, management fees and other expenses still apply. Please refer to the prospectus for more information.

Opinions expressed in the article are those of the author and the interviewee, and the information has not been verified by Osterweis Capital Management. These opinions are subject to change at any time, are not intended to be a forecast of future events, a guarantee of future results, or investment advice.

Lipper's Multi-Sector Income Funds classification includes funds that, by portfolio practice, seek current income by allocating assets among several different fixed income securities sectors (with no more than 65% in any one sector except for defensive purposes), including U.S. government and foreign governments, with a significant portion of assets in securities rated below investment-grade.

Price-to-Earnings (P/E) Ratio is the ratio of a company's stock price to its twelve months' earnings per share.

A basis point is a unit that is equal to 1/100th of 1%.

The Bloomberg U.S. Aggregate Bond Index is widely regarded as the standard for measuring U.S. investment grade bond market performance.

Investment grade bonds are those with high and medium credit quality as determined by ratings agencies.

Yield is the income return on an investment, such as the interest or dividends received from holding a particular security.

The Sharpe Ratio of a manager series is the quotient of the annualized excess return of the manager over the cash equivalent and the annualized standard deviation of the manager return.

A variation of the Sharpe ratio, the Sortino ratio is a return-versus-risk trade-off metric that uses downside deviation as its measure of risk.

The Martin Ratio or Ulcer Performance Index was authored by Peter G. Martin. The higher the Martin Ratio the better the instrument's performance. The main ingredients are current price and a prior price which are adjusted with the user defined safe return. An average and the Ulcer Index are taken; and the Martin Ratio is their quotient.

Max drawdown is a fund's largest peak-to-trough decline during the period of analysis.

Duration measures the sensitivity of a fixed income security's price (or the aggregate market value of a portfolio of fixed income securities) to changes in interest rates. Fixed income securities with longer durations generally have more volatile prices than those of comparable quality with shorter durations.

Standard Deviation is a measure of dispersion that represents the degree to which an investment's returns vary around a mean. The greater the Standard Deviation, the more volatile an investment's returns were during the period measured. This statistic is calculated using the population standard deviation formula: Standard Deviation = Square root of [(Sum of squared deviations from mean)/(Number of returns in the period measured)] If the return periodicity is less than one year, the standard deviation is multiplied by the square root of the number of periods in one year in order to arrive at an annualized measure.

The APR Rating represents quintile ranking of a fund's APR within category across specified evaluation period. It uses similar methodology as MFO Rating. An APR Rating of 5 represents "Best" in category.

MFO Rank is a simple sequential ordering methodology within category of fund performance based on Martin. It is less sophisticated than the MFO Rating metric; therefore, funds with comparable or even identical Martin values the will receive sequential ranking.

MFO Risk is the principal risk ranking metric used in the MFO rating system and found across most of the MFO Premium pages. It designates a fund's risk relative to overall market, defined by SP500 index.

The Mutual Fund Observer (MFO) Rating is the principal performance ranking metric used in the MFO rating system and found across most of the MFO Premium pages. It ranks a fund's performance based on risk adjusted return, specifically Martin Ratio, relative to other funds in same investment category over same evaluation period. Evaluation periods include lifetime, 20, 10, 5, 3, and 1 year, plus full, down, and up market cycles, as applicable. Funds in the top 20 percentile (top quintile) are assigned a 5 for "Best," while those in bottom 20 percentile (bottom quintile) are assigned a 1 for "Worst." MFO "Great Owl" distinction is assigned to funds that have earned top performance rank for evaluation periods 3, 5, 10, and 20 years, as applicable.

Osterweis Capital Management is the adviser to the Osterweis Funds, which are distributed by Quasar Distributors, LLC. [OSTE-20230410-0834]