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SUSTAINABLE CREDIT STRATEGIES: QUARTERLY LETTER – 1Q2023

2023 Will Be a Year to Remember. But for What?

2020: Pandemic. The Fed. Reopening. Variants. 2021: Next-level political chaos. Relieved consumers. Global supply chain. 2022: Inflation. Quiet quitting. Actual quitting. Ukraine. Energy prices. The Fed… again.

The last three years have felt a bit like running a marathon at a sprinter's pace. Each December, market participants have exhaled, grateful for the end of a trying year, only to realize a few months later that the next one is just as trying. 2023 seemed like the one in which investors could finally catch their breath. With the Fed's battle with inflation well underway, the remaining questions were not inconsequential but felt knowable and manageable: How much demand could the Fed curb, how deep a recession might they cause, and how long would that last?

The markets seemed to have already priced in a deep economic slowdown, and the likelihood of investors being further surprised to the downside appeared low. Political gridlock and brinkmanship appeared to be the main stories to watch when 2023 began, comforting in their predictability. But as I write this today, market confidence has been shaken anew with an ongoing wave of unexpected bank failures. Here we are, only a few weeks past the first quarter of 2023, and markets are again breathless, processing volatility-inducing headlines and events that were wholly unexpected just a few months ago. Investors are left asking what the rest of 2023 will have in store?

Our answer: Your guess is as good as ours, and that is okay. It has been our experience that trying to be "right" about the broader markets tends to get in the way of being "right" about investments. But therein lies the path from exhaustion to opportunity. As our colleague Craig Manchuck, portfolio manager on the Osterweis Strategic Income Fund, often says, we invest in "a market of bonds, not a bond market." And not since the aftermath of the Great Financial Crisis in 2009 have we seen a market in which selecting individual securities and being fluent in fixed income risk can reveal short-term opportunities that make a profound difference in long-term portfolio outcomes.

Here We Go Again: Seeking Refuge and Returns in Panicky Markets

We have seen a lot over our careers in the credit markets. We have been through periods of high conviction and periods of high uncertainty. We have watched some credits get dismissed by Wall Street analysts and then prove them wrong, and others get cheered by the same analysts and then run into trouble. We have seen more incorrect economic and market forecasts than we can count. And we have witnessed a systemic underestimation of good management teams in good businesses for a wide range of bad reasons.

It is this experience that has informed our approach to the markets. We have found it imprudent to try to manage a portfolio based on market perceptions or predictions of investor sentiment. Meanwhile, we have traditionally gravitated toward the securities of issuers we refer to as misunderstood, mispriced, or misrated. It has always been our view that assessing a company's ability to repay its debt is paramount, regardless of what happens in the market, hence our relentless focus on fundamentals. This is what gives us confidence in our issuers: we choose them not because we believe their price will go up if the market perceives them to be creditworthy, but because we believe they will be repaid because they *are* creditworthy.

Seeking that fundamental consistency is the lifeblood of prudent investing. When combined with experience and the discipline to stick to a time-tested investment process, it enables us to avoid getting caught up in the emotions that distract many less-rigorous market participants. There are many factors that impact pricing of shorter duration high yield bonds, but we have found over the years that three key drivers explain most of what we observe: overall credit market sentiment, the rate of new issuance, and the underlying fundamentals of the issuers themselves.

Typically, we are primarily focused on the third. In our view, if the underlying fundamentals of an issuer point to a demonstrated ability to repay debt when due, then little else matters. If this is the case, then we can know at least one future price of a bond we purchase: par at maturity. In between now and then, prices will vary, but we work hard to build the confidence that the intermediate volatility is limited and mostly noise. However, over the course of our careers, we have seen times when the first two drivers conspire to drive volatility that exceeds our expectations.

When such times arise, the question we always ask ourselves, and which determines how we react, is whether those price impacts are due to a change in underlying fundamental factors or due to changes in market perception. This distinction is ultimately the difference between long-term investing and short-term trading. Regardless of market perception, if we determine underlying fundamentals remain intact, we do not to try to time markets. We may average down our positions when faced with lower prices, but we do not sell bonds we like to make a directional bet that we can buy them back lower. Similarly, we do not buy bonds we do not fundamentally like with a directional view that they will go higher anyway. We believe our focus on building portfolios designed to deliver on long term goals ultimately serves our clients better and more consistently.

We have seen all three of the factors we mentioned come into play at various points during the past year. In the second half of 2022, primarily from August to October, market sentiment was the biggest challenge. High yield spreads significantly diverged due to a fear that the Fed's aggressive response to inflation would cause capital markets to close and make it impossible for some companies to refinance their debt. This especially impacted issuers with shorter-term maturities. But we observed a second cohort of issuers, many of which were in our universe of misunderstood, mispriced, or misrated companies, that also widened disproportionately to the broader markets. Unfortunately, once investors start to worry, it is harder to rely on them to do the work necessary to distinguish one company from another. Put another way, a misunderstood issuer tends to be most misunderstood when investors are least willing or able to take the time and clear the mind to understand it.

Beginning in December 2022, the next earnings season turned this market on its head. Many companies that were perceived to be risky in October reported stronger-than-expected results, which improved sentiment and triggered a robust new issuance market in January. Fundamental strength relative to market perception caused credit spreads, particularly in misunderstood companies, to compress. This, in turn, caused the entire high yield market to rally, as investors expected this fundamental recovery to be widespread. And it generally has been. However, the market's expectations for the perceived "safer" credits, which investors favored in late 2022, were higher. For that set of issuers, results that showed largely the same positive trends were met with disappointment. This culminated in an interesting observation in February, in which we found our portfolio not just performing relatively strongly but moving in the opposite direction of the broader high yield market.

With an unexpected banking crisis creating fear and uncertainty, March brought us more of what we saw the previous October. Several misunderstood issuers once again declined disproportionately to the broader market, even as some delivered better-than-expected business results in the process. In most cases, one or two price-insensitive sellers traded indiscriminately and caused unexpected price movements. But we have seen this movie before. We saw it in 2020, when well-researched companies with good underlying fundamentals overcame market perception. And we saw it in 2009 as well. For anyone who wants to hear them, my co-portfolio manager Marcus Moore can regale you with stories of high-quality issuers that were unduly cast aside.

Fortunately, we do not believe today's markets are anywhere near that level of distress. However, we will argue that, as much as markets may differ over time, the characteristics that enable companies to deliver on their business plans and demonstrate creditworthiness do not, however misunderstood the issuer might be. It will not always be perfect, but having been investing in our corner of the credit markets for a long time, we have found consistency and confidence in sticking to discipline, drawing from experience, and always prioritizing investment theses based on underlying fundamentals rather than market perception. It is this unwavering commitment to process and rigor that drives our excitement for how our portfolios are positioned for the remainder of 2023 and beyond.

A Market Worth the Effort

In today's environment, there is an abundance of bonds we would consider cheap. Many of them are priced that way precisely because of inherent supply/demand imbalances in choppy markets and the increasing lack of rigor among most market participants. While we could use this as an explanation for price movements in securities we already own, we prefer to use it to highlight an opportunity that bears many similarities to the post-2008 markets that gave birth to our investment approach in the first place.

Our backgrounds in finding less-trafficked investments, which many investors discard due to one shortcut or another, have never been as useful as they are at this moment. It takes work, patience, and humility to manage a fundamental portfolio in a market full of both real and perceived headwinds. Fortunately, the current environment seems to be filled with misunderstandings across a variety of factors, which makes for a plethora of interesting and exciting opportunities worth the effort. We are looking forward to capitalizing on these circumstances for the benefit of our clients in the months and years to come.

As always, we are available for your questions, comments, or feedback. We thank you for your continued support and confidence in our management.

Sincerely,

Venkatesh Reddy
Chief Investment Officer—
Sustainable Credit & Portfolio Manager

Par is the face value, or value at which a bond will be redeemed at maturity.

Maturity is the date on which the life of a financial instrument ends, after which it must either be renewed, or it will cease to exist.

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