The Road Ahead: What’s Next for Fixed Income

Consuelo Mack: Hello and welcome to this State Street Global Advisors discussion on the investment implications of the Fed's rate decision, "The Road Ahead, What’s Next For Fixed Income"? I’m Consuelo Mack, anchor and executive producer of Wealth Track on public television. And I'm going to be moderating this discussion. And we'll try to include as many questions that are coming in from all of you in the audience as we can. And we've gotten quite a few in hand already.

Biographies slide

So joining me on the call are two top professionals in their respective fields. Jeffrey Gundlach needs no introduction, but he's going to get one regardless. He is CEO and Chief Investment Officer of DoubleLine Capital where he oversees about $80 billion in assets\(^1\), including the DoubleLine Total Return Bond Fund. And in February he and SSGA launched an actively-managed ETF, the SPDR DoubleLine Total Return Tactical ETF\(^2\), symbol TOTL, which we all call Total for short. And we'll do so in this conversation. It is the fastest-growing ETF launched this year and just passed $1 billion in assets.\(^3\)

The SSGA executive responsible for the creation of that ETF is Jim Ross. He is a pioneer in the ETF field. Jim was part of the original team that launched the first US-based ETF in 1993 here at State Street. And he is Executive Vice President of SSGA and global head of SPDR ETFs. He is also Chairman of SSGA Fund Management. And in these roles, he is responsible for all aspects of the company's SPDR ETF business globally, a portfolio that is expanding rapidly and TOTL being a prime example of that.

So welcome to both of you. Great to have you here for this call. And, Jeffrey, I'm going to start with you. The Fed's decision, it was not a surprise to you. As a matter of fact, you have been vociferously telling the Fed and the world that raising rates would be a mistake.

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Jeffrey Gundlach: Well, basically there's four major market-based variables that strongly suggest that conditions really aren't there for a Fed rate hike. The first is commodity prices, which are at more than decade lows. It's kind of remarkable that commodity prices are lower today than they were at the depth of the global recession in 2009.\(^5\) Another thing, and so clearly inflation is not really showing up in commodity prices.

And I'll just add onto that, the PCE deflator, which is the inflation indicator that the Fed for years has highlighted as being one of their favorites to look at, is not only not rising. It's in

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1 Source: DoubleLine Capital, as of June 30, 2014.
2 TOTL's inception date is February 23, 2015. Source: SSGA.
3 TOTL is the fastest growing, newly launched ETF in 2015 based on asset under management. Source: Bloomberg.
4 "In Our Time", Webcast Source: DoubleLine, September 8, 2015
5 Source: Bloomberg, S&P GSCI, September 2015
a persistent declining trend. And it's not close to the 2% level that the Fed says that they're kind of targeting for inflation.

So inflation doesn't argue for raising rates, nor do financial conditions as best represented by junk bond prices. If you look at the ETF JNK, it is at a four-year low nearly. And that's a pretty significant development because usually junk bond prices are leading indicators of trouble in the financial system, at least potentially are. Another thing that argues against raising rates is the performance of emerging market equities, which are at six-year lows, having broken down from a meaningful shelf of support.

And, of course, a lot of that has to do with China. And it's interesting that the Fed in their communication in the press conference and in their statement on Thursday for the first time in recent memory talked about global markets and global conditions. And so probably the Fed is looking at that emerging market situation. And so you can look the EEM ETF, which is as I said at a six-year low.

And then finally, nominal GDP in the United States is at a level utterly inconsistent historically with raising interest rates. It's at 3.7% nominal GDP year over year. And the Fed has raised rates 118 times since 1948. A hundred and twelve of those times nominal GDP was above 5.5% and only twice was it below 4.5%. And when they raised rates those times, the second time was 1982, they had to reverse course almost immediately.

So you don't really have the conditions in place from global market conditions or inflation conditions to raise rates, so I think that's why the Fed didn't do it.

Consuelo Mack: So from the Fed's most recent comments, you just cited the fact that they mentioned what was going on and events overseas. Are you seeing indications that Fed officials are coming around to your position do you think?

Jeffrey Gundlach: I think reluctantly. I think the Fed wants to raise interest rates. First of all, I think they're curious as to what will happen. And also they just don't want to be at zero should -- when and if economic conditions deteriorate.

So the two takeaways that I thought were interesting from the Fed were the global conditions aspect, which I suppose if we started to see increases in junk bond prices or stabilization in China, then maybe that would be satisfied.

The other thing the Fed talked about was they need greater confidence in the inflation outlook, that their 2% target would be approaching in terms of reaching it with greater confidence. And that I think has got them in a little bit of a problem because inflation data other than commodity prices, the data series, the indexes of inflation, they only come out once a month.

So the Fed said in their press conference, I think what became problematic for the Fed, Janet Yellen said she expects inflation is going to fall further in the near term. And that means that there's no chance that the confidence of inflation going back to 2% is likely to improve in the next few months. And for that reason, I think maybe reluctantly and inadvertently the Fed has kind of boxed themselves a little bit into a position with that

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-source: Saint Louis Federal Reserve Bank PCE Index, September 2015.
-source: Bloomberg, September 2015.
-source: Bloomberg, September 2015.
statement about confidence on inflation that they're going to be not raising rates at all this year.

I think the press conference was a little bit of a debacle last Thursday.

Consuelo Mack: How so?

Jeffrey Gundlach: It creates a lot of confusion. Well, people thought that the Fed had a framework for raising interest rates. They've been working hard to create a framework. And it was largely based around unemployment. And that's been working the right way. The unemployment rate is down near 5%. And they had a framework on that.

And it seems like now that they've introduced this global conditions aspect and they've got themselves in a situation where it's not really that possible to have a near-term reversal in your confidence on inflation, they kind of no longer have a framework. It's sort of like people are wondering what really are the levers that are going to move the Fed whereas in the past they were a little bit clearer about what variables they were looking at. I think there's a little bit of a vacuum right now and investors understanding what exactly are the parameters that the Fed is going to look at.

So I think that rates aren't going to rise on the fed funds level this year. And they were talking about it today in I think a little bit of retroactive damage control based upon the uncertainties that came up in that press conference.

Consuelo Mack: And, Jeffrey, I've got one more question for you on this, on the Fed, before we bring Jim into this. And that is you just mentioned, I mean, there's been a continuous stream of messaging from Fed officials that a rate hike was possible and it's desirable this year.

So what is the harm of a 25-basis point rate hike? I mean, even an eighth of a point as your friend Larry Kudlow is suggesting kind of as a gesture that hey, things in the US are okay and we're in a sustainable recovery. What would be wrong with just a small move?

Jeffrey Gundlach: Well, I think what stayed the Fed's hand is the global conditions are not that good

So the deterioration in financial conditions, which you can see, there's a Bloomberg financial conditions index, which is actually at zero and was even in negative territory at the lows of equities in August. And there's a Goldman Sachs index where they measure it a little bit differently. And that one's even weaker. So it's the financial conditions I think have already tightened a little bit with equity prices falling.

And the other thing is I think it's a big deal when the Fed starts raising rates. I know a lot of people think it's no big deal and some people even say that if they raise rates 25 basis points and somehow make very dovish language going forward that it will create certainty in the minds of investors.

And I think that's not right. I think that if the Fed were to have raised rates a quarter point last Thursday, I think by tomorrow or even today, we'd be talking about the next Fed rate hike. My experience is that invariably when the Fed moves rates once, the market starts to
really look carefully at data. And if the data stayed strong, they might start pricing in yet another hike. And if the data got weak, they'd be talking about the Fed made a policy mistake.

So I just think that if the Fed raised rates, it really might be the exclamation point on what seems to be already a bottom on interest rates in the United States. The two-year treasury bottomed in 2011. The three, five, ten-year treasury rates bottomed in July of 2012. The long bond rates bottomed at the end of January of this year. Junk bond yields bottomed in June of 2014.15 And if you raise the fed funds rate, it's kind of like gee, we really are in a rising rate environment with an exclamation point. And I think markets always get a little bit of indigestion when they realize that a rate cycle has turned.

So all of these reasons, I kind of argue it the other way. A lot of people say what's a quarter point? I say well, if zero and 25 is the same thing, then just leave it at zero. Other people say the same thing, so put it to 25, but I think there is a psychological impact on the Fed moving rates and I'm glad they didn't do it.

**Consuelo Mack:** Yes. So, Jim, until recently most of the investment community has been expecting and they've been preparing for kind of ad nauseum for like the last three years for a rising rate environment in the US. What are you hearing from clients now?

**Jim Ross:** What we're hearing from clients now honestly is a couple of different things, one, a lot of questions about how their portfolio should be positioned in the near term. We are advocating that they continue to look for balance and diversified exposures in today's market. And I don't think anything changed since the Fed's decision that would change that.

We do look at this as if we continue to look at what's out there, really sort of how you position your portfolio and how you're making sure you're leveraging both the best you can, especially in the fixed income market from a passive perspective, but also leveraging active management where it's available and where it's appropriate.

So we see a lot of different things happening from a client perspective. And one of the questions here is pertaining to the flow pattern since the Fed, but we haven't seen anything dramatic there. But we continue to look at that. And those patterns sometimes don't -- and in the ETF space take a couple of days to form because there's timing of trading and things like that. But we continue to try and evaluate what we see going on in the marketplace and how clients should be best positioned.

**Consuelo Mack:** So are you two seeing any reaction at all in the total ETF? And I guess, Jeffrey, both from a -- well, and Jim, from a flow perspective and/or as far as how the portfolio is being affected, Jeffrey. That would be the question for you.

**Jeffrey Gundlach:** Yes, we haven't really made changes much in the portfolio.

**[Key Information slide]**

We've taken risk down a little bit since we launched TOTL back in February. We've taken a little bit of the risk, the credit risk out of the portfolio.16 But the environment that's been transpiring is one that we've been expecting.

**[Growth in Assets slide]**

15 Source: Bloomberg, September 2015
16 Source: DoubleLine, September 2015, based on asset allocation of TOTL.
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Our viewpoint at DoubleLine for the year 2015 is for choppiness in the fixed income market without any real net change in yields.

So we've had a lot of choppiness. The ten-year treasury was as low as 164 back at the end of January. The ten-year treasury got to 250 back in June. And when the ten-year treasury goes above 225 in the context of this range-bound concept that we've believed in for this year, we tend to buy a little bit and take a little bit more interest rate risk. And then when the yield goes down below 2% or towards 2%, we tend to sort of not commit money as aggressively.

But TOTL is a balanced portfolio, which follows on from our longstanding total return strategy. And the beauty of it is that it's a balanced portfolio in terms of its credit risk with a lot of assets relative to most fixed income strategies in very high credit quality and in treasury bonds, in government-guaranteed mortgage-backed securities, in very high quality corporate bonds. And it allows us to take with more confidence other types of risk like emerging market risk or high yield risk because we do have such a large part of the portfolio that's so highly liquid and benefits from flight to quality.

So one of the things you'll notice with TOTL even though we own emerging market debt and we own high yield debt, which have not been very strong since June, the portfolio hasn't suffered very much because we have had declining interest rates causing gains on that big bulk of the portfolio.

But we run the portfolio in this environment a little bit cautiously. We don't take a lot of interest rate risk. We compare ourselves to the category of intermediate-term bonds, which are represented by the Barclay's Aggregate Bond Index. And that index has interest rate risk. It's called duration, which is the measure of interest rates risk of about 5.5. And we're running more like 3.75. So we have quite a bit less interest rate risk because while we don't think we're on an imminent rate rise, we also aren't looking for a trending market to lower interest rates.

So if we can have a premium yield, which we do, versus an index fund or passive management or many other active funds in the category, if we can have that premium yield with lower interest rate risk, it's kind of like I facetiously call it the Miller Lite beer of fixed income investing, tastes great, less filling. You've got tastes great means the yield is a premium and less filling, less interest rate risk. And we've been pretty consistent in how we've been managing the portfolio so far with small, short-term changes with interest rate risk and a little less credit risk now than we had back in June.

Consuelo Mack: So the Fed decision, which, again, kind of the rest of the investment community is coming around to the fact that they weren't going to hike, and now everybody seems to be a little bit more dovish. But there has been so much focus on this decision. Were you surprised by the market's reaction? Or did anything surprise you at all? Maybe the lack of reaction after the first day or two?

Jeffrey Gundlach: I'd say the biggest surprise has been the strength in the dollar since then. The dollar was pretty high going into the Fed decision. But they didn't raise interest rates and yet the dollar is actually higher than it was before the Fed move. So maybe that has

17 Source: Bloomberg, September 2015
18 Approximately two-thirds of the portfolio is rated investment-grade and is interest rate sensitive. Source: DoubleLine, September 2015
19 Generally the lower the durations, the lower interest rate risk. Source: spdrs.com, September 2015
20 Source: Bloomberg US Dollar Index, September 2015
to do with some of the noise coming out of Europe and talking about greater stimulus there and so on. But it is interesting that the dollar is actually stronger versus the euro and other major currencies than it was before the Fed decision.\(^\text{21}\)

And the other thing that I don't find surprising, but I think many investors would appreciate a comment on is just how little long-term interest rates in the United States changed based on the Fed decision.\(^\text{22}\) Most people think that if the Fed were to hike rates, long bonds, long maturity government bonds would do terribly and if they would not hike that would make a big rally to lower interest rates on the 30-year treasury, but that really hasn't been the case for a long time. And, in fact, I think the rate is down by about 5 basis points on the 30-year treasury since before the Fed announcement.\(^\text{23}\) And that's not very much.

And the reason I think is that the long-term treasury market kind of counterintuitively for many investors actually wants the Fed to raise interest rates because if the Fed were to raise interest rates against some of these market indicators that I talked about earlier, maybe it would cause more dis-inflation and maybe it would cause a weaker economy, at least over time. And that's exactly what you want. If you are a cynical person that owns 30-year treasury bonds, you want low inflation. You want negative inflation actually if you’re taking down 3% yielding 30-year treasury bonds.

So I think one of the fallouts of this Fed decision is we may actually see 30-year treasury yields edge higher with the Fed not raising interest rates. That's counterintuitive for a lot of people. And it's interesting that short-term interest rates also have, I mean, they're down about 10 basis points on two-year treasuries.\(^\text{24}\) And I think that the Fed not hiking will keep a lid on the two-year treasury yield of about 70 basis points, 75 basis points or so.

But if, indeed, the Fed finally raises interest rates in December or in the first quarter of 2016, one thing that I believe quite strongly is that you would see the yield curve flatten. You would see long-term interest rates shock people and not move higher if the Fed hiked and you would see almost for sure short-term interest rates, which are so sensitive to fed funds and what the Fed does, they would go higher. And you'd start to see a yield curve get even flatter than it is now at very low interest rates relative to most of our professional experience.

So I think that long-term interest rates are more likely to go up in the weeks ahead thanks to the Fed not raising rates.

**Consuelo Mack:** But we were talking a little bit about liquidity. And, Jim, I want to ask you, I mean, bond market liquidity volatility is a major concern of clients. How big a concern is it? And did you see any indication of stress in the ETF market around this Fed decision?

**Jim Ross:** So the short answer is we saw no indication of stress around the Fed decision. We continue to monitor and it continues to be a front page story about the potential for bond illiquidity.

I think we saw that in the Wall Street Journal today. We look at this and we have a history of ten-plus years of fixed income ETFs today. They have shown strong resiliency through many market cycles since their launch over a decade ago. But, once again, they are part of
the overall fixed income ecosystem. And the question really is not an ETF question. Really the question is about the bond liquidity. And liquidity in the bond market and some of the structural shifts we've seen in that coming out of the crisis, we do believe that fixed income ETFs will continue to represent and present a way for investors to explore and express a view on fixed income, but from the overall market perspective, how that will play out during a time of rising rates.

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or we have seen a couple of things from Bernanke a few years ago straight through where you've seen some interesting short-term trading challenges, but long term we have not seen any structural challenges.

And I think that the view from how we see this from a fixed income ETF perspective is really it's the question around the broad market. But when we look back at how fixed income ETFs have come through different market cycles, including 2008 when, frankly, you could express a view in fixed income ETFs and, frankly, the underlying was virtually frozen at the time. We're talking short-term corporate. We're not talking structured high yield and things like that. So I think what we've seen historically is the ETF has been able to as a structure work effectively in times when there has been challenges in liquidity in the underlying. So I think that's the best way I would answer that for investors.

Consuelo Mack: And, of course, there was a flash crash in equity ETFs this year, but you're not concerned about that in the fixed income ETF?

Jim Ross: I want to just hit on that very quickly. What we saw on August 24 is very unique and open for a variety of different reasons that I don't want to get into on here, but we do have plenty of information available on that.

The most interesting thing on August 24 is the fixed income ETFs were trading effectively and efficiently during the same time when the equity ETFs seemed to dislocate, which is completely opposite of what anyone in this world has been talking about for the last three years with regard to fixed income liquidity.

So we'll just go back to one best practices there as we have a bunch of investors on the phone. We are an adamant believer that if you are going to trade any ETF, we really strongly, strongly recommend the use of limit orders. And if you're going to put a stop loss out there, put a limit order below that. We do think one of the challenges on August 24 was folks had market orders in the system for the market opening on August 24. And we always recommend you don't trade around the open if you don't have to, especially as price discovery that in equities was really a challenge, which led to a knock-down effect to the ETFs.

Consuelo Mack: Jeffery, any thoughts? I mean, how concerned are you about bond market liquidity, especially considering that, again, we've got a couple of more meetings this year coming up and there is going to be a lot of focus on them and who knows what positions people are going to be taking. There's a lot of uncertainty. How concerned are you about bond market volatility and is there any difference in your mutual funds, for instance, versus the ETFs?

25 Source: Bloomberg, September 2015
Jeffrey Gundlach: Just to take the second part of that first, I totally agree with Jim. There’s nothing specifically about ETFs that makes them any different in my experience versus other portfolios like mutual funds. It’s really a question of if you’re worried about bond market liquidity, it’s going to hit all bond portfolios and all deliverables in a similar way I think.

But I’m not that worried about bond market liquidity. I certainly get a lot of questions about it. I don't think I've given a talk this year or even in the last two years where that wasn’t one of the first questions that was brought up in the Q&A session.

But one of the things that I like to stress is that at DoubleLine in our TOTL strategy and all of our bond market strategies, frankly, we are quite low in terms of turnover. I’ve even been criticized by investors for not turning the portfolio over enough, as if somehow turning over automatically guarantees better results.²⁶

I think it’s, frankly, it’s rather the opposite. We usually invest with a three-year horizon, two years at a minimum when we think about valuation and how we want to sector position. And our turnover is about one-tenth of what the category averages are for bond mutual funds and ETFs.²⁷

And so we don’t have a great need for day-to-day high liquidity. We don’t cherish it the way that a lot of other investors that run very high turnover strategies might cherish it. We only run rather minimal turnover anyway. We re-sculpt portfolios using cash flows, which are pretty significant in fixed income portfolios with maturities and principal coming back, particularly when you’re buying mortgage-related securities in a significant way, which we do in TOTL because it does have about a 50% weighting in government-guaranteed mortgage-backed securities, and they pay monthly and they pay back principal every month and interest. But under most conditions we can re-sculpt just on the cash flows of the portfolio.

But we also hold cash. Our strategy for TOTL and for our Total Return mutual fund is holding about 10% cash on policy right now simply because we don't really see the value of owning very short-maturity bonds. They yield almost zero anyway. I would rather own cash just in case we do have need for investing in other sectors because of great opportunities that might arise.

This has nothing to do with bonds specifically. When there's great opportunities in any market, it's due to some lack of liquidity. The prices are down because of a fearful market. And so we want to have cash should a fearful market show up.

[Where to Learn More slide]

And we also want to be able to offer liquidity, redemptions and so on, should they occur to investors.

So we aren't very worried about bond market liquidity, but we should probably always at DoubleLine be less worried about liquidity than most investment management firms that handle fixed income because our style is one that is very low turnover.

Consuelo Mack: And you mentioned the 50% weighting in mortgage securities in the TOTL portfolio. And one of the things that you were quoted in saying that at DoubleLine that

²⁶ Source: DoubleLine
²⁷ Source: Morningstar, September 2015
you’d never create a fund that would compete with another fund, so clearly the TOTL bond return mutual fund is different from TOTL ETF. Do you want to just quickly give us a brief update on the major strategy, core strategy in each and how they differ?

Jeffrey Gundlach: Yes, there's a couple of significant similarities and there's a significant difference between TOTL, the ETF, and our Total Return mutual fund. The biggest similarity is the balance of risk and in credit versus government credit and also in interest rate risk.

Both my DBLTX mutual fund, the Total Return fund, and TOTL, T-O-T-L, the ETF, they have exactly the same duration, which is going to be the interest rate risk. They're both at 3.75. So their sensitivity to interest rate movements is identical based upon that statistic.

Also both funds have a very high weighting in safety, which is government bonds, be they treasury bonds or Ginnie Mae’s, Freddie Mac’s and Fannie Mae’s in the mortgage space and also very high quality either securitized assets in the mutual fund, and I mean by that AAA-rated, really high quality securities or else AAA-rated or very high quality corporate bonds in the case of TOTL.

Now what's different is when it comes to the true credit risk that we take in the portfolios - and the quantum of credit risk is about the same, they're quite similar, it's around a third to 40% of the portfolio in both the mutual fund and the ETF -- is in credit risk. And what I mean by credit risk, there are things like bank loans, high yield corporate bonds, below investment-grade emerging market bonds. So these are things that truly do have honest-to-goodness credit risk and might suffer when there’s a flight to safety and fear.

But the way in which the actual securities and sectors that we're using, this is the big difference between the mutual fund and the ETF -- the mutual fund is in all securitized credit. And almost all of that is mortgage-backed securities. So the credit risk that we're taking at about a third of the portfolio

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in the mutual fund is basically all mortgage-backed securities.

In the case of TOTL, that credit exposure is diversified. So we have some emerging market debt from time to time, high yield bonds from time to time, bank loans, perhaps non-US bonds, though we don’t own any right now in the developed world. So it's more diversified. And in that way, it's really more of a diversified solution.

So the ETF takes some of the attributes that investors have found attractive from the mutual fund, namely the lower interest rate risk, and the balance of the portfolio having so much in very safe bonds relative to many other offerings in fixed income, those themes are used in the ETF, but the credit exposure is more diversified.

And we've actually started implementing this coincidentally for institutional investors who come to us without us reaching out to them, them coming in to us asking for precisely this construct of TOTL interestingly. I've had institutional investors call up DoubleLine and say we love your Total Return Bond Fund, but we just kind of think that a more diversified solution is better. We went to business school and we learned in finance about diversification benefits. I would just feel better if the credit was not just mortgage credit and diversified.

And just coincidentally we have investors coming to us internationally really for this same type of solution that TOTL ended up hitting on in a way of differentiating itself from our
mutual fund, but while retaining some key attractive components that investors have found helpful over the years.

**Consuelo Mack:** We’ve got some questions coming in from the field. And speaking of is it time for more bank loan and floating rate notes in a portfolio? That's one of the questions.

**Jeffrey Gundlach:** Probably. We like bank loans a little bit more than standard high yield bonds right now, particularly because if you’re trying to run lower interest rate exposure like we are in TOTL and we are in most of our portfolios, we’re running without a great deal of interest rate exposure, one way to get there is to have floating rate securities as opposed to fixed rate securities. And even if you're like me and don't think that interest rates are really going to rise that much this year and that the Fed won't even move this year, I do think that as you think forward two or three years, which is our horizon typically in these portfolios, probably you're going to see rising interest rates and therefore there’s a good reason to have lower duration than a bond passive portfolio. And to get there, floating rate securities obviously with their zero interest rate risk, they're a useful tool.

Having said that, we aren’t in any hurry to make that switch. We’re doing it deliberately and gradually. And right now in our world, the market seems to be a little bit on its heels regarding credit risk. Junk bonds are doing quite badly. Emerging markets have been shaky. Even investment-grade corporate bonds have done fairly poorly this year. In a year with positive treasury returns, investment-grade corporate bonds are negative.28

So there’s some cracks a little bit showing in the market signals of credit. And for that reason, we’re not really gung ho about credit risk, junk bonds, bank loans included. But I think systematically adding bank loans to the portfolios in a methodical way makes sense looking forward a couple of years.

**Consuelo Mack:** So junk bonds, another question is that you mentioned on CNBC that if the Fed didn’t raise rates in September, which they didn’t, that you’d be buying high yield bonds. What if they raise in October and December and were you accurately quoted?

**Jeffrey Gundlach:** Yes. Well, I basically thought that if you were a short-term trader, which DoubleLine is not, so this is really meant for media consumption, if the Fed doesn’t raise interest rates, that's a good thing for junk bonds. Junk bonds were kind of struggling underneath the fear that the Fed was going to hike because when the Fed does hike, contrary to conventional wisdom, when the Fed hikes rates, you do not want to own junk bonds.

I did a study that I went back since the inception date of the junk bond market. And if you had a one-decision rule method of trading that you just traded off the Fed and you either owned treasury bonds or junk bonds, you had to toggle back and forth between treasuries and junk, one of the best signals to buy treasuries, to sell junk bonds and buy treasuries, is the day the Fed hikes execute that trade. The day the Fed hikes, if you sell junk bonds and buy treasuries without exception, you have been able to reverse that trade at a substantial profit every single time the Fed has raised rates.29

28 Source: Bloomberg, September 2015
29 Summer Insects, DoubleLine webcast, June 2015
Now it doesn't happen necessarily immediately. Sometimes it takes a while. But the theme of the trade has worked 100% of the time. So hiking rates is not good for junk bonds.  

Jim Ross: Jeff, the question I would ask, then, were you prepared to do that?  

Jeffrey Gundlach: Yes. Yes, if the Fed had hiked, I would have sold junk bonds for sure. I was quite certain the Fed wasn't going to hike, though. And it's not that I have some crystal ball necessarily. It's just that the bond market odds of the Fed hiking can be looked up on Bloomberg. If you type in the letters F-E-D for Fed, this thing comes up, it starts with a W. I haven't got it memorized because I just click on it, but it's WIRP or something like this. And it gives the probabilities based on the shape of the front end of the US treasury yield curve what are the odds based upon market pricing that the Fed will raise rates. And those odds were only at 30% on Thursday.

So the bond market did not think the Fed was going to hike and I didn't either. But if they had, I think the junk bond market could've gone into a tailspin because it was already on its heels. It stabilized. It hasn't rallied. Junk bonds are basically where they were.

Again, you've mentioned things that surprised me. I should throw this one in. I think junk bonds should've done a little bit better. I'm a little bit disappointed that junk bonds didn't do better with the Fed not raising rates. But maybe, again, the bond market really did think that the Fed wasn't going to raise rates, so it wasn't a surprise. So maybe the lack of real fireworks is consistent with the idea that the bond market really was of the mind that the Fed wasn't going to hike.

Consuelo Mack: I think we've got time for a couple more questions. And we've gone over our time because there's so much to talk about.

But one of the questions is you clearly think that the Fed should not raise rates this year, but it seems like a lot of the questions that we have, they are still preparing for significant or at least a rise in rates this year. Do you have a fallback position? I mean, should we be preparing for a rate hike? And if so, what should we be doing?

Jeffrey Gundlach: Well, I think there's about a 50/50 chance given from that same pricing mechanism I spoke to that was 30% last week. It's about a 50/50 shot now for December. So it's certainly possible that the Fed would raise rates.

I believe if you think the Fed is going to raise rates in December, I know this is counterintuitive, but it's consistent with what I said earlier. You should actually be taking more interest rate risk.

I know that most people don't agree with that, but if we had an hour, I could take you through the logic that's been shown ever since 2013. When there's greater confidence that the Fed is going to hike, long-term bond yields fall. The 30-year Treasury bond yield fell all the way through 2014 consistently. And through that year, last year, 2014, consistently...
throughout the year, the belief that the Fed was going to hike in 2015 increased in confidence nonstop. And yet bond yields fell. And then when the Fed blinked on the dollar back on March 18 and it became less likely that they were going to hike in 2015, that's when bond yields started to rise.

Again, I try to get reporters, I tape, you know, if you're having trouble understanding the bond market repeat after me. The long bond wants the Fed to tighten. So ironically, if the Fed is going to tighten, your best investment I think, believe it or not, in fixed income is long-term government bonds.

Consuelo Mack: And to come back to the TOTL

[Standard Performance slide]

and the Total Return Bond Fund and I'm going to look at Jim here across the table and that is the role of each, Jim, from your perspective, how does the ETF role differ in a portfolio from Jeffrey's mutual fund?

Jim Ross: I think Jeffrey did a great job of explaining the differences in the portfolio construction. We look at when you think about ETFs and most folks on this line will probably think about ETFs and think about passive. We believe in the places where passive makes the most sense and obviously a majority of our assets are there, but we believe in core fixed income in particular that taking an active approach and getting away from the predominante benchmark of fixed income is the old Lehman, the Barclay's Agg. And it has over the number of years increased its exposure to a much more concentrated position in treasuries.

And we just think that when you see that and kind of getting back to any time we see volatile markets and people asking what the reason is, first of all, confirm your asset allocation and risk tolerance and align. Step one, pretty straightforward, focus on your risk-adjusted return and diversification and understand your exposures.

And what we see investors struggling with over the years is they'll think they're aligned, they'll think they understand their exposures and don't realize the risk that they have in certain types of whether it can be ETFs or mutual funds or different positions they have that can overlap with others and really try and make sure that you're making active decisions where active pays off. And the history is that the core fixed income space, the corporate space, active fixed income, has historically paid off and just going to the passive benchmark.

Jeffrey and I can debate that in other spaces. We haven't seen a similar trend in high yield fixed income. But once, again, I think it's really about understanding your exposures, your risk tolerance, and making sure your portfolio is positioned with products that can get you there without taking on undue risk.

Jeffrey Gundlach: Well, I completely, completely agree that investors often make the mistake of not understanding how their pieces of their portfolios fit together. There's often much more overlap than they think. And knowing what you own is the absolute starting point. It's required for there to be long-term investment success. That's the message I drill into the heads of the young people when they start learning the trade at DoubleLine. You've got to know what your true risks are.

And in fixed income, a lot of people, they've gravitated to high yield sector-only funds or to international bond funds, which are tons of risky assets. And they don't realize that they
have no offset to that in their fixed income portfolio. You buy the XYZ high yield bond fund or the ABC international income fund. And when there’s a flight to safety like there was in August, you’re going to be surprised how badly you do in those funds. I pity the investors in the ABC international income fund who were afraid to get their equity statements at the end of August and then got all happy when they saw that their ABC international income fund fixed income statement showed up. And I bet you they were horrified when they found out that they lost more money in that than they did in some of their stock portfolios.

You’ve got to understand what your risks are. That's why at DoubleLine in our TOTL ETF strategy and in the Total Return strategy, that’s why we have this balance of assets where we have assets that will do well when there’s a flight to quality. We didn’t have a problem in the TOTL ETF. When the markets fell off a cliff, some of our positions did badly. But we have offsetting positions that truly have a balanced risk exposure.

So that’s true on a one-stop shopping solution in fixed income, which I think TOTL is really a good example of. It’s diversified, but it has this balance with flight-to-quality assets and yet still a premium yield.

Our mutual fund, I think the reason that these institutions have come to us looking for something like TOTL is they say I don't just want something that's nothing but mortgage-backed securities. I can understand that if you’re going to own one fixed income portfolio, you probably want to be more diversified along the lines of the TOTL ETF.

[Disclaimer slide]

Consuelo Mack: Okay, we’ll leave it there, Jeffrey Gundlach, thanks very much for joining us from DoubleLine. We appreciate it. And Jim Ross from SSGA, thanks for joining us.

Jim Ross: Thanks Jeffrey.

Consuelo Mack: Also, audience, thanks for your questions. We also want to tell you that this webcast will be replayed.

[Disclaimer (continued) slide]

You’ll get announcements of when it will be replayed sometime within the week. And thank you so much for joining us.

If you'd like more information about TOTL ETF as well, it is in your resources folder on your screen. So have a great rest of the day. Thanks for joining us.

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The speakers reference Federal Reserve Chair Yellen’s September 17, 2015 Press Conference throughout the discussion. The transcript can be found: http://www.federalreserve.gov/medialcenter/files/fomcpresconf20150917.pdf.

Definitions

**Barclays U.S. Aggregate Bond Index**
A benchmark that provides a measure of the performance of the US dollar denominated investment grade bond market, which includes investment grade government bonds, investment grade corporate bonds, mortgage pass-through securities, commercial mortgage backed securities and asset backed securities that are publicly for sale in the US.

**Quality Breakdown**
Barclays uses the “middle rating” of Moody’s, S&P, and Fitch to determine a security's index classification. If only two of the agencies rate a security, then the most conservative (lowest) rating will be used. If only one rating agency rates a security, then that rating will be used. Where there are no security level ratings, an issuer rating may be used to determine index classification. Barclays Index breakdowns are grouped into larger categories. For example, AAA and AAA are listed as Aaa; AA1, AA2, and AA3 are listed as Aa, etc.

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Source: DoubleLine, September 2015
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Diversification does not assure a profit or protect against a loss in a declining market.

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Investing in high yield fixed income securities, otherwise known as “junk bonds”, is considered speculative and involves greater risk of loss of principal and interest than investing in investment grade fixed income securities. These Lower-quality debt securities involve greater risk of default or price changes due to potential changes in the credit quality of the issuer.

Increase in real interest rates can cause the price of inflation-protected debt securities to decrease. Interest payments on inflation-protected debt securities can be unpredictable.

Investments in asset backed and mortgage backed securities are subject to prepayment risk which can limit the potential for gain during a declining interest rate environment and increases the potential for loss in a rising interest rate environment.

Government bonds and corporate bonds generally have more moderate short-term price fluctuations than stocks, but provide lower potential long-term returns.

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The Road Ahead: What’s Next for Fixed Income

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