

Westcore: Higher Rates Still a Year Away

Just because rates seemingly cannot go much lower does not mean they have to go up soon, say Westcore's Mark McKissick and Lisa Snyder.

Fund Manager Q & A | 12-09-11 | By Liana Madura

Mark McKissick and Lisa Snyder, comanagers of Westcore Plus Bond (WTIBX), recently answered our questions on the current happenings in the investment-grade corporate bond and high-yield markets and discussed how they balance those two investments in their portfolio. They find attractiveness in the high-yield market and don't foresee a significant risk of higher rates in the near future.

1. Why have you reduced your exposure to corporate bonds during the last year?

When you combine investment-grade corporate bonds and high-yield corporate bonds, we have actually increased our exposure to corporate bonds. We just changed the mix to include more high-yield. We focus on the higher-rated categories of the high-yield market, BB and sometimes B rated bonds. The overall financial health exhibited by selected corporate issuers, both being investment-grade and high-yield, led us to believe that offered yields would generate ample income and would be well-supported by capital flows into fixed income. In our opinion, corporate bonds appear to provide a better risk/return opportunity today than Treasuries and mortgage-backed securities.

2. Do you think the risk/reward trade-off is more attractive in the high-yield or investment-grade areas of the corporate bond market?

Given the low-return, low-yield environment that the market presents, we think that the higher-rated categories of high-yield-rated BB and B are attractive. If you look at the long-term default histories of the different high-yield rating categories, managing credit risk in BB rated bonds looks very manageable to us. Doing so in CCC rated bonds appears challenging and makes it a sector more suited for strategies based upon trading in and out of securities. All that said, we do see value in investment-grade corporate bonds, and they are the largest sector weighting in the fund.

3. Where are you looking for yield in today's market?

For the most part, we are looking at corporate bonds, both investment-grade and high-yield. Again, our focus in high-yield is on the

highest-rated category, BB rated bonds. Because liquidity is at a premium these days, we are also opportunistically finding value in corporate and asset-backed bonds we think are very solid but maybe are a little atypical or "off-the-run." For example, there are some higher-coupon, higher-dollar-price bonds of very high-quality issuers that offer material incremental yield over bonds trading closer to par of the same issuer.

Similarly, less-well-covered sectors of the asset-backed market, such as those supported by billboard advertising revenue, offer additional yield over more traditional asset-backed sectors like auto loans and credit cards. Because we have an investment-oriented, long-term view, we are comfortable owning some of these slightly less-liquid, but still-high-quality, securities to benefit from the extra yield they offer.

4. Are you worried about rising rates? Have you made any changes in your portfolio to protect the fund in a rising-rate environment?

We think that the risk of significantly higher interest rates is still a year or more away, so we have not yet made changes to the portfolio. However when we do feel the risk of higher rates is more imminent, we can decrease the interest-rate exposure in the fund and adjust the maturity mix held in the portfolio if we anticipate that short interest rates will rise more than long interest rates. Also, we might be able to buy quality securities whose return is positively linked to inflation or whose coupon changes as short-term interest rates change. Our weighting of corporate bonds might provide some cushion against rising rates as their yield spreads over Treasuries might narrow as rates rise.

5. Can the Treasury bull run continue or have rates fallen as low as they can go?

Just because it appears that rates cannot go much lower, that does not mean they have to go up soon. The money that has been printed in the various stimulus measures since 2007 still amounts to much less than the asset value lost in the Great Recession. The Federal Reserve

has indicated it will anchor short rates at zero until the middle of 2013. Japanese interest rates are meaningfully lower than U.S. rates, and U.K., Canadian, and German rates don't make U.S. rates look particularly low.

We believe that consumers still must deleverage further before significant economic growth can take hold. The housing market is still suffering, the Fed is on hold at "lower rates for longer," and the U.S. dollar is still perceived to be the safe haven amid European fiscal woes and questionable structural underpinnings of the Chinese economy. Practically speaking, almost the entire developed Western world is in need of debt and deficit reduction.

Liana Madura is an assistant site editor with Morningstar.com.

Important Disclosure Information

The Westcore Plus Bond Fund is subject to additional risk in that it may invest in high-yield/high-risk bonds and may be subject to greater levels of liquidity risk. Additionally, investing in bonds entails interest rate risk and credit risk.

Credit quality ratings are by Standard & Poor's and are measured on a scale from AAA (highest) to D (lowest).

An investor should consider investment objectives, risks, charges and expenses of the Fund(s) carefully before investing. To obtain a prospectus, which contains this and other important information about the Fund(s), please call 800.392.CORE (2673) or visit www.westcore.com. Please read the prospectus carefully before investing.

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