More Effectively Communicating Negative Returns to Stakeholders

Q&A | January 2023

Recent market volatility has caused most fixed-income investors to experience significant unrealized losses. To better understand what this means and how to effectively communicate these types of "paper losses" to stakeholders, we conducted the following Q&A session with PFM Asset Management's (PFMAM) Sarah Meacham and Monique Spyke.

Sarah and Monique are managing directors co-leading the firm's California practice which manages discretionary fixed-income assets across portfolios comprising operating and bond-proceeds-related funds. Sarah also serves as the Program Administrator for the California local government investment pool for which PFMAM serves as Investment Adviser/Administrator.

What is an "unrealized loss,"and what caused recent unrealized losses?

Meacham: Unrealized gains or losses are the difference between the current market value of an investment and it's carrying value on the books, usually measured by amortized cost (or under some accounting treatments, original purchase cost). For fixed-income securities, the current market value is determined by current market conditions, such as interest rates and yield spreads.

The recent surge in unrealized losses occurred primarily because interest rates rose sharply in 2022, noting that fixed-income security prices and therefore market values move inversely to interest rates. In addition to rising rates, yield spreads on securities like corporates and mortgage-backed securities also increased, further reducing market values. Although market values always fluctuate with interest rates, unrealized losses were particularly large in 2022 because the Federal Reserve (Fed) raised rates at a historic pace. Unrealized losses (and gains when they exist) are also typically greater for longer maturity investments as the market value impact of changing interest rates is a function of the duration of the investment.

How should agencies be thinking about "unrealized losses"?

Spyke: Unrealized losses reflect market values at a point in time and will vary day-to-day. However, losses are only monetized, or "realized," when a security is sold. If fixed-income investments are held to maturity, unrealized losses dissipate and the full principal is returned at maturity. So, while unrealized losses reflect the value of each asset if it were sold at today's prices, outside of a permanent impairment, unrealized losses could be thought of as temporary, if the intent is to hold to maturity.

Over a full economic or interest rate cycle, portfolios will naturally swing from having unrealized gains to unrealized losses and back again, simply as a function of interest rate movements and other market changes. For this reason, we recommend taking a longer-term, holistic view of any investment strategy. Establishing and adhering to your long-term investment strategy is vital to maintaining expected performance over full market cycles, particularly during periods of market volatility.

What about negative returns?

Spyke: The industry standard method of measuring portfolio performance is using "total return," which includes both interest income and changes in market value. When portfolios have unrealized losses, total returns will be lower. When losses are very large, as they became in 2022, returns can be negative, meaning market value losses exceeded interest income for the period. In a rising rate environment, losses, and therefore negative returns, can be difficult or impossible to avoid, especially over a short time period such as a single quarter. While uncommon, negative returns for a full calendar year have occurred in the past, even for short/intermediate mandates, like 1-3 year or 1-5 year strategies. However, 2022's negative returns were far greater than the market has ever experienced before.

Since interest rates move in cycles, history tells us that periods of low or negative returns are frequently followed by periods of higher-than-normal returns. At today's market yields, income is likely to be a much stronger contributor to overall return going forward. This is also a good reminder that it's important to establish a well-defined and broadly accepted investment strategy that stakeholders will be comfortable with at all points throughout an interest rate cycle.

Finally, proper benchmarking is crucial as well. Using a market-based index that reflects the investment strategy can inform, over time, if a portfolio is dramatically under- or outperforming the market. If performance is generally in-line with the market index, that should provide a certain level of comfort. But, because market conditions can change over a short period of time, we suggest placing greater importance on performance against a benchmark over a multi-year period.

There can be different types of governing bodies and stakeholders depending on the type of public agency. What are some of the ways one might tailor communications to best inform each party?

Spyke: For most stakeholders, the most important question to answer is "are my investments safe?" As we noted earlier, market values and the resulting unrealized gains or losses are a measure of value at a point in time and will dissipate if investments are held to maturity. They are not a good measure of the safety of an investment or the portfolio. Other measures, such as credit quality, liquidity, and consistency to the strategy may be better measures of safety.

For all stakeholders, it's important to understand three key things: First, the overall investment strategy, including the stated investment objectives and how they are aligned with the organization's mission and financial goals, the desired maturity range, the types of permitted investments that can be used, and any benchmark or index used to gauge performance. Second, the current economic and investment landscape – what is moving the markets and why. And third, the current state of the portfolio and how it is aligned with the organization's investment goals and objectives. This could include a discussion of the amount and source of any unrealized gains or losses.

How this information is communicated will depend upon the audience. The level of detail may be different, but each stakeholder would be well-served by understanding these three important areas.

Volatile conditions in the markets can naturally raise concerns. Describe ways a manager might temper a stakeholder's emotions or otherwise help them to better navigate a tumultuous period.

Meacham: I would suggest that substantial emphasis be placed on educating stakeholders about the root causes of the volatility or losses, as well as the ways the issue may be resolved over time. For example, an unexpected surge in inflation triggered the Fed to initiate a series of aggressive rate hikes in 2022, causing rates across the yield curve to surge, leading to unrealized losses on most bond investments. The goal of the Fed is to slow down the economy and bring supply and demand back into equilibrium to fight inflation, but their actions have had significant consequences for the investment markets.

With much of the Fed's work behind them, the next phase of this cycle could see an economic slowdown or recession, and possibly lower yields at some point in the future. Should that occur, market values and returns should begin to improve. Obviously, every situation is different, but having a good grasp of the causes and likely outcomes can help your agency weather the storm and help them remain committed to the agency's longer-term investment plan and strategy.

For more detail-oriented stakeholders, one could demonstrate that under some circumstances, even selling at a loss may make sense, if the proceeds can be used to purchase a higher-yielding investment that can recoup that loss over time and garner additional income as well.

The initial yield and income component tends to be the biggest contributor to returns over the long-term. So, while rising interest rates and the resulting unrealized/realized losses and negative returns might be painful in the moment, it is a necessary part of the interest rate cycle going from zero or low interest rates to a level that is more consistent with historical norms.

Are there any other issues that should be conveyed or discussed with stakeholders during periods of elevated volatility?

Meacham: Emotions can play an outsized role during periods of significant market swings. It can be helpful to communicate and reinforce the major components of the organization's investment program. Supplementing that with information about internal controls that help prevent things like fraud can provide additional confidence to the stakeholder.

While this has nothing to do with volatility or losses in the capital markets per se, it may help the organization realize that their investment program was developed for a reason, has "good bones," and can weather the storm.

Spyke: Beyond internal controls, it is also paramount to revisit how and why the investment strategy and risk tolerance parameters were developed in the first place. Assuming nothing has changed in terms of goals or needs, and the only concerns are external or macro conditions like interest rates, it is important to reiterate to stakeholders that sticking to the previously-established strategy is essential. This is not to say that investment preferences can't change based on market opportunities, but that the discipline to follow the overarching strategy should remain. The investment manager should regularly ask probing questions to make certain that there aren't any changes in fundamental needs. At PFMAM, we generally do not advocate a change in strategy merely because we are in a different phase of the interest rate cycle.

That said, if there is indeed a change in the organization's needs, that is a different story. For example, a need for increased liquidity should be communicated as soon as possible so the portfolio strategy can be appropriately adjusted to the new requirements.

Ensure that major components of your entity's investment program are conveyed to managers/elected officials

- Investment policy goals and risk tolerances
- Overall investment strategy
- Internal controls

What to communicate

- Three key things: strategy, markets, current portfolio
- Long-term view of the strategy
- Details appropriate to the audience

Be prepared to educate

- Emerging market conditions
- Market value losses (unrealized/realized)
- Initial losses on sales of securities, but overall benefit

How should agencies be thinking about liquidity in a rising rate environment?

Meacham: Planning for liquidity needs is important in any environment, but especially so when rates are rising. If longer-term investments are used as a secondary source of liquidity (to pools or other liquid funds), sales to raise cash may result in un-recoupable, realized losses.

There is always a balancing act when it comes to holding cash. On one hand, having cash to meet day-to-day needs is a necessity. On the other, there is usually an opportunity cost to holding more cash or short-term funds than needed, given the higher yields typically available on longer-term investments. As most investment policies make clear, however, ensuring safety and having sufficient liquidity should always take precedence over seeking higher yields.

The bottom line is that frequent communication among staff, departments, stakeholders, and with an investment manager, if applicable, can help maintain the appropriate balance of liquidity and longer-term investments and keep your investment program on course to help achieve its objectives.

How does PFMAM keep its clients informed during volatile periods or market downturns?

Spyke: PFMAM does its utmost to be proactive and transparent. We maintain regular contact with clients and endeavor to keep in more frequent contact when the capital markets are volatile, like they were throughout 2022. We place emphasis on our formal quarterly portfolio reviews, but also reach out to clients on a frequent informal basis to discuss the markets, the investment strategy, or other matters of importance.

Meacham: To keep clients informed, we also distribute monthly market updates that delve into recent economic data and market movements. In addition, we distribute podcasts and Thought Leadership pieces that touch on timely topics of interest. Recent examples can be found on the PFMAM website in the Newsroom.

To learn more or discuss in greater detail, please contact us:

Monique Spyke
Managing Director
spykem@pfmam.com

Sarah Meacham
Managing Director
meachams@pfmam.com

PFM Asset Management LLC ("PFMAM") is an investment adviser registered with the U.S. Securities and Exchange Commission and a subsidiary of U.S. Bancorp Asset Management, Inc. ("USBAM"). USBAM is a subsidiary of U.S. Bank National Association ("U.S. Bank"). U.S. Bank is a separate entity and subsidiary of U.S. Bancorp. U.S. Bank is not responsible for and does not guarantee the products, services or performance of PFMAM.

NOT FDIC INSURED : NO BANK GUARANTEE : MAY LOSE VALUE