MONEY MANAGER INTERVIEW

Deploying a Catalyst-Driven and ESG Overlay in a Fixed Income Strategy

ADAM FALCON, PRINCETON ASSET MANAGEMENT, LLC

ADAM FALCON, CFA, co-founded Princeton Asset Management, LLC and is the firm's Chief Investment Officer. Mr. Falcon sets the firm's investment strategies and leads the firm's investment committee. Mr. Falcon oversees fixed income research, trade identification, allocation, portfolio construction and monitoring. From 2009 to 2015, Mr. Falcon was Executive Director and Chief Investment Strategist of The Cline Group, where he managed large fixed income portfolios for over six and a half years and developed the credit strategies. Prior to The Cline Group, Mr. Falcon managed fixed income portfolios for seven years at PNC Bank in Washington, D.C. Mr. Falcon is a graduate of the University of Chicago Booth School of Business, where he received his MBA with concentrations in finance and financial accounting. He received his B.A. from Bowdoin College, where he graduated summa cum laude and was a member of the Phi Beta Kappa honor society.

SECTOR — GENERAL INVESTING

(AHO507) TWST: Could you explain a little about the firm, how you got started and what its philosophy is?

Mr. Falcon: Princeton Asset Management was established in 2008 as a women-/minority-owned investment manager. The firm started with managing assets for friends and family accounts and gradually grew into the institutional space. We specialize in fixed income and credit investments.

I started my career with PNC Bank and moved into discretionary trading in a single-family office in the Palm Beach, Florida, area. My wife and firm Co-Founder, Rui Falcon, started her career at J.P. Morgan Securities' Debt Capital Markets performing credit analysis, underwriting, loan and bond issuance. She also gained an in-depth understanding of agency and mortgage-backed securities as a senior manager during her tenure at Fannie Mae.

Our investment team managed large fixed income and credit portfolios for a single-family office in Palm Beach, Florida. Currently, we are focusing on growing the firm and servicing Princeton's clients. Last year, we broadened our talent pool with the addition of new team members.

Highlights

Adam Falcon discusses Princeton Asset Management, LLC and the Princeton Core Fixed Income Strategy. This flagship strategy has high credit quality and low-to-moderate sensitivity to interest rates. Mr. Falcon begins his investment process by analyzing interest rate direction. This helps him adjust the portfolio's duration and position along the yield curve. He then segments the portfolio into non-spread and spread sectors. One unique element of Mr. Falcon's investment philosophy is the inclusion of an ESG and catalyst-driven overlay.

Companies discussed: Regions Financial Corp. (NYSE:RF).

TWST: Does the firm have a unique investment philosophy and investment process?

Mr. Falcon: Our firm's flagship strategy is called Princeton Core Fixed Income. If we think in terms of the Morningstar style box — would be high credit quality and low-to-moderate interest rate sensitivity. Our investment philosophy is unique in that it includes an overlay of catalyst-driven and ESG — environment, social and governance — factors in the spread sector of the Core Fixed Income Strategy.

With regard to our investment process, the first step is to understand and analyze central bank activity, interest rates and inflation direction. We review Federal Reserve action and market expectation on rates and examine G6 central bank activity throughout the world. We assess and ascertain both interest rate direction and inflation expectations. Then, we adjust portfolio duration and position the portfolio favorably at key points along the yield curve.

The third step includes segmenting the portfolio into non-spread sectors and spread sectors. For the non-spread sectors, such as U.S. Treasuries and to some extent U.S. agencies, we actively overweight or underweight for duration and sector purposes. With respect to the spread sectors, which include investment-grade corporate bonds, mortgage-backed securities and to some extent supernationals, we would apply those catalyst-driven and ESG factors to overlay for price appreciation and alpha generation.

"Additionally, catalysts may be created by an idiosyncrasy specific to a company. For example, a company may be coming out with a new product or repositioning itself within an industry. There may exist a general misperception of risk around a company. These all may result in higher revenue and higher-bottom-line EBITDA and, in turn, higher net income."

The catalyst-driven overlay is a five-step process, beginning with catalyst identification. Catalysts can come from a variety of sources. There can be structural change within an industry, such as the one we witnessed several years ago when crude oil went from $105 a barrel all the way down to less than $33 per barrel. This produced some favorable yield opportunities within the energy sector.

Additionally, catalysts may be created by an idiosyncrasy specific to a company. For example, a company may be coming out with a new product or repositioning itself within an industry. There may exist a general misperception of risk around a company. These all may result in higher revenue and higher-bottom-line EBITDA and, in turn, higher net income. This would favorably impact the bonds.

Our second step is to research and undertake meticulous financial modeling. Specifically, we look at what line items of a company's income statement and balance sheet are impacted by the catalyst. The third step is a unique feature that's proprietary to Princeton. We will undertake a catalyst probability ranking. This ranking assesses the scope of impact of the catalyst upon a company and the probability or likelihood of the catalyst materializing.

We then look for a favorable asymmetric outcome that can be a multiple of a best-case return scenario. We overweight those positions within the portfolio, and this is what attributed to the positive alpha within the Core Fixed Income Strategy. With our fifth step — five — we have various monitors to assess risk management relating to duration, yield curve and monitoring the positions continuously within the portfolio.

TWST: Of these five things, some of them sound like they're distinctive. Do you want to mention which ones are and anything else that might be particularly distinctive about your approach?

Mr. Falcon: The asymmetric return outcome is fairly distinctive, and I'll give an example of that. We model a base-case return scenario as well as a best-case return scenario. The key is we look for where the best-case return scenario is significantly higher, sometimes by a full multiple or two, than the base-case return scenario.

And as an example of this, we had analyzed a super-regional bank, **Regions Financial** (NYSE:RF), in early 2017. **Regions Financial** is a Birmingham-based regional bank. It had been a TARP beneficiary, but through conference calls and through our research, we detected a concerted effort that management was undertaking to reduce its nonperforming loans and improve its profit margins.

And so in our analysis, our base-case scenario indicated that **Regions Bancorp's** efforts to drive improvements and improve its risk management would be mediocre, and so the **Regions'** equity and bond price would remain constant. And so you'd only receive the bond coupon income with no price appreciation on the bond. Therefore, you'd only receive 7.375% per year. Our best-case scenario indicated that, if indeed **Regions Financial** increased its profitability, drove down its nonperforming loans, there could be price appreciation of the bond between 10% to 14%.

And so we did purchase **Regions Financial**, and the result was that there was a decrease in nonperforming loans, there was an improvement across its return on assets, as they rose to 1.01% versus 0.93%, and its return on equity, which rose to 7.4% versus 6.8%. And the result was that S&P gave **Regions** a credit upgrade from BBB to BBB+ in November 2017. In addition to the bond coupon income of 7.3%, we also received price appreciation of 14.3%, resulting in a total return on this bond of 21.8%. This return under a best-case scenario was certainly a multiple of the base-case return of only 7.4%, and that's the type of asymmetric outcome Princeton endeavors to make.

1-Year Daily Chart of Regions Financial Corp.

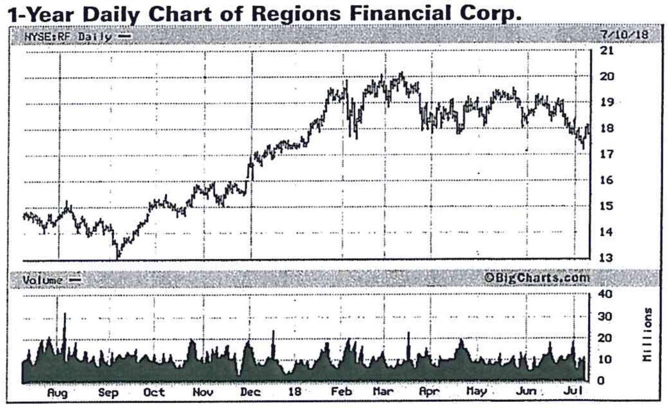

Chart provided by www.BigCharts.com

TWST: Going into 2018, how did you apply your investment process to the core fixed portfolio?

Mr. Falcon: In the first part of the investment process, we seek to have an understanding of the interest rate direction. This shapes duration control and yield curve positioning. We correctly determined that regime change was occurring at the Federal Reserve when Jerome Powell, who is hawkishly leaning and places a strong emphasis on interest rate normalization, replaced Janet Yellen, who was quite dovish and continued the policies of Ben Bernanke, which favored a low interest rate environment. Princeton determined that with a new Fed chairman, regime change would occur.

Accordingly, early in 2018, we reduced portfolio duration to 5.86, below the benchmark, which is 6.08. Accordingly, we made the portfolio more resilient to changes in the interest rate. Additionally, we held more securities on the front end of the yield curve. These factors led Princeton Core Fixed Income Strategy to outperform the benchmark as the Fed embarked upon raising rates and continues to raise rates through the time of this interview.

"A recent institutional allocator survey indicated that institutional investors, including insurers, sovereign wealth funds and private banks, are now more likely to allocate into core fixed income when yields are going up. And that is precisely the environment that we're in right now."

TWST: Did you want to highlight a fixed income sector that you think investors might find interesting?

Mr. Falcon: Overweighting or underweighting sectors also is a contributor to the portfolio returns. We are allocating more to agency mortgage pass-throughs for the following reason. A mortgage pass-through consists of two parts: the regular coupon payment and a payoff payment should a homeowner choose to pay down their mortgage.

Well, when the portfolio receives the mortgage payoff payment, that is equivalent to an early return of principal, which can be reinvested at the now-higher interest rate. Thus, this bond sector is superior to a bullet bond where the investor collects the coupon only and must wait longer for the return of principal before reinvesting in higher rates. For this reason, we have been increasing our exposure to agency mortgage pass-throughs in the rising rate environment.

TWST: Is there a target investor that you have, or is it different types of investors that would be most interested in what you're offering?

Mr. Falcon: For our Core Fixed Income Strategy, we target institutional investors such as defined benefit pension plans, endowments, foundations, insurers, sovereign wealth funds, private banks and institutional consulting firms.

TWST: I would think then a lot of those institutional-type investors are looking for yields and risk reduction from fixed income investments. Is that true?

Mr. Falcon: I would agree with that. Core fixed income is a very important component of an institutional investor's portfolio to provide yields and lower risks. Approximately 88% of institutional investors have exposure to fixed income in their strategic asset allocation. And the benefit is that yields are more competitive in a rising rate environment. For example, 85% of the market valuation of the Bloomberg Barclays US Aggregate Bond Index has a yield to worst, equal to or greater than 3%, which is much more favorable than where was at five or even three years ago.

Second, core fixed income serves as a very important rebalancing mechanism within a strategic asset allocation. During early 2018, given the relative underperformance versus equities, there could be continuous significant rotation of assets into fixed income sectors. Its risk profile, as measured by standard deviation, is much lower than other asset classes, and in times of economic shock or economic uncertainty, it certainly holds its value head and shoulders above other asset classes.

TWST: So then, whether it's a rising rate environment, which we're going through now, or if there is some type of change to the economy, the Princeton Core Fixed Income Strategy would be a good place to put part of a portfolio?

Mr. Falcon: Yes, Princeton Core Fixed Income Strategy would be a good place to allocate to as part of the fixed income allocation. On a year-to-date 2018 basis, we are outperforming the benchmark, the Bloomberg Barclays US Aggregate Bond Index, by 61 basis points. We have tactical weightings in place to overweight what we believe are bond sectors that will outperform and underweight those sectors that will not perform.

TWST: Do you think that a number of investors, be they institutional or retail, have been looking for fixed income to become more a part of their portfolio, but simply because of the interest rates that were being set by the Fed, they weren't as eager to get involved in those things, and now it looks like they have renewed interest?

Mr. Falcon: A recent institutional allocator survey indicated that institutional investors, including insurers, sovereign wealth funds and private banks, are now more likely to allocate into core fixed income when yields are going up. And that is precisely the environment that we're in right now.

TWST: We've talked about the Fed a bit. Did you want to talk about what you're looking at in terms of what you think that Fed might be doing the rest of this year and into next year, depending of course on some outside events, but your best guess as to where they might be headed?

Mr. Falcon: I'd be happy to comment on the path of future interest rates. As we are all aware, the Fed raised the federal funds rate by 25 basis points, and the fed funds rate range is now between 1.75% and 2%. Based on FOMC economic projections for the fed funds rate, by the end of this year, the average fed funds rate is expected to be 2.4%. And by 2019, it's expected to rise to an average of 3.1%. By 2020, it's expected to range to an average of 3.4%. There's a caveat on our assessment of the 2020 ending average value of 3.4%; it's likely that Jerome Powell is giving the Fed a little bit of wiggle room with respect to inflation and with respect to the economy.

These are the Fed's official numbers. However, the Fed may be constrained in achieving these rate levels for several reasons. First, the majority of the G6 central banks are maintaining a negative rate policy — Switzerland and Japan — or a low interest rate policy, such as the ECB. This could constrain the Fed with respect to steadily increasing during 2019. Second, the Fed's version of inflation expectations is moderate and not high. Third, by its own forecasts, the Federal Reserve is predicting U.S. GDP to decline over the next several years. Thus, my view is that there are a number of factors that could constrain the Fed's efforts of interest rate normalization.

Also, I sense an urgency in the Federal Reserve to return rates to a level where the use of interest rates to help offset any future economic downturn can be effective once again. If a recession had developed in 2014 or 2015, the Federal Reserve would have been very hard-pressed to come up with an effective monetary solution. Rates were already so low, they could not go any lower. Now, with a fairly regimented path for higher rates, there is now flexibility once again in the arsenal of tools the Fed can use to help the economy in the possibility of an economic downturn. That is a positive development and a net plus. I am not predicting an imminent economic downturn, and I believe it is unlikely, provided that the tariff and trade war issues eventually resolve.

TWST: Maybe we can compare that to the broader markets — where we envision them acting in the next year to come or maybe beyond that — things like equity, fixed income, the dollar?

Mr. Falcon: It's always difficult to precisely pinpoint where the Dow Jones Industrial Index or where the S&P 500 Index will close. Perhaps I could answer that in the following way. Broadly speaking, within every economic cycle, there are five phases. After the recession phase, there's a bottoming phase. After the bottoming phase is the initial recovery phase, and after that is the expansion phase and then the peaking phase, and then it goes back to the recession phase. Every economic cycle includes these phases in that order from the 2001 recession to the 2008 Great Recession.

Right now, we are in the expansion phase. The expansion phase is marked by actual Fed rate hikes, by increased economic activity and by increased corporate profits, and that is the current phase of the economic cycle. I believe that there's possibly several years' more runway to the current expansion phase. Not all phases are the same length.

For example, the recovery phase in the 2001 and 2002 recession was very quick, it was a matter of months, whereas the initial recovery phase in this current economic cycle lasted years. So the length of time that each phase lasts depends upon the present economic conditions. I think in terms of phases, and that helps frame the proper positioning of the Core Fixed Income portfolio.

TWST: We discussed a little bit about pensions. When you talk with folks that are involved with pensions, what are their concerns looking forward, and why might the fixed income approach be important to them?

Mr. Falcon: Pension plans monitor the investment return assumptions, and most plans have a range of investment return assumption between 6.5% and 8% as of June 2018. Public Plans Data produced the analysis on the average implied return assumption in 2015. The implied expectation for fixed income returns is approximately zero. The trend that we've seen over the years are multiple pension plans revising down the expected return on planned assets. We feel that Princeton's now seven-and-a-half-plus-year GIPS-verified annualized return of 6% and a very favorable downside capture ratio will add alpha and reduce risks in the fixed income allocation for the plans.

TWST: Anything we didn't bring up that you care to talk about, either about the sector or about the Princeton Core Fixed Income itself?

Mr. Falcon: Princeton does deploy an ESG overlay. ESG refers to environmental, social and governance. We feel this is important for several reasons. First, one can have superior returns while at the same time having a positive social impact. Studies have shown you don't have to sacrifice returns to invest in a way that impacts society in a positive manner.

Second, there is a very excellent study done by Barclays Capital that shows that within core fixed income, of those three components of ESG, the G factor — corporate governance — counts very much because what it does is you avoid investment losses from companies that have good corporate governance in place at the board level, that emphasize transparency and emphasize good communications with their shareholders. The study has shown that the incidence of downside surprises is significantly less than companies that exhibit poor corporate governance. So the net effect is, in a core fixed income portfolio, that you avoid holding the bonds of companies that are susceptible to nasty surprises, and you wind up outperforming because you engage in the avoidance of losses. So that's another important point.

One thing I want to add is that since our firm is a women-/minority-owned investment manager, I feel that our dedication into identifying similar investment credit and investment opportunities is using our action to support diversity and governance. It's not just waiting for the growth from new allocations but to use our dollars, our investment, to support this aspect. So the observations we have from the allocator or the plan perspective is that they either dedicate their program or require their partners in the consulting area to look for such type of managers. So I think the trend here is that on a going-forward basis, we're going to see a lot more investment and dollars being spent on this type of investment, both on the manager level and on the level that managers are making investment to on a corporate level.

TWST: Thank you. (ES)

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