The Search for Yield - "Water, Water Everywhere, but Not a Drop to Drink"
By Alan Snyder

"The Rime of the Ancient Mariner," by Samuel Taylor Coleridge, bemoans a sailor becalmed on his ship, surrounded by saltwater. Many hapless yield investors feel the same these days. It is of scant utility to ponder the many water terms used in finance – liquidity, cashflow, float, bail out, levy, and rainmaker to name a few.

We believe there is hope, but first we need a consideration framework without any water terms!

1. **Fees and expenses:** Yield perishes with high costs, and also increases downside risk and limits one's confidence interval. Most importantly, this can be avoided or minimized with careful research of alternatives.

2. **Risk tolerance:** Each investor must look deeply to determine how much risk and downside exposure is acceptable. Most often, the yield portfolio allocation is expected to be a reliable performer, leaving higher return possibilities to equities and private illiquid deals. For older investors with shorter timeframes and the possible need for current income, reliability is paramount.

   One might argue that the alchemy of converting lower yields to higher ones, often with substantial leverage, takes this asset class into a high-risk category, possibly similar to equities. Does such a strategy defeat the portfolio risk-balancing that durable yield investments can provide? And, how often is this risk step-up truly understood? The margin for error, and "oops" factor, can be small and happen unexpectedly. Principal loss is forever versus the security provided by a more modest return.

   For perspective, most quantitatively oriented financial planners assert that 4% returns are the proper long-term forecast for a well-diversified portfolio of equities and yield investments. This argues for the return smoothing characteristics of yield allocations.

3. **Assessment of the future:** No investment lives in a vacuum, unencumbered by what might happen. Moving from a historic low interest rate environment to a more normalized, or higher, one, has a significant negative impact on a yield portfolio. There are two risk mitigants. One: short duration allows for individual positions to be rolled over to higher yielding ones as they mature, even with fixed interest rates. The challenge lies in determining how quickly overall rates will move up versus the term of each investment. Currently, a

horizon of two years seems to offer flexibility, without betting the ranch, from longer duration in expectation of an imminent recession. Two: positions with floating rates tied to an interest rate benchmark such as the Bank Prime Rate or LIBOR, either alone or in combination with fixed rates. Sometimes, floating rates are glibly proffered as the perfect solution. But, what is the reset timeframe and mechanism? Plus, spread duration counts too, relating to yield convexity. Thus, floating rates can be a help, but do not negate consideration of shorter duration.

4. **Cash yield/cash out availability:** If current income is sought for living expenses or portfolio liquidity for redeployment to new opportunities, then non-cash yield from P.I.K. (payment-in-kind) and balloon payments that lengthen duration should be used only sparingly in the underlying investments.

   Cash out availability is another critical factor. Can the investment be liquidated on a timely basis without substantial downside market risk to principal? For example, a floating rate portfolio can be subject to substantial market valuation risk due to spread duration and market sentiment viz. collateralized loan obligations ("CLOs") lent by banks to riskier credits in the 2008/2009 crisis.

Yes, we do have an opinion on each of these considerations:

Fees and expenses: Clearly, lower is better.

Risk tolerance: For most, modest is best. Use higher octane places for higher returns versus polluting and distorting a yield portfolio. Currently, rate risk may eclipse some moderate credit risk in a well-diversified portfolio.

Leverage: This is a sneaky risk to your portfolio. In short, only use sparingly.

Assessment of the future: It is true; we are worrywarts. The U.S. Federal Reserve bank has stated that they must raise rates to more normal levels which means higher than where they are, possibly as much as 2% - 3%. As a result, our bias is short duration.

Cash yield/cash out availability: Both are extremely desirable for portfolio flexibility and proof of that old bromide – in this case a bird in the hand is worth more than two in the bush.

In all investment endeavors, we remain skeptical yet not cynical. Research, careful position selection with low volatility and sound collateral, ongoing portfolio position monitoring and intense diversification carry the day. Higher octane drinks can deliver good cheer as well as hangovers. Drinking water quenches thirst with many positive health benefits. Today, our yield water is alternative lending which can deliver its benefits against all of the above considerations when carefully, not greedily, undertaken. Imagine consistent yields exceeding a two-year junk bond portfolio; maybe water is truly an elixir. See www.shinnecock.com for more.