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Osterweis Total Return's Vataru Stays Flexibile

This month, ***BFI*** interviews **Eddy Vataru**, Portfolio Manager of the **Osterweis Total Return Fund**. We talk with the San Francisco based manager about his bond fund, which focuses on "**picking securities, rotating sectors and hedging duration**." We also discuss a number of other issues in the fixed-income market. Our Q&A follows.

BFI: *Give us a little background.*
Vataru: Osterweis was founded in 1983. We launched our first fixed income fund in 2002, the **Osterweis Strategic Income Fund**, which was among the earliest unconstrained funds…. Carl Kaufman started the fund and still manages it today.

The firm decided to launch the Total Return fund because it really needed an investment grade analog to the Strategic Income Fund — something with same kind of DNA but focused only on the investment grade market. It uses a different toolkit, but the aim is the same: to have a benchmark agnostic, absolute return strategy with lower volatility.

Eddy Vataru

I joined Osterweis 2 1/2 years ago.... Here I'm not required to run money using a specific style. I wanted a little more freedom to run money the way I think it should be run, and Osterweis has always been skeptical of the style matrix, so it's been a great fit. **We call it the common-sense approach to managing money**.

Our fund is a combination of disciplines — both quantitative and fundamental…. In many ways there are similarities to what Carl and his team are doing, as their fund is unconstrained and also does not fit neatly into a particular style box. So, it was a good match from a philosophical standpoint. We launched at the end of '16, and we're coming up on three years at the end of this year.

BFI: *Talk about your allocations.*
Vataru: Actually, it changes quite a bit depending on market conditions. The allocation a year ago was probably closer to 75-80% mortgage and 20% corporate. **We increased our corporate holdings throughout 2018 as spreads widened over two different periods, and our current corporate allocation is about 40%.** At the same time, our mortgage allocation has decreased from 80% to about 50%. We've generally kept a relatively low allocation to Treasuries, although we did increase it in the fourth quarter to about 12%, predominantly in TIPS. We've since reduced that position…. We also have about 2-4% in ABS, which was a late-year addition to the fund.

The fund relies on three primary levers to deliver our returns. **Number one is sector allocation, number two is security selection, and number three is duration management/interest rate hedging.** The third lever can be both a risk reducer and an alpha producer, depending on market conditions.

Sector allocation is an area that through time has been really a compelling way to outperform the index. In fact, with the recent era of central bank easing mostly behind us, I believe sector allocation will be a primary driver of returns moving forward. **The three largest components of the investment grade bond universe — treasuries, agency mortgages, and corporates — have very different risk profiles.** For example, agency MBS carry none of the default or liquidity risk that corporates have but are exposed to callability.... Treasuries carry the least risk and, over the long term, the lowest return. The interplay between volatility, level of rates, liquidity, and macroeconomic-driven default risk [is] fertile ground for generating strong returns.

Obviously, security selection is also very important. There are plenty of investment grade names that we've seen over the last few months that we've deliberately avoided. Recent examples include **General Electric** or **PG&E**, both investment grade names that obviously hit some headwinds in recent months. So there is certainly some opportunity within investment grade not just from a sector basis, but from a security selection standpoint.... On the mortgage side there are also some very compelling opportunities, especially if you dig beyond vanilla passthrough securities into structure.

We also use interest rate futures in an effort to boost returns, particularly when attractive securities carry durations that are longer than we are comfortable with. But our hedging strategy is mostly to limit the portfolio's exposure to rising rates – especially now because our index, the Bloomberg Barclays Aggregate, has a duration just under 6 and a yield below 3%. That's a lot of duration to take for not a lot of yield, especially when yields at the very short end of the curve are around 2.5%. **We are very focused on being smart about our interest rate risk, and right now we feel taking duration risk is ill-advised.** Short rates have increased but the middle of the curve has inverted, and we think the rally in that part of the curve is overdone.

BFI: *What can't you buy?*
Vataru: Our prospectus doesn't place too many restrictions on us, but we maintain a credit profile in the fund that is very distinctly investment grade. We think there's enough opportunity in the space to deliver a good return without having to go down the credit spectrum. We rarely hold high yield or emerging market bonds, and you won't find munis and CLOs in our portfolio. We don't use leverage, which is another key attribute that some total return funds use. We've added some asset-backed positions recently, but they have all been AAA-rated.

BFI: *Is volatility a big challenge?*

(Continued on page 2)

*(**Osterweis Total Return** from p.1)*

Vataru: I actually like volatility. I've always done well in volatile markets, so I like 'vol' because I think it creates opportunities. Like I said, **the trinity of ways in which we can generate returns are sector allocation, security selection, and then hedging**. When rates move, our hedging program is going to capitalize on movements in markets.... The drivers of sector performance are different. Corporates are driven largely by pricing based on liquidity risk and default risk. With mortgages, you're looking at call risk of the underlying pools or the borrowers in those pools, and volatility risk because there's a call option that those borrowers can exercise. **These are very different and fairly uncorrelated drivers of returns.**

So when you have moves like we've had over the last 12 months in particular, **sector allocation has been an area where you really have a lot of opportunity to deliver of performance**. I would say that's really the number one area where we've had success over the last year. Looking at our one-year returns, we've had pretty substantial outperformance against our peers and against the 'Agg.' A lot of that has really come from well-timed sector allocation decisions that we've made.

BFI: *What about your investor base?*

Vataru: At this point it's primarily the intermediary market — financial advisors and RIAs. They have responded well to how we have performed and our approach risk. But, my entire experience pre-Osterweis was with an institutional client base, and I think this strategy should appeal to them. We have not yet had much direct exposure to retail investors, so that's an open question, but I think over time we could be a very attractive option for them, too.

BFI: *Talk about your outlook.*

Vataru: My view on inflation is a little bit of an outlier. In the last 3-4 months the market has really priced in not only a pause in hikes, but a cut…. I don't agree with that. **I actually don't even see a cut in 2020, and I think that the next rate move will be a hike.** [That] makes me very defensive against short and intermediate yields. So while I'll take floating-rate risk all day long, I'm not as constructive on 2-5 year interest rates.

BFI: *What about the future of funds?*

Vataru: Bond funds are something you're always going to need, whether as a ballast against an equity holding or as a dividend stream for investors…. In particular, **I do think that active bond funds should see some growth in the next few years**. We've been kind of in a secular decline over the last 10 years versus passive and ETFs…. I think all that's going to change…. **What we've seen over the last year and half really tells me that there is a lot of value to the tools and strategies that active managers use — including security selection, sector rotation, and duration hedging.** I think all of those approaches have a home in this new landscape and I expect that to continue for years to come. ◈

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Mutual fund investing involves risk. Principal loss is possible. The Osterweis Total Return Fund may invest in fixed income securities which are subject to credit, default, extension, interest rate and prepayment risks. It may also make investments in derivatives that may involve certain costs and risks such as liquidity, interest rate, market, credit, management and the risk that a position could not be closed when most advantageous. The Fund may invest in in debt securities that are un-rated or rated below investment grade. Lower-rated securities may present an increased possibility of default, price volatility or illiquidity compared to higher-rated securities. Investments in foreign and emerging market securities involve greater volatility and political, economic and currency risks and differences in accounting methods. These risks may increase for emerging markets. Leverage may cause the effect of an increase or decrease in the value of the portfolio securities to be magnified and the fund to be more volatile than if leverage was not used. Investments in preferred securities have an inverse relationship with changes in the prevailing interest rate. Investments in Asset Backed and Mortgage Backed Securities include additional risks that investors should be aware of such as credit risk, prepayment risk, possible illiquidity and default, as well as increased susceptibility to adverse economic developments. It may also make investments in derivatives that may involve certain costs and risks such as liquidity, interest rate, market, credit, management and the risk that a position could not be closed when most advantageous. The Fund may invest in municipal securities which are subject to the risk of default.

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The Fund's average annual total return for the one month, quarter-to-date, year-to-date and since-inception periods ending 3/31/2019 were as follows:

	1 Month	QTD	YTD	1 Year	Since Inception (12/30/2016)
Osterweis Total Return Fund	***0.49%***	***2.58%***	***2.58%***	***5.78%***	***4.14%***
Bloomberg Barclays U.S. Aggregate Bond Index	***1.92%***	***2.94%***	***2.94%***	***4.48%***	***2.88%***

Gross/Net Expense Ratio as of 3/31/2018: 0.71% / 0.76%. The Adviser has contractually agreed to waive certain fees through June 30, 2019. The net expense ratio is applicable to investors.

Performance data quoted represent past performance; past performance does not guarantee future results. The investment return and principal value of an investment will fluctuate so that an investor's shares, when redeemed, may be worth more or less than their original cost. Current performance of the Fund may be higher or lower than the performance quoted. Performance data current to the most recent month end may be obtained by calling shareholder services toll free at (866) 236-0050.

The Bloomberg Barclays U.S. Aggregate Bond Index (BC Agg) is an unmanaged index which is widely regarded as the standard for measuring U.S. investment grade bond market performance. This index does not incur expenses and is not available for investment. The index includes reinvestment of dividends and/or interest income.

One cannot invest directly in an index.

Fed refers to Federal Reserve.

ABS refers to asset-backed security.

Treasury Inflation Protected Securities (TIPS), are treasury securities that are indexed to inflation in order to protect investors from the negative effects of inflation.

Cash flow measures the cash generating capability of a company by adding non-cash charges (e.g. depreciation) and interest expense to pretax income.

Yield curve risk is the risk of experiencing an adverse shift in market interest rates associated with investing in a fixed income instrument. The risk is associated with either a flattening or steepening of the yield curve, which is a result of changing yields among comparable bonds with different maturities.

Alpha is a measure of performance on a risk-adjusted basis. Alpha takes the volatility (price risk) of an investment and compares its risk-adjusted performance to a benchmark index. The excess return of the investment relative to the return of the benchmark index is an investment's alpha.

Duration measures the sensitivity of a fixed income security's price (or the aggregate market value of a portfolio of fixed income securities) to changes in interest rates. Fixed income securities with longer durations generally have more volatile prices than those of comparable quality with shorter durations.

A basis point is a unit that is equal to 1/100th of 1%.

Correlation is a measure of the strength of association represents the degree to which the volatility of an investment is related to the volatility of the market during a given period. A Correlation Coefficient of +1 indicates a perfect linear association between an investment and the market, while a Correlation Coefficient of -1 indicates a perfect negative linear association. A value of 0 suggests a lack of association. It is important to note that this statistic provides no information about causation.