YORKTOWN FUNDS

Fixed Income Overview

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Macro Update

Risk assets surged into year-end with investors convinced that market tail risks have subsided. On December 12th, a phase-one trade deal with China was announced. The agreement is set to halt tariff escalation, pare down levies already in place, and address intellectual property and forced technology transfer concerns. The deal is expected to be finalized in early January and analysts believe it could double U.S. exports to China within a few years. The trade news provided a significant boost to markets as the largest macro risk roadblock was seemingly removed, well, at least for the time being.

Other macro and geopolitical uncertainties abated as well. In the U.K., Boris Johnson's election victory gave him the Brexit mandate he'd been looking for. The U.S. Federal Reserve remained patient with no changes to its dot plot and pledged to ensure funding markets remained liquid over year-end. Meanwhile, new ECB President Christine Lagarde's first press conference was well received as policy was left unchanged.

Subdued volatility and diminished tail risk meant higher stock prices and tighter credit spreads. Month over month, the S&P 500 finished 2.8% higher and Dow Jones Industrial Average was 1.7% in the green. The MSCI Emerging Markets Index was up 7.1%. The risk-on move led to a selloff in government rates as the 2-year and 10-year U.S. Treasury yields changed by -4 bps and 15 bps, resulting in a 19-basis point bear steepening. Credit spreads turned in exceptionally strong performances in the rally as yield buyers moved in quickly with Treasuries selling off. The U.S. investment grade index tightened by 12 bps while high yield was in 34 bps. Impressively, the high yield energy index tightened by 149 bps – a dramatic reversal which entirely overrode the preceding 11-month widening and quieted one of the most discussed thematic narratives of 2019. Additionally, equity and rate volatility stayed close to flat, while gold improved by 4.0% and oil rallied 10.6%.

Yorktown Funds Fixed Income Focus – Goodbye LIBOR, Hello SOFR

Some cause happiness wherever they go;
others whenever they go.
- Oscar Wilde

The end of year holidays seem to come with a lot of anticipation - really a forward-looking feel to them. The possibilities (and presents maybe?) seem to be limitless. But New Year's comes, and we have this bizarre desire to suddenly look backward. How else does one explain the inordinate amount of Top 10 lists that litter my social media feed and overwhelm the content of my TV viewing, especially news shows? The financial markets? Those tend to stop looking backward or forward sometime around halfway through December as everyone hits the vacation cruise button and awaits the end of the year.

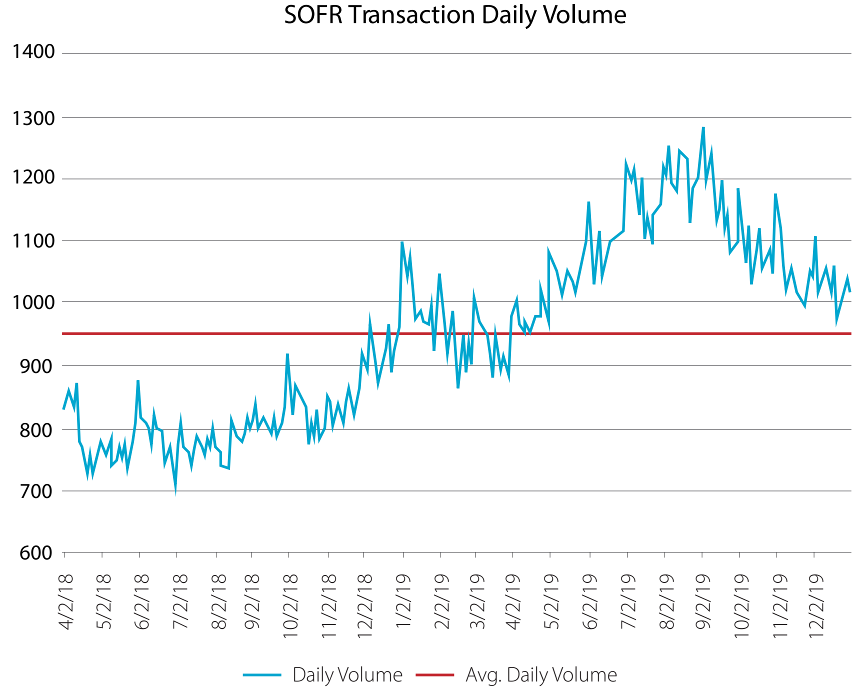
One issue in the financial markets gets the best of both those worlds. That thing, which finds itself on the path to end is the demise of the London Interbank Offering Rate (LIBOR). LIBOR has been for many years widely recognized as "the" benchmark for short-term interest rates. Typically, participants relied and rely on it as a benchmark for the short end of the curve, with a series of benchmark interest rate indices ranging from overnight to one year. The most recognizable generally being one-month LIBOR (1 ML) and three-month LIBOR (3 ML). Initially, LIBOR was intended to be a reported measurement by which unsecured funding between banks could be obtained. Over time it morphed into being used as a reference benchmark-indices for financial products estimated at well over $200 trillion in securities, derivatives and agreements, including things such as mortgages, loans, corporate and securitized debt, and swaps and other derivatives.

LIBOR is expected to fade in importance over the next few years and be replaced. Part of the reasoning behind its replacement is how antiquated it has become. Sell-side participants would point out that its methodology no longer makes it relevant. In the beginning, LIBOR rates were based more on observable and reported transactions. But over time as fewer and fewer transactions occurred it began to rely more on judgment. A panel of banks would convene each morning and rely on transactions, derived transactions, and "expert-judgment" to determine LIBOR rates. But over time as fewer banks participated and others were reluctant to do so (as we will discuss below), actual transactions were not really used and instead "expert-judgment" became the prevalent manner to determining the LIBOR rates. As such, market participants felt perhaps that LIBOR wasn't truly representative of market conditions due to a lack of data. Ah, but it also didn't help that LIBOR became the subject of a scandal when a number of banks, as part of the Financial Crisis, were caught dishonestly reporting low interbank rates and the panel banks ended up being fined hundreds of millions of dollars. Indeed, any entity that was running a matched book of assets to liabilities knew something wasn't quite right when their funding costs skyrocketed and their spreads over LIBOR spiked, but somehow LIBOR itself didn't quite move in a corresponding manner to match the spiking of their financing spreads. Interestingly enough one of the main arguments against SOFR, as we will see, has to do with it being potentially more volatile than LIBOR, almost as if everyone seemed to forget how or why that would be true.

So replacement benchmarks were investigated and proposed, and while there will be replacement benchmarks, depending on geographic location, the expected global benchmark replacement for LIBOR, which is due to occur by the end of 2021, is going to be the Secured Overnight Financing Rate (SOFR). SOFR is formally defined by the Federal Reserve as a "broad measure of the cost of borrowing cash overnight collateralized by Treasury securities." This includes all trades in the general collateral rate plus bilateral repo agreement transactions cleared by the Fixed Income Clearing Corp. (FICC). The Federal Reserve began publishing the SOFR rate sometime in April of 2018, with trading and clearing of SOFR-based swap and futures occurring sometime shortly after.

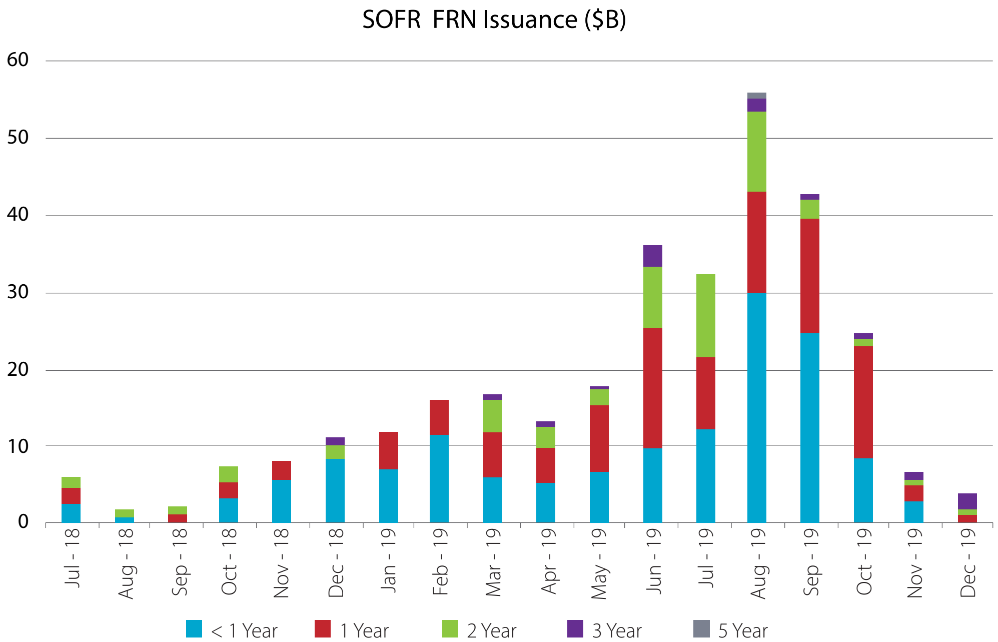
One of the main characteristics that was desired for a replacement benchmark was transactions and transparency. LIBOR which had begun based on heavy observable transactions had morphed over the years as more and more panel banks (those relied on for benchmark data) limited reporting transactions or ceased altogether and became almost totally reliant on being a creation of "expert judgment." In contrast, SOFR is pretty much entirely based on observable transactions. But it was starting mostly from zero. Over time the number of transactions has grown, and while many still consider LIBOR as so much more prevalent, it's because of the $200 trillion of outstanding transactions based on it from previous issuances and transactions. SOFR is growing and by year-end 2019 was reporting over $1.0 trillion of daily SOFR-based volume, with an average daily volume (since its beginning in April 2018) of $949 billion.

As a relatively new benchmark index, and in direct contrast to LIBOR, critics would point out that SOFR is really just a single rate at this point, while LIBOR has many tenors or, put more clearly, a term structure (i.e. 1 month, 3 month, 6 month, etc.). This is a potential problem when one considers derivatives but also floating rate notes (FRNs). This should be expected as SOFR is meant to be based on observable transactions, and that means issuance must be launched utilizing SOFR to build out those transactions. In July of 2018



Source: Bloomberg, Federal Reserve Bank of NY

Fannie Mae became the first issuer to utilize SOFR-based benchmark notes. Fannie issued around $6.0 billion at that time, with $2.5 billion in 6-month notes (SOFR +8 bps); $2.0 billion 12-month notes (SOFR + 12 bps); and $1.5 billion 18-month notes (SOFR +16 bps). Since that time, issuance has slowly been building with more and more FRN issuance observed. In fact, as of year-end 2019, total SOFR issuance was around $313 billion. It is expected that the majority of FRNs issued going forward will be SOFR based, and as a result, with more observations, eventually will lead to a term structure for SOFR to be developed.

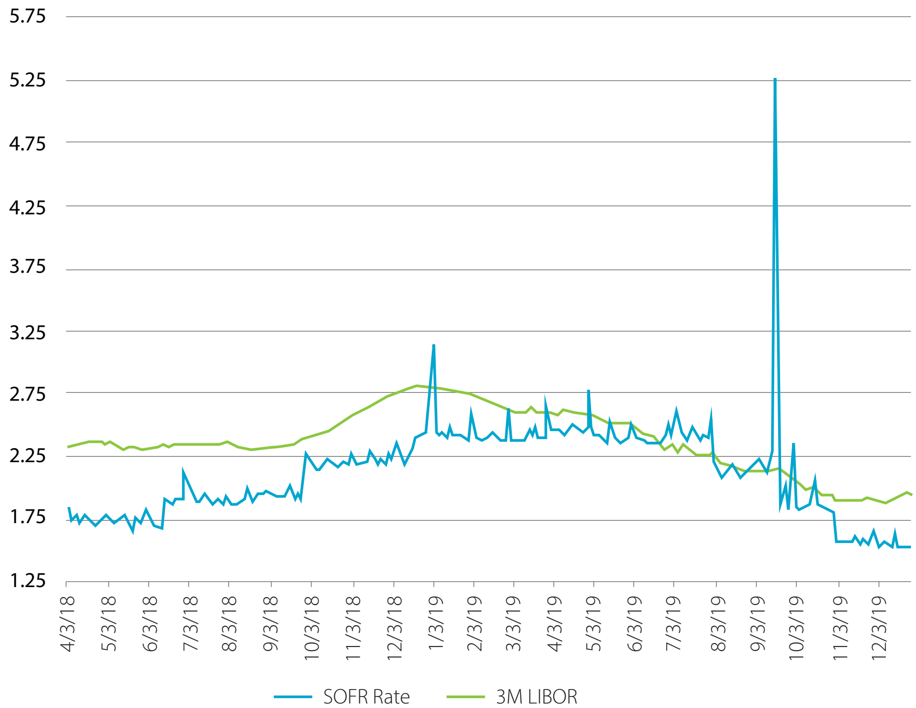


Source: CME Group

Besides age and term structure, there are also a few other notable differences between LIBOR and SOFR. One of the biggest differences has to do with credit. Because SOFR is a secured rate, given it is based on collateralized transactions, such as repo, it is thus more of a risk-free rate. LIBOR on the other hand is unsecured and as such has a credit spread component. As a result, there is a noticeable spread difference between SOFR and LIBOR, and worse, which we will discuss a bit further down, some potential fallout when it comes to transitioning. Over the past few years, at least since its initial publication, SOFR has a correlation to LIBOR of 0.62, which makes it not exactly a perfect match as a replacement. There are reasons for this less than perfect correlation.

One thing that is fairly easy to see is that despite it being based on a risk-free rate, it appears, at least initially, that SOFR is more volatile than LIBOR. As illustrated in the chart below, in mid-to late Sept. 2019, the markets were witness to what is described as "a surge event" whereby the cash markets saw a harsh reaction to a confluence of a few sub-events. This put a strain on those markets causing a pull-back in funding and a spike in financing costs. And because SOFR is transaction-based, it was reflected in the rate. As mentioned above, some market participants pointed out that because SOFR is transaction-based and thereby backward-looking, LIBOR, which is now considered forward-looking, would be more stable and maybe by extrapolation considered preferable. However, as we discussed, that would be a reinvention of the past, given that LIBOR was more transaction-based years ago and only became more forward-looking as a necessity given the more reliance on "expert-judgment" than actual transactions. And worse, this would seemingly forget the LIBOR scandal during the Financial Crisis that was discovered where panel banks were dishonestly posting funding levels and therefore artificially pushing LIBOR down.

SOFR vs. 3M LIBOR



Source: Bloomberg, Federal Reserve

Some of the bigger concerns for market participants when considering the shifting of benchmarks from LIBOR to SOFR have to do with two main issues: transition and legacy legal documentation. In certain instances, such as those involving swaps and other derivatives that are LIBOR-based, there is a concern that as they are transitioned over to

SOFR there are "fall-back" clauses in these contracts. Those would necessitate addendums and other documentation changes be approved to account for the differences between SOFR and LIBOR, including, and most importantly, the manner in which those differences will be calculated. For instance, it is anticipated that by October, while swaps will remain LIBOR-based, they will then be discounted at SOFR. As such, when the FSA triggers a LIBOR fall-back, all coupons and cash flows will be migrated to SOFR-basis.

However, the other concern may be more problematic. There are countless legacy bond issues in the market outstanding with language that references LIBOR. In many of those are mentions or clauses that refer to LIBOR not being available on reset-dates or might even contemplate LIBOR no longer existing. In those clauses, there is generally some sort of language that considers remedies. But there are certainly other issuances that don't have prescribed remedies. At best this would indicate a need for those issuances whose documentation reference LIBOR to be amended to represent the transition to SOFR and how current coupon and even step-up terms for trigger-related resets are calculated. At worst, however, there is a concern of non-conformity, and that in theory would mean that certain bonds may be more liquid than others simply because they have language that considers LIBOR not being available or a replacement benchmark index being needed and bonds whose legal documents do not.

LIBOR's shelf life is expected to expire by year-end 2021. By that point SOFR should have the participant levels, transactions observed, issuance, and term structure in place to be an adequate and accepted replacement for LIBOR. But the real question is what is going to occur in-between. As is so often the case, participants tend to under appreciate the ripples of events in the marketplace. SOFR will be more volatile than LIBOR for the reasons mentioned above, but also simply due to how it is determined. Cash markets tend to be dismissed as sleepy and non-volatile, but the events in September of this past year and year-end 2019 are clearly recent evidence to the contrary. Funding costs, secured or not, on the short-end can be moved by myriad events and headlines. Cash investors can be and are notoriously fickle and it is not unheard of for a strong corporation whose long-term debt has a strong liquidity base and tight bid-ask spreads to suddenly find their ability to roll 90-day commercial paper strained. All of which means that there should be expected movements and sometimes harsh ones in SOFR.

Additionally, the replacing of LIBOR with SOFR is sure to come with some confusion and an occasional stumble as legacy documentation is picked through. That is a given, as there simply is no easy way to identify or anticipate what might lead to every ripple that occurs within the documents when the switch occurs. Rather expect a few bumpy moments, some loud headlines, and some threatened legal action as investors, issuers and underwriters are faced with a document rep or warranty that hadn't been discovered just yet and was suddenly triggered, or a warehouse line to a large, important client is pulled or not renewed. Lastly, simply understanding and being able to properly calculate the levels upon reset either due to a normal benign reset due to a calendar requirement or those under more stressful moments such as a credit event trigger will be an effort. There are most certainly going to be mis-steps in these cases at least initially, and only later will market participants come to understand that perhaps the calculations done at the time were either too lax or too punitive, creating some potential value or arbitrage opportunities down the road.

Our expectation is that there will be some noise, and while the amount of issuance and documents that don't have replacement language or contemplate it most likely are less than one would expect (and we do anticipate that most of the updating and amending of documents will be fairly seamless), it will cause enough disruption to become a worrisome headline. We, like the rest of the market, continue to adapt and wait for the full embracing of SOFR. Nevertheless, we do feel there is enough confusion, as is normal when something new is introduced to the market, that there will be opportunities to be had. We are focused on not only reviewing legacy documentation for language and terms, but also exploring new issuance for opportunities for both diversifying the portfolio in names and sectors, as some sectors have seemed to become more aggressive in utilizing SOFR than others, and also being ready to take advantages of the ripples when others may be caught unaware of what is occurring.

Short Term Bond Fund

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As expected, liquidity dried up the last few weeks of the year. On the positive side of that, most issuers seemed to expect that and as such there also wasn't much supply available as those issuers made sure no last-minute financing was needed. With no primary issuance to look at and a dearth of secondary offerings available, the end of year was absent of any real coal in the stocking type of credit failures. Nevertheless, the occasional buying opportunity did present itself, and given the low supply, staying short over the turn was advantageous to going long and picking over more credit sensitive secondary leftovers. The end of year was also a time to continue to focus more on the short-end of the curve overall, and as we look forward, continue to avoid headline sectors no matter how appetizing they might seem on a day where a tweet might indicate a temporary cessation of tariffs or the spiking of oil due to a geopolitical event occurs.

Credit-wise, value continues to be available in structured product, which remains a focus. A few sub-sectors within the highly liquid ABS auto space have an attractive risk reward profile, and we continue to look to diversify and pick up performance in other sectors of structured finance, including equipment leasing and rail. Floating rate notes continue to provide value. The overall market continues to focus on fixed rate product and reaching for yield through longer dated exposures. Floating rate notes, especially given the expected pause by the FOMC, provide an opportunity to pick-up relative current value and potential forward value if and when rates see a hike in the future. Floating rate notes value can also be picked up with the recent emergence and increased issuance of notes relying on SOFR as the benchmark index. Within that value is also diversification, as issuers utilizing SOFR include desired exposures in certain hard to find sectors such as insurance. Diversification also remains a focus. We continue to keep lower exposure limits to sectors, and further limit by names within those sectors, with a preference for adding more high-quality names at smaller exposures. We view this as a means to limit volatility and mitigate the impact of unwanted and unexpected credit turbulence. Despite the allure of higher spreads, we continue to avoid sectors such as commercial real estate, REITs and BDCs due to credit concerns and worries about credit spreads moving in a negative and damaging fashion.

With more value found on the shorter end of the curve, maturity targets remain shortish, with points of value on the yield curve a focus in 3-year maturities. This targeted area includes not only fixed rate product, but FRNs, which we found of particular value in that maturity range. This targeted area continues to provide not only best value, but is of interest when we consider credit outlook, rate expectations and liquidity. With the beginning of a new year, we do not believe funding pressures are truly alleviated, despite the Fed running in with a renewed vigor and willingness to expand their balance sheet. Given that, we continue to keep an appropriate amount of dry power available to take advantage of those structural issues that provide opportunities in the shorter maturities. Name targets within preferred sectors has been our focus over the past month and is one we expect to continue to follow over the near term.

Multi-Asset Income Fund

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December was relatively muted with a short month of trading due to end of month holidays and vacations. Risk-on, however, continued off and on for the markets. With a dearth of supply, out of favor names and sectors suddenly became more appealing, and investors seemingly were willing to take a plunge on exposures they had been avoiding. As a result, we continued our focus of selling into that demand to pare exposures to names and sectors we consider out of favor or inflated valuations. We continued to move away from BDC and REITS, and avoid CMBS, while repositioning the portfolio in names and sectors with what we feel is better liquidity and stronger credit profiles. We also continue to take advantage of the recent energy rally to decrease exposures, with an eye toward creating more NAV stability. Energy is still heavily influenced by headlines, and correlation to sub-sectors to crude prices remains extremely high; thus, the risk of negative price movement volatility remains undesirably high. Longer maturity buckets continue to be used for opportunistic purchases in more stable, higher quality names and shorter maturity buckets for more credit sensitive but high value exposures. With valuations and demand at historic highs, we continue to be focused on avoiding a sharp reversion which we expect to come either from negative economic news or a geopolitical spark. As a result, we continue to move defensively in preparation of such an event and are creating room in the portfolio for opportunistic purchases if events provide it.

Diversification continues to be a top priority. Structured credit has been a recent focus of ours, and we continue to see value not only in terms of credit and performance, but with strong diversification benefits. Of particular focus recently has been subordinate tranches of new issue credit card and auto ABS, as well as whole business securitizations. Floating rate notes with longer maturities with strong names have also been a point of attention, with the added benefit of providing exposures to desired sectors such as life insurance. The space has become of more interest to other investors, but we still feel there is additional value to be captured and it remains of strong interest. The hybrid space has become more heated of late, and similar to the long FRNs, while value can be found, it is important to pick through the offerings to find the better, more stable credits, along with a better understanding of regulatory rules influencing when calls will occur in order to maximize that value. We continue to pare exposures in non-bank hybrids and baby bonds, the latter of which have decreased liquidity in certain environments. We continue to move up in credit when possible and have been aggressive in moving defensively when we see opportunity to do so or when we feel issuer-specific credit deterioration is on the horizon.

From a maturity standpoint, we find more value in the 5-7-year area in certain names, and when possible, prefer the 1-3-year area in sectors we feel might be vulnerable to added volatility.

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