YORKTOWN FUNDS
Short Term Bond Overview

August 2021

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Macro Update

July featured a significant rally in Treasuries as bond yields reached their lowest levels since February. The accompanying price action on Treasuries was notably at odds with the prevailing narratives around economic reopening and strong growth. Investors debated the causes of these unexpected yield moves but failed to reach a satisfying consensus.

The most likely explanation probably lies in an aggregation of July data points, policy interpretation, and qualitative market sentiment. Perhaps most prominently, commentators have recently expressed worries that peak post-pandemic growth may have already been reached, and that growth may be expected to grind along more slowly, sputtering with higher frequency. Shortly after this talk became mainstream, the COVID delta variant spiked and stole headlines, leading to second guessing about the return to normalcy. Compounding these discussions were weak jobs data and concern over a potential hawkish mistake from a Federal Reserve which could try to move too fast.

Meanwhile, consistent with this muddled picture was a mixed July market performance from a cross-asset perspective. There was no discernible, holistic risk-on or risk-off trend. Corporate credit spreads blew out during two furious mid-month rate rallies, as one might expect, with some bondholders taking profits by selling into the Treasury rally, and thus pushing spreads wider. However, U.S. stocks performed well, therefore breaking their usual correlative relationship with Treasury prices and credit spreads. On the other hand, large cap European stocks didn't move much, while equities in Asia and emerging markets sold off tremendously, driven by regulatory crackdowns from the Chinese government. Without any distinctive, overall theme this month, markets reminded all of us that they tend to be far more complex than human nature would like.

U.S. equities enjoyed another month of gains. The prominent U.S. indices outperformed global stocks, with the S&P (+2.2%), Dow (+1.2%), and NASDAQ (+1.1%) all higher, and the VIX Index (measuring equity volatility) up a touch. The major European indices were positive as well. The large cap STOXX Europe 50 Index was up 0.6%. The German DAX (+0.1%) was flat whereas the French CAC did very well (+1.6%). Meanwhile, Asian markets fell dramatically the last week of the month as the Chinese government announced a major crackdown on tech companies. China's Shanghai Composite was off by 5.4%, Japan's Nikkei declined 5.2%, and Hong Kong's Hang Seng sold off by 9.9%. The MSCI Emerging Markets Index posted a 7% market value loss for the month as well.

In Treasuries, the 10Y rallied 25 basis points (bps) from 1.47% to 1.22%. UST 5Y and UST 30Y had similar moves of 20 and 19 bps, respectively. Even the front end of the curve saw excess buying, with the 2Y lower in yield by 7 bps, in a partial retracement of last month's 11 bp selloff. As a result, the 2s-10s spread bull flattened by 18 bps to 1.04% which is its flattest level since February. The MOVE Index ticked up as well, from 57 to 61, but remained within its four-month range.

Corporate credit spreads widened for the month with the investment grade index out from 80 to 86 bps and the high yield index moving from 268 up to 294 bps. Spreads on HY

energy widened substantially, going from 375 to 425 bps on the index. Looking at credit by rating tranche, AAAs through BBBs all widened between 5 and 6 bps. In high yield, BBs were 14 bps worse while Bs moved drastically wider by 41 bps. CCCs performed about the same with 40 bps of spread widening after bouncing off a recent 14-year low in Options-Adjusted Spreads (OAS).

The bid for high quality spread products softened in July. Agency Mortgage-Backed Security (MBS) spreads on fixed rate products (30Y and 15Y mortgages) moved out by 7 bps yet remain at tight levels overall. AAA auto paper was wider by 5 bps while 10-year agency debt spreads were off by 4 bps. Meanwhile, commodities and alternatives were slightly higher, with oil up 0.6% to $73.95 per barrel, and gold up 2.3% to $1,813 per ounce. Bitcoin finished the month higher for the first time since March, with a 17.6% pickup to settle at $40,689 for month-end.

Yorktown Funds Fixed Income Focus – Asset-Backed Securities

"To improve is to change; to be perfect is to change often."

- Winston S. Churchill

July defines summers. June technically has the longest day of the year, but it always seems to me the sun doesn't set until late most of July, making each summer day all the more enjoyable. Summer usually translates into being outside, enjoying the heat and doing summer-type things like grilling. We tend to use a lot of rubs and marinades on things we grill in our house which can mean adding a number of ingredients. Sometimes a little salt, a little pepper, some Worcester sauce, some lemons, teriyaki sauce, maybe even a little cayenne pepper. The right mixture of ingredients of course can make everything taste great. Too much of one, or even the wrong one at the wrong time, and then well, dinner is ruined.

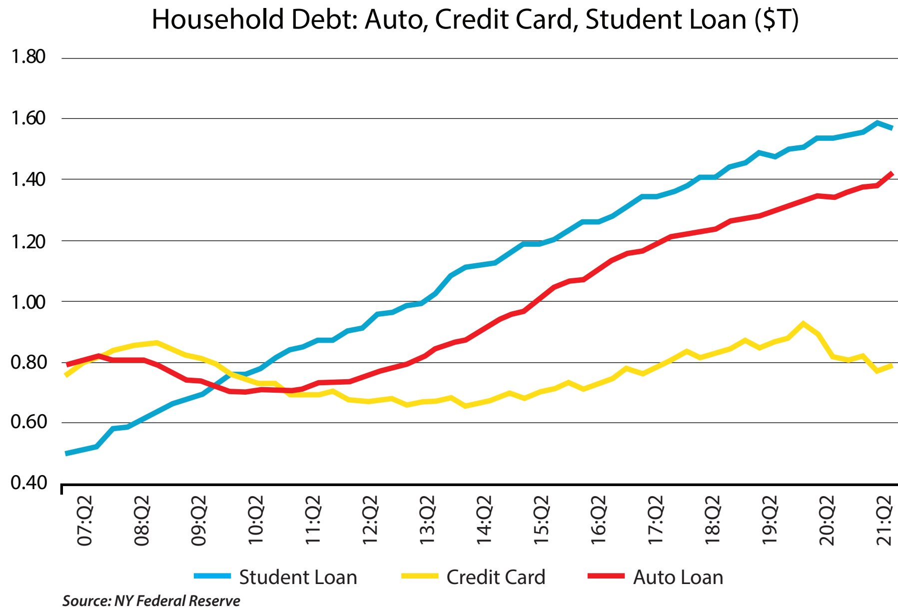
We are in the midst of a corporate debt renaissance in the fixed income markets. Every day seems to bring more and more issuance: re-financing, additional leverage, mergers and acquisitions fueled, first time issuers; it is a potpourri of issuance. As we have noted over the past few months, there is more than enough demand for this seemingly endless supply. So much demand that it overwhelms even this gold rush-like historic level of issuance from corporations. In response, a theme we have been witnessing play out over and over on a monthly basis is credit spreads continuing to grind in, hovering around and through historic tights. This level of demand spurs banks and underwriters on to press the next deal forward, and in certain sectors, such as structured finance, asking themselves, "what else can we structure and feed into this black hole of demand?"

Structured finance can be a great diversification trade, allowing the investor to find ample value on a secured basis. In the current environment, structured finance has found a larger and growing investor base due to its issuance, allowing investors to find products to park cash at levels wider than comparable (or even lower) rated corporate credits. As bankers search for additional products to sell into the capital markets, the first thing to consider is just how much structured finance or Asset-Backed Securities (ABS) are available. Unlike corporate credits where one might find a firm pushing the envelope on things like leverage (handcuffing their ability to issue more debt or even refi outstanding debt), structured finance is theoretically unburdened by those constraints. In theory, as long as there are receivables or loans for instance out there, one can gather them up and crank out some securities. However, without underlying credits, there can be no securities backed by them. So where are we? Are there enough receivables to keep the ball rolling? Well, the good

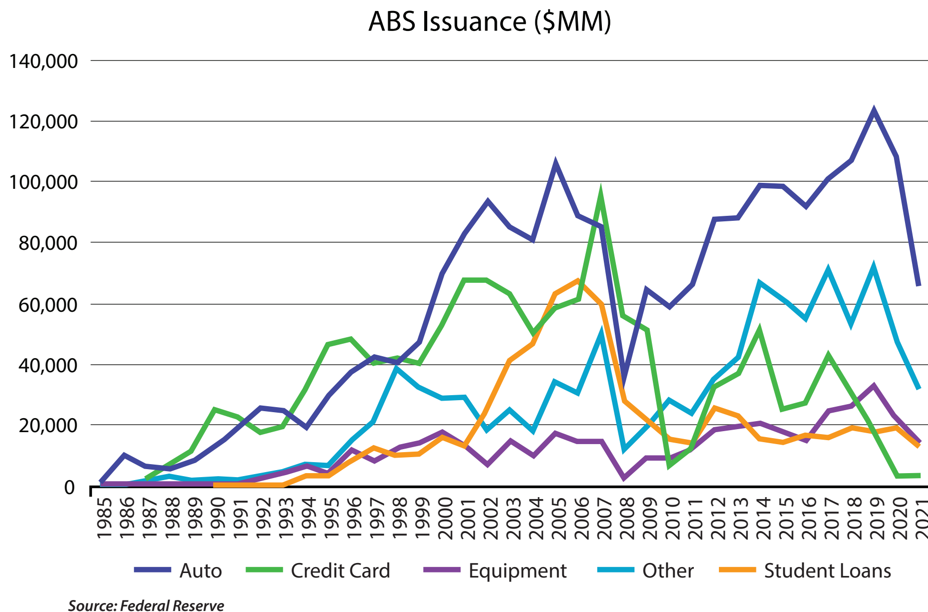
news is that as a nation, we are all pretty good at generating debt. While that obviously can be a problem on an individual basis, as a source of underlying loans for ABS, it's is a very good thing. Additionally, most households seem comfortable carrying debt in many forms including mortgages, auto loans, personal loans, credit card balances and student loans. According to the NY Federal Reserve, household debt reached nearly $15 trillion in the US by the end of the second quarter of 2021. The majority of that was in mortgage debt, which is generally the case most of the time, simply because home ownership typically is comparatively expensive due to the home's purchase price and is an individual's biggest burden.

The housing market has been red-hot; certainly, the amount of mortgage debt should not be surprising, but like most things these days, we are now at a historic high in terms of outstanding mortgage debt for households. Nevertheless, from a product standpoint, and one focused on ABS, mortgage debt isn't so high on our list. The private label MBS market, despite several efforts to get going, simply hasn't regained any momentum since the Great Recession. Understandably, investors have shied away from this sector. There have been several prime private label MBS deals over the past few years, but overall, most MBS debt would be that issued under Agency MBS.

For consumer ABS, the bigger well-known categories tend to focus on auto loans/leases, credit card, and student loans. As one would expect given the level of total household debt mentioned above, we are seeing households embrace certain types of debt such as auto loans and student loans as never before. The one exception being credit card debt, which seems to be hovering at levels consistent to that exhibited over the past 20 years. Nevertheless, auto loans and student loans continue to grow, making them prime areas for future ABS issuance.

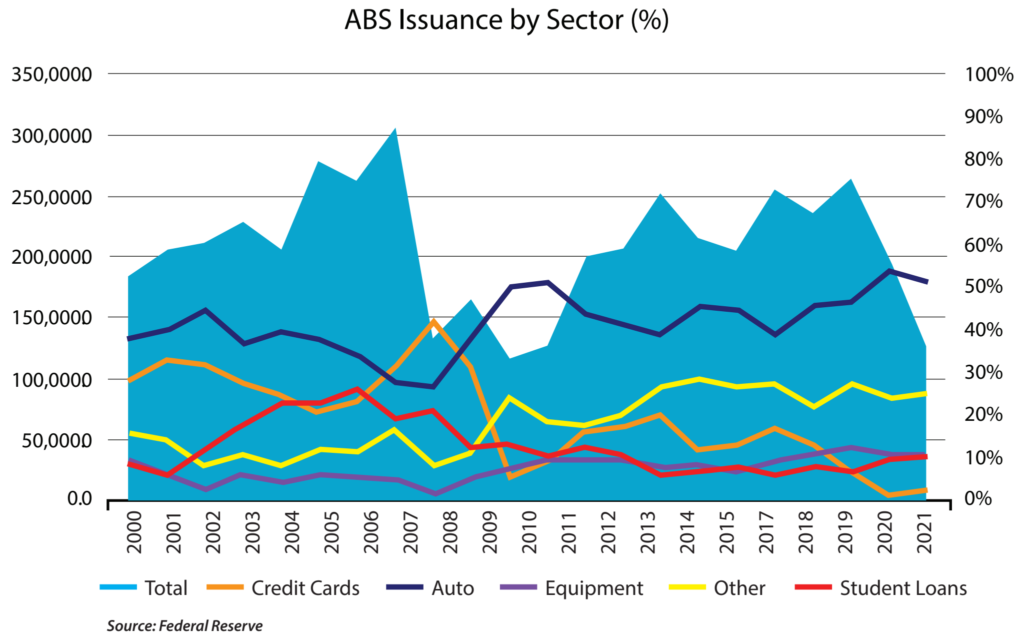


With a large amount of loans available, it has provided fodder for increased issuance in ABS in general. This is especially true in consumer ABS. As can be seen below, issuance in most plain vanilla consumer ABS has been strong and climbing. The only laggard has been credit card ABS, which is down a great deal over the past two years, as banks (the biggest issuer of credit card receivables debt) have eschewed this type of financing, which can be more expensive than say low financing costs of deposits.

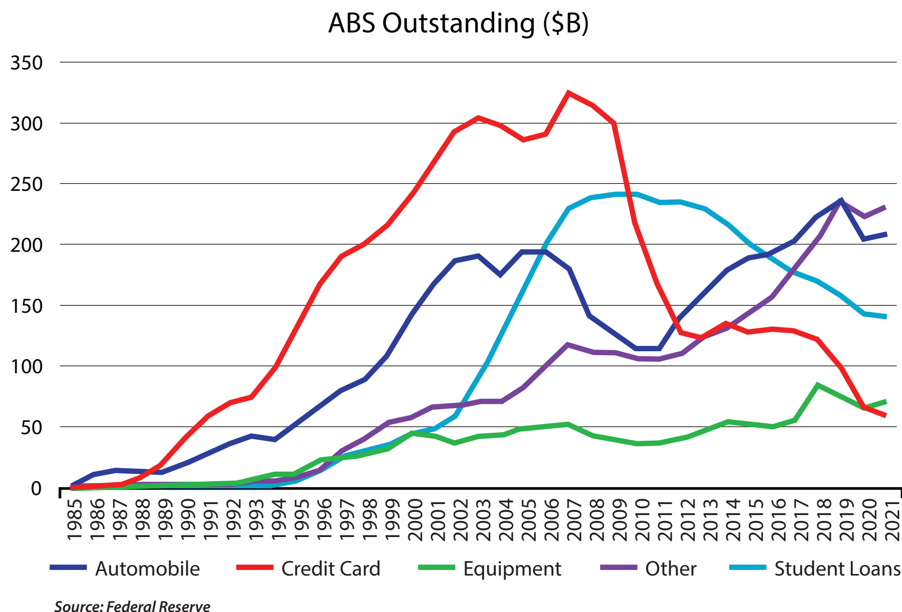


Not surprisingly, auto ABS continues to be the bulk of the issuance. Auto ABS is one of the oldest sectors in structured finance. Its long performance history provides rating agencies and investors comfort that they have a grasp on future performance of the sector. This translates into the sector having a robust investor base when compared to most other ABS sectors, with the only other sector comparable in this regard being credit card ABS. Indeed, the investor base for these sectors sometimes can stretch from money market funds to hedge funds, as there is generally a tranche in the capital structure that interests investors up and down the risk spectrum. This type of interest and dedicated investor base results in auto ABS not only typically being a solid performer but also having sizeable and a reliable

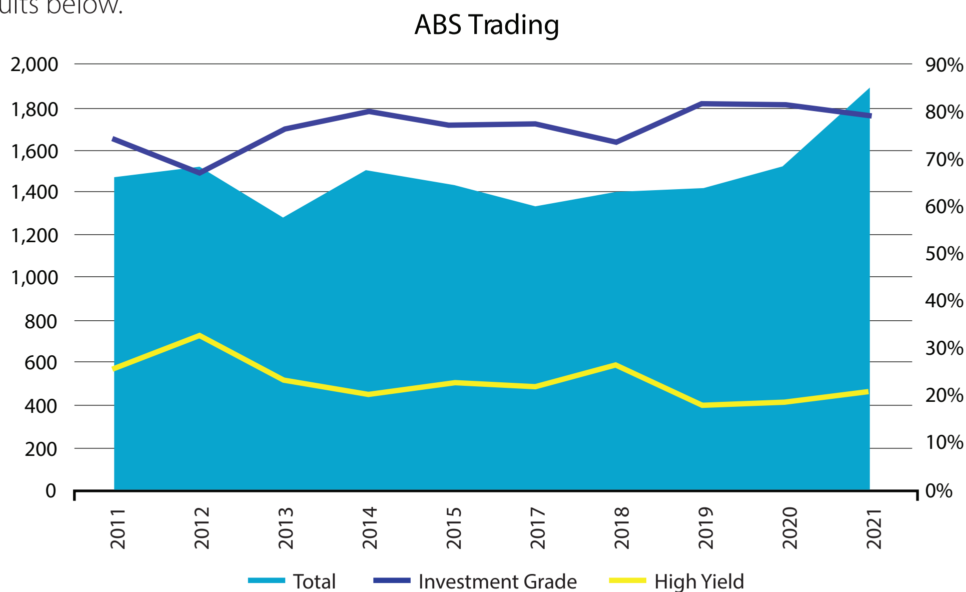
secondary liquidity market.



Having a solid investor base for auto ABS for secondary trading purposes makes this sector attractive. Lately, secondary trading has been robust as well not only for this sector but others in ABS as well, although not as robust in terms of offerings available as one would expect. Interest is there, especially given the heated demand in fixed income overall. The issue for ABS for this purpose, however, is that there isn't as much outstanding as one would hope or come to expect. Part of that has to do with how ABS is structured. Unlike corporate debt (the majority of which tends to be a bullet maturity), ABS pays down principal over time. Thus, deals with 3-year average life, depending on the cycle and how fast borrowers pay down the outstanding loans that comprise those ABS trusts, the securities issued can pay down much quicker than anticipated at initial issuance. The paydowns thus can influence just how much outstanding is in the market. As a result, even if initial issuance is robust, it's possible paydown speeds will shrink just how much outstanding amounts of ABS would be available for secondary trading, something we've seen as of late.

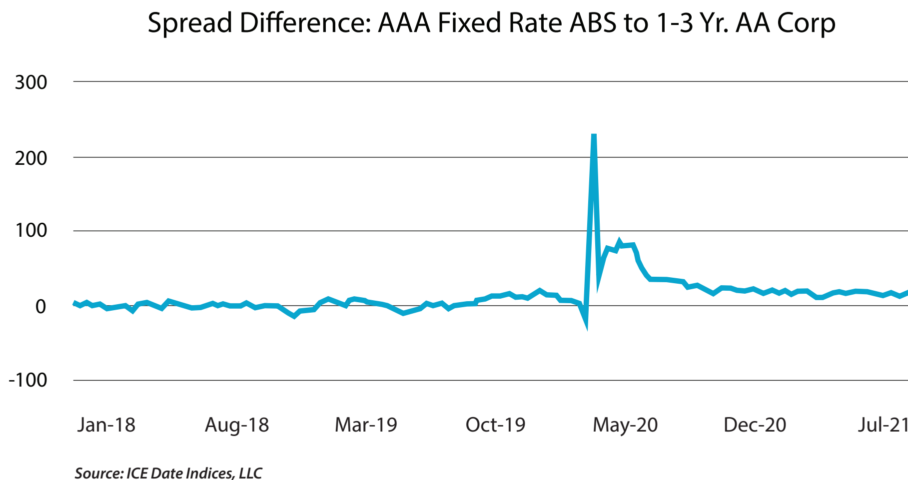


That said, what is available has been trading at levels of interest not seen since the heyday of 2007. As we have discussed, because of the excess capital in the markets and a dearth of products, trading in ABS continues to not only benefit from long-term investors in the sector but also newer investors who are drawn by the perceived safety in terms of the secured nature of the product. Potential pick-up in terms of yield (see below) when compared to corporates also remains a drawing factor. As illustrated below, ABS trading continues to pick-up in terms of amounts, the bulk of which has been in investment-grade tranches. That would seem intuitive given how ABS structures are created. The bulk of those transactions tend to be structured such that the tranches are predominately Investment Grade (IG). Furthermore, as time goes on, and a trust performs well, senior tranches pay down and credit enhancement builds in subordinate tranches, odds are that rating agencies will then upgrade those subordinated classes within the structure. Thus, a class that was initially rated BB over time would be upgraded into IG, and further skew the results below.



Source: Federal Reserve

As mentioned, investors newer to the bpsector have found the fact that ABS can be a bit wider to similar and even lower rated credit quality corporate exposure to be appetizing. As seen below, when comparing AAA fixed rate ABS to AA corporates there is typically a small pick-up in terms of spread. Currently that pick-up is right around 16 bps.



Source: ICE Date Indices, LLC

Lastly, similar to just about everything else in fixed income, credit spreads in ABS have been grinding in as well. In certain cases, this type of tightening has been far more dramatic than that witnessed in corporate credit. According to Bank of America, over the past 12 months, spreads on BBB prime auto 5-year paper have tightened some 165 bps, BBB subprime 5-year auto paper tightened 105 bps, AAA credit card 3-year paper tightened 23 bps, and A container 5-year paper tightened 223 bps.

Overall, and generally speaking, outside of sectors such as aircraft, ABS has performed well, and in certain cases, especially at the beginning of the pandemic, ABS (with a few exceptions) has exceeded expectations in terms of performance. The sector is also filling a need in terms of creating supply for a market that is starved for product, and doing so at wider spreads than corporate credit, providing some yield pick-up to an investor group looking for any sort of yield benefit in this low-rate environment. Furthermore, there are sectors with long history, such as auto ABS and credit card ABS, which have a high degree of liquidity, making them solid holdings for those that might need to handle unexpected outflows in their funds. Done right, the ABS sector can provide diversification, liquidity, performance, and these days, importantly, an availability of offerings.

Much like one of our summer marinades, too much of the wrong ingredient can sometimes ruin a good thing. In this era of supply not keeping up with demand, banks continue to look for new ways to create product, which as mentioned, can be a bit easier with structured finance than corporate debt. Thus, under the ABS tent we constantly see "new" securitization types such as data center or airplane engine or diamonds be introduced into the market. Many of these new(er) types of securitizations have limited performance history; one simply doesn't know how some of those will perform in the wrong environment. Another thing to consider is liquidity. While the ABS auto investor base is robust, it is still small when compared to corporates, and as one moves into the other ABS sectors and into esoteric ABS types, the investor base will dwindle even further. The recent grinding in with regards to spreads can be partially attributed to newer investors looking for a yield pick-up venturing into a space that they had avoided in the past. That can often lead to an ill-timed exodus from the space at the wrong time. That type of newer investor leaving the space during a rough patch can cause a dramatic widening out of spreads and falling prices as they look to sell at no matter how low a price. Those types of investors, history has shown, will leave just as fast they came in.

ABS can be a valuable and important part of a portfolio. The right sectors and the right deals provide solid performance, diversity, and liquidity. We tend to keep to sectors which have a long performance history, preferring those sectors we know have performed throughout some of the rougher times in the financial markets history, and have performed well. Those sectors tend to have a more loyal investor base and proven liquidity even in the toughest times. We are in a moment when demand is pushing investors to not only reach for yield, but potentially into certain ABS sectors they are not familiar with or that have limited operating history. That historically has not ended well. As is our mantra, we stick to the names we know, in the sectors we like because of their long performance history and proven reliability. Keeping to that investment theme tends to result in the sector providing the performance we expect, with the additional benefits of diversification and liquidity.

Short Term Bond

July has had its hiccups. Concerns in the marketplace seemed to focus on the Delta variant, its ease of transmission, and ultimately how it was driving increased number of positive cases, hospitalizations and deaths. The headlines continue to populate news cycles, and this ultimately began to weigh on the capital markets as participants began show concern

that it would blunt an economic recovery most had assumed would be coming out in full force during the summer. But that concern seemed to take on a certain kind of rhythm where it would manifest itself in the markets one day, ease the next, and come roaring back the day after that. What hasn't changed much has been the amount of money needing to be placed in the markets. Despite the stop and start Delta-influence on the markets, issuers continue to come to market in full force, both high-yield and high-grade issuers, taking advantage of historic low rates to grab as much funding as possible. This supply continues to be met with a seemingly tireless investor base eager for the next issuance. This has also engulfed the secondary markets, where we hear anecdotally from dealers how difficult it is to simply source paper in order to continue reaping profits on market activity. There is heavy secondary market activity, and even on days where credit spreads might leak out, it doesn't seem to slow the demand down. Even despite these days of credit spread widening, the overall health of firms remains strong. While there are always laggards, the market is currently showing an openness to embracing even those credits that might be stumbling a bit. This credit environment is meeting our expectations over the past few months, and we remain positive on the overall tone in the markets. We have taken a slight step back from sectors that had overperformed over the past 6 months, such as leisure, hotels and cruise line, as we are beginning to see them reaching a point where there is little room left in that trade. Consumer-driven sectors such as auto manufacturers, and auto loans remain an attractive area and there is ample issuance available. Another sector of interest to us over the past 6 months has been telecom and technology. New issuers have entered the market, providing an opportunity to not only diversify into these sectors, but do so in names where we have interest in adding. Overall, we continue to stay true to our approved issuer lists, including preferred names and targeted sectors.

Our positive view of credit continues to be illustrated in our interest in Collateralized Loan Obligation (CLO) paper. Underlying credits in the deals are performing, and additional credit support is found within the deal structure. The paper is floating rate, which also helps us remain neutral to rate movement. The CLO space has become more popular over the past 9 months, with many deals in the market and many more coming, based on anecdotal stories we hear about dealer and bank warehouses in use. With many more deals to choose from, we find it of importance to stay with the managers we feel comfortable with and the credit area within the structure we find of value. Senior notes, or those in the AAA tranches down to single A, continue to be our preference, and we continue to stick with tier 1 managers, who exhibit long track records, solid performance, and a commitment to the space. Consumer ABS is a solid contributor of value. Auto ABS remains an important holding, but as spreads tighten becomes more valuable in terms of liquidity and its amortizing structure. We also find value in solar deals and of late, student loan paper. Private and Federal Family Education Loan Program (FFELP) student loan paper have a floating rate structure, making them a desirable means to neutralize negative rate movement, and also have a long history, showing over the past year to have solid credit performance. Agency MBS remains a neutral sector. We like the liquidity of the holdings, and it allows us a means to offer a view on the residential housing market, albeit in a government backed note. Payment speeds remain the focus in that sector, and we remain committed to finding the right pools in order to help mitigate some of the interest rate risk but still capture upside in terms of yield.

Business Developement Company (BDC) paper remains an avoided sector. Despite our overall positive view on credit (and even senior secured loans), the structure of BDCs and the large amount of competitors in their space continues to have us wary of the sector. BDC paper continues to trade wide to corporate paper with similar ratings, and we have not seen any evidence that demand is picking up. As such, we don't expect value to be

available. CRE paper has had a nice run of late with certain dealers pushing the product. We see a renewed interest in repurposing and updating of properties as part of the economic recovery from the pandemic, something many perceive as an upside. We remain skeptical however and still avoid the sector given that we have not seen enough positive traction in the space and most of what we see in terms of market participation is based on expectations and not fully realized yet. Energy overall continues to be highly volatile. However, we do find value in the renewable space and consider the sector of interest when opportunity arises. Nevertheless, fossil fuel, which dominates the space, continues to be avoided, given its history; we continue to expect a high degree of unappetizing volatility in the sector. Utilities are a more neutral sector of late. The space is dominated by solid names but, during the wildfire season in California, can have headlines that impact all names in the sector.

Rates dropped throughout the month. Nevertheless, we remain concerned that there is ample runway for rates to rise and close the year much higher than currently reported. As such, we remain concerned over rate volatility. As we have done previously, we continue to try and keep as neutral to rates as possible. We continue to keep duration in a targeted area, utilizing floating rate notes and the amortizing structure of ABS to help mitigate potential negative rate movement.

Download Fact Sheet

Download Holdings

Barry D. Weiss, CFA

Portfolio Manager, Yorktown Management & Research

Barry D. Weiss, Portfolio Manager, is responsible for fixed income strategies at Yorktown Funds.

John Tener, CFA

Portfolio Manager, Yorktown Management & Research

John Tener, Portfolio Manager, is responsible for risk management strategies at Yorktown Funds.

Definition of Terms

Basis Points (bps) - refers to a common unit of measure for interest rates and other percentages in finance. One basis point is equal to 1/100th of 1%, or 0.01%, or 0.0001, and is used to denote the percentage change in a financial instrument.

Curvature - A yield curve is a line that plots yields (interest rates) of bonds having equal credit quality but differing maturity dates. The slope of the yield curve gives an idea of future interest rate changes and economic activity.

Mortgage-Backed Security (MBS) - A mortgage-backed security is an investment similar to a bond that is made up of a bundle of home loans bought from the banks that issued them.

Collateralized Loan Obligation (CLO) - A collateralized loan obligation is a single security backed by a pool of debt.

Commercial Real Estate Loan (CRE) - A mortgage secured by a lien on commercial property as opposed to residential property.

CRE CLO - The underlying assets of a CRE CLO are short-term floating rate loans collateralized by transitional properties.

Asset-Backed Security (ABS) - An asset-backed security is an investment security—a bond or note—which is collateralized by a pool of assets, such as loans, leases, credit card debt, royalties, or receivables.

Option-Adjusted Spread (OAS) - The measurement of the spread of a fixed-income security rate and the risk-free rate of return, which is then adjusted to take into account an embedded option.

Enhanced Equipment Trust Certificate (EETC) - One form of equipment trust certificate that is issued and managed through special purpose vehicles known as pass-through trusts. These special purpose vehicles (SPEs) allow borrowers to aggregate multiple equipment purchases into one debt security

Real Estate Investment Trust (REIT) - A company that owns, operates, or finances income-generating real estate. Modeled after mutual funds, REITs pool the capital of numerous investors.

London InterBank Offered Rate (LIBOR) - a benchmark interest rate at which major global banks lend to one another in the international interbank market for short-term loans.

Secured Overnight Financing Rate (SOFR) - a benchmark interest rate for dollar-denominated derivatives and loans that is replacing the London interbank offered rate (LIBOR).

Delta - the ratio that compares the change in the price of an asset, usually marketable securities, to the corresponding change in the price of its derivative.

Commercial Mortgage-Backed Security (CMBS) - fixed-income investment products that are backed by mortgages on commercial properties rather than residential real estate.

Floating-Rate Note (FRN) - a bond with a variable interest rate that allows investors to benefit from rising interest rates.

Consumer Price Index (CPI) - a measure that examines the weighted average of prices of a basket of consumer goods and services, such as transportation, food, and medical care. It is calculated by taking price changes for each item in the predetermined basket of goods and averaging them.

Net Asset Value (NAV) - represents the net value of an entity and is calculated as the total value of the entity's assets minus the total value of its liabilities.

Definition of Terms

Duration Risk - the name economists give to the risk associated with the sensitivity of a bond's price to a one percent change in interest rates.

Federal Open Market Committee (FOMC) - the branch of the Federal Reserve System (FRS) that determines the direction of monetary policy specifically by directing open market operations (OMO).

United States Treasury (UST) - the national treasury of the federal government of the United States where it serves as an executive department. The Treasury manages all of the money coming into the government and paid out by it.

High Yield (HY) - high-yield bonds (also called junk bonds) are bonds that pay higher interest rates because they have lower credit ratings than investment-grade bonds. High-yield bonds are more likely to default, so they must pay a higher yield than investment-grade bonds to compensate investors.

Investment Grade (IG) - an investment grade is a rating that signifies that a municipal or corporate bond presents a relatively low risk of default.

Exchange Traded Fund (ETF) - an exchange traded fund (ETF) is a type of security that tracks an index, sector, commodity, or other asset, but which can be purchased or sold on a stock exchange the same as a regular stock.

Federal Family Education Loan Program (FFELP) - a program that worked with private lenders to provide education loans guaranteed by the federal government.

Business Developement Program (BDC) - an organization that invests in small- and medium-sized companies as well as distressed companies.

You should carefully consider the investment objectives, potential risks, management fees, charges and expenses of the fund before investing.

The fund's prospectus contains this and other information about the fund and should be read carefully before investing. You may obtain a current copy of the fund's prospectus by calling 800-544-6060.

The fund itself has not been rated by an independent rating agency. Ratings (other than U.S. Treasury securities or securities issued or backed by U.S. agencies) provided by Nationally Recognized Statistical Rating Organizations (NRSRO's) including Standard & Poor's, Moody's, Fitch, Kroll, Morningstar DBRS, A.M. Best, and Egan-Jones. This breakdown is not an S&P credit rating or an opinion of S&P as to the creditworthiness of such portfolio. This breakdown is provided by Yorktown Management & Research. When calculating the credit quality breakdown, the manager selects the middle rating when three or more rating agencies rate a security. When two agencies rate a security, the higher of the two ratings is used, and one rating is used if that is all that is provided. A rating of BB and below would represent below investment-grade. Ratings apply to the credit worthiness of the issuers of the underlying securities and not the fund or its shares. Ratings may be subject to change.

Per the most current prospectus, (1) Fund total operating expense ratios are: Class A, 0.88%; Class L, 1.53%; Institutional Class, 0.88% until at least May 31, 2022. (2) In addition, the Adviser has entered into contractual expense limitation agreement with the Trust so that the Fund's ratio of total annual operating expenses are limited to 0.84% for Class A shares and Institutional Class shares and 1.49% for Class L Shares until at least May 31, 2022.

Fixed income investments are affected by a number of risks, including fluctuation in interest rates, credit risk, and prepayment risk. In general, as prevailing interest rates rise, fixed income securities prices will fall.

Past performance is no guarantee of 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. There is no guarantee that this, or any, investing strategy will succeed. Diversification does not ensure a profit or guarantee against loss.

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