Transcript

Beverly Chandler

Hello, my name is Beverly Chandler and I welcome you to this outing of Off the Record, the podcast about all things ETF brought to you by ETF Express in partnership with asset managers and ETF issuers Harbor Capital Advisors. All views expressed in this podcast are the speakers' own and we hope suitably controversial. In this outing for the ETF Express podcast, we're going to focus on fixed income ETFs and I'm joined by Dale Korman, regional investment consultant with Harbor Capital Advisors Inc and Heather DeGarmo, Head of Product Strategy at Blue-Cove. Let's open with you Dale, and I want you to tell me a little bit about Harbor Capital Advisors Inc and then the firm's relationship with Blue-Cove.

Dale Korman

Thanks for the opportunity to be here, Beverly. Harbor Capital Advisors has roots dating back over 50 years in extensive manager research. The firm partners with best in class outside money managers across the globe in most of the major asset classes and we wrap those into either mutual funds, or what we'll be talking about today in active ETFs, in equity and in fixed income. We were really excited to work with Blue-Cove, they were actually our first partner on the active ETF expansion that Harbor has done over the last two and a half years; and they run two active ETFs today for us that we'd be happy to get into. But we're really excited about the partnership and happy to be here today with Heather.

Beverly Chandler

And Heather, your turn. Can you just tell me a little bit about Blue-Cove.

Heather DeGarmo

Yes, thank you, and I echo Dale's sentiments, thank you for inviting us today. We think that the growth of the scientific market within fixed income is a real opportunity and if we look at what's happened in equity markets which were in this space for several decades, it's fairly nascent in the fixed income space. And we saw today that the necessary ingredients are in place to support a scientific investment approach and it was for us as a firm, we thought a generational opportunity to launch a firm that specialises in scientific fixed income. We think that scientific approaches have been largely unexploited so far but today can present a compelling opportunity for investors, particularly in comparison to more traditionally discretionary active mandates or passive strategies, which I think we're going to talk a bit more about. Blue-Cove itself was founded in 2018. We're a specialist active manager with a platform that's custom built for scientific fixed income investing. Our investment team, even though the firm is relatively new, our investment team is not. We have very seasoned professionals with over two decades of experience in this area and as a firm we offer a range of products to a largely global institutional investor base.

Beverly Chandler

And you described the firm as having this scientific asset management approach. What does that mean in the context of the investment process? And why would someone reallocate to this process?

Heather DeGarmo

Yes, I think it's first helpful to even talk about the word scientific. When we founded the firm, we went through, lots of discussions internally because there are a lot of words that float around on the Street, is it systematic? Is it quantitative? Is it model based? You know, we prefer scientific and that word is important to us. And the reason is that we view scientific investing as the implementation of an investment process that is evidence based, it's based on economic intuition, it's data-driven and it's fundamentally grounded in the scientific method; which really means that we start with an investment hypothesis, we gather information, we test that hypothesis, we implement it, and then as I like to say, lather, rinse, repeat. See how it's done, refine and evolve. And from that perspective, you know it is a scientific process and it relies on a very transparent and structured investment approach which really seeks to take advantage of persistent market inefficiencies that again we think are underexploited by most participants. We actually benefit from some of the changes that have occurred like the growth in data, increasing market breadth, credit markets themselves have increased by a factor of four in the last 20 years. We've seen trends such as the electronification of trading which have opened new streams of liquidity. Investment grade and high yield bonds, 30 to 40% of those now trade electronically. When I go back to the beginning of my career 30 years ago, it was all pick up the phone and hope for the best. So, there's a lot that has changed in recent years that we think we can benefit from in terms of running a scientific approach, and I think importantly for investors to your question is what I like to say, why would they care about something like a scientific approach? It's really two reasons. One, we think it can offer a complementary return stream to their existing fixed income allocation. Sometimes you can say that diversification is the only free lunch, and investing and finding something that complements what you already have can be quite attractive. And it also provides the potential for a more consistent repeatable source of returns or more consistent outcome for investors by nature of the investment process that we run.

Beverly Chandler

And why as a firm do you focus on fixed income only?

Heather DeGarmo

It's a great question and you know one that again gets to the heart of why Blue-Cove is what Blue-Cove is. When you think about equity markets, they have evolved much faster and for many reasons - so you have one stock versus several bonds. It's a far less complex, far more homogeneous market, let's say in comparison to fixed income and fairly mature in that space. So, from a business perspective, we felt that fixed income was the real opportunity for us as a business. But equally to give investors an opportunity of choice within fixed income, which historically has not existed and given the changing landscape that I've described in terms of some of the factors that now exist, those necessary ingredients to run a fixed income approach in a scientific way we thought was very compelling. We do think that unlike equity markets, which again are fairly mature in this area, you really need to have market practitioners in place. And if we go back again to this idea of more quantitative, let's say, strategies that a might spit out a number, you trade, you move on. That could be far more common in a more developed market such as equities. Within fixed income, we really need to have seasoned market practitioners that sit between the research and the output and the execution and so having that human intervention is particularly important and relevant, and we've sought to build a very strong talent pool in this area with seasoned professionals that have been in this space for the last two decades. So, it was very much a both from a business perspective in terms of the opportunity, but also for investors, we think it’s a real opportunity now to be looking at scientific strategies within their fixed income allocation.

Beverly Chandler

And you use that term active in describing your approach to investment. So, can you explain that? Is that part of this approach of having seasoned professionals?

Heather DeGarmo

Yes. If we really want to simplify it, there are two ways to invest. One is passive, where you get the benchmark and two is active, where you're looking to outperform the benchmark. And so really what an active manager like Blue-Cove looks to do is to make forecasts in terms of expected returns and then position the portfolio or the fund accordingly. So, in a in the case of a passive strategy, you're really getting index replication, risk replication, you're buying the market. There could be situations where you might have, even though it's a fairly low-cost solution, you might have positions or risk exposures that might not be desirable let's say based on the underlying characteristics of the index, you get what you get. In the case of active we are looking to outperform a target benchmark or outperform, I should say a target return and provide what we call a high-quality alpha stream and we do that by making a number of decisions along the way. And so if we take, for example, in a say, a high yield credit mandate, you're going to get similar levels of risk between an active and a passive strategy. But what might be different in an active approach is you might remove some unwanted risk exposures. You for example, how much sector risk do you want to take, how much market direction risk you want to take, how much interest rate duration risks you want to take and we can remove those risks and instead focus on what we want to take, which is what I like to say trading Company A versus Company B, or Bond A versus Bond B, which we refer to as security selection. We can also bring in important factors that we think, particularly fixed income and again this is a good contrast to equity markets which are things like liquidity risk and transaction costs, which are particularly relevant in fixed income. How often does the bond trade? How expensive is it to trade? How does that trade over time or how does that change over time? And we very much want within our research process to produce realistic and tradeable portfolios because in the end you can have great ideas but if you can't get them into the portfolio, who cares? And so, a scientific approach from an active perspective really takes all of those elements into account when constructing portfolios. And I think that's the primary difference between an active and a passive approach.

Beverly Chandler

Thank you for that, that was really interesting. I'm going to ask you both about how this approach works in the context of the ETF that you manage, well you have two ETFs you manage for Harbor Capital Advisors. But let's start with Harbor Scientific Alpha High Yield ETF, S-I-H-Y? and I don’t know which one of you wants to go first. Tell me a little bit about that and how the Blue-Cove approach works within it? Maybe Dale start?

Dale Korman

Sure, thanks, Beverly. I just wanted to emphasise a few of Heather's points before I answer that directly. She mentioned the active approach in fixed income. Again, everything that Harbor does, we're looking to partner with active managers that focus on one key area and are market leaders in that area, and I think Blue-Cove checks that box with flying colours. So, I just wanted to re-emphasize that that is a big part of why we are so excited to partner with Blue-Cove is they’re specialist in scientific fixed income. That is all they do, and they do it well. In terms of how the approach works within the ETF, and we'll talk about the high yield, the SIHY, S-I-H-Y is the ticker. I'll point out another great observation that Heather had. In active management sometimes what you do not own may be even more important than what you do own, that act of omission. And to be blunt the high yield benchmark has a lot of, hence the name, low quality paper in it that candidly we believe investors shouldn't be focused on. So, they're looking to use their scientific process to focus on the top opportunities. Again, wrapping it into a clean cost-effective tax efficient active ETF at 48 basis points. Heather, what would you add to that in terms of the process?

Heather DeGarmo

Yes, I think that's a great backdrop and it's sometimes helpful to answer the question, what are you actually doing in this fund? What are you doing with the money? So as Dale said, we invest across a broad portfolio of high yield bonds. These are liquid U.S. dollar, high yield bonds. The fund is managed against a U.S. dollar high yield benchmark. We are looking to very much isolate security selection risk within this fund. Company A versus Company B and Bond A versus Bond B and that's security selection. We're looking to take very limited sector risk, very limited market direction risk, very limited if zero interest rate risk versus the benchmark, so when an investor looks at the return stream, they're looking to get broadly the risk profile of the market, but an excess return each year. And again consistency in that return is particularly important, what we like to call the quality of returns within the fund.

Beverly Chandler

And then we're just going to turn to the other product that you managed for Harbor Capital Advisors. This is SIFI. I'm liking these tickers, now I've got the names right. This is Harbor Scientific Alpha Income ETF. So maybe again start with Dale and then Dale hand over very smoothly to Heather.

Dale Korman

Sure. Thanks, Beverly. At the risk of repeating myself, everything you know as it relates to the ETF structure, fairly similar as you'd imagine. What SIFI does is it gives Blue-Cove a little more flexibility to go across sectors, it’s not strictly high yield or below investment grade. This is a good cross section of both investment grade and below investment grade, and really works well as kind of a core holding or to tag on to Heather's comment before, could be a complement to more of a core fixed income type holding. Heather, I’ll let you dig int o more of the details into how SIFI is managed differently than SIHY, but again, structurally fairly similar to SIHY.

Heather DeGarmo

Yes. And to pick up on your point, Beverly, we thought a lot about the tickers too, and we like them too. Once you know how to say them they’re actually quite memorable so we’ll take that as a compliment. With respect to SIFI, S-I-F-I, the goal in the fund is really threefold. One, to provide investors with an attractive income stream. Two, to dynamically manage the fund’s risk based on what we view the current opportunity set to be. And then three to provide investors with an attractive total return and a high-quality return stream. And really what we're doing looking to do there is preserve capital. And as Dale mentioned, we think that SIFI presents a real kind of staple opportunity, a core foundation allocation for investors within the fixed income market around which they can build their portfolio. Something that's offering attractive income which we think is particularly relevant in this environment as we think about the central banks considering the beginning of the rate cutting cycle, what do I do with my cash and finding attractive income is particularly important today. What's in the fund, as Dale alluded to, a diversified portfolio of high yield and investment grade bonds. This fund does sit within and is designed to sit within the Morningstar Multisector Bond category and that category itself dictates that at any one time roughly between one third and two third of the fund is going to be invested in high yield bonds, hence the income focus. But what we do is manage the positions within that fund, both utilising our security selection insights and that would be similar to how we do it in SIHY, looking at things like company fundamentals, market sentiment or bond valuations and then we also look to manage the overall credit and duration within the fund in order to manage the overall return stream.

Beverly Chandler

Thank you for that, Heather. Dale I'm going to ask you, what do you think differentiates these products from other fixed income ETFs? I mean it's been the biggest growth area of ETFs last year I think, fixed income came to the forefront. But how do these products, how do they differ?

Dale Korman

Sure. At the risk of sounding too salesy or talking our book too much. Again, while we are so excited to work with Blue-Cove, they are truly the pioneer in scientific fixed income investing, which is why we're so excited to partner with them a little north of two and a half years ago. So how they are different, they you really kind of get the best of both worlds here. You get the structural advantage of the ETF which is far more tax efficient and more cost effective than the typical mutual fund. And on top of that, I'd say the biggest benefit again, I really emphasise that actively managed approach with a scientific repeatable process. I love how Heather calls it the “quality of that return stream”. You could have a manager, and this applies to equity or fixed income, you could have a manager that has a great five-year return but if all of that return comes in one year and if the financial advisor or the clients are lucky or patient enough to hold it in that one year, great. But I do believe that the path of investment returns and sequence of returns matters. So that is something that Blue-Cove, with their process, they have really honed in on. Those would be the key things that I would emphasise that really sets SIHY and SIFI apart. And the punchline is in the performance.

Beverly Chandler

And then probably another one for you Dale is just tell me about the outlook as you see it for fixed income ETFs and SIHY and SIFI within that. Also possibly just worth mentioning that obviously the tax break on an ETF is only really applicable in the US so if anyone's listening to this and they're feeling very short changed, it's because they live in the wrong continent.

Dale Korman

I don't know if I'd say the wrong continent.

Beverly Chandler

A different continent.

Heather DeGarmo

Yeah, that's a that's a different podcast Beverly.

Beverly Chandler

Let's get back to what we're here to discuss. Fixed income ETFs, the outlook and how particularly these two products will fit within that.

Dale Korman

It's a great question. I think there's a ton of demand for both aspects of that question. The active ETF structure, if you read the industry news over the last couple of years because of a lax in some legislation a few years back, there's been an explosion of active ETF creation and subsequent demand. And we've seen that within our lineup at Harbor, we've seen that in the industry and again clients and financial advisors really do want the best of both worlds and in a lot of cases now they can get that which is strong, repeatable, active management in the tax and cost-efficient, cost-effective wrapper which is the ETF as it relates to fixed income. I've been in the business close to twenty years and interest rates have essentially gone straight down over those twenty years. And especially over the last few years, looking back at COVID four years ago, interest rates were essentially zero. Over the last few years we've seen the income go back into fixed income, which as investors know that is the lion share of total return in a fixed income investment over its life cycle is the income component.

Beverly Chandler

And is there anything you'd like to add to that, Heather?

Heather DeGarmo

Yes, I think specifically for if we look about the funds in terms of where they're invested and where their opportunity set is, again, SIHY, you're going to get this is a high yield fund, you're going to get high yield market exposure. So, you've made the decision that you want to buy high yield. The question is how and how do you think you can outperform the market and we think particularly and if we think about the backdrop today, as I mentioned more data, more to trade, more ability to trade, we think that speaks very well to a scientific process. But even today, as we think about default rates remaining above long-term averages and we're seeing the lagged effects of monetary tightening work their way through, we think this creates an opportunity set for security selection within SIHY. So that ability to outperform the high yield market we think is still very much there. And then for something like SIFI, which is more of a total return focus, as I said earlier, you know, when we're entering the potential for a rate cutting cycle, what do I do with my money? And as Dale said, you know, fixed income is finally fashionable again, having a robust income solution within the portfolio we think is particularly attractive for investors.

Beverly Chandler

So just closing points really, now. Let's just ask you, Dale, I'd like to hear what you're hearing from clients because you actually speak to investors so you're the other end of the business as it were. What are you hearing?

Dale Korman

We have had some good early success with the products, especially with SIHY. I think a lot of advisors are really struggling with what to do in high yield. We've had a lot of really good conversations, have started to see some good flows from some of the largest financial advisors and RIAs here in the States who really have bought into this scientific process and see that Blue-Cove really is the expert and pioneer in this space. So still early stages and still a long way to go but we're excited at the early progress and looking forward to continuing to grow them.

Beverly Chandler

Thank you for that. Is there anything you'd like to add, Heather? Feel you haven't said? Any, am I putting you on the spot now?

Heather DeGarmo

No, not at all. I think we're very passionate about this. I would say, if we think about the people at Blue-Cove, we're here because we want to be here. We believe in the investment philosophy. We've been around for a while, we've been thinking about this area for a long time, and we're really excited about the potential now as I said, to offer that complementary return stream and consistency of performance to investors, particularly against the backdrop that has changed so quickly in terms of what information is out there and what to do with it. So, we see this as a potential complement to what investors might be considering and something that we think is really a core decision for investors to consider, particularly in this environment.

Beverly Chandler

Thanks very much for that. So, thank you to my guests today, Dale Korman from Harbor Capital Advisors and Heather DeGarmo from Blue-Cove. And thank you to you for listening. Remember to subscribe and leave a review and feel free to contact us at podcast@chandlerpublishing.com. This has been an Off the Record podcast from ETF Express brought to you in partnership with Harbor Capital Advisors.

Outro

Off the Record is brought to you by ETF Express. Production by Imogen Rostron and Lisa Hines and Music by Otto Balfour. Thank you to our guests on this episode of Off the Record from ETF Express and to you for listening. We look forward to you joining us next time.

Important Information

Investors should carefully consider the investment objectives, risks, charges and expenses of a fund before investing. To obtain a summary prospectus or prospectus for this and other information, click here or call 800-422-1050. Read it carefully before investing.

Investing involves risk, principal loss is possible. Unlike mutual funds, ETFs may trade at a premium or discount to their net asset value. Harbor ETFs are new and have limited operating history to judge.

Shares are bought and sold at market price not net asset value (NAV). Market price returns are based upon the closing composite market price and do not represent the returns you would receive if you traded shares at other times.

The views expressed herein are those of BlueCove and Harbor Funds Distributors, investment professionals at the time the comments were made. These views are subject to change at any time based upon market or other conditions, and the author/s disclaims any responsibility to update such views. These views may not be relied upon as investment advice and, because investment decisions are based on many factors, may not be relied upon as an indication of trading intent. The discussion herein is general in nature and is provided for informational purposes only. There is no guarantee as to its accuracy or completeness. Past performance is no guarantee of future results.

SIHY and SIFI Risks: All investments involve risk including the possible loss of principal. Fixed income securities fluctuate in price in response to various factors, including changes in interest rates, changes in market conditions and issuer-specific events, and the value of your investment in the Fund may go down. There is a greater risk that the Fund will lose money because they invest in below- investment grade fixed income securities and unrated securities of similar credit quality (commonly referred to as “high-yield securities” or “junk bonds”). These securities are considered speculative because they have a higher risk of issuer default, are subject to greater price volatility and may be illiquid. Because the Fund may invest in securities of foreign issuers, an investment in the Fund is subject to special risks in addition to those of U.S. securities. These risks include heightened political and economic risks, greater volatility, currency fluctuations, higher transaction costs, delayed settlement, possible foreign controls on investment, possible sanctions by government bodies of other countries and less stringent investor protection and disclosure standards of foreign markets.

Alpha refers to excess returns earned on an investment.

Diversification in an individual portfolio does not assure a profit.

BlueCove Limited is the subadvisor of the Harbor Scientific High Yield Alpha and Harbor Scientific Alpha Income ETFs

Foreside Fund Services, LLC is the Distributor of the Harbor ETFs.

3532478