

## Portfolio

# DoubleLine's Other Jeffrey Has a Warning for Bond Investors

by Jane Wollman Rusoff

Bond investors need to keep interest-rate risk “at the forefront of their minds: If we have a meaningful move-up in rates, you could see negative returns in the bond market this year.”

That's the crystal-clear warning from Jeffrey Sherman, deputy chief investment officer of DoubleLine Capital, helmed by Jeffrey Gundlach, who is CEO and CIO.

ThinkAdvisor held a wide-ranging interview with Sherman on Feb. 12.

He forecasts “a challenging year for fixed income investors” and urges particular caution in the corporate bond market, which likely has the highest interest-rate risk in history, he says.

With the U.S. economy poised to gradually return to healthy growth, Sherman anticipates rising interest rates.

That scenario won't occur overnight, however: In view of the continuing weak labor market, America is “still mired in the recession,” he argues.

Sherman, DoubleLine's lead portfolio manager for multi-sector and derivative-based strategies, was named one of “10 Fund Managers to Watch” by Money Management Executive magazine in 2018.

The chartered financial analyst hosts a popular interview podcast, “[The Sherman Show](#).”

He joined DoubleLine in 2009 from TCW, where he focused on fixed income and real-asset portfolios.



[Credit: Allison Bell/ALM]

In the interview, he discusses several good alternatives to bond investing this year: securitized assets, for example.

He also offers his broad picks in both the equity and bond sectors and unpacks the firm's current strategy for the DoubleLine Core Fixed Income Fund.

ThinkAdvisor's phone interview also revealed Sherman's expectations for Janet Yellen as treasury secretary, as well as for Gary Gensler, President Joe Biden's choice for SEC chairman.

Here are highlights of our conversation:

**THINKADVISOR:** What's the most important thing advisors should know about fixed income this year?

**JEFFREY SHERMAN:** It's going to be a challenging year for fixed income investors. The key is trying to manage the interest-rate risk: Where do interest rates go from here?

Rates have to be at the forefront of bond investors' minds because yields are low, in general; spreads are tight. This means that if we have a meaningful move-up in rates, like 50 to 100 basis points, you could see negative returns in the bond market this year. It depends on the assets.

**What approach should advisors use in talking with their clients about bonds?**

Our advice to advisors is that you need to really think about the interest-rate component of [a] bond allocation. That's the important thing at this stage of the cycle, as we talk about potentially more inflation or reinflating the economy; that is, getting back to things looking more normal-ish.

[But] if we have higher growth rates, that tends to lead to higher interest rates. The interest-rate piece is one of the bigger risks of markets today.

**So, do you foresee rates rising in 2021?**

Interest rates are likely to go higher this year as we reset back to a normalized growth environment. That means Treasury yields will go up, and there likely could be some negative returns in that area if they rise more than half a percent or so.

**Please elaborate on your thoughts about inflation.**

We think inflation is going to spike in the next couple of months, probably [to] 2%. Core inflation has been flat in the last couple of months. So the potential for inflation is there. It's on a lot of investors' minds; it's on a lot of people's lips. But it hasn't come to fruition yet.

Once people think inflation will come, it can be very unwieldy because if you think prices are going up, and I think prices are going up and *your neighbors* think prices are going up, it creates the idea

that you want to consume now before prices go up. So because everyone thinks inflation is coming, it can be a self-fulfilling prophecy.

**What else should advisors keep in mind when recommending if clients should invest in bonds this year?**

Typically bonds are owned as a risk offset; they're in a portfolio to dampen volatility. So bonds were helpful last year in the downturn, especially Treasuries, in March. Today you have roughly more interest-rate risk in the corporate bond market than there has been historically.

As an advisor, you need to be cautious. What I don't like is the high valuation of investment-grade corporate bonds. I don't like taking significant amounts of interest-rate risk in the portfolios today.

**Are there any good alternatives to owning bonds?**

Yes. There are other things to buy that are exposed to the U.S. economy that have less interest-rate risk. For instance, you can buy bank loans. They, effectively, have no interest-rate risk; they're tied to Libor [London Interbank Offered Rate] risk. They float with Libor.

That's one way an advisor can say [to a client], "I recommend own[ing] some lower-risk assets; and maybe floating-rate loans make sense in this environment."

**Any other effective alternatives to bonds?**

Securitized assets, like residential and commercial mortgages. Also, securities backed by student loans or franchise loans. There are a lot of different products out there that have exposure to the credit markets in the U.S. but have significantly less interest-rate risk.

And these securities have a higher yield than the corporate bond market, as well as about 20% to 30% of the duration of that bond market — so,

a duration of two to three years. These are other ways to have exposure to the market and get what we think is a better yield profile with less interest-rate sensitivity.

### **Is the United States still in a recession?**

The labor market says yes. Financial markets say no. GDP hasn't gone back to an all-time high. So, if GDP isn't at an all-time high, it's hard to say we're out of the recession.

One thing that really points to our being in a recession is the continued weakness in the labor market. Labor participation is down. That's not healthy; it isn't a good thing.

### **That certainly doesn't say that the recession is over. What would it take?**

To declare we're out of the recession, it's not just the GDP number. We need significant improvement in the labor market. We're seeing signs of improvement, but [they're] not exemplary of an expansionary environment. We're still mired in the recession.

### **Is there a bubble in the stock market?**

A bubble is very hard to identify. What we saw with GameStop, Reddit, retail trading — those are bubblish ideas. Retail trading is making a comeback. But that doesn't make a bubble.

There are lots of parts of the market that look rich, but there are also pockets that are on the cheaper side of history, like financials and energy stocks — things unloved for the last few years that have started to get some nice momentum as of late.

### **Where can one find that value?**

There are parts of the market where, if you're not an indexer and have the ability to buy either sectors or downtrodden names, there's still relative value out there that's somewhat attractive.

### **Please elaborate on the statement you just made: "Retail trading is making a comeback."**

We've seen numerous new brokerage accounts

open last year and many [more] small-volume traders, the activity of Robinhood, low commissions, zero commissions, fractional shares' trading. The opening of new brokerage accounts has exploded in the last couple of months.

There are significantly more people who are trading. The pickup happened when everything shut down; some attribute it to the [imposed] lack of sports and gambling. There has been more money sloshing around the system. There's liquidity. There's support from the Fed.

### **How will the next stimulus impact the market?**

A lot of that is priced in because it's been talked about for so long. The market already expects \$1 trillion-plus.

### **What sectors of the equity market do you like for this year?**

I like the energies and the financials. I like financials because we've seen the yield curve steepen. The fed is committed to having a front-end policy [of] near zero [interest rates] for a long time.

The vaccine [rollout] has moved up. That's good for the banking system in general. I still think commodities have a way to run. There's a lot of talk about doing an infrastructure package. I like industrials.

### **What do you favor within the bond sector?**

I like the bank loan sector. We like CLOs — collateralized loan obligations. I also like parts of the commercial real estate market, which are pretty attractive opportunities. There's risk there, but I think you're getting paid for that risk today.

You don't want to buy the broad sector — you've got to be careful. You need to be active this year. But you need to see how the new administration's policies develop. I think you've got to focus on pockets that struggled last year. Some of those pockets have opportunity today.

### **What's your strategy for DoubleLine's Core Fixed Income Fund?**

We have underweight positions to agency mortgages, which are government-guaranteed mortgages. These are interest rate-sensitive assets. We're overweight residential mortgages — this doesn't have a huge upside, but we don't think it has much downside either — also, commercial mortgages and asset-backed securities.

We own a little bit of high-yield. One of our lowest weightings — compared to the last six or seven years — is emerging markets because we think [they're] more sensitive to the vaccine rollout.

### **What are your thoughts about gold?**

Gold goes as the dollar goes. The last [few] months or so it has traded in lockstep with the dollar, so it hasn't really moved a lot; but I could see it going significantly higher once the dollar really starts a down-trend.

A lot of gold bugs seem to have moved to cryptocurrencies and the like. Right now I'm agnostic about gold at these levels. If it gets back into the \$1,700 range that we saw last week, I can see a place to accumulate.

### **How does Janet Yellen's appointment as treasury secretary fit into all this?**

I'm conflicted about Ms. Yellen. She was portrayed to be extremely dovish and very accommodative to the market. But if you look at her track record as a member of the Federal Reserve's FOMC [Federal Open Market Committee], she voted for every

single rate hike. [Federal Reserve Chairman] Jerome Powell is a disciple of Yellen.

### **What's the implication?**

Some people postulate that there's going to be easy financing. I don't know that to be a fact. We'll have to wait and see. Janet Yellen is one of the old guard; she brings stability.

But I think people are a little too accepting of the idea that she's going to let all this financing go through. I don't know if she'll be super-accommodative to all the whims of the Fed.

### **What do you think Gary Gensler, President Biden's nominee for SEC chair, will bring to the party?**

He introduced a lot of regulation when he was [chairman] of the Commodity Futures Trading Commission [during the Obama administration]. So to me, bringing Gensler back into the mix sounds like more regulation, not less.

*Jane Wollman Rusoff is a ThinkAdvisor Contributing Editor specializing in interviews with thought leaders. She has written for The New York Times, The Washington Post, USA Today and Esquire, among numerous other publications. Author/co-author of five books, Jane was a staff editor at London Express Features and Billboard's Merchandising Magazine. She is the founder of www.FamilyStarProductions.com.*

**Jeffrey Sherman, CFA**  
Deputy Chief Investment Officer

As DoubleLine’s Deputy Chief Investment Officer, Jeffrey Sherman oversees and administers DoubleLine’s Investment Management sub-committee coordinating and implementing policies and processes across the investment teams. He also serves as lead portfolio manager for multi-sector and derivative-based strategies. He is a member of DoubleLine’s Executive Management and Fixed Income Asset Allocation Committees. He can be heard regularly on his podcast “The Sherman Show” (@ShermanShowPod) where he interviews distinguished guests, giving listeners insight into DoubleLine’s current views. In 2018, Money Management Executive named Jeffrey Sherman as one of “10 Fund Managers to Watch” in its yearly special report. Prior to joining DoubleLine in 2009, he was a Senior Vice President at TCW where he worked as a portfolio manager and quantitative analyst focused on fixed income and real-asset portfolios. Mr. Sherman was a statistics and mathematics instructor at both the University of the Pacific and Florida State University. He taught Quantitative Methods for Level I candidates in the CFA LA/USC Review Program for many years. He holds a BS in Applied Mathematics from the University of the Pacific and an MS in Financial Engineering from the Claremont Graduate University. He is a CFA® charterholder.

"Money Management Executive, 10 Fund Managers to Watch. Managers were chosen based on factors including long-and short-term performance in their specific categories, individual strategies and their length of time in the business. All funds considered were led by single managers

**The Fund’s investment objectives, risks, charges and expenses must be considered carefully before investing. The statutory and summary prospectus contain this and other important information about the investment company and may be obtained by calling (877) 354-6311 / (877) DLINE11 or visiting [www.doublelinefunds.com](http://www.doublelinefunds.com). Read them carefully before investing.**

#### Risk Disclosure

Mutual fund investing involves risk. Principal loss is possible. Investments in debt securities typically decrease in value when interest rates rise. This risk is usually greater for longer-term debt securities. Investments in lower-rated and non-rated securities present a greater risk of loss to principal and interest than higher-rated securities. Investments in ABS, MBS, and floating rate 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. Investments in floating rate securities include additional risks that investors should be aware of such as credit risk, interest rate risk, possible illiquidity and default, as well as increased susceptibility to adverse economic developments. The Fund invests in foreign securities which involve greater volatility and political, economic and currency risks and differences in accounting methods. These risks are greater for investments in emerging markets. The Fund may use leverage which 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. Derivatives involve special risks including correlation, counterparty, liquidity, operational, accounting and tax risks. These risks, in certain cases, may be greater than the risks presented by more traditional investments. Investing in ETFs involve additional risks such as the market price of the shares may trade at a discount to its net asset value (“NAV”), an active secondary trading market may not develop or be maintained, or trading may be halted by the exchange in which they trade, which may impact a Funds ability to sell its shares.

#### Select Definitions of Terms Used in this Article

**Basis Points (BPS)** - Basis points (or basis point (bp)) refer 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. The relationship between percentage changes and basis points can be summarized as: 1% change = 100 basis points; 0.01% = 1 basis point. **Duration** - Commonly used measure of the potential volatility of the price of a debt security, or the aggregate market value of a portfolio of debt securities, prior to maturity. Securities with a longer duration generally have more volatile prices than securities of comparable quality with a shorter duration. **Investment Grade** - Rating that signifies a municipal or corporate bond presents a relatively low risk of default. Bonds below this designation are considered to have a high risk of default and are commonly referred to as “junk bonds.” The higher the bond rating the more likely the bond will return 100 cents on the U.S. dollar. **London Interbank-Offered Rate (LIBOR)** - Indicative average interest rate at which a selection of banks, known as the “panel banks,” are prepared to lend one another unsecured funds on the London money market. **Spread** - Difference between yields on differing debt instruments, calculated by deducting the yield of one instrument from another. The higher the yield spread, the greater the difference between the yields offered by each instrument. The spread can be measured between debt instruments of differing maturities, credit ratings or risk. **Yield Curve** - 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.

#### DoubleLine Core Fixed Income Fund Top Ten Holdings as of January 31, 2021

DoubleLine Global Bond Fund	5.55%
DoubleLine Infrastructure Income Fund	4.19%
T 0 3/4 01/31/28	1.94%
T 0 3/8 01/31/26	1.84%
FNCL 2 3/21	1.77%
T 0 1/8 06/30/22	1.16%
T 1 1/8 08/15/40	1.15%
T 0 1/2 06/30/27	1.10%
T 0 7/8 11/15/30	1.09%
T 2 1/4 11/15/27	1.04%

Fund holdings are subject to change and should not be considered a recommendation to buy or sell any security.

While the Fund is no-load, management fees and other expenses still apply. Please refer to the prospectus for further details. DoubleLine Funds are distributed by Quasar Distributors, LLC. DoubleLine® is a registered trademark of DoubleLine Capital LP. ©2021 DoubleLine Capital LP