Dodge & Cox Funds®

Video Transcript
February 21, 2018

2017 Fixed Income Review

Question: What drove the bond market and Income Fund performance in 2017?

Jim Dignan: The Income Fund returned 4.4% in 2017, beating its benchmark by roughly 80 basis points. The primary driver of performance in 2017 was the Fund's higher yield, and the narrowing of the yield premiums between credit securities and comparable Treasury securities. Non-Treasury fixed income securities do disproportionately well price-wise when yield premiums narrow, because in order for those yield premiums to narrow, either the yields on those securities have to fall by more than Treasury yields or, conversely, rise by less than Treasury yields, giving them superior relative price performance. So the Fund's overweight towards credit in 2017 helped with relative returns. With regard to credit broadly speaking, in 2017 the Credit Index began the year at 118 basis points above the treasury curve and ended the year at roughly 89 basis points to the Treasury curve. So again, tightening meaningfully to a relationship we haven't seen since before the financial crisis began in 2007. While most things went right for the portfolio in 2017, yield curve positioning did hurt relative performance as short rates rose meaningfully, and that was driven by the Fed hiking schedule of 25 basis points per meeting, of a total increase of 75 basis points, where longer rates actually fell over the course of 2017.

Question: How has Fund positioning changed from a year ago?

Jim Dignan: As you expect from Dodge & Cox, as yield premiums contracted over the course of 2017, we took advantage of this change in market psychology to trim our credit exposure. Specifically, we reduced our credit weighting by roughly 6.4 percentage points over the course of 2017, that left us with approximately 42.6% in credit as of the end of 2017. This brought our total credit weighting down by 12.6%, roughly, from our most recent peak that we reached in the first quarter of 2016, when yield premiums, yield spreads, were very generous. While we're finding on balance less opportunities in the credit space because of the repricing, we're still finding a lot of opportunities within credit for our strategy. As of year end, we have 51 discreet credits, where we're optimistic about the prospects for total returns over the next three to five years.

Question: What are the anticipated impacts of U.S. tax reform on credit?

Jim Dignan: Well we expect the most recently passed tax reform to have broad implications, not just for U.S. credits or credit in general, but for the entire capital markets and the U.S. economy. So our view is that this tax reform will provide meaningful fiscal stimulus to an economy that's been operating above its long-run potential for a bit of time now, putting upward pressure on growth and inflation and interest rates, giving us more confidence with our shorter duration stance versus the benchmark. So while we do view it as a credit positive, we think it has much broader implications than just that.

Question: With fewer oppportunities to be found in credit, where are we still finding value?

Jim Dignan: Well from a big picture perspective, when the risk/reward relationship becomes less attractive, we simply take less risk at Dodge & Cox. So, for example over the last two years we had a little less than 10% of the portfolio in cash and Treasuries during the first quarter of 2016, when yield premiums, again that spread relationship between risk securities and the risk-free rate, was very generous, versus a little over 20% in cash and Treasuries at the end of 2017, when that relationship was less interesting. Now, even in a more challenging backdrop, a more challenging market environment like we're seeing now, we generally can find interesting investment opportunities. In the fourth quarter of 2017, Ginnie Mae guaranteed home equity conversion mortgages and U.S. Treasury inflation-protected securities were examples of new securities that we found opportunties with in 2017.

Question: What is our outlook for fixed income?

Jim Dignan: While we were pleased with the Fund's results in 2017, we would caution our investors to be modest with their expectations of returns going forward, given the level of interest rates and where spreads are for credit and structured securities.

Dodge & Cox Funds SEC Standardized Average Annual Total Returns as of December 31, 2017: 1 Year 4.36%; 5 Years 3.07%; 10 Years 5.01%.

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