YTM Capital Quarterly Perspective

September 2020

Deadweight Bonds: What to do?

Investors are facing a dilemma that is forcing a rethink of asset allocation strategies: traditional bond investing has a gloomy outlook of historic proportions. In the coming quarters, what fixed-income alternative has excess return potential and will add diversification without significant expected risk to your portolfio?

Bonds in traditional portoflios have lost utility

Government of Canada Bonds have never returned less. The yield on a GOC 10 year bond is 0.56%. With inflation currently at 1.5% and the Bank of Canada targeting an inflation rate of 2%, it seems likely that investors who hold GOC bonds will suffer losses in real terms.

Source: Bloomberg

While increased rates would improve yield, there is no expectation of rates rising in the near to mid-term. The U.S Federal Reserve recently changed its policy and is now providing forward guidance. The Fed said that rate increases are not likely until 2023. And, unlike the past where rate increases were triggered by inflation approaching 2%, the Fed will now let inflation run above the 2% target, taking into account that many past periods were below 2% in judging when to intervene. The Bank of Canada is considering a similar policy and is subject to pressure to follow the U.S. and other nations. This possible new approach, added to the significant excess capacity in the Canadian economy, has generated a consensus view that 2023 is the earliest Canadian rates will rise.

When rates do rise, the increasing yields will help new long bond investors. Existing investors will, however, experience losses resulting from declines in the value of bonds they hold. For example, an investor who holds a 10 year Government of Canada bond will suffer a capital loss of 4.43% if rates rise by 0.50% and a capital loss of 8.65% if rates rise by 1.00%.

Although corporate bonds yield higher than Government bonds as a function of credit risk, those yields are also low. A representative portfolio of investment grade issuers is yielding 1.40%. A diversified portfolio of government and corporate bonds (Bond Index) is currently yielding 1.17% .

With such poor prospects for traditional bond portfolios, considering alternatives is critical.

Traditional Alternatives

The most obvious alternatives flank the risk continuum for income-oriented investments. At the most conservative end are GICs. GICs are currently yielding 2% for a 5 year commitment.

At the other end of the continuum are high yield bonds. A representative portfolio of high yeld bonds has a more compelling yield of 5.69%, but faces significant incremental risk stemming from the economic impact of COVID-19 that arguably makes it significantly riskier than a traditional Canadian bond portfolio.

Many investors would judge the expected risk / return tradeoff for high yield bonds to be out of balance in this enviroment. Depending on their objectives, investors would also conclude that the small expected real return of a GIC in no way compensates for the 5 year liquidity penalty, even with the guarantees that protect the investment and a nominal return.

Credit Hedge Strategies

YTM Capital Credit Opportunities Fund employs an actively managed credit hedge strategy that focuses on short maturity investment grade bonds and avoids many of the pitfalls of traditional bond investing. The Fund effectively eliminates the interest rate risk that is so impactful to traditional bond portfolios and provides isolated credit exposure. The portfolio managers of the Fund carefully manage this credit exposure, both in terms of selecting issuers and the maturity of the Fund's portfolio. And in today's market that credit exposure provides signfincalty more yield than a government bond.

What it means for investors is that they can gain exposure to meaningful expected returns that are not correlated to traditional bond returns. At the end of September 2020, the Fund had a yield of 2.60% and a correlation to the Bond Index of 0.22. And, unlike traditional fixed income alternatives such as high yield bonds, the Fund is not expected to be substantially riskier. Since the Fund's inception in 2015, it has an annualized standard deviation of 5.4% compared to 4.0% for the Bond Index over the same period.

The Solution

Investors who are concerned about the outlook for bonds and who do not view equities as a safe place to reallocate should consider the Fund. It offers the potential for downside protection, excess returns, and diversification away from traditional bond investing.

All data is as of September 30, 2020. The corporate bond portfolio is represented by the Bloomberg Barclays Canada Aggregate Corporate Total Return Index. The diversified bond portfolio is represented by the Bloomberg Barclays Canada Aggregate Total Return Index (Bond Index). The high yield bond portfolio is represented by the Bloomberg Barclays High Yield Total Return Index. This document is for information only and is not intended to solicit orders for the Fund. Investors should read the OM before investing. Past risk and performance may not be repeated. You can obtain the OM from YTM Capital Asset Management Ltd. or your Investment Advisor. **www.ytmcapital.com**

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