# Why isn't a levered credit strategy dangerous?

Investors most often react viscerally to leverage. That reaction is justified in instances where leverage is applied to a risky asset, but it is not justified in every instance.

As the CFA Institute says:

> Leverage is ***neither*** inherently ***good nor bad***. Leverage amplifies the good or bad effects of the ***income generation and productivity of the assets*** *in which we invest*. Be aware of the potential impact of leverage inherent in your investments, both positive and negative, and the volatility therein.

Leverage applied to low volatility, high quality assets creates risk that is a fraction of the risk embedded in unlevered volatile assets.

Our Credit Funds remove interest rate risk and focus on short-term, investment grade bonds. These securities are not volatile because, when interest rate risk is removed, the core risk is that a high quality company will not be able to repay its debt in a short period of time. This short-term repayment risk pales in comparison to the risk embedded in other securities of the same company: long term debt and, even more so, equity.

Consider the total risk – embedded risk plus leverage – of these three security types issued by Hydro One over the tumultuous period that was 2020. Risk is measured by price volatility and the two bonds are hedged to eliminate interest rate risk.

| | Volatility | Leverage | Total Volatility |
|---|---|---|---|
| **Short-term Bond** (1 year) | 0.7% | x 5 | 3.7% |
| **Long-term Bond** (30 years) | 19.6% | x 1 | 19.6% |
| **Common Stock** | 36.3% | x 1 | 36.3% |

**Unlevered long-term bonds and stocks were approximately 5x and 10x more volatile than levered short-term bonds.**

We have successfully employed a low-vol credit strategy since the mid-90 and, over the last 7+ years, in YTM Capital Credit Opportunities Fund. During that time, the Fund had average leverage of 5.5 times. Its standard deviation of 4.98 is virtually the same as the FTSE Canada Universe Bond Index at 4.95.

Here is how major investment categories available to Canadians, represented by indexes, have performed from a risk perspective:

| | YTM Fund | FTSE Bond | U.S. I.G. | Global Bond Uni | U.S. H.Y. | Canadian Equity | Preferred Shares |
|---|---|---|---|---|---|---|---|
| **Standard Deviation** | **4.98** | 4.95 | 6.83 | 7.35 | 8.15 | 13.17 | 13.77 |
| **Annual Net Return** | **5.65%** | 1.12% | 1.54% | 1.15% | 2.81% | 7.90% | 1.76% |
| **Maximum Drawdown** | **-9.15%** | -15.04% | -20.89% | -20.67% | -15.04% | -22.25% | -28.34% |

These measures demonstrate convincingly that leverage applied to a low volatility, high quality pool of securities has been not only a less risky choice, it also has provided substantial outperformance on both an absolute and risk-adjusted basis.

We manage this credit strategy in two funds: ***YTM Capital Credit Opportunities Fund*** is an OM fund and ***YTM Capital Fixed Income Alternative Fund*** is a liquid alt fund with a regulatory limit of 3 times leverage.

Ask us how a credit strategy can be effectively deployed into your portfolio.

**Risk and returns are for the period July 1, 2015 to November 30, 2022.** Source: Morningstar Direct. FTSE Universe = FTSE Canada Universe Bond Index; YTM Fund = YTM Capital Credit Opportunites Fund (Class F, distributions reinvested); U.S. I.G. (Investment Grade) = Bloomberg U.S Corporate TR Hdg CAD index; Global Bond Uni = Bloomberg Global Aggregate TR CAD Index; U.S. H.Y. (High Yield) = Solactive USD HY Corp TM TR Hdg CAD; Canadian Equity = S&P/TSX Composite TR Index; Pref Shares = S&P/TSX Preferred Share TR Index. Drawdown represents the percentage loss for the Fund from peak to trough. Index returns are provided as a comparison to demonstrate the Fund's utility as an alternative investment. Although it is not possible to invest directly in an index, indexes can be used as a proxy for investment categories. Investors should consider differences between the indexes and the Fund, such as risk profiles, investing strategies (the Fund uses leverage and shorting), fees, and taxation of returns. We use the regulatory definition of leverage which is equal to the liabilities of a Fund divided by its NAV. This document is for information only and is not intended to solicit orders for the Fund. Investors should read a Fund's OMs before investing. Past performance and risk will not be repeated. Obtain the OM and more info here: www.ytmcapital.com

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