It’s time to rethink your fixed-income allocation

Fixed-income investing has been an important part of asset allocation for decades. It has provided investors with diversification away from equity markets and potential for lower volatility.

Things have changed

The current environment of ultra-low rates is forcing investors to reconsider traditional fixed-income allocations. Most diversified long bond portfolios – whether offered as mutual funds or ETFs – do not offer the potential for a positive real return. Moreover, they are subject to the risk of meaningful capital losses if interest rates increase. The business press is replete with stories about institutional investors abandoning traditional fixed-income investing. Interest rate risk is off the charts and diversification alone is not enough to justify the traditional 40% allocation to bond funds.

Credit hedge funds are a compelling fixed-income alternative. They offer potential for real returns that are uncorrelated to traditional bond funds.

Traditional Bond Funds

At a high level, there are two types of bonds: government – or sovereign – bonds and corporate bonds. Government bonds are subject to interest rate risk. If interest rates rise, bonds held by investors decline in value.

Corporate bonds face interest rate risk as well as credit risk. If the market believes the issuer of a corporate bond is in a worse financial position, buyers will demand a lower price – which is also expressed as a higher yield – for that issuer’s bonds. The lower price reflects credit risk: i.e. the risk that the issuer may not be able to pay the bond back at maturity.

Traditional bond funds are subject to two primary risks: interest rate and credit

Funds generate positive returns in two ways: (1) buying bonds at a low price and selling at a higher price; and (2) earning interest while holding the bond. Any interest rate increase from the current lows creates significant risk to the return potential for traditional bond funds.

The key structural disadvantage of bond funds is that they cannot protect – or hedge – against interest rate risk and credit risk. Most bond funds do not have a mandate from investors to hedge and, even with a mandate, legal constraints make it impossible to hedge effectively. If rates are ultra-low, as they are now, a manager cannot easily or efficiently buffer a bond fund against the negative impact of interest rate increases on the value of its portfolio. In other words, there is nothing”fixed” about the expected returns for traditional fixed-income funds.

Credit Hedge Funds

Unlike bond funds, the predominant risk for most credit hedge funds is credit risk.

Credit hedge funds have the option of effectively eliminating interest rate risk by buying corporate bonds long and selling Government of Canada (GOC) bonds short. Because there is a tight relationship between the movement of corporate and GOC bonds triggered by interest rate changes, these paired trades eliminate the impact of interest rate changes. Credit hedge funds may also choose to be short or long interest rate risk and credit risk, giving these PMs more flexibility than traditional fund PMs.

Credit hedge funds face one primary risk: credit

The market values corporate bonds by requiring a risk premium over comparable risk-free GOC bonds. That premium is a function of events relating to the bond issuer and its sector, macro-economic factors, and corporate bond market factors. Market values are expressed as the difference between the yield of a corporate bond relative to the yield of a comparable GOC bond. This difference is called the “credit spread” or just “spread” and it is the risk premium. Spreads tighten if the corporate bond is viewed to be less risky and the corporate bond has gained in value. Widening spreads mean that the corporate bond is viewed as riskier and it is losing relative value.

Credit hedge funds also earn returns by buying bonds low and selling high and earning interest income while holding bonds.

There are, however, three critical differences:

1. Where a credit hedge fund eliminates interest rate risk, the corporate bond volatility it experiences is lower than a traditional bond fund. That is because the main component of risk – interest rate risk – has been eliminated.

2. Credit hedge strategies use leverage to enhance the income earned as well as to increase credit exposure. When used prudently, leverage amplifies returns without exposing a fund to excessive return volatility.

3. Bond funds are handcuffed by long-only bond exposure. When interest rates are ultra-low, traditional bond funds don’t have the tools to protect capital. Credit funds with no interest rate exposure are not directly impacted. When the economy is in a difficult spot and credit market expectations are poor, bond portfolio managers with corporate exposure cannot protect their funds. Credit hedge funds can short corporate credit exposure, both protecting a fund’s assets and maintaining return potential.

Limited Access

Credit hedge strategies are only viable through a fund. That is because three essential ingredients are available only to an institutional investor. First, a prime brokerage relationship is necessary to facilitate trading, to access leverage capacity, and to finance investing activities at reasonable rates. There is a relatively high AUM hurdle to enter into a prime brokerage relationship. Second, PMs need experience in navigating the market. They must have the skill and judgment to manage critical risks to the strategy, such as liquidity, credit, and maturity. Last, institutional dealing relationships with all major dealers are essential to access the market at fair prices.

How is Credit Opportunities Fund different?

We strongly believe that credit hedge funds are a compelling fixed-income alternative because they provide the potential for strong, uncorrelated returns. We believe with equal conviction that there are several factors setting YTM Capital apart in the credit hedge fund category.

Capital preservation. The portoflio managers learned early in their careers that excessive risk taking is not a recipe for success. They employ a seasoned, rigourous approach to risk management and, in the process, implement credit and trading strategies that protect on the downside. The PMs utilize both risk models and metrics, as well as managing the qualitative aspects of risk such as liquidity and market tone that have outsized impacts on return. And, the fact that the majority of their investible wealth is invested in YTM Funds ensures an alignment of interests with investors.

Pedigree. The portfolio managers are the only team of former Head Corporate Bond Traders from a major Canadian bank dealer in Canada. In our view, this distinction matters. For many decades and through many cycles, the PMs employed each of the trading and investment stategies neccesary to succcesfully manage a credit hedge fund and – unlike equity traders – with significant bank capital at risk. That experience and expertise provides the PMs an edge when it comes to risk management and trading. This advantage serves investors well.

Short maturity bonds. There are several structural features that make a short-term bond strategy rewarding from a risk / return perspective. Short-term bonds are much less volatile, they continue to appreciate as they approach maturity both for credit reasons and because large institutional money market funds often seek the bonds out when they approach 1 year to maturity. Plus the interest income paid by short-term bonds serves as a buffer if spreads widen. The average maturity of the Fund's portfolio since inception has ranged from 0.9 years to 2.3 years.

Predominantly investment grade. Bonds that are rated BBB or higher are inherently less volatile than non-investment grade bonds. The average credit exposure over the life of the Fund has been 99% investment grade.

Commitment to hedge interest rate risk. The portoflio managers decided from Day 1 that the Fund would not be exposed to interest rate risk and have managed the Fund accordingly.

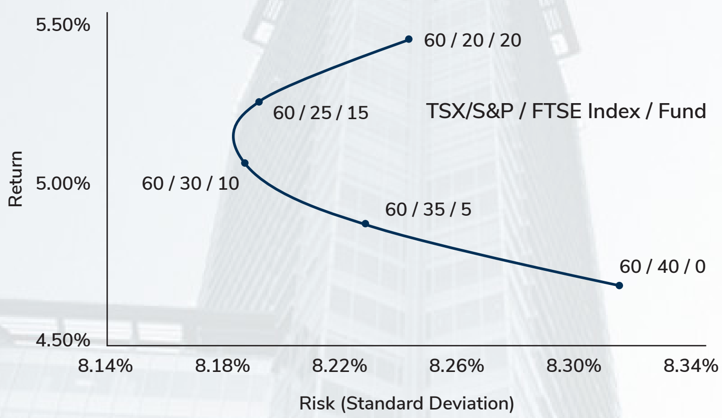
Why is correlation important?

Understanding correlation helps to build better performing portfolios. Correlation forecasts how one asset class will move compared to another asset class based on past performance. The less correlation between asset classes in a portfolio, the less volatility. In other words, if one asset class is performing poorly, an uncorrelated asset class is more likely to stay static or perform well.

The main measure of correlation is called the correlation coefficient. It ranges from -1.0 to +1.0. The closer to -1.0 or +1.0, the stronger the likelihood two asset classes will move at the same time. If the coefficient is negative, any movement between the classes will be in opposite directions.

Defining the relationship betwen asset classes gives investors the power to choose an optimal mix. It is often expressed in the form of an efficient frontier – a line chart that shows the optimal asset mix at the point of the line that intersects the highest expected return with the lowest expected risk.

Since inception, the Fund has a low correlation with the FTSE Index of 0.22. To put that measurement into the context of portfolio building, consider an efficient frontier based on the Fund's performance since inception relative to the FTSE Index and the S&P/TSX, taking correlation into account. It demonstrates that for portfolios with a static equity allocation of 60%, a 20% allocation to the Fund would have produced the best return and a 10% allocation to the Fund represents the best risk / reward trade-off.



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What are the results compared to traditional asset classes?

Since the Fund's inception on July 1, 2015 it has outperformed the bond market and the equity market on returns and risk-adjusted returns, as measured by the Sharpe Ratio. Interestingly, that 63 month time period included lengthy periods of falling interest rates. This factor created a strong return environment for traditional bond funds. Despite that opportunity, Morningstar 5 star traditional bond funds with a fee-based structure in the Canadian fixed income category had an average 5 year return of 4.42% and an average 5 year Sharpe Ratio of 0.80%, both less than the Fund.

	Annualized Net Returns (%)				Standard	Sharpe
	1 year	3 years	5 years	SI	Deviation (SI)	Ratio (SI)
Fund	3.81	4.40	8.06	7.86	5.3	1.30
FTSE Index	7.10	6.10	4.26	4.04	4.0	0.78
S&P / TSX	-0.03	4.24	7.13	5.14	12.7	0.33

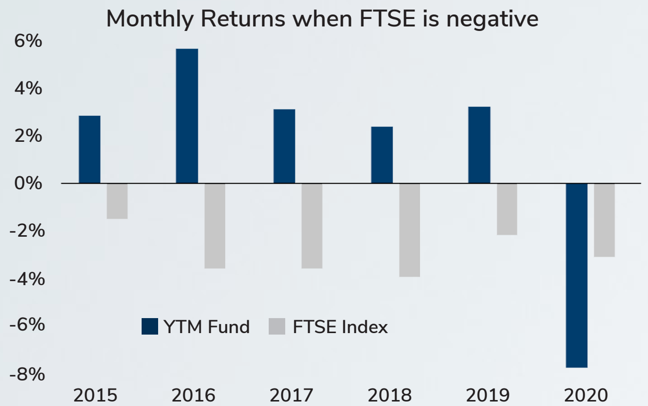
And what are the Fund's results compared to other alternative funds?

The Fund has also outperformed its peers since inception. It earned Canadian Hedge Fund Awards for both return and Sharpe Ratio for the 5 years ending June 30, 2020 in the credit-focused category. This category includes credit hedge funds as well as other types of public market alternative fixed income strategies.

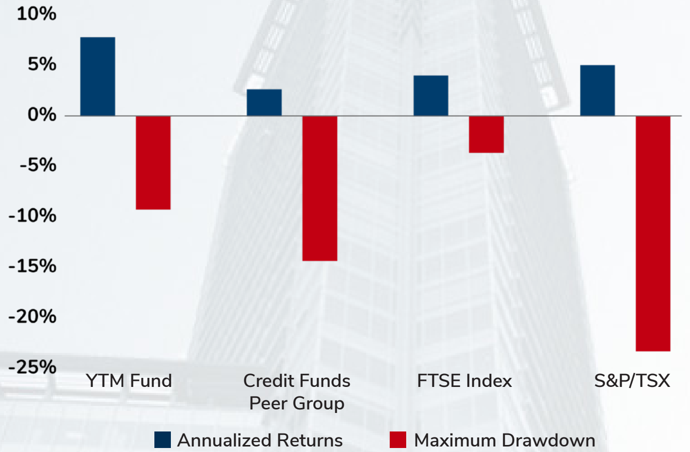
The Sharpe Ratio is a measure of risk-adjusted return. The higher the Sharpe Ratio, the less risk the portfolio managers took in acheiving the return. In our view, earning a high return while managing the Fund with a strong risk discipline is validation of both our approach to managing credit hedge stateggies and our commitment to capital preservation.

Looking forward, downside protection is critical

The Fund has provided investors with protection in times of economic and market turmoil. Downside capture ratios measure performance in those periods. The Fund's downside capture ratio compared to the FTSE Index since inception is -52%. In other words, for periods where the FTSE, was down the Fund returned +152% relative to the FTSE.



Compared to other asset classes and peers, the Fund has provided similarly strong downside protection, without sacrificing returns. Consider these drawdowns – the largest declines in value – since Fund inception and corresponding annual returns.



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What is the outlook?

Traditional Bond Funds

To provide context for "ultra-low yields", Government of Canada bonds have never yielded 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

Low yields mean low income and a low likelihood of future capital gains triggered by rate decreases. 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. 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 is currently yielding 1.17% *. With such poor prospects for traditional bond funds, considering alternatives is critical.

YTM Capital Credit Opportunities Fund

The Fund's current yield is 2.6%. That is significantly higher than GOC yields and diversified portfolios for two reasons:

1. The corporate bond credit premium paid is unusually large relative to ultra-low GOC yields.
2. The Fund has levered the spread it earns 2.4 times. We view this level of leverage on a short maturity, low volatility, liquid portfolio of 1.4 years to be prudent in the current environment.

Spreads have a meaningful impact on the future performance of the Fund. Spreads are currently not so tight that there is no expectation of improvement.

This chart provides context for changes in spreads over the last 13 years:

Source: Bloomberg

Most importantly, unlike traditional bond funds, the portfolio managers have the tools to protect the Fund no matter the future direction of the credit market and interest rates. They have the ability to position the Fund to profit if spreads widen and, as always, the Fund is hedged against interest rate risk. When rates eventually do rise, those rates will not have a negative impact on the value of the Fund's portfolio.

The PMs have set themselves apart in the use of those tools, as demonstrated by the Fund's track record through an unusually volatile time since inception.

All data is as of September 30, 2020. *The representative corporate bond portfolio is the Bloomberg Barclays Canada Aggregate Corporate Total Return Index. The diversified bond portfolio is the Bloomberg Barclays Canada Aggregate Total Return Index. **FTSE Index** = FTSE Canada Universe Bond Index. **S&P/TSX** = S&P/TSX Composite Index. This document is for information only and is not intended to solicit orders for the Fund. Investors should read the OM before investing. You can obtain the OM from YTM Capital Asset Management Ltd. or your Investment Advisor. Performance is net of fees and expenses, is for Class F, Initial Series, distributions reinvested. **SI** = July 1, 2015. Past risk and performance may not be repeated. Sharpe Ratio is calculated using a 3 month GOC T-Bill as the risk free rate. The **Canadian Hedge Fund Awards** are administered by Alternative IQ. The awards are a quantitative measure of a fund's performance in a category. Of the 33 Credit Focused funds considered, the Fund earned an award for the 3rd highest return for the year ending June 30, 2016. Of the 27 funds considered, the Fund earned an HF award for the 3rd highest Sharpe ratio for the 3 years ending June 30, 2019. Of the 18 funds considered, the Fund earned an HF award for the 2nd highest return and for the 2nd highest Sharpe Ratio each for the 5 years ending June 30, 2020. **Credit Funds Peer Group** is comprised of 6 hedge funds that use similar investment grade credit strategies to the Fund. **www.ytmcapital.com**