At the Cross-Roads: Modernize your Fixed Income

Take the lead from savvy institutional investors and add Credit

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We read recently that "investment returns during the pandemic look a lot better through the rear-view mirror". That resonates with us, while it also refocuses us on the path forward. Most forecasts currently lack clarity, as we are bombarded with a myriad of economic warnings, from rates to inflation to valuations to geopolitical risks, proffering a time for caution. We don't confuse that with a reason to exit the market. Instead, we recognize it as a healthy reminder to revisit goals, refresh return expectations, re-prioritize diversification, and to embrace the information offered by risk-adjusted return analysis.

Sharpe Ratio Measures Risk-Adjusted Returns

Risk-adjusted returns are defined as "a measure of how much return you are getting for each unit of risk taken." Investors often ignore a proper consideration of expected return per unit of risk because they reach for higher absolute returns or have embedded personal biases in assessing risk. The current risk climate may also be mistakenly ignored, after a period of such healthy market returns and a conscious or unconscious desire for more of the same.

Consider this example, using the Sharpe Ratio to produce a risk-adjusted return.

	Return	Std Deviation	Sharpe Ratio
Investment A	10.0%	14%	0.59
Investment B	6.5%	5%	0.90

The Sharpe Ratio demonstrates that Investment B, with the lower absolute return, is the better investment for most investors once risk is considered. That is because the amount of risk any investor should be willing to accept is finite. It is best to use each expected risk unit to generate a higher return. Doing so will improve the total return of an investor's portfolio, while managing risk.

This analysis leads us to highlight a rewarding part of the Fixed Income market: short-term investment grade corporate bonds. We prefer to gain exposure to this investment without exposure to low and volatile interest rates. The elimination of the interest rate exposure creates a pure credit spread, which is the yield premium over Government Bonds that a corporate borrower pays to borrow funds in the bond market. ***Short-term investment grade credit without interest rate risk*** is a distinct asset class, with a low-risk and low-volatility profile that makes it more compelling than most other asset classes.

We refer to this distinct asset class as *Credit* because of its pure exposure benefits for a portfolio and because it eliminates interest rate risk with a low-to-moderate correlation with equities. For more information on *Credit* visit ytmcapital.com/credit.

Why Credit?

Credit has low volatility in the short end because of the high likelihood that the bonds will be repaid at maturity. There have been zero or essentially zero defaults in the investment grade credit universe and with short-term bonds investors have a much greater ability to assess the outlook of an issuer over months rather than years. In addition to low volatility, short term bonds benefit from a pull-to- par, supporting the bond's price performance.

One of the reasons we advocate for *Credit* is because it can offer a high risk-adjusted return, as demonstrated by a high Sharpe Ratio. Consider the performance of YTM Capital Credit Opportunities Fund since inception (July 1, 2015 to February 28, 2022) compared to long-only fixed income portfolios as represented by the FTSE Canada Bond Universe Index.

	Return	Std Deviation	Sharpe Ratio
YTM Fund	6.23%	4.9%	1.11
FTSE Bond	2.22%	4.2%	0.34

Modernizing your Fixed Income Allocation

Credit is a solution for Fixed Income investors looking to optimize their portfolios. The Fixed Income bucket is still an essential part of an effective portfolio despite the risk of rising rates. While investors like Canadian public pension plans have revamped their Fixed Income holdings to focus on effective solutions, others have not yet or have simply reduced duration, which has not worked. Now is the time to reassess and prioritize an effective Fixed Income allocation.

Mortgages, private debt, real estate, infrastructure, blue chip dividend-paying equity, and high yield are also alternatives to traditional Fixed Income. Each of these can play a role, as long as the investor assesses their unique risks. These investments may be similar to equities, while others may rely on "smoothed performance" making them seem less risky, and some are illiquid.

Portfolios should be designed for the long haul, with the right choice of exposures to withstand all market environments. Investment theory demonstrates that a major reason for successful long-term investing is time in the market. A properly designed portfolio takes into account total risk and allows investors to remain fully invested. A portfolio requires an effective Fixed Income allocation to maximize diversification and would benefit from *Credit* as part of that allocation.

Contact us to discuss the benefits of Credit and for an assessment of your Fixed Income portfolios using Morningstar Direct.

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