Why this fixed-income portfolio manager is bullish on corporate bonds right now

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When Daniel Child founded YTM Capital Asset Management Ltd. 13 years ago, fixed income was considered the sleepy side of investing. But the rise of alternative assets, and last year's unprecedented bond rout, has awakened investors to the wider world of fixed income.

Mr. Child sees growth opportunities in select areas of the fixed-income market for the next several years.

"Bonds are never sexy, but it's an exciting time from a return perspective – and something we haven't seen for quite a long time," says Mr. Child, a former bond trader at Canadian Imperial Bank of Commerce and Bank of Nova Scotia, who founded Oakville, Ont.-based YTM in 2010. YTM stands for yield to maturity.

Mr. Child is particularly bullish on corporate bonds right now, given their higher yields, and predicts the long-awaited recession could hit in the first quarter of next year.

"You're getting paid a decent amount of money to wait until we find out if there's a recession or not, and then the market will start pricing in a recovery before we get there," says the portfolio manager.

"Then you get that huge lift in return as credit spreads compress. We think we're in Year 1 of a two- to three-year window of above-average returns."

YTM currently has about $500-million in assets under management across three funds – YTM Capital Credit Opportunities Fund, and YTM Capital Mortgage Income Fund. YTM Capital Credit Opportunities Fund returned 11.6 per cent over the past year, while

YTM Fixed Income Alternative Fund returned 8.3 per cent. The mortgage fund saw a return of 6.5 per cent.

The credit fund has seen an annualized return of 6.2 per cent since its inception in July, 2015, while the fixed-income fund has seen an annualized return of 2.8 per cent since it was created in June, 2019. The mortgage fund has seen an annualized return of 7.2 per cent since it started in May, 2011. The performance data are as of July 31 and net of fees.

The Globe and Mail recently spoke to Mr. Child about his take on the market and his firm's fixed-income investment strategies.

Describe your investing style.

We focus on short-maturity bonds because they have lower volatility and more liquidity. Our credit funds deploy a long-short strategy, which is quite different from what an investor might be used to with a long-short equity strategy. We are typically long (buy) public, short-maturity, predominately Canadian corporate bonds and short (sell) similar-dated Government of Canada bonds. That isolates the credit spread. It also hedges away the interest-rate risk, which is the biggest component of risk in a fixed-income portfolio.

Because credit spreads tend to tighten and widen together, there's less sector outperformance or divergence than in the equity market. The corporate bond market is also opaque; there's no exchange where you can see prices and trades. That kind of imperfect information often leads to mispricing, which makes security selection very important. We rely heavily on data analysis models, including our own proprietary models, and use an active trading strategy to find investment opportunities.

What's your take on the current market environment?

We believe there will probably be a mild-to-moderate recession in the first quarter of next year. That said, we don't think it will be as bad as what we had in the 1990s. We also believe interest rates will be higher for longer and are defensively positioned based on that view. Our risk is about 50 per cent of our historical average.

It's very hard to have rates rise by about 500 basis points and not have something break. If you look at the interest-rate market, which is the government bond market, or the Canadian corporate bond market, they're both saying something very different than equities. Both those markets are pointing toward a recession. The equity market seems to think it's business as usual. It will be interesting to see which one is right. Remember, it was only a few months ago when the markets were pricing an interest-rate cut by the end of 2023.

How are you investing based on this view?

While we are bearish, the good news is that Canadian dollar investment-grade corporate bond spreads are already pricing in a softer landing. They look very cheap versus other risk assets such as high-yield bonds, equities and even investment-grade U.S. dollar bonds. If we get the type of recession we expect, credit spreads don't have to widen that much to be appropriately priced. If we're wrong or early, they have a huge amount of upside.

What have you been buying or adding?

We've shortened the average maturity of the bonds in the portfolio. We've also chosen higher credit-quality companies, prioritized more liquid securities, and shifted our exposure to certain sectors like higher quality real estate investment trusts, banks and auto finance companies. For example, we've been adding short-maturity international auto finance bonds that traded at a discount of 40 to 50 basis points here in Canada compared to their home markets. We've also been adding short-maturity senior bank paper from the Big Six Canadian banks.

What have you been selling or trimming?

We have been trimming some of our longer-dated bond exposure, which has significantly outperformed other maturities, including from companies such as Inter Pipeline Ltd., Saputo Inc. and Brookfield Infrastructure Partners L.P. We sold Inter Pipeline after its recent earnings based on the market's perceived increased risk of a downgrade to high yield. We've also been selling Saputo and Brookfield Infrastructure Partners not because of company-specific factors, but instead because we don't want exposure to 10 and 30-year bonds due to the higher volatility of those terms. We do sometimes own bonds with 10 and 30-year maturities but in much smaller quantities.

What's your advice for new investors?

Despite our view of a pending recession, we don't think investors should sell everything. Just ensure your portfolio is well-diversified, has sufficient liquidity and the total portfolio represents the appropriate risk for you. Also, consider alternative credit and mortgage investments that suit your risk and return profile.

This interview has been edited and condensed.