



Should You Still Own Bonds? | July 2016

"Only the wisest and stupidest of men never change."
Confucius

Graham and Dodd (two rather wise men) once referred to fixed income investing as 'the negative art'. This is because unlike equities, with bonds the maximum upside is 'fixed'. And it is the investor's job to focus on the risk of loss, the negative, and decide if they are being adequately compensated for it.

As of this morning, the XBB Canada Bond ETF has a net yield of less than 1.5% a year. The effective duration of the underlying portfolio is 7.73 years. In English, this means that a 1% rise in rates could lead to an 8% loss. Rates might not be going higher anytime soon, but the risk/reward profile doesn't seem to justify the investment.

While the wisest of investors may already have their ideal portfolio allocation for the current environment, the rest of us can make efforts not to be amongst the stupidest. The logical conclusion is therefore to consider change.

The natural question is if not bonds then what?

One option is to just allocate to stocks, REITs and preferred shares. The theory behind this approach is if you're in it for the long run the volatility shouldn't matter, and historically the equity premium has been worth it.

Some investors have elected to stick with fixed income but have shifted their focus to high yield, emerging market and private debt. Others have opted to increase their cash holdings. A high interest savings account pays you 0.75% and cash has inherent optionality. It can be deployed when opportunities present themselves.

We also live in a world full of choice. Just going to the grocery store can create decision anxiety. Similarly, there is a wide array of investment products outside of the traditional options. We recognize that our fund represents one of these alternatives but also acknowledge that there are many others to cater for all tastes.

So how does one select from the menu of options?

When deciding where to allocate, your choices should match your needs, objectives and ability to withstand loss. In the end, how you choose to adapt needs to work for you. The important thing is to adapt.

The Fund

	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	YTD
2016	0.19%	1.49%	5.32%	3.51%	0.60%	0.54%	1.73%	-	-	-	-	-	14.05%
2015	-	2.29%	2.51%	1.27%	2.46%	0.25%	0.73%	(0.25%)	1.68%	1.71%	1.37%	0.87%	15.86%

The Algonquin Debt Strategies Fund LP was launched on February 2, 2015. Monthly returns are based on 'Series 1 X Founder's Class' NAV as calculated by SGGG Fund Services Inc. and are shown in Canadian dollars, net of all fees and expenses.



After maintaining a light risk posture through June, our plan was to be a buyer of the post-Brexit dip. Although the dip was both shallower and shorter than anticipated, we were aggressive and managed to enter positions at attractive levels.

As the month wore on, we steadily increased our exposure, balancing the portfolio between both high quality and BBB credits. Of particular note was our position in subordinated Bank NVCC bonds, where we saw good value supported by strong technicals. The outperformance of these bonds along with the rest of our BBB exposure contributed significantly to the net return of 1.73% for the month.

Our plan for August is to slowly peel back risk in anticipation of robust issuance in the fall.

Credit

Credit spreads typically grind tighter over the summer as new issue supply is limited. After \$11.5bn worth of issuance last month (largely bank paper), one is hardly justified using the term 'limited'. Yet this supply was absorbed surprisingly quickly, and credit spreads did as they are supposed to in July and tightened across the spectrum. Lower rated/higher beta securities outperformed due to the preponderance of bank bonds.

Towards the end of the month, the rally stalled as a few portfolio managers decided to reduce exposure. They were either locking in gains or having flashbacks of last August when stocks decided to drop 10% in a matter of days. Barring an exogenous shock, spreads ought to remain stable for a few more weeks until people start to focus on the threat of new supply.

Rates

As Brexit fears receded, yields shifted slightly higher. With rumours of 'helicopter' money in Japan as well as further monetary stimulus by the ECB and BOE, bond markets ought to remain well supported. A few folks have suggested that the Fed could raise rates in September; an event we consider unlikely until December at the earliest. The Canadian economy continues to limp along, keeping the Bank of Canada patiently waiting (and perhaps praying) for the weaker currency and fiscal stimulus to boost hiring.

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