

Much Ado About Nothing | November 2017

“Doing nothing is very hard to do...you never know when you’re finished.”

Leslie Nielsen

In a world that values and incentivizes action, ‘doing nothing’ carries with it certain negative connotations. It conjures up images of laziness and complacency or succumbing to inertia and the status quo. But there are often times when doing nothing is our best option, and it’s usually when it is the hardest thing to do (or not do).

A famous medical example is the insertion of stents, tiny wire cages, to open narrowed arteries in the heart. Studies have shown that for patients with stable chest pain this invasive procedure is no more effective than taking medications. Despite this evidence and the risks of the procedure, many cardiologists continue inserting stents, finding it hard to believe that nothing can be better than something.

Perhaps this is why in training army officers to make combat decisions, one of the most valuable pieces of advice is ‘doing nothing is also a decision.’ While inaction on the battlefield may not be a particularly wise choice, when investing money, sometimes doing less yields more desirable results. After all, most of us can think of a time when we would have been better off sitting on our hands.

In their paper, ‘Trading Is Hazardous to Your Wealth,’ Brad Barber and Terrance Odean concluded that the more retail investors traded, the further their performance lagged the market. While the commissions and costs of transacting contribute to this lag in returns, the underlying theme is that we are often our own worst enemies due to overconfidence and poor market timing.

This effect is also chronicled in Morningstar’s annual ‘Mind the Gap’ report. These reports analyze the difference between a mutual fund’s net return and that earned by the average investor in that fund. In the 2017 report, the gap for Canadians over the last five years was -1.09%. The obvious question is why are people underperforming to such a degree? The costly difference is mainly attributed to the timing and magnitude of the inflows and outflows into and out of the funds.

Put simply, this ‘behavioral return gap’ is caused by buying high and selling low, with people piling into investments during periods of strong returns and running for the exits when results are poor. The fear of missing out pushes us to chase good performers, and the bitter pain of loss leads us to sell at the troughs.

Naturally the definition of ‘doing nothing,’ is broad, and it needn’t imply the sort of laziness or inertia that gyms rely on to have more members than they could fit through their doors. For some, it simply means following a passive investment strategy, while for active managers, it could mean patiently letting winners run or adopting a defensive posture in the late stages of a bull market.

No matter how one chooses to define it, following through can be very difficult. A runaway bear or bull market will test the resolve of a passive investor to stay the course, and an active manager always needs to resist the urge to tinker simply because they feel they ought to. In both cases, discipline is required and an understanding that doing nothing is something and sometimes it is the best option.

The Fund

Corporate spreads experienced a modest tightening in Canada and a small widening south of the border. The weakness in the US market was led by a sell-off in High Yield combined with bloated US dealer inventories caused by higher than average new issuance. As a result, recent CAD\$ bonds issued by foreign corporations into Canada (“Maples”) weakened in sympathy. US credit spreads did stage a partial recovery late in the month which stabilized the Maples.

Domestically, corporate issuers were busy, setting a record for November volumes in addition to year-to-date gross issuance. Metro Inc. was the most notable issue as \$1.2B was sold in 5, 10 and 30 year tranches. Although the deal looked expensive, it was widely placed and performed well. As a consequence, the retail sector outperformed as credit curves were repriced tighter.

The Fund benefited from the move in the retail sector and positions in REITs, energy, and banks. A portion of these gains was offset by losses from Maples and credit hedges. The net effect was a November return of 0.45%.

	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	YTD
2017	1.73%	1.30%	0.44%	1.03%	(0.22%)	0.53%	0.94%	(0.09%)	0.70%	0.83%	0.45%	-	7.91%
2016	0.19%	1.49%	5.32%	3.51%	0.60%	0.54%	1.73%	1.63%	1.01%	1.86%	1.60%	1.62%	23.15%
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.

Credit

As usual, equities get all the attention when it comes to the ‘Santa Claus rally,’ however, credit often participates as well. Not only do corporate bonds get a boost because of rising stocks, but new issue supply all but disappears during the latter half of December. Typically, this leads to a drawdown of dealer inventories as cash continues to be put to work resulting in a steady bid for corporate debt. The prospects of significant tax cuts south of the border are so far driving the rally. As long as those efforts don’t falter and barring any macro tape bombs, credit spreads should grind tighter over the next few weeks.

Rates

It is becoming increasingly difficult for central bankers to do nothing. The global economy continues to strengthen as unemployment rates steadily decline. So far, wage growth and inflation pressures have been muted, but the risks remain tilted towards both firming in 2018.

The Bank of Canada continues to be cautious given the uncertainty surrounding trade negotiations and housing, as well as the impact of higher rates on over-levered consumers. Despite these factors, they are likely on a path to raising the overnight rate a few times next year.

The Federal Reserve is expected to raise rates later this month and is on track for two to three further hikes in 2018. If the US administration is correct in their assumption that tax cuts will lead to 3+% GDP growth, the Fed might have to be far more aggressive than anticipated.



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