

Who's The Boss? | September 2018

“If you think your teacher is tough, wait until you get a boss. He doesn’t have tenure.”

Bill Gates

On the list of things not to lose, our jobs typically rank pretty high. That’s why, as our mothers encouraged us to, we come to work ready to do our best. But sometimes doing the ‘best’ job can put that very job at risk.

Politicians forgo pursuing a policy they deeply believe in because of re-election fears. Corporate executives bite their tongue as not to express an unpopular opinion in the boardroom. Doctors overprescribe and overtreat to appease patients and avoid backlash.

The bottom line is that we all have a boss, directly (org chart) or indirectly (voters, clients), and therefore, all run the risk of being fired. And in the world of investment management, where results are so easily quantifiable and trackable, portfolio managers certainly feel the heat. This pressure can exert undue influence on investment decisions and is a risk that is often neglected by investors.

Of the 200 institutional investors interviewed by the Centre for Applied Research, the majority cited career risk as the largest determinant in their decision-making process. With around half of them feeling their jobs would be in jeopardy after 18-24 months of underperformance. Thus in asset management, career risk comes from underperforming your benchmark or peers in the short-term.

And herein lies the portfolio manager’s dilemma. To generate excess returns, you have to be different. But the more you deviate from your peers, the more likely you’ll have periods of underperformance. Thus running the risk of having a potentially superior portfolio but no investors.

In his quantification of career risk, Joachim Klement (2014) concluded that with quarterly evaluation periods, even highly skilled managers risk being unduly terminated. And the best way for them to protect their jobs is to minimize deviation from benchmarks. Thus industry professionals are incentivized away from outperformance and towards herding, closet indexing, and short-termism.

But surely, this isn't what clients want. Or is it? Modern corporate culture purports to encourage failure in the pursuit of greatness. But how often does the leader of an ambitious yet ultimately unsuccessful project get promoted? Similarly, the objective for investors and boards might be long-term outperformance, but their behaviour is usually more short-sighted. And while retail investors typically get a bad rep for chasing returns, institutional allocators don’t appear to be much better.

Goyal and Wahal (2008) examined 9,000 hiring and firing decisions made by pension funds. They concluded that these decisions were based on who out or underperformed during the previous three years. Only for the pension funds to see the fired managers generate greater returns than the hired ones over the next three years.

Similarly, Goetzman and Oster (2012) discovered that university endowments, much like the students of their institutions, are subject to peer pressure. They noticed allocations being adjusted to more closely reflect peer groups, particularly by those that had been underperforming.

So, from the top down, investors, allocators and money managers fear leaving the herd and failing unconventionally. Portfolio managers are scared that markets can stay irrational longer than they can keep their clients. And investors worry about missing out by exiting a good fund too quickly or sticking with a bad one for too long. These fears create a spiral of irrational expectations from the bosses being met with irrational behaviour from the employees.



But as with most relationships, the one of boss and employee can be mended with communication, understanding, and trust.

Transparent communication ensures everyone is on the same page and offers the client a more holistic understanding of the strategy and its risks. With this deeper understanding, the investor can move away from evaluating the fund solely based on short-term performance.

And with this greater communication and understanding comes trust. The clients can trust that the manager has their best interest at heart. And the manager can trust that the client won't run for the hills at the first signs of underperformance. And they both can trust that their interests are aligned in the common pursuit of 'long-term greed.'

The Fund

In technical terms, September was a mixed bag for credit markets. Canadian spreads were essentially flat with modest moves on either side of unchanged depending on issuers, ratings, and maturities. Meanwhile, US credit had a particularly strong month with spreads broadly tighter by 8 bps.

NAFTA concerns weighed on the domestic market, and new issue supply picked up relative to August as approximately \$10 bn hit the primary market. New supply was weighted towards financials with the most notable (and highly anticipated) transaction being the first domestic bank "bail-in" bond. This new structure will replace legacy senior unsecured funding and applies to domestic systemically important banks (D-SIBs). RBC was the first out of the gate to issue bail-in debt bringing \$2 bn to market at a spread of about 16 bps over legacy deposit notes (around the midpoint of expectations). RBC followed this up with USD 1.8 bn issued south of the border.

Other notable transactions were foreign issuers, Sysco (wholesale food distribution) and Aroundtown (German REIT), tapping the Canadian market. CIBC also launched Canada's first Women in Leadership bond, with the proceeds of the transaction going to support companies committed to promoting gender-diversity at the executive and board level.

While the performance in domestic credit gave little to be excited about, the mixed moves did provide some trading opportunities. In particular, the fund benefited from exposure to legacy deposit notes en route to a 0.47% month. Given that Canadian bond and equity funds were down around 1% in September, we hope our bosses are happy.

	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	YTD
2018	1.19%	(0.45%)	(0.35%)	0.77%	(0.25%)	0.26%	0.46%	0.52%	0.47%				2.64%
2017	1.73%	1.30%	0.44%	1.03%	(0.22%)	0.53%	0.94%	(0.09%)	0.70%	0.83%	0.45%	0.50%	8.46%
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 we head into the last quarter of the calendar year, the outlook for domestic credit is more positive than has been for several months. New issue supply should be manageable, and there is a significant amount of cash coming from bond maturities and coupon payments (particularly in December) to help provide extra demand. Furthermore, the resolution of NAFTA (now USMCA) will help calm some of the nerves that had been nagging the market.

Furthermore, the general environment supports risk taking. The US-China trade war is in full swing with few shots left to be fired until early next year, leaving the Brexit negotiation (or fumbling) and Italian budget process as the potential spoilers. The latter two issues are probably not significant near-term factors. Given the dissipating headwinds and slight tailwinds for corporate credit, we have taken the opportunity to selectively add exposure.

Rates

Rates continued their steady ascent as deflation continues to ebb. In recent years, the final quarter has not tended to be friendly to bondholders. It appears that trend may continue this year. The USMCA deal should seal another 25 bps rate hike by the Bank of Canada on October 24th, and increase the odds of further move in January 2019. The Federal Reserve is poised to hike in December as it continues the steady march towards neutrality.

We think that Federal Reserve Chairman Jerome Powell is going to make the US Treasury market a little more interesting by doing away with the 'dot plot' in the coming months. The 'dot plot' is essentially a poll of where Federal Reserve Governors expect the overnight rate to be over the next two years. The Federal Reserve started this process as a form of forward guidance to prevent bond traders from freaking out that quantitative easing had ended and that monetary accommodation was being withdrawn. Bank of Canada Governor Stephen Poloz did away with forward guidance early in his tenure because he said that it dampened 'signals' from the bond market. In other words, the Bank of Canada is very interested in understanding investor expectation on how growth and inflation are evolving. Forward guidance by central banks diminished this signal.

With the US overnight rate approaching 'neutral,' we think the Federal Reserve will drop forward guidance as it too will need a clear picture as to what market participants are thinking.

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