

The Crooked Path Down Memory Lane | February 2017

"Memory is deceptive because it is colored by today's events."
Albert Einstein

Suppose your doctor tells you that you must undergo an uncomfortable medical examination and that there are two choices available.

Option A: 8 minutes of sharp, intense pain and the procedure ends.

Option B: The same 8 minutes of intense pain as Option A, followed by an additional 16 minutes of moderate pain, concluding with some mild discomfort.

At this point, you're probably considering switching doctors. Oddly enough, despite how ludicrous the second choice seems, it may give you a better memory of the experience.

This is not to say you are a masochist, but this was the surprising result of a study conducted by Daniel Kahneman and UofT's Donald Redelmeier. They asked colonoscopy patients to rate the intensity of pain at one-minute intervals as well as give an overall pain rating afterwards. Their findings drew an interesting distinction between the experience and the memory of the procedure, offering evidence of a heuristic known as the peak-end rule.

The peak-end rule states that our memory formulates an opinion of an experience based on how we feel at its most intense point and at the end, remaining largely indifferent to the duration and the sum of the individual moments.

For example, Patient A goes through an 8-minute examination with a peak pain of 8 (out of 10) and in the last minute a rating of 7. Patient B experiences the same 8 minutes, and for the next 16 minutes is exposed to varying degrees of pain, finishing with a mild discomfort registering a lowly rating of 1.

When asked to rate the overall experience, Patient A gives it a 7.5 on the pain scale while Patient B gives it a much lower rating of 4.5. This despite the process lasting three times longer and the person enduring a much greater aggregate amount of discomfort.

Thankfully anaesthetics are administered for colonoscopies now, but the peak-end rule has much wider and deeper implications. In the wonderful world of investing, history is often used as a guide to gain perspective. This particular bias leads us to overemphasize market extremes and give disproportional weight to recent events. Because 2008 left an indelible mark on investors; they may find themselves overly referencing this period as well as the most current market events in their analysis.

The problem with this is that it ignores important considerations such as the passage of time, the fact that markets can spend ages at fair valuations, and changes to the macroeconomic fundamentals. Without careful analysis and thought, there is a significant risk of jumping to erroneous conclusions.

When we base investment decisions purely on gut-feel or intuition, we are relying heavily on our memory. Unfortunately, the peak-end rule and a host of other biases indicate that our memory is not 'all that it is cracked up to be.'

The Fund

Credit spreads continued to tighten in February with ongoing demand for higher-yielding names. Domestic bank subordinated debt (NVCC) outperformed, and the fund benefitted from this. New issue activity was abnormally light to start the month but bounced back strongly in the second half. Deals were priced with no concession (and in some cases negative concessions) to existing secondary levels. Despite this, the new deals performed extremely well. Amongst this supply, two energy focused names came to market as Canadian high yield issuers continue to offer a steady stream of new financings. Notably, domestic banks were absent from the Canadian primary market after their earnings season. They chose instead to finance in international markets.

Although we maintained a modest exposure, the narrowing of credit and interest carry contributed to a solid 1.30% gain in February.

	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	YTD
2017	1.73%	1.30%	-	-	-	-	-	-	-	-	-	-	3.05%
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

The adage that 'March comes in like a lion' also applies to new issues. Given the sustained demand for credit, deals should continue to perform well. Increased primary activity often creates good opportunities in secondary product as investment managers attempt to reposition portfolios, and bond dealers manage their inventories. Despite the positive tone in credit markets of late, we are taking a more cautious approach. Moderate risk positioning and an increased focus on sector and security selection seem appropriate to us.

Rates

Despite some recent strength in Canadian employment figures, the Bank of Canada preferred to highlight that the economy faces a material degree of excess capacity. As such, Governor Poloz is likely to remain on hold for the balance of 2017. The caveat being any adverse impact from US fiscal policy that would warrant further easing.

Governor Yellen and her colleagues at the Federal Reserve have made it clear that a rate increase in March is nearly a done deal. Should the US economy continue to strengthen, the Federal Reserve will probably hike two more times, bringing the 2017 total to 75bps. The measured pace of hiking coupled with on-going quantitative easing by the European Central Bank and the Bank of Japan makes it difficult for yields to rocket higher. Instead, the bond bears will have to be content with a painfully slow rise in interest rates.



Contact

Algonquin Capital Corporation
1 Yonge Street, Suite 1801
Toronto, Ontario, M5E 1W7
www.algonquincap.com

Raj Tandon
Founding Partner
raj.tandon@algonquincap.com
+1 (416) 214-3493

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