

Oops, I Did It Again | April 2019

“Heads I win, tails you lose.”

Norville “Shaggy” Rogers

Becoming better investors involves learning from mistakes, our own and those of others. While some lessons need to be learnt the hard way, the preferred method is to draw wisdom from the missteps of others. It is, after all, the cheaper option.

This month, our ‘others’ are the darlings of so many academic studies: university students and young finance professionals. This particular lot was staked \$25 to play a game with odds that would make a casino owner salivate. They had half an hour to bet on flips of a coin that they knew was rigged to land heads 60% of the time.

Easy money. Right?

The optimal strategy has the potential to turn the \$25 into over \$3 million. And while perhaps not intuitive, it is rather simple: bet 20% of your stack on heads each time (as per the Kelly Criterion, for you fellow nerds out there). Three million isn’t too shabby for half an hour of repeatedly betting heads.

To spare themselves from financial ruin, the researchers, Victor Haghani of Elm Partners and Richard Dewey of Pimco, capped the maximum payout at \$250. If the participants consistently wagered 10-20% of their money on heads, it was expected that 95% would reach this upper limit.

The results were not flattering. Only 21% of people walked away with \$250, while a shocking 28% went totally bust. Amongst the various conclusions we could draw, one is that most of us are idiots. Fortunately, the researchers, being far less shallow than we at Algonquin are, devoted some thought in trying to understand the poor results.

Overall, the approaches to the game were ad hoc and overcomplicated, with some doubling down after losses (martingale), and others betting too little, too much, or too erratically. Remarkably, the majority of participants even placed wagers on tails.

Thus, the first lesson from this experiment is that you need to understand the appropriate strategy to follow. This can be accomplished through research and working with the right people.

But even knowing the right path isn’t necessarily enough. Some of these well-educated lab rats knew the optimal strategy but were still unable to capitalize on the opportunity. From them, we get the second lesson, that execution and ‘stick-to-it-ness’ matters. It’s easy to know you should exercise more and be committed to it. It’s a different story getting your butt to the gym.

In their meta-analysis, psychologists Gollwitzer and Sheer concluded that motivation and intention alone aren’t enough. We also need help regulating our behaviour towards achieving our goals. In this regard, one measure they found moderately to largely effective was ‘implementation intentions.’

These are ‘if/then’ statements of the form ‘if situation X arises, I will respond with Y,’ where Y is some goal-oriented behaviour. Thus turning ‘I intend to exercise more’ into ‘if it’s Tuesday and my work is finished, then I’m going to the gym.’

Like Britney Spears, investors are notoriously bad at self-regulating. Too often their reactions to market swings run counter to their ultimate objectives. Cognitive sciences have shown these counterproductive misbehaviours

to be instinctive and evolutionary. Given that much of our hard wiring is working against us, an implementation plan could be very useful.

As fans of simple and effective solutions, one easy method is to pursue the path of sloth-like laziness. There is plenty of evidence showing that less frequent (even just annual) portfolio reviews can curb misbehaviour and help achieve long-term goals. And to assist the process, investors can add the implementation intention, 'if markets are volatile, then I will ignore the noise and wait for my next investment review date.' After all, sometimes less is more and the best (and often hardest) thing to do is nothing at all.

The Fund

April was an eventful month with North American equity indices hitting all-time highs. The euphoria crept into credit spreads as the domestic index narrowed 10 bps while the US tightened 8 bps.

The telecom sector garnered most of the attention as the results of the spectrum auction were announced early in the month. Rogers made the biggest splash picking up \$1.7bn worth of spectrum. Other notable buyers were Telus, Shaw, and Quebecor, while Bell surprisingly bought none.

There is normally some post auction trepidation as people brace themselves for a slew of bond deals to raise funds to pay the bills. To use a dangerous cliché, this time it's different. Rogers successfully raised \$1.25bn in the US, leaving them only \$1bn to raise at home. Given the last time they issued in Canada was in 2014, the domestic deal also performed well.

S&P also released a timely note stating that Rogers, Telus and Bell could incorporate higher leverage and maintain their high-BBB ratings. Separately, Moody's upgraded Shaw one notch to reflect the improvement in its business profile. Sentiment in the sector was further aided by good results from AT&T, which saw its spreads narrow 30bps.

In other security-specific news, Allied Properties was upgraded to a positive outlook, and WestJet was downgraded to junk.

The Fund benefited from the overall rally in credit and was able to generate excess returns through overweight positions in telecoms and other outperforming securities. The net result of the spread performance along with the yield earned was a gain of 1.54% for the month.

	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	YTD
2019	2.03%	1.15%	0.36%	1.54%									5.17%
2018	1.19%	(0.45%)	(0.35%)	0.77%	(0.25%)	0.26%	0.46%	0.52%	0.47%	(0.34%)	(1.57%)	(0.81%)	(0.13%)
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

After a rather dismal 2018, credit and equity markets have rebounded this year. Although equities reached a new apex last month, credit is merely back to where it was in early November, before the tantrum escalated. Perhaps this is because fixed-income managers have pessimistic tendencies.

Of the performance we have seen, a significant contributor is the lack of new issuance which is running roughly 20% lower than last year. The main culprits behind the decline in supply are financials, who have found foreign jurisdictions to be very receptive. The banks need to issue some \$150bn by November 2021, so the drought will end, perhaps soon after earnings which are due in late May.

Issuance is expected to pick up south of the border. However, dry conditions are expected to persist here. Although droughts are not good for crops, they do lend support to spreads. 'Patient' central banks are also having a positive influence on risk assets.

In the very near term, all eyes are on the US/China trade negotiations. Other things to watch closely include the unrest in Venezuela, the tightening of sanctions on Iran, and corporate earnings.

Upon weighing the pros and cons against current valuations, a modest risk exposure seems sensible. Such a posture allows us the flexibility to dynamically adjust our portfolio.

Rates

The Bank of Canada followed other central banks in abandoning their hiking bias. Although his peers are questioning whether current monetary policy is stimulative or not, Governor Poloz has not yet joined this debate. Nonetheless, bond traders are betting that both the Bank of Canada and the Federal Reserve will cut rates later this year.

The wild card is an escalation of tariffs. Comments and papers by both central banks suggest they will hike rates in a higher tariff world. Despite knowing the odds are biased towards hiking rates if this situation evolves, it will be interesting to see whether investors continue to bet on 'tails.'

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