

If Peter Piper Picked a Portfolio Manager | March 2019

“Dogs got personality. Personality goes a long way.”

Pulp Fiction

In our business and professional lives, one of the most important choices we make is who we hire and work with. For investors and allocators, this is usually the final step of their investment process. After determining the financial objectives and portfolio allocation, comes the selection of the assets and managers.

Given the plethora of options to choose from, this can be a daunting task. To assist in separating the wheat from the chaff, allocators have devised rigorous due diligence processes with checklists full of ‘P’s’: Performance, Process, Products, Partnerships, Philosophy, Price, Portfolio, People, and a Peck of Pickled Peppers.

Of all these factors, the one that is most personal and subjective is the ‘People’. After all, what criteria do we use to judge the management team? To examine this, we are adding another couple of ‘Ps’ to the pile, and ask if any ‘Personality’ traits or ‘experiences’ impact performance.

The Hollywood portrait of the successful investment professional is that of a ruthless, arrogant, and unempathetic character (think Gordon Gekko). There is also the notion that these psychopathic, Machiavellian character traits can lead to success in high-powered and competitive arenas. A research study of hedge fund managers discovered that those with greater psychopathic tendencies produced lower absolute returns, and those with narcissistic qualities delivered inferior risk-adjusted returns (2018, ten Brinke et al.).

Further debunking the media’s stereotype is a study of sensation and thrill-seeking in hedge fund managers, as measured by the cars they own (2016, Brown et al.). They concluded that drivers of ‘powerful sports cars take on more investment risk but do not deliver higher returns.’ Although they should easily beat their minivan safety-first peers in a street race, they lag in Sharpe and information ratios.

Garage inspections and Myers-Briggs tests are rather extreme measures. Although interesting and novel, the research in this field is not deep enough to draw any concrete conclusions. Thus far, the mapping of character disposition has been concentrated on the risk tolerances of inexperienced investors. But one thing that most allocators agree on is evaluating the experience of the ‘People.’

Grey hairs, wrinkles, and battle scars provide investors with a sense of comfort. But the hard data does not suggest a correlation between time served and results. If anything, we’ve come across several papers pointing to out-performance early in one’s career. The thesis being they are hungrier and more willing to take the risk to out-perform rather than protect a legacy.

With industry experience offering little guidance, perhaps investors should focus on other aspects of a manager’s personal history. In an analysis of mutual fund performance, researchers found that managers from families in the bottom quintile of wealth outperformed those in the top quintile by over 1% a year on a risk-adjusted basis (2016, Chuprinin & Sosyura).

The popular explanation is Darwinian natural selection, with individuals from poorer backgrounds facing greater barriers of entry. Consistent with this thesis, Chuprinin and Sosyura also found that the silver spoon crowd are more likely to be promoted while their less fortunate peers must outperform to rise to the top.

Digging deeper into a manager’s life story comes the awkward topic of losing a parent. While there is no research specific to the investment industry, analysis on world leaders, Nobel prize winners, and prominent

historical figures shows a high percentage lost a parent at a young age. Overcoming adversity and early independence seem to be a strong motivation to excel.

This is not to say that investors should be looking for poor orphans driving family cars. For every study of this nature, there is another proving the opposite. But amongst all the numbers and analysis, perhaps pausing to assess a manager's character and history is worthwhile. For the curious who are wondering, the Algonquin car collection consists of a Honda, an Audi, a Toyota, a Mini Cooper, and a TTC Metro Pass.

The Fund

After the volatility of the past few months, March provided a bit of respite with spreads trading in a narrower range with mixed moves across the maturity spectrum. As the interest rate curve inverted, credit spreads adjusted to keep corporate yields positively sloped. As a result, short-dated credit spreads declined marginally, while longer maturities slightly widened.

With lower all-in borrowing costs enticing corporate treasurers, the new issue market finally opened up. Banks, auto finance, Telus, Investors Group, and Canadian Pacific were among the featured names. Inter-Pipeline brought their inaugural hybrid deal, joining the ranks of Enbridge and TransCanada who also use this innovative structure.

After two very strong months in credit, we hedged a portion of the portfolio exposure with short derivative positions, as we assessed the longevity of the rally. While corporate bonds spreads were a touch wider in March, the derivative index was tighter by 4 bps. This divergence was modestly unfavourable for the fund.

The moves in credit spreads had a de minimis impact on the Fund and the losses from hedges were more than offset by the yield on the portfolio and profits from active trading. The net result was a return of 0.36% for the month.

	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	YTD
2019	2.03%	1.15%	0.36%										3.57%
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

Market sentiment is currently positive, but the inverted yield curve serves as a reminder that all might not be well. Although recent economic data has softened, there have been enough upside surprises in North American and Chinese employment and Purchasing Manager Indices to support the pundits who claim the weakness is transitory. Germany's numbers continue to be horrible, but one can't be certain how much impact Brexit and weakness in China is having.



With the new issue market finally open, there should be a steady stream of deals until the summer doldrums. With fears of higher interest rates vanishing, flows into bond funds have been strong. US investment grade funds have seen weekly inflows since early January. Not to be outdone, high yield funds attracted \$14.3B of new money which is the second-best quarterly inflow ever. The flow of funds is a strong tailwind for credit markets.

Should the US and China reach a trade agreement and the UK agree on a deal with the EU (we've given up trying to predict the outcome), there could be a surprising recovery in growth.

As a result, we have slightly increased exposure, but remain mindful that sentiment can easily turn negative very quickly.

Rates

Canadian and US yield curves have inverted as people anticipate the next central bank move will be to lower interest rates. The Federal Reserve has made it quite clear they are going to be patient. With the US overnight rate above inflation, Chairman Powell and Co. have the luxury of waiting to see whether the economy is in a soft patch or heading into a slump.

The Bank of Canada is also on hold, but Governor Poloz is leaning ever-so-slightly in favour of the next move being a hike, largely because the overnight rate is still lower than inflation. Furthermore, the Bank still thinks that if the broader trade issues are resolved, there should be a bump in business investment and exports. That said, bond traders, being a pessimistic lot, are more focused on the slump in residential real estate and the high level of consumer indebtedness, so continue to price in healthy odds of a cut this year.

We believe the bar is high for either central bank to ease or hike. Bond yields could swing violently depending on how the next few months of economic data unfold, and on whether trade tensions mount or subside. As a result, we are keeping our interest rate exposure to a minimum.

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