

We The North. | May 2019

“There's no place like home.”
The Wizard of Oz

Along with sports fans across the country, we have firmly entrenched ourselves aboard the Raptors' bandwagon. And Kawhi not? The newly anointed King of the North and his troops are one win away from being crowned champions. The energy and enthusiasm are palpable and infectious, with Jurassic Parks popping up from sea to shining sea.

Amidst all the buzz and excitement, it's natural for local fans and media to be biased in their commentary and analysis: overemphasizing the bad calls and bounces that go against 'us' and skewing predictions in favour of the hometown boys. Even gamblers over-bet on their favourite teams. Objectivity be damned when it's your side playing.

This home-bias extends beyond sports and creeps its way into our investment portfolios. Reports published by Vanguard indicate Canadians hold 60-65% of their equity allocation in domestic companies, even though they represent less than 5% of the global pie.

Does it make sense for investors to be so heavily concentrated in our home and native land?

To be clear, this behaviour is not specific to Canada but is a global phenomenon. Despite ample evidence on the benefits of an internationally diverse portfolio, people the world over disproportionately invest in their home country. But given the multitude of simple ways to get foreign exposure and the advantages of doing so, why the tendency to stick within the confines of our borders?

The most rational explanation is that we irrationally expect higher returns from domestic securities. Studies by French and Porterba (1991) and Kilka and Webser (1997) concluded that investors illogically expect higher and less volatile returns from home markets. Just like sports fans and gamblers, investors cheer on local companies and expect them to win.

Another reason for concentrating domestically is believing one has an edge. In some cases, staying close to home can be very profitable. Consider a real-estate investor with deep local knowledge, access to deals, and the resources and relationships to boost overall returns. Interestingly, Coval and Moskowitz (1997,1999) found US equity fund managers not only favoured local companies (within 100 miles) but were able to generate better returns from these holdings than from those located further afield.

For specialized and niche players, there can be advantages to focussing and concentrating investments. We, for example, believe our competitive advantage is greater within our borders than outside of them. But for the average investor, any informational advantage is typically outweighed by the benefits of diversification. This is particularly true for Canadians where the market compounds the risk of home-bias with both security and sector concentration. The ten largest companies account for around a third of the TSX with the financial and energy sectors comprising over half. Thus, overly patriotic allocations are missing both industry and foreign exposures.

So how do we overcome our home-bias?

As we are also fans of the Toronto Maple Leafs, we find stats can often sober optimism and add some objectivity. Over the past decade, the S&P returned 269% while the TSX was up only 107%. Ignoring our elephant neighbour to the south over this period would have been rather detrimental. Furthermore, there is a

plethora of quantitative research indicating superior risk-adjusted returns from global portfolios over allocating solely to a single country.

But numbers and facts are usually not enough to break biases. To overcome a behavioural tendency, it also helps to understand its root cause. In this case, it appears that ‘familiarity breeds investment.’ In an extreme example, respondents to a Gallup survey (Driscoll et al., 1995) viewed their employer’s stock as safer than a diversified equity fund. There is a certain comfort that comes with the familiar. Consider how we are more amenable to strangers if we’ve seen their picture before or if they look like someone we know. We need to remind ourselves that the slimmest of personal knowledge can make us feel that the risks are lower than they might be.

The bottom line is that our portfolios are often much more than the abstract return streams of economic models. There are a whole host of factors at play, some rational, some emotional, and others based on external drivers. We are often more enamoured by the stories behind investments, which can be more compelling and interesting than boring risk-return projections and models. But given our jobs, homes, and so much else is correlated to domestic asset prices, it probably makes sense to examine how much extra home-bias your investments are adding.

Playing at home doesn’t confer a return advantage and may increase risk. But we are hopeful home-court will give the Raptors a decisive edge tonight. While we can’t advocate a ‘We the North’ portfolio, when it comes to the Raptors, we fully support going all in. Let’s Go Raptors!

The Fund

With trade tensions and geopolitical risks in the spotlight, May was a difficult month for risk assets. A souring in US-China negotiations led to a sell-off in equities. And with no further talks scheduled with the Chinese, US negotiators had time on their hands to pick another fight, this time with the ‘bad hombres’ to the south. The White House opted to link immigration with trade and threatened tariffs on Mexican made products. The surprising move caught investors off guard, who unsurprisingly hit the ‘sell’ button. Energy and auto-related securities were hit particularly hard. Over the month, the TSX was down 3.1% while the S&P plummeted 6.4%.

Credit markets jumped on the risk-off bandwagon with US investment-grade spreads higher by 17 bps and high yield climbing a whopping 74 bps. Like our beloved Raptors, the Canadian market proved more resilient. Domestic credit was relatively unchanged until the last few trading days in May, when the ‘Mexican Job’ finally pressured spreads 6 bps higher.

The muted move in domestic spreads was due to the large amount of cash building in fixed-income funds. The build-up of dry powder is the result of lower than expected issuance (down around 25% year over year), and inflows from large maturities and coupon payments through May and early June. As a result, the market remained open all month and notably saw the pricing of two high yield issues as both Cominar REIT and Kruger Packaging priced new deals. Even TD’s \$1.75B bail-in deal couldn’t really dent demand.

With trade concerns leading to fears of impaired and slowing growth, we elected to reduce corporate exposure and increase hedges through short credit positions. Thus, despite the negative tone, we managed to preserve capital and post a modest gain of 0.15% (F Class 0.10%) 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%	0.15%								5.33%
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

The Canadian banks seem to be diminishing their home bias as they continue to tap foreign jurisdictions to raise debt. Since financials represent roughly 50% of the corporate debt securities, their activity or lack thereof does leave a mark. Going forward we do expect them to return home (at least to a greater extent than they have done so far this year), but we also anticipate less supply from non-financial companies.

The recent decline in sovereign yields and curve inversion is a strong motivation for managers to increase their allocation to the corporate sector to meet return targets. Thus, all else being equal, the supply and demand dynamics appear positive for domestic credit spreads.

As for the broad credit market, debt-funded mega-mergers are still possible, but we continue to think that large high-quality companies are making decisions with a careful eye on their balance sheet. With concerns of a slowdown mounting, there is additional impetus to decrease financial risk through debt reduction to balance off increased operational risks.

With rising geopolitical and macro risks leading to wild gyrations, we expect to see an increased bifurcation in spreads based on quality and idiosyncratic business factors (i.e. an auto company may find its assets in Mexico impaired because of tariffs, but a mobile tower company would feel far less impact). We remain cautious with over-levered companies (high yield and levered loans) who have fewer leverage reduction options.

Rates

It increasingly appears that the Federal Reserve is going to lower rates sometime this year. The 'easy-to-win' trade war with China is hurting the US economy. While we thought the potential inflationary impact of tariffs could dampen their instincts to ease, it appears that fears of rising unemployment are of greater concern. Prices of sovereign bonds suggest that participants are expecting 75 bps of cuts over the next 12 months.

Canadian economic numbers have bounced higher from the terrible data several months ago. This rebound will make it more difficult for the Bank of Canada to lower rates, although yields have a 70% chance of a cut priced in before year-end.

As things are unfolding so far, it seems that the Federal Reserve will lower rates more aggressively than the Bank of Canada. This should be good news for snowbirds as the Canadian dollar should strengthen making the trip south a little cheaper.



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