The Fixed Income Bucket List | February 2021

"You can't always get what you want
But if you try sometimes, you just might find
You get what you need."
The Rolling Stones

Over the past few months, we've asked hundreds of investors and allocators a very simple question: what do you want from your fixed income?

Imagine for a moment that interest rates aren't zero (and climbing), and that bonds aren't a source of frustration and stress. What is it that you require from this part of your portfolio?

Depending on the client, the exact phrasing and number of f-bombs varied, but the answers boiled down to three simple desires: we want safety, income, and hedging.

Sounds reasonable. After all, for the past forty years, granting these three wishes was as easy as owning a government bond. But in 2021, playing fixed-income genie is a rather difficult proposition.

So how can you get what you want from your fixed income?

The Three Bucket Method.

We begin at the fifth and final stage of the Kübler-Ross cycle of grief: acceptance.

Unfortunately, there's no magic pill for the current environment. We even checked with Jefferson Airplane and the White Rabbit. But when the starting point is interest rates at the 'effective lower bound,' there are certain realities we must accept.

The first being that we can no longer get the trifecta of safety, hedging, and income from a single product or fund. In most cases today, you can only get one.

This is why we propose separating the triumvirate of desires into distinct buckets. Thus, viewing fixed-income products according to the function and purpose they fulfil in your portfolio.

Safety.

In the safety bucket are short-duration, high-quality bonds. They offer capital preservation, minimal volatility, and are very liquid. These investments provide peace of mind but earn next to nothing.

The yields on short-term ETFs are below 0.5%, and 1-year bank GICs pay between 0.15 – 0.45%. And these figures are before fees and taxes.

Hedging.

If you're looking to hedge your equity portfolio, the typical option is longer-dated government debt. The yields are paltry, but sovereign debt tends to rally when equities fall.

But the duration knife can cut both ways, and rising yields can hurt. This can be particularly painful when the relationship between stocks and bonds breaks down. As witnessed over the past few weeks, rising yields can spook equity markets, leaving investors to get pummelled with the 'old one-two.'

Income.

The income bucket is the least straightforward, as it covers such a broad range of products. On the vanilla side of things, we have investment-grade debt yielding 1.5-2%, and high-yield indices offering 3.5-4%.

For those seeking more income, there are a plethora of options from emerging market debt to all sorts of niche alternatives. These options span the risk/return spectrum, each with different levels of security, liquidity, and transparency.

As with lunch, there is no free yield. So extra work is required to understand the risks one is eating.

The Balancing Act.

Separating the products into buckets is the easy part. The more difficult step is balancing the pros and cons.

Each bucket comes with a trade-off. If you need safety, you have to accept a minimal return. If you hedge equities with duration, you have to deal with losses from rising rates. If you fancy more income, you need to take on more risk.

As forewarned, there is no quick fix for fixed-income in an ultra-low yield environment. And while this might mean you can't get what you want, with the right mix of buckets, you just might get what you need.

The Fund.

One of our favourite expressions is 'bonds are boring, but the bond market is not.' After months of relative calmness, February turned out to be rather eventful. With an accelerated vaccine roll-out and the promise of a significant fiscal stimulus bill, credit spreads began the month grinding tighter.

As the month wore on, everything became about interest rates, as the promise of strong growth brought with it the risk of rising inflation. The resulting concern drove 5-year government yields 0.45% higher. The move, while sharp, had a minimal impact on the fund given our low sensitivity to interest rate moves.

The turmoil in rates limited the narrowing of spreads to 7 bps in the US and 2 bps in Canada.

Surging rates caught the eye of some CFOs who rushed to lock in attractive financing levels. Interesting new issues included Manulife doing $2 bn of LRCN, Allied Properties issuing a 5-year, Fairfax bringing a 10-year, and Cineplex doing $250 mm of an unrated 5-year deal.

The fund was active, adding the above-mentioned names to the portfolio while continuing to sell expensive shorter-maturity securities. Through the yield earned and trading activity, the fund generated a return of 0.33% in February.

	1M	3M	6M	YTD	1Y	3Y	5Y	SI
X Class	0.33%	2.60%	5.68%	1.33%	4.96%	4.89%	8.84%	10.13%
F Class	0.27%	2.32%	5.10%	1.17%	4.15%	4.09%	NA	NA

As of February 26, 2021

The Algonquin Debt Strategies Fund LP was launched on February 2, 2015. Returns are shown on 'Series 1 X Founder's Class' since inception and for 'Series 1 F Class' since May 1st, 2016 and are based on NAVs in Canadian dollars as calculated by SGGG Fund Services Inc. net of all fees and expenses. For periods greater than one year, returns are annualized.

Looking Ahead.

The dominant theme for months to come will be the pace of economic growth and its impact on inflation and yields. For now, central bankers continue to focus on the downside risks to the economy (i.e. unemployment). Investors, however, are more concerned that growth and inflation numbers will exceed expectations. As such, employment and inflation data are once again going to be market-moving events.

Although the Federal Reserve and Bank of Canada have communicated that they don't expect to raise rates until 2023, the odds favour that timetable being accelerated. How much sooner will depend on the willingness and speed of consumers and businesses to ramp up spending and consumption. Our read of the landscape is that interest rates move higher for the balance of this year and into the next.

One would expect that a stronger economy means a lower risk of corporate defaults, and therefore tighter credit spreads. Fundamentally this is true, but perversely, the threat of higher rates could cause temporary weakness in credit. With corporate borrowers rushing to lock in attractive funding levels before yields climb further, we anticipate a larger than normal amount of supply. On the other side, rising rates could cause demand to wane as investors shun fixed-income markets.

This potential imbalance in supply and demand could lead to wider credit spreads. While by no means is this a certainty, but should it occur, it would present a very attractive buying opportunity for the fund.

Contact

Algonquin Capital
40 King Street West, Suite 3402
Toronto, Ontario, M5H 3Y2
www.algonquincap.com

Raj Tandon
Founding Partner
raj.tandon@algonquincap.com
+1 (416) 306-8401

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