ALGONQUIN
CAPITAL

Breaking Up Is Hard To Do | July 2023

"Sometimes good things fall apart so better things can fall together."
Marilyn Monroe

One of the biggest regrets investors have is overstaying their welcome and holding on to a position for too long. They either miss the opportunity to take profits before things take a turn for the worse, or they ride a loser down hoping in vain for a miraculous rebound.

It is like watching a gambler on a run that can't get up from the table before giving it all back to the house. Or dealing with a friend that is unable to end a toxic relationship.

But as we all know, 'breaking up is hard to do'.

After all, ending a relationship comes with a certain amount of psychological and emotional baggage. There are bonds of attachment, the fear of change and of being alone, and the guilt of hurting someone we care about. Similarly, certain psychological and emotional impediments make it harder to exit an investment.

The endowment effect leads us to overvalue an asset simply because we own it. An overvaluation that is exacerbated by confirmation bias, which has us emphasizing good news or evidence supporting the trade and discounting the bad news. Then there is the status quo bias which creates a reluctance to make changes, along with good old-fashioned laziness and procrastination.

And if the investment is performing well, we fear exiting too early and missing out on further gains. And when the trade is going against us, we become more risk-seeking in trying to recoup the losses. Hence the tendency to double down on a loser; 'if you liked it at $80 you love it at $60.'

This is not to say that there is anything inherently wrong with riding a winner or sticking with a loser. When the original investment thesis holds or conditions change in your favour, then holding on or adding to the position could be warranted. But far too often it is these other, non-economic factors that lead us to overstay our welcome, even when the landscape and value proposition change.

For example, when interest rates were sub-1% we continuously argued that traditional fixed income was at best a dead weight and most likely a negative drag. Some investors, understanding the return-free-risk proposition in bonds, sought alternative sources of income and diversification. These solutions covered both public and private markets, from structured notes and options strategies to private credit and mortgages. But unfortunately, most investors stuck with their typical allocation to traditional fixed income and incurred some nasty losses.

But now the tables have turned. Boring old bonds are not only offering attractive income but also the upside and hedge potential from a rate-cutting cycle. So, now the time has come for fixed-income replacements to be re-examined against a much higher hurdle. Today, investors need to receive significant compensation to take on greater risks, illiquidity, and sacrifice transparency.

But we understand that it can be tough to ditch the friends that got us through the challenges of a zero-rate world. Especially when their investment thesis is sound, and they have provided us with decent, steady returns. But portfolio holdings don't just need to stand on their own merits but must also be considered relative to other opportunities.

It might sound cold-hearted, but after such a dramatic paradigm shift in interest rates, many of our existing relationships need to be re-evaluated against what else is available. The good part of breaking up with an investment is that, unlike a jilted ex, if conditions change and the value proposition returns, you can always get back together.

The Month of July.

Credit.

Greater optimism for a soft landing combined with attractive all-in yields drew money into investment-grade debt. New issue supply stood at $6.3 bn spread over 11 issuers including Choice Properties REIT, 407ETR, and Brookfield, with all the deals performing well. The modest supply calendar in July helped motivate portfolio managers to scoop up product in the secondary market leading to a narrowing of spreads.

Domestically, subordinated bank debt and the regional banks outperformed. Laurentian Bank bonds enjoyed a particularly strong rally, fueled by the prospects that they might be sold to a stronger player.

August is typically a slow month for issuance, however, the impact on spreads is often mixed as some portfolio managers try and reduce holdings ahead of the expected September supply deluge.

- Canadian spreads narrowed 7 bps to 144 bps
- US spreads narrowed 11 bps to 112 bps

Interest Rates.

July was not a pleasant month for long-duration securities. Conflicting signals on the trajectory of growth and inflation, coupled with surprising changes by the Bank of Japan to yield curve control, a higher-than-expected increase in treasury issuance, and the Fitch downgrade of US government debt conspired to push yields higher.

Sovereign yields:

- Canadian 2y finished at 4.67% (+9 bps) and the 10y at 3.49% (+22 bps)
- US 2y finished at 4.89% (-1 bps) and the 10y at 3.96% (+12 bps)

The Funds.

Algonquin Debt Strategies Fund.

The main drivers of return in July were the yield earned and the performance in our credit positions. Over the month, we added exposure to 1y and under securities, given the attractive all-in yields available. We also see value in Canadian 2y bonds and have tactically increased duration in the front end of the curve. On top of seeing value in this part of the curve, these positions could act as a hedge should a recession materialize.

Portfolio Metrics:

- 10% yield
- IR Duration: 1.5y
- Average maturity: 2y
- Average credit rating: A-

	1M	3M	6M	YTD	1Y	3Y	5Y	SI
X Class	1.39%	2.73%	3.09%	5.57%	8.68%	4.31%	3.79%	7.81%
F Class	1.26%	2.44%	2.66%	5.15%	8.00%	3.61%	3.07%	NA

*As of July 31st, 2023

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.

Algonquin Fixed Income 2.0

The returns generated from the portfolio yield and our credit positioning were partially offset by losses from rising interest rates. We used the sell-off in yields to increase the Fund's duration to 5y, by increasing our exposure to CAD 2y and 5y rates as well as US 10y bonds.

Portfolio Metrics:

- 7-8% yield
- IR Duration: 5y
- Average maturity: 3y
- Average credit rating: A-

	1M	3M	6M	YTD	1Y	2022	2021	2020
F Class	0.50%	-0.17%	0.98%	4.04%	4.33%	-6.15%	2.42%	10.53%

*As of July 31st, 2023

Algonquin Fixed Income 2.0 Fund is an Alternative Mutual Fund and was launched on December 9, 2019. Returns are shown for Class F since inception and are based on NAVs in Canadian dollars as calculated by SGGG Fund Services Inc., net of all fees and expenses. Investors should read the Simplified Prospectus, Annual Information Form, and Fund Facts Documents and consult their registered investment dealer before making an investment decision. Commissions, trailing commissions, management fees, and operating expenses all may be associated with mutual fund investments. An Alternative Mutual Fund is not guaranteed, its value changes frequently and its past performance is not indicative of future performance and may not be repeated. Payment of quarterly distributions is not guaranteed and paid at the discretion of the manager; therefore, it may vary from period to period and does not infer fund performance or rate of return.

Looking Ahead.

Not only do we need to occasionally break up with securities, but sometimes we need to end relationships with long-held perceptions and beliefs. Today, two such concepts being challenged are the appropriate long-term levels for inflation and rates.

For most investors, portfolio decisions have been made in a world of low inflation and ultra-low interest rates. Over the past decade, 10y interest rates in North America have traded below 3% and for long stretches below 2%. Thus, on a historical basis, Canadian and US 10y rates at 3.61% and 4.20% respectively would appear to offer significant value.

But the problem with historical analysis is that it presupposes that the future will look like the past. As a result, one can get stuck in thinking the market is cheap or expensive without considering what structural economic and/or market changes could be occurring. And as we have pointed out, one should not get too attached to a particular investment thesis and instead should be continuously open to the idea that a different approach might be needed to garner future success.

We get the sense that the bond market is shifting to conclude that the yield levels of the past decade or so, are unlikely to be achieved anytime soon. Instead, people are starting to get their heads around the idea that perhaps we are in a 3%-5% fixed-income world, which does not necessarily result in financial Armageddon.

Given the deeply inverted yield curve, we would not be surprised to see further volatility in long rates as investors consider what levels constitute value. Thus, while we see value in the front end of the Canadian yield curve (i.e. <5y), we are less dogmatic on long-end rates.

US credit markets have rallied sharply this year and are close to historical averages, while domestic investment grade spreads remain well above the average. In our opinion, high-quality Canadian bonds are extremely attractive on both a historical and relative value basis. Accordingly, we are slowly but surely increasing our exposure. At the same time, we remain aware that a sudden sharp economic contraction might yet occur due to the accumulation of significant rate hikes. Therefore, we continue to favour banks, telcos, and energy infrastructure, which offer the trifecta of value, security, and liquidity.

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