Return of the "Reach for Yield"

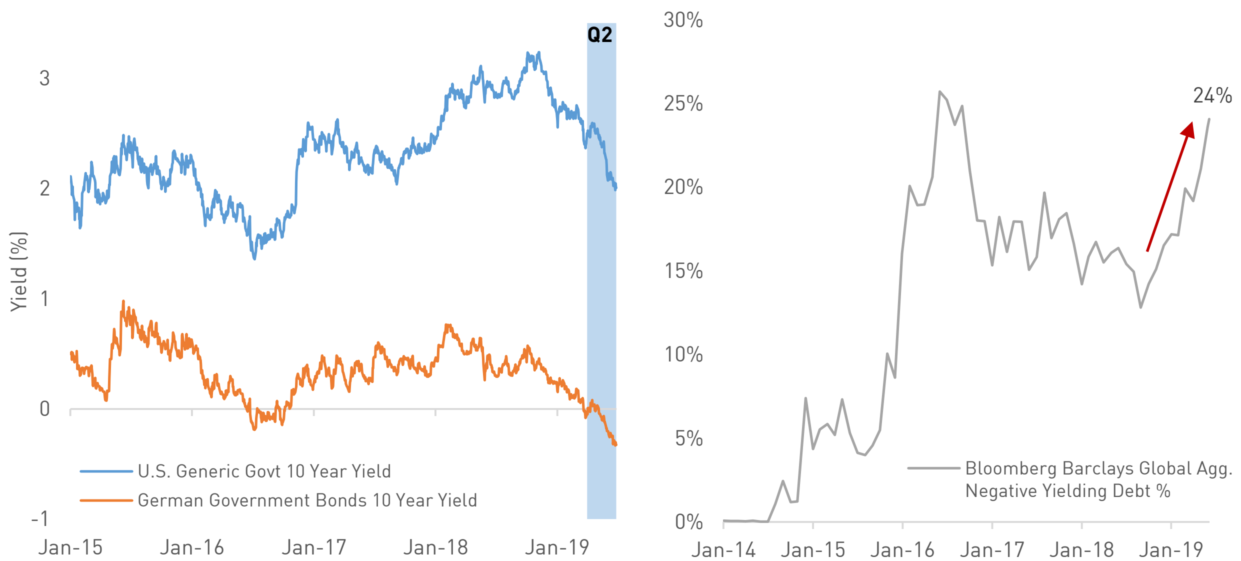
Q2 2019 Commentary

Executive Summary

- During Q2 bond yields fell globally as central banks adjusted their rhetoric and investors revised down their views on the neutral rate of interest.
- Given current valuations and the change in environment, portfolio managers will need to be nimble and tactical to succeed over the balance of the year.
- With the "Reach for Yield" back on, capital will continue to flow into corporate bonds and other asset classes that offer additional yield.
- Funds may also continue to flow into private asset classes – and we share some caveats around private market investing.

The single biggest theme of Q2 was the sharp drop in government bond yields across the globe. During the quarter the yield on the 10yr Treasury dropped from a high point of 2.60% to almost exactly 2%. In theory then, if one buys a 10yr Treasury today, one will earn exactly enough return to keep up with inflation and nothing more[1]. Canadian investors are currently paid 1.47% to lend to the government for 10yrs. However, these yields still look enticing when one considers the yield on the 10yr German Bund is now minus 0.33%. In other words, Eurozone investors lending money to Germany once again have to pay for the privilege. The universe of negative-yielding bonds has now increased to almost a quarter of the Global Aggregate Bond Index. 2019 to date has been the complete opposite of 2018 – when risk assets were under pressure and fears were centered around rates moving higher.

Global Yields Fell in Q2... And Now Around a Quarter of all Bonds Have Negative Yields



Source: Bloomberg

[1]Assuming central bankers meet their target – which is admittedly not a given.

The major central banks played a key role in shaping expectations. In recent weeks, the Federal Reserve have strongly hinted that there are interest rate cuts to come. The Bank of Canada is likely on hold for the balance of the year. The European Central Bank ("ECB") has stated that in the absence of improvement in the economic data, additional monetary stimulus will be required. Market consensus is now that it is a matter of when - and not if - the ECB starts to buy corporate bonds again. In fact, there is speculation that this time around, the central bank will also look to buy financial bonds, high yield bonds, and equity ETFs.

The decisive factor may have been investors revising down their views of the neutral rate of interest. If central banks are so worried about economics that they are embarking on stimulus measures, why did risk assets post such stellar returns in Q2? The S&P 500 and the Dow Jones Industrial Average are now at all-time high levels. Corporate bond markets have retraced most of the spread widening of 2018. There has to be something else going on. Reconciling these movements suggests that during Q2 - besides taking stock of the economics - investors dramatically revised down their views of the "neutral" rate of interest. Concerns around growth, trade and inflation captured the headlines, but more crucial was investors re-thinking the normal level of rates. This is the narrative that can explain why yields fell, yet risk assets were able to post such strong returns.

Portfolio managers will need to be nimble and tactical to succeed over the balance of the year. Relative to the start of the year, valuations for risk assets look less attractive. Without question there are some headwinds with slowing corporate earnings and elevated leverage for some segments of the corporate bond market. However, with government yields at low levels, we expect funds to continue to flow into corporate bonds and other asset classes that offer additional yield. This will be supportive for the market. We believe there will be volatility during the balance of the year so the key to success will be an active approach to investing. We believe our tactical approach to corporate bonds best positions us for success in this environment.

Assets continue to flow into private investments – both debt and equity. One of the responses to the problem of low yields in the past has been to replace public market investments with private market equivalents. This has been a trend for both equity and credit, in Canada and elsewhere. We have had many interesting discussions with investors about our views on this trend and so we wanted to share our perspectives here.

Three benefits are commonly cited for private investments – diversification, additional return, and less volatility. Each individual has unique investment objectives, risk tolerance and liquidity needs – and ultimately these considerations should determine how one's portfolio is constructed. For appropriate investors we believe that there are some genuine advantages to be had from private asset classes. However, it is important to understand both the benefits and the risks. The three most commonly cited reasons for "going private" are as follows. Firstly, private asset classes have the potential to offer investors exposures that provide portfolio diversification. Secondly, private asset classes offer investors compensation for forgoing liquidity – something that can be attractive. Finally, private allocations exhibit less volatility, and so can help smooth portfolio returns[2].

It's important not to confuse genuine diversification with return-smoothing. On the diversification issue, private strategies may indeed offer diversification benefits – but it depends a lot on the type of strategy under consideration. Allocating to infrastructure investments or a factoring strategy may indeed add a different return stream to the portfolio. However, something like a mid-market private equity allocation arguably won't offer much diversification versus a public equity allocation. It's important not to confuse genuine diversification with return-smoothing. The private equity investment will look like a much smoother ride, as portfolio valuations are periodic in nature and based on appraisals rather than observable market levels. However, the underlying return driver in both cases will be equity valuations and so adding that private strategy to the portfolio is unlikely to offer genuine diversification benefits.

[2] Because of this, private fund managers can post some very high Sharpe ratios relative to managers that are required to "mark to market" their portfolios

Investors need to consider where the extra return is coming from. On the topic of additional return, studies have estimated the compensation for sacrificing liquidity to be around 3% per annum over the long term[3]. However, in recent years there has been an abundance of capital chasing deals in the private space. McKinsey recently estimated that there is $2.1 trillion of private equity dry powder globally. This competition to deploy capital will mean elevated deal multiples and so lower returns going forward. Secondly, it's important to keep in mind that the extra return from a private allocation may not come from the liquidity premium but may be driven by more risk. A study published in the Financial Analysts Journal[4] looked back at the risk-adjusted performance of US buyout firms from 1986-2014. The authors found that if you adjust private equity returns to account for their bias towards certain sectors and small cap companies, then there was no additional return at all from public equity investments versus public market equivalents over that period.

Overall, we are not opposed to private market allocations per se. Rather, the allocation decision should be made based on an individual's portfolio objectives and with a thorough understanding of the strategy pursued and its risks. In an environment of low yields, investors are right to ask whether their investment portfolio is equipped to meet their objectives in the coming years. Allocating to private strategies is one response to the challenge, but not the only one. We believe there are other approaches to investment that can achieve similar goals – without sacrificing liquidity.

Should you wish to discuss our approach to fixed income and the investment solutions we offer, please don't hesitate to reach out to the Client Portfolio Management team.

[3] Equity estimate from "Private Equity Performance: What Do We Know?" - Harris, Jenkinson and Kaplan (2014). Credit estimate taken from "US Mezzanine Debt and Its Relationship to Other Credit Driven Asset Classes" by Cliffwater LLC.
[4] A Bottom-Up Approach to the Risk-Adjusted Performance of the Buyout Fund Market – FAJ 72, Number 4.

Performance Commentary

RP Debt Opportunities

With a pronounced compression in credit spreads, the RP Debt Opportunities strategy a posted strong return of 1.92% during Q2. During Q1 the strongest contributor was Short Dated Income, but during Q2 the majority of the return came from Outright Value and Active Trading.

Many of the top performers during the quarter were high conviction investments in companies where we see long-term value – examples being NGPL PipeCo LLC, Deutsche Bank and AT&T Inc. So far, 2019 has been one of the lightest years for net USD investment grade bond issuance, and this drop off in supply was supportive for new issue performance. We saw BB-rated bonds perform particularly well relative to BBB-rated bonds. Another noteworthy contributor were a group of positions we have in USD-denominated preferred shares issued by money center banks and regional financials. These securities benefitted from the fall in rates and the general search for yield. The largest detractors to performance were credit hedges to reduce sensitivity of the portfolio to macro moves, and some short positions in retailers that performed in line with the broader market.

At the end of the quarter we have modestly reduced our exposure to BBB rated companies, although we retain significant exposure to this rating category. We have marginally reduced our USD holdings, and deployed the proceeds in Canada where at the juncture we see some attractive opportunities. The 5yr equivalent leverage metric for the portfolio remained consistent at 1.6x.

RP Select Opportunities

The RP Select Opportunities strategy posted a strong return of 1.99% during Q2. The strongest contributor was the Yield Opportunities segment, which generally contains securities fairly close to their maturity / call date.

During Q2 we saw strong performance from USD preferred shares and bank capital instruments against a backdrop of lower rates. BB rated bonds performed very well relative to BBB rated bonds. There still seems to be a reluctance in the High Yield community to add to securities that have a sub-B rating, particularly in economically sensitive companies and sectors. A number of the longer-term positions we have in the portfolio performed particularly well in Q2 including MDC Holdings Inc, Synovus Financial Corp and secured bonds issued by Frontier Communications.

The risk profile of the strategy closed the quarter similar to where it began in terms of credit duration. It currently sits at 3.6yrs. In other words, the portfolio theoretically has a similar sensitivity to movement in credits spreads as an unlevered portfolio of 4yr corporate bonds. The composition of the portfolio now has a greater tilt towards BBB and BB rated securities. From a sectoral perspective we reduced our exposure to Energy and Financials while increasing our positions in Real Estate and Consumer companies. Our largest exposure overall remains to Financials and the USD market continues to be the one where we currently see the most attractive investment opportunities.

RP Fixed Income Plus

RP Fixed Income Plus returned 1.23% in Q2, helped by lower yields and tighter credit spreads. The Strategy has outperformed the FTSE Canada Short Term Overall Bond Index this year – despite having less exposure to interest rates. In other words, this outperformance has been driven by credit positioning. A key driver was the fact that global credit performed considerably better than Canadian credit during Q2, as was also the case during Q1.

Only one of the top five contributors of the portfolio is a Canadian issuer (Fairfax Financial Holdings Ltd) – the other four are large global companies where the most attractive securities to own are in USD. Our positions in provincial bonds were a small detractor with respect to performance.

During the quarter we reduced our holdings in Canadian dollar securities from 57% to 52% of the portfolio. The corporate bond exposure of the portfolio moved from 69% to 76%. The overall duration of the portfolio remained less than 2yrs, although credit duration ticked up to just above 2yrs as we moved some exposure from government bonds into corporate bonds. From a sectoral perspective we trimmed our exposure to Communications and increased our exposure to Industrials and Financials. We continue to own several floating-rate bonds in the portfolio – with a focus on securities that are trading at a discount to their fixed coupon equivalents.

Important Information

Unless indicated otherwise, all returns and portfolio data is presented as at June 28th, 2019.

The information presented herein is for informational purposes only. It does not provide financial, legal, accounting, tax, investment or other advice, and should not be acted or relied upon in that regard without seeking the appropriate professional advice. The information is drawn from sources believed to be reliable, but the accuracy or completeness of the information is not guaranteed, nor in providing it does RP Investment Advisors LP ("RPIA") assume any responsibility or liability whatsoever. The information provided may be subject to change and RPIA does not undertake any obligation to communicate revisions or updates to the information presented. Unless otherwise stated, the source for all data cited is RPIA. This document does not form the basis of any offer or solicitation for the purchase or sale of securities. Products and services of RPIA are only available in jurisdictions where they may be lawfully offered and to investors who qualify under applicable regulation. The investment strategies presented herein are offered in Canada as RP Fixed Income Plus Fund, RP Debt Opportunities Fund Trust, RP Select Opportunities Fund and RP Corporate Index Plus. These funds are qualified investors only, pursuant to prospectus exemptions in NI 45 106 "Forward Looking" statements are based on assumptions made by RPIA regarding its opinion and investment strategies in certain market conditions and are subject to a number of mitigating factors. Economic and market conditions may change, which may materially impact actual future events and as a result RPIA's views, the success of RPIA's intended strategies as well as its actual course of conduct. Trade examples are presented for illustrative purposes and does not necessarily reflect a trade or current holding in any particular RPIA strategy or fund.

The index performance comparisons presented are intended to illustrate the historical performance of the indicated strategies compared with that of a specified market index or blend of indices since the strategy inception. The comparison is for illustrative purposes only and does not imply future performance. There are various differences between an index and an investment strategy or fund that could affect the performance and risk characteristics of each. Market indices are not directly investable and index performance does not account for fees, expense and taxes that might be applicable to an investment strategy or fund. Strategy returns are in Canadian dollars and is net of all fees and expenses. Actual returns may vary from one investor to the next in accordance with the terms of the governing documents of relevant entities. Unless specified otherwise, returns presented for periods greater than one year are annualized. Performance is not guaranteed and past performance may not be repeated. RP Debt Opportunities strategy returns are based on composite returns of RP Debt Opportunities Fund LP Class A and RP Debt Opportunities Fund Ltd. Class A, from October 2009 to July 2011 and RP Debt Opportunities Fund Ltd. Class A. from August 2011 onwards. RP Fixed Income Plus strategy returns are based on the weighted average composite return of separately managed accounts utilizing a similar strategy from inception in July 2010 to April 2013 and linked to the returns of the RP Fixed Income Plus Fund Class A thereafter. RP Select Opportunities strategy returns are based on the weighted average composite return of a separately managed account utilizing a similar strategy from inception in April 2014 to June 2014, and then linked to the returns of RP Select Opportunities Class A thereafter. Growth charts are used to illustrate the effects of a compound growth rate and is not intended to reflect future values of any RPIA fund or strategy.

The portfolio characteristics presented, including risk measures and holdings based data reflects that of the indicated RPIA strategy. Certain investment strategies offered by RPIA in Canada may gain indirect strategy exposure by investing in units of applicable strategy feeder funds.