Executive Summary

- We began 2020 with a healthy and robust economy heading into its record twelfth year of expansion, only to see it quickly derailed by the spread of Covid-19. The crisis led to the most violent and high-velocity repricing of long and short term investments since the great financial crisis.

- Central banks were quick to react and engaged in monetary stimulus to support the economy by lowering prescribed rates back to zero or close to zero across the globe. This in turn lowered yields across money market instruments and short-term bonds.

- Yield-seeking investors may need to re-evaluate their portfolio allocations to ensure that their short-term investments can continue to generate a satisfactory return.

Comparing Liquidity, Yields and Risks Among Popular Options

Investors may hold cash for a variety of purposes, but we can typically bucket them into one of two reasons: a transitory allocation or a longer strategic allocation.

The recent drop in money market and cashable GIC yields means these vehicles may no longer meet the income needs for many investors. Though they are still useful for transitory purposes and for very risk averse clients, long-term allocations to these instruments are much less attractive than they were prior to the crisis.

Consequently, allocations to short-term bond strategies which offer a mix of higher yields and reasonable amounts of liquidity could be a better solution for clients with medium and long-term income needs.
Investing in a Low Yield Environment

Money Market Funds and Savings Accounts

Money market funds, cashable GICs and HISAs provide a set rate of interest with little to no constraints on liquidity. But one key disadvantage is that they offer very low yields. Money market funds typically hold short-term debt securities such as U.S. Treasury bills and other cash-equivalent securities which generate low levels of interest income in this environment. Adding to the issue of low yields is that the income generated is taxed at an individual’s highest marginal tax rate. This can be a significant drag if these funds are held in accounts that are not tax sheltered.

Losing to Inflation and Taxes

The combination of lower yields and lower tax efficiency means most money market funds today provide a rate of return of less than 0.50% (before taxes). Factor in inflation, which has traditionally averaged between 1.5% to 2.0%¹ in Canada over the past 20-years and you can see that buying and holding these instruments at such low rates could cause a significant degradation of purchasing power over time.

<table>
<thead>
<tr>
<th>Liquidity</th>
<th>Types of Instruments</th>
<th>Average Forward Yield</th>
<th>Potential for added value</th>
<th>Credit Risk</th>
<th>Issuer Solvency Risk</th>
<th>Higher than Inflation</th>
<th>Tax Efficiency</th>
</tr>
</thead>
<tbody>
<tr>
<td>Immediate Drawdown</td>
<td>Physical Cash / Deposit Account</td>
<td>Minimal</td>
<td>No</td>
<td>No</td>
<td>No</td>
<td>No</td>
<td>Poor</td>
</tr>
<tr>
<td>Readily available (1 to 5 days)</td>
<td>Money Markets (T-bills)</td>
<td>~0.35% and lower*</td>
<td>No</td>
<td>No</td>
<td>No</td>
<td>No</td>
<td>Poor</td>
</tr>
<tr>
<td></td>
<td>Cashable GIC / High Interest Savings Accounts</td>
<td>~0.50% and lower*</td>
<td>No</td>
<td>No</td>
<td>Yes</td>
<td>No</td>
<td>Poor</td>
</tr>
<tr>
<td></td>
<td>Short-Term Bond Funds</td>
<td>~1% to 2%</td>
<td>Yes</td>
<td>Yes</td>
<td>No</td>
<td>Maybe</td>
<td>Savings Potential</td>
</tr>
<tr>
<td>Not Readily Available or Penalty for Early Withdrawal</td>
<td>Locked in GICs or HISAs</td>
<td>Depends on lock-up period. 1-year average of ~1.2% average 5-year average of ~1.8% average</td>
<td>No</td>
<td>No</td>
<td>Yes</td>
<td>No</td>
<td>Poor</td>
</tr>
</tbody>
</table>

¹ Based on a list of GIC rates compiled by RBC as of May 21, 2020 and a sample of HISA rates at major Canadian financial institutions.

The table below compares some key attributes to consider when constructing your portfolio:

12-month % Change in Consumer Price Index

Source: Statistics Canada

¹ Based on rolling monthly 12-month Canadian CPI rates
Investing in a Low Yield Environment

Financial Insolvency Risk

An often-underappreciated fact is that though GIC and HISA accounts offered by banks and other financial institutions are insured by the Canada Deposit Insurance Corporate (CDIC) there are limits to this safety. For example, in Ontario only $100,000 is protected per account, meaning balances above that could be affected if the issuing bank becomes insolvent.

Similarly, if a client has direct holdings in bonds or short-term investments such as Treasury Bills or Canada government bonds at a bank – and that bank goes through an insolvency event – those assets could be affected. For example if those assets are not custodied separately (as assets of a mutual funds typically are), they could get swept into the general pool of assets that creditors have claim over in a worst case scenario and lead to delayed repayment or potential losses.

Locked-in GICs

GIC rates have decreased in lockstep to the drop in Bank of Canada rates in response to COVID-19. The major Canadian banks were offering rates of above 2% or higher prior to the crisis, but now yields range from approximately 1% to 2% depending on the lock up period agreed upon by the investor.

<table>
<thead>
<tr>
<th>Fixed Term GICs</th>
<th>1 Year</th>
<th>2 Year</th>
<th>3 Year</th>
<th>4 Year</th>
<th>5 Year</th>
</tr>
</thead>
<tbody>
<tr>
<td>Estimated Average Rates*</td>
<td>1.2%</td>
<td>1.4%</td>
<td>1.5%</td>
<td>1.7%</td>
<td>1.8%</td>
</tr>
</tbody>
</table>

* RBC GIC Rate Table. GIC Rates are estimated as of 05/21/2020. Rates are subject to change and availability.

In an uncertain environment, it can seem intuitively attractive to purchase an investment with a guaranteed return. But there is both an opportunity cost and a liquidity cost to purchasing locked-in GIC’s.

1. By “locking in” a guaranteed return, investors are foregoing the opportunity to earn higher returns as market conditions evolve and the yield on fixed income investments increase. This is particularly the case for longer-term GICs.
2. GIC investors are giving up liquidity. Although there are secondary markets for GICs, they are typically captive markets within a specific dealer channel. As such the transactional spread tends to be very high – dramatically reducing the yield on the investment if the investor decides to “break” the GIC ahead of the maturity.

Additionally, investors have been historically able to earn a higher return than the locked-in GIC rates by seeking out other fixed income investments such as in bonds. Thus, the safety of GICs could be overvalued by investors who have a reasonable time frame and ability to bear some incremental risk.
Short-Term Bond Strategies

The DIY Approach - A Laddered Bond Portfolio

A bond ladder is a portfolio of fixed income securities with staggered maturity dates. As bonds mature, the proceeds are reinvested. This represents a low cost and straightforward way of getting average yields, decent liquidity and allows for some participation if yields move higher in the following years.

However, we believe this type of investment will struggle to generate an attractive return as the upside is limited to the yield to maturity of each of the bonds in the ladder. Additionally, the bonds are purchased mechanically based solely on their maturity date and without consideration to their attractiveness or risk-adjusted return properties. Furthermore, credit exposure in a laddered bond portfolio tends to be static and Canada-focused. This limitation means many of the most attractive areas of the bond market are ignored completely.

The Passive Indexed Bond Solution (Mutual Fund or ETF)

Investing in a passive product – either via a mutual fund or an ETF – has many of the same advantages and disadvantages of a DIY laddered bond portfolio. Although this option will increase diversification by limiting individual bond exposure, its mechanical approach to investing can lead to unintended credit and interest rate exposures. For example, passive funds generally seek to track their benchmark – which for bonds translates to indexes that are issuance-weighted. Unfortunately, fixed income indices place larger relative weights in those companies or governments that issue the most debt, which is hardly an ideal way to invest.

Additionally, we seem to be reaching the tail end of a 30-year bull market for bonds driven by lower and lower rates. Passive indices which typically have had significant interest rate exposure have fared well in this environment, but a potential move higher in rates in the future could work against them.

Actively Managed Fixed Income Solution

Considering the options discussed above, we believe that many investors can improve their short-term investment strategy by allocating to actively managed solutions with an aim of increasing yields by taking on selective credit risk, but without sacrificing liquidity. The flexibility that active bond managers have is a key advantage to help meet investor goals as they can tactically preserve capital if rates rise and lock in more attractive yields as they become available.

Active managers can also optimize credit exposure to generate excess returns from opportunities within an inefficient asset class and can generate returns from a combination of both income and capital gains which can markedly improve after-tax returns for investors.
Conclusion

As the macroeconomic backdrop has changed, investors are right to reconsider their fixed income strategy. We believe that actively managed bond solutions offer investors an attractive blend of characteristics relative to the alternatives that now pay rates that are often too low to meet investor income needs.

Please reach out to the Client Portfolio Management team at RPIA should you wish to discuss our fixed income solutions and the role they might play in your clients’ portfolios.
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