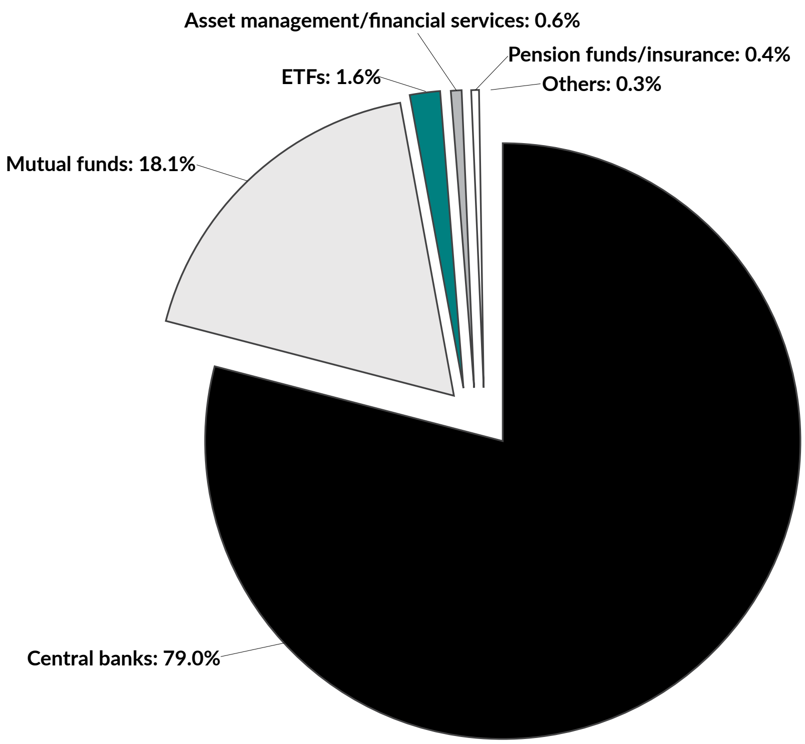
FIXED-INCOME COMMENTS For the quarter ending September 30, 2019

Illusions of quality

By Derek Skomorowski, credit analyst

Negative bond yields – now there's a great dinner party topic! As you've probably heard, some US$17 trillion worth of bonds globally offer investors a return of less than zero percent,[i] so we're often asked the confounding question: "Who's actually willing to buy them?" After all, stashing cash under the mattress offers a better proposition than a guaranteed loss, even in the doomsday deflationary scenario usually used to explain why negative bond yields make perfect sense. Well, put your mind at ease. The chart below shows that 79% of negative-yielding bonds are held by the central bankers of the world. Adam Smith's invisible hand price-discovery mechanism has officially been replaced by the invisible brain at the Bank of Japan (BoJ), European Central Bank (ECB) and the U.S. Federal Reserve.

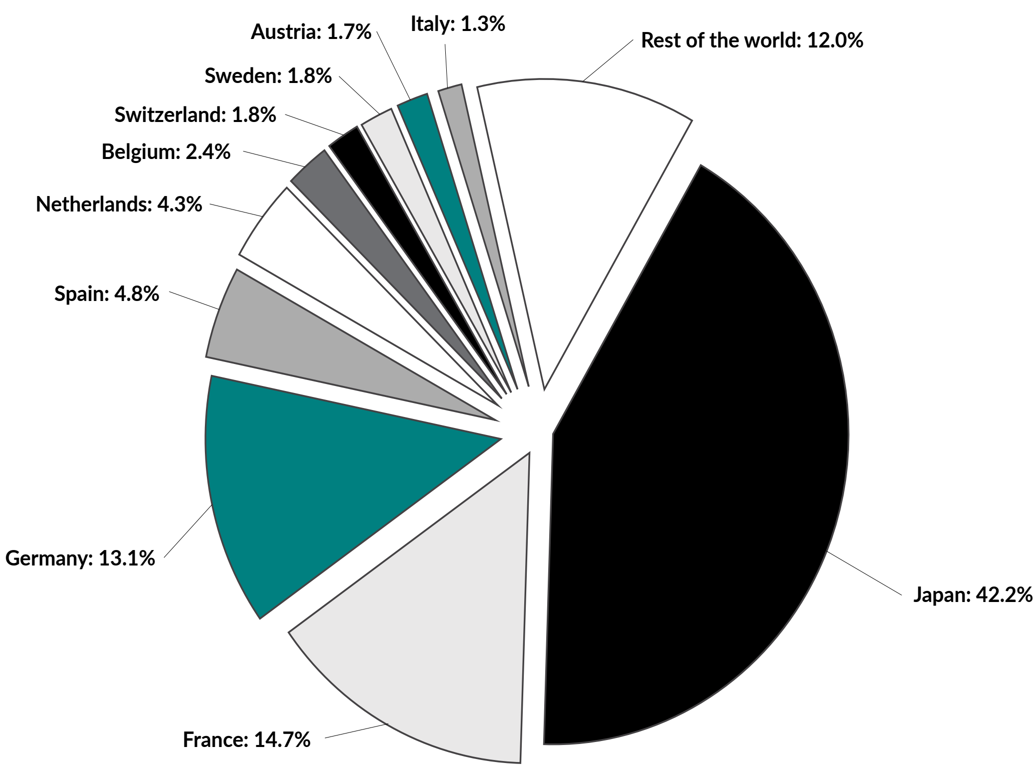
Holders of negavtive-yielding debt



Source: Bloomberg LP, DB Global Research. Data is a Bloomberg sample of negative-yielding debt. The "Others" category consists of hedge funds and similar private investment companies.

Of course, that means that the remaining 21% of negative-yielding bonds must be bought by "rational", return-seeking investors, although we could probably chalk up the discrepancy to passive funds that abdicate any intellectual responsibility to whether-or-not something is included in an index (not that even active bond funds were ever known for deviating very far from their benchmarks). Needless to say, indiscriminate buying of negative-yielding bonds by central banks to the tune of US$13 trillion has an impact on asset prices everywhere.[ii] The BoJ and ECB continue to buy bonds at a rate of about US$30 billion and US$25 billion per month, respectively, and in doing so supress yields globally.[iii] It is confusing to think that so-called "risk-free" government bonds are now guaranteeing losses to their holders.

Issuers of negative-yielding government debt

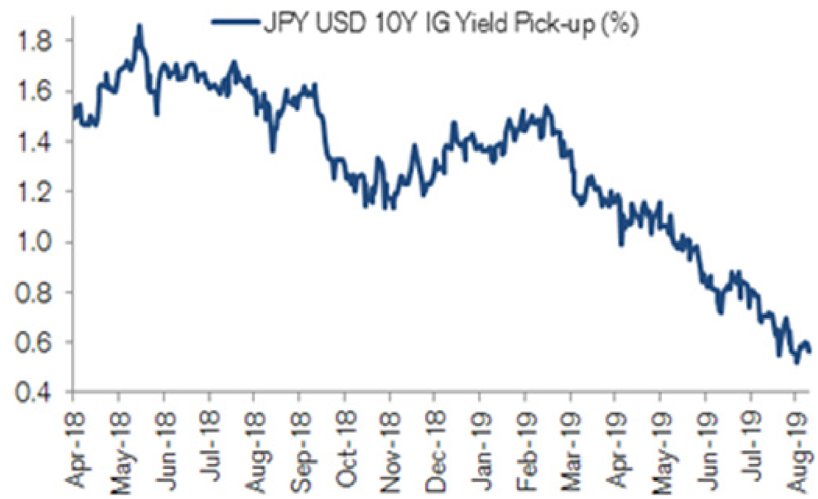


Source: Bloomberg LP. As at August 1, 2019.

While North America so far remains free of the negative-yielding bond problem, this doesn't mean that domestic yields aren't influenced by the mess we see abroad. In their search for yield, investors put pressure on interest rates everywhere. The chart below shows the yield realized by a Japanese investor buying a basket of U.S. investment-grade corporate bonds (Credit Suisse US IG Corporate Index) while hedging the currency risk. The buyer does concede some return to hedge the currency, but even after accounting for the incremental cost, 0.6%[iv] in yield is sunshine and rainbows compared to the -0.25%[v] currently available on the 10-year Japanese Government Bond.

U.S. corporate bond yield realized by a Japanese investor, hedged currency

Apr. 2018 to Aug. 2019



Source: Credit Suisse. In C$. As at August 2019. JPY USD 10Y IG Yield Pickup: the yield realized by a Japanese investor buying a basket of U.S. investment-grade corporate bonds (Credit Suisse US Investment Grade Corporate Index) while hedging currency risk.

With 27% of U.S. corporate bonds now held by foreign investors, we get a sense of why corporate bond yields, are also so compressed here at home.[vi] But in the zombies-making-decisions world we live in today, when swaths of money start flowing into corporate debt, rarely are investors nit-picky about the bonds that are purchased. Instead these capital flows rely on a group of financial clairvoyants – the bond rating agencies – to set the parameters of an attractive investment.

The Authenticators

In “The Hand of Leonardo”, an episode on Michael Lewis’ podcast, “Against the Rules”,[vii] he draws a humorous parallel between the art authenticators and the corporate bond rating agencies that dictate so much of what is bought and sold in corporate credit markets. Spoiler alert – the plot goes something like this:

In 1958, a couple from New Orleans bought a painting of Jesus in London, England, for £45 (call it 60 bucks). The painting is passed to their son, and later sent to auction after his death in 2005. There, a consortium of art dealers purchases the painting for US$10,000 with a view that the piece might be a “da Vinci original”. To confirm their hypothesis, according to Michael Lewis, the dealers pass the painting to a restoration specialist to clean and reassemble its crumbling pieces, and alterations are made that include, among other things, removing the figure’s beard (?!?), a feature that didn’t quite fit the da Vinci narrative. The painting is later presented to an exclusive group of well-paid, handpicked authenticators who confirm its originality, and the artwork is sold as Leonardo’s “Salvator Mundi” for a cool US$450.3 million.

The conflicting relationship here is in the group of handpicked authenticators, hired by the art dealers and paid large sums of money to confirm whether their suspicions (wishes?) are correct that the hand of Leonardo held the brush responsible for this discovery. Since art dealers are almost certainly an authenticator’s most lucrative (only?) clients, these experts have a huge incentive to satisfy this client; what better way to lock-in repeat business?

Similarly, in bond markets, the largest companies with the biggest balance sheets are the best possible customer a ratings agency can have. A good rating from Moody’s gets a low interest rate for the issuer, and the issuing company gives more business to Moody’s as a result.

At EdgePoint, we’d prefer to think of ourselves as “authenticator agnostic.” Consider us the New Orleans couple buying an unassuming, high-quality painting for 60 bucks while on vacation (slightly less stylish, of course). The value in the painting derives from the pleasure we get from showing it off in our living room – and not what some experts tell us it’s worth. If the businesses we lend to are successful as businesses, our bonds will be successful investments.

This year, the ratings agencies have had a particularly influential impact on credit markets, most notably in the market for high-yield bonds. The conflict of interest described earlier that sees ratings agencies compensated by repeat bond issuers is compounded by the fact that investors want a “high-quality” stamp on their high yield bonds. As strange as it may sound, according to Michael Lewis, the art collector who ultimately purchased the “Last da Vinci” also had an interest in having the painting authenticated as an original. After all, who would impress patrons with an exhibit featuring a painting whose origins are tied to a Louisiana basement?

Reaching for “authenticated” yield

As low rates from around the world supress future returns, investors indeed are reaching. As flows chase yields, the high-yield bond market continues to rally. But unlike the majority of buoyant high-yield markets, this rally is being led by the highest-rated component of the asset class. Specifically, BB-rated issues are trouncing their lower-rated counterparts, which leads us to believe one of the following is happening:

- Non-traditional investors are creeping down the credit spectrum from investment grade corporates to buy junk bonds, and are doing so by dipping their toes in the highest-rated sector; or
- More traditional high-yield funds are huddling in the BB-rated corner, fearing a recession is right around the corner.

It’s probably a bit of both. Non-traditional high yield bond and leveraged loan buyers continue to pour money into the market, while high-yield funds shun everything with any cyclical bend or even the slightest hint of incremental risk.

The table below shows the yields of BB-rated and CCC-rated bonds over the past five years. In 2016 and 2017, high-yield bonds had strong returns. Strong junk bond returns are typically accompanied by a decline in the yields of CCC-rated bonds, and in both years the yields on these lower-rated issues compressed much more than the yields on BB-rated bonds. As their yields declined, CCC-rated bonds posted much stronger returns in these “risk-on” years.

BB- and CCC-rated bond index yields by year

Dec. 31, 2014 to Sep. 30, 2019

			Rally year	*Rally year*		*Rally year(?)*
	Dec. 31, 2014	**Dec. 31, 2015**	**Dec. 31, 2016**	**Dec. 31, 2017**	**Dec. 31, 2018**	**Sep. 30, 2019**
Yield						
BB bond index	5.03%	6.14%	4.70%	4.37%	6.24%	4.05%
CCC bond index	9.97%	16.23%	10.11%	8.45%	12.55%	10.73%
Change in yield						
BB bond index			-1.44%	-0.33%		-2.19%
CCC bond index			-6.13%	-1.65%		-1.82%

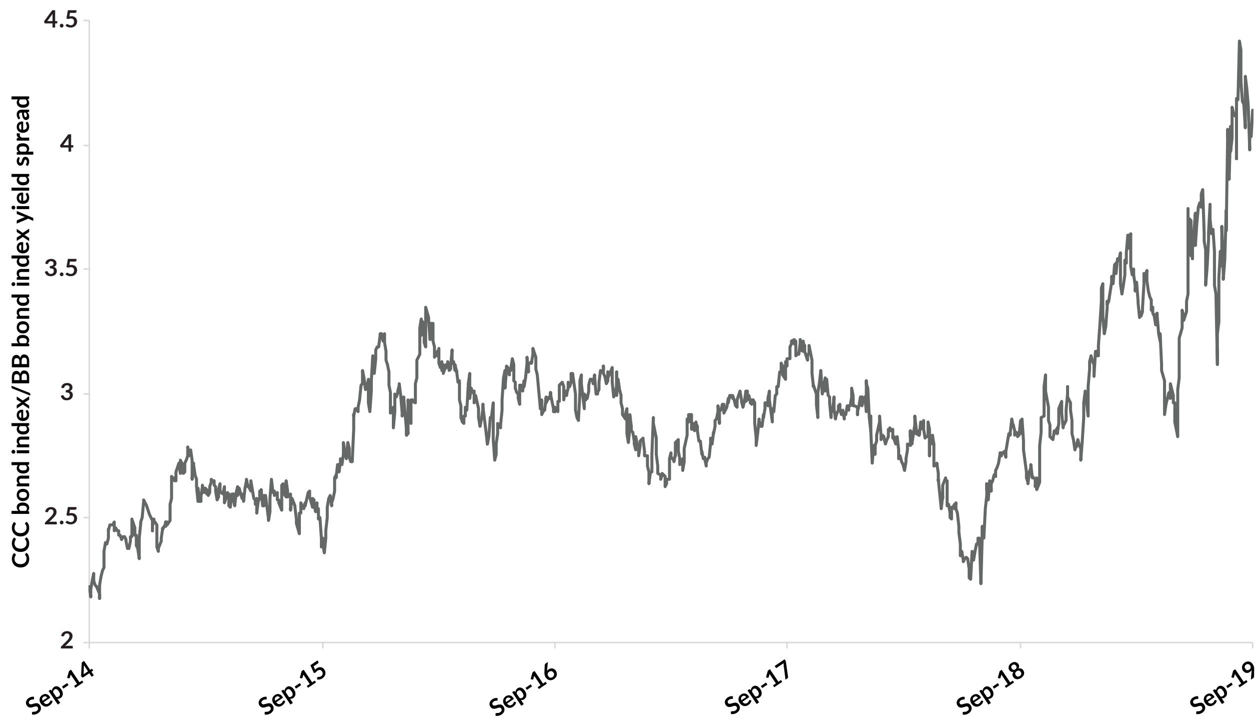
Source: Bloomberg LP. Yield to worst was used to measure bond yields. The yield to worst is the lowest potential yield that can be received on a bond without the issuer actually defaulting. The yield to worst is calculated by making worst-case scenario assumptions on the issue by calculating the return that would be received if the issuer uses provisions, including prepayments, calls or sinking funds. Bloomberg Barclays Ba US High Yield TR Index Value Unhedged USD was used to represent BB rated bonds. Bloomberg Barclays Caa US High Yield TR Index Value Unhedged USD index was used to represent CCC rated bonds. The Bloomberg Barclays US Corporate High Yield Bond Index measures the USD-denominated, high yield, fixed-rate corporate bond market.

This certainly has not been the case in 2019. In fact, this year the yields of BB-rated bonds have compressed more than their CCC-rated counterparts, which shows just how much investors have flocked to buying the “best” high-yield bonds. At 10.73%, CCC-rated bonds offer a yield very much in line with prior years, while the yield on BB-rated bonds continues to decline.

If you’re still not convinced, the chart below should drive home the point; the spread on CCC-rated bonds in relation to BB-rated issues is almost double its average over the past five years.

CCC bond index/BB Bond index yield spread

Sep. 30, 2014 to Sep. 30, 2019

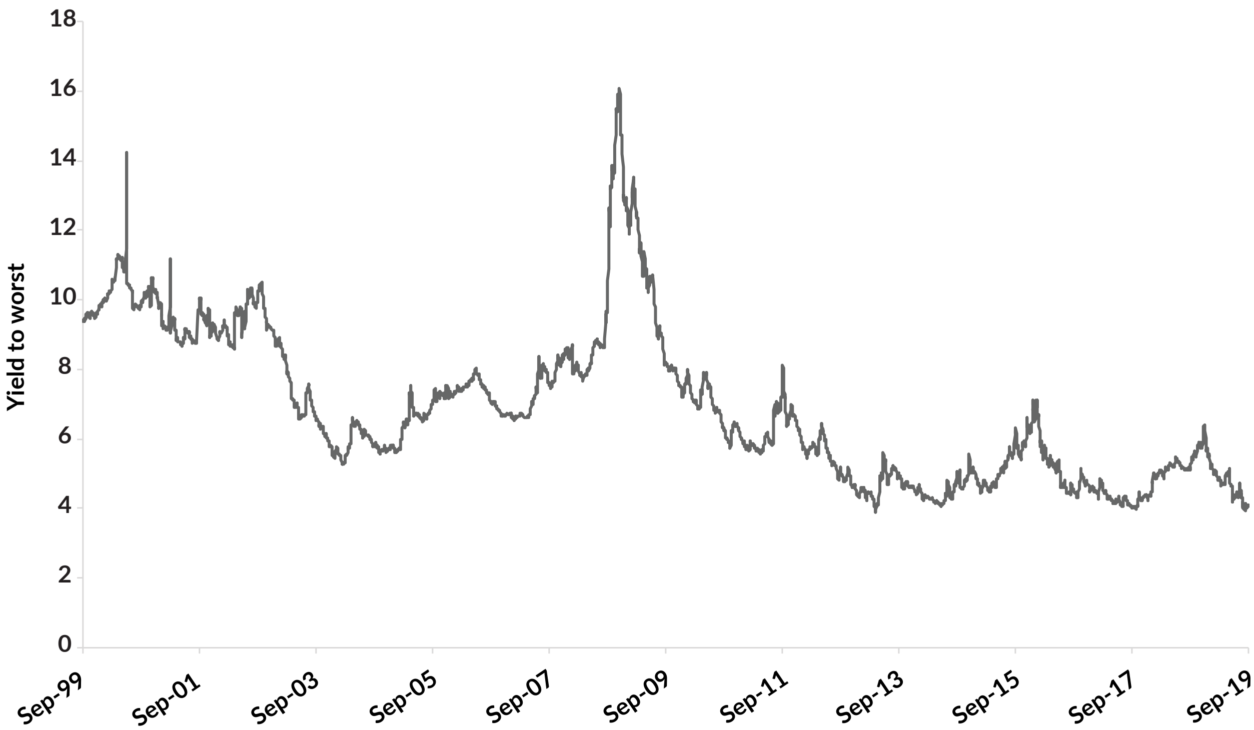


Source: Bloomberg LP. As at September 30, 2019. Bloomberg Barclays Ba US High Yield TR Index Value Unhedged USD was used to represent BB rated bonds. Bloomberg Barclays Caa US High Yield TR Index Value Unhedged USD index was used to represent CCC rated bonds. The Bloomberg Barclays US Corporate High Yield Bond Index measures the USD-denominated, high yield, fixed-rate corporate bond market.

Money flooding the high-yield bond market appears blindly committed to buying only those issues authenticated as "highest quality" by our friends at the rating agencies. It seems like investors are abandoning the very simple principle of being compensated for the risks inherent in an investment. The chart below shows that BB-rated bonds touched their lowest yield ever in early September.

Bloomberg Barclays US High Yield Total Return Index BB-rated bonds yield to worst

Sep. 30, 1999 to Sep. 30, 2019



Source: Bloomberg LP. As at September 30, 2019.

If you thought this was going to turn into a sales pitch for CCC-rated bonds, guess again. By this tier of the high-yield market, even the ratings agencies can figure out when a business has too much debt. We also agree with the idea of approaching the market with complete awareness of how long the economic expansion has been; only a character from Loonie Tunes would think recessions are gone for good.

At the same time, the market has gotten ahead of itself in discarding anything that requires independent credit analysis (or thought), which provides opportunities for those willing to do their own research. At EdgePoint, since we evaluate each bond issuer independently for its merits as a business and ultimately as a lender, we are not confined to parameters set by a bond's ratings.

Between the BB-rated bonds yielding 4.0% and the CCC-rated bonds yielding 10.7%, we continue to find high-quality businesses with conservative capital structures offering attractive returns. The breakdown of the high-yield portion of our portfolio by bond ratings is shown below. The iShares IBoxx High Yield Corporate Bond ETF[viii] is used to represent the overall high yield bond market in the U.S. As you can see, relatively, we observe fewer opportunities in BB-rated bonds, but find the single-B bond universe as a significant hunting ground. As previoiusly mentioned, CCC-rated bonds are not our cup of tea. Finally, we thumb our nose at the authenticators by having a particular bias for unrated securities, which includes unrated bonds (6%), convertibles (17%) and preferred shares (1%).

High-yield credit rating breakdown - EdgePoint Global Growth & Income Portfolio vs. iShares iBoxx High Yield Corporate Bond ETF

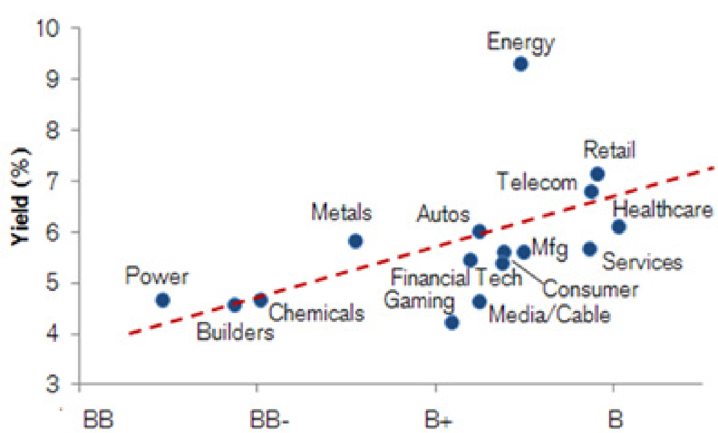
	EdgePoint Global Growth & Income Portfolio*	iShares iBoxx High Yield Corporate Bond ETF
BB	39.80%	53.68%
B	33.60%	34.58%
CCC	2.30%	11.46%
Unrated	24.30%	0.28%
Total	100.00%	100.00%

* High-yield securities. As at August 31, 2019, high-yield securities currently represent 34.39% of the fixed-income allocation in EdgePoint Global Growth & Income Portfolio.

Source: Bloomberg LP. As at August 31, 2019. The iShares iBoxx High Yield Corporate Bond ETF was used to represent the high yield bond market. This ETF seeks to track the investment results of an index composed of U.S. dollar-denominated high-yield corporate bonds.

By far our most fruitful hunting ground has been an area of the market completely shunned and abandoned by everyone and their brother. Left for dead is what we call the "gift that keeps on giving" – the high-yield bonds of companies in the Energy sector, who've participated in precisely none of the broader rally in high-yield credit. Over the past five years, our portfolios have benefited in a big way from their Energy holdings. If investing were some kind of short-term performance derby, Energy bonds have been a drag in recent months. But when we compare the Energy component of the high-yield index offering a 9% yield, to the paltry 4% on the BB-index, prospective returns are attractive. When we consider that these businesses continue to operate with cleaner balance sheets, more prudent management teams and fewer competitors, the prospects for select companies become very bright indeed.

U.S. High-yield bond yields and ratings by sector



Source: Credit Suisse, CS Credit Strategy Daily Comment, September 20, 2019.

Concluding remarks

Investible assets everywhere are impacted by negative interest rates. The global financial markets export this frustrating phenomenon to every corner of the world, and the result has been a relentless reach for yield and a flood of capital into high-yield markets. More than ever, high-yield investors seem to be relying on a set of "authenticators" to filter through their investments – experts in the form of credit rating agencies who approve or disprove of different junk bonds for those unwilling to do independent work. But between the extremes of the rating buckets – the BB-rated bonds that offer minimal return for their inherent risk and the lowest tier, CCC-rated credits – we believe there is an area of opportunity largely ignored by the market. In particular, debt in the Energy sector continues to present an area where we can deploy capital at very attractive rates. Ignoring the authenticators, this is where we are looking to find quality.

[i] Source: Ainger, John, "The Unstoppable Surge in Negative Yields Reaches $17 Trillion", Bloomberg, August 30, 2019. https://www.bloomberg.com/graphics/negative-yield-bonds/.

[ii] Source: Ibid. Based on the estimated US$17 trillion dollars of negative yielding bonds and 79.04% of the debt held by central banks.

[iii] Source, Bank of Japan: Fujikawa, Megumi, "Trillion Schmillion: Japan Isn't Even Trying to Hit Its Bond-Buying Target", The Wall Street Journal, January 21, 2019. https://www.wsj.com/articles/numbers-game-for-the-bank-of-japan-80-trillion-means-about-20-trillion-11548072005. Source, European Central Bank: Martin, Katie, Strauss, Delphine, et al., "ECB's Mario Draghi sees 'low but rising' recession risks — as it happened", Financial Times, September 12, 2019.

[iv] Source: Credit Suisse, CS Credit Strategy Daily Comment, September 20, 2019. https://plus.credit-suisse.com/rpc4/ravDocView?docid=V7i2Md2AC-WErCLO.

[v] Source: Bloomberg LP. 10-year Japanese government bond yield. As at September 26, 2019.

[vi] Source: Credit Suisse, CS Credit Strategy Daily Comment, September 20, 2019. https://plus.credit-suisse.com/rpc4/ravDocView?docid=V7i2Md2AC-WErCLO.

[vii] Source: Lewis, Michael. "The Hand of Leonardo - Against the Rules with Michael Lewis Podcast." Podcast audio. Against the Rules with Michael Lewis. April 23, 2019. https://www.citefast.com/styleguide.php?style=Chicago&sec=Audio.

[viii] The iShares iBoxx High Yield Corporate Bond ETF seeks to track the investment results of an index composed of U.S. dollar-denominated high yield corporate bonds.

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