Quiet Counsel

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Investment Outlook

Leith Wheeler INVESTMENT COUNSEL LTD.

Quiet Money.®

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Evolution of Fixed Income: Meeting Your Needs

Recent issues of Quiet Counsel have looked at how Leith Wheeler has managed portfolios for our clients throughout our 35 year history. This edition looks at the evolution of how the firm manages fixed income (or more accurately, investments in debt instruments) for taxable investors.

New problems require learning new methods and if we don't have the talent to be exceptional at dealing with them, we need to hire it, or buy it.

Chapter 1: The Financial Crisis and a New Beginning

2009 saw the end of the financial crisis but it also marked a new beginning for Leith Wheeler with the hiring of Jim Gilliland as Head of Fixed Income. Jim was a Vancouver native who had spent the previous seven years at Barclays Global Investors (BGI) in San Francisco, building and managing a team of professionals covering interest rate strategies, corporate credit, securitized credit, emerging markets and developing platforms to manage risk and customized client solutions. At Leith Wheeler, Jim's task was not an easy one, 'build a Fixed Income team and track record that would earn the respect similar to that of the firm's Canadian Equity team'. Much of the effort focused on maximizing performance but Jim also had a keen awareness of other client needs and a desire to build a team with equal measures of talent and curiosity to address such needs. This is where we start our look at the evolution of Fixed Income at Leith Wheeler.

The plan was simple - look at every possible investment option on an after-tax basis.

Chapter 2: The Only Certainties in Life are Death and Taxes

While clean living may delay the eventuality of death, a few simple actions will definitely keep more money from the taxman. The main source of bond returns come from coupon payments, which are taxed as interest income, at rates well above those of dividends (generated by equities) or capital gains. The traditional strategy to minimize taxation for investors involved simply tucking away fixed income investments in tax deferred or tax free accounts. While this remains a good strategy when structuring clients' portfolios, it was not enough. In 2011, Leith Wheeler changed our approach to how we selected securities for taxable clients. The plan was simple - look at every possible investment option on an after-tax basis. Two directives emerged:

1. Where possible, avoid bonds trading at prices well in excess of their maturity value, otherwise known as par or $100. Selecting bonds priced close to par value means fewer capital losses occur as prices revert to par at maturity. While any such realized capital losses can be written off against realized capital gains a client might have, only half the income tax paid on interest earned from a bond's coupon can be recovered. Put another way, you cannot simply assume a bond with a higher coupon will produce better after-tax results. In reality, there can be a large after-tax difference from avoiding bonds priced at high premiums, if the plan is to hold them to maturity. Following this strategy has become easier since 2011. The ultra-low interest rate environment we find ourselves in has been around for a while and many bonds issued during this timeframe trade at prices closer to par value and, in some cases, below par. And yes, the opposite is true, bonds trading at a discount are actually more tax efficient.
2. When considering corporate bonds, we look at the attractiveness of the company's preferred shares, versus its bond. Why? Preferred shares offer superior tax treatment over a bond – i.e. tax on dividends from a preferred share is about half of that applied to a bond's coupons. This process is easier said than done, as these two investments are very different – both in risk and in their structure – so careful analysis is critical. Furthermore, maintaining a material ownership of preferred shares consistently can prove difficult as many investors simply overpay for them, making them expensive at times to the disciplined value investor. It is good then that we are continually reminded that, 'if nothing attractive is available, wait. The next opportunity is just around the corner'.

The application of this analysis was the creation of our Income Advantage and Corporate Advantage Funds.

Chapter 3: Own the Risks You Understand and Watch Them Carefully

We are entering a new world after enjoying over three decades of declining interest rates. We have seen two interest rate increases so far in 2017 and expect to see more in 2018. When interest rates rise, bond prices fall (holding all else equal) and, with interest rates still at such low levels, clients were asking, "what do we do now to protect and/or grow our investments?"

The Leith Wheeler tax-advantaged strategies offered some protection for investors against rising interest rates by holding more corporate bonds, which generally have shorter terms to maturity (therefore less sensitivity to rising interest rates) and also have a built-in natural offset to rising rates through higher yields. Despite this, we were still playing on the fringes in regards to protecting clients in a rising rate environment. However, while this concern was emerging, interest rates actually continued to fall, making it even more difficult for clients to fund lifestyle expenditures when the consistent and reliable source of income from their portfolios continued to drop.

The 2015 lows in interest rates coincided with further additions to the Leith Wheeler bond team – in people and skill sets – resulting in the Leith Wheeler high yield bond product. Post-financial crisis, we saw much stricter ratings on bonds. Many bonds considered investment grade or rated BBB or above in the pre-financial crisis world, had their ratings downgraded to what is referred to as non-investment grade or high yield. However, reduction in ratings alone does not necessarily make these businesses poor investments. Value is what you get for the price paid and companies typically issuing high yield debt (such as Burger King, Dell Computers, Teck Resources, ADT Home Security, Air Canada, Levis) can still be quite responsible and credit worthy while compensating investors for the extra level of risk they take when investing in these companies. With this product, we were able to diversify and reduce clients' equity risk or improve and diversify their bond returns (the latter albeit with a higher level of risk). Investing in high yield should be viewed as opportunistic and as the market continued its recovery from the financial crisis, investors in high yield were handsomely rewarded, both through higher coupons and also higher prices as yield-hungry investors flooded into the space, necessitating a value manager like us to reassess the risk and rewards available.

Chapter 4: A High Yield Solution 'For All Seasons'

If you could perfectly predict market cycles, how would you manage your bonds? In most balanced portfolios, ownership of government and high quality corporate bonds offer safety, liquidity, cash flow and an offset to the risks assumed in equities – ideal to withstand an equity market downturn but a drag on performance in the good times. Like these investment grade bonds, high yield bonds offer similar characteristics but carry more risk (still much less risk than equities) and are desirable for balanced portfolios during most other stages in a typical cycle. Unfortunately, nobody can predict the timing and severity of market cycles.

At Leith Wheeler, we try not to outguess the markets in the short term as markets are unpredictable. Instead, we focus on maintaining a disciplined value-approach to building portfolios one security at a time. As the market has recovered from the lows of 2009, high yield bonds have produced strong returns from both their higher coupon payments and price appreciation as investors entered the market and bid-up prices to satisfy their need for yield. To sell and wait for the next opportunity meant funds would typically flow back into investment grade bonds, equities or cash.

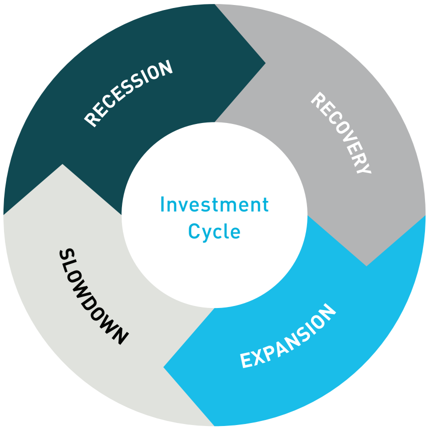
An alternative is to have a flexible strategy that can move between high yield, investment grade, and senior secured loans, depending on the environment and where we are in an economic cycle. At Leith Wheeler, we began to invest in senior loans at the beginning of 2017 as a natural extension of what we were already doing in our high yield strategies. Senior loans are part of a $1 trillion market in the U.S. These are loans issued by high yield companies that are then syndicated by banks to institutional investors. These loans exhibit two characteristics in general: they are secured by hard assets (manufacturing facilities, inventories, etc.) and they are floating rate instruments. As such, the income they produce increases as short term interest rates rise. And because these loans are secured, they are the highest tier of a company's capital structure, ranking above its unsecured bonds and well above equity. This distinction is very important to recovery rates in the extreme example of a business failing but more typically explain why, in times of market stress, loans exhibit less volatility than other risky assets.

Recession

Weaker economy favors Loans and Investment Grade.

Slowdown

Defensive positioning drives higher loan and IG allocations depending on relative value vs High Yield.



Recovery

Early stage favors a defensive posture, ie. Loans and Investment Grade, but add improving High Yield Credit.

Expansion

Early phase of expansion favors High Yield, while late stage expansion calls for adding some Loan exposure.

Chart 1: Typical High Yield Investment Cycle

At Leith Wheeler, our Multi Credit Strategy (launched October 1, 2017) is an example of such a flexible strategy, where we can take some of the risk chips from high yield bonds off the table and allocate some of that capital to loans or investment grade bonds. In the current market environment, we can do this without giving up much in terms of yield, all while increasing the ability to preserve clients' capital.

Chart 1 shows the typical high yield investment cycle and how we might adjust the holdings in the Multi Credit Fund to take advantage of opportunities in the market.

Jim Gilliland, now the President of Leith Wheeler, challenges his people to seek solutions to client problems. New products can sometimes be the result of this process but much of the time it is simply what is quietly going on behind the scenes at Leith Wheeler. New problems require learning new methods and if we don't have the talent to be exceptional at dealing with them, we need to hire it, or buy it, so we can honestly say we are a best-in-class provider of investment services – a promise we make our clients.

This article is not intended to provide tax advice. Taxation matters are complex and dependent on personal circumstances, please consult your professional tax advisor.

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