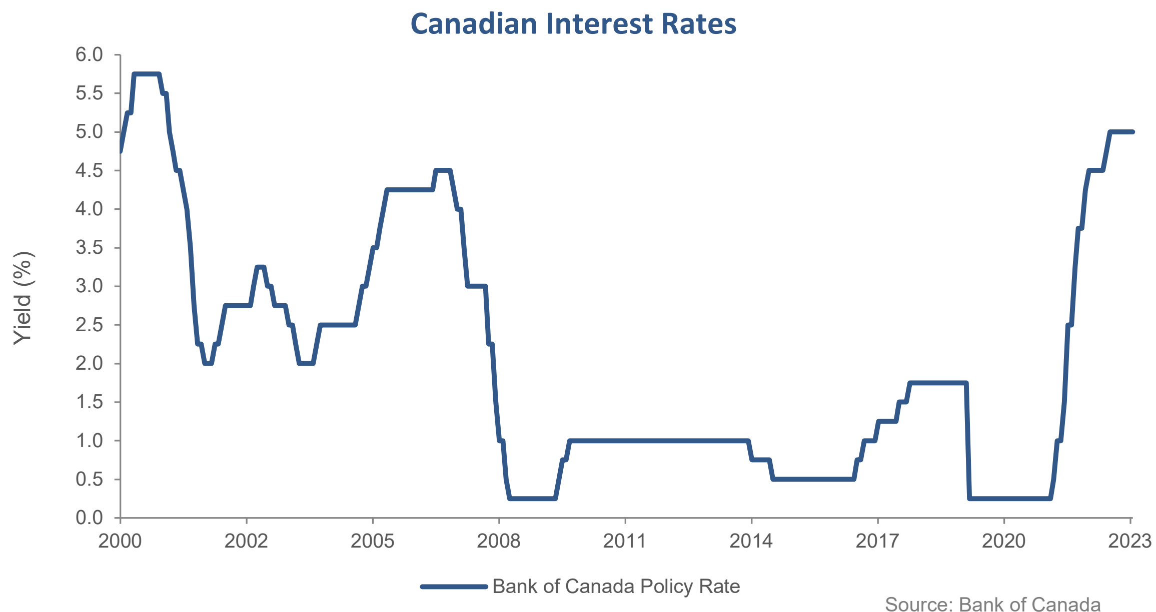
The Times They Are A-Changin'

With Bond Yields Up, There Is Less Need To Take Undue Risk

Investors are always on the lookout for the next great investment idea. Portfolio managers and analysts scour quarterly company reports, engage with company management teams, look at data sets from industries all over the world, and read the latest economic releases. This work feeds into portfolio construction that aims to generate consistent and repeatable risk-adjusted returns for clients.

But, for many market participants, the last few years have driven their investment time horizons shorter and shorter seemingly with each passing quarter. When attention becomes so focused on the here-and-now, there is a real risk of missing the bigger, fundamental changes that often have much larger and longer-lasting impacts on investment portfolios. As the saying goes, investors often can't see the forest for the trees.

Before we look too far forward, we need to look back. Mention the years 2008 and 2009 and most people will immediately jump to thoughts of the Global Financial Crisis (GFC). In the early days of the GFC, central banks around the world cut their policy interest rates to historic lows in an attempt to save their economies from financial collapse.



Even after the economic recovery had taken hold, inflation remained subdued thanks to certain structural forces. This low level of inflation allowed policymakers to keep their accommodative policies firmly in place, thereby suppressing the market clearing price of money - interest rates - for a very long time. It was said many different times in many different words, but the deduction was always the same – we were living in a low yield world.

This decade-plus market environment, covering 2009 through 2021, had a direct influence on many parts of the financial markets. The low yields pushed up the valuations, and by extension, the prices, of certain financial assets while making other asset classes less attractive. TINA, or "there is no alternative", was a phrase uttered by many investors when justifying risky investment decisions they may not have made under different circumstances.

At the same time, the ultra-low interest rates shown in the chart above reduced the cost of capital to practically nothing, allowing the flourishing of many investment strategies reliant on leverage, lower discount rates, or a combination of both.

Higher asset values and flourishing investment strategies - you might be reading this and thinking that it sounds pretty good. Is there a catch? We think there is, and it can be summed up in four letters: R.I.S.K.

We suggest the risk side of the risk/reward investment paradigm increased throughout this period, sometimes knowingly and sometimes unknowingly to the end investor. Thankfully, for the broader economic landscape, many of these risks were not realized, but that does not mean they were not present or should have been ignored. Frankly, many investors got away with taking a much higher degree of risk in their portfolios, and for a much longer period, than what would have historically been acceptable.

Example: The Foundation

We saw this situation play out in variety of ways with many types of investors. Let's take a mid-sized foundation as a hypothetical example. This foundation is a steward of perpetual capital that needs to be managed in a way to ensure stability of its asset base while generating sufficient and consistent income to support its philanthropic or goal-based efforts.

Because of the low-yield world, this foundation, like many others, was finding it increasingly difficult to meet disbursement goals because they could not generate similar investment income as in the past. The problem the foundation faced was simple, but the choice was by no means easy. At the risk of oversimplifying the situation, the foundation could cut commitments, dip into capital, or attempt to generate needed returns by increasing investment risk. None of these choices were ideal.

Even though we are using our hypothetical foundation as an example, the problem was likely all too familiar for many different types of investors: from smaller individual investors all the way up to the largest pension funds in the country.

It was our experience that a majority of investors chose the last of the three options. A reach for yield here, a stretch for return there, and gradually many asset mixes moved away from traditional lower-risk asset classes towards higher-risk, private, or opaque corners of the financial market in search of higher returns.

Future Expectations

Fast forward to today. We are sitting in a very different market environment. Reacting to increasing inflation in many countries, central banks aggressively increased their policy rates in 2022 and 2023. This action led to a large fundamental shift in the investment landscape. This type of change sometimes goes unnoticed or underappreciated when investors are focused on the tree in front of them rather the entire forest around them. To state it simply, we are no longer living in a low-yield world.

Just as the low-yield world had certain investment implications, so does the current higher yielding world. As an example, these changing implications can impact what types of companies one would prefer to own (strong balance sheets, reoccurring revenue streams, little reliance of capital markets for refinancing operations, high degrees of operational optionality, etc.). Or they can impact what combination of asset classes one should use to construct an overall portfolio that will meet their financial objectives.

As we look forward, the future always contains a degree of uncertainty or unpredictability but there is one aspect of our current environment that seems very clear to us at FGP. Investors can now meet their objectives with less risk and without reaching for yield.

One asset class that felt one of the largest impacts during the ultra-low interest rates era was traditional fixed income. Some investors deserted bonds and went chasing higher returns elsewhere.

After the significant rise in yields over the last two years, the situation looks very different today. When we have higher bond yields, we have higher bond return expectations for the entire asset class.

When we were in the low-yield world, it was common to come across yields-to-maturity in the 1% to 3% range. As an example, a five-year bond issued by ABC Corp. at a yield-to-maturity (YTM) of 2% would deliver an expected average annual return of 2% over the five years until maturity. This level of return made it hard to meet investment objectives for many types of investors.

(The YTM is the average total return anticipated on a bond if it is held until maturity assuming all coupon payments are made and reinvested, and assuming the issuer does not default on the payback of the principal at the end of the contract.)

Times have changed. Higher bond yields have increased the return expectations of all fixed income investments. For example, as at December 31, 2023, the YTMs of the bonds in the FTSE Canada All Corporate Bond Index fell roughly in the 4% to 7% range. At the same time, the FGP Corporate Bond Fund had a YTM of 5.8% and the FGP Corporate Plus Bond Fund, a strategy with additional flexibility to take advantage of unique opportunities in credit markets, had a YTM of 6.9%. Again, a YTM is an anticipated annualized return figure and higher bond yields have increased the return expectations for all fixed income investments.

What about the decisions of our foundation example from earlier? Structuring an investment portfolio to generate total returns and cash flow to meet program commitments and grant objectives has become much easier. Furthermore, in the current environment, investors can use much more steady, reliable, and liquid investment options to achieve cash flow and return requirements without aggressively adding risk. (Of course, if interest rates fall as they one day will, the foundation's YTM will fall too, but we view a return to the ultra-low interest rates reached during the pandemic as unlikely barring a major economic shock.) The foundation's board can now spend less time looking to make cuts and more time funding the programs and grants that help deliver on the foundation's mission.

It is not just income-focused investors who stand to benefit. The current environment provides all investors with higher future return potential from lower risk fixed income investments. As an example, a pension fund can shift away from higher-risk investments and focus instead on strategies using investment-grade long-term bonds. This approach helps meet or even exceed return requirements, better match assets to future liabilities, and generate sufficient income to meet current pension payments.

While these strategies were out of favour for some time, fixed income investors can rest easy knowing they can now invest in lower-risk securities to achieve their investment goals while also holding assets that have good liquidity and provide a ballast to their portfolios during times of stress.

This document has been prepared for informational purposes only without regard to any particular investment objectives or financial situation and should not be construed as financial advice or as a solicitation, recommendation or offer to buy or sell any security, financial product or instrument. At any time, FGP accounts / portfolios could buy, sell or hold securities of the issuers mentioned herein. The securities mentioned herein are not representative of FGP accounts/portfolios as a whole.

While the information included in this document is obtained from sources that FGP believes to be reliable, we do not guarantee its accuracy, and the information may be incomplete or condensed.

1 Adelaide Street East, Suite 2600
Toronto, ON M5C 2V9
Telephone: 416.362.4725 | Toll-Free: 1.844.FOYSTON (369.7866) | Fax: 416.367.1183
www.foyston.com

Foyston, Gordon & Payne Inc.
INVESTMENT COUNSEL