ESCAPING THE INCOME PROBLEM IN A LOW-YIELD WORLD

Eight tactics that may enhance income, returns and portfolio diversification

Ten years ago, when interest rates were much higher and government bonds actually produced yield, index bond funds were solid products because they delivered income with much less sensitivity to the movement of interest rates. Today, a traditional fixed income fund typically yields less than 2.0%, and that's before fees.

Most bond mutual funds and ETF strategies are passive and constrained, meaning they must mirror a benchmark like the ICE Canada Broad Market Index. Typically, about 75% of the securities contained in these bond funds are low yielding government or quasi-government bonds (source: Bloomberg). As a result, these indexed bond funds yield less than a GIC, but with significant duration risk of around 8 years. If interest rates move up by only 0.25% an investor starts to lose money because bond prices go down when interest rates rise.

Government bonds are safe, but they aren't risk-free. Locking in an interest rate for 10 years or more, that you wouldn't normally accept for a year, isn't a productive way to invest in bonds. Taking that much interest rate risk to earn a GIC equivalent yield shouldn't be acceptable to investors who are concerned about risk and capital preservation.

And, in the pursuit of income, adding an over concentration of high-yield bonds and/or additional preferred shares and dividend-paying equities just increases unwanted portfolio risk that may lie dormant until it doesn't.

What's an investor to do?

Liquid Alt bond funds can provide investors with an alternative that offers several benefits: **more opportunities for income, greater flexibility to generate returns, and excellent portfolio diversification.**

In this paper we'll explore eight tactics that an unconstrained bond strategy can use to help investors escape the troublesome portfolio income trap that index funds can create.

An unconstrained fund strategy does not require a fund or portfolio manager to adhere to a specific benchmark. Unconstrained investing allows managers to pursue returns across many asset classes and sectors.

ESCAPING THE FIXED INCOME TRAP: INVESTMENT TACTICS BY STYLE

	Conventional Strategies*	Unconstrained Strategy
1. ASSET ALLOCATION	Limited by Index Weighting	Has Broader Limits
2. DURATION MANAGEMENT	Limited by Index Duration	Has Broader Limits
3. CREDIT SELECTION	Limited by Mandate of the Fund	Has Broader Limits
4. GEOGRAPHICAL ORIENTATION	Limited by Mandate of the Fund	Has Broader Limits
5. CURRENCY EXPOSURE	Limited by Mandate of the Fund	Has Broader Limits
6. SHORT SELLING	Allowed but Rarely Used	Allowed
7. OPTIONS STRATEGIES	Allowed but Rarely Used	Allowed
8. LEVERAGE ENHANCEMENTS	Not Allowed	Allowed on Liquid Alt

*For the purposes of this paper, conventional strategies are primarily considered to be typical index funds.

TACTIC I: ASSET ALLOCATION

Unconstrained strategies are not constrained by a narrow benchmark.

That means that managers of these funds can be highly tactical in their asset allocation. They can have weightings across many fixed income asset classes, including cash, without as many restrictions. This table shows you the relative performance of seven fixed income asset classes over an almost nine-year period.

You will note that more than one of these asset classes has been both the best-performing and worst-performing over the period. An unconstrained strategy has the freedom to move in and out of these asset classes at will, changing the characteristics of the portfolio to be defensive or opportunistic.

IN FIXED INCOME SECTORS DIFFERENTIATION IS IMPORTANT

Asset allocation matters.

HIGHEST RETURNS

2013	2014	2015	2016	2017	2018	2019	2020	2021 POSITIONING
US High Yield	20+ Year US Gov't	Emerging Market Bonds	US High Yield	20+ Year US Gov't	Emerging Market Bonds	20+ Year US Gov't	20+ Year US Gov't	Canada Corporate
Canada Corporate	20+ Year Canada Gov't	20+ Year Canada Gov't	US Corporate	US High Yield	20+ Year Canada Gov't	US High Yield	20+ Year Canada Gov't	US Corporate
Emerging Market Bonds	Emerging Market Bonds	Canada Corporate	Emerging Market Bonds	US Corporate	Canada Corporate	US Corporate	US Inflation-Linked Gov't	US High Yield
US Corporate	US Corporate	US Corporate	US Inflation-Linked Gov't	Canada Corporate	US Inflation-Linked Gov't	20+ Year Canada Gov't	US Corporate	Emerging Market Bonds
US Inflation-Linked Gov't	Canada Corporate	20+ Year US Gov't	Canada Corporate	US Inflation-Linked Gov't	20+ Year US Gov't	US Inflation-Linked Gov't	Canada Corporate	US Inflation-Linked Gov't
20+ Year Canada Gov't	US Inflation-Linked Gov't	US Inflation-Linked Gov't	20+ Year US Gov't	20+ Year Canada Gov't	US Corporate	Canada Corporate	US High Yield	20+ Year Canada Gov't
20+ Year US Gov't	US High Yield	US High Yield	20+ Year Canada Gov't	Emerging Market Bonds	US High Yield	Emerging Market Bonds	Emerging Market Bonds	20+ Year US Gov't

LOWEST RETURNS

HIGHEST WEIGHT

LOWEST WEIGHT

Source: Ninepoint Partners, ICE Bond Indices as of December, 31, 2020.

TACTIC 2: DURATION MANAGEMENT

Unconstrained strategies can increase or shorten the duration of their portfolio in response to the interest rate outlook.

In a falling-rate environment, an unconstrained strategy enables a manager to increase duration to capture more upside. In a rising-rate environment, they may shorten duration to reduce the risk of loss. This chart gives you a quick rule of thumb for estimating the impact of duration:

DURATION AND THE IMPACT OF A CHANGE IN INTEREST RATES

Portfolio Duration	1% Increase in Interest Rates Impact on Portfolio Value	1% Decrease in Interest Rates Impact on Portfolio Value
3 YEARS	-3%	+3%
5 YEARS	-5%	+5%
10 YEARS	-10%	+10%

For illustrative purposes only

Conventional bond fund managers most often have to construct their portfolios' duration to mirror that of their index. The Bloomberg Barclays Canada Aggregate Index is one of the benchmarks commonly used by Canadian bond managers. The duration of this index has steadily increased as interest rates have fallen over the years and is currently at approximately 8 years*. This means that these funds, traditionally viewed as safe, have in fact a high degree of interest rate sensitivity and can become more volatile.

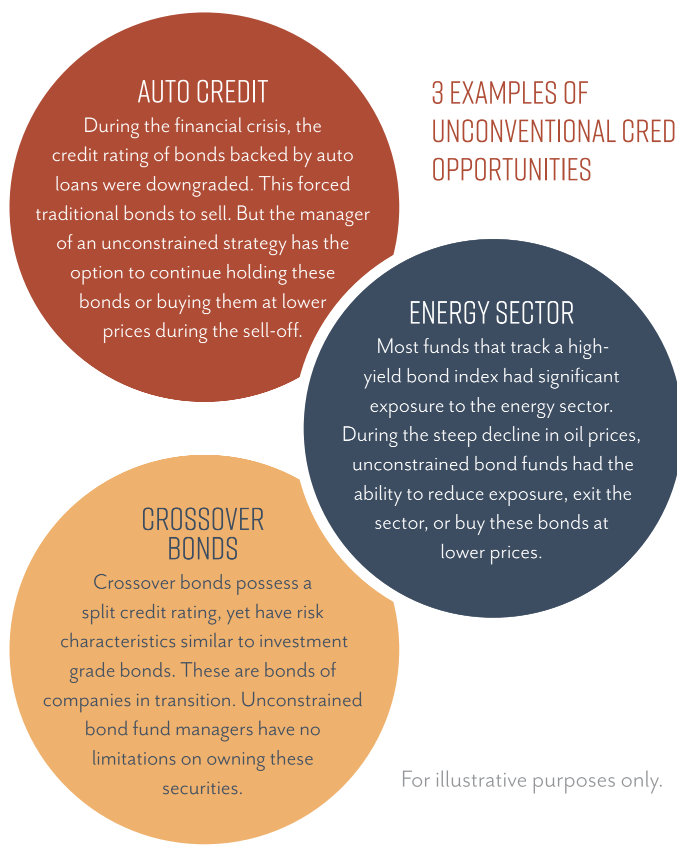
*Source: Bloomberg as of November 1, 2021.

TACTIC 3: CREDIT SELECTION

Unconstrained strategies recognize that the global fixed income market is not perfectly efficient.

This means that it is sometimes possible to invest in illiquid bonds or lower quality credit that can add return without adding equal risk. When these opportunities emerge, unconstrained strategies can take advantage of them to improve risk-adjusted returns. Credit quality is one of many factors prescribed by an index. This can prevent conventional bond fund managers from taking advantage of certain opportunities, and it can also force them to sell or remain in areas of the market that are likely to underperform. Flexibility around credit quality is another important lever that the manager of an unconstrained strategy can pull.

3 EXAMPLES OF UNCONVENTIONAL CREDIT OPPORTUNITIES

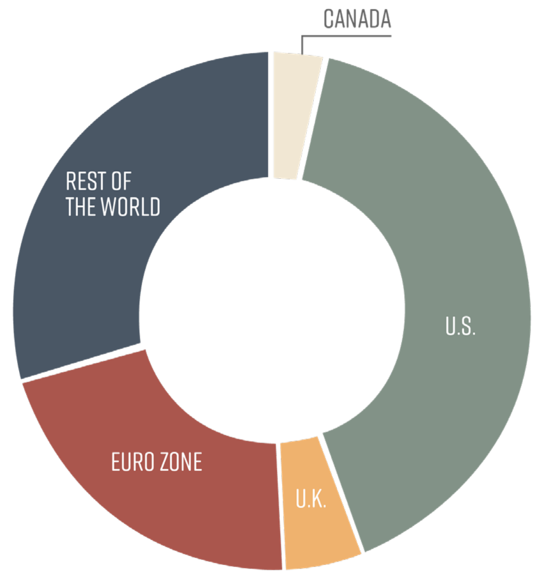


For illustrative purposes only.

TACTIC 4: GEOGRAPHICAL ORIENTATION

Unconstrained strategies can invest anywhere in the world.

Although Canada is generally a desirable market, it makes up a thin slice of the global pie. The face value of all Canadian bonds outstanding was about USD$2.2 trillion at November 25, 2020, or just 3% of the $66 trillion global total, as the graph to the right illustrates. Being able to cross borders gives unconstrained strategies better diversity and the ability to pursue value wherever it may be found. This is in contrast to conventional managers who may be tied to an index with undesirable traits.

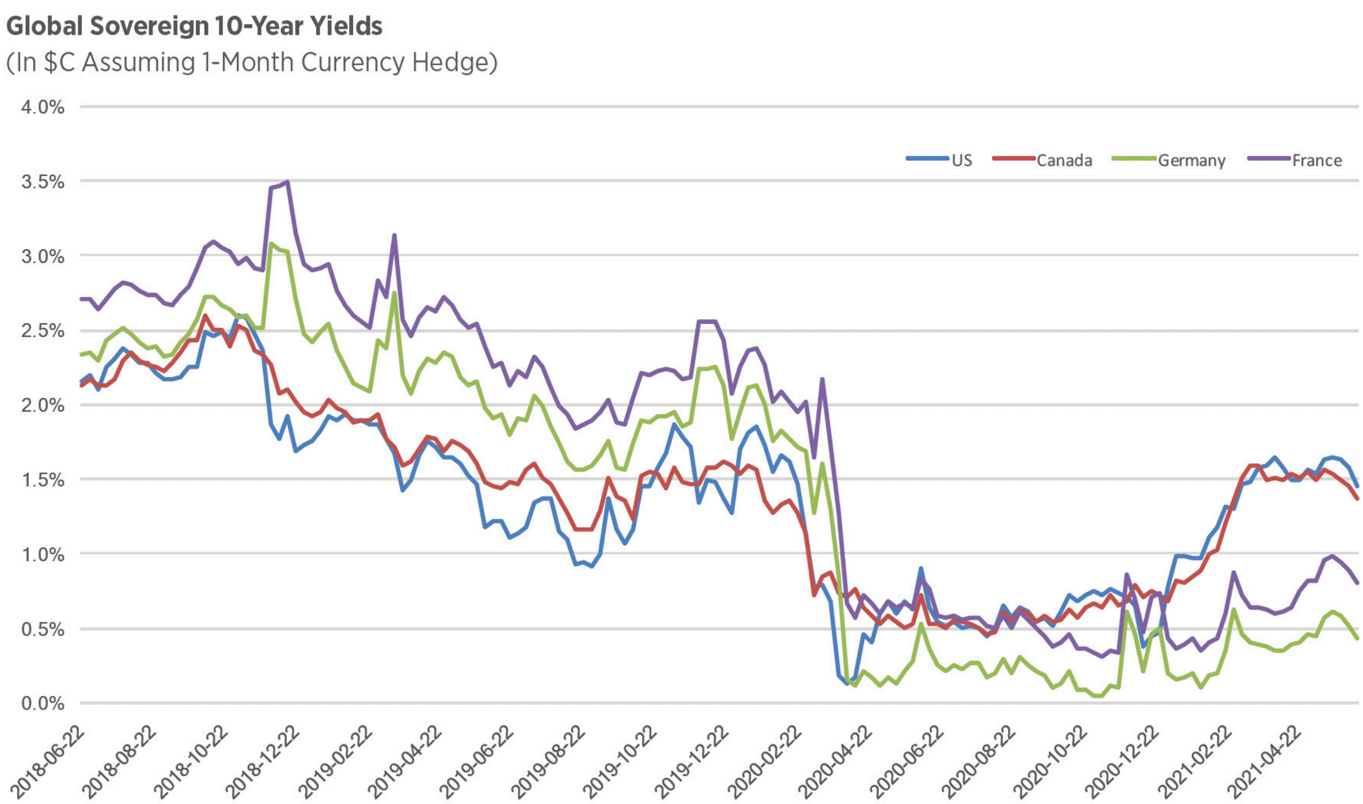


Source: Bloomberg, Barclays Bond Indices.

TACTIC 5: CURRENCY EXPOSURE

Unlike index funds, unconstrained strategies can buy bonds denominated in almost any currency.

Interest rate differentials can sometimes result in higher yielding securities when converted back to Canadian dollars.



For illustrative purposes only. As of June 11, 2021

TACTIC 6: SHORT SELLING

Unlike index funds, unconstrained strategies have the freedom to utilize short selling.

In essence, short selling means "selling high and buying low." You borrow a bond from a broker, sell that bond in the market, re-buy it for a lower price at a later date, give it back to the lending broker, and keep the difference (minus interest) as a profit. Here are two scenarios where the manager of an unconstrained strategy may use short selling.

Unconstrained strategies can use short selling to seek profits and to manage credit and interest rate risk. These strategies can be used to capture returns from securities that are expected to decline in value, or as a pre-emptive move against market declines.

TWO SHORT-SELLING STRATEGIES

1

ANTICIPATING A RISE IN CREDIT SPREADS

If the manager of an unconstrained strategy anticipates that a corporate bond's price will fall, he or she can protect against loss by shorting that credit security.

2

ANTICIPATING A RISE IN INTEREST RATES

If the manager of an unconstrained strategy anticipates that interest rates will rise and government bond prices will fall, he or she can protect against loss by shorting the government bonds.

TACTIC 7: OPTIONS STRATEGIES

Unlike index funds, unconstrained strategies can use options to reduce losses and enhance returns.

The two basic types of options are puts and calls. When you buy a put option, you are buying the right to sell an asset at a fixed price – such as a bond index ETF – at a specified "strike" price until a certain expiry date. Call options are the opposite – they give you the right to purchase an asset at a certain strike price until the expiry date. A manager under an unconstrained strategy can use combinations of calls and puts on fixed income ETFs to alter duration and credit risk, either to be defensive or opportunistic.

Sometimes, the manager of an unconstrained strategy will simultaneously buy or sell a number of put and call options at the same time with the goal of improving the overall risk/reward profile of the portfolio. Strategies using multiple options are often aimed at reducing the portfolio's downside potential in exchange for a small reduction in its upside potential.

TWO OPTIONS STRATEGIES

DEFENSIVE
BUYING PUTS TO REDUCE LOSSES

If the manager of an unconstrained strategy thinks High Yield bonds are at risk of decline, he or she can purchase a put option on a high yield bond index ETF. If the index declines below the strike price, the option will rise significantly in value. The manager can then sell the option and realize a profit that can help offset the overall impact of a market decline on the portfolio.

OPPORTUNISTIC
BUYING CALLS TO ENHANCE RETURNS

If the manager of an unconstrained strategy expects the bond market to rally significantly, particularly after a large drawdown, he or she can purchase a call option on a bond index ETF. If the market fails to rise above the strike price before expiry, the only loss will be the cost of the option. But if it rises above the strike price, the manager can sell the option and realize significant profit.

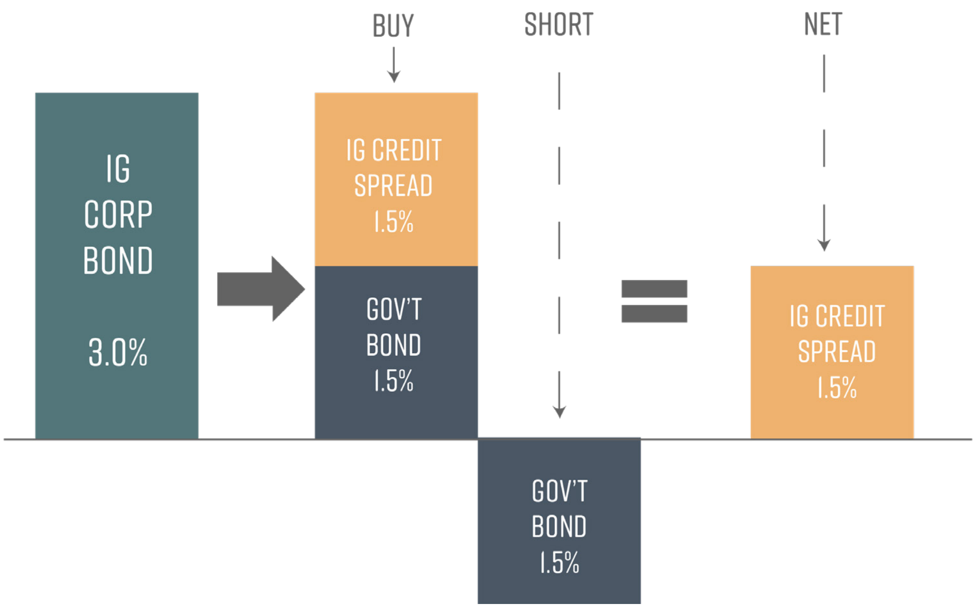
TACTIC 8: LEVERAGE ENHANCEMENT

Within the Liquid Alternative fund format, unconstrained strategies can use leverage to enhance returns.

Corporate bond returns are made up of two components:

1. government bond yield (the interest rate risk), and;
2. the credit risk or spread (compensation for probability of default).

By buying a corporate bond and then selling short the corresponding government bond, the manager of an unconstrained strategy gains exposure to a security that generates yield with no interest rate risk.



USING LEVERAGE EFFECTIVELY AND INTELLIGENTLY

	Unlevered Corporate Bond	Leverage Credit
CREDIT SPREAD/YIELD	3.0%	1.5%
DURATION	10 Years	5 Years
LEVERAGE	N/A	2X
TOTAL YIELD	3.0%	3.0%
CREDIT DURATION	10 Years	10 Years
INTEREST RATE DURATION	10 Years	0 Years

For illustrative purposes only

SAME YIELD, LESS INTEREST RATE RISK

ESCAPING THE FIXED INCOME TRAP

Today's fixed income investing environment has become even more challenging due to the persistence of ultra-low interest rates. Government bond yields are so low, a traditional fixed income fund now yields around 1.0% and that's before fees. If interest rates rise, it's conceivable that these index bond funds will never produce a positive return. This is the conundrum globally: low bond yields are rendering traditional bond funds ill-suited to do their job – to generate income and preserve capital with low volatility.

Unconstrained bond strategies, and especially Liquid Alternatives bond strategies, are a game-changer for fixed income. Investors have access to differentiated bond funds that can deliver higher returns with much less correlation to the bond market, resulting in less volatility.

For bond managers this provides more tools to do a better job – a bigger opportunity set of assets and strategies to generate returns, with improved diversification, less correlation to the index, and a higher level of risk management. And for investors, this approach provides an escape from the unrelenting Income Trap.

SIGHTLINE
WEALTH MANAGEMENT