EDGEPOINT®

FIXED-INCOME COMMENTS **For the quarter ending December 31, 2021**

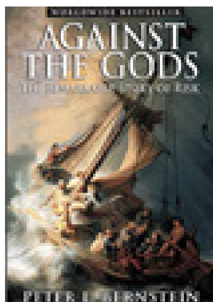
Loaded dice

By Derek Skomorowski, portfolio manager

Gerry Tsai joined Fidelity Funds in the 1950s, becoming manager of what is widely considered the first ever "momentum" fund in 1958. From 1958 to 1965, his fund delivered a 296% total return, compared to an average of 166% among equity mutual funds.[i] Gerry Tsai was a hero. Gerry Tsai walked on water. With newfound glory, Gerry Tsai went out on his own, launching the Manhattan Fund in 1966 and raising the highest amount of money ever for an investment company at the time. In its first year, the fund returned 39%.[ii] But by the end of 1969, the fund had lost 90% of its value.[iii]

It's a funny thing about the investment business. As the good times roll, it's all about making the most money, but investors are often blind to the risk they're taking until it's too late. Like Warren Buffett's famous line, you don't know who's swimming naked until the tide goes out. Don't get me started on the debacle in private debt.

The treatise on risk in the investment business has to be *Against the Gods: The Remarkable Story of Risk* by the late economist Peter L. Bernstein. If the title doesn't draw you in, the cover will. The book documents the 1500-year evolution of everything we know about numbers, probability, uncertainty and, of course, risk.



The seemingly grandiose title colours one of the most important messages conveyed by Bernstein's book; that is, in dealing with risk we're trying our best to anticipate the future. Before numbers, there was no way to measure return, cost or assign the odds of various outcomes. The future was left to the gods – left to the fates or some kind of mystic – and men and women were passive to eventualities.

Risk means more things can happen than will happen, and the ability to anticipate and price various outcomes had a major influence on the evolution of industry. Farmers were able to set up agriculture cooperatives that would insure against bad weather, where those with a good growing season would agree to compensate farmers whose weather had been less favourable. Financiers in the coffee houses lining London's docks began underwriting expeditions while ships were commonly lost at sea. And gambling casinos and organized lotteries appeared taking similar forms.

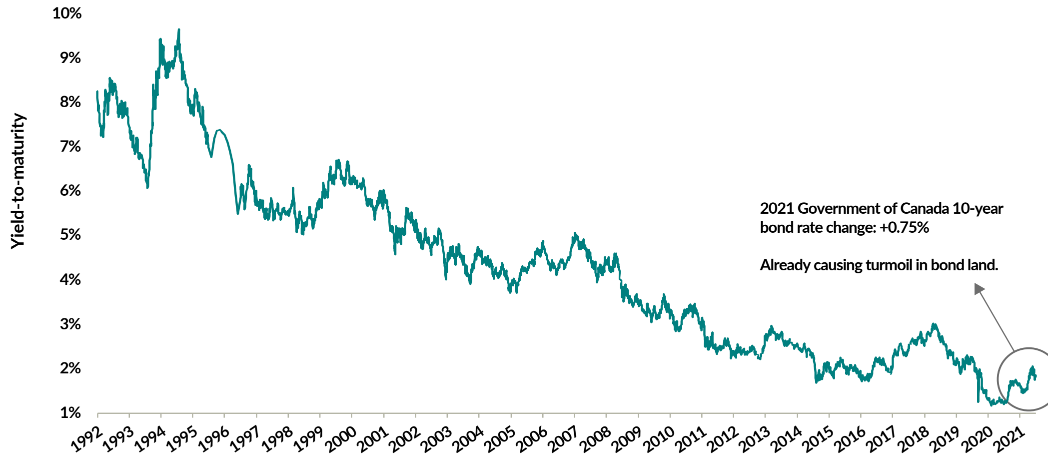
In each example, the short-term winner on any wager was in fact the long-term loser, while the intermediary assessing the risk – and making the seeming "losing" payout – was holding all of the proverbial cards. Over the average farmer's life, the premiums paid into the insurance cooperative far exceeded any claim receipts. Riches returned from the New World were more than adequate to cover the odd wreckage. And at the casino, any jackpot was just enough to keep the betting dollars pouring in. But in the long run, the house always wins.

Time is the dominant factor in gambling – it's what brings a hot streak crashing into reality. Gamblers are betting against the clock. They want luck to run while odds are suspended. As described by Bernstein, risk and time are two sides of the same coin. If risk means grappling with the future, then if there is no future, there is no risk. Time accentuates risk, and the nature of risk is shaped by the time horizon – the future is the playing field.[iv] Gerry Tsai should have quit while he was ahead.

As Benjamin Graham put it, markets are a short-term voting machine, long-term weighing machine. It's almost impossible not to have a few phenomenal years in a professional investment career. It's also impossible to escape the true value of your investments. If phenomenal returns are nothing but a by-product of excessive risk, at some point luck is going to run out. Making statistically stupid bets and hoping the winds blow your way is no better than asking the Ephors[v] what crop to sow at planting season. In today's markets, the oracles seem to be in vogue.

Bond markets have come to be accepted as an effective risk-free, guaranteed return in investment portfolios. We object vehemently to this position. In our view, the average bond fund today offers more risk and less reward than at any time in history.

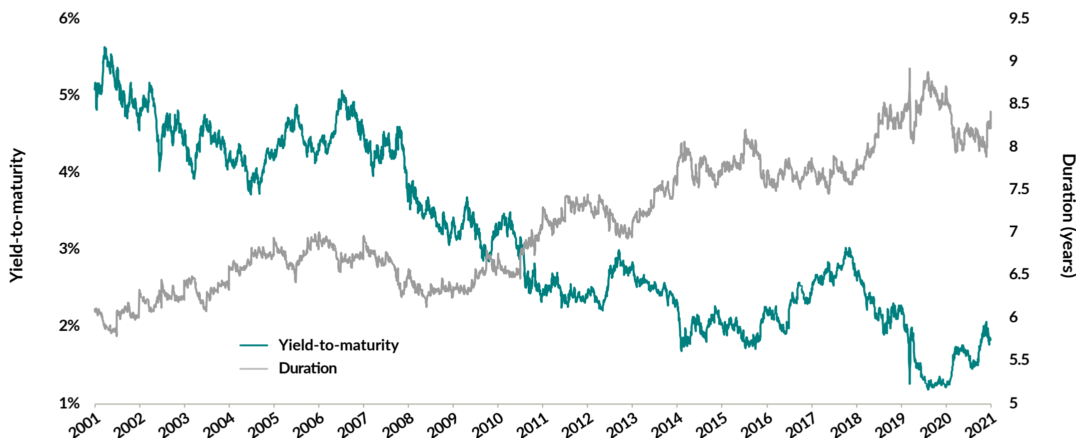
ICE BofA Canada Broad Market Index yield-to-maturity (since inception)
Jun. 30, 1992 to Dec. 31, 2021



Source: Bloomberg LP. The ICE BofA Canada Broad Market Index tracks the performance of investment-grade debt publicly issued in the Canadian domestic market. Yield-to-maturity is the total return anticipated on a bond if it's held until it matures and coupon payments are reinvested at the yield-to-maturity. Yield-to-maturity is expressed as an annual rate of return.

Over the past 30 years, interest rates have done nothing but decline, with the Government of Canada 10-year bond yield declining from 10.28% on December 31, 1990, to 1.42% on December 31, 2021.[vi] This decline has been a massive tailwind to returns. But yields available today don't lie – return prospects going forward are dismal. At the same time, numerous risks are creeping into fixed-income portfolios. As measured by duration, bond prices are more susceptible to an increase in interest rates than ever before.

ICE BofA Canada Broad Market Index yield-to-maturity and duration
Dec. 31, 2001 to Dec. 31, 2021



Source: FactSet Research Systems Inc. The ICE BofA Canada Broad Market Index tracks the performance of publicly traded investment-grade debt denominated in Canadian dollars and issued in the Canadian domestic market. Duration is a measure of a debt instrument's price sensitivity to a change in interest rates. The higher the duration, the more sensitive a bond's price is to changes in interest rates.

If you buy a 30-year bond yielding 2%, it's going to deliver a 2% annual return over the next 30 years, all else being equal. That doesn't stop bond market prognosticators from preaching about the potential for short-term returns. With rates having declined as much as they have, this is doubling-down on a one-sided bet – picking up pennies in front of a steamroller. And it's inevitable at some point that this bet ends badly for the average fixed-income investor. Time is the enemy of the gambler, and time is running out. The tiny rise in interest rates we saw in 2021 led to the worst bond market performance since 1994.[vii]

Mutual fund statistics – Canadian Fixed Income category

As at Dec. 31, 2021

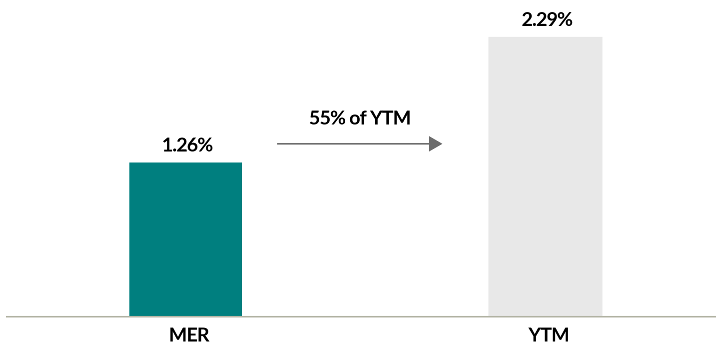
Fund name Series A, as at December 31, 2021	AUM (C$)	MER	Duration (years)	Yield-to-maturity YTM	ASSUMES 1-YEAR HOLDING PERIOD (As of Dec 31, 2022) Net return YTM – MER	ASSUMES 1-YEAR HOLDING PERIOD (As of Dec 31, 2022) Hypothetical return % not received by client	2021 total return	5-year total return annualized
Bank Bond Fund A	$24,557,716,672	1.06%	8.20	2.30%	1.24%	46.1%	-3.3%	3.1%
Bank Canadian Bond – A	$14,374,442,733	1.10%	8.46	2.26%	1.16%	48.6%	-3.3%	2.7%
Bank Canadian Core Plus Bond - A	$13,744,903,633	1.36%	8.32	2.64%	1.28%	51.5%	-2.8%	2.5%
Bank Total Return Bond Fund A	$11,580,121,866	1.05%	8.00	2.10%	1.05%	50.0%	-3.0%	2.8%
Bank Fixed Income Pool Series ISC	$11,107,458,570	1.11%	8.25	2.67%	1.56%	41.6%	-1.5%	0.0%
Bank Bond Fund A	$10,393,586,129	1.05%	8.00	2.10%	1.05%	50.0%	-3.2%	2.7%
Fund co. Canadian Bond Sr B	$9,976,488,217	1.26%	8.68	2.52%	1.26%	50.0%	-3.2%	2.4%
Fin. services co. Canadian Bond A	$8,558,712,428	1.36%	8.10	2.30%	0.94%	59.1%	-3.5%	2.1%
Bank Canadian Bd Priv Port Ser Adv	$5,295,688,306	1.03%	8.60	2.17%	1.14%	47.5%	-3.1%	2.2%
Bank Canadian Bond	$4,434,015,726	1.40%	8.77	2.68%	1.28%	52.3%	-3.6%	2.6%
Fund co. Canadian Bond A	$4,270,734,587	0.68%	8.00	1.90%	1.22%	35.8%	-3.0%	2.7%
Fund co. Total Return Bond Ser A	$4,173,384,994	1.40%	7.62	2.40%	1.00%	58.3%	-3.6%	2.0%
Bank Core Plus Bond A	$3,800,156,256	1.39%	7.16	1.84%	0.45%	75.5%	-3.8%	2.2%
Fund co. Fixed Income Pool Sr B	$3,498,245,392	1.43%	7.30	2.41%	0.98%	59.3%	-2.6%	2.6%
Fund co. Canadian Bond	$3,362,351,481	1.55%	8.17	1.90%	0.35%	81.6%	-3.4%	1.5%
Bank Bond A	$2,889,488,186	1.59%	8.59	2.16%	0.57%	73.7%	-3.7%	2.2%
Fin. services co. Canadian Bond A	$2,866,606,707	1.42%	7.90	2.20%	0.78%	64.5%	-3.6%	2.0%
Fund co. Canadian Bond	$2,744,149,251	1.41%	7.55	2.26%	0.85%	62.3%	-3.0%	2.4%
Bank Canadian Income A	$2,434,183,996	1.30%	8.32	2.00%	0.70%	64.8%	-4.0%	2.3%
Fin. services co. Enhanced Bond A	$2,396,936,880	1.43%	8.50	2.60%	1.17%	55.0%	-2.6%	2.0%
Bank Canadian Bond Index	$2,414,947,449	1.16%	8.36	2.07%	0.91%	56.0%	-3.7%	2.3%
Fund co. Core Plus Bond A	$2,100,646,741	1.21%	7.70	2.85%	1.64%	42.5%	-1.6%	3.0%
Average	**$6,862,498,464**	**1.26%**	**8.10**	**2.29%**	**1.0%**	**55%**	**-3.1%**	**2.3%**

"Hypothetical return % not received by client" is a projected return calculated as the MER divided by the yield-to-maturity of the fund and assumes a one-year holding period and all other factors in the market remain the same.

Source: Morningstar Direct, fund websites. Total returns are net of fees. Total returns and assets under management (AUM) in C$ and as at December 31, 2021. All funds listed above are actual funds, company names were changed to preserve their identity. The listed funds represent some of the largest funds in the Canadian Fixed Income category where duration and yield-to-maturity were available. The Canadian Fixed Income category are funds that must invest at least 90% of holdings in C$-issues, have a minimum of 60% invested in investment grade (BBB or higher rating) issues and an average duration greater than 3.5 years. Up to 30% of foreign fixed income can be considered Canadian if it is hedged against C$. Categories are maintained by the Canadian Investment Funds Standards Committee (CIFSC). Latest available MER, duration and yield-to-maturity taken directly from fund websites if disclosed or Morningstar Direct if not. Assumes one-year holding period ending December 31, 2022 and no changes to interest rates and respective fund MERs over the period. "Hypothetical return % not received by client" is calculated as the MER divided by the yield-to-maturity of the fund and assumes a one-year holding period and all other factors in the market remain the same.

Beyond the return-free risk offered by the average bond fund, these portfolios haven't adjusted to the reality of a low-rate world and the poor return prospects that result. According to Harbor Fund (who just replaced their own fixed-income manager due to excessive fees[viii]), in 2001, core-plus investors got to keep 89% of their yield and paid just 11% in management fees, while they now are paying over 31% of their yield in fees while retaining just 69%. The average Canadian Fixed Income portfolio is even worse; Canadian bond funds still charge 1.26% in fees, consuming 55% of the yield-to-maturity of the average portfolio.

Average MER and YTM for the Canadian Fixed Income category (Funds over $2 billion in AUM)
As at Dec. 31, 2021



Source: Morningstar Direct. *Fund universe analyzed only includes funds with available duration and yield-to-maturity values, as well as a minimum asset under management (AUM) of C$2 billion in the Canadian Fixed Income category.

In November 2021, we launched the EdgePoint Monthly Income Portfolio (EPMIP). This isn't a Portfolio that's going to make anyone rich in the current interest rate environment. It's our strong belief that the average fixed-income investor doesn't understand the risks they're taking in their fixed-income portfolios. But like the misfortune that fell on Manhattan Fund investors, they're unlikely to recognize it until it's too late. EPMIP is an avenue to avoid these risks.

That doesn't mean we aren't taking some risk. We work every day to manage risks we understand. We're business analysts, and the risk we take is business risk or credit risk (the risk of lending money to businesses). We're taking these risks because we think the reward, however slight, will exceed the risk we're managing. Because we're operating predominantly in a high-grade bond universe, the risks we're taking are very low, and for that we're charging a commensurately low fee. Talk to your advisor.

In the short run, it's inevitable that we underperform bond portfolios taking entirely different risks. Over the long run, we have a big advantage by taking a dramatically lower fee. And in the end, EPMIP could be the lifeboat when risks prevalent in the bond market come screaming to the fore.

EdgePoint Variable Income Portfolio

The forward thinkers who recognized that numbers and probability could be applied in navigating future outcomes didn't use these tools to live mundane, uninterrupted lives. The laws of risk management allowed individuals to position themselves more aggressively to capitalize on the inevitable – to profit from events when odds were in their favour. The early financiers of shipping expeditions recognized the profit that could be made by pricing to cover loss, and it was only a matter of time before insurance intermediaries displaced the early agriculture cooperatives.

Without risk, there is no reward. Reward is highly motivating, and few people get rich without taking some sort of gamble. There are two sides to every bet, and while each roll of the dice has a winner and a loser, the casino isn't worried about losing money at the craps table. The casino doesn't stress when the bettor is on a hot streak, and payouts are little more than a ruse to attract more gamblers. The casino knows that the odds are in their favour. Time is on their side.

Risk management means stacking the odds in your favour, regardless of the current investment fad. This isn't easy, but, as investors, it lies at the core of everything we do. Long-term investment is all about risk management – it's why we highlight the longevity of the EdgePoint investment approach dating back to the 1970s. Any successful approach needs to withstand cycles. If it can, you're converting the future from an enemy into an opportunity.

If everyone valued every risk in precisely the same way, there wouldn't be many risky opportunities. But they don't; different investors assess different risks differently. The variation in risk assessment is what creates a market – and creates our opportunity. We can exploit this opportunity with relative impunity in the EdgePoint Variable Income Portfolio (EPVIP). EPVIP has the flexibility to offer a solution for qualified investors[ix] not only concerned with avoiding excess risk in the fixed-income asset class, but also interested in generating competitive long-term returns across market cycles.

It's a Portfolio that capitalizes on mispriced risk that appears in markets as it does in life. As Bernstein describes, people frightened by thunderstorms aren't simply overestimating the small probability of being struck by lightning. They know that it's highly unlikely that lightning will strike where they're standing, but for some people the consequences of the outcome mean that they tremble on every strike.[x] In much the same way, everyone knows that flying is far safer than driving a car, yet during turbulent flying conditions, some will panic while others relax. Gut rules the measurement.

The following table shows the evolution of EPVIP over the past 24 months. Leading up to and through the pandemic, mispricing appeared in different parts of the market. As always, we're looking to buy the bonds of out-of-favour businesses when we have a view toward improving fundamentals. But we're also asking what the business would look like if it's walloped by some adverse event. Every bond we buy, we buy for the long term. It's a sad fact that a low-probability event over a long enough time horizon becomes a certainty.

Sep. 30, 2019

Business	Portfolio %	YTM
Pulse Seismic PL, 10%, due 2023/12/31	5.5%	10.0%
PHI Holdings Term Loan, due 2024/09/01	5.2%	9.2%
Era Group Inc., 7.75%, due 2022/12/15	3.9%	7.6%
Livingston International (4/19) 1st Lien, due 2026/04/25	3.3%	7.3%
Mattel, Inc., 6.75%, due 2025/12/31	3.3%	5.9%
Total weight	**21.2%**	

Jun. 30, 2020

Business	Portfolio %	YTM
AutoCanada Inc., 8.75%, due 2025/02/11	6.4%	10.0%
Alcanna Inc., 4.7%, due 2022/01/31	4.9%	7.7%
Osisko Gold Royalties Ltd., 4%, due 2022/12/31	4.8%	3.4%
Mullen Group Ltd., 5.75%, due 2026/11/30	4.7%	7.1%
Tervita Corp., 7.625%, due 2021/12/01	3.3%	26.5%
Total weight	**24.1%**	

Dec. 31, 2020

Business	Portfolio %	YTM
AutoCanada Inc., 8.75%, due 2025/02/11	6.8%	6.9%
Optiva Inc., 9.75%, Debentures 2025	5.3%	8.5%
Osisko Gold Royalties Ltd., 4%, due 2022/12/31	5.3%	0.9%
Alcanna Inc., 4.7%, due 2022/01/31	4.9%	4.5%
Mullen Group Ltd., 5.75%, due 2026/11/30	4.6%	4.6%
Total weight	**26.9%**	

Jun. 30, 2021

Business	Portfolio %	YTM
Optiva Inc., 9.75%, Debentures 2025	7.7%	8.0%
AutoCanada Inc., 8.75%, due 2025/02/11	5.4%	6.2%
Osisko Gold Royalties Ltd., 4%, due 2022/12/31	4.1%	0.9%
Cineplex Inc., 7.5%, due 2026/02/26	4.1%	6.3%
Secure Energy Services Inc., 7.25%, due 2026/12/30	4.1%	7.0%
Total weight	**25.4%**	

Dec. 31, 2021

Business	Portfolio %	YTM
Optiva Inc., 9.75%, Debentures 2025	6.7%	7.6%
Shawcor Ltd., 9%, due 2026/12/10	6.7%	8.3%
Osisko Gold Royalties Ltd., 4%, due 2022/12/31	5.0%	1.9%
AutoCanada Inc., 8.75%, due 2025/02/11	4.5%	6.8%
Cineplex Inc., 7.5%, due 2026/02/26	3.6%	6.0%
Total weight	**26.5%**	

EdgePoint Variable Income Portfolio, Series PF
Performance as at Dec. 31, 2021. Annualized, total returns, net of fees in C$
YTD: 15.23%; 1-year: 15.23%; 3-year: 9.16%; since inception (Mar. 16, 2018 to Dec. 31, 2021): 7.50%

As much as the Portfolio has changed, we haven't sold any of these bonds. Over the past 24 months, each of our top five holdings coming into the pandemic were refinanced at a lower rate. While Pulse Seismic, PHI Helicopter and Mattel were out of favour when we bought them, the interest rate available to each business at refinancing was no longer enticing. We found more attractive bonds to replace them. Even through COVID, business fundamentals improved to the point that mispriced risk became fully priced.

Mullen Transport, Alcanna and Tervita were opportunistic investments made at the height of volatility. The bonds of Alcanna and Tervita have since matured, while Mullen remains a holding at a lower weight. Many of our largest current positions were bought as new bond issues that EPVIP led alongside our larger Growth & Income Portfolios. AutoCanada and Optiva were large new issues in 2020 when each company was struggling. With improving prospects, both businesses have been able to access lower-cost financing more recently.

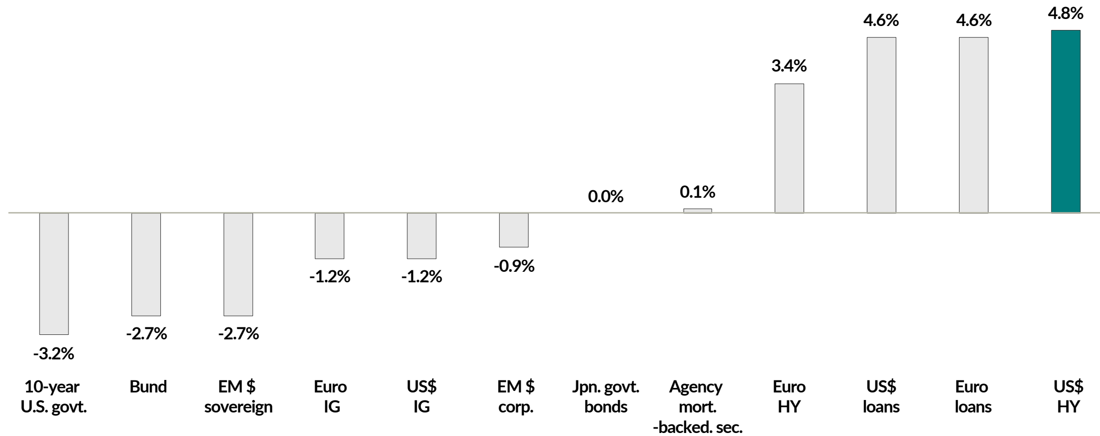
By investing in businesses when risk is mispriced, we're loading the dice to with the hope of earning outsized returns over time. In the short run, a credit portfolio can be volatile. But like the casino, time is our friend. In 2021, we were significant supporters of new bonds issued by Cineplex and Shawcor, the latter closing in December at an attractive 9% yield. We aren't forecasting clear skies the entire time we own them, but we expect the resilience of each business to shine through any turbulence on the horizon. For investors buying bonds with a view of holding them until maturity, volatility represents opportunity.

Performance as at Dec. 31, 2021 **Annualized, total returns, net of fees in C$**	**YTD**	**1-year**	**3-year**	**Since inception** (Mar. 16, 2018 to Dec. 31, 2021)
EdgePoint Variable Income Portfolio, Series PF	15.23%	15.23%	9.16%	7.50%

Historical performance as at Dec. 31, 2021 **Annualized, total returns, net of fees in C$**	**2021**	**2020**	**2019**	**2018***
EdgePoint Variable Income Portfolio, Series PF	15.23%	4.90%	7.60%	1.15%

*Mar. 16, 2018 to Dec. 31, 2018

EPVIP is different – look no further than the concentration of our holdings. Our top five positions have consistently represented about 25% of assets. These companies will change over time as we look to improve expected return given our view of risk. But this concentration means our returns are going to look very different, too. In our view, this is a very good thing for anyone trying to earn a return in fixed-income markets. High-yield bonds were by far the best performing fixed-income asset class in 2021. But in a market that seems to crave risk rather than shun it, it is not a market that would be easy to navigate without our level of flexibility.



Source: Credit Suisse, HY 2021 Recap, CS Credit Strategy Daily, Jan. 3, 2022.

John von Neumann, the father of game theory, recognized that certain defeat results from any strategy whose aim is to win rather than to avoid losing. Dealing with the possibility of losing is the most important part of risk management. Bernstein summarizes:

> *"The essence of risk management lies in maximizing the areas where we have some control over the outcome while minimizing the areas where we have absolutely no control."* [xi]

In the long term, the house always wins. At EdgePoint, we try to put the odds on our side. We want to be the house, not the degenerate trying to turn a 2%-yielding bond into something dramatically different.

Concluding remarks

It's so easy to outperform in the short term by betting that some inevitability won't happen tomorrow. Just buy momentum stocks or use a bit of leverage. Most of the managers running such strategies have probably convinced themselves that things have changed, it's different this time and the hot streak is the result of their genius. But the good times never last. The managers taking these risks will come and go, and well be measured against whoever's at the top of each cycle. But EdgePoint's approach will remain the same, stacking the odds in our favour by managing the inevitable risks that will come along the way.

i Source: Batnick, Michael, Big Mistakes: The Best Investors and Their Worst Moments (Hoboken, NJ: John Wiley & Sons, Inc., 2018).

ii Source: Ibid.

iii Source: Nocera, Joe, "The Go-Go Investor", The New York Times, Dec. 24, 2008. https://www.nytimes.com/2008/12/28/magazine/28wwln-tsai-t.html?searchResultPosition=4

iv Source: Bernstein, Peter L., Against the Gods: The Remarkable Story of Risk (New York, NY: John Wiley & Sons, Inc., 1996).

v The five highest magistrates in Sparta, elected by citizens and equivalent in power to the city-state's two kings.

vi Source: Bloomberg LP. As at December 31, 2021.

vii 2021 calendar year return of -2.7% for the ICE BofA Canada Broad Market Index was the worst calendar year return for the index since 1994 when it had a return of -5.4%.

viii Source: Weiss, Miles, "Pimco Ousted as Harbor Fund's Manager After 34 Years Over Fees", Yahoo.com, Dec. 17, 2021. https://ca.finance.yahoo.com/news/pimco-three-decade-run-managing-172401327.html.

ix See the Offering Memorandum ("OM") for more details on the EdgePoint Variable Income Portfolio ("Portfolio"). This document is not an invitation to invest in the Portfolio nor does it constitute a public offering of sale. Applications for purchases in the Portfolio will only be considered on the OM's terms, which may be obtained from your financial advisor. Each purchaser of units in the Portfolio may have statutory or contractual rights of action. The information in this document is subject to change without notice. The Portfolio is sold via OM and pursuant to exemption from prospectus requirements. As such, the Portfolio is not available to the general public and is only available to, for example, accredited investors, within the meaning of National Instrument 45-106 — Prospectus Exemptions. Please read the OM before investing.

x Source: Bernstein, Peter L., Against the Gods: The Remarkable Story of Risk (New York, NY: John Wiley & Sons, Inc., 1996).

xi Source: Ibid.

Commissions, trailing commissions, management fees and expenses may all be associated with mutual fund investments. Please read the prospectus and Fund Facts before investing. Copies are available from your financial advisor or at www.edgepointwealth.com. Unless otherwise indicated, rates of return for periods greater than one year are historical annual compound total returns net of fees including changes in unit value and reinvestment of all distributions, and do not take into account any sales, redemption, distribution or optional charges, or income taxes payable by any securityholder, which would have reduced returns. Mutual funds are not guaranteed, their values change frequently and past performance may not be repeated. This is not an offer to purchase. Mutual funds can only be purchased through a registered dealer and are available only in those jurisdictions where they may be lawfully offered for sale. This document is not intended to provide legal, accounting, tax or specific investment advice. Information contained in this document was obtained from sources believed to be reliable; however, EdgePoint does not assume any responsibility for losses, whether direct, special or consequential, that arise out of the use of this information. Portfolio holdings are subject to change. EdgePoint mutual funds are managed by EdgePoint Investment Group Inc., a related party of EdgePoint Wealth Management Inc. EdgePoint® is a registered trademark of EdgePoint Investment Group Inc.

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