Business owners lending to businesses™

EdgePointWealth.com

The cover image shows one of 300 electric busses in Go-Ahead London's fleet, the city's largest bus company. This 1500th electric bus manufactured by the partnership between BYD UK and Alexander Dennis Ltd., a subsidiary of NFI Group Inc. NFI has been one of our bond holdings in the EdgePoint Portfolios and is one of the world leaders in the transition towards electrifying mass transit.

Photo credit
NFI Group Inc.

Environmental assessment

By Frank Mullen

It's important for a business owner to understand both the performance and opportunity set of their business in the context of the current market environment. Eking out 2% to 3% sales growth doesn't sound like an achievement in isolation, but it's fantastic if we're in a recession and your competitors are shrinking. Understanding your competitors' positioning and their financial health will help guide your investment decisions. Adding capacity could be your ticket to continue stealing market share, or it could simply flood the market with excess supply. Having a deep understanding of the market structure and your competitors' behaviour tilts the odds in your favour to stay one step ahead of the competition.

At EdgePoint, we believe investing is best when it's most businesslike. I think it's essential for investors to understand the type of market environment they're investing in. Is it an easy money era where capital is free and loose, where even the worst businesses are being funded? Or is capital constrained and only available to a select few? The first environment is likely one of excess risk and low returns, while the second is the complete opposite and much more investor friendly.

Knowing where you stand is especially helpful to credit investors as it can help guide your positioning. For years we have been in a period of cheap and easy money. The need for yield was unrelenting and the interest rates at which businesses could borrow were pushed lower and lower. Investors lined up to invest in sub-par businesses at paltry yields with weaker and weaker protections. It's hard to imagine that any investor would be excited about taking on more risk at a lower potential return, but as Chuck Prince has become infamous for saying, they needed to dance while the music was playing.

Dance lessons

I can't dance, both literally and figuratively. Reaching for yield doesn't make sense in a negatively asymmetric asset class like bonds. That's a fancy way of saying that you can lose a lot more than you can gain when you buy a bond, and the last 24 months have woken up many investors to that ever-present possibility.

Rather than hold our nose and dance, we prefer to use our flexibility to our advantage, finding investments that aren't on the radar of most bond investors. Our 15-person Investment team scours the world looking for businesses, and our interdisciplinary approach allows us to find unique ideas, many of which have been written about in the past. We have proven that we can grind out returns when everyone is on the dance floor,[i] but we really get excited when the music stops. When something shocks the system and investors become more risk conscious, we pay attention.

There's no such thing as a free lunch

The primary market is a great barometer for the risk appetite that's available to credit investors. Throughout EdgePoint's history we haven't participated heavily in new-issue bonds. When a new issue comes to market, investors usually get treated to a fancy lunch and hear a management team talk about all the great aspects of their business. Bond investors are constantly searching for new investments as their current holdings mature, and the new-issue market is a liquid source of ideas. Many listen to management and make a decision even before lunch has digested. That's a challenging environment for us to have an investment edge. Management and the company are the only real winners because they can access cheap and freely available capital. That's a sign of a borrower's market.

However, there are times when no one shows up for lunch. When management hopes to raise money at 5% and no one is there to listen, it's a clear sign that power is shifting back towards the lender. These are the times when we get excited. Rather than raising money in an afternoon, investors are given time to conduct their due diligence. Management's rosy forecasts can be contrasted against real analysis, discussions with competitors and a thorough review of the important drivers of the business. If our work leads us to believe the idea is investible, we can then name the price/yield that would get us interested. These are all signs of a lender's market. A market where the power shifts to those with capital and a skillset at putting it to work.

If you were to look at the credit market's stats, it would be easy to dismiss this as an uninteresting time to be an investor. Recessionary fears don't seem to be reflected in credit spreads and the number of new issuances in September suggest that we're in a borrower's market. While it's true that high-quality issuers have free-flowing access to capital, any business with a hint of risk or controversy associated with it is being forced to pay a higher yield to attract investors.

Great narratives don't always have happy investment endings

We were uninterested in new issues in the first eight months of 2023, but we analyzed three in the second half of September. All three businesses thought they were going to take advantage of a vibrant credit market and were quickly stunned back to reality when investors balked at a particular part of their business.

The three businesses we looked at and subsequently purchased were in different sectors and had distinct drivers of their business. The only thing they had in common was that none of them had a perfectly clean narrative surrounding the investment. We typically avoid investing in businesses with great stories as they're generally priced to perfection, providing little margin of safety. We prefer companies that have some "hair" on them. Those uncertainties give us opportunities to develop insights. Many times, we agree with the market and avoid an investment, but there are times when our analysis comes to a different conclusion. These are the times when the *perceived* risk of an investment is high, yet the fundamentals are solid. This combination creates an opportunity for outsized returns. All three of these investments had some perception of risk that we believe was overdone.

Shopping trip

We don't like to make a habit of writing about recent investments, but I think we should make an exception to stress how quickly the market is changing and how an opportunistic credit investor can capitalize on it.

Malls have become a dirty word to many investors. It's well known that North America has too many malls, and many of them are struggling to remain relevant. We have years of data that confirms this, and I wouldn't want to make a bet that this trend reverses. However, as the second- and third-tier malls in a city struggle, we have seen the primary, or Class A, malls become more valuable. Their big-name anchors, experience-driven attractions and declining local competition have led to increasing sales per square foot and extended lease terms. Class A malls have never been healthier.

Rising interest rates affect all business models, but real estate has been one of the hardest hit. Leverage is a constant in the industry and many are grappling with the cost of refinancing their debt. One of the premier malls in North America was just forced to face this reality when it had to refinance debt that cost just over 4% with a bond that now pays close to 8%. This is an A-rated bond (tongue firmly in cheek) for a mall whose fundamentals have never been stronger. Sales are growing, attractions have been upgraded and more shoppers than ever are coming through their doors.

Many investors are avoiding real estate altogether, especially retail-focused assets. We don't like to force ourselves to live in such a black-and-white world. While we don't love real estate or retail in this environment, there are assets that we would love to lend money to and gladly own if we had the chance. We had no interest in meeting this mall owner when their debt yielded 4%, but we believe it's an attractive investment in today's new operating and pricing environment. I suspect there are many real estate businesses struggling to grapple with higher interest rates, and we think we're well positioned to capitalize on the opportunities that are bound to come our way.

Bank shots

Our largest competitor over the past decade hasn't been other asset managers. Canadian banks have happily lent to companies that we believe were better suited for the corporate bond market. The lure of fees and a "deeper relationship" led banks to lend huge sums of money at very attractive rates. This looks to be changing. Credit conditions are tightening in Canada and the banks are acting with sharper elbows than we've ever seen. This trend is just starting, but I suspect that it will continue providing a larger supply of borrowers to the corporate bond market. We welcome less competition and more diverse borrowers to our investible universe.

We firmly believe that we are in the midst of a shift in the corporate bond market. Credit conditions are tightening in the areas of the market in which we generally hunt. Our ability to generate insights has never been stronger and the new market environment is providing more attractive returns. We believe that all of our fixed income Portfolios are nimble, flexible and well positioned to take advantage of the new market environment. Most bond investors fear rising interest rates. We feel the complete opposite. We don't need rates to decline in order to earn a return over the next five years, and investors in our fixed income Portfolios should be welcoming the potential for a "higher for longer" interest rate environment.

[i] **Total cumulative returns, net of fees, in C$ (December 31, 2019 to December 31, 2021)**

EdgePoint Global Growth & Income Portfolio (fixed income allocation): 12.98%
EdgePoint Canadian Growth & Income Portfolio (fixed income allocation): 15.91%
ICE BofA Canada Broad Market Index: 5.66%.

The "dance floor" period was chosen owing to the low-rate (and resulting low-yield) environment experienced by fixed income investors.

The ICE BofA Canada Broad Market Index was used as a proxy for general fixed income performance over that time. The index tracks the performance of publicly traded investment-grade debt denominated in Canadian dollars and issued in the Canadian domestic market. The index is not investible. It was chosen to represent the market environment available to investors seeking fixed income options at the time. It was also chosen as the benchmark for the fixed income portion of the EdgePoint Growth & Income Portfolios because it is representative of fixed income opportunities consistent with the Portfolios' mandates.

The returns for the EdgePoint Growth & Income Portfolios' fixed income allocation are shown to highlight the work done by the Investment team during the period relative to the general fixed income market. They are hypothetical, shown for illustrative purposes only and aren't indicative of future performance. The returns aren't intended to represent returns of an actual fixed income fund, as they weren't investible. The EdgePoint fixed income performance figures are net of fees and approximations calculated based on end-of-day holdings data (actual trading prices not captured). A hypothetical management expense ratio (MER) of 0.62% was applied to the fixed income returns of the EdgePoint Growth & Income Portfolios, and prorated daily. The fixed income MER was calculated based on the average MER for EdgePoint Global and Canadian Growth & Income Portfolios (0.84% and 0.86%, respectively), relative to the EdgePoint Global and Canadian Portfolios' MER (0.97%), then scaled to reflect the average fixed income weight of the Growth & Income Portfolios (35%).

Annualized total returns, net of fees (excluding advisory fees) in C$ as at September 30, 2023

EdgePoint Global Growth & Income Portfolio, Series F
YTD: 4.75%; 1-year: 14.25%; 3-year: 8.63%; 5-year: 4.10%; 10-year: 8.73%; Since inception (Nov. 17, 2008 to Sep. 30, 2023): 11.09%

EdgePoint Canadian Growth & Income Portfolio, Series F
YTD: 9.03%; 1-year: 18.03%; 3-year: 17.09%; 5-year: 9.40%; 10-year: 8.79%; Since inception (Nov. 17, 2008 to Sep. 30, 2023): 11.04%

Series F is available to investors in a fee-based/advisory fee arrangement and doesn't require EdgePoint to incur distribution costs in the form of trailing commissions to dealers. Excludes advisory fees.

Published October 17, 2023.