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The cover image shows a variety of Miracle-Gro products in a Los Angeles gardening centre. They're some of the many products made by The Scotts Miracle-Gro Co., one of our credit holdings in the EdgePoint Portfolios. It's been in business since 1868 and is a leading manufacturer and innovator of lawncare, gardening, hydroponics and pest control products.

The Certainty Bubble

By Frank Mullen

I have always thought investing was rooted in making decisions with imperfect information. It would be great if we could make decisions with perfect information, but I've yet to know someone who has legally figured that one out. We're forced to deal with imperfection because the future is uncertain. Ambiguity is a fact of all of our lives but something we grapple with continually as investors. Regardless of our conviction in any given idea, we know that we can be wrong. Demand can slow more than expected, a competitor can act irrationally or a government can change the rules.

We compensate for uncertainty by ensuring that we pay a fair price for our investments. "Fair" is purposefully ambiguous as only time can judge what we paid, highlighting the constant difficulty that uncertainty poses to the investment process. Ben Graham coined the term "margin of safety" to describe the difference between the price paid for an investment and its intrinsic value. I grapple with the exactness implied by a term like "intrinsic value," but we certainly endeavour to pay a price that gives us a margin of safety in each of our investments. Not paying a full price gives us room for uncertainty. Paying a fair price allows us to still generate a pleasing return in a scenario where revenue doesn't grow quite as much as we had forecast, or margins didn't hit management's target.

If you pay a fair price, then being "approximately right" works, but the opposite is also true. If an investment is priced to perfection, you need to get everything right. The market is already pricing in a rosy scenario so the only way to outperform is for an even rosier scenario to play out. That's a tough game to play as there's no margin of safety, leaving no room for the uncertainty we know exists.

The market is well aware of the uncertainty of the future. Every investor knows that the second they finish their model they're almost 100% certain to be precisely wrong. What changes is the market's willingness to listen to rationality. Stock and bond prices are much more volatile than the underlying assets they give us exposure to, and history is full of examples of sentiment swinging from unending pessimism to wild exuberance. This is another way of saying the market can frequently move from discounting a great deal of uncertainty to pricing assets to perfection. I believe we're seeing signs today that the market is closer to the latter scenario. This is prevalent in many asset classes but I believe it's especially evident in the credit markets these days.

An unhealthy appetite

Credit spreads are the level of interest that investors are paid to take corporate credit risk, the possibility of a company defaulting on its debt. They can be thought of as a measure of the risk appetite of the credit markets. Tight credit spreads mean that the market isn't demanding to be paid much to compensate for credit risk. To keep with this commentary's theme, you could say that the market is relatively certain that credit risk is low for the foreseeable future. This quarter, high-yield credit spreads have gotten very close to the tightest level they have been in the last decade,[i] touching 3.05%.[ii] Rather than fill the rest of this page with doom-scrolling headlines about the precarious state of the economy, we can best summarize our thoughts with one question: "Is this the most certain time in the last decade for you to lend money to a high-yield-rated company?" I believe that you can say the market is pricing credit risk to perfection and not leaving you much margin of safety.

Another sign that the market is certain there's no credit risk is the strength of the new-issue market. The ability of high-yield-rated issuers to come to market and issue new debt is a great barometer for the market's perception of risk. Just over US$86 billion in high-yield bonds were issued in the first quarter of 2024.[iii] This is a big number and doesn't include the capital that was raised in the levered loan and private debt markets. To put that into context, the high-yield market only financed US$104 million in deals for all of 2022,[iv] a year characterized by much more stringent lending conditions. At this pace, the high-yield market is on track to double the value of bonds issued in all of 2023. It's safe to say the market is wide open right now and willing to lend to companies that weren't considered investible six short months ago.

I would argue the fundamentals of most businesses haven't changed dramatically since the fall, but their credit spread certainly has. The market's pendulum has swung from pessimistic – with credit spreads in excess of 5% at one point in 2023 – to exuberant in 2024. The market seems certain that there's no credit risk and they're welcoming more borrowers each and every day.

Not only are more new issues getting done, but they're pricing at lower yields than initially expected and seeing their books oversubscribed. This overwhelming demand is causing some investors to miss out on the quick gains that can come from investing in a hot new issue. The "FOMO" from seeing your peers make a quick buck is self-reinforcing, driving new-issue yields lower as more investors clamour to buy what's coming to market. Witnessing investor behaviour reminds me of the now-infamous words of Citigroup CEO Chuck Prince prior to the Financial Crisis: "As long as the music is playing, you've got to get up and dance."

The average market participant is dancing as the siren songs of hot new issues are being played, but we're sitting on the sidelines. Citigroup didn't fare very well with Prince's mindset,[v] and we think we're better off waiting to dance when the floor is far less crowded. We haven't made that decision lightly. We don't want to miss out on return, but it can't come with inordinate risk. We're seeing bonds being refinanced at low levels that weren't imaginable only several months ago. Remaining disciplined to our investment approach is how we ground ourselves during time periods like now, and this discipline has helped our Portfolios in the past.

Unwilling to pay the price of perfection

Our memories can play tricks on us so I challenged myself to look at our historical track record. I wanted to find past examples of businesses that we had analyzed, identified as investable, but chose not to participate in their new issue due to the low yield. These are businesses where we liked the underlying assets and cash flow, but thought it was priced to perfection.

I chose 10 Canadian high-yield bonds that were still outstanding today. The following table highlights each bond's return as well as the return of the fixed income portfolio within our Canadian Growth & Income Portfolio. This allows us to see if we made the right choice passing on bonds that we thought had too low of a yield and were priced to perfection, not taking the uncertain future into account. You will notice that I intentionally chose businesses most readers would know. The quality of these businesses wasn't in question; their price was. We passed because we believed we had a good chance finding a better idea or waiting until these bonds were at a lower price.

High-yield bonds considered, but not purchased, in EdgePoint Canadian Growth & Income Portfolio (EPCIP)

		Annualized total return (local currency) Issue date to Mar. 31, 2024	
Bond	**Issue date**	**Bond**	**EPCIP (fixed income only)***
Parkland Corp., 6%, due 2028/06/23	Jun. 23, 2020	6.10%	7.23%
Parkland Corp., 4.375%, due 2029/03/26	Mar. 25, 2021	2.04%	5.75%
Superior Plus LP, 4.250%, due 2028/05/18	May 18, 2021	2.38%	5.12%
GFL Environmental Inc., 4.750%, due 2029/06/15	Jun. 8, 2021	2.76%	5.01%
Videotron Ltd., 5.125%, due 2027/04/15	Apr. 13, 2017	4.95%	5.12%
Air Canada, 4.625%, due 2029/08/15	Aug. 11, 2021	2.91%	4.67%
Brookfield Property Finance ULC, 4.74%, due 2026/09/30	Oct. 12, 2021	2.27%	4.83%
Mattamy Group Corp., 4.625%, due 2028/03/01	Mar. 5, 2020	3.19%	6.10%
Cascades Inc., 5.125%, due 2026/01/15	Nov. 26, 2019	4.87%	6.05%
ATS Corp., 4.125%, due 2028/12/15	Dec. 29, 2020	1.32%	5.93%

As you can see, we made the right choice. The low coupons on these new issues kept their returns low. We were better off investing in our existing portfolio holdings or waiting for a superior idea than investing in bonds that were priced as if their future was certain. The difference in return is even more striking if I expand the investment universe to our flagship credit fund (which you can read about here).

***Hypothetical returns for fixed income only returns. They are not investible. They're a best-estimate of EdgePoint Canadian Growth & Income Portfolios' fixed-income performance.**

Performance as at March 31, 2024
Annualized total returns, net of fees (excluding advisory fees), in C$

EdgePoint Canadian Growth & Income Portfolio - Series F YTD: 7.09%; 1-year: 16.40%; 3-year: 13.57%; 5-year: 11.93%; 10-year: 8.99%; 15-year: 11.41%; Since inception (Nov. 17, 2008): 11.52%

Source: Morningstar Direct. Returns shown for illustrative purposes only and aren't indicative of future performance. The EdgePoint Canadian Growth & Income Portfolio (EPCIP) fixed income returns are in local currency, net of fees and approximations calculated based on end-of-day holdings data (actual trading prices not captured). 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. The high yield securities were selected for comparison as they were potential investible credit securities consistent with the EPCIP investment mandate. See *Important information – EdgePoint Canadian Growth & Income Portfolio fixed income returns* for additional details.

We believe we have a pleasing fixed income track record because of our strict adherence to our investment approach. We don't buy bonds of companies simply because we like the business; we have to believe we are getting them at a good price. While we are disciplined, we do make mistakes. We had a long history with AutoCanada. We participated in past bond deals and owned the equity of the business. In 2022, it refinanced our high-coupon bond for a new issue with a coupon of 5.75%. We didn't like the price but convinced ourselves that the business quality and strength of the idea made up for it. We acknowledged our displeasure with the price by decreasing the weight of the investment in our credit portfolio and convinced ourselves to buy a more marginal position. That rationale didn't end up working. We achieved a measly 1.56% return on that investment compared to the fixed income portion of the EdgePoint Canadian Growth & Income Portfolio returning in excess of 5%* over the same time period.[vi] This is yet another reminder to remain disciplined to our investment approach – we should walk away when the market is certain that something is a great investment.

One could argue that I'm cherry-picking examples. I might be, but the point still holds. To further reinforce our conviction in the importance of maintaining discipline, we can return to a table that many clients have seen and we have used in past commentaries. In May 2020, yields on the largest, most-indebted companies in North America (the biggest weight in the high-yield index) were very low. As you can see in the following table, we looked at the top-10 names in the U.S. high-yield bond index[vii] and said the average yield-to-worst[viii] of 4.2% was far too low for the amount of uncertainty in the world. We were in the heart of COVID-19 lockdowns. I can't remember a more uncertain environment yet markets weren't worried about it, pricing many high-yield bonds at high prices and low yields. They rationalized that government bonds were yielding zero, so getting 4.2% on large, liquid names was worthwhile. That is the type of rationalization that we need to avoid. We believed that locking in those type of yields was bound to haunt investors as the environment changed. Our discipline paid off, with the fixed income portion of the EdgePoint Canadian Growth & Income Portfolio returning 7.86%* since then and the high-yield index ETF returning only 3.30% from the end of May 2020 to today. Pricing certainty in uncertain times strikes again!

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iShares US High Yield Bond Index ETF – Top-10 holdings
As at May 31, 2020

Holding	Weight	Bond rating (S&P)*	Issue size ($M)	Yield-to-worst
Altice France SA, 7.375%, due 2026/05/01	0.6%	B	$5,190	3.4%
Transdigm Inc, 6.25%, due 2026/03/15	0.5%	B	$3,800	5.1%
Sprint Corp, 7.875%, due 2023/09/15	0.5%	BB	$4,250	3.0%
Centene Corporation, 4.625%, due 2029/12/15	0.5%	BBB	$3,500	3.0%
Ford Motor Company, 8.5%, due 2023/04/21	0.4%	BB	$3,500	4.8%
Ford Motor Company, 9%, due 2025/04/22	0.4%	BB	$3,500	6.0%
Altice Financing SA, 7.5%, due 2026/05/15	0.4%	B	$2,750	3.4%
CCO Holdings LLC, 4.75%, due 2030/03/01	0.4%	BB	$1,350	3.9%
Teva Pharmaceutical Finance, 3.15%, due 2026/10/01	0.4%	BB	$3,500	4.8%
Teva Pharmaceutical Finance, 2.8%, due 2023/07/21	0.3%	BB	$3,000	4.3%
Total	**4.4%**	**Average**	**$4,664**	**4.2%**

* If S&P ratings were not available, DBRS, Moody's or Fitch ratings were used.

Source: Bloomberg LP. All data as at May 31, 2020. May 31, 2020 was chosen because we highlighted the state of the high-yield market during the EdgePoint June 2020 fixed income webinar. Issue size in local currency. Yield-to-worst is a measure of the lowest possible yield an investor would receive for a bond that may have call provisions, allowing the issuer to close it out before the maturity date. Averages are simple averages. See *Important information – comparisons* for additional details.

The only thing we know for sure is our commitment to our investment approach

We can't ignore the fact that the market could be right, but I will pose a question to the reader. Is now a certain time period? Assuming that certainty exists (a large assumption), are the following points the hallmarks of a period of certainty?

- Political discontent in North America and many places around the globe
- Governments more indebted than they have ever been
- Challenging demographics in many major markets
- Two kinetic conflicts going on – one involves a Global Superpower and the other is in the Middle East, a historic powder keg for conflicts with global ramifications
- The market's faith in the Fed is unrelenting even as we transitioned from a "hard landing" to a "soft" one. There's now even talk of a "no landing" scenario. I'm not even sure I can explain that one!
- Many investors are betting that artificial intelligence will save the world, while others warn it may end the human race

The list could go on but I hope you get the picture. There is a great deal of uncertainty in the world and the capital markets, yet credit investments aren't being priced that way. It's worth highlighting that the more certain the market feels, the larger the loss that can occur should uncertainty prevail. It seems to me that it is a better time to be a borrower than a lender.

It's a good thing that our Portfolios don't own the market. We have generally avoided the large index names and chosen to focus on more off-the-run ideas. There is less competition fishing in these pools, improving our ability to find both insights *and* mispricings. There are still many businesses pricing uncertainty in these corners of the market. We will continue to turn over rocks finding unique ideas and will remain disciplined in the price we're willing to pay regardless of what the rest of the market is doing. In another 10 years I hope we can convince our clients to expand the list of certainties in life: death, taxes and EdgePoint's adherence to our investment approach.

Important information – EdgePoint Canadian Growth & Income Portfolio fixed income returns

The EdgePoint Canadian Growth & Income Portfolio (EPCIP) fixed income returns are hypothetical, local currency and net of fee 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 EPCIP fixed income returns and prorated daily. The fixed income MER was calculated based on the average MER for EdgePoint Global Growth & Income Portfolio (EPGIP) and EPCIP (0.84% and 0.85%, respectively), relative to the EdgePoint Global and Canadian Portfolios' MER (0.97%), then scaled to reflect the average fixed income weight of EPGIP and EPCIP (35%).

Important information – comparisons

The iShares US High Yield Bond Index ETF is a market-capitalization-weighted ETF that provides exposure to a broad range of U.S. high-yield, non-investment-grade corporate bonds.

Although not the official benchmark of the credit portion of the EdgePoint Canadian Growth & Income Portfolio, the iShares US High Yield Bond Index ETF was chosen for comparison because it is representative of high-yield corporate bonds that are investible based on the Portfolio's credit mandate. We manage our Portfolios independently of any indexes we use as long-term performance comparisons. Differences including credit quality, issuer type and yield may impact fixed-income comparability and could result in periods when our performance differs materially from the index. Additional factors such as security holdings and geographic/sector allocations may impact comparability from the index.

[i] Source: Federal Reserve Bank of St. Louis. As at March 31, 2024, the tightest high yield spread in the last decade as measured by the ICE BofA US High Yield Index Option-Adjusted Spread, was 3.01% on December 28, 2021. The credit spread uses the ICE BofA US High Yield Option-Adjusted Spread (OAS). It's the difference between the ICE BofA US High Yield Index and a spot U.S. Treasury curve.

[ii] Source: Federal Reserve Bank of St. Louis. The ICE BofA US High Yield Index Option-Adjusted Spread reached 3.05% on March 21, 2024.

[iii] Source: LevFin Insights.

[iv] Source: LevFin Insights.

[v] Prior to the 2008-09 Financial Crisis, Citigroup traded heavily in various debt securities. It almost collapsed during the crisis but was saved thanks to a US$45 billion bailout from the U.S. federal government. Chuck Prince resigned in 2007 and was one of several Citigroup executives to testify before a U.S. Congress-appointed commission. Source: Rachelle Younglai and Kevin Drawbaugh, "Ex-Citigroup leaders contrite, defensive on crisis", *Reuters.com*, April 8, 2010.

[vi] The return period was from February 7, 2022, the issue date of the AutoCanada 5.75% due 2029 bond, to March 31, 2024.

[vii] The high-yield index is represented by the iShares US High Yield Bond Index ETF, a market-capitalization-weighted ETF that provides exposure to a broad range of U.S. high-yield, non-investment-grade corporate bonds.

[viii] Yield-to-worst is a measure of the lowest possible yield an investor would receive for a bond that may have call provisions, allowing the issuer to close it out before the maturity date.

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