EDGEPOINT®

## FIXED INCOME COMMENTS

For the quarter ending March 31, 2022

# Earning our wings

**By Frank Mullen, portfolio manager**

A friend of mine is a pilot and he once laughed at a common description of his job: "hours and hours of boredom punctuated by moments of sheer terror." A pilot's success can be determined by their reaction to those brief moments, regardless of how long they have successfully flown without prior mishaps. In Morgan Housel's great book, The Psychology of Money, he likens an investor's success to that of a pilot. An investor's reaction during periods of so-called terror will likely drive their long-term performance and ability to compound their capital.

Does the terror of declining asset values cause you to sell and wait for clearer skies, or does it prompt you to revaluate your thesis and take advantage of the now-discounted prices? Both are understandable responses, but far too often the average investor sells and locks in a loss before truly evaluating the investment's future prospects. I have witnessed this countless times over the years. The natural human reaction to fear overwhelms one's ability to reason, and it can lead to undesirable consequences.

## Seat sale

Why is that the case? What is it about investing that makes people likely to sell at the first sign of a decline? When prices of everyday items fall, consumers generally rush to buy more. How many people feel uncomfortable when they see a sale sign on a new shirt or bike that they were hoping to buy? Sale signs usually do the opposite – they get us excited. When that shiny new bike was $1,000 last week and is now on sale for $900, it's a better deal. We all love a good deal. But why doesn't that apply to an investment? Why do we head for the exits instead of the register when an investment declines in price?

I believe it's because most investors don't know the value of what they own. They know that saving $100 on a bike is good value, but many aren't sure if watching a stock or bond fall in price is a better deal or another mistake. The only way to distinguish between the two is understanding what you own and having a skillset at valuing investments. While this is something we're excited to do every day, it remains difficult for the average end client. Untangling the value of a business is much harder than for a bike, but it's also more important.

Nothing is more uncomfortable than watching an investment's price fall if you don't have a sense of its value. The once-deafening roar of Bitcoin bulls sure sounds more like a whisper after its price declined significantly from its peak in the fall.[i] The same can be said of the unprofitable technology companies that had an insatiable bid until the price corrected and gapped downwards. Both are examples of investors fleeing an asset when its price declined because these assets were difficult to fundamentally evaluate.

The EdgePoint investment approach is centred on valuing a business. The price of that business changes daily but its value doesn't. It's similar to the bike in our example above. The price may have come down by $100, but it's still the same bike with the same attributes. Intraday ticks in the stock or bond market don't change the value of a company's assets or its ability to generate free cash. A real opportunity arises when emotions drive price declines that aren't matched by a change in the fundamentals of the business. Distinguishing between price and value is arguably the most important part of our job.

Some investors understand this concept when valuing equities, but lose sight of it when talking about fixed income. Thinking about duration, interest rate hikes and quantitative tightening can present enough uncertainty to confuse even seasoned investors, but returning to first principles can help you distinguish the signal from the noise.

## Flight school

A bond is simply a loan whose value is derived by the borrower's ability to pay you back. Most of our bonds are issued by companies. It's our job to determine if that company has a high probability of paying us back and if the bond's yield is high enough to compensate us for that risk. If we lend money to a Canadian company, our primary focus is ensuring that they pay us back. Many things can change during the time of our investment, but if we buy a bond with a 5% coupon and the company pays us back at maturity, we will earn 5%. The original contract that we entered ensures this.

Over this time, the bond's price will change daily, but it's crucial to remember that if our credit work was correct and we get paid at maturity, the return of that investment will be 5%. Investors are best served to remind themselves of this when they're bombarded with comments regarding rate hikes and quantitative tightening. These factors affect the price of your investment, but the return won't change if the credit work proves true and you hold until maturity.

## Unexpected turbulence

While I think the topic that I just described is a timeless concept, it's especially timely in today's fixed income market. Many of our past commentaries warned that bond investors have become too complacent. Falling interest rates have lulled them into a sense of complacency where returns on their fixed income portfolios were assumed to be strong year-after-year. The trend has reversed (and it's done so jarringly), shocking some investors. The loss and the psychological wake-up call have focused a spotlight on fixed income at a crucial time. Do investors run for the exits because the safe part of their portfolio declined, or do they recognize that now is the time to focus and ensure that they're positioned to take advantage of the increased volatility?

Yields on investment-grade and high-yield bonds are up materially this year. This gets us excited. But wait, don't higher yields mean lower prices? How can we be cheerleading a negative return? We get excited because we haven't locked in that negative return – the bond's price has simply fallen. As long as we get our money back and nothing has changed our fundamental view of the business underlying the bond, we're actually better off. The reason is that the coupons and maturity payments our investments generate can now be re-invested at a more attractive level. I know that watching the value of a bond portfolio go down can be unpleasant, but the discomfort comes with superior investment prospects.

This might not be intuitive, so let's walk through two scenarios using the yield (3.6%) and duration (2.07 years) of the fixed income portion of the EdgePoint Global Growth & Income Portfolio. Scenario 1 assumes that there are no changes in yields over a five-year period. This means that an investor should expect to earn 3.6% annually over the next five years. Scenario 2 assumes an immediate increase in yields to 5.6% on the first day of investing, which would result in a decline of roughly -4.1% in the value of the investment. Most people aren't investing with a one-day time horizon. In the long run, the ability to re-invest coupon payments at a discount and maturities at a more attractive yield results in a superior return as shown in the following table.

**EdgePoint Global Growth & Income Portfolio duration: 2.07**

| Scenario 1: Portfolio yields stay at 3.6% | Day 1 | Year 1 | Year 2 | Year 3 | Year 4 | Year 5 |
|---|---|---|---|---|---|---|
| **Value of $100 investment** | 100 | 103.6 | 107.4 | 111.3 | 115.3 | 119.5 |
| **Total return since initial investment** | - | 3.60% | 7.40% | 11.30% | 15.30% | 19.50% |
| **Compounded annual growth rate** | | 3.60% | 3.60% | 3.60% | 3.60% | 3.60% |

| Scenario 2: Portfolio yields rise to 5.6% on day 1 | Day 1 | Year 1 | Year 2 | Year 3 | Year 4 | Year 5 |
|---|---|---|---|---|---|---|
| **Value of $100 investment** | 95.9 | 101.2 | 106.9 | 112.9 | 119.2 | 125.9 |
| **Total return since initial investment** | -4.10% | 1.20% | 6.90% | 12.90% | 19.20% | 25.90% |
| **Compounded annual growth rate** | | 1.20% | 3.40% | 4.10% | 4.50% | 4.70% |

As of March 31, 2022. The returns are for illustrative purposes only to show the effects of rising yields on a fixed-income portfolio. They are not indicative of future performance. 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. 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.

EdgePoint Global Growth & Income Portfolio, Series A
Annualized total return, net of fees, performance in C$ as at March 31, 2022
YTD: -4.51%; 1-year: 1.17%; 3-year: 3.71%; 5-year: 5.13%; 10-year: 9.13%; since inception (Nov. 17, 2008 to Mar. 31, 2022): 10.62%.

It doesn't feel good to buy a bond and see it fall in price. Bonds are supposed to be safe! But you should actually welcome the price decline because you're improving your long-term investment return prospects. The same principle applies to a portfolio. The ability to re-invest is dictated by your duration. All of our fixed income portfolios have a duration that's relatively low. That gives us the ability to play stronger defence and offence during a period of rising rates. Our relatively low duration helps to insulate the mark-to-market performance of our portfolio and the frequent principal payments at maturity allow us to invest in a more attractive environment. We positioned the Portfolios to be able to take advantage of the environment that we are now in.

## The importance of a flight plan

Our fixed income portfolios have gone through several periods of volatility and our investors are better off for it. While the drawdowns are uncomfortable to watch, they increase our ability to generate superior returns. The following chart highlights several key time periods for the fixed income segment of the EdgePoint Canadian Growth & Income Portfolio. The grey column shows the Portfolio's yield-to-maturity during the drawdown, followed by the subsequent returns in the next columns. These superior returns wouldn't have been attainable if we didn't experience periods of volatility. While it wasn't pleasant at the time, the volatility enabled us to achieve our primary goal of compounding your capital.

**EdgePoint Canadian Growth & Income Portfolio (fixed income securities) returns following the decline bottom**

| **Date*** (decline bottom) | **% decline** | **Yield-to-maturity** (start of decline) | **Returns following the decline bottom** | | | | | |
|---|---|---|---|---|---|---|---|---|
| | | | **3-month** | **6-month** | **1-year** | **3-year**** | **5-year**** | **10-year**** |
| **Dec. 30, 2008** | -4.41% | 7.03%† | 6.49% | 13.94% | 25.98% | 14.07% | 11.05% | 7.65% |
| **Jan. 20, 2016** | -5.20% | 3.35% | 4.52% | 8.13% | 12.03% | 6.74% | 6.66% | ? |
| **Apr. 6, 2020** | -7.62% | 4.25% | 7.33% | 11.74% | 19.32% | ? | ? | ? |

* First decline: Nov. 17, 2008 to Dec. 30, 2008. Second decline: Jul. 7, 2015 to Jan. 20, 2016. Third decline: Dec. 31, 2019 to Apr. 6, 2020.

** Annualized.

† Yield-to-maturity shown at decline bottom as the portfolio had just been launched and needed time to build positions.

Source: FactSet Research Systems Inc. As at March 31, 2022. These returns are shown for illustrative purposes only. They are not indicative of future performance or intended to represent returns of an actual fixed-income fund as they weren't investible. Returns are gross of fees, in local currency and approximations calculated based on end-of-day holdings data (actual trading prices not captured).

EdgePoint Canadian Growth & Income Portfolio, Series A
Annualized total return, net of fees, performance in C$ as at March 31, 2022
YTD: 1.55%; 1-year: 16.85%; 3-year: 11.05%; 5-year: 7.14%; 10-year: 8.08%; since inception (Nov. 17, 2008 to Mar. 31, 2022): 10.23%.

As mentioned, seeing the value of your investments decline isn't fun. It's human nature to avoid pain but all investors should remind themselves what true discomfort is – not having enough money for retirement. This long-term view should trump all other feelings, which should ease the short-term declines needed to avoid that worst-case scenario. You can centre yourself during these periods by thinking about your portfolio the same way we do, and revisiting its first principles:

- Can you explain the decline?
- Is it the result of a permanent loss of capital or is it a mark-to-market decline?
- Has the thesis changed on the underlying asset value or cash flow that would affect the borrower's ability to pay you back?
- Is the portfolio structured and managed to take advantage of this volatility and come out stronger?

These are important questions as some losses should be scrutinized. Locking in a loss because you were surprised with a default, government expropriation or faulty analysis is hard to overcome. Dig through the portfolio and determine if the loss is permanent or an opportunity.

The fixed income portfolios at EdgePoint include the EdgePoint Global and Canadian Growth & Income Portfolios, the Variable Income Portfolio[ii] and the Monthly Income Portfolio. We believe each one is well positioned to take advantage of this market environment. All Portfolios have a duration that's below their benchmark, allowing us to redeploy capital into a more attractive environment.[iii] This is a key differentiator of our Portfolios and was done purposefully. A portfolio with an index-like duration of eight years won't be able to capitalize to the same degree. They won't have the benefit of reinvesting chunky principal payments into the new environment, as a larger portion of their portfolio generally will not mature for many years. All of our Portfolios have short-dated maturities that we will re-invest to your benefit in more compelling opportunities.

## Ready for takeoff

Yields on investment-grade bonds have increased materially this year, which will benefit future returns. Our high-yield allocation started the year at an all-time low and has begun to increase as we take advantage of opportunities in both the primary and secondary markets. None of our Portfolios have suffered a permanent loss and we're excited about the opportunities that are beginning to come our way.

The first quarter of this year has surprised many investors. Rates have risen much faster than most anticipated and caused declines in fixed income portfolios. We believe EdgePoint Portfolios are well positioned to capitalize on the shock that many are feeling. Many investors will see declines in fixed income portfolios and allow their fear of loss to force them to sell their holdings. We want to buy from them.

Our Portfolios are structured and managed in a way so that we can buy from those succumbing to their fear. The long-term return prospects are better than they were at the beginning of the year. I encourage investors to look through the holdings of our fixed income portfolio. Do you see bond holdings issued by businesses you understand? Can you envision our proprietary insight? Do you see mark-to-market declines or permanent impairment? I think you will find confidence in a collection of solid businesses, an understandable investment approach and a portfolio that is well positioned to capitalize on today's volatility, so they can have the potential to soar in the future.

[i] Source: Coindesk.com. Bitcoin's all-time high was C$86,112.03 on November 8, 2021. As at March 31, 2022, it closed at C$45,655.75.

[ii] EdgePoint Variable Income Portfolio is only available via prospectus exemption to qualified investors. Please see the EdgePoint Variable Income Portfolio offering memorandum for additional details.

[iii] Duration versus the benchmark. 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 rate.

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Published April 19, 2022.