QV UPDATE
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A Negative Art

Investment legends Benjamin Graham and David Dodd famously referred to bond selection as a negative art in their book *Security Analysis*. They argue that as returns from interest income are fixed over the contract life of a bond, the primary objective of credit analysis is therefore to avoid the risk of capital loss. Bonds issued during good years may offer attractive yields, but can result in significant downside when the cycle unexpectedly turns. The high yield energy market is the most recent evidence of this. We believe a defensive posture fixated on minimizing risk will equate to a positive real rate of return over a long time horizon.

In the current setting of low government bond yields, corporate bonds offer attractive yield premiums (the yield differential between a corporate bond and its underlying government benchmark) over governments of equal maturity. At the end of April, a 10yr Canadian government bond yielded 1.5% vs a 10yr BBB corporate bond of 3.7% (credit spread of 2.2%). But with broadly elevated credit risk, investors need to be highly discriminating in their analysis to minimize the chances of negative returns in the future. With cheap capital in abundance, corporate managers have shown a higher appetite for debt to finance acquisitions, share repurchases and dividend growth. This rise in balance sheet leverage can be seen with many credit metrics returning to similar levels not seen since 2000. However, interest coverage ratios remain healthy as central banks stay highly accommodative with their low interest rate policies.

The emphasis we place on classic in-depth fundamental research helps us separate the strong credits from the weak and identify larger trends that we should avoid. Our team's preference for cash flow stability, sensible management teams, and strong business franchises help keep cyclical risks at bay, but even these credits can exhibit some deteriorating trends. Take the Canadian telecommunications sector for example, major operators (BCE, Rogers, and TELUS) have all been running with leverage ratios above their stated targets for a few consecutive years. And despite our favourable view on their quasi-regulated and oligopolistic industry, increasing competitive pressures and high capital intensity have led to stubbornly elevated leverage metrics. Furthermore, with revenue growth in the low single-digits at best, the longer term debt profile may likely remain elevated, especially with the next spectrum auction slated sometime in the next two years. We hold the 2yr to 5yr bonds of Bell Canada and Rogers, but remain cautious on the sector's longer term outlook.

Investing with a defensive mindset also requires a strong valuation discipline. One of the most prudent forms of defense is building a margin of safety in case our forecast is wrong. Our discipline in earning an attractive yield for the amount of accepted duration risk (a measure of bond price sensitivity to interest rate movements) led to our focus in short to mid-maturity corporate bonds. The corporates in our bond strategy earn a yield-to-maturity of 2.2% at a duration of 3.0 years versus the FTSE TMX Canada Universe Index's corporates that earn a yield of 2.7% at a duration of 6.2 years. Our lower relative duration helped buffer credit spread volatility experienced over the last twelve months. Only in the most recent months have we seen a strong rally in corporate bonds with higher quality sectors returning to their tighter credit spread levels of 2014. Our view is that the dramatic shift in sentiment is overly optimistic and that current corporate spreads provide an opportunity to upgrade credit quality in our strategies with minimal yield sacrifice.

We have been selectively paring back our corporate credits and emphasizing greater provincial exposure in our strategy, in turn foregoing marginal yield for higher liquidity and downside protection. While we remain overweight corporate bonds at 39% versus the benchmark at 28%, our corporates are instrumental in augmenting portfolio yield with half the price sensitivity to rate movements than the index. In this current risk taking environment, the amount of fortitude required to uphold a defensive stance is why we understand Graham and Dodd chose to use the word art and not science.