QV UPDATE

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Credit Considerations

The swift return of monetary policy accommodation from the U.S. Federal Reserve last year was a major theme that reverberated throughout all investment markets. In fact, the absurdly low interest rate environment over the past decade has had a profound effect across all assets – from stocks to real estate, even the Canadian corporate credit market has been no exception.

With Government of Canada bonds currently yielding less than the rate of inflation, many corporate managers have taken on a more aggressive approach to capital allocation. Whether for acquisitions, share buybacks, or growth projects, debt has been the preferred method to finance corporate endeavours. According to RBC, the total supply of the Canadian corporate bond market grew by an average of $104 billion/annum between 2017 to 2019, versus $75 billion/annum from 2005 to 2007, a 39% increase. Furthermore, of this annual growth in supply, investment grade non-financial corporate bonds grew by an average of $34 billion/annum in the last three years, an increase of 2.5x versus the pre-crisis level of $14 billion/annum.

This growth in new supply has meaningfully altered the composition of the Canadian bond market – namely the BBB rated market, which has grown in both size and breadth. Recall, a BBB credit rating is the lowest tier within the investment grade class (comprised of AAA at the top, followed by AA, A, and then BBB at the bottom). A rating any lower ventures into the high yield market which suggests a higher probability of default relative to investment grade. Over the past decade, the BBB market has nearly doubled as a percent of the overall Canadian corporate bond market and accounts for almost half of this market today. Furthermore, the bond market is much more diversified across corporate sectors than it ever has been.

The weight of BBB rated bonds in the QV Canadian Bond Strategy is currently twice that of the overall market. Naturally, one may ask whether our clients are overexposed to this market risk? Our response is no. Risk management is a key tenet in our investment philosophy and will always be so. It is not simply returns, but risk-adjusted returns that we seek for our clients over time.

The credit premiums (or credit spread) an investor earns when buying BBB rated bonds versus Government of Canada bonds account for a large percentage of the total all-in bond yield. The premiums vary by term and issuer, but, on average, can make up about 40% of the all-in yield. With Canada bonds yielding so little, these premiums add up over time and become a meaningful contributor to total return. Second, BBB rated bonds have historically exhibited similar levels of volatility to A rated bonds, yet offer a higher credit spread. The ratio of return-to-volatility for BBBs is more attractive and supports their higher exposure in the strategy relative to A rated credits. Lastly, at times we need to take a step back and consider the potential risks at the portfolio level instead of being fixated on just one sector. While the strategy holds a higher weight in corporates overall, our emphasis towards shorter maturities lowers the price sensitivity of our corporate portfolio to about 60% of the market – a tolerable level considering the additional yield offered.

As bottom-up investors our risk managed approach starts with security selection. We select issuers that meet or exceed the criteria of our seven tests and that have demonstrated a willingness to uphold credit health. Saputo is a good example of a quality business that used attractive interest rates to grow and diversify its global asset base. QV owns both its equity and credit in our Canadian equity and bond strategies, respectively. Its credit rating was recently downgraded to BBB as debt levels increased following some sizeable acquisitions. Its credit spreads widened as a result. Our view of the company as a leading global franchise run by a capable and well-aligned management team with an excellent long-term track record of profitable growth held firm, and our fixed income strategies increased their investment in Saputo bonds when the relative value improved. Management then continued to demonstrate a strong willingness to protect its credit when it used proceeds from a public equity offering to reduce balance sheet leverage. Management had not publicly raised equity in decades, and this was a welcome surprise.

Adhering to our security selection discipline while mitigating portfolio risks should help our clients navigate what could be a volatile yet stubbornly-low interest rate environment to come.

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