P: 1 (416) 274-9992
E: info@cortlandcredit.ca W: www.cortland credit.ca
3044 Bloor St., W., Suite 596, Toronto ON M8X 2Y8

The Fixed Income Dilemma

March 11, 2015
Authored by: Sean Rogister
CEO, Cortland Credit Group Inc.

The fixed income side of the investment spectrum is an asset class desperately in need of policy reform. Regulators, institutional governors, overseers of investment policy and self-regulatory organizations have all grown comfortable with directing conservative, risk averse investors to high grade bond strategies and have yet to address the fact that they are encouraging a strategy expected to have negative returns net of inflation, or possibly much worse if rates rise significantly from current low levels. An important alternative entails consideration of commercial lending strategies, private debt originated by specialists who not only focus on obligors but also on collateral they require to protect the value of their principal – these strategies do not have a government guarantee, but have much lower probability of loss than the sovereign issues currently proposed.

The fixed income asset class fills a need for contractually predictable income, wealth preservation and interest rate sensitivity. After 30 years of declining interest rates policy makers in regions with structurally established financial sectors have grown comfortable with the premise that sovereign debt allocations serve this set of objectives. Unfortunately they are wrong – nominal yields are too low now to deliver reasonable income while real yields for high grade securities under 10 years to maturity in most of the world's regimes are negative or virtually zero. The only real justification for making allocations to this asset class in the current rate environment is duration matching, an approach that can only be valuable if interest rates have a reasonable probability of declining.

The perspective that the fixed income asset class should be a cornerstone in the foundations of portfolio management without consideration of interest rate risk can be justified by the successes of the last 30 years, highlighted in Chart 1, below. The period covered by the declining trend in rates fully covers the career span of basically everyone working in the financial markets today so few managers today can relate to bonds being anything but a steady contributor to strong portfolio performance. It's no wonder that the leadership of the investment industry remains stalwart supporters of the ability of traditional bonds to add value in an investment strategy despite the mathematical constructs of a low yield environment to the contrary.

Source: Montly data from January, 1955 to January, 2015 provided by Bank of Canada.

Fixed income securities have several defining characteristics – principal protection, income, diversification, liquidity and sensitivity to interest rates being most prominent. Consideration of these characteristics should reflect a fundamental factor in making an investment allocation to the asset class - interest rates can't continue the path of the last 30 years – they have little room to fall further.

With the high probability that this 30 year trend is coming to an end, past performance of fixed income investment strategies are not a useful indication of future results. Continued justification for allocations to the asset class requires a compromise. For example, institutional investors with long term liabilities to pensioners and life insurers ensuring they have assets to meet expected mortality rates are among the investor categories who like to inhabit the long end of the yield curve. An exposure expected to lose money, either nominally or on an inflation adjusted basis for the next 5 to 10 years cannot be otherwise justified by prudent investment managers.

In the context of an overall portfolio strategy, prudent investors are now being tested to identify debt-based securities that add value in rising interest rate environments. This paper presents an alternative set of fixed income strategies with the potential to be a core asset class allocation that does just that.

In defining the features and characteristics of the asset class, it is important to remember that as fixed income investors we are at all times really just lenders. Borrowers of all stripes look at lenders the same way – they would prefer not to pay us back and would choose to do otherwise if not for the indenture we have over them. Fixed income securities represent a contractual obligation only – the lender is not, generally, brought into the decision processes of the corporation – including repayment of principal value at, as well as interest as a cost of capital until, maturity. From an investor's perspective, five critical features differentiate the risk profile of fixed income from other asset classes:

Principal Protection:

- Most public bonds do not carry a senior lien on the assets; instead principal is protected by a general obligation of the corporation to meet debt service obligations as laid out in the covenants of a bond

indenture; however, obligations to bondholders, in general, must be paid before other junior securities such as convertible and subordinated bonds, preferred shares and other types of equity
- Similar to equities we require regular updates on financial status of the borrower, but as lenders our focus is on the borrower's ability to service future contractual obligations and maintain assets
- Investors in debt securities have come to lean on 3rd parties, the rating agencies, to provide assessments of the probability of default and recovery in its event

Income
- Lenders require interest payments as a part of the cost of their capital
- We also discount to today the value of all future cash flows and the accretion to final value paid is part of our income
- We should always classify income as either "nominal" or "real", depending on whether it's adjusted for inflation; with the principal repaid at maturity being the largest cash flow on most debt securities, fixed income investors should always be concerned about their real returns – the purchasing power of their cash when it comes to them, after deducting inflation
- With core inflation at 2.2% in Canada and 10 year Government of Canada bonds yielding 1.6%, this objective is not being met with traditional securities

Diversification
- Perhaps a professional investor's most important portfolio management tool
- Best utilized by having a menu of strategies with a history of strong risk adjusted returns, selecting those appropriate to a specific strategy with low correlation to one another
- As demonstrated in Table 1 below using historical data, only traditional fixed income strategies can be a clear source of diversification versus equity allocations, given negative historical correlation between these asset classes; the stretch for better returns from high yield and emerging markets compromises the objective

Table 1

Correlation Matrix

(using 10 years of month-end total returns, as of Feb. 28, 2015)

	Total Return Index				
	US Treas Bonds	US Corp FI	US High Yield	EM Bonds	S&P 500
US Treas Bonds	1.00				
US Corp FI	0.48	1.00			
US High Yield	- 0.24	0.57	1.00		
EM Bonds	- 0.26	0.32	0.74	1.00	
S&P 500	- 0.29	0.25	0.72	0.92	1.00

Source: Bloomberg, Cortland.

Liquidity
- Deep secondary markets exist for high grade fixed income securities and provide the ability for investors to readily liquidate or rebalance their portfolios should the need arise

- Recently, central banks around the world have been buying their own debt securities for cash as a tool for injecting liquidity into the economy
- In most developed financial regimes sovereign bonds can be substituted for cash with minimal regulatory capital required

Interest rate sensitivity

- This characteristic of debt securities drives much of the institutional allocations to long bonds
- The premise is that declining discount rates lead to increasing liabilities to beneficiaries, for life insurance companies and pension plans, can be offset by gains in long duration bond holdings
- The challenge in considering this characteristic of traditional bonds is threefold:
    - Inevitably, fixed income holdings are not the sole asset class in the portfolio, so interest rate exposure is an allocation risk for the investment management team
    - With interest rates near all-time lows, their forecasts are highly skewed to the upside
    - Any real or perceived inflation risk under management responsibility is multiplied by holding traditional bonds
- Other than real rate bonds, the strategy with the strongest correlation to inflation is short term interest rate exposure, as the capital market sector most impacted by monetary policy

A New Perspective on Fixed Income – Asset-Backed Lending

At the end of 2013, the Canadian federal market debt was $668 billion[1]. At that year-end, marketable bonds in Canada of $426 billion[2]. Total business credit was a much larger number at $1.5 trillion[3]. While the underwriting of principal for corporate bonds is not backed by a sovereign entities ability to raise taxes, the mission critical assets of going concern corporations can, when supported by strong due diligence and covenants, represent excellent security. Traditional bonds, with a fixed coupon, bullet payment at maturity and a general obligation of the corporate borrower to meet debt service obligations, do not need to be the sole investment strategy in the fixed income asset class. The real discipline of investing in this asset class is that of lending money and this perspective changes the risk management approach. If we approach each debt security as a loan, we focus on the following objectives:

1. Make sure you're paid back through full collateral coverage and strong covenants, including ongoing maintenance obligations and reporting;
2. Earn a decent return above inflation for capital utilized;
3. Diversify to manage business risk; and
4. Establish capital withdrawal rights that match liquidity in the underlying assets; shorter liquidity availability will require either gates on redemption that match interim liquidity events in the assets or committed lines of credit (and thereby leveraging exposure of remaining investors).

Investment portfolios holding loans that fully meet these objectives will, in turn, have the following characteristics:

[1] Department of Finance, Canada Archived – Debt Management Report 2012-2013 – Part 1

[2] Bank of Canada Banking and Financial Statistics, February 2014, Suite E2, S56 Other Business Credit Bonds and Debentures.

[3] Bank of Canada Banking and Financial Statistics, February 2014, Suite E2, S57 Total Business Credit.

1. Through collateral protection, losses in bankruptcy are expected to be substantially reduced;
2. Yields will tend to be higher, as lenders focus on returns in excess of capital costs;
3. Sources of diversification are expanded to include types of collateral, alternative levels of security and term to maturity of assets; and
4. Liquidity will be appropriate for the assets.

Investment Management Implications:
Fees will rise compared to traditional investment strategies in public securities, due to higher on-going due diligence costs and monitoring of maintenance covenants. However, net returns will incorporate these fees into costs of capital, such that net returns will increase; in conjunction with reduced downside risk. Overall Sharpe ratios are expected to be higher, as well.

Prospectus Exempt
It should be noted, that securities that fully meet these objectives will tend to be private transactions or strategy specific investment funds. The securities will be issued under prospectus exemptions, requiring additional up-front due diligence on the part of investors.

Portfolio Management Implications
There are a number of challenges with this distribution strategy: documentation is by offering memorandum, which is a lower information standard than that of a prospectus; by definition, price discovery is weak for private transactions, impacting the ability to systematically compare these assets with public securities; there is no historical data on performance and volatility, making it difficult to identify a risk profile for the asset class; most of these securities have not been rated by a 3rd party, a somewhat independent assessment often relied upon by fixed income investors; also by definition, liquidity in general is reduced, and conservative investors often assume it matches the term to maturity of the security in question. The combination of these issues represents a significant challenge for investors considering allocations to asset-backed fixed income securities. The challenge is met with thorough due diligence.

Classifications of asset-backed debt strategies typically include auto equipment, airplane leasing and mortgages for longer duration strategies and supply chain finance (the primary strategy utilized by Cortland) and factoring for shorter maturity assets.

Long Maturity Asset-Backed Debt
In general, these lenders sit at the top of borrower's capital structure with a direct and segregated claim on specific assets of the corporation – this status in the capital structure must be confirmed through inter-creditor agreements with any pre-existing general security agreement. Commensurate with funding any asset without full amortization to maturity requires consideration of residual risk. Most real estate is financed with limited loan to value – asset specific market risk must be monitored for devaluation, to maintain ability to refinance at maturity. Leasing strategies must be assessed for the manager's ability to determine a conservative residual value for the assets at maturity of the lease as these assets become part of the lender's exposure at that time. Assets with floating rate reset structure may have money market rate exposure for evaluation of general interest rate sensitivity but must be represented to the full term of lender obligations for evaluation of liquidity and credit risk.

Short Maturity Asset Backed Debt

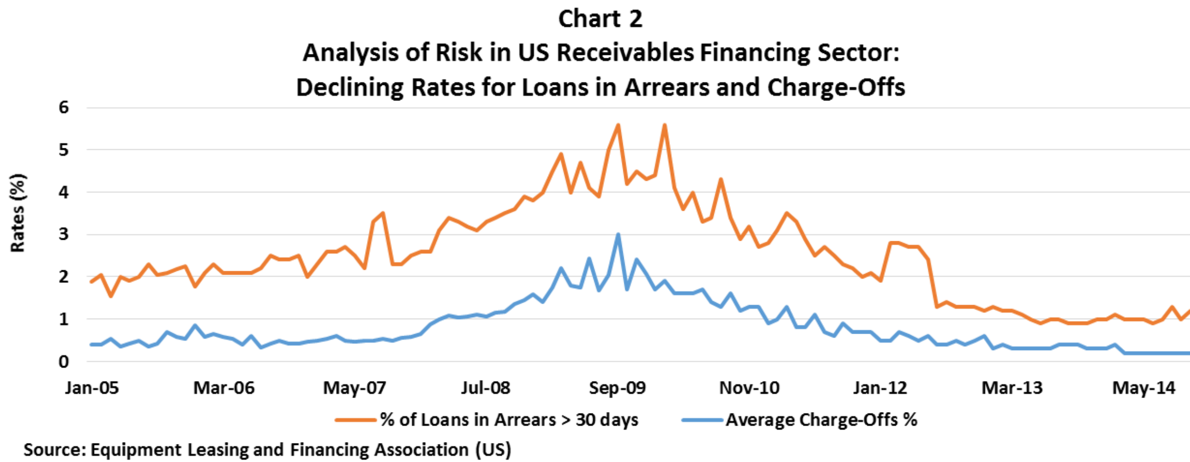
Vendor's Corporate Scale	Source of Capital	Collection strategy
Mid to large, established	Bank lines	Not applicable
Small to medium	Supply chain finance	Senior unsecured position with borrower, excess vendor collateral, recourse to vendor, lock box, may have credit insurance
Start-up/small	Factoring	Senior unsecured position with borrower, may have recourse to vendor, may have credit insurance

Short term debt securities are sourced from vendors of goods and services that are the mission critical capital and growth drive labour expenditures in the business to business supply chain. Most buyers, other than early stage or micro capitalized buyers, purchase on a delayed payment basis, with the obligation due, normally, in 30 to 90 days. Established suppliers, if they are mid- to large capitalized firms, have working capital financing arrangements with traditional banks – these lines of credit normally require a general security agreement (GSA) as collateral, allowing lenders to be repaid first in financial distress through cash, or sale of liquid assets such as receivables or inventories, and then less liquid assets such as property, plant, equipment.

Supply chain finance is a tool developed primarily in the last 2 decades for the purchase of pools of short term obligations of mid to large capitalized enterprises with good working capital credit histories, sourced from small to mid-sized vendors. Financiers provide capital by buying a significant percentage, often 50-70% of the vendor's receivables and purchase orders at a small discount to generate commercial lending rates, with multiple levels of credit enhancement. At the first level, the lender has a clear claim on the end customer, and is normally paid directly at maturity of the receivable contract. If payment is in arrears, the lenders preference is to look to other levels of recourse, before suing the end buyer – vendors are required to carry, and retain clear of encumbrances, excess collateral that is a material portion of the initial funding is segregated. In many cases credit insurance has been acquired as well. If the vendor does not replace the delinquent receivable, unless there's credit insurance, the financier takes the end buyer to court and sues the vendor for any losses. This strategy has no sector-wide loss history reporting available. My experience incorporates senior portfolio management reports, including those seen through board seats for institutional allocations to this sector, as well as data from my current role as CEO with an origination firm in the sector – over my firm's 18 month history we have no delinquent receivables remaining unreplaced. However, this is a very short term for data analysis – we encourage analysts to look to the structure and to develop appropriate due diligence processes to address this deficiency.

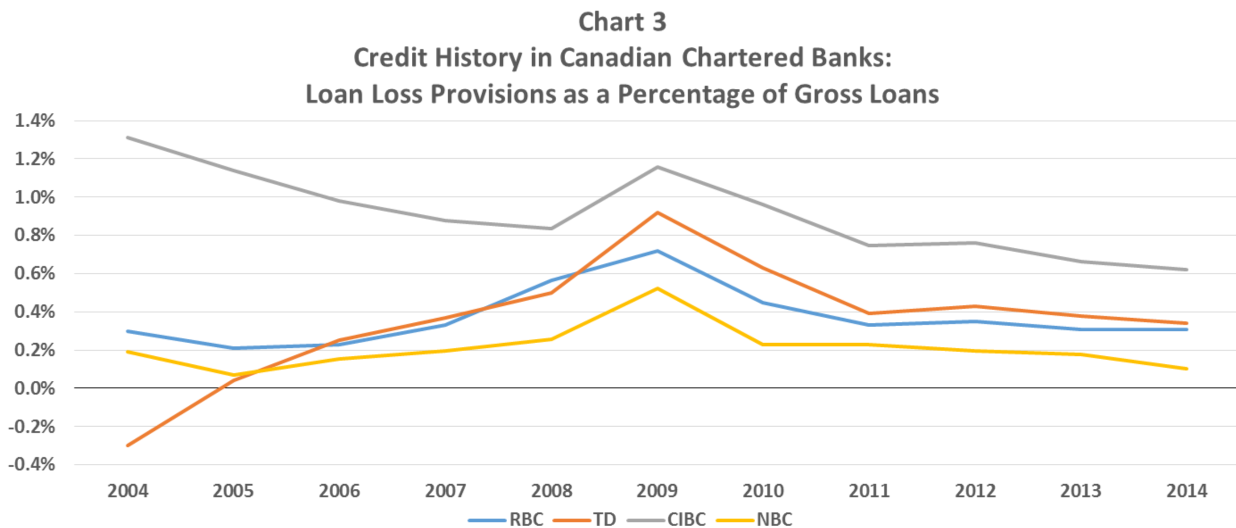
Factoring is a well-established financing strategy that has been utilized extensively as a source of working capital in many industries for centuries. The strategy has several characteristics that differentiate it from supply chain finance. Typically the financier purchases the receivables at a discount of 1.5 to 4% and focuses on minimizing obligor delinquencies to maintain positive returns. Factors typically look to provide credit enhancement through purchasing credit insurance, overcollateralization and vendor recourse. Historical data on performance in the factoring exposure category is limited by the fact that these are private transactions.

The Equipment Lease Finance Association in the US tracks losses net of recoveries, with the results captured in Chart 2 below:



Loss Experience of Large-Cap Market Participants

As noted above, general security agreements are a standard tool utilized by the major banks to collateralize commercial lending. Reported loan losses provide macro information on results of asset-backed lending across a public bank's platform. Chart 3 presents the loan loss provisions set aside by the major Canadian banks publishing historical data on this result of their lending activity over at least 10 years:



Conclusion:

The stewards of the capital markets are in a tenuous position – they are challenged to find alternatives to traditional fixed income strategies in a low rate environment. There do have choices. As a broad exposure category, corporate debt offers significantly more selection than basic general obligation corporate bonds. In particular this paper focuses on private collateralized lending strategies accessed through offering-memorandum based funds. These asset-backed debt portfolios carry dramatically improve principal

protection. By characterizing investors in debt securities as lenders we bring the portfolio allocation back to the first principals of commercial financing. Oversight of allocations continues to address key traits of the fixed income asset class as follows:

Principal protection
- A borrower's promise to pay is backed up by their key assets, those critical to the corporate mission

Income
- In contrast to public corporate bonds, which generally are priced with a yield represented by government yields plus a credit spread, commercial credit occurs when the interest rate is above the lender's cost of capital, often a higher benchmark

Diversification
- While historical time series to provide reliable risk profiles on the various sectors of asset-backed debt are inadequate, allocators have indicators of strong risk adjusted return ratios and available data

Liquidity
- While liquidity enhancements may be available through committed lines of credit, in general investors should target exposures that match their redemption rights with maturities in the assets making up the investment strategy

Interest rate sensitivity
- A key benefit of the asset-backed debt spectrum is the access to alternative strategies. Long-dated asset backed debt will respond to interest rates with negative correlation, in the same manner as traditional bonds. In marked contrast, investors in short-dated asset-backed debt can expect returns to rise with money market rates, monetary policy targets and inflation.

About the Author

Sean Rogister is CEO of Cortland Credit Group Inc., a portfolio manager registered in Ontario, operating an investment fund established in 2013 that focuses on supply chain finance, a category of the private debt markets noted for its short duration and multiple levels of collateral for principal protection, as its primary investment strategy. His background includes Adjunct Instructor of the Fixed Income Instruments and Markets course at Queen's University within the Master of Finance program and 10 years leading the fixed income asset class (including the Tactical Asset Allocation Department for the last year) at Ontario Teachers' Pension Plan Board, where he oversaw several allocations to managers of short-term asset-backed debt origination platforms. His education includes an MBA from U. of Toronto and the ICD.D designation from the Canadian Institute of Corporate Directors.

Cortland Credit Group Inc. ("Cortland Group") is an Exempt Market Dealer ("EMD"), Portfolio Manager ("PM") and Investment Fund Manager ("IFM") registered in the Province of Ontario. The information provided herein is for general information purposes and does not constitute solicitation for the purchase or sale of securities. The opinions expressed herein reflect those of the author, Sean Rogister, as at the date of publication and Cortland Group does not undertake to notify readers of any change in opinion. The data provided herein has been obtained from sources deemed to be credible, but cannot be guaranteed by Cortland Group.