Philip Doyle

00:05: Well, hello. Thanks to everyone for joining us. My name is Philip Doyle. I'm an Investment Counsellor in Burgundy's Private Client Group and I'm here today because I organize some of our activities with not-for-profit investors, such as endowments and foundations. This is part of an ongoing series of events aimed at foundations and endowments, but hopefully it'll also be of interest to individual investors and families.

Today, we'll be focusing on the challenges that face not-for-profit investors, particularly in investing in bonds in light of today's low interest rates and the coronavirus pandemic.

Let me introduce James Arnold, who's our panelist today. James manages Burgundy's Bond Fund and Investment Grade Corporate Bond Fund. James has been with Burgundy since 2017, but brings many years of experience managing bonds and also working in research and bond ratings. James' position prior to joining Burgundy was senior portfolio manager with the Canada Post Pension Plan. James is also a very effective multitasker, as demonstrated by the fact that he's able to manage our bond funds while also working from home with a toddler running around the place.

01:33: LET'S BREAK DOWN BOND

Let me turn it over to James to tell us a bit about the fixed income landscape and the major types of bonds that are available to a portfolio manager or to not-for-profit investors in building portfolios.

James Arnold

01:48: Thanks, Phil. So, particularly within Canada, there are sort of four primary types. The last two sort of fall within one bucket but I'll cover them as four as we go along here.

So the first is Government of Canada bonds. This is fairly straightforward. These are issued directly by the Government of Canada. They're the highest rated entity, AAA rated. They have the lowest yields due to them being the lowest risk. You can see this line here on the slide highlighting modified duration, that's really just sort of a fancy term for weighted term to maturity. So you can see here, the Government of Canada issues bonds that average with a six-and-a-half to seven-year maturity. They do issue from anywhere from three months right out to 50 years though. They issue bonds very consistently via auction, well-established process, and they're certainly the biggest bond issuer within our market.

Moving over one, provincial and municipal, this is also fairly straightforward. You can see the yield to maturity's a little bit higher than that on the Government of Canada bonds. There are two reasons for this, primarily is that there is a spread, so there is a differential between the yields on provincial and municipal bonds and the Government of Canada bonds,

which highlights the increased risk profile. And the other thing to note with provincial bonds is that they tend to actually issue them over longer terms, so they have a much more heavily weighted maturity towards the long end, which would be 30 years, hence the higher modified duration.

Within provincials, every province and territory now within Canada issues bonds as well as several municipalities. That would include the city of Toronto, city of Montreal, city of Vancouver, et cetera, as well as some of the smaller regions, like region of Peel, for example. Investors are probably most familiar hearing about Ontario and Quebec. They're very, very large issuers in our bond market and very large issuers globally, actually. There were some headlines a few years ago about Ontario being one of the largest sub-sovereign debt issuers in the world, and that remains the case today. Them and Quebec are a huge part of the Canadian bond market but also represent a fairly significant piece of international issuance as well, issuing primarily in the U.S., but also in some other international jurisdictions as well.

The next bucket that we're going to talk about is investment grade corporate bonds. You can see again here, a little bit higher yield to maturity. This is again due to the credit spread relative to the Government of Canada bonds. These are riskier bonds than provincial bonds. Therefore, they pay a higher yield. Modified duration sort of right in there around the seven-year point, so a lot of corporate issuers tend to issue sort of 10 years or under. It's been a more recent trend that they've been attracted to the long end and issue 30-year bonds, but still very heavily weighted towards the 10-year and under bucket.

Investment grade corporate bonds tend to be issued by fairly large, national, stable businesses. So think things like the major Canadian banks, our national telcos, like Bell Canada, Rogers, and regulated utilities. Think about Hydro One, for example. So these are all investment grade issuers within the Canadian bond market.

And the last bucket here is high yield. And you can see here, there's a noticeable jump in the yield to maturity at 5.59% there, and that really just highlights the more risky nature of this sector. There are a number of names for high yield. There's high yield speculative grade, junk, which is a term that we don't like to use all that often as it's not particularly forgiving. And you can see here that they tend to issue bonds that are much shorter dated as well, and this again really goes to the higher risk profile of these issuers. They tend to be smaller businesses, more regionally focused, exposed to more cyclical end markets, and they tend to carry higher debt loads as well, so just sort of generally more risky entities.

Some examples of these would be things like casinos, or in Canada, for

example, a fairly high-quality, high-yield issuer, but a high-yield issuer nonetheless, would be the regionally focused telecom companies in Quebec, the Videotrons and the Quebecor, as well as a significant number of energy names would issue in the high market. In fact, the Canadian high-yield market is somewhat dominated by energy names at the moment.

06:42: THE PANDEMIC'S EFFECT ON CREDIT MARKETS

Philip Doyle

06:45: So, shifting gears from the sectors as they stand today, maybe we could look at a little bit of history and how things have changed, both with the coronavirus pandemic, but also over the last few years. I think we have a slide coming up on interest rates, maybe we could start with that.

James Arnold

07:01: Right. And so you kind of mentioned how things have changed in the wake of the coronavirus pandemic, and the reality of it is, from a central bank perspective and from an interest rate perspective, the answer really is not actually that much. As you can see from this chart here, interest rates have been on a fairly downward trend since the early '90s. There have obviously been a few blips where they've jumped back up and whatnot, but the trend here is extremely clear that it's going down.

Central banks both in Canada and in the U.S. were trying to raise interest rates over the past couple of years, although faced many headwinds in doing so as the economy was not particularly stable when they attempted to do so. And what the coronavirus pandemic really did was just exacerbate this trend. It forced, back in February and March, central banks to take extremely quick action in terms of not just lowering policy rates, but also sort of throwing the kitchen sink, so to speak, at the economy, utilizing almost every tool that they have available to some degree, or at least expressing the willingness to utilize those tools to drive rates lower and stimulate the economy as best that they could from a monetary perspective.

And it's interesting to note that the central banks, both in Canada and the U.S., well, in Canada more so, actually, but in the U.S., they were actually able to deploy almost their entire playbook from the global financial crisis back in sort of 2008, 2009, 2010. They were able to deploy almost their entire playbook from that time period in a matter of weeks in an effort to support markets and shore up the economy and do what they could from a monetary perspective.

Philip Doyle

08:49: So that's been a continuous trend for a couple of decades now of base government rates going lower, but I guess not everything in the fixed income market has been going down on the yield front. We have had some forces pushing the other way, and I guess the next slide can illustrate those.

James Arnold

09:09: Yeah. So, this slide sort of highlights credit spreads and what they have done over a slightly more condensed timeframe than the previous slide, but nonetheless it's a pretty lengthy history that we can talk about here.

So just for everyone's benefit here, the bottom burgundy coloured line is investment grade credit spreads and the darker blue top line that shows a little bit more volatility is representative of high-yield spreads. And this is exactly what we would expect. As I mentioned, high-yield bonds tend to be a little bit more volatile, they're more exposed to cyclical markets, default rates are higher, and so we would expect in times of market volatility or risk-off markets to see spreads there move significantly more than we see in the investment grade market. And this is highlighted pretty clearly in this slide here.

And we can see the impact that we had back in February and March of this year, when the coronavirus pandemic really started to hit home in North America. And equity markets bottomed out around that time, obviously, and we also saw credit spreads get to the widest point that they've gotten really since the financial crisis back in '07 and '08. And it happened very quickly, obviously, as we can see from the chart here, and came back similarly quickly, largely due to a lot of that stimulus that I spoke about on the previous slide from the Federal Reserve in the U.S. and the Bank of Canada here in Canada.

What's interesting to note about this chart though, as you mentioned, is that yields from a government perspective have been trending pretty much one way, going down for 30-plus years. Whereas here, market forces tend to make these spreads a little bit more volatile and provide a little bit more opportunity for attractive entry points to build up perhaps a little bit of capital appreciation within a portfolio and to increase any incremental yield that an investor can capture over Government of Canada bonds.

11:12: WHY WE FOCUS ON A COMPANY'S BALANCE SHEET

James Arnold

11:14: Phil, you mentioned a few more sort of micro-level risks that we try and think of in the bond market. And so there are two that I would highlight there. One is liquidity within the marketplace. And so it's important to note here that bonds do not trade over an exchange the same way that equities do. So anytime I'm looking to buy or sell a bond, I essentially need to find somebody else willing to take the other side of that trade. And that's usually done through a dealer intermediary, that would be one of our larger banks here in Canada, or if it was a U.S. dollar bond, one of the larger banks in the United States.

What's happened in the last 10-plus years or so though is that regulations have reduced banks' ability to hold these types of securities on their own balance sheet, which means they're less likely to be a willing trade counterparty on these transactions. And so they actually need to go out and find, if I'm selling something because I think that it's a deteriorating credit, they need to be able to go out and find someone on the other side to actually buy that bond and want to invest in that bond probably for the opposite reason of what I'm thinking, and so that can be very challenging.

So liquidity in our market is significantly lower than it was before, and that can be a challenge, particularly when markets are volatile, which, coincidentally enough, is when liquidity seems to be at its most scarce. So the way that we think about mitigating this risk is really having a very good understanding of what we're buying and why we're buying it, and buying almost everything with the expectation that we're going to be forced to hold it to maturity, because the most challenging time to get out of a position is when it's going bad. So, we definitely take the liquidity risk in our portfolio very seriously and, as I said, we really try and focus on understanding what we own and being prepared to hold it to maturity when we buy it because oftentimes, we're not sure if we'll be able to trade it in the future or not.

The other one on a more micro level is defaults. And I mentioned earlier higher levels of debt. In the U.S., certainly, that's on corporate balance sheets. In Canada, it's on consumer balance sheets. But it doesn't really matter in the sense that within Canada, consumers that have more strained balance sheets are less likely to be out spending money in the economy, less likely to be buying goods and services from businesses. Whereas in the U.S., those businesses already have strained balance sheets.

And so as a result of these things, everyone is sort of at an increased risk of default, and that is particularly true these days as we sit here in the middle of a pandemic and varying regions and geographies are enacting varying degrees of economic shutdowns. And so every company that we own is at a greater risk of default than they were a year ago. I should say almost every company that we own would be at a greater risk of default than they were a year ago. And how we mitigate this is really just through in-depth levels of research.

I mentioned on the liquidity front that we try very hard to understand what we own. That's not just about the specific bond and the structure, but it has a lot to do with the company, the management team, the balance sheet and the specific structure of the bond as well. And so we spend the vast majority of our time researching these companies and getting comfortable with their balance sheets and with their businesses so that we're confident that they can pay back their debts under any economic situation. So we try

not to expose ourselves to companies that need sort of a best-case scenario within the economy to be able to pay back their debts.

Philip Doyle — **14:59:** So it's that notion of buying arks rather than trying to forecast storms.

James Arnold — **15:06:** Absolutely.

Philip Doyle — **15:08:** And what are some of the tools you use in doing that? When you look at an individual company, what are the characteristics that you're looking for and how do those overlap with maybe what people on the equity side might be looking for?

James Arnold — **15:22:** So there's a fair bit of overlap on the equity side, and we spend quite a bit of time talking to our equity colleagues about these things. There are a number of factors that we look at and they are different depending on the company and the industry that they operate in. Balance sheet strength, obviously, is paramount. That's number one. A very important one for me really though is management's attitude towards capital allocation.

And so what I mean by that is: Is a management team likely to go spend money on an acquisition that seems risky? Are they likely to borrow money for stock buybacks? Are they likely to pay special dividends to satisfy their equity holders at the expense of bond holders? Or do they have a track record of treating bond holders fairly? Do they have a track record of good capital allocation decisions? That's really one of the most important things for me because at the end of the day, you're entrusting that management team to act in the best interest of all stakeholders of which bond holders are one.

And so, obviously, industry dynamics, balance sheet strength, competitive environment, these are all very important things, but management attitude towards capital allocation is a big one for us.

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