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Navigating a Fixed Income Reversal of Fortune

How Derek Amery's dealing with a challenging bond market at 1832 Asset Management.

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Last year proved to be a strong one for fixed income as the COVID-19 pandemic and the resulting policy responses from central banks generated strong returns. The Canadian Fixed Income category returned 8.29%, while funds such as the 3-star silver-rated $235.5 million Dynamic Advantage Bond Fund Series F fared even better and returned 8.34%.

But 2021's been different year-to-date (August 31) with the category returning -2.15% compared to the Dynamic fund which is down -0.87%. Indeed, Derek Amery, who oversees the fund, anticipates that the challenges will continue to the year's end, and possibly beyond.

"In 2020, we saw yields on benchmark U.S. 10-year treasuries drop from 1.9% to 90 basis points [bps] by the end of the year or a full 100 bps. It's important to note that over short term horizons the main driver of fixed income returns is changes in yields and the resulting capital appreciation or depreciation that results," says Amery, vice-president and senior portfolio manager at Toronto-based 1832 Asset Management LP and a 27-year industry veteran who joined the firm in March 2019 after lengthy stints at HSBC Asset Management and TAL Global Asset Management.

"Similarly, we saw the yield on the Canadian universe bond market fell a full 100 bps, from 2.2% to 1.2%," Amery continues. "The broad bond universe had a sensitivity of eight years; so a 1% drop in bond yields generated a capital appreciation of 8%. That's what drove the high single-digit returns last year." Moreover, he notes that investment-grade bonds rallied as well. "A lot of things went right in fixed income markets last year."

Inflation and Growth Changed the Game

While not as volatile as 2020, this year has been a "tale of two halves, so far, especially in the rates market," says Amery, who earned an MA in economics from Dalhousie University in 1992 and a BA in economics from Queen's University in 1991. The first quarter saw a spike in bond yields in response to expectations of higher inflation and economic growth. "Expectations of additional fiscal stimulus in 2021, on top of what we saw in 2020, and the re-opening of economies thanks to vaccines fueled some large revisions upwards of inflation and growth expectations. With that, we saw the converse of what we saw in 2020. U.S. 10-year treasuries saw yields spike to 1.75%. That resulted in the worst quarterly returns in recent memory—and the Canadian market was down 5% in the first quarter."

Since then, Amery observes, yields have backed down again and many of the first-quarter losses were recouped. "The biggest driver has been a re-pricing downwards of expectations for growth and inflation," says Amery, noting that benchmark U.S. 10-year Treasury yields are now about 125 bps or up about 35 bps since the start of the year. "Obviously that's still a challenging environment for total returns. That's why we have seen negative returns so far this year."

Returns Rely on Transitory Rebound

Going forward, Amery believes that yields have to trend lower and so-called risk premiums must remain stable to generate better returns in 2021. "We have to see a continued moderation in growth, from the unsustainably very high levels in late 2020 and early 2021, [that were] on the back of the reopening of the economy. We also need to see a moderation in inflation rates. Both of those factors have to moderate from current levels, for yields to push even lower and thereby generate positive returns from here."

From a strategic viewpoint, Amery notes that the fund invests across a wide range of assets, from investment-grade corporate bonds to mortgages. "It's a one-stop North American focused fixed income solution. As such, it gives investors an opportunity to get access to this very diverse collection of fixed income assets in one fund. This more diversified approach has historically outperformed the broad Canadian bond market."

Over three and five years the fund returned an annualized 4.35% and 2.97%, respectively, compared to the Canadian Fixed Income category which averaged 4.28% and 2.34%.

"By using all these diverse asset types across North America, it allows the fund to leverage the entire 1832 Asset Management fixed income team," says Amery, citing the investment-grade credit group and specialized credit group, by way of example. In aggregate, the 27-person team manages $60 billion in assets. As lead manager of Dynamic Advantage Bond Fund, Amery is responsible for determining the allocation to each asset type and the level of interest-rate risk. Of note, the investment-grade bond exposure is obtained through the 1832 Asset Management Investment Grade Canadian Corporate Bond Pool (Series I), while the U.S. corporate bond weight is achieved through another fund-of-fund, 1832 Asset Management U.S. $ Investment Grade U.S. Corporate Bond Pool (Series I). The two pools offer greater liquidity than holding individual bonds, says Amery.

From a duration perspective, the fund is running at eight years, or a half year shorter than the FTSE Canada Universe Bond Index. "We have kept the interest-rate risk below that of the benchmark. But earlier in the year, we were 1.25 years shorter than the benchmark. Based on our outlook for interest rates we want to be conservatively positioned with respect to the amount of interest-rate risk we have in the portfolio. But we have actively managed the degree of exposure."

From a currency perspective, about 75% is held in Canadian dollar securities and 25% in U.S.-denominated assets, which is hedged back into the C$. "This year, the U.S. market has outperformed and it looks expensive. So we have kept our exposure [to U.S. assets] on the lower end of the range. We expect the Canadian market to recover some of its relative underperformance that we've seen this year."

Continuing Low Yields Favour Corporate Credit

Currently, Amery and his team are favouring corporate bonds. About 35% of the portfolio is held in investment-grade corporate bonds, 25% high-yield bonds, plus 16% real-return government bonds and 15% federal and provincial bonds. "Typically, the fund looks to allocate more of its 'risk budget' into credit strategies as opposed to interest rate strategies. We are looking more to asset allocation and security selection as ways to generate excess returns, as opposed to allocating to things like duration and yield curve strategies," says Amery.

"Historically, credit strategies generate better risk-adjusted returns over time," he adds. "That's why we have more of the portfolio in credit. As active managers, we are of the view that the fundamental and technical backdrop is going to continue to be constructive for credit. While valuations are somewhat expensive, they are likely to remain stable. On a tactical basis, we want to overweight corporate credit versus government bonds." The fund has a running yield of 2.65%, before fees, compared to 1.85% for the universe benchmark.

Amery says there are over 200 securities, although compliance rules prevent him from discussing individual holdings. But he does highlight the fact that his team further reduced their underweight high yield exposure at the start of the pandemic and then gradually targeted an overweight position. "The specialized credit group got more constructive on the COVID recovery sector and focused on travel and leisure. But this year, as those sectors have rallied significantly, we have cut our exposure."

Not Out of the Woods Yet

Looking at the balance of the year, Amery expects the challenging environment to continue. "If our base case is correct and we do see some modest upward pressure on yields, as we did in the first quarter, and bond yields end 2021 25-50 bps higher than where they are today, that would not be an environment with positive returns," Amery observes. "We are not at the point where the headwinds will subside. That being said, there are some drivers that could push yields lower—such as an increase in COVID infections, which could slow economic growth, a quick drop in inflation levels and less fiscal stimulus than is currently expected. But that's not our base case scenario. We expect a somewhat challenging environment---which could be partially offset by continued outperformance of the credit sector."