TD Greystone Asset Management

Incorporating Private Debt into Bond Portfolios

In the current low yield and low return environment, investors are searching for opportunities to enhance the performance and diversification of fixed income portfolios. As a result, many are turning towards private debt to achieve these goals.

Fixed income portfolio returns are largely driven by three factors: duration premium, credit premium and private premium. While duration and credit premiums can be accessed through traditional fixed income securities, such as government and corporate bonds, private premiums are attained by investing in private debt, which is generally not traded daily in public markets. Investors in private markets demand a higher premium for equal levels of risk given infrequent trading, complexity of access and lower levels of competing capital. This additional yield is the private debt premium over duration and credit.

Types of Private Debt

Private debt comes in several forms, including infrastructure debt, mezzanine debt, leveraged loans, direct corporate lending and real estate debt. Although each type provides investors with some exposure to the private premium, other yield factors also tend to be embedded in private debt premiums, resulting in exposure to duration and credit risk. By breaking down the premiums generated by different types of private debt, it is possible to understand the yield factors associated with each type and the respective risk and return profiles:

Figure 1: Harvesting Illiquidity Premiums

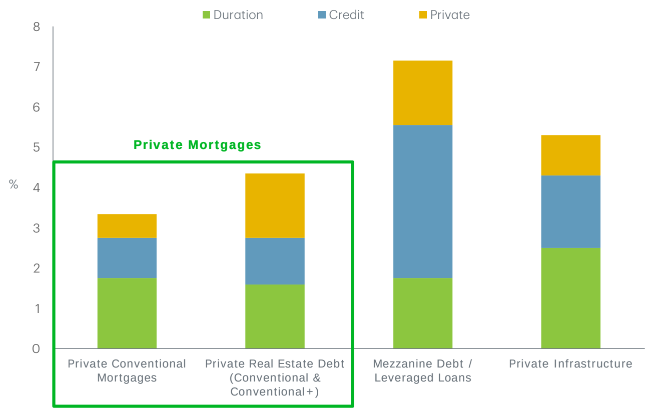
Type	Yield Factor	+Private Premium
Infrastructure Debt	Long Credit	✓
Mezzanine	Short Credit/ High Yield	✓
Direct Lending	Investment Grade/ High Yield	✓
Real Estate Debt	Investment Grade/ High Yield	✓

Source: TD Greystone Asset Management.

For instance, given the long-term nature of infrastructure assets, a significant component of the yield is achieved through duration and credit as opposed to the private premium. Given the importance of matching a plan's duration profile to its cash flow requirements, infrastructure debt tends to be compelling for defined benefit plans that typically have long-dated liabilities.

Mezzanine debt and leveraged loans also offer attractive yields; however, a significant component of the yield is achieved through lower quality (i.e. high yield) credit. Typically, this type of credit exposure can also be accessed through traditional high yield bonds, which generally provide a higher level of liquidity than private debt.

Figure 2: Building Yield Factors to Isolate Private Premium



Source: TD Greystone Asset Management. Indicative spreads based on recent market transactions for private spread. Duration Calculated based on 5-yr Canada yield for short and 30-Yr Canada for long duration. Credit premium based on investment grade and high yield bond spreads. Public premiums as at Dec 31, 2017.

The real estate debt market provides an interesting case study on the different levels of private premiums available within a single asset type. While many investors consider the private real estate debt market to consist of only private conventional mortgages, private real estate debt can in fact be divided into two components:

1. Private Conventional Mortgages
2. Private Conventional Plus Mortgages

Private Conventional Mortgages are typically longer-term loans with a first charge on a property that is occupied by a tenant base and is generating a stabilized income stream (i.e. office, retail, industrial and multi-unit residential). Private Conventional Plus Mortgages are loans on real estate at earlier stages of the real estate life cycle, before the property reaches stabilization. Conventional Plus loans generally include land, land servicing, construction and interim/bridge financing for lease-up periods. These types of loans are generally shorter term, floating rate loans with lower loan to value ratios and greater recourse to the borrower to reduce the risk profile.

The supply of capital for these shorter term loans tends to be lower than for Conventional loans, which allows lenders who participate in this space to command higher spreads. The underwriting process for Conventional Plus loans is more complex and requires a deeper understanding of the underlying real estate in order to ensure that risk-adjusted returns are being maximized.

Figure 3: Exploring the Commercial Mortgage Market

Conventional Plus | **Conventional**

Land/ Land Servicing

Short-term financing for the purchase or preparation of land prior to construction.

Underwriting criteria

- Long-term strategic plan in place for the development of the land
- Proper zoning credentials received by borrower
- Loan to value generally between 30% and 60%
- Additional covenants, such as full recourse, incorporated

Construction

Short-term financing for the construction phase of a development.

Underwriting criteria

- Construction budget verified by third party at several stages of the project
- Loan to value generally between 55% and 65%
- Funding is paid out in tranches to manage exposure to the loan
- Borrower capital required to align interests
- Additional covenants, such as full recourse, incorporated

Interim/ Bridge

Short-term financing prior to securing a long-term mortgage. Funds are generally used for the lease-up period.

Underwriting criteria

- Funding is paid out in tranches to ensure borrower meets leasing targets
- Loan to value generally between 60% and 75%
- Additional covenants, such as full recourse, incorporated

Term

Long-term financing on income-oriented real estate.

Underwriting criteria

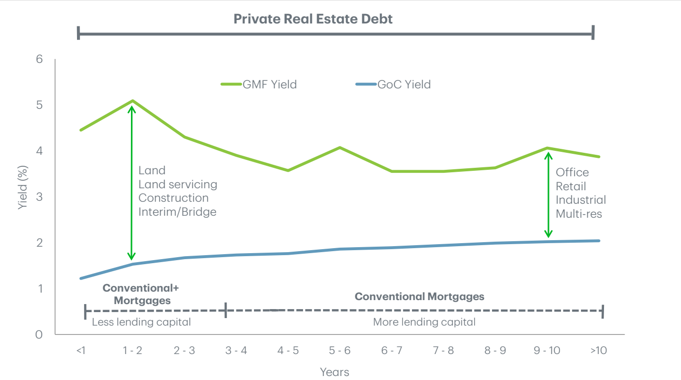
- Loan to value generally between 65% and 75%
- Property occupied by well-capitalized tenants
- Exit strategy built in to determine repayment or renewal upon maturity

Source: TD Greystone Asset Management.

Real estate debt strategies that access all segments of the real estate debt market and invest in different loan types (i.e. Conventional and Conventional Plus) can therefore provide an attractive yield to investors, which is in line with other types of private debt. This is reflected in Figure 4, which compares the yield curve of the Greystone Mortgage Fund ("GMF") to the Government of Canada ("GoC") yield curve.

Conventional Plus loans may be associated with a higher risk segment of the real estate debt market. However, comparing historical loss rate data of investment grade corporate bonds to our mortgage strategy reveals loss rates from credit events in line with investment grade corporate strategies. We believe that an ability to underwrite with strong covenants can result in high-quality exposure within Conventional Plus sectors.

Figure 4: Private Real Estate Debt Strategy



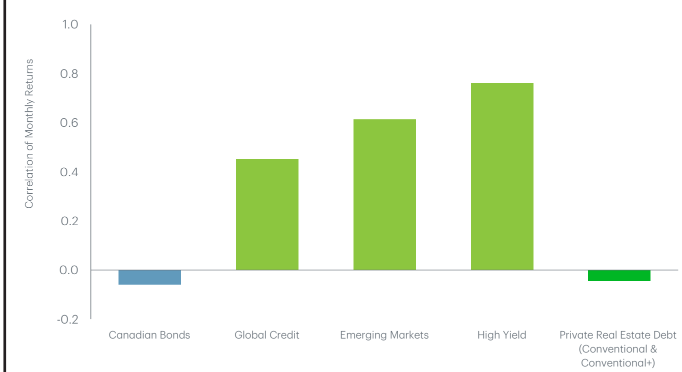
Source: TD Greystone Asset Management, FactSet. Mortgage commitments over the last 12 month period. As at Dec 31, 2017.

Core Plus Bond Strategies: Integrating Private Premiums with Traditional Fixed Income Portfolios

Core Plus Bond Strategies retain the FTSE TMX Canada Universe Bond Index while incorporating investment opportunities found outside the benchmark to enhance yield. These strategies hedge back all external risks, such as interest rate and currency, when opportunities are sourced globally. We believe that using private premiums as the lever for enhancing returns against a universe bond benchmark is a highly compelling opportunity when compared to using global or high yield bonds. In fact, by integrating private debt, such as commercial mortgages, into a fixed income portfolio, investors can enhance their yield experience across the maturity spectrum while maintaining a desired duration level (i.e. short-term, universe bonds or long-term bonds). The Greystone Bond Plus Fund, which is currently allocating a 25% weight to private real estate debt through the Greystone Mortgage Fund, has generated a 50 basis point yield pick up relative to Greystone's Core Fixed Income Strategy since its inception in July 2014.

In addition, while traditional higher yielding fixed income assets that are typically used in Core Plus Strategies (i.e. high yield bonds, global bonds and emerging market debt) tend to have a positive correlation to equity returns, private debt tends to be negatively correlated to equities, thereby enhancing the diversification and reducing the volatility of a balanced portfolio.

Figure 5: Diversification Benefit through Private Premiums



Source: FTSE TMX Universe Bond Index, Barclays Global Aggregate Corporates, Barclays Emerging Market USD, Barclays Global Corporate High Yield. Correlation of monthly returns to MSCI World (USD Hedged) from Sep 30, 2007 to Dec 31, 2017.

Summary

Private debt continues to offer a compelling source of risk-adjusted returns. Private premiums tend to be less correlated with traditional public market securities and integrating them into a traditional fixed income portfolio can enhance the overall yield premium across a desired duration profile.

For more information on how to incorporate private debt into a fixed income portfolio, please contact:

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