TD Greystone Asset Management

Adding Stable Yield to Fixed Income Portfolios

CIO *View*Point

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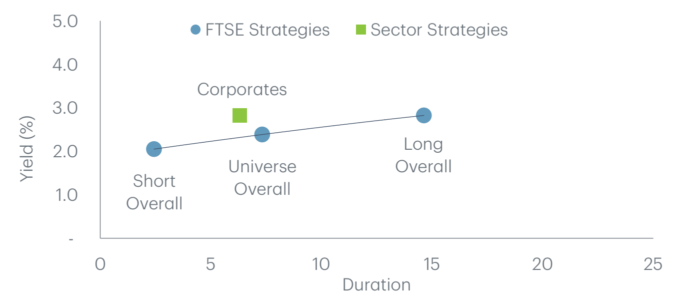
At TD Greystone Asset Management, we pride ourselves on multi-asset capabilities that help clients achieve their investment objectives through different investment solutions. Given the low interest rate environment, we have been working with clients to enhance their fixed income portfolio yield in a riskconscious manner. Below we highlight stable yield opportunities that we believe can be harvested by institutional investors.

Background

There are two primary drivers of yield enhancement to fixed income investors, the term (or duration) of a fixed income investment and the credit quality. Longer term and lower credit quality investments generally provide for a higher yield. In Figure 1 we show how investors receive higher yield as they move out the maturity spectrum of Canadian investment grade bond strategies. We can also see the higher yield in corporate bond strategies that have greater credit exposure.

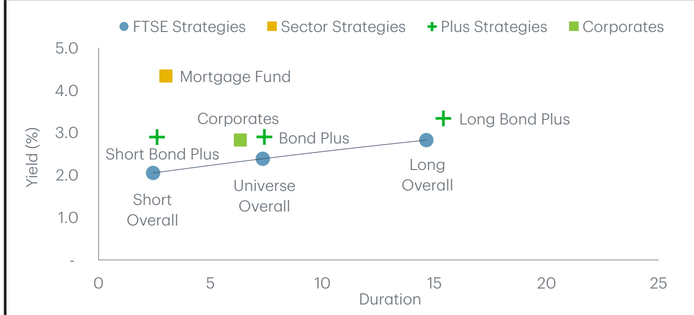
Figure 1: Yield vs Duration in Canadian Fixed Income



Source: Greystone Canadian Short Bond Fund, Greystone Canadian Fixed Income Fund, Greystone Long Bond Fund. As at Mar 31, 2019.

There is a third premium in addition to term and credit quality that is available to investors, the private debt premium. In this note, we will highlight what we believe is a strong case for seeking "Plus" strategies that use private debt as a lever to enhance yield. In Figure 2, we can see how integrating private debt can improve the yield profile of a portfolio given its duration objective.

Figure 2: Yield vs Duration with Private Debt



Source: Greystone Canadian Short Bond Fund, Greystone Canadian Fixed Income Fund, Greystone Long Bond Fund, Greystone Mortgage Fund, Greystone Short Bond Plus Fund, Greystone Bond Plus Fund, Greystone Long Bond Plus Fund. As at Mar 31, 2019.

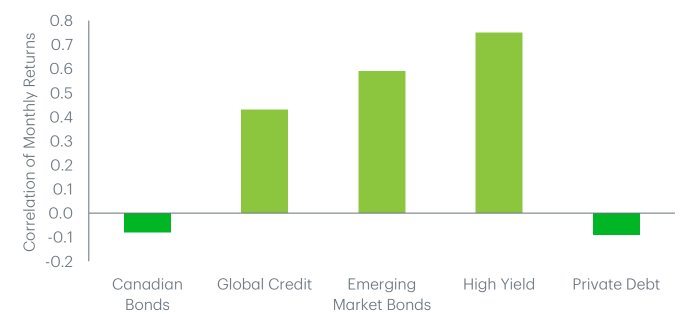
Benefits of Private Debt over Global Credit Sectors

We believe that there is a diversification fallacy when it comes to global fixed income sectors found in traditional core plus strategies. While there are diversification benefits found in global equities we do not believe the same holds for fixed income. Traditional Core Plus bond investments have provided additional credit exposure through a global basket of credit opportunities, including but not limited to global high yield, global investment grade credit and emerging market bonds.

Global credit sectors largely provide a yield pickup through different forms of credit risk. While there is potential diversification within bonds, the high correlation of global credit sectors to equities indicates the total portfolio will likely face higher volatility.

Conversely, private debt tends to exhibit a lower correlation to public equities if sourced through high quality investments (see Figure 3).

Figure 3: Correlation to Equities of Fixed Income Sectors



Source: FTSE Universe Bond Index, Barclays Global Aggregate Corporates, Barclays Emerging Market USD, Barclays Global Corporate High Yield, Greystone Mortgage Fund. Correlation of monthly returns to MSCI World (USD Hedged) from Sep 30, 2007 to Dec 31, 2018.

Figure 4 analyzes the correlation of traditional core plus value added to global equities. We then show the correlation of a "Plus" strategy that utilizes private debt (Bond Plus) as the yield enhancement. We can see that the value added is less geared to equity markets when utilizing private debt versus core plus strategies.

Figure 4: Ten-year Correlation of Value Added to Equity Markets

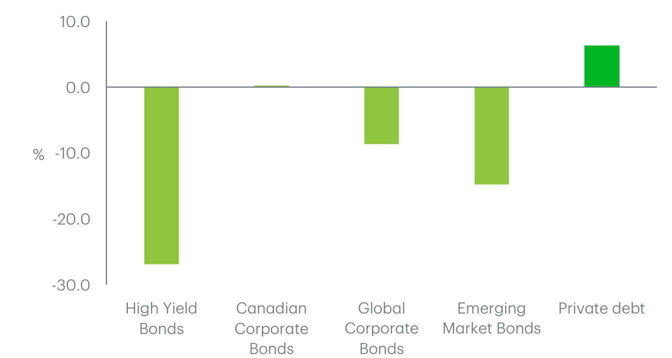
Public Core Plus Value-add	0.68
Private Core Plus Value-add	-0.18

Source: Bloomberg L.P., eVestment Alliance, LLC, TD Greystone Asset Management, Morningstar Inc. Correlation of value-add to MSCI World (Hedged).
As of Dec 31, 2018. TD Greystone Asset Management. For illustrative purposes only. Information related to claims made are based on backtested performance data (simulations). Backtested performance is hypothetical (it does not reflect trading in actual accounts) and is provided for informational purposes to indicate historical performance had the portfolio(s) been available over the relevant period. Hypothetical data is speculative in nature and based on assumptions. It can be expected that some or all of the assumptions underlying the hypothetical illustrations will vary from actual results. No representation is made that the actual returns will be consistent with those described herein.

Tactical Opportunity

From a tactical perspective, the premium (or spread) investors can harvest by investing in domestic and global credit has been declining over recent years. This has been a positive total return development for investors as many active strategies benefit by having more corporate exposure than the FTSE Canada Universe Bond Index. Conversely, private asset classes tend to exhibit a lower correlation to public markets and may provide more defensive exposure in times of financial distress (see Figure 5).

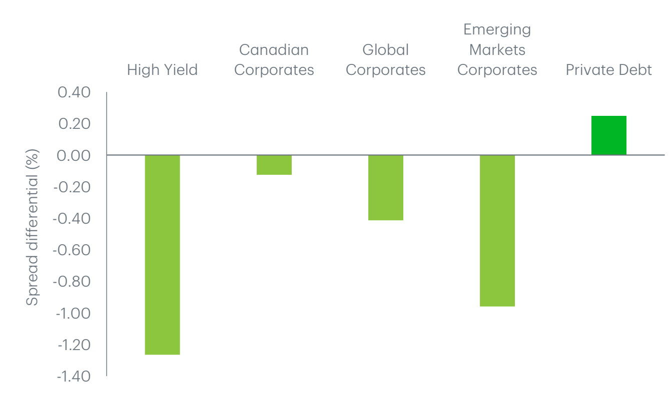
Figure 5: Total Returns in 2008 For Fixed Income Sectors



Source: Barclays Global High Yield Index, FTSE Canadian All Corporate Bond Index, Barclays Global Aggregate Corporate Index, Barclays EM Aggregate Bond Index, Greystone Mortgage Fund.

With the premiums on global credit sectors falling to postcrisis lows, we believe investors are at an inflection point due to lower expected returns going forward and risk towards a sell-off in global credit if and when the business cycle ends. We believe opportunities to harvest premiums still exist but investors need to look outside of public markets, which we believe are increasingly expensive from a valuation perspective, as shown in Figure 6 below.

Figure 6: Relative Value of Credit Sectors vs Post-Crisis Average



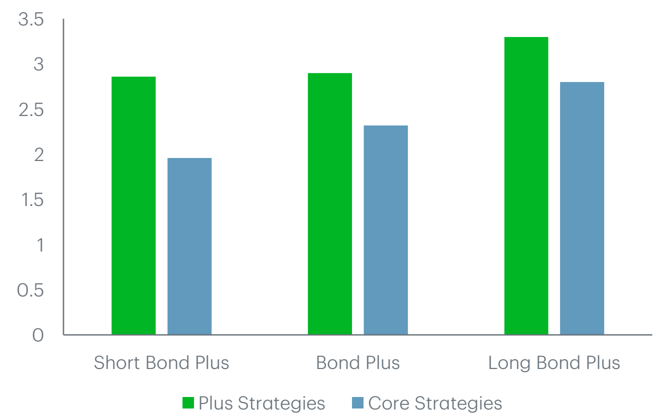
Source: December 2008 to March 31 2019 – Barclays Global High Yield Index, FTSE Canada All Corporate Bond Index, Barclays Global Aggregate Corporate Index, Barclays EM Aggregate Bond Index, Greystone Mortgage Fund. Spreads for universe bond sectors represent yield over similar duration government bonds.

Harvesting Private Debt

As a multi-asset solutions provider, we have worked with clients to integrate private debt into their existing fixed income programs. We have combined private debt into fixed income programs ranging from a duration of 0.5 to over 10 years, driving yield pickup of 50 bps to 100 bps over public bond benchmarks.

Figure 7 reveals the yield to duration enhancement available with private debt strategies integrated into fixed income portfolios (denoted with plus strategies in green and core strategies in blue). This is similar to what was revealed in Figure 2.

Figure 7:
Enhancing Yield Across FI Duration Profiles



Source: FTSE Cda 91 Day T-Bill, FTSE Cda Short Term Overall, FTSE Cda Universe, modelled liability matching portfolio, TD Greystone Asset Management.
As at March 31, 2019.

At their heart, private debt strategies encompass direct lending between a private investor who underwrites the loan and borrower. Private debt strategies can take many different forms with variability in terms, pricing, characteristics, covenants, borrowers and collateral.

We have been underwriting private debt in Canadian commercial real estate since 1988 through our Greystone Mortgage Fund. The fund reaches across multiple sectors of direct real estate to provide a yield of 4.3% as of March 31, 2019. We believe this private premium is attractive on a risk-adjusted basis versus other potential sources of yield enhancement.

We welcome the opportunity to discuss with you how TD Greystone Asset Management can help improve the yield profile of your fixed income portfolios through the integration of private debt premiums.

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