Canadian Family Offices

A fixed-income credit fund, without interest rate exposure, can buoy a portfolio

These funds provide a compelling yet defensive investment now, along with potential outperformance later as the economy improves, writes Kevin Foley

Kevin Foley for Canadian Family Offices

Published Jul 28, 2023 • 4 minute read

Many individual, family and institutional portfolios have exposure to credit, although only some choose it as a distinct asset class or consider how they should best establish credit exposure within their fixed-income investments.

Investing in bonds, often referred to as fixed income, includes an interest rate exposure and a credit spread exposure. It makes sense to consider the two exposures separately, since they are each major factors that move independently of each other, and because investing in each requires specific considerations and skill sets.

Credit can mean many things. In this context it is an investment in the bonds of a blue chip Canadian corporation. When corporations want to borrow money they issue a bond in the public bond markets. The company's cost for that bond, known as the "coupon," is made up of the yield of a similar term government bond plus a credit spread, which reflects the credit worthiness of the corporate borrower. The government yield reflects the risk free rate for that tenor, such as five years at 4 per cent, and a good quality company might need to pay a 1.5-per-cent credit spread, making the five-year corporate bond coupon 5.5 per cent.

Further, interest rate exposure has produced poor returns in the last few years, while credit has outperformed. Some credit funds have produced returns greater than 10 per cent in the last year, and have produced better return and risk-adjusted return than traditional fixed income for most of a decade.

This is not to say that you should eliminate all interest rate exposure, often referred to as duration. Rather it's a reminder to:

1. Choose your desired duration and credit investments separately.
2. Recognize that price changes in the two asset classes happen for different reasons, at different times.
3. Keep in mind that expertise in interest rate investing and credit investing are distinct skill sets, each requiring expertise.

Interest rates have been rising, but one option is fixed-income investing without rates

You can invest in high quality fixed income and then separate – or bifurcate – the interest rate exposure to isolate your credit spread exposure.

This is particularly poignant in the current environment of rising interest rates, while optimizing your desired credit exposure is important in all environments. Rising rates have produced surprising losses for fixed-income investors, and rates are expected to continue to rise. Credit, on the other hand, has proven to produce impressive returns, including positive returns in months when fixed income generally loses money.

Some credit fund managers are set up to efficiently eliminate interest rate exposure. One straightforward way to do that is to sell-short a government bond of the same tenor as the corporate bond purchased.

At YTM Capital, a Canadian asset manager dedicated to credit, we like the recent, current and future opportunities in credit. In fact, we foresee an exceptional opportunity in credit over the next 24 to 36 months. In general, we focus on short-term, public, investment-grade Canadian corporate bonds and eliminate the interest rate risk, thereby isolating the corporate credit spread.

Investment-grade credit spreads are meaningfully cheaper than their historical average, reflecting the likelihood of a coming recession. We believe that credit spreads have already built in more pessimism than many asset classes, having sat out most of the recent market rally. Because of that we believe that credit is set up to perform better than many other asset classes, even in an economic downturn, with protection built in via the buffer created by the fund's running yield, along with its historically low price volatility.

Investing in fixed income is often optimized through a proven portfolio manager. That manager will have the tools, skill set, experience and market access that most investors don't have. The better managers have integrated big data and advanced algorithms into an active trading strategy to effectively invest in a diversified portfolio of high-quality Canadian corporate bonds, while eliminating the interest rate risk.

Consider bifurcating your fixed income investments with a qualified credit investment partner. High-quality credit spreads probably already reflect at least a modest recession, providing a compelling yet defensive current investment along with a potential near-term opportunity for outsized gains as the economy resets its footing.

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