Ewing Morris Perspectives:

A New Take on Fixed Income

By Randy Steuart
January 2, 2018
Toronto, Canada

MARKETS LOOK EXPENSIVE

In trying to make thoughtful asset allocation decisions, many investors see both the fixed income and equity markets as currently overpriced and unattractive. The historical record certainly supports this idea. Bond yields are near the bottom of their 150-year range and stocks have surged to levels that clearly imply weak long-term return expectations. This issue is compounded by the fact that the highest quality bonds (i.e. investment grade; fig. 1) and stocks (i.e. S&P 500; fig. 2) are some of the most expensive components of the broad markets. Valuations are not comforting.

Fig. 1 - Fixed Income Markets Historically Expensive

Source: Yale Economics (Robert Shiller), 2017.

Fig. 2 - Equity Markets Historically Expensive

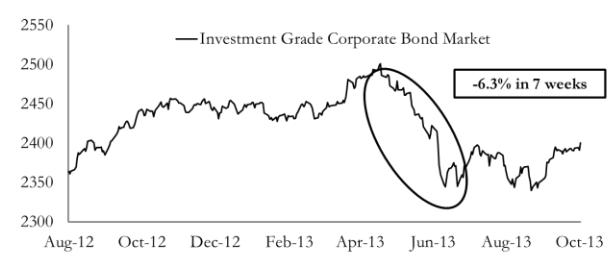
Source: Bloomberg, 2017.

Asset classes that have historically been safe harbors amidst market storms could now be the most dangerous places to hide. It is no surprise that prudent investors are anxious in this current market context.

In the past, investors have been, at worst, cushioned or at best, rewarded by inaction. Falling interest rates have been a boon for almost all asset classes. Today, however, **the consequences of inaction are real**. As an example, in both the 2013 'taper tantrum' (fig. 3) and the recent U.S. election season (fig. 4), investment grade bond investors witnessed meaningful declines in investment value. In short periods of time, investors lost years of interest income.

Relying on old assumptions regarding traditional fixed income's ability to preserve capital is no longer adequate. Treasuries and investment grade corporate bonds are now potentially at high-risk should we enter a fast-rising interest rate environment. Therefore, a thoughtful approach to capital preservation demands new, alternative perspectives.

Fig. 3 - Taper Tantrum



Source: Bloomberg, ICE BAML USD Corporate Index, 2017.

Fig. 4 - US Election Season

Source: Bloomberg, 2017.

A NEW TAKE ON FIXED INCOME

1) The "Spectrum" Perspective

The investment opportunity set available in markets exists as a risk-reward continuum, where the expected returns are assumed to be commensurate with the risk undertaken. However, there are circumstances where the risk-reward equilibrium become 'dislocated' and some areas of the capital markets offer exceptional risk-reward opportunities relative to other asset classes. For example, in 2009, the U.S. high yield bond market returned 58%, more than doubling its small cap equity counterpart, the Russell 2000, which returned 27%.

This concept is also applicable for identifying risk-reward opportunities within the fixed income asset class, where we can compare the risks and rewards of investment grade versus high yield, Canada vs U.S., short-term vs long-term, etc. Today, we are seeing exceptional value in the intersection of smaller, Canadian Dollar denominated, shorter-term high yield bonds and debentures of healthy credits. We have constructed the Flexible Fixed Income Fund's portfolio to earn returns safely from these areas.

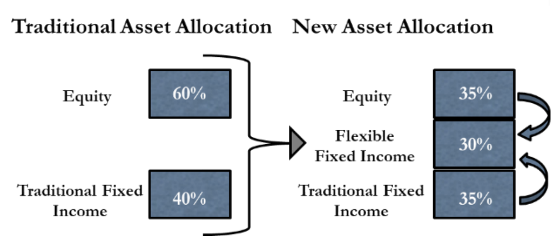
As noted below, it is possible to construct a portfolio with shorter duration, less volatility and higher yield than traditional fixed income or large cap equities (fig. 5). We are confident that a flexible approach to investing in the North American credit market will outperform on a risk-adjusted basis.

Fig. 5 - Asset Allocation

	Risk		Reward		
Allocation	Duration	Volatility Since Inception	Since Inception	Current Valuation	Future
Traditional Fixed Income	5-8	3.3	3.8%	2.8%	?
Equity	15-20	5.6	16.9%	5%	?
Flexible Fixed Income	3	2.6	11.7%	6.5%	?

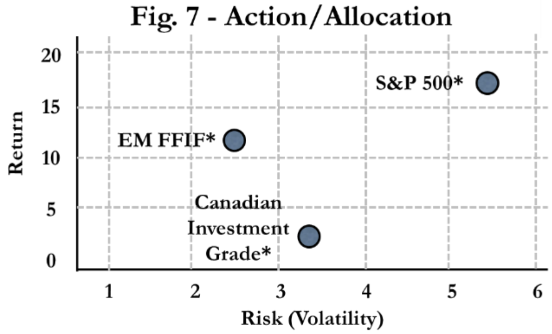
We recommend investors consider (and actively debate) rotating out of long-duration fixed income <u>and</u> equities into alternative fixed income strategies that are positioned to deliver mid-high single digit returns with less expected risk (fig. 6).

Fig. 6 - Action



Over time, we think the pockets of value we have identified in fixed income will provide a superior risk-adjusted return than what can be offered from a traditional mix of debt and equity investments (fig. 7).

Fig. 7 - Action/Allocation



*Since Ewing Morris Flexible Fixed Income Fund inception.

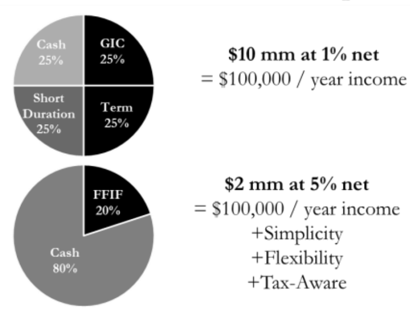
2) A New Take on Cash

A conversation that concludes with everything is expensive should be followed by a conversation challenging conventional customs of cash management. Most strategic asset allocations have some allocation to cash and short-term investments – 5% is not uncommon. This cash is typically used for operating capital or as 'dry powder' for opportunistic investments. Given most short-term rates are around 1%, the allocator would expect $100,000 annually from a $10mm investment.

We think there is a better way to invest cash than the short-term rate in the above example.

Our "new take on cash" solution is a 'barbell' approach inside the short duration fixed income space. Using the same $10mm example, the allocator could earn the same $100,000 by owning $2mm in the best-value areas of fixed income, which earns closer to 5%, with strong confidence in capital preservation over a one-year period. The approach has the benefit of generating the desired income while also leaving $8 mm of liquid capital available for opportunistic investments or operating requirements (fig. 8). The value of liquid capital will prove to be underestimated as markets become more expensive and inevitably sell off.

Fig. 8 - Traditional vs. New Perspective: Cash



CONCLUSION

Everything is expensive, and no one knows what to do. We think it makes sense to reallocate part of both traditional fixed income and equity mandates into fixed income strategies that can access the narrow segments of public fixed income markets. This approach presents good value while controlling (i.e. hedging) for risks like interest rates. By investing in the Flexible Fixed Income Fund, you increase the defensive nature of your portfolio while also earning higher income than traditional cash or cash-equivalent allocations.

ABOUT EWING MORRIS

Ewing Morris & Co. Investment Partners Ltd. is a value driven Canadian boutique investment firm established in September 2011 by John Ewing and Darcy Morris. Our aim is to achieve preservation and growth of capital for our limited partners by focusing on inefficient markets. We do this by relying on fundamental analysis, high conviction and the use of flexible capital. We manage two distinct strategies with a focus on North American small-capitalization companies and high yield bonds. We manage investments for individuals as well as charitable organizations, institutions and corporations.

CONTACT INFORMATION

Ewing Morris & Co. Investment Partners Ltd.
1407 Yonge St., Suite 500
Toronto, ON M4T 1Y7
Canada
416.640.2791