# Reduce Portfolio Risk & Discover Value in a Little-Known Area of the High Yield Bond Market

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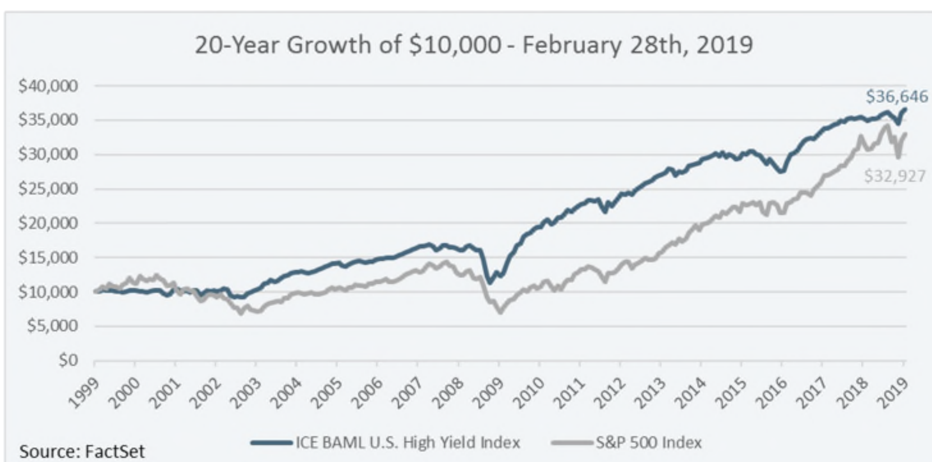
**The Holy Grail?**

Any investment professional can tell you about the "holy grail" of investing – an investment with great return potential and no risk. Unfortunately, as the saying goes, there are no free lunches. With the S&P 500 Index finishing 2018 with its second worst quarterly return since 2008 and the subsequent rebound to start 2019, investors may be searching for an investment substitute for stocks that reduces downside volatility and maintains upside potential.

**Risk Adjustment with High Yield**

In today's low-yield environment, the term high-yield-bond can seem like an oxymoron and can be equally confusing for investors trying to fit them into their asset allocation. In the traditional paradigm of asset allocation, stocks = growth, and bonds = safety; high yield bonds can be a challenge because they are generally not seen to have the safety characteristics of traditional bonds, nor the growth characteristics of stocks.




Examining data over the past 20-years, the ICE BAML U.S. High Yield Index produced better risk-adjusted returns compared to the S&P 500 Index, returning 6.7% and 6.1%, respectively, on an annualized total return basis, as of February 28th, 2019. Furthermore, the ICE BAML U.S. High Yield Index exhibited approximately 40% less volatility than the S&P 500 Index, and in the past five calendar years when the S&P 500 Index was negative, the average outperformance of the ICE BAML U.S. High Yield Index in those years was approximately 1100bps (11%)!

## Spotting Idiosyncrasies

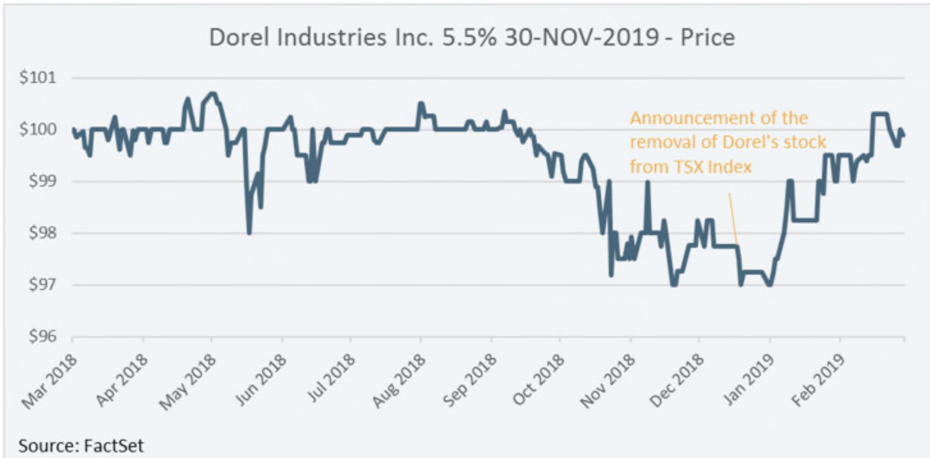
Investors looking for broad high yield exposure can find it through different investment vehicles including passive mutual funds and ETFs that seek to track the performance of indices such as the ICE BAML U.S. High Yield Index. However additional value can be achieved by identifying unique, or "idiosyncratic", opportunities not typically captured by passive indices and have the potential to produce above average, non-correlated returns compared to the rest of the high yield market. While there isn't an Investopedia definition for these idiosyncratic opportunities, our view is they tend to exhibit three common attributes: small issue sizes (less than $500 million), recently downgraded or no credit rating by credit rating agencies, whose prices have been impacted by a structural catalyst.

## Aimia Inc.

To illustrate, take the Aimia Inc. 6.85% May 17, 2019 bond; a $250 million (CAD) issue that was downgraded by S&P and DBRS in August 2017. On May 11th, 2017, Air Canada announced it was cutting ties with Aimia, the owner and operator of Air Canada's loyalty program, Aeroplan. As shown in the chart below, the price of the Aimia bond dropped sharply after this announcement, and at the low price had a yield of 18.8% to its 2-year maturity. The attractiveness of this bond was bolstered by the fact that the contract with Air Canada was set to expire in June 2020, with the bond maturity in 2019. With adequate liquidity, the price of the Aimia bond was affected by news possibly not relevant to the company's ability to meet this debt-obligation. The issue was called by the company in February 2019, at a price of $101.1. From the low price in May 2017, this represented a holding period return of approximately 35% in less than 2-years; not bad for fixed income!

**Dorel Industries Inc.**

Another example using a current bond issue is Dorel Industries Inc. 5.5% November 30, 2019; a $120 million (USD) convertible bond issue, not rated by credit rating agencies. After a weak Q3/2018 earnings report and it being announced on December 14th, 2018, that Dorel's stock would be removed from the S&P/TSX Composite Index, the bond traded down in tandem with the stock. At the low price in late December 2018, the bond had a yield to maturity of 9.0% with less than 1-year until maturity. Two months later, the price had returned to par; not bad for money market!




**Lysander-Fulcra Corporate Securities Fund**

An important distinction must be made in regard to idiosyncratic opportunities. It is not to say that any security that goes down in value is a good investment; good idiosyncratic opportunities must be distinguished from the bad, that is, the "value opportunities" must be distinguished from the "value traps". This is where the savvy of the investment manager is put to the test.

Lysander-Fulcra Corporate Securities Fund (the "Fund") is a mutual fund focused on fixed income securities including high yield bonds. Fulcra Asset Management, the Fund's portfolio manager, has a process that centres on identifying idiosyncratic value opportunities such as the Aimia and Dorel examples. The Series F of the Fund has been ranked by Morningstar as "first quartile" in the High Yield Fixed Income category in each of the calendar years since its inception – December 30th, 2016, to December 31st, 2018. While the Fund is relatively young, Fulcra Asset Management has a robust track record running a similar strategy in-house. As of February 28th, 2019, the Fund had a yield to maturity of 8.3% with a duration of 1.5 years.

**Skip the Fear of Missing Out ("FOMO")**

Over the past 20-years, high yield bonds have produced similar long-term returns with less volatility compared to stocks. Further value can be created by active managers, such as Fulcra Asset Management, by effectively identifying idiosyncratic value opportunities in downgraded, or non-rated securities of smaller issuances, whose prices have been adversely affected by structural catalysts at a given point in time. The holy grail might not exist, but in a period of increased stock market volatility, a greater exposure to high yield bonds as part of a stock risk asset allocation could be one way to protect against downside risk, maintain upside potential and keep FOMO at bay.

## Important Disclaimers

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Standard performance data and Morningstar quartile rankings for Lysander-Fulcra Corporate Securities Fund (the "Fund") are as follows:

| **Lysander-Fulcra Corporate Securities Fund – Series A (As of December 31, 2018)** | **1-Year** | **Since Inception (December 31, 2016)** |
|---|---|---|
| Standard Performance | -0.6% | 3.6% |
| Morningstar Quartile Rank<br>(High Yield Fixed Income Category) | 2nd<br>(December 31, 2018) | 1st<br>(December 31, 2018) |

| **Lysander-Fulcra Corporate Securities Fund – Series F (As of December 31, 2018)** | **1-Year** | **Since Inception (December 31, 2016)** |
|---|---|---|
| Standard Performance | -0.1% | 4.2% |
| Morningstar Quartile Rank<br>(High Yield Fixed Income Category) | 1st<br>(December 31, 2018) | 1st<br>(December 31, 2018) |

Morningstar quartile rankings are determined by Morningstar Research Inc., based on categories maintained by the Canadian Investment Funds Standards Committee. The "High Yield Fixed Income" category had 613 funds in the category as of December 31, 2018. Quartile rankings are comparisons of the performance of a fund to other funds in a particular category are subject to change monthly. The Morningstar quartile for the Fund referred to herein are as of December 31, 2018. The quartiles divide the data into four equal segments expressed in terms of rank (1,2,3,4). The quartile measure shows how well a fund has performed compared to all other funds in its peer group. Peer groups are defined such that mutual funds are ranked only versus other mutual funds that are in the same category and segregated funds are ranked compared to other segregated funds in the same category. The top 25% of funds (or quarter) are in the first quartile, the next 25% of funds are in the second, and the next group is in the third quartile. The 25% of funds with the poorest performance are in the fourth quartile. © 2019 Morningstar. All Rights Reserved. The information relating to Morningstar and Morningstar quartile rankings contained herein: (1) is proprietary to Morningstar and/or its content providers; (2) may not be copied or distributed; and (3) is not warranted to be accurate, complete or timely. Neither Morningstar now its content providers are responsible for any damages or losses arising from any use of this information. Past performance is no guarantee of future results.

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