

# An Update on the IA Clarington Core Plus Bond Fund

Andrew Khazzam: After the repricing we've seen across fixed income, future returns are looking very attractive for Core Plus. The fund's yield has now been boosted to nearly 5.25%. That's the tallest yield since inception. And we've also reduced the duration of the fund, which is now sitting at 3.25.

## Can you review Q1 in the fixed-income markets?

Andrew Khazzaam: To start off, I think it's important that we put some context around the moves we witnessed in fixed income to kick off the year. Government bonds across the globe have repriced violently after having reached a low two years ago. Fixed income experienced its worst start to the year ever. Year to date, the 10-year Government of Canada bond has practically doubled in yield to 2.8%. From a total return perspective, if you purchased a 10-year Canada at the start of the year, you would be down double digits today, in less than a four-month period.

And that's perceived to be the safety in your portfolio. This has been the single largest drawdown for the US Treasury index in the last 50 years and we've seen no sign of it stopping yet. Even negative rates have fallen victim with this brutal repricing. Negative rates first started popping up when the ECB introduced the policy back in 2014. Since then, we peaked in 2021 when \$1.5 trillion of debt, mostly based in Europe, traded at a negative yield. But this volatility in the bond market has been so swift that in less than a year we've completely reversed that trend and today all bonds in the Bloomberg Global High Grade index are now yielding more than 0%.

## Have you made portfolio adjustments given recent volatility in fixed-income markets?

Andrew Khazzam: There have been little to no places to hide within IG fixed income. Investment grade corporate bonds haven't helped offset any of this decline unfortunately, as credit spreads have widened in sympathy with rates. The US Investment Grade Corporate index is down 11.5% year-to-date, with a negative excess return of 2.5%. That's isolating for the credit spread impact.

So, what have we done with Core Plus to adapt to this environment? Firstly, we've increased our exposure to floating rates securities which outperform in a rising rate environment. Twenty-two percent of the fund is now invested in floating asset classes such as senior secured loans, AAA and AA CLOs, and a moderate proportion of floating rate Canadian preferred shares. This allocation helps insulate the fund from rising rates and it's been the largest contributor to performance.

We've also decreased our weight to high yield bonds, some of which were trading yield to call or relatively tight. We've reallocated that into IG corporate bonds, particularly higher quality bonds which have sold off more because of liquidity factors, and we've also deployed into the primary market as issuers are forced to pay greater concessions on new deals.

## **Do you continue to prefer Canadian corporate bonds relative to U.S. corporate bonds?**

Andrew Khazzam: Canadian investment grade bond valuations are very attractive in our view. Credit spreads have cheapened since the end of 2021 with valuations being impacted by duration, higher real yields and, more recently, economic concerns. So, when we look at spread valuations, we compare them to where they've been trading benchmarked to their 10-year history. Canadian IG corporates are trading in their 22nd percentile. That means that from current levels, spreads have been cheaper only 22% of the time. For comparison, the US corporate index was trading in its 91st percentile at the end of last year but has since dropped to the 44th percentile.

So, CAD bonds do look attractive in our view across the rating spectrum. The spread on that index of 150 basis points is now 50% higher than the lows we saw last year. High yield, on the other hand, is more richly valued in its current 73rd percentile and it's part of the reason why we've been rotating out of that asset class and going up in quality.

## **Why is this fund still a compelling option for investors?**

Andrew Khazzam: I think there's an important distinction to make, and that is, yes, we are entering a period of rising rates, but that's largely been priced in, in our view. The market is currently expecting the Fed to hike a total of 10 times this year. That will be a huge accomplishment over an eight-ish month period, especially considering they're reducing their balance sheet as well. So, for rates to continue negatively impacting returns, the market would need to price in over and above that number of hikes, and the economy would need to be able to sustain that amount of tightening. We think it may be a tall task to accomplish.

After the repricing we've seen across fixed-income, future returns are looking very attractive for Core Plus. The fund's yield has now been boosted to nearly 5.25%. That's the tallest yield since inception. And we've also reduced the duration of the fund, which is now sitting at 3.25.

Compare that to the US corporate index which has yield of 4.18% but a duration of 7.7. So, Core Plus has an above average yield with a below average duration. That is precisely what you want in a rising rate environment.

Don't forget, we mentioned that 22% of the fund is invested in floating rate securities. Apart from lacking interest rate sensitivity, that portion of the portfolio will also benefit as the Fed hikes. So, as we progress throughout the year, you can expect the fund's yield to increase, all else equal, as LIBOR continues to rise.

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