# Pembroke Virtual Lunch Summary
## Richard Usher-Jones: Portfolio Manager, Canso Investment Counsel

March 27th, 2020

A number of our portfolio managers at Canso are from mainland China and many of their families are still back in China. Very early on in the pandemic they let us know how serious this is or this could be and that this could very well make its way over to North America. And it was in the mid part of January that we went about a process of actually testing our pandemic or testing our business resumption process, which meant that every single one of us had an opportunity to work from home for a solid week and remote in and use Webex.

So, safe to say that now we have a skeleton staff at the office just to make sure that it's still there actually but we're fully up and running and operating remotely, and it's actually been a far more seamless transition then I think any of us would have expected.

When you're with Canso or entrusting us to manage some of your money, you're relying on the insight of our investment team, and that's 27 people doing the bottom-up focused research and I think for those of you who that have heard me speak over the last couple of years, we have been talking at Canso how for the last couple of years you really have not been compensated for assuming credit risks and that means that if you've been investing in less credit worthy bonds, issued by less credit worthy companies, and similarly you weren't protected. When we evaluate every investment, we look at what's the yield we're getting paid and if things don't work out as planned, what provisions do we have what covenants and protections are there for us as a bond holder to recover that investment.

And in the environment that about up until a month and half or two months ago that we were in it was pretty boring, money was unbelievably cheap and because we hadn't seen any defaults and any real problems in the market investors were sort of oblivious to the risk and really nobody was sticking their necks out to invest, much less in investments that they should have been. In that environment, we transitioned the portfolio to be in much higher quality investments and have to say that set us up to be in, I think, a pretty favorable position today, that we think we have done a pretty good job understanding the run to save people money, protecting capital going into this environment because this is an environment where there are some tremendous opportunities that we think we're going to be able to take advantage of to assemble within the portfolio.

It's interesting that causing that stretch for yield that people dipping into little quality investments the other dangerous thing we've also seen is many investors have employed leverage so not only not being satisfied with the yields that are getting with some bonds they have gone out to borrow money to invest more in some of these investments and what's happened is that the market has become quite illiquid and I'm sure that that's a term that many of you heard over the last couple of weeks. It's almost a perfect storm what has come about with COVID-19 there's still a lot of unknowns out there, if you're managing a business and you're worried about what your future business prospects are going to look like for the next while, what do you do? Do you approach the bank, and do you completely draw down your line of credit so that's what many businesses have done and many individuals as well. What does that do? That depletes the banking system of a lot of the money and business resources they may have.  I talked about some of those leveraged…and these are individuals that don't go out and buy a bond they buy a bond, they borrow more money, and buy more bonds.  So, they bought more than the actual monies they have and it's that deleveraging that's happened in the system right now.  The other thing that's also new in this environment, new this time is the amount of money that is in indexed products and ETFs (exchange traded funds), and in our view, as there's a rush for the exits.  The amount of money that's in those products is really exaggerating and exacerbating the lack of buyers in the liquidity.

You also have to remember is that this quite an unnerving time for a lot of people including those in the investment business.  A lot of the trading desks at the banks who trade most of the bonds in the portfolios are also separated.  They used to trade together but typically what all of those organizations have done is they moved half their staff to an off-site location and the other half has stayed on-site so that the person you've been bouncing ideas off is no longer right beside you, they're at quite a distance.  So it's been quite an interesting period, I have to say though that on the Canso side, we are pretty comfortable with the fact that we have assembled a lot of very high quality positions in the portfolio which should allow us to weather through the storm but also more importantly put us in a pretty good position to take advantage of some of the opportunities that are presenting themselves. Hopefully I have given you a better idea as to where we are.  I'll pass it to you Ian, I know you had some questions.

**Q:  How has the sudden stop in global economic activity and the massive fiscal and monetary response been factored into your analysis (bond fund managers)?**

A: We evaluate every investment in light of the shocks to the existing portfolio investments and how the two big measures which is first the pandemic itself and also monetary stimulus how they will affect each one of the businesses and certainly there are some that are going to be impacted quite negatively but also some of those, certainly the travel industry, the restaurant business, it's almost like a void, an air pocket going through those particular businesses and the real unknown is when they will get back to normal and when business will resume.  But I would also say that there are some businesses that will do very well in this environment and you have to think that this is not an environment when someone will cut their Cogeco, Rogers, or Bell services and if it's like the credit crisis, it's an environment where a lot of people are going to upgrade their cable packages thinking well I'm not going out and will be spending a lot more time at home.   So those are businesses that I think will do well as well as grocery retailers.  If any of you have been in a grocery store, it's amazing how empty the shelves are and actually in Ontario, I didn't go in, I looked in the window of the LCBO, the liquor store, your SAQ, those are also doing pretty good business because no one is buying drinks, no one is buying food at a restaurant, they are all buying food to bring home, bring bottles of wine home. It's factoring that in, these two shocks and updating all your modeling on your businesses and your expectations. Some will be very negatively impacted but there are also some businesses that are really going to benefit from this.

**Q: How have the characteristics of the bond funds changed due to the pandemic? And for example, how has the yield to maturity changed during march?**

A: You know, again, I don't think I've seen such a rapid change in some of the characteristics in the funds ever. The increase in yield spread, so the additional yield that you're getting today by investing in corporate bonds has increased. That's had an impact, increasing the yield in the fund. But we've also been very active using our liquidity to buy some really attractive bonds, and so the yield is gone from a level of about 2.8% about a month ago, up to a level approaching 6%. And the duration hasn't moved very much. It's gone for about 1.2 years to just inside of two years.

**Q: The stock market is down because of the economic impact of the virus. But why do you think financial markets have been so volatile?**

A: That's an interesting question. I think it sort of leads to some of my opening comments on the fact that this is a bit of a perfect storm. Volatility is, you know what's happening, cutting straight to the chase is, there are way more willing sellers than there are willing buyers. So, you've got a gapping of prices on the way down and there's a real lack of liquidity. I talked about how the banks' backstops aren't there. Every single line of credit it has been drawn by every business almost immediately, instantaneously. There's panic selling it's happening out there and I mentioned all those leveraged buyers are likely getting margin calls. And they are being forced to sell into this weakness as well. And all of this is also being exaggerated by the new entrance in the last decade to the market, which of those entities are ETFs and index funds and I think all of this is combining to really create a significant amount of volatility. You know that, and I think volatility is not just the market going down right? It's also prices going up and the announcement of all these stimulus packages are happening globally, but significant ones in the US and in Canada is causing a lot of those upside swings as well, creating a healthy floor or foundation to some of these price levels.

**Q: Given that you are fully invested, how does Canso take advantage of the decline in markets? Said another way, how do you go on the offensive during a time of crisis?**

A: Well, so you're right, we don't carry cash, particularly in the last few years because you don't get paid anything if you own cash in a portfolio. But as I mentioned, when you're not paid to take risk you will migrate to something that is very, very high quality where we're still collecting a yield while we're waiting for opportunities to present themselves and the categories of bonds that we've owned in the portfolio, number one we owned about 18% in NHAMBS, that stands for National Housing Association Mortgage Backed Securities, which are AAA rated, they're guaranteed by the federal government, principle and interest. So, they're very high quality and the benefit of owning those is they pay us more than cash. We get some additional yield, but they're very high quality and very liquid. The other category of bonds that we've owned is, and some of you may have heard me talk about these before, but they're covered bonds issued by the Canadian banks. So not only are we backed by the covenant of the banks, say Royal Bank, Bank of Nova Scotia, CIBC, TD - we're also backed by an identified pool of assets that we have prior charge on, so those are also AAA rated. And it's having these very high quality securities in a period like this where there is panic that those panicked investors retreat to things that are very solid and stable, which are those AAA rated government guaranteed which are NHAMBS and also that liquidity category that we've got in the bank covered bonds. So those are very liquid positions that we've been able to sell down to take advantage of the opportunities.

**Q: You touched on ETFs before, but how important is active management at times like these?**

A: I think active management is important all the time because we're kind of deeply rooted in the policy of active management. But certainly this is not a time you want to just be following the herd and the herd right now is running from products and you know, particularly ETFs and index products, when things are going well, you're systematically buying more of what's going up, and you're almost pushing those prices up. And the opposite is also true when you're selling an ETF or index fund, you are pushing the prices lower and lower. Indexing, while it may have some validity in buying say large cap stocks, it makes no sense whatsoever when you're buying credit or debt instruments. A quick explanation of that is if a particular stock is doing well in an index and you are buying that index fund, that means the weight of that company is increasing in the index. So, you'll earn more. That kind of makes sense on the equity side, on the debt side to become a bigger part of the index, a company has to issue more debt. So, you're almost systematically being over weighted to the most indebted companies. In an environment like this you want to be over-weighted to the companies that have the *least* amount of debt.

**Q: Another question here. How is the current situation different than 1929?**

A: It's interesting. We read a couple of books as an investment team at Canso recently about the dynamics and the types of products that brought about some of the crash in 1929. I'd say some of the difference today is that there's more leverage in the system. ETF index products, fast rapid trading, algorithmic trading that happens it can step in and exaggerate those trends and much more complex corporate structures, in the research that is required to really understand some of the underlying investments. So, there are two or three things that are different.

**Ian:** So those are some differences in the structure of the market, but how about the kind of responses that we're seeing from central banks and governments?

A: Well, you know the responses we're seeing today are unprecedented. The amount of liquidity that has been put in the system and the Canadian government is basically buying, they've announced they've got a program to buy insured mortgages, actually, which is providing some great liquidity for our NHAMBS. And they're also have another program starting to buy actually covered bonds starting early next week, and in the U.S., they basically announced they are buying anything that's investment grade. To be honest, I don't think we have ever seen such measures of liquidity injected into the system.

**Q: Clients are wondering about the liquidity of the corporate bond market. How does it compare to say the liquidity of the stock market and how is it changed because of the pandemic?**

A: I always kind of go back to the fundamentals and market prices. Securities are supposed to be priced based on all available information and with this pandemic that is a significant piece of new information and with it also comes, I'd say more questions then answers. How long is this going to go on for? What is the impact going to be? So, you know, all these prices are being reset and a term that is being used quite a bit that you know we use in the debt side is price discovery. As new price levels are found, you see smaller volumes. When something was worth X on one day and 10 days later, even though it hasn't traded, it's trying to find the new price level that makes sense, and that's price discovery that's happened. And then stimulus packages come into play. This is another big new significant piece of information providing a supporter floor for some businesses. And you know the difference in all of this is between bond trading and equity trading. Equity trading is I would say quite transparent. Everyone trades on the exchange and you can see the bid and ask spreads and it's all there and you can see the prices and you can see the volumes. Bond trading is really not as transparent. There are some online trading portals that we can use and trading systems, but much is done through dealer bond desks which is negotiated transactions. So, the liquidity can be quite different in finding liquidity in the bond market than in the equity market.

**Q: So now I will combine a few questions that we received along the same theme: What can we learn from the great financial crisis of 2008 and 2009 to help us now? And more specifically post 2008-2009 Canso posted some exceptional returns in corporates. Are you drawing similarities to what we're facing now to that period? And if you read John Carswell's recent letter, he is suggesting that it is now a great time to buy corporate bonds.**

A: We think it's an amazing time to be buying corporate bonds. That sounds a bit self interested, but I mean you mentioned you guys are buying, making investments in your own portfolios and we are doing exactly the same thing at Canso. You know there are definitely some similarities between what's going on now, with the financial shock and what's going on now. You know that was very focused. The downside was on financial services, an on the banks and now it's a different category of bonds altogether. You know, we think the banks, even though they're tight on liquidity now, solvency is not an issue, so we've got a stable banking system. But we're seeing certainly different types of bonds trade at very similar prices to what we saw in 2008 and 2009.

**Ian:** Back then I remember corporate spreads blew out to a very wide level. Where are we now?

A: High-yield bonds had the biggest jump out and I think they went to spread levels of 2000. At that peak level, you don't see a lot of trade out there, but, if you look at the last couple of days and we've seen high-yield spreads on average out at levels of about 1000. To give you some context here, high-yield bonds trading at yield spreads of 1000, that's 10% over the risk-free rate. The Government of Canada bond or US Treasury bond not that long ago, about a month ago, they were at about three, three and a half percent. So, there's been a significant move in a very, very, short period of time.

**Q: Maybe you will not want to answer this question, but what would you predict the US ten-year to be yielding in one year's time? It's currently around 0.85 I think.**

A: I predict that I'll be wrong in my prediction. I know, that's not much help, but maybe I'll give you some insight on the path. You know, we think that based on the amount of stimulus that's coming, we're going to get through this. It's going to take some pretty extreme measures. There's, we call it an

air pocket, a void going to go through the economy. Right now, we don't know how long it's going to last. How long it's going to take businesses to resume and get back to normal. Once that happens and the stimulus is supposed to provide a cushion to get us through that, we're probably going to go

through a period of deflation. Deflation is where things are cheaper as things get up and running, and the market stabilizes again, but our view is down the road, the amount of stimulus, the amount of money that's being put in the economy is going to create potentially a wildfire of inflation, which

means that yields on bonds are going to be climbing quite significantly in the future.

**Ian Aitken:** That will be a tough environment to be a bond investor in isn't it?

A: Yes. On average if yields are rising, bond prices are declining. Certainly, having a short duration like we do, certainly within the corporate bond fund and a significantly shorter duration as well within the GCC Canadian Bond Fund we will protect during those types of environments. And there's a number of instruments that we can buy that actually benefit from the appreciating yields. I have to say, it's going to be, if we're right in this, it's going to be an environment, once again, where if you've amassed some savings, you're actually going get paid without assuming a lot of risk. We're going to get inflation back in the system, but there should be some healthy bond yields again in that environment. And also, this massive amount of debt that we're creating, the thought has always been that we're going to be able to service the debt by keeping rates low. The other way you make a significant debt load serviceable is you get inflation, which includes wage inflation. So, your ability to pay down that debt is that much greater.

**Ian:** The portfolios have been positioned for some time for rising rates and it might finally be right in that positioning, is that right?

A: Yes, our positioning over the last couple of years has been on the defensive in the event of rising rates, but also very high quality. I'd say we're batting 50% there. We would've been better off having more duration, but certainly were very happy with the stance of quality we have in the portfolio.

**Q: Is Canso seeing significant inflows or outflows into its strategies? Are institutional clients increasing or decreasing their fixed income exposure at this time?**

A: We've seen a bit of both. Initially going back the last week or the last ten days, we were seeing some redemptions and the redemptions were as a result of investors following their investment policy statement, 60% stocks and 40% bonds, and with the equity market activity and dropping, that meant that those asset mixes were very much out of wack. So, our clients were telling us very directly, hey, we need to rebalance, so we need some liquidity from the bond fund or the bond investment to invest back in equities. So, we did see some redemptions, but I'd say this week we're seeing a lot of strategic allocations come in and buys come into our credit funds in our corporate bond funds to take advantage of the wider spreads and the attractive yields that are available. And that momentum really seems to be picking up.

**Q: The credit rating agencies, S&P and Moody's, received a lot of negative press during 2008-2009 for their lack of due diligence on issuers. Have the rating agencies cleaned up their acts and how much reliance does Canso place on outside ratings when they're assessing risk?**

A: We don't put any emphasis on the external rating agencies. That's just someone else’s opinion.

We also think it’s a fairly kind of potentially conflicted opinion. But how have they changed from the credit crisis? If anything, they are more negative than they used to be. When in doubt, they're going to knock something down in the credit rating. While we don’t care and we don't look at what the rating agencies do, we are quite aware of it and we use that to our advantage. As an example, there's a bond that we've been buying in your portfolio for the last number of months that it's been rated at one level and in our view, it actually should be rated quite a bit lower. Even at the lower rating that we've been using at Canso it's, we think, a very attractive bond at a very attractive price but based on the sentiment it's been trading at very attractive prices and we continue to buy it. Long and short of it, we use those rating agencies in the moment to the benefit of our investors. Often times, if a bond gets downgraded, there are investors that they just have to sell it. They're not permitted to continue to hold a bond that may have been knocked down by credit rating agencies. It's something that we don't use in our analysis but that we will use to the advantage of our investors in our portfolio management.

**Q: When Canso assesses the attractiveness of any given bond, they calculate what they are likely to recover in the event of a default. How confident are you in the maximum loss recovery calculations that you conducted in the past given the scale of the current shutdown?**

A: A max loss - just a quick view of that. Whenever we invest in a bond, we do our analysis, we look at the business and we assess a Canso rating which is the dependability of the cash flows and it's really a probability of default. But if an issuer defaults, that doesn't really tell you how much money you might lose or how much you might recover. And for that analysis, we use our maximum loss which says that in the event of default, how much money might we lose? I guess your question is, and I may adjust it a bit, given this new information and the pandemic and the response and the business interruptions. As an analyst it's our job to review and revisit all of the rankings and loss and research what we've done and re evaluate that and certainly it hasn't really impacted a lot of the existing issues that we know, but it's a significant input into everything we're looking at that is coming forward as potential opportunities to put into the portfolio.

**Ian Aitken: Because certainly if you had to, if the bond went into default and you had to look at the underlying value of the assets, the ability to realize on those assets now would be quite difficult.**

A: But I would say you always predict that in the event of default, your recovery is going to be pretty limited. So, whenever there's a range of recovery on a potential asset, we always take the lowest value in that range.

**Q: Can you give an example of a bond that has fallen precipitously? It has more than enough cash to weather the next year.**

A: One comes to mind, the great thing about this business and I'm sure you'd agree you guys over at Pembroke is that you're always learning. Coming into this, we've owned a bond and had a significant weight in the portfolios of Apple bonds. I think many of us own Apple products. I'm talking on an Apple iPad and we talked yesterday on my iPhone. This is a company that the bonds are down about 4%, and to me that makes no sense whatsoever. I would rather own Apple frankly than a Government of Canada bond. Why? Apple has more cash on their balance sheet than they do debt outstanding. And yet the bonds are down, to me that makes no sense, yet you get an unbelievable rally in a Government of Canada Bond or the US Treasury. You tell me who has more debt or cash. You're always learning, and you know when I look at a bond like that, that makes no sense to me. We would have thought coming into this period, it would have been rock solid and a great diversifier, certainly only being down 4% in this environment, as a relative performance is quite strong, but to me that makes no sense.

**Q: We see examples now in the economy of landlords giving breaks to their tenants, banks not charging mortgage payments. As we get through this pandemic, do you expect that bondholders will be expected to delay the receipt of interest or forgive debt payments?**

A: What we love about a corporate bond is when you buy a corporate bond it comes with basically a contract, an agreement between you and the issuer, and it lays out all the provisions, protections and one of the things that you look for when you're analyzing the bond, is it identifies events of default. And typically, an event of default is if an issuer misses an interest payment. So, I would think it would be highly unlikely that we could see that rule change. In order for those rules to get changed as a bondholder, we'd have to agree to that change. And you know, the reason I say that is why we like corporate bonds. Governments can create their own new rules. The Government of Canada could say, hey, we're taking a holiday on all our interest payments and all or bonds, or you've seen this in European countries. All these bonds are issued at par. Well, hey, they're only worth $0.60 now. That's why in many ways, I think investing in corporate bonds is a great thing because you're backed by that contract.

**Q: Now we have the last question that we received from a client and it's from a distinguished professor. I have a question that focuses on the post-pandemic period. Given the very low interest rates that have prevailed for some time and the flood of liquidity currently being created in the US and in Canada, I wonder how, once normal conditions return, holders of fixed-income securities can avoid capital losses when central banks begin to soak up liquidity to fight inflation? So, this is really a question focusing on what happens after we get through the pandemic.**

A: I think we've alluded to this, but what I love about this question is it's already where are you into the next crisis? And you know, I said it's going to take some time to get through this, but the next crisis it could be one of duration and rising interest rates and rising yields. You know, we were worried even before the stimulus packages that have been put in place came in to be that the amount of growth and inflationary pressures in the market were significant and were going to result in significant inflation down the road. And what's going on now with these stimulus packages means that, and I've mentioned it before, we could really be creating a wildfire of inflation, and we've talked about it at Canso, that we could see a crisis in duration.

Ian Aitken: That's the list of questions that we got from clients.

With the technology that we have right now, we're not able to let clients ask questions live without unmuting everybody, which would be noisy. We are working on improving our technology platform going forward and we will figure out how to ensure that we don't have the names of everybody audible to all participants when they join the call and when they leave the call.

With that, I'd like to thank Richard Usher-Jones for sharing his insights with us and I hope that our clients have found this call to be helpful. There will be a replay available on our website.

We are going to have another Pembroke virtual lunch Monday at noon with Andy Flynn, portfolio manager at William Blair, who will share some of his international perspective with us.

I thank you all for joining us today and for your continued confidence that you have had in us during this tumultuous time.

Thank you very much. Have a great day, stay safe.