

Interest rates, pooled funds and leverage



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The first quarter of 2021 ended with equity markets posting another positive return of around 5%. However, bond markets showed a quarterly loss of 3% due to rising interest rates globally, but especially in North America.

While the stock market has stayed strong, performance contribution has shifted from industries that benefited from the COVID-driven health emergency to more traditional ones that will benefit from the return to normalcy, also dubbed as the “re-opening” of the economy.

As markets tend to be forward-looking, it seems to tell us that we will have a healthy economic recovery. With the promise of most central banks to stay accommodative (i.e., keeping the money printing press going and interest rates low) for many years to come, coupled with the commitments of governments almost everywhere to outsized deficit spending to provide financial support and stimulus, we may be in an economic recovery that proves to be quite long.

After a breathtaking rise from the COVID-induced low in March 2020 to today’s level, the S&P 500 has risen close to 77%, excluding dividends. No

wonder so many investors are wondering how high this market can keep rising. Much of the worry is related to valuation and whether we are in a bubble.

To be sure, today’s asset prices are by no means considered cheap. We would venture to say that they are probably on the high side of fair, but not so high as to be unreasonable.



Let us explain:

- Asset prices generally reflect the interest rate environment. Based on consensus earnings of 2021, the S&P 500 price earnings ratio is roughly 22 times, which reflects an earnings yield (i.e., the inverse of price earnings ratio, earnings divided by price) of 4.5%. By contrast, the US 10-year government bond is only yielding 1.7%. In other words, the S&P 500 is paying investors close to 3% more to take on the risk of owning the top 500 companies in the US, instead of the risk-free fixed rate bond. Historically, this risk premium is pretty much in line with the average of the last 20 years;
- Valuation can also be viewed relative to short-term interest rates. Lots of people tend to compare today's market action with the Internet Bubble of 2000. Just to put everything in perspective, the S&P 500 P/E ratio back then was 24, which reflected an earnings yield of 4.2%. However, the interest rate was at 6.5% then. Today's market has an earnings yield of 4.5% within an interest rate environment of 0%. In other words, the S&P 500 is much cheaper today than it was 21 years ago.



As far as equity markets are concerned, the biggest risk of all is the possibility of rising inflation leading to rising interest rates. Rates having declined for 40 years have offered a huge tailwind to investors, moving asset prices higher. Now that they have fallen to 0%, they will probably no longer keep going down (unless of course they become negative, like in Germany, which is unlikely as per the Fed's assurance that it will not take rates into negative territory). But they could rise from here. Although the Fed has control on the short-term interest rate, there is limitation on its ability to control longer maturities. Rising inflation could wreak havoc and force rates up.

Economic theory suggests that money printing will lead to inflation. Yet developed economies across the world printed excess money, and inflation is nowhere to be found. Japan has been

printing money since the early '90s and they are still trying to induce, unsuccessfully we might add, a 2% inflation. Europe has also done its fair share of printing without creating significant inflation. Is inflation a threat any time soon? Short answer: Who knows?

Another imperceptible risk is one of leverage. We have witnessed wild fluctuations in some stocks that are completely disconnected from fundamentals. For example, GameStop, a video game reseller, went from a low of \$5 to a high of over \$450 in a matter of weeks, only to reverse to below \$50 in a matter of days. All these wild moves have been created by a combination of high speculation among day traders (think Robinhood) and hedge funds, supported by financial institutions all too willing to lend huge amounts of money to facilitate trading for the sake of commissions.

History tells us that these reckless activities will end with somebody losing a lot of money, and unfortunately, sometimes creating tremendous stress on the financial system (think; the economic collapse of 1929, the Long Term Capital Management debacle in 1998, and the 2008-2009 Financial Crisis).

In conclusion, we can argue that although equity markets are not in bargain territory, we don't see it as being unreasonably valued in a context of continued low interest rates. Since the biggest risk is potentially rising inflation leading to rising interest rates, as Howard Marks says it often enough, although we cannot predict, we should prepare and position portfolios accordingly:

- Avoid long term bonds (10 years or longer);
- Favour companies with power to pass on price increases;
- Favour companies with flexible cost structures;
- And above all, invest in long-term, profitable companies.

I know many of you think we disagree with the structure of mutual funds. Actually, we only disagree with the costing and the pricing to the client and the restricting nature of some funds.

At Claret, our funds are structured only to benefit our clients:

- First, they offer better diversification when a portfolio is of smaller size.
- Second, they offer access to a much broader diversification within an asset class so as to benefit from where the market's inefficiencies are more pronounced. The Claret Income Fund is this type of strategy.
- They also help clients avoid constant focus on individual names in the portfolio. They especially help clients and portfolio managers focus on needs and goals instead of news and volatility.
- Finally, there are no additional management fees, no administration fees, and no audit fees. Claret covers all these expenses because you pay us to offer you the best investment structure.

I would like to take this opportunity to talk more in detail about our Income Fund and the reasons why it is designed to fit into every investor's fixed income portfolio. Our philosophy regarding fixed income portfolios has always been that it's very easy to have good performance when interest rates are going down.

For the last 40 years, that is what has happened. What is not told to investors is that most of the good performance comes from the rising price of a long-term bond when rates go down. That rising price will also slowly erode as the bond comes closer to maturity: a bond starts at a price of 100, then moves up or down depending on interest rates but will end up back at 100 at maturity. In other words, it could go to 160 and then slowly will go back down to 100, regardless of interest rates.

As you might guess, to capture that big price increase, you must sell and buy something else. While it is easy to do during a period when rates declined for 40 years from 18% to 2%, it is no longer so when rates move around at low levels, or even begin to rise.

That is why fixed income funds are performing so badly in the first quarter of 2021 – the benchmark bond index has a negative return of 4%. The return in the last 5 years has not been better at 1.6% annually. If interest rates start to rise, it will be worse.

We have a very different approach to fixed income. We use corporate debentures and preferred shares to create the portfolio with the following characteristics:

We favour smaller issuers because there are fewer potential buyers thus less competition to bid up the price leading to lower yield to maturity.

We pay the utmost attention to yield to maturity since we have no intention of selling our debentures/bonds; most of them yield 5% or more.

We avoid long maturities: since we invest in companies and there are always unpredictable events in the economy in the long term, we are more comfortable to lend our money for shorter rather than longer maturities, generally 5 years or less.

We also favour issues that include an equity participation, usually a conversion privilege to common equity or an extra right to buy common equity. Thus, when equity prices go up, we would harvest an extra return above the coupons of the debentures.

We include preferred shares in our strategy because not only do dividends tend to be higher than the prevailing interest rate, they also possess characteristics that do not exist in the standard fixed income bond: floating rates, fixed-reset

features allowing us to choose our rates, minimum guaranteed rates just to name a few.

To be sure, we could definitely build a segregated portfolio using the same strategy as above. There are however significant advantages using the pooled fund concept:

For this strategy to work well, it needs an “extreme” diversification, meaning the portfolio must hold a very big number of positions of different debentures, ranging from different issuers, different industries, and different structures. In short, the more the better. Hence, it is not conceivable for accounts of smaller size: for example, 200 positions at \$1,000 each would make up a portfolio of \$200,000 in fixed income. If a client’s objective is to have 80% in equity and 20% in fixed income, the minimum size of the account would have to be at least \$1,000,000. Moreover, it would be impossible to buy 200 positions at \$1,000 each with any dealer since the cost of processing these trades far exceeds any reasonable amount of commissions a dealer can make. However, within a fund, since we buy in bigger amounts, dealers are happy to look for products for us;

It is much easier for clients to add new money in the portfolio without having to rebalance, so it reflects his/her objectives. Alternatively, it is also much easier when the client needs to withdraw some money. Selling and buying our funds is as easy as pie.

Our funds are audited annually and tax receipts are produced on time, saving your accountant a tremendous amount of work. You should definitely have a conversation with your portfolio manager if you do not own the Income Fund in your portfolio as part of your fixed income allocation.



Alain Chung, Chief Investment Officer for the Claret Team

Alain began his professional career in 1983 and is a CFA charterholder. He holds a bachelor’s degree in Business Administration from HEC Montreal, for which he obtained an award of excellence in finance. Alain co-founded Claret Asset Management and is the Chairman and Chief Investment Officer. Before joining Claret, Alain worked for 16 years as an investment advisor and as a Vice-President at CIBC Wood Gundy. Alain speaks English, French, Cantonese, Mandarin and Vietnamese.