Rethinking Bonds from the 'Bottom Up'

March 31 2021

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After a tumultuous first quarter in fixed income markets, credit investors may understandably feel caught between a rock and a hard place. Government yields are historically low despite a sudden spike in corporate spreads, bond inventory continues to be challenged, and central banks are raising their inflation targets based on expectations the recent stimulus and vaccine rollouts will spur an economic recovery.

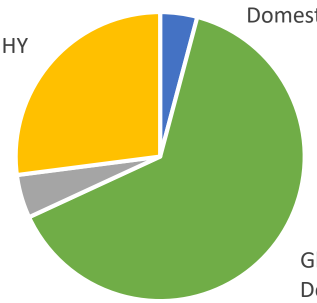
Growth expectations may prompt questions about existing bond allocations, which have historically been based on government issuances for their stability and diversification properties. If anticipated growth is realized, it may be appropriate to stretch into the further reaches of Credit to avoid potential losses on government bonds.

Traditionally, Family Offices and Investment Counsellors have displayed deep expertise in equities and managed Core exposures in bonds. Looking ahead, how should FOs/ICPMs balance their focus on yield generation with the need for true diversification?

Actively-managed ETFs could prove beneficial in this environment. Canada represents a tiny fraction of the global Fixed Income market, and has a limited number of issuers concentrated in limited sectors. Incorporating global bonds into the asset mix provides more data points to exert greater control and, importantly, expand yield opportunities. This is beyond most FO/ICPM capabilities, so it makes sense to outsource this expertise.

A solution we would like to suggest: ZMSB (BMO Global Multi Sector Bond ETF) – a "go anywhere" credit solution that has a broad mandate covering government, investment grade corporate, high yield, emerging markets sovereign bonds, and securitized debt. There are no additional foreign tax considerations in fixed income, so Canadian investors should diversify globally, levering the greater opportunity set in global fixed income to drive yield and control risk.

Chart: Bond Issuers by Market

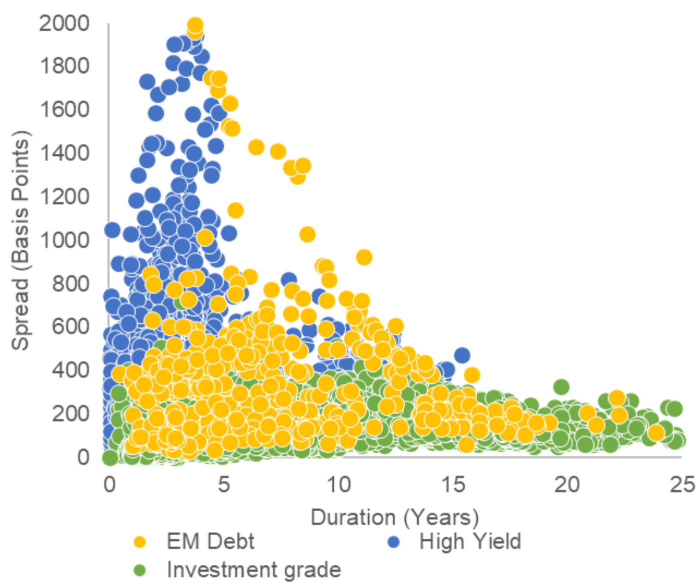


Source: ICE BAML Indices BMO Global Asset Management at 24th August 2020.

ZMSB: A Differentiated Approach to Diversification

The strategy deployed in ZMSB provides a diversified yield by focusing on security selection rather than allocation to asset classes – building a portfolio bottom-up to avoid extreme positions or "tails". Using DTS (duration times spread, or credit exposure) to measure credit risk captures the credit quality of the underlying security, and shows that, all else being equal, lending for longer also increases credit risk (for example, a 10yr duration corporate bond with a spread of 0.5% would have a DTS of 500).

Avoiding extreme positions on either side is vital because each tail represents distinct risks: accenting Credit significantly increases the potential for defaults, while and over-reliance on Government bonds risks being left penniless.



Credit Risk - Default / Downgrade risks;
Government risk – inability to keep pace with inflation

Source: Indices used: ICE BofAML BBB & Lower Sovereign USD External Debt Index, ICE BofAML US High Yield Index, ICE BofAML US Corporate Index 01-Jun-18. Barclays US MBS Index. We have excluded bonds with a spread > 2000. All data at 31st December 2020.

In this strategy, the security selection "sweet spot" is at the intersection between BBB and BB where risk adjusted returns are comparable to those of higher rated bonds:

Credit	Yield	Volatility	Yield / Vol
AAA	4.98%	3.26%	1.53
AA	5.01%	3.34%	1.50
A	5.10%	3.84%	1.33
BBB	5.76%	4.21%	1.37
BB	6.41%	6.56%	0.98
B	6.06%	8.17%	0.74
CCC	7.43%	13.46%	0.55

Source: Bloomberg. Indices used are: ICE BofAML 3-5 Year AAA US Corporate Index, ICE BofAML 3-5 Year AA US Corporate Index, ICE BofAML 3-5 Year Single-A US Corporate Index, ICE BofAML 3-5 Year BBB US Corporate Index, ICE BofAML 3-5 Year B US Cash Pay High Yield Index, ICE BofAML 3-5 Year CCC &Lower US Cash Pay High Yield Index. Observation period is 31st December 1996 to 31st December 2020. To calculate the Sharpe Ratio we have used the ICE BofAML US 1-Month Treasury Bill Index

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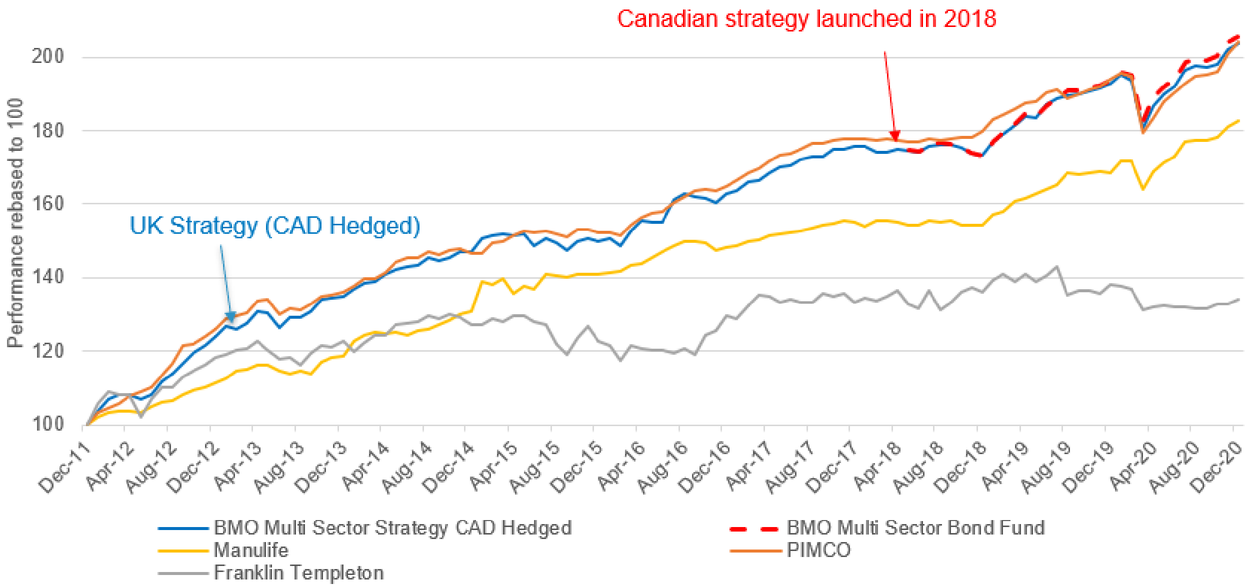
BMO Global Multi Sector Bond Strategy

Performance since end 2011 – CAD Hedged



Past performance should not be seen as an indication of future performance. The performance figures are shown gross of fees and net of all costs for a pooled mandate. The effect of fees or costs will be to lower the figures shown. Changes in rates of exchange may also reduce the value of your investment.

Source: Bloomberg, BMO Global Asset Management from 31st December 2011 to 31st December 2020. A small hedging differential has been added to the track record of the BMO Global Multi Sector Bond Strategy, a UK-domiciled mutual fund, which is priced in GBP terms, to present the information in CAD hedged terms. We have shown performance from the 31st May 2018 for the BMO Global Multi -ector Bond Fund F, a Canada-domiciled mutual fund. For comparative performance, we have shown performance of the Manulife Strategic Income Fund, the PIMCO Monthly Income Fund and the Franklin Templeton Global Bond Fund. Performance in the chart is gross of investment management fees.

Sixty-five percent of ZMSB is invested there, with approximately 40% of the portfolio having a maturity exposure of three to five years. What you'll notice is that the strategy remains highly diversified despite this apparent concentration, weighting 294 securities from 214 separate issuers across multiple geographies, currencies and sectors – including Banking, Consumer Goods and Services, Industrials, Non-Cyclical Goods and Telecoms.

The strategy has a consistent track record of producing 3-year rolling Sharpe Ratios that far exceed the median of its peer group. This has proven true across the market cycle, within the mandate having outperformed in favourable and adverse macro environments. In particular, BMO's Global Multi-Sector Strategy demonstrated significantly lower downside capture versus peers last March, and also during the brief sell-off in the fourth quarter of 2018.

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BMO Global Multi Sector Strategy (gross performance in USD terms)

eVestment – 3 year rolling Sharpe Ratios over last five years

eVestment Peer Group:
Global Multi Sector
Fixed Income

Rolling 3 year periods
(Ann.) to end Dec 20

In % terms & USD terms	3 Yr (Ann.) Dec-16	3 Yr (Ann.) Dec-17	3 Yr (Ann.) Dec-18	3 Yr (Ann.) Dec-19	3 Yr (Ann.) Dec-20
BMO Global Multi Sector ★	1.65	1.66	1.43	1.42	0.61
25th percentile	1.14	1.39	1.33	1.35	0.62
Median	0.84	1.15	0.97	0.99	0.49
75th percentile	0.30	0.88	0.49	0.70	0.36
No. of observations	44	43	46	45	41

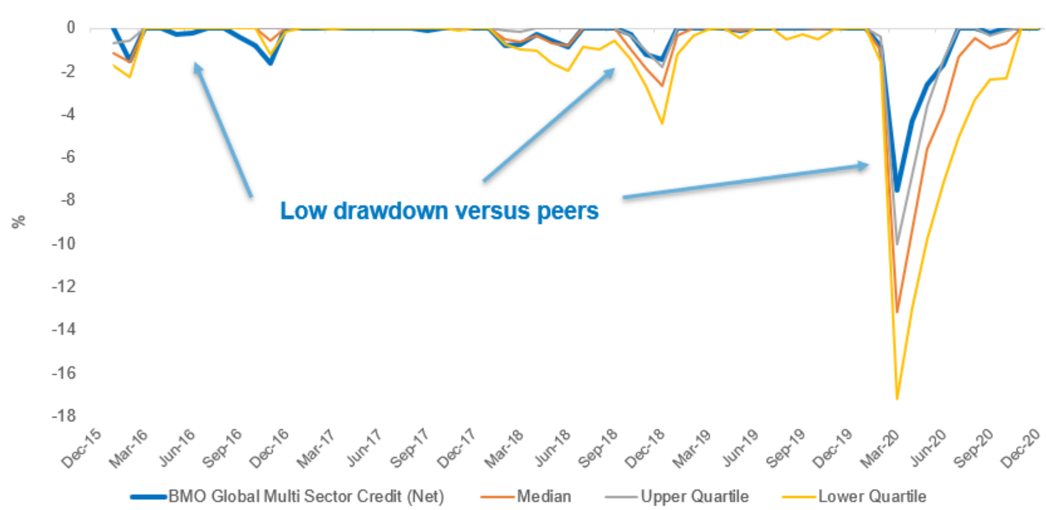
Past performance should not be seen as an indication of future performance. The performance figures are shown net of fees. The effect of fees or costs will be to lower the figures shown.

Source: eVestment as at 31st December 2020. A hedging differential has been added to the return series for the Global Multi Sector Strategy, which is priced in GBP terms, to present the information in USD hedged terms. Performance for this sector has been shown gross of investment management fees. We have excluded outliers from first and fourth quartiles in bar charts.

BMO Global Multi Sector Strategy (net performance)

Mercer global peers – Drawdown 5 years to end Dec 2020

Mercer international fixed multi asset credit (net) universe – US$



Past performance should not be seen as an indication of future performance. The performance figures are shown gross of fees. The effect of fees or costs will be to lower the figures shown.

Source: Mercer. A hedging differential has been added to the return series for the Global Multi Sector Strategy, which is priced in GBP terms, to present the information, gross of investment management fees in USD hedged terms. This represents the 5 year performance ending December 2020.

*ZMSB was launched in Canada in 2018, but the active fixed income team in the UK has been managing this mandate since 2011 so this reflects the full track record

Conclusion

With many observers expressing concerns about inflation, FOs/ICPMs may need to adapt their fixed income strategies while maintaining a hedge against equity market risk. The BMO Global Multi-Sector Strategy provides easy access to a globally diversified opportunity set for fixed income investment, an active management approach to interest rate and credit risk throughout the cycle, a pooled structure for simple implementation – and, most critically, true portfolio diversification.

Appendices:

BMO Global Multi Sector Bond Strategy

Current Portfolio positioning – December 2020

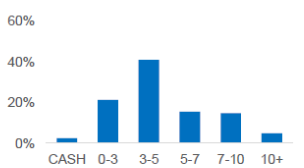
Duration	
Duration X spread (DTS)	805
Interest rate duration (years)	4.4
- GBP	1.0
- EUR	1.8
- USD	1.6
- Other	0.0

Geography of issuer	
United States	38.3%
Canada	1.3%
Eurozone	22.0%
Other developed Europe	3.3%
United Kingdom	21.0%
Pacific	1.6%
Emerging Markets	8.2%
Other	4.3%

Denomination (100% hedged to CAD$)	
US $	35.5%
Euro	39.6%
UK £	24.5%
CAD $	0.4%

Credit rating	
AAA	0.5%
AA	3.1%
A	14.8%
BBB	44.2%
BB	20.5%
B	12.9%
CCC	0.2%
NR	1.4%
Cash	2.4%

Maturity exposure

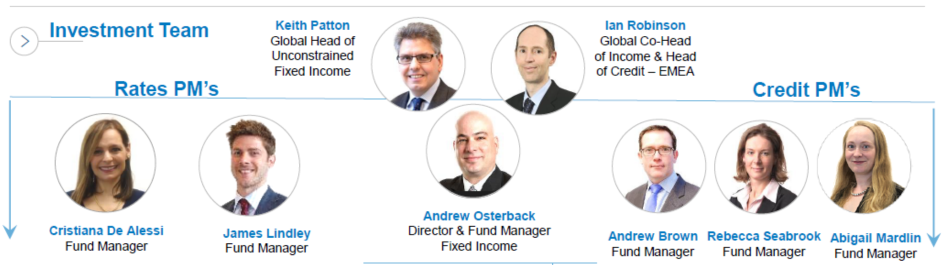


Sector allocation	
Banking	17.5%
Consumers goods and services	18.4%
Energy	2.4%
Financial services	2.1%
Industrials	13.7%
Insurance	4.7%
Non Cyclical Goods	15.4%
Property	5.4%
Securitised	0.4%
Supranational / Govt Related	2.8%
Telecoms	11.7%
Utilities	2.1%
Cash / other	3.6%

Cash securities and issuers	
Number of securities	294
Number of Issuers	214

Source: BMO Global Asset Management at 31st December 2020. NR = Not Rated. The category derivatives refers to the net impact of FX forwards, FX options, interest rate swaps, exchange traded interest rate options, exchange traded interest rate derivatives and credit default swap indices. Ref account BMMB

Highly experienced team with specialised resources



Years' industry experience	22
Years' BMO tenure	12

Specialised resources across our investment hubs

Macro	
# in team	10
Years' industry experience	16
Years' BMO tenure	5

Credit	
# in team	26
Years' industry experience	15
Years' BMO tenure	8

EMD	
# in team	7
Years' industry experience	16
Years' BMO tenure	6

Responsible	
# in team	24
Years' industry experience	14
Years' BMO tenure	4

Dealing	
# in team	6
Years' industry experience	20
Years' BMO tenure	13

Additional fixed income resources at BMO Global Asset Management include another 55 fixed income professionals

Source: BMO Global Asset Management at 31st December 2020.

Investment process

Stage 1 Beta position	Stage 2 Sector allocation	Stage 3 Credit selection
FUNDAMENTALS		
• Macro-economic factors • Monetary policy • Credit fundamentals	• Sector view based on sector credit fundamentals • Point of the economic cycle e.g. cyclicals v non cyclicals	• Individual company analysis • Suitability of names for the mandate • Full integration of ESG analysis
VALUATIONS		
• Absolute valuation of credit given perceived risks • Relative values of credit versus other asset classes	• Relative value of sectors versus others based on maturity and rating	• Analysis of issues across the curve • Are idiosyncratic risks priced in?
TECHNICALS		
• Risk tolerance and market positioning • Overall supply and demand dynamics • Market sentiment	• Funding requirements for each sector • Market positioning	• Does the company need to issue in the short to medium term • Liquidity of a particular issue
• Overall credit positioning • Rating breakdown • Country allocation	**Overall assessment and strategies**	• Sector allocation • Curve positioning • Individual issuer positioning