TAKOTA
Asset Management Inc.

Reflections

Partners in Capital Growth

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When “safe assets” hit a bump - Introducing the Takota Income and Arbitrage Account

“Safe assets” hit a bump
Since the beginning of the current financial crisis, many investors have sought refuge in “safer” assets while also looking for yield. Safe assets mostly meant gold (a traditional refuge), government bonds and the shares of large, well-known companies. Yield meant forays into higher yielding bonds, like corporate and high-yield bonds (“junk bonds”), a preference for dividend paying stocks, and an array of products specifically manufactured by financial institutions to answer the demand.

Sustained demand led to price increases for all of these assets, to the point where they became quite expensive from our “intrinsic value” point of view. Now, with signs of a recovery making the news, the process has started to reverse itself even though the actual strength and sustainability of this recovery remains in doubt, given the persistence of high unemployment and private debt.

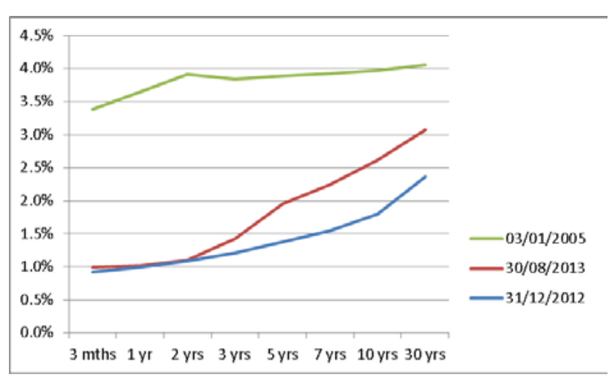
Gold, which had doubled in price from 2008 to 2012, has lost 20% of its value this year. Having no intrinsic value, gold depends solely on investors’ psychology for its price. Its lack of return usually causes its demise when things get better: as soon as confidence begins to return, some investors start to question holding such an unproductive asset. Fearing a similar reasoning from others, they start selling which leads sequentially to lower prices, more general anxiety about possible further declines, and sometimes a rush to the exit in fear of everyone else selling.

A further negative for gold is that over the last five years its price has been propped up by forecasts of large and imminent inflation due to the large quantity of money being injected by central banks, especially in the US. Five years later, the announced inflation is still not there (which should not be surprising as, in the absence of consumer demand, injecting cash adds liquidity without increasing demand). Obviously, the forecasters were wrong, even if many have had a hard time admitting it. Without inflation, it is harder to justify holding gold.

Bonds have enjoyed a 30 year bull market, interest rates having declined steadily from the mid-1980s to 2008 with few interruptions. The financial crisis led to even lower rates and a very flat yield curve (the curve showing how interest rates increase with maturity – see graph below). Overnight money is basically at 0% - and cannot go lower, which limits what central banks can do to help.

The problem for bond investors is that bond prices decline when interest rates rise. Furthermore, many investors never experienced rising interest rates, which may add to the bond market volatility through bouts of panic selling. Currently, rates have gone down almost as far as they could and in any case cannot go lower than 0% (a rational investor will prefer holding cash than paying out a negative interest rate to hold a bond). As the economy recovers, whenever that happens, rates will inevitably rise, and bond prices will inevitably decline (for a given interest rate rise, the longer the maturity of the bond the larger the price decline). In the meantime, just knowing that it might happen “soon” will be enough to add volatility to bond prices.

The graph below illustrates the potential rise of interest rates. The shift from the blue to the red curve represents the actual increase in Government of Canada interest rates since the beginning of 2013. That increase (and parallel increases in all interest rates) is behind the losses



Yield of Government of Canada Bonds - Source: Bank of Canada of about 3% to 4% incurred this year by broadly diversified bond funds and of 8% to 10% by long-term bond funds[1]. The green curve is where interest rates were at the beginning of 2005, when the economy was going strong with moderate inflation, and where Canadian rates could be heading once our recovery becomes well established (there is no way to know where exactly rates will be in the future, the point here being that, when rates rise, bond portfolios suffer losses).

Bills and short term bonds will decline less in price and can be a refuge. Holding individual bonds to maturity, when the capital will be repaid in full, avoids capital losses but at the cost of a lower yield than available in the market. However this strategy does not work with bond funds, which have no maturity.

Government bond prices are driven solely by interest rates and may decline more than corporate bonds, which have a credit component – as the economy improves, the perception of credit risk may improve and partially offset the decline due to rising interest rates.

Other assets may also suffer from rising interest rates. ***Real estate*** is an obvious one. Rising interest rates will make mortgages less affordable. The issue in Canada is that compared to the US we have not had a price correction and are still theoretically in "boom" mode. A marked decline in real estate activity (which has begun to occur at the construction level) would have negative consequences for the Canadian economy and slow a rise in interest rates. How a correction, if any, would unfold is anybody's guess, but record housing price levels, record level of consumer indebtedness (still going up) and the substantial weight of the construction industry in the Canadian economy could render a correction challenging.

Equity securities remain in this strange limbo where some appear expensive and fully priced while others, completely neglected, offer excellent value but see no demand. Equity markets appear very thin – little trading is occurring. The likelihood is that when positive changes come, prices will move quickly, with investors rushing in to take advantage of the "newly discovered" opportunity that these stocks represent, as happened following the internet bubble in 2000.

Our new Income and Arbitrage Account: to generate both income and potential for capital appreciation.

For some time we have been approached by investors and investment professionals wanting us to structure for them a value-based Managed Account focusing on income generation.

Current developments have opened the door to this possibility – especially when targeting securities which are undervalued compared to their intrinsic value. As the fear of rising interest rates makes investors divest positions, assets of interest that were expensive become more affordable, allowing the construction of a well-diversified portfolio aimed at generating income while still offering the potential of capital accumulation.

Our new **Income and Arbitrage Accounts** are personal accounts offering this portfolio. To generate income these accounts will be invested primarily in yield bearing securities of solid but undervalued corporations, and in arbitrages that generate a return while limiting or eliminating the risks related to the credit of the company.

The potential for capital accumulation will come mostly from the selection of undervalued dividend-bearing equity securities, bought well below our estimate of their intrinsic value, and from bonds bought below their nominal value.

By selecting assets for both their yield and capital gain potential, Income and Arbitrage Accounts should be able to weather over time the negative effect of rising interest rates through the realization of capital gains. In the current environment, we firmly believe this is an attractive solution to negotiate all the current and forthcoming uncertainties while benefiting from an income flow.

By focusing on income generation, Income and Arbitrage Accounts complement our other portfolios whose aim is capital accumulation.

For additional information about the Income and Arbitrage Account, simply call us at 416-363-3050 or toll-free at 1-800-665-1757, or email us at connect@takota.ca .

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[1] Globe and Mail, Aug. 23, 2013