High Conviction: Real Return Strategy

OPTIMUM Asset Management

An actively managed Canadian Real Return Bond strategy.

EXECUTIVE SUMMARY:

Real return bonds are an asset class to closely monitor. We may be at a crossroad in terms of inflation expectations. The market is still expecting a drop in inflation (expectation of 1.40%) as we see signs that inflation is starting to rise (currently at 2%). This analysis reviews the markets and proposes an entry strategy.

OPPORTUNITIES:

Real return bonds used to be a critical part of pension fund asset allocations as they were the only asset class which directly protected against inflation. In 2008, pension plans began to invest in real assets which also provide inflation protection. As a result, we posit that they began to divest/invest less in real return bonds. This potentially created an overhang in the market which caused a dichotomy between expected inflation and realized inflation with breakevens trading significantly below Bank of Canada stated inflation 2014 targets and diverging significantly from US breakevens.

Source: Bloomberg, September 2020

INVESTMENT PROCESS:

Our investment thesis is that when real inflation is higher than expected inflation, real return bonds should outperform traditional bonds. Conversely, when real inflation is lower than expected inflation, real return bonds should underperform traditional bonds. We have developed a four-criteria methodology to indicate entry levels.

- **Anticipated inflation:** We are looking for a breakeven smaller than 1.9% inflation. The lower the breakeven, the higher the probability of outperforming this breakeven.
- **Weakness of the Canadian dollar:** A weak Canadian dollar is inflationary.
- **Accommodative monetary and fiscal policies:** Monetary and fiscal policies can make and break inflation. We are looking for accommodative Central Banks and Governments.

EXIT STRATEGY:

Provided nominal rates do not rise too fast, which we do not currently see as a threat, we propose to exit the market when inflationary expectations rise above stated Bank of Canada targets.

RISKS:

The main risk is that inflation decreases below the purchased breakeven. This risk manifests itself in a decrease in inflation expectations (i.e. a decrease in prices) and a decrease in the inflation factor. There is also a risk that nominal interest rates rise faster than inflation expectations which could create losses in real returns. In this current cycle of heavy government indebtedness, we do not see this as a very significant risk.

WHO ARE WE?

Combined, our asset management subsidiaries manage $8.2 billion* Canadian dollars globally for an institutional and private wealth clientele. These subsidiaries are held by Optimum Financial Group, which employs 600 employees across Canada, the United States and in France. Our "value-type" approach enables us to offer our clients sophisticated investment strategies, while emphasizing capital preservation and risk management.

* As at December 31, 2020.