

## FUND COMMENTARY

# Purpose Canadian Preferred Share Fund

## FUND DETAILS

FX HEDGED	
<b>ETF TICKER</b>	<b>RPS</b>
MGMT FEES	0.75%
<b>SERIES F</b>	<b>PFC1901</b>
MGMT FEES	0.75%
<b>SERIES A</b>	<b>PFC1900</b>
MGMT FEES	1.75%

INCEPTION DATE:  
**MARCH 15, 2017 (ETF CLASS)**

INCEPTION DATE:  
**AUGUST 24, 2007 (CLASS A/F)**

**We continue to view post-lockdown corporate earnings growth and inventory rebuild as the most important fundamental opportunity today.**

## FUND MANAGER



**Sandy Liang**

Sandy Liang has more than 30 years of institutional investment experience. He spent 12 years working on Wall Street, leading fixed income for Cobalt Capital Management, and was a Senior Managing Director at Bear, Stearns & Co. Sandy has won a Canadian Hedge Fund Award for top performance in the Credit Focused category in 2018, 2019 and 2020 and he is also a Morningstar 5-Star Fund Manager.

## MARKET OVERVIEW

September 2021 was a reality check for asset managers and investors as both equities and traditional bonds traded down together. The S&P500 declined by 4.7%, while the bond market measured in various ways returned negative 1.5% (XBB ETF) to negative 2.9% (TLT ETF) in the month. It is often difficult to pinpoint a market narrative but in this case it's pretty clear the stock market and bond market accelerated its sell-off (with yields higher) after the September 22 post-Fed meeting press conference. During the press conference it became apparent the Fed will be tapering its support of the bond market, with a likely exit from quantitative easing (QE) over the next 12 months. We view

this news as a mixed message for risk assets because the Fed is only tapering its bond buying due to "substantial further progress" on its dual mandates of employment and inflation – in other words, the economy is moving forward so the training wheels are coming off through withdrawing support of the bond market and long-term interest rates. Thus, if earnings growth and credit quality improvement are an important component of your portfolio's returns, the news wasn't all bad – the economy is moving forward. This was reflected in the relative performance of non-investment grade credit during the month where high yield debt, preferred equity, and bank loans were all roughly flat during the month.

In previous commentaries we have observed that the path of the traditional bond market, using TLT as a proxy (the largest long-term bond ETF with 20+ year bonds), moved lockstep with how the S&P500 Index was doing relative to the Equal Weighted S&P500 Index. In other words, how mega-cap technology equity shares, or the largest weights

in the S&P500, are doing relative to the rest of the stock market, or growth vs. value in equities, is all the same trade as buying long bonds and enabled by the Fed's QE supporting the bond market. Conversely, as QE gets tapered and interest rates go higher, the market values near-term earnings over long-term earnings and value /re-

open /small-cap stocks outperform due to lower duration. Then market leadership broadens. And as QE taper is positive for high-yield bond performance over investment grade corporate debt, because it's all the same dynamic, near-term earnings and credit quality improve over long duration and interest rate risk.

We know Fed support of the bond market (QE) will be waning – most likely after the next Fed meeting in November. Remember from our commentary last month that long-term fair value for 10-year bond yields is not 1.53%, or the most recent level, it's higher. Fair value should be higher than the inflation rate, and historically it has resembled nominal GDP growth (inflation plus real growth). We are not saying it's going there overnight, and we don't know where the 10-year trades next month. But we can tell you about historical fair value going back decades: U.S. CPI is 5% today, in Canada it's 4%. Inflation may moderate to 3% next year, but that's still a lot higher than where bond yields are today – real interest rates are still negative.

In summary, the longer-term interest rate picture is currently at a crossroads with the Fed openly discussing tapering its support of the bond market. This makes the current period analogous to the 2013 "Taper Tantrum," with similar implications for real interest rates. However, this news is not all bad because it means the economy is moving forward which is positive for earnings growth and credit quality. We do not expect a real recession any time

**TLT Bond ETF (blue, left axis) vs S&P500/S&P500 Equal Weight (red, right)**

ALL PERFORMANCE DATA AS AT OCTOBER 13, 2021.



Source: Bloomberg

soon for several reasons, but mostly because economies are only now emerging from lockdown and pent-up demand for goods and services, combined with off the charts money supply growth in the past 18 months, should result in above-trend economic growth at least through 2022. We continue to view post-lockdown corporate earnings growth

and inventory rebuild as the most important fundamental opportunity today and view the environment as constructive for investment risk assets, including non-investment grade corporate credit, however less positive for traditional, long duration fixed income where investors get all the interest rate risk with little reward (yield).

## FUND PERFORMANCE AND POSITIONING

In the month of September, the Fund returned 1.1% compared with 0.9% for the S&P/TSX Canadian Preferred Equity Index. This year to date, through October 13, the Fund has returned 29.7% compared with 17.9% for the S&P/TSX Preferred Equity Index. While the volatility of the asset class in recent years has been outsized compared with underlying fundamentals, we believe that from here volatility will likely be lower due to a sea change in asset class supply and demand dynamics. In July 2020, the Royal Bank of Canada issued \$1.75 billion principal value of the first Limited Recourse Capital Note (LRCN) that is pari-passu with its preferred equity but receives the preferential tax treatment of a debt security. In short, the company can deduct its preferred dividends in LRCN paper, as it would bond interest, for tax purposes. This event over one year ago has skewed supply/demand dynamics in favour of existing preferred equity investors for the foreseeable future, as there will not likely ever be traditional preferred equity issuance from Canadian banks or insurance companies. Since the first Royal Bank issuance, there has been \$12 billion in LRCN issuance from banks and insurance companies that displaces

Canadian preferred equity. The total preferred equity market size was in the \$70-\$80 billion area, and we believe as much as 25-30% of the market will be called by issues in the next five years – in other words there is rapidly shrinking supply. At the same time, the asset class is increasing in attractiveness to investors due to the built-in inflation hedge – variable coupon rates benchmarked on bond yields every five years. In summary, we do not expect anywhere near the downside volatility in this asset class that has been experienced in the past. And thus, investors should keep clipping those inflation-adjusted coupons for real yield on capital.

The two largest factors that impact valuation of the Canadian preferred equity asset class are how the underlying equities are doing (common shares of same issuers) mostly financials, utilities, and pipelines issuers, and how the 5-year Government of Canada bond yield is doing. Most recently, the Index is at fair value compared to its underlying factors. However, “fair value” does not mean the group will not move if the underlying drivers are now moving with QE taper coming and as the bond market adjusts to a world without artificial support from central banks, which has potential for further bond yield increases.

The average dollar price of securities in the Fund is \$23 (versus \$25 par value), which leaves continued room for capital gains. The internal yield in the Fund is in the mid-4% area before favourable tax treatment of the asset class. The Fund is a relatively pure play on high credit quality, with preferred equity trading below par value because these securities benefit disproportionately from increases in inflation and interest rate outlook. The Fund also generates alpha from research-driven investment ideas, including Element Fleet Management, Brookfield Asset Management, and most recently ECN Capital preferred equity, which is now a Top 10 position in the Fund. Since mid-2020 the Fund has been increasing weighting in low-dollar priced preferred issues from banks and insurance companies we view as likely to be called by issuers, given the availability of LRCN capital from the fixed income market. Both Royal Bank of Canada and TD Bank preferreds have become top 5 positions since July 2020.

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## FUND PERFORMANCE

ALL PERFORMANCE DATA AS OF SEPTEMBER 30, 2021

PURPOSE CANADIAN PREFERRED SHARE FUND	1 MONTH	3 MONTHS	6 MONTHS	YTD	1 YEAR	3 YEARS	5 YEARS	SINCE INCEPTION
SERIES A	1.07%	3.74%	10.59%	28.47%	43.52%	4.42%	6.69%	6.61%
ETF	1.13%	3.96%	11.05%	29.26%	44.70%	5.30%	-	4.97%
SERIES F	1.13%	3.96%	11.04%	29.25%	44.69%	5.30%	7.57%	6.20%

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All data sourced to Bloomberg unless otherwise noted.

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