Mark Noble
Welcome to the latest episode of Generation ETFs. I'm Mark Noble executive vice-president of ETF Strategy at Horizons ETFs, and today we have with us for the first time, Barry Allan, the founder and CEO of DMAT Capital. This is an exciting guest for us because Barry and the team at DMAT Capital recently came on as sub advisors with Horizons ETFs, where there'll be sub-advising a number of ETFs for us, including the recent announcement that they'll be sub-advising the Horizons Active High Yield Bond ETF, which trades under the ticker symbol, HYI.

Mark Noble
One of the key ideas behind building this sub-advisor relationship with DMAT is to really harness the power of true discretionary active management to find the best opportunities in the respective investment universes of any of the ETFs that they will be sub-advising for us. We talk a lot about active management, but typically, a lot of times in fixed income, the active management comes, the benefit of active management comes from managing sort of the periphery, managing bid-ask spreads, keeping sort of close to the benchmark.

Mark Noble
There's definitely value in that because of the fact that bonds in particular trade over the counter. I think we're going to take a bit of a departure with the products that we manage here with DMAT, in that this is going to be discretionary. These are going to be mandates where there's a real focus on going where the market or the view that Barry believes the market is going to be going to take advantage of market opportunities. Barry has more than 38 years of industry experience running investment mandates, involved in the full spectrum of the fixed income world from government bonds, investment grade bonds, high yield bonds, and even distressed bonds. He's one of the few managers in Canada that has a deep expertise in the full spectrum of credit and fixed income securities, which means our discussion today can really cover the full gamut of fixed income markets, where we can talk about the areas of the market with the greatest amount of risk. I think more importantly for our listeners today, also the areas that offer the biggest opportunities. Thanks so much Barry for being with us today.

Barry Allan
Great to see you, Mark.

Mark Noble
So I think what we'll start off with is obviously you're a well-known figure in Canada. I would argue one of the preeminent fixed income managers over the last two decades. I think a lot of people would be interested to hear about what you're doing here at DMAT Capital and sort of what the idea behind your new firm is, because this is obviously your latest venture after a very long and distinguished career.

Barry Allan
Yes. Well, I think that the investment world has changed dramatically over the last 20 to 30 years, primarily driven by the decline in interest rates. This is the major driver of the changes, and I think there's also been changes in the volatility characteristics of the market. I've come to the conclusion that you need to be much more flexible and tactical in your investment approach, than the kind of buy and hold scenario of passive management. I think those days of being rewarded for that, and they were some very good days, I think have generally passed. I wanted to start a firm that would be smaller, more flexible, more focused, and particularly more tactical than what I had done before. When you found companies and you work on them and you build them up for 20 years, they become bigger, you have bigger staffs. They become a little more bureaucratic. I just think that the world requires a much more tactical approach, as I said. I wanted to start a firm that was going to be smaller, more flexible and more focused than what I had been involved in the past, because I think that's really the way where the world is going.

Mark Noble
Is there kind of a key demographic of investor that you're looking for to serve with this particular firm?

Barry Allan
No, I wouldn't say so. I mean, I think the demographics of the investors over the last 20 or 30 years has changed in that they become older, but they're generally the same investors. You look at the wealth creation the baby boomers had and the concentration of wealth in the world, that has all developed within one segment of society. I think that those are the group that still bears the bulk of the assets in that community.

Mark Noble
You mentioned the way that we invested funds before for fixed income, and very static, very siloed. You look at a fixed income suite, you have the high yield bond suite, you have the investment grade suite, you have the government suite. I'm just wondering, given the upheaval we've seen, particularly in the last five to six years with declining interest rates, clearly the pandemic is in focus, but how has fixed income investing changed over the last decade? Do we need to look at maybe rewriting the rules of fixed income in terms of how we approach things on a go-forward basis? Because it does seem like maybe of all the areas of the investment management sphere, this could be the one that's been disrupted the most.

Barry Allan
Yeah. I totally believe that. I think it's a function of two specific things. One obviously, 10 years ago, or five years ago, there was yield in the marketplace. You could get 3 or 4% in investment grade and you could get 6 or 7% in high yield, and you'd set up your portfolio. Basically, those are the returns you would get with the exception of mistakes you might make and defaults you might incur and so on, but it was primarily a yield gathering game and don't take too much ... Don't make mistakes such that you give up that yield. The world is completely different now in that there is no yield. The government bonds are yielding below 1% and I think are going lower over the next couple of years, which seems almost astounding and you have investment grade bonds yielding at one and a half to 2%.

Barry Allan
The high yield market yields roughly 5%, but it's so bifurcated that the credits that you want to own actually yield three and a half to 4. Then above that is a whole bunch of distress names that are yielding 15% and your average yield at 5. You can't really build a 5% high yield portfolio with reasonable risk parameters. You're better off having a distress portfolio yielding 12 or 13% where you know you're going to take losses and hopefully come out at nine or 10%. Then in high yield and investment grade, stay in safer names and try and get your 3 to 4% out of that. The number one thing that has changed is you cannot invest for yield anymore because there is virtually no safe yield in the world. The other major aspect to it is volatility.

Barry Allan
The volatility isn't any higher on average in markets now than it was 10 or 15 years ago, but the nature of the volatility has changed dramatically. What you have now is periods of extremely low volatility, long periods of extremely low volatility that are fabricated by central banks in the world that are suppressing volatility, followed by numerous short periods of extreme high volatility. If you look at the markets just in the last two or three years, we had at the early 2019, we had a 20-plus percent correction in the markets. In March of 2020, we had a 20-plus percent thing. Also in 2018 and 2016, you had generally strong rising markets, but you had at least one or two periods where you had a definitional bear market trade where the markets could go down 20%. That was all met with central bank reactions to suppress that volatility and bring the market back.

Barry Allan
What you can't do, it's just another argument for not investing passively, because if you invest passively, you can earn that small, single digits, sub 5% returns, but if you want returns higher than that, in my view, you have to invest tactically. To do that, you have to do it a couple of ways. One, you have to have the ability to go long and short because you can control volatility by being short. You can protect yourself against those bouts of volatility with short positions. Then when you get them, you can lift the short positions and go long at the right time. I think the world has come, and it's not just fixed income, it's equities and everything else, you have long periods or prolonged periods of suppressed volatility, followed by violent moves that last two to three months at most. To me, that argues for a more tactical investment style.

Mark Noble
It's sort of startling too, because if you think about, you go back 10 years ago, 4% is kind of my investment grade kind of bogey on the investment grade bonds. I think a lot of people don't have that mind change where they think, "If I'm going after 4% right now, my risk return profile in that 4% is totally different than it used to be. The risk in fixed income investing hasn't changed, where you still have the same sort of levels of default risk, but your compensation from a risk return perspective is totally different, right? That 1.8% risk that you're getting from corporate bonds right now, you're still taking on corporate credit risk. As we saw in March of 2020, that risk can be substantial.

Mark Noble
How do you wrap your head around that part of the market where we see credit spreads coming in and part of it, because as you mentioned, the central bank's now the largest buyer of US corporate bonds in the world right now, and then you have yields that are extremely low, like treasury bonds are strategically low. It seems to me something has to give, but I'd be interested on your opinion. I mean, is this kind of market even sustainable?

Barry Allan
Yes, I think it's sustainable in an artificial sense because central banks force it be sustainable, but it's certainly left on its own. We would probably be in a severe recession if not, depression, which could last a decade or longer like we had in the 1930s. That's why the central banks are doing what they're doing, but you have to realize, you talked about the unattractive risk reward and fixed income. That is completely true because not only have yields fallen, but risk has increased dramatically over the last 10 years, even in the investment grade area, which primarily doesn't have a lot of default risk. Default risk is real in the investment grade world. In 2008, we went into the world where the average investment grade rating was in the single A high category.

Barry Allan
Ten years later, the average credit rating and investment grade is triple B low, only one notch above high yield or junk bonds. The leverage on corporate balance sheets as interest rates have fallen has increased significantly. The risk is with investment grade is not that the company defaults, although I'm certain, we will have large companies that will go from investment grade to default in very short periods of time. We've had that in the past. We've had companies like Nortel, the largest single company in Canada, went from investment grade to default, WorldCom all within a few months, Parmalat.

Mark Noble
GE getting downgraded, right? I mean, yeah.

Barry Allan
GE, so what the real risk is that we go into an economic downturn that the central banks are ineffective at stalling. Then you have a enormous number of these triple B, low investment grade names downgraded to high yield, and they overwhelm the high yield market. The investment grade US market is close to $10 trillion, and the high yield market is around 1.2 to 1.4 trillion. If 20% or if 15% of the names that are triple below that were downgraded, that would double the size of the high yield market. It would cause relative chaos in the credit markets, in both investment grade, and that's the single reason why the fed came out in March and said they're going to buy investment grade bonds, to protect the world from that systemic risk.

Mark Noble
Right, and in terms of ... Quickly for an overview of sort of the next 12 to 18 months, because one thing anecdotally we're hearing a lot, particularly with Canadian financial advisors is, they're moving a lot more of their holdings to the ultra conservative sphere, right, so they're moving to treasuries maybe. Maybe a lot of cash. We're seeing a lot of increase in cash instruments, which are only yielding maybe 50, 60 basis points. Highlighting this concern about risk. If I'm in a yield-focused investor and I'm looking to find somewhere to generate some excess return above inflation, let's say even, where would I find that best opportunities over the next 12 to 18 months in your view?

Barry Allan
Yeah. Well, so I'll twist that slightly and make the assumption that you're asking for my outlook on high yield in the short term, because we've just recently taken over [inaudible]. I'm cautious in the near term, on credit markets for all the reasons you've mentioned, but I'm not bearish. I think what the central banks have accomplished in the marketplace leads you to believe you can be cautious, but don't be bearish because a bearish view, which requires the markets to decline materially or in this case for credit spreads to widen materially for your view to be effective, the probability of that is relatively low, given the stance of the central banks.

Barry Allan
Having said that, in 38 years of doing this, I've never seen the worst risk reward in the credit markets than we're in now. You have the highest leverage, highest default risk, and you have the lowest credit spreads that I've seen all the way through that timeframe, but that's the fact of life. You could be bearish and invest in cash alternatives and earn 1%, or you can adjust to take the yields that you think is safe and then maybe invest in things that are a little more riskier, offset by short positions in high yield indices, which allow you to capture a higher yield without taking that on that additional volatility.

Barry Allan
That's really what our strategy is, but you have to realize that… We're not going back. Interest rates are not going up other than small cyclical upticks like we maybe observed in the last couple of months, and we may see in the next six months or so, but my long term view on inflation is that it's falling much more rapidly. Whatever small uptick in inflation we have in the short term is simply due to a decline in the US dollar and the US dollar can't really decline for multi-years in my view, because if that happens, the rest of the world's currencies have to go up and if their currencies go up, then that hurts their economic growth. Then it starts to affect US economic growth.

Barry Allan
You have to realize that high yield is probably the only asset class, fixed income asset class that's going to get you more than a 2% yield going forward. It's just how you manage it, and whether you do it tactically, and whether you have the ability, and the propensity, and the mandate to invest in it on a long, short basis. Long, short doesn't mean leveraged. It simply means that you could deploy leverage without taking on incremental risk, because you've got short positions that are dampening the volatility to begin with. Bottom line is, you can't really invest for yield anymore where you can, is in high yield, but it's about half the yield that you could previously.

Barry Allan
Again, I think what you have to do is rotate amongst the fixed income categories, and that is governments, high yield investment grade and short duration. You have to be able to rotate to the area of one of those mandates that has the best risk reward at the time. If you're successful at that, you can produce returns that are materially higher than the one and a half or 2%, the fixed income benchmarks are going to produce with not a lot of incremental risk.

Mark Noble
Right. I mean, that's the key there, right, because with the index strategies that they are going to buy or sell whatever meets the index requirements, but that has nothing to do with independent credit analysis, cashflow analysis, revenue analysis, which someone like yourself brings that expertise on board.

Barry Allan
Correct.

Mark Noble
Yeah. That's a great segue because you just mentioned in terms of finding the best opportunities or rotating into the best opportunities, as you have these cyclical changes in the market. One of the new ETFs that we are launching with you is the Horizons Tactical Absolute Return Bond ETF. Can you provide an overview of what this strategy is? I think we've kind of seen it as sort of a, almost like a best ideas strategy coming from you, where we've kind of taken the constraints off of siloing the fixed income mandate and allowing you to really just go where you need to go. I'm interested to hear in your words of what the idea is behind this strategy on a go forward basis and why you think this is important for Canadian investors.

Barry Allan
Yeah, this is what I spent at least a couple of years thinking about as to what's going to happen when governments yield zero and investment grade yields one and a quarter, one and a half and high yields at three and a half or four. If you want returns higher than that without going directly to distressed, where you have very high levels of default risk, how are you going to do that? The industry tends to want you to have single mandate funds. When you really think about that, there's by definition, if you have a single mandate, there's always going to be periods where it's going to be in favor and there's going to be periods where it's not going to do well. It's going to be out of favor. That argues against single mandate, even though the industry is primarily built around that.

Barry Allan
I simply designed a fund, which I believe is tactical and can gravitate to the area of the fixed income that at that point in time, and it's usually a 12, 18, maybe 24-month period, where that particular segment has the potential to produce returns that are much higher than the indices. In some cases, even double digit returns, because if you own long duration government bonds in a recession, traditionally, if you own 30-year treasuries in March, you made a 30-plus percent return or between 25 and 30% return in a six-week period because the interest rates fell so dramatically. In recession periods, obviously, even at these low yields, you want to own long duration government bonds and coming out of recessions historically, you want to be in the high yield market because highly yield is an early cycle asset class.

Barry Allan
Traditionally, the first in the last three or four cycles, the first two years of high yield captures 50 or 60% of the return of the entire cycle. You've got years like '03 where the high yield market was up almost 30%, and '04 was in the single or in the mid-teens. Typically, in the first two years, you get a 15 to 25% return in the high yield market. In that point of the cycle, you want to be in high yield. Once the big gains are made and high yield, then you want to start reducing risk and move into the investment grade market. Then late in the cycle, if we ever have a late cycle again, where the fed is actually capable of raising interest rates, then you want to be in a short duration mandate.

Barry Allan
I've taken all those four areas and put all those strategies into one single fund, which allows investors to invest and rely on the investment management team to make the decision when to shift from one part of the complex to the other. I've been doing this a long time, but nobody will ever get it perfectly, but the returns are high enough that you don't have to get it done perfectly. The alternative returns are so low that it doesn't take a lot of expertise to move, to get more than a return than the index is giving you these days.

Mark Noble
It makes perfect sense where you sort of have this one ticket solution for sort of this new fixed income paradigm. The idea here is that a lot of the value that fixed income is not by tilting double Bs to single Bs in high yield, it's from tilting high yield to treasuries when that's in that cyclical moment. I think that's where people kind of miss that connection.

Barry Allan
Exactly, and traditionally, people will never buy long duration government bonds anyway, because that ... Usually the time to buy long duration government bonds is late in the cycle when the fed is raising rates and the returns are double digit negative. It's a hard sell to tell people to call a client and say, "I know it's down 20% right now, but I know it's going to be up 20% at sometime in the next two years." That's a tough conversation to have with any client, right?

Mark Noble
Yeah, exactly. Well, listen, this has been a great conversation. Again, at Horizons, we're very excited to be working DMAT and you in particular. The whole idea here is really to provide some new fixed income solutions, and some new ways of looking at fixed income, as we mentioned, to really address what we're calling the income challenge in the global market. The fact that the rules around fixed income have really changed to this low interest rate, still high volatility in some area environment, and that's why we've partnered with people like Barry, DMAT, to really start to provide some new strategies and some new approaches to fixed income. Thank you again, Barry, thank you to our listeners. We look forward to continuing this relationship and touching base again in 2021, so thanks again.

Barry Allan
Great, thank you.

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