Mark Noble:
Hello, I'm Mark Noble and welcome to the latest episode of Generation ETFs. On today's episode, we have one of our favorite recurring guests, Nicolas Normandeau, Vice President and Portfolio Manager for Fiera Capital's integrated, fixed income team. Nick has been a longstanding portfolio manager on a number of our largest actively managed, fixed income ETFs. Including probably our largest ETF the Horizon Active Preferred Share ETF, which is not only one of our largest ETFs, but one of the most widely held amongst Canadian financial advisors and has been a key mandate, that advisors and Canadian investors have used to get exposure to preferred shares.

Mark Noble:
We also have another ETF offering that went through extensive obstruct changes last year, the Horizon active hybrid bond and preferred share ETF. Which trades under the ticker symbol, HYBR and offers a bit more exposure to hybrid, fixed income securities.

Mark Noble:
But in either case, both of these ETFs have been longstanding top tier performers in the preferred share market. And what a year it was last year for preferred shares. 2021 was an exceptional year for preferred share performance. And a lot of investors now are wondering if there's any more opportunity in 2022.

Mark Noble:
In fact, I would go as far to say that probably the most widely received question we've had at Horizon so far this year has been, is the pref rally over, or should I get out of preferred shares? Well, Nick is here today to talk to us about why he still sees some really interesting upside potential in this yield rich asset class as well he will be discussing with us his outlook for the broader fixed income corporate credit and fixed income market. And some additional strategies investors can look at to navigate what could be and already has been a challenging fixed income market given the inflationary pressures on the global economy. Nick, always a pleasure to have you on, how are you doing today?

Nicolas Normandeau:
Doing great Mark.

Mark Noble:
So let's just get right into it. 2021 was an unbelievable year for Canadian preferred shares as both a combination of expected rising interest rates and a massive wave of announced redemptions from financial share services companies, as they converted to limited recourse capital notes or more commonly referred to as LRCNs. It really helped propel the broad preferred share benchmark to returns that we hadn't seen in a very long time. More than 18% in 2021 for the benchmark. And of course, I'd be remiss not to say HPR did even better generating a roughly 24.5% return last year. Would you expect there's still some growth in this asset class? As I mentioned, a lot of investors are asking, is there any more opportunity in preferred shares? I'd really like to know your thoughts, Nick, on what you expect for 2022 in this asset class.

Nicolas Normandeau:
We're expecting around 4% to 6% will return this year. So let's not hope to get the return we had last year. It's not going to happen again. But four to six is good. So we still think that the fact that both the Fed and the Bank of Canada will hike soon, that it will continue to put a little bit of pressure to the five year rate in Canada. So that's a positive when the five year rate increases. And we're still expecting a lot of redemption this year.

Nicolas Normandeau:
It's like $8.3 billion of redemption. This is like still 12.7% of the overall market. That's a lot. That's a lot of redemption that will help again, to sustain the tone. And they're still preferreds that trade at a discount. In HPR, we have almost 30% invested into pref that trade at below $23. So there's still some capital gain potential for these, less than last year, but still. So that's why we think that start with the yield around four and some potential capital gain here and there. Some good trades that we'll do over the year, again, that could bring you easy to 6%. Which is still good when you compare versus the low yield of all the other asset classes on the fixed income side.

Mark Noble:
So, I think that's really important to highlight is that while you may not get the double digital return expectations, because you have a lot more of these issuances trading sort of in the $23 range, as you highlighted, or above, you still have this, this yield that you still anticipate to be 4% plus for the foreseeable future. Right?

Nicolas Normandeau:
Yep. That is correct. And in fact, we're able to buy these days, some hybrids with coupons starting with a five end. 5% plus. So hopefully when rates, five year rates continue to increase, some of them won't get calls, so we'll extend that higher coupon rate. So I would even say that down the road, maybe your hybrid yield will get closer to 4.50%, depending how high the five year rate goes. So this is really attractive even when you compare versus high yield.

Mark Noble:
One of the stories last year preferred shares was the LRCN redemptions that you referred to earlier. You've highlighted in some of your commentary that there could be as much as $10.5 billion more potential in bank LRCN redemptions, and about $3.5 billion in issuances from insurers. I just wonder if you could probably a little more context on why you think that this amount of money is still open for redemptions and is that all being priced in the preferred share market right now.

Nicolas Normandeau:
The numbers you highlight are kind of the room those banks and insurers have. They won't necessarily print all these [inaudible]. So they will continue to kind of redeem the expensive preferred and replacing them with LRCN. So there's no rush to do it one time. Just this year, we're expecting around 5 billion of expensive preferred and insurance pref that will get redeemed. So expect at least 5 billion of new issuance on our hands, if not more.

Mark Noble:
Perfect. And I think, again, I want to highlight because one of the things that if you look at HPR and its performance last year and where it's positioned right now. You have a lot of allocation to that sort of mid rate, reset area. If I look at the overweight versus the broader index, that seems to be where I would notice the largest overweight. Is that again, because you feel that both hybrids and LRCNs are going to offer a little bit more upside potential for those slightly discounted preferred shares.

Nicolas Normandeau:
Not necessarily. The fact that we like those resets with 250 and 300 resets, it's mainly on the non-financial side. So some of them are still trading at important discount. So they still have capital gain potential. Even more if we think that the five year rate increases. So as for the, let's say whatever the rate, let's say between 200 and 250. Again, here, we prefer the non-financial and the [inaudible].

Nicolas Normandeau:
We think that there's a lot of value within these and a lot of potential capital gain with these issues. So on the bank side, the bank, let's say the 200... All the banks, in fact, there's a lot of good news price already on these prefs, so there's not much cap gain, anymore potential with these. So on the LRCN, it's a different trade. When you go there, you go and focus on they're all trading close to par. So you kind of focus on the yield on the name and make sure you have good resets to minimize let's say, the extent of risk.

Mark Noble:
Okay. Trade a lot more like a bond obviously, because they are, when it comes to LRCNs.

Nicolas Normandeau:
Exactly.

Mark Noble:
When you are looking at the marketplace. I mean, one of the questions we're getting, I'd say outside of the question about is the rally over. And you've highlighted the rally is, but the opportunity versus other fixed income is still so attractive for this space. But when we look at these redemptions of LRCNs and the potential for new hybrids, one of the... And it might be a little bit of a myth or some misinformation coming from the broader financial community, but there's a big focus on the fact that there's not going to be any good preferred shares left after four or five years. And I wonder what your thoughts are in terms of these new issuances, and is there still going to be quality prefs over the next decade? Because this is something that we're certainly hearing a lot more concerns and questions about.

Nicolas Normandeau:
Well, if you're forced to buy just the $25 one pref, it is fair to say that down the road, not today, but down the road, you'll have less bank issuance, less insurance issuance, less non-financials with floor or with big resets. So all and up you'll end up with less diversification and lower resets for all the resets that will still be outstanding. So more vol.

Nicolas Normandeau:
But if you choose an active manager like us for both HPR and even more for HYBR, we can buy those hybrids, we can buy these LRCNs. So we can make sure that we keep this great diversification of issuers. In fact, and improving it with the one, let's say Roger's example that we bought the hybrid last November. And no way, no chance, they will ever print the pref. But now it's only these issuers, there's new issuers into the hybrid space.

Nicolas Normandeau:
We bought it. It performed really well and we will continue to do so. So we'll able to continue to keep this good diversification, but also the good diversification across the reset level. That's important too. And yes, it will be at a cost. In a way that not going to be the product won't be 100% dividend, but we think there's many, many advantage to go within those LRCNs and hybrids. Assuming they're well priced. You are improving your liquidity. That's important. And expect less vol within these hybrid and LRCN versus the pref market down the road. So that's, I think really, really important and the yield are attractive right now.

Mark Noble:
Well, and you've highlighted this, I think with the new issuance of RBC data at the end of 2021. Where RBC did a $275 million issuance of an institutional preferred share. And I'll be honest, I still don't quite understand how these work, but my understanding from you is that this is also a new way to breathe new life into the preferred share market with quality issuances. Could you give us a little bit of a education on, what is this type of preferred share and do you expect the banks to offer more of them?

Nicolas Normandeau:
Yes. For sure. This Royal Bank issue is a real preferred share. So it's dividend income, just like a $25 price. The only difference is where it is trading. This one, this new one is trading OTC within the bond market and not on the exchange. That's the only difference. And now why did they print that? Well, OFSI, as you know all the banks have capped or limits on how many LRCNs they can print. OFSI allowed the bank banks to increase that limit from 60% to 80% only if they show to the market that they can print those institutional preferred. As RBC was kind of already capped at 50. It's okay so they were kind of forced to print this preferred to be able to be able to done around more LRCNs.

Nicolas Normandeau:
So expect more as they're not yet at 20%. So they will probably print another deal. If it's in Q2, Q3, I'm not so sure, but they will do it. The other banks right now, they still have room to print the LRCNs. So I would be surprised that they favor this institutional preferred before the LRCN. It is more expensive for them. But down the road, maybe late this year or early next year as they won't have room anymore in LRCN, we could see those printing in social preferred.

Nicolas Normandeau:
So this market will grow. That's a really good news. We bought them in both our funds. It was well priced. It performed better than some of the prefs and even better than the LRCN. So it's great. It's another opportunity for us down the road to add value. Which I think it's getting really interesting. And with that, with RBC, we'll see with the other banks, but assuming RBC goes with this 80% LRCN, 20% in social preferred, we should expect that they will redeem all their $25 price, whatever the reset level. So that's the expectation for RBC. We'll see if the other will follow the same road. But that's the anticipation right now.

Mark Noble:
Well, I think a key feature there too, is you highlighted is that these trade over the counter, instead of in the secondary market, which creates a lot more opportunity and depth liquidity for an institutional manager like yourself, if I'm getting that correct.

Nicolas Normandeau:
That is correct, yes.

Mark Noble:
In terms of where we see this year, I've been a little bit surprised at the returns of preferred shares going into 2022, they're sort of flat to negative. But we've seen obviously a view that inflation is going to rise. Interest rates are going to rise. And historically that's been really good for rate reset preferred shares. Are credit concerns outweighing rate rises with investors right now? Is that something that's sort of, been of little bit of a weight on the performance of preferred?

Nicolas Normandeau:
Clearly the volatility we're seeing right now in the equity market rate, performance is pretty soft so far this year. I would say, even for credit, spreads are widening across the board. Investment grade, high yield. There's a repricing going on with, I would say they mainly the fact that maybe there's risk out of the Fed and the bank of Canada being forced to hike faster and sooner because of the high inflation right now.

Nicolas Normandeau:
And also there's some geopolitical risk also not helping the situation. So preferred, they're not immune to wider spreads. So clearly wider spreads are not helping the asset class. But the fact that the five year rate is increasing, that is helping though a lot, the asset class. Like we mentioned, there's still a lot of preferred trading at discount. Some of them perform really well so far this year. So I agree with you performance this year is close to zero, slightly negative, but it's way better than bonds.

Mark Noble:
That's true.

Nicolas Normandeau:
And way better than equities. So it's doing the job. And seriously for us, that's what we think will continue to happen. Even if we see more vol, a little bit more volatility within the credit space, if the private rates come to stay that high or even increase towards the two handle, at some point, that's going to be good for pref. And that will help at least to sustain the performance, I think.

Mark Noble:
So switching gears a little bit we've had a lot of conversations about HPR and I would find the other mandate that we're getting a lot of questions on is the Horizons Active Ultra Short-Term Investment Grade Bond ETF. And I know that's a mouthful for a name, but it highlights exactly what it does. It's a investment grade ETF with very ultra short duration. Due to that low duration, as you've mentioned, given the inflationary environment, I mean, does HFR also make sense for this type of rate environment?

Nicolas Normandeau:
Oh, of course. Big time. And right now the yield on HFR is at 1.7 years. Duration is really low around, let's say 0.77, so less than a year. So the fund was not impacted too much by the higher rates that we saw across the yield curve. And have upside on the road in terms of yield. So as the bank and the Fed clearly mentioned yesterday, they will start hiking in March and you should expect the yield of HFR to increase.

Nicolas Normandeau:
So for us, we think that we'll see four hikes this year by the bank of Canada.

Mark Noble:
Four hikes, okay.

Nicolas Normandeau:
So the yield should move at the end of this year around 2.7, 2.8. So which is great. Yes, spreads are moving slightly wider year to date. But remember that we are buying investment grade corporate bonds. And the average duration is only three years. So really, really short. So spreads need to widen a lot before, let's say washing all the extra spreads we're getting with those corporate bonds. So yes, this is still a really good price to buy.

Mark Noble:
And investors see this right now because there's obviously other short-term or ultra short-term ETFs and strategies out there in the Canadian marketplace. But given the ultra short duration, but we're yielding 1.7. The question we get is how are you able to generate that higher yield without increasing the duration risk? I'm wondering if you can just go through the basic mechanics of the ETF to explain why it is you're able to harvest that excess yield.

Nicolas Normandeau:
Yeah. What we do is we buy corporate bonds, let's say between one month maturity to 10 year. But most of them we're buying are between, let's say one year and five year, really. That's a lot of what we are buying in this fund. So average duration on this credit bond, credit corporate bonds portfolio is around three year.

Nicolas Normandeau:
So we think it's too high. So we enter into plain vanilla interest rate swaps. So we sell the fixed rate and we're receiving CDOR three months. So really what do you have when you buy HFR is you hone CDOR three months. So when the banks start hiking, this CDOR will increase, the yield will increase on that. And so you own this plus the credit spread. So plus the corporate bond portfolio that you're buying, less what you pay on the swaps.

Nicolas Normandeau:
So when spreads are widening, that's not good. But when spreads are tightening, that's good news. But remember, again here, we're focusing on investment grades, mainly. And it's really short, three year. And the three year, in fact the five year and lower part of the yield curve has repriced a lot over the last year. You can buy bail-in bank with spreads around 95, if not 100. That's easy, 30, 35 BPS wider versus the level we were able to get last year.

Nicolas Normandeau:
So there was a lot of repricing. Spreads are better. We could see some volatility again this year, but for us that's opportunity. We're doing all this selection too within the fund. Not just with HAB and HAEB, but with HFR also. That's what we do. We participate in new issue when we like the level and we're really active and the secondary market to try to add value. To be at the perfect place on the curve. So it's a great product and it offers nice yield and potentially higher yield and not much risk on the interest rate part, with this low duration.

Mark Noble:
Well, and I think that's the key piece that sometimes investors miss with this ETF is that the actual portfolio management is active, which means that if the market dynamics change, you have the ability to actually shift some of the credit quality. Of course stay above investment grade, but also shift the underlying duration because you use the swaps to bring the duration in. But you have a wide flexibility where you're not stuck being one tool for one market. HFR can change as the market dynamics change.

Nicolas Normandeau:
Yeah. And we have changed it too. There's many hikes priced in the market right now, in Canada, almost six hikes. That's a lot. So remember in the past the market, the duration on HFR was closer to 0.5 year. We're getting closer to 0.8 now, 0.77 to be precise. But expect us to continue to increase it. If let's say the bank continue to, well, start hiking and continued to hike and hike maybe at some point later this year, maybe next year. And when we feel that rates are getting attractive a little bit more in the front end yeah, we could increase a bit that duration, so do less swaps. So all of this to improve the yield of the portfolio. So we're active on rates, interest rate risk. We're on the curve, we're active, of course, on all this credit bonds, corporate bonds selection which rating, which company, which seniority. So it's really active.

Mark Noble:
Perfect. Nic, thank you so much for being with us today, because I think what you've really highlighted is something that underscores why we've had such a long and successful relationship with your team at Fiera over a decade now running these ETFs. And it shows the flexibility that you have within your mandate. We've always been of the belief at Horizon that active management and fixed income is crucial because of the fact that when you use an index methodology, you don't have the flexibility to reorient the strategies to make changes for market conditions.

Mark Noble:
But as you can see, whether it's a HPR taking advantage of LRCNs and a different range of hybrid securities or HFR's ability to move some of its duration and credit risk to take advantage of the market. These are options that simply don't exist with index products where you get boxed in on a methodology. And so I think really does underscore why active manage matters and why it matters more than ever for 2022. So Nick, thanks again as always for being with us, I look forward to chatting with you in the next few months and seeing where this interesting market goes.

Nicolas Normandeau:
All right. Thank you, Mark.