Expanding on our Fixed Income Investing Process

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Since an initial blog on August 29th, 2018 outlining Cambridge's fixed-income investment process and the tools we use to add value and control risk, we wanted to expand on that and provide greater detail, along with an example of the tools in action within Cambridge Bond Fund (the "Fund").

To demonstrate this process, we can look at the period that includes the fourth quarter 2018 and first quarter 2019 (the "Period"), since there was significant change in both the level of interest rates and the spreads on corporate and provincial debt. This also happened to be a period during which the Class I units of the Fund underperformed the FTSE Canada Universe Bond Total Return Index (the "Index")[1]. That said, the Fund has outperformed the Index by 1.47% on a three-year basis (as shown in the performance data chart for Class I at the end of this commentary).

While this short time horizon is being used for illustrative purposes to provide an example of how we approach fixed-income portfolio construction at Cambridge, we would discourage you from thinking of your investment portfolios in a short-term fashion.

The 10-year Canadian government bond price rallied significantly. As seen in the chart below, yields fell from 2.57% to 1.53% and produced an 8.7% return for the Period.

[1] Cambridge fund returning 5.17% over the period from October 2018 to March 2019 and the Index returned 5.74% over the same period. Further, all reference to the performance of the Fund contained herein refer to Class I units of the Fund.

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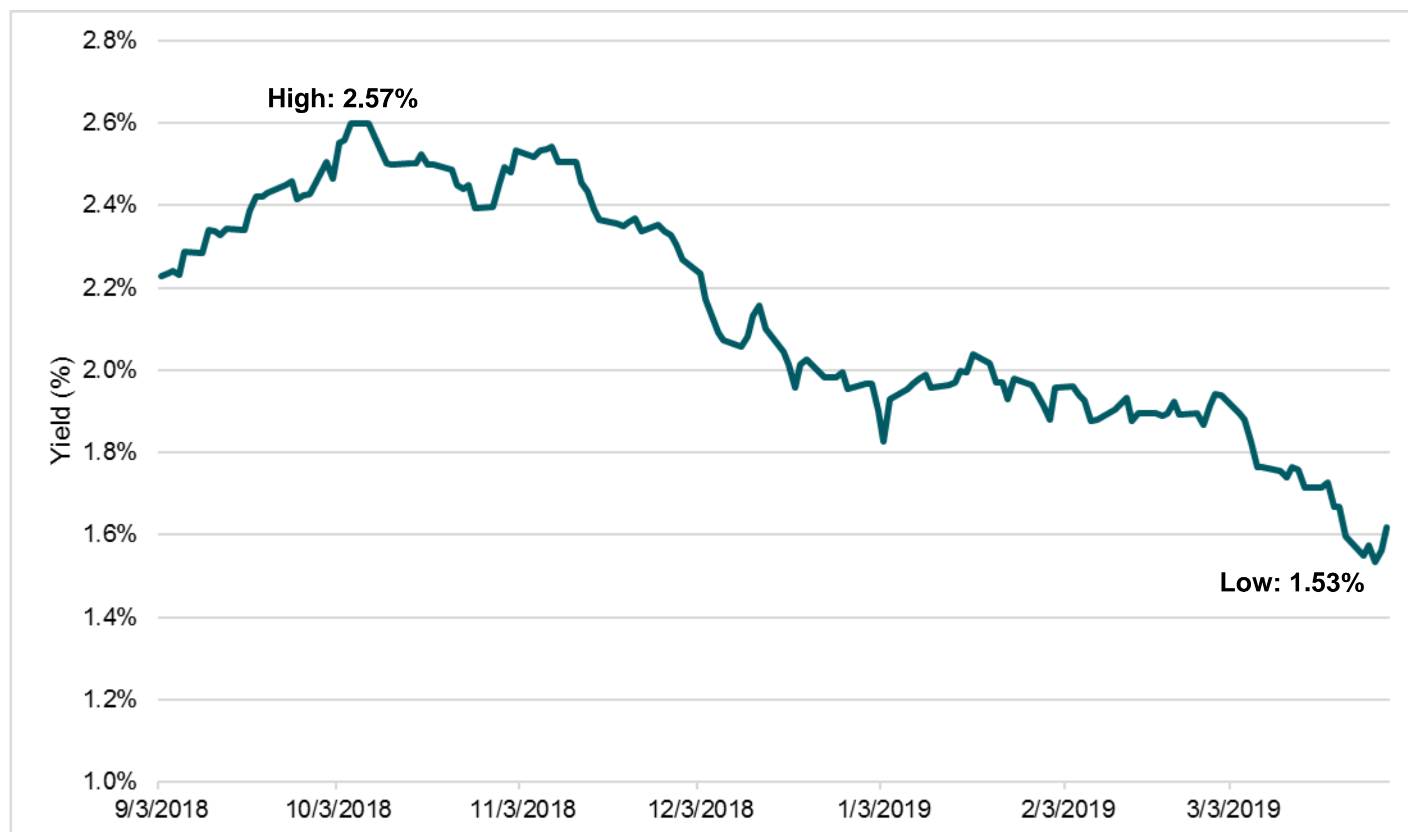
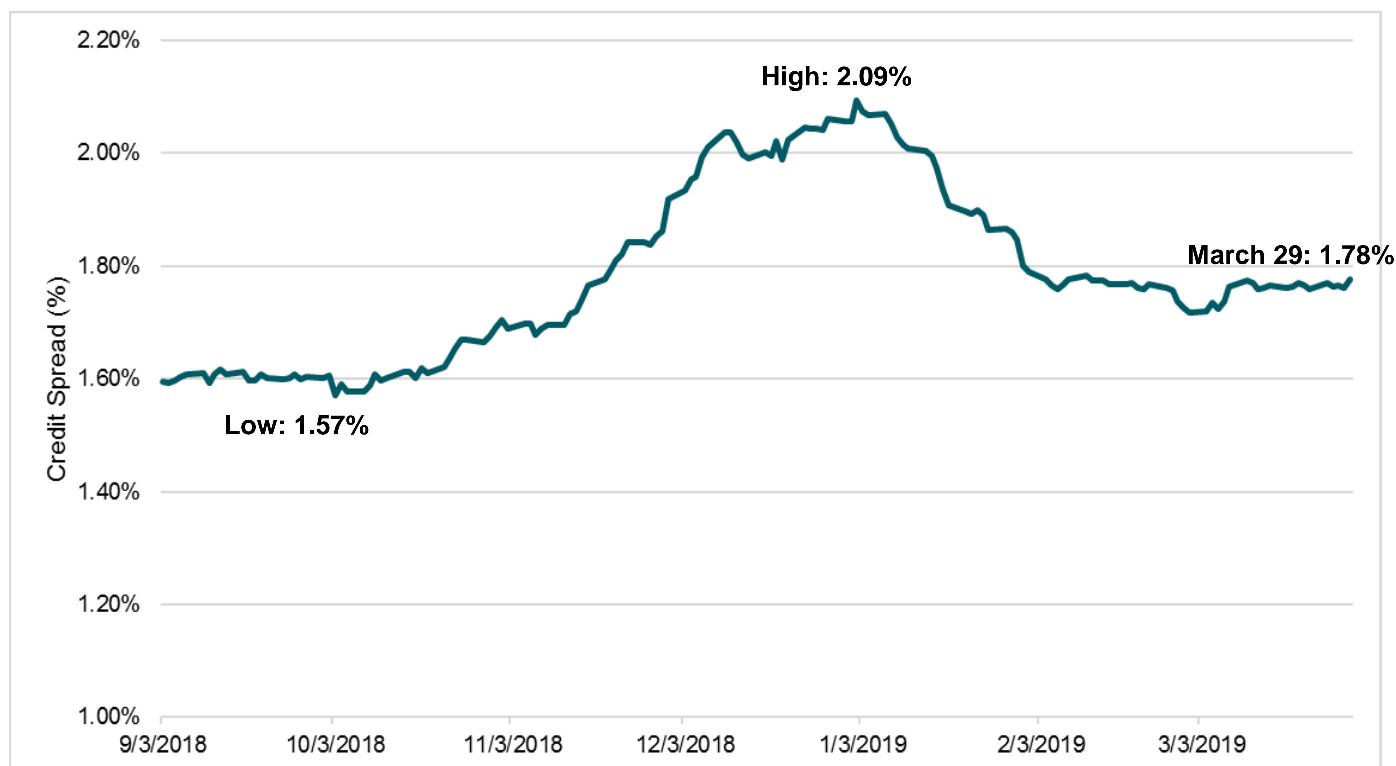
10-year Canadian Government Bond Yield October 1, 2018 – March 31, 2019



Source: Bloomberg L.P. April 11, 2019.

At the same time, corporate and provincial bond spreads widened in the fourth quarter of 2018 and subsequently tightened in the first quarter of 2019. This movement coincided with the change in risk appetite in the market. An example, seen on the chart below, shows the spread between 10-year BBB-rated corporate bonds and the 10-year government bond yield in Canada. The spread moved from 1.57% in early October to 2.09% in early January, followed by a retracement to 1.78% at the end of March.

Yield Spread 10-year BBB-rated corporate bond minus 10-year Canadian Government Bond, October 1, 2018 – March 31, 2019



Source: Bloomberg L.P. April 11, 2019.

In October 2018, I was happy with the corporate bonds the portfolio owned and was also finding additional corporate bonds in the market. That said, we were becoming increasingly concerned about the tight spread environment, combined with the weakening quality of corporate balance sheets. This was also happening while we believed that there were signs that the economy was weakening. Although we are holding what we would consider corporate bonds with good value (given the risk/return), an aggressively spread-widening environment would have a negative effect on the Fund's performance. Reducing our corporate bond exposure was an option but selling large amounts of corporate bonds quickly had the potential for high transaction costs. It also raised the possibility of not being able to repurchase the same corporate bonds in the future. I was comfortable with a corporate bond allocation below 45% in the Fund and therefore wanted to look for other ways to balance this risk in the Fund's portfolio.

The opportunity came in the duration profile of the Fund's portfolio, as a spread-widening market would likely mean that government bond rates would also go lower. We felt comfortable adding duration given our view that it would be difficult for interest rates to move much higher before really starting to slow the economy. At the start of October, the portfolio of the Fund was already long duration at 8.2 years and we felt far more comfortable raising the duration risk rather than lowering the credit weighting much below 45%.

The decision was made to extend the Fund portfolio's overall duration to its maximum of nine years, a position that was held through the fourth quarter of 2018. As of the end of March 2019 we continue to have a total corporate bond weight below 45% and duration has been lowered only slightly to 8.7 years. The Fund's portfolio did increase its corporate bond weight closer to 50% in December 2018 and January 2019, as spreads widened and allowed us to add credit at good prices. The correlation benefit from the long duration positioning gave us conviction to add additional credit risk to the Fund's portfolio. We have since reduced our corporate bond exposure to below 45% as the trend reversed and spreads tightened in the first quarter of 2019.

The long duration position of the Fund added approximately 0.5% in return, helping the Fund to produce an absolute positive return of 0.28% in the fourth quarter of 2018. The obvious question is, if this strategy "worked," why did the Fund underperform the Index over the Period? The answer is that these strategies are used to add value and control risk, not to outperform the Index over a short period of time. We hope this example gives clarity on the tools we use to add value for clients in the Fund.

Paul Marcogliese

Class I Performance as at March 31, 2019

Fund Name	YTD	1YR	2YR	3YR	Since Inception (03/27/2015)
Cambridge Bond Fund Class I	4.85	4.93	3.58	4.17	2.41
FTSE Canada Universe Bond Index	3.91	5.27	3.30	2.70	2.21

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