RBC Dominion Securities Inc.

Re-Thinking Fixed Income

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Agenda

1. Current State of Fixed Income

2. New Strategy for Fixed Income

3. Managing Inflation Risk

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Planning for a post-Pandemic Fixed Income Strategy

- The health crisis posed by the pandemic will be dealt with by a combination of better treatment and ultimately a vaccine will reduce the economic impact over the next six to eighteen months, thereby permitting more normal economic activity
- The explosion of government debt and the central banks ability to keep rates low for longer to enable a full economic recovery is a new risk for investors
- Meanwhile for investors seeking safety and regular income the options have become very unattractive with most government bonds yielding under 1% and in Europe are negative
- Investing capital with a long term time horizon requires the investor to ask the most basic question – is the reward worth the risk? We think right now for large parts of fixed income markets the answer is No.

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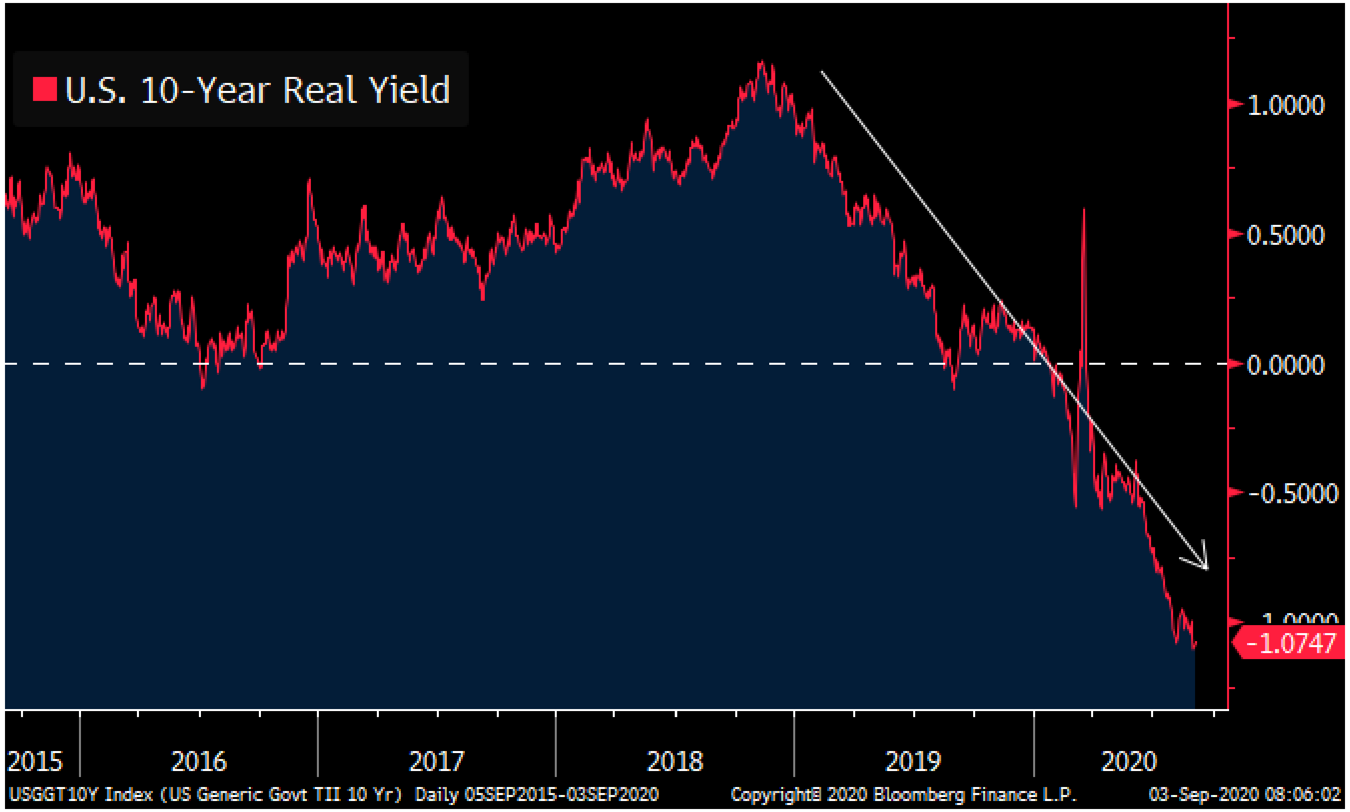
Real Yields are negative

- The most basic concept in fixed income is that in adding fixed income securities to a portfolio, the investor is reducing risk in exchange for security and regular payments of return on capital
- For much of recent economic history fixed income returns had to offer high yields than stocks, because they offer limited potential for capital gains
- In 2020 with all the monetary stimulus enacted, US real interest rates (nominal yield less inflation) went negative
- Meanwhile the fundamentals of the credit risk are deteriorating rapidly
- This relationship looks irrational to us and we question the fundamental basis for investing in many of the fixed income markets



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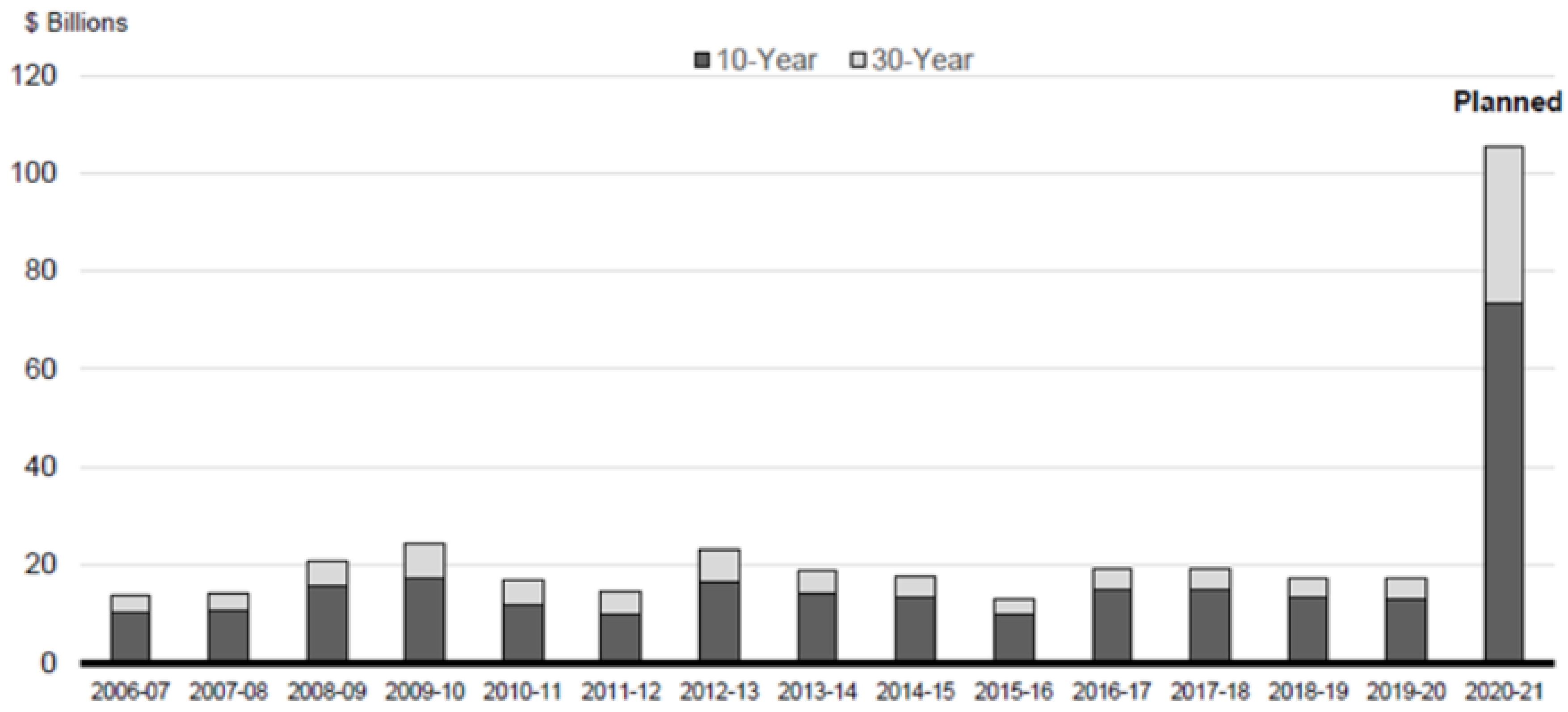
Explosion of New Government Debt

Exhibit 3: Historical vs. planned GoC long bond issuance (10 and 30-year terms)



Source: Department of Finance

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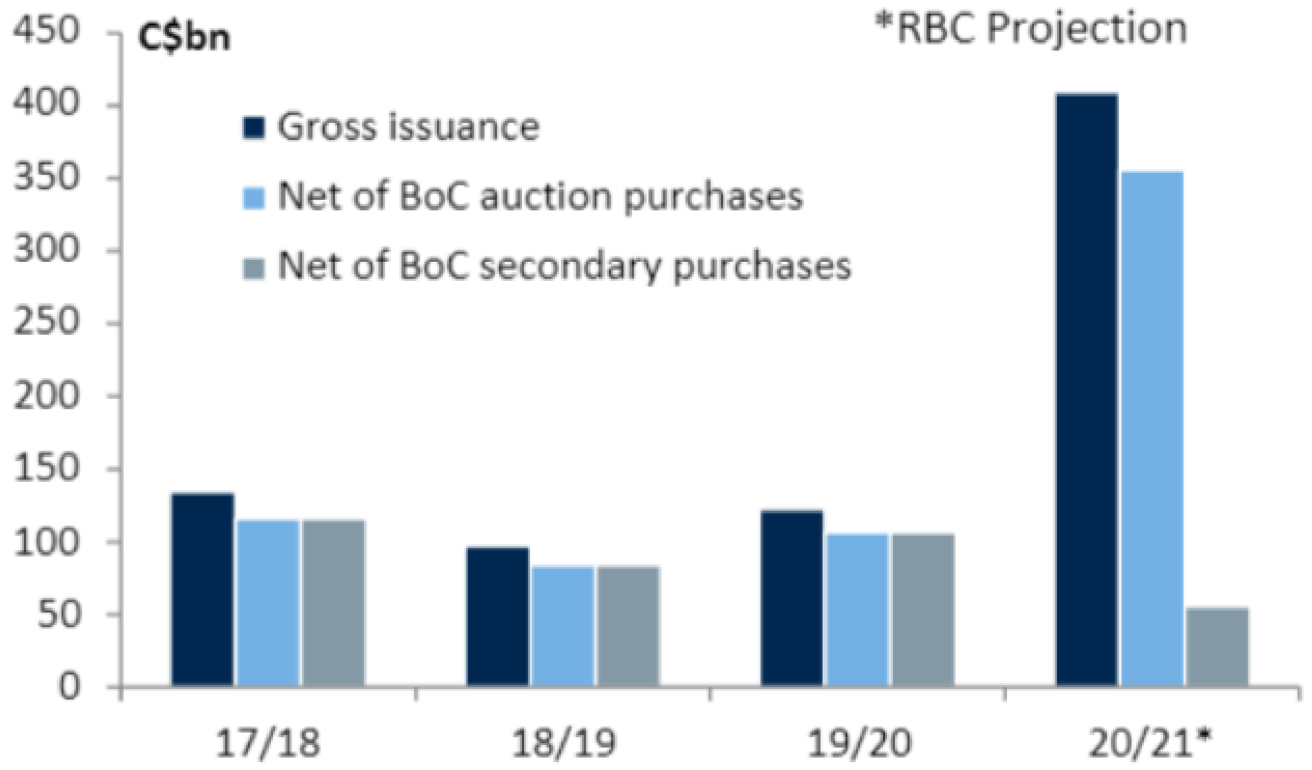
Bond markets now rely on Central banks

Exhibit 4: Projected issuance net of BoC purchases (assuming current pace continues) is C$56bn for this year



Source: BoC, DoF, RBC CM

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Bond yield & returns

Govt Bonds (bps change)	Yield	1 week	MTD	YTD	12 Mo	Cumulative BPS Change 3 Yr.	5 Yr.	10 Yr.
U.S. 2-Yr Tsy	0.153%	0.0	0.4	-141.6	-167.5	-123.0	-48.4	-47.2
U.S. 10-Yr Tsy	0.645%	-2.5	-1.1	-127.3	-141.7	-172.8	-175.3	-240.7
Canada 2-Yr	0.290%	-1.1	-0.2	-140.7	-129.7	-86.8	-20.9	-142.6
Canada 10-Yr	0.550%	-0.8	2.2	-115.2	-103.5	-134.0	-113.5	-267.9
U.K. 2-Yr	-0.108%	-2.8	-2.4	-65.3	-68.1	-40.3	-68.4	-84.9
U.K. 10-Yr	0.155%	-3.3	-1.7	-66.7	-60.3	-111.3	-192.5	-317.7
Germany 2-Yr	-0.689%	-0.6	-0.2	-8.8	4.4	-8.1	-47.9	-145.7
Germany 10-Yr	-0.465%	-3.3	-1.1	-28.0	-15.8	-100.5	-136.3	-309.9

Fixed Income (Returns)	Yield	1 week	MTD	YTD	12 Mo	Annualized Returns 3 Yr.	5 Yr.	10 Yr.
Global Aggregate *	0.92%	0.6%	0.8%	3.8%	5.6%	4.3%	3.8%	2.8%
U.S. Aggregate *	1.17%	0.5%	0.7%	6.8%	9.6%	5.6%	4.5%	3.9%
U.S. Invest Grade Corp *	2.04%	0.9%	1.5%	6.6%	11.4%	6.9%	6.2%	5.6%
U.S. High Yield Corp *	6.57%	0.4%	1.1%	-2.7%	0.9%	3.8%	5.0%	6.7%
U.S. Municipal Bond *	1.46%	0.3%	0.3%	2.4%	4.5%	4.4%	4.0%	4.2%
Canadian iBoxx Agg *	1.25%	0.0%	0.0%	7.4%	8.3%	5.5%	4.1%	4.7%
Canadian Inv. Grade Corp *	2.03%	0.2%	0.2%	5.3%	6.8%	5.0%	4.2%	4.8%

The Biggest Question facing investors making asset allocation decisions: are long-term bond returns repeatable, or is there too much risk and not enough return?

For most bond classes outperformed the TSX the last ten years?

Source: RBC Wealth Management, Bloomberg As of July 10, 2020

Asset allocation

- Over the last 20 years, 60/40 equity & bond portfolios generate less and less return
- Equities remain the best asset class, despite near-term volatility
- While bonds can help reduce volatility, the returns are now so low as to materially reduce expected return

2018 Conservative Portfolio		
Asset Class	**Weight**	**Return**
Cash	10%	0.1%
Bonds	50%	2.0%
Equities	40%	3.2%
Expected Return		**5.3%**

2020 Conservative Portfolio		
Asset Class	**Weight**	**Return**
Cash	10%	0.0%
Bonds	50%	0.5%
Equities	40%	3.2%
Expected Return		**3.7%**

2000 Conservative Portfolio		
Asset Class	**Weight**	**Return**
Cash	10%	0.5%
Bonds	50%	4.0%
Equities	40%	3.2%
Expected Return		**7.7%**

2010 Conservative Portfolio		
Asset Class	**Weight**	**Return**
Cash	10%	0.1%
Bonds	50%	3.0%
Equities	40%	3.2%
Expected Return		**6.3%**

Case Study

- Remember the goal in investing in bonds is to reduce risk in exchange for regular income and getting your cash back at maturity
- Also in Canada, interest income is taxed as coupons received, not your yield to maturity
- On September 30, 2020 you can buy a ten year BC provincial debt, the bond has a 2.2% coupon, it sells for 109.54 which yields 1.16%
- So for the retail shareholder, the tax on the bond is 2.20 % times 54% or roughly 1.19% which is more than the yield of 1.16%, and because the purchase price is 109.54 and the bond at maturity is 100, if you hold to maturity you are guaranteed a loss over 9% spread over ten years
- So when we look at this bond i) if held to maturity it is guaranteed to lose money ii) after tax provides no cash flow and iii) if interest rates rise it will lose value – why would you invest in this ? This is not safe !

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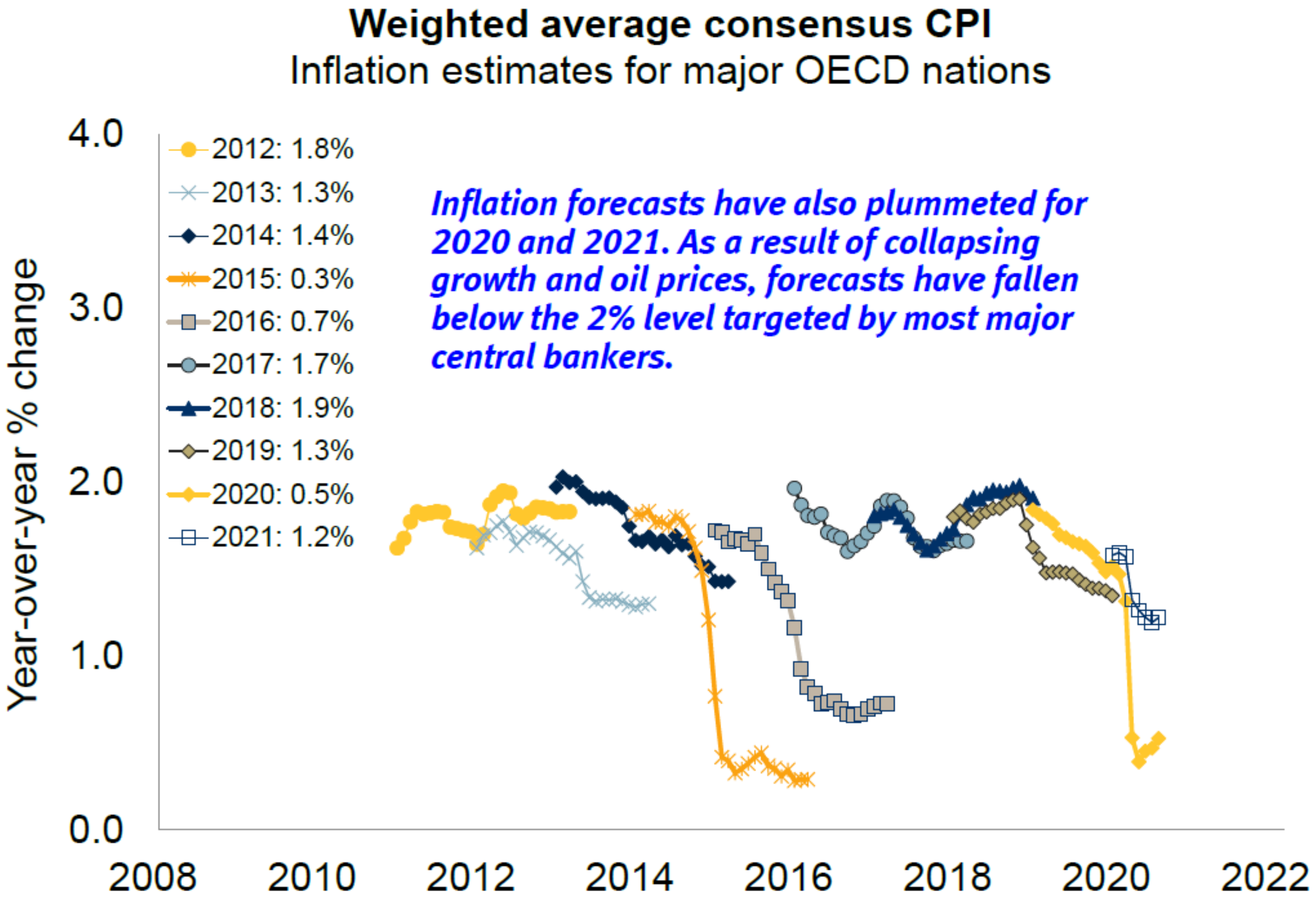
Bond Investors Bet Inflation is dead Forever



Source: Consensus Economics

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Our base case

- Our base case however is that the economic recovery will be longer and unequal

- We accept that it is very likely that rates will be lower for longer, however:
  1. Central banks control the short end of the curve, but rely on outside investors at the longer maturities
  2. Governments have massive amounts of debt that will need to be financed
  3. The current bond market assumes we will NEVER have high inflation again
  4. Bond investors have been wrong before

- We believe we need to be humble and recognize there are aspects to the current recession that we have not experienced before and our portfolio needs to be designed for a variety of different outcomes

The New Income Portfolio

Since we feel that the income offered by much of the bond market is inconsistent with the underlying risks, we have re-thought the income part of the portfolio to include

- Cash and shorter term US government bonds
- TIPS , and other inflation protected assets
- US apartment REITs
- US Utilities
- A Variety of inflation hedges
- Canadian Reset Preferred Shares
- Agricultural Commodity ETFs

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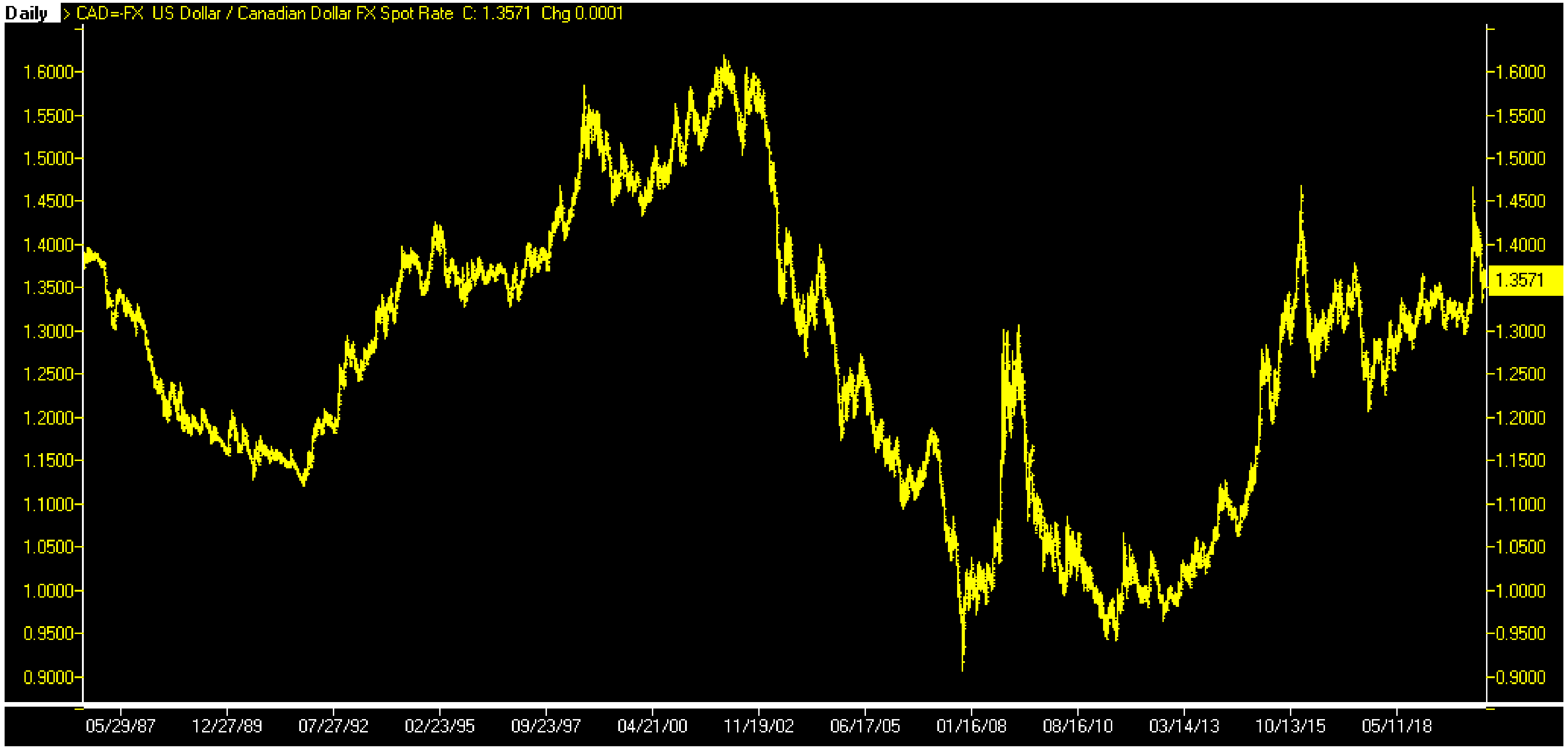
CAD to USD historical chart



Looking back 40 years, the Canadian dollar is only slightly higher than the long-term average. The peak weakness in the C$ FX rate in the late 90s to early 2000s is muted with low energy.

CAD/USD July 17, 1986 – July 17, 2020. Source: Thomson Reuters Eikon

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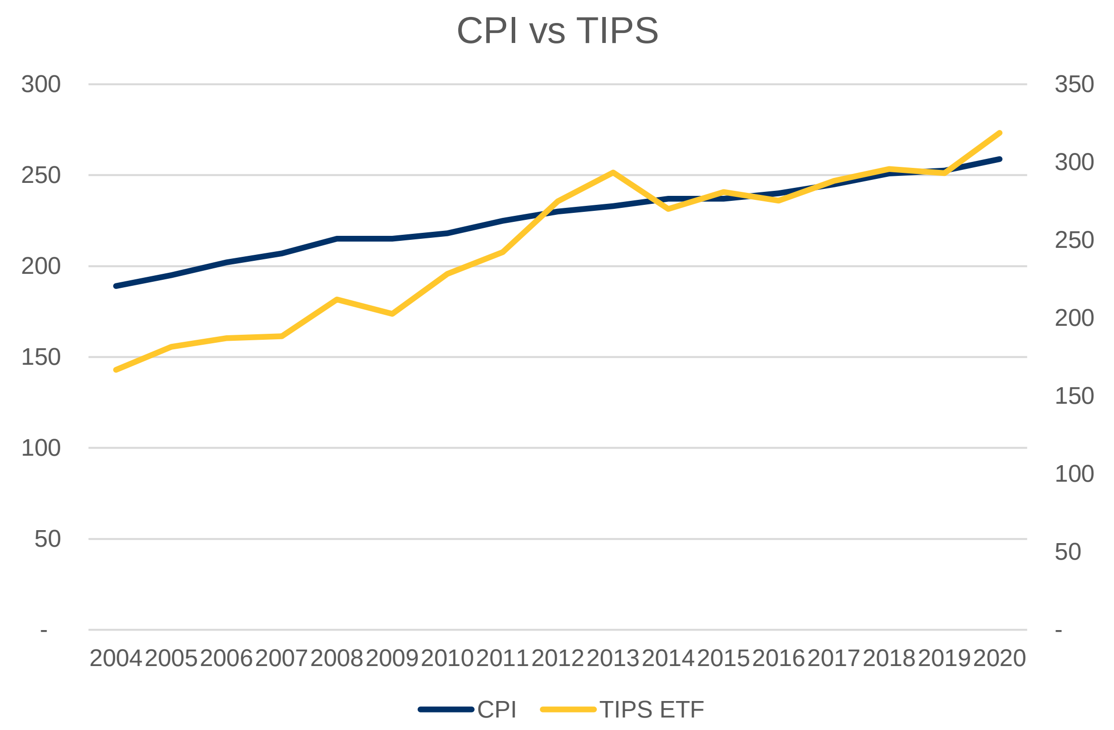
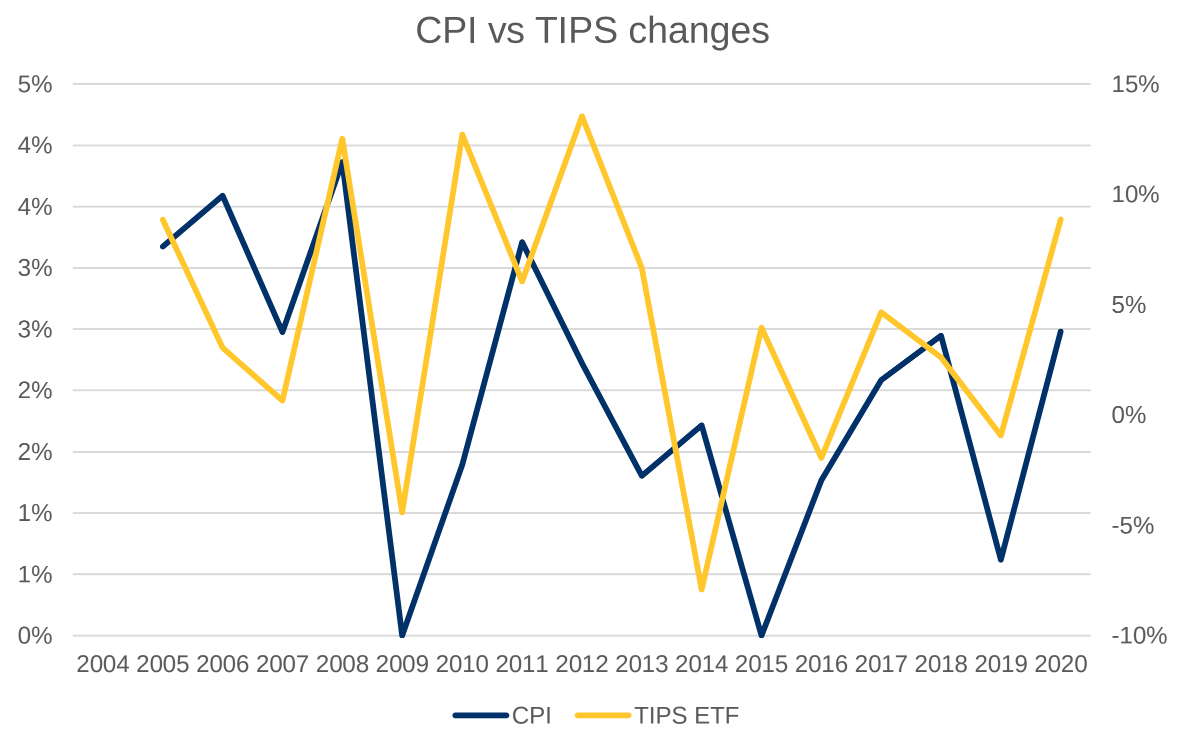
TIPS as a hedge





Date	Correlation
2004-2020	0.967

Source: Federal Reserve Bank of St. Louis, BlackRock, since December 4, 2003

Other hedges

Ticker	TIPS	TBT	RINF	IVOL
Description	Track the investment results of an index composed of inflation-protected U.S. Treasury bonds	Seeks investment results that correspond to two times the inverse (-2x) of the daily performance of the ICE U.S. Treasury 20+ Year Bond index	Seeks investment results that track the performance of the FTSE 30-Year TIPS Index	Seeks to hedge relative interest rate movements, whether these movements arise from falling short-term interest rates or rising long-term interest rates, and to beenfit from market stress when fixed ncome volatility increases.
Inception Date	12/04/2003	04/29/2008	01/10/2012	05/13/2019
Expense Ratio	0.19%	0.90%	0.30%	1.04%
Total Return since inception	97.87%	-20.77%	-3.98%	11.20%
CPI return matching inception	37.04%	20.47%	12.61%	0.80%

Source: BlackRock, ProShares, Quadratic Capital

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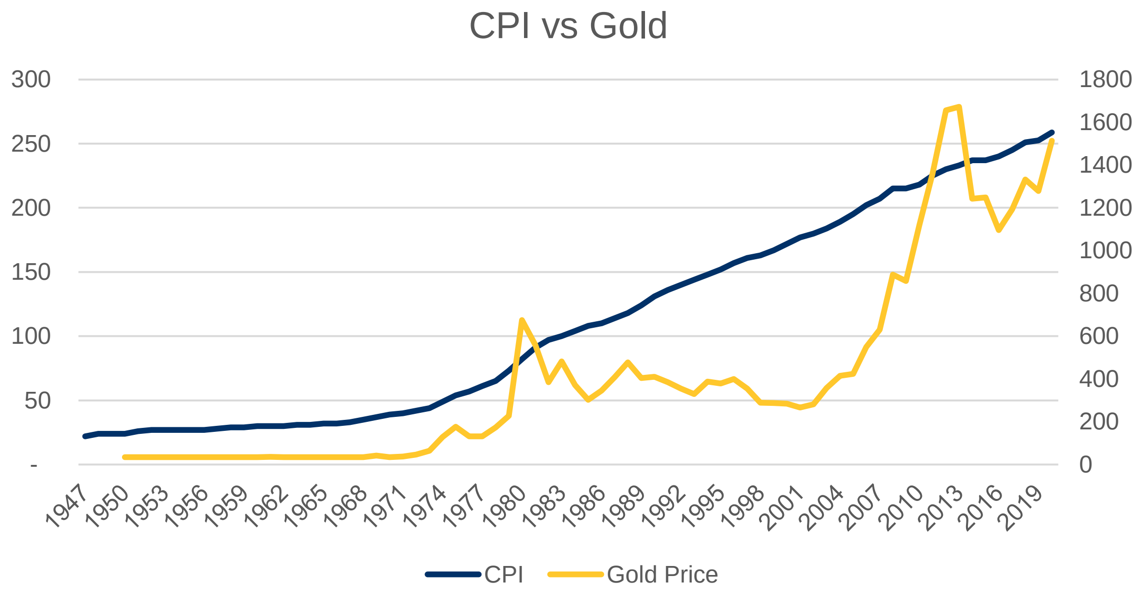
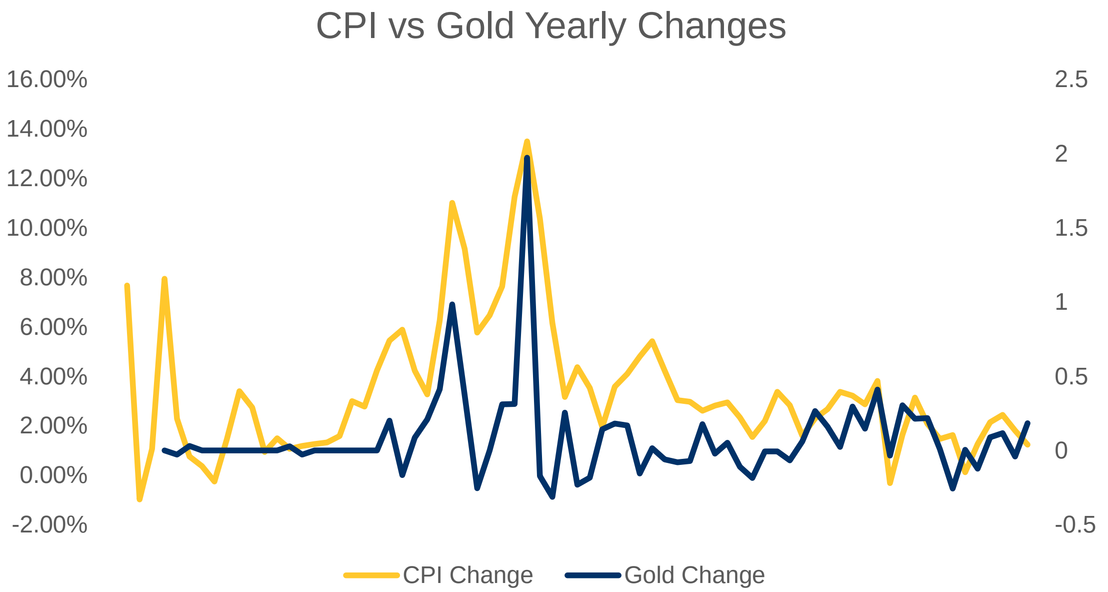
Gold as a hedge





Date	Correlation
1950-2020	0.865
1972-2020	0.802

Source: Federal Reserve of St. Louis, Bundesbank, Gold Data since 1950, CPI Data since 1947

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The Warren Buffett Approach

The unconventional, but inescapable, conclusion to be drawn from the past fifty years is that it has been *far* safer to invest in a diversified collection of American businesses than to invest in securities – Treasuries, for example – whose values have been tied to American currency. That was also true in the preceding half-century, a period including the Great Depression and two world wars. Investors should heed this history. To one degree or another it is almost certain to be repeated during the next century

– 2014 letter to shareholders

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Thank you!

Questions?

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