October 2017

"You load 16 tons and what do you get? Another day older and deeper in debt…"
-From the song "16 Tons" (Merle Travis)

Debt Trap

Dear Investor,

During the first part of the 20th century, coal miners worked in company towns where everything was owned by the mine operator, including the general store. These stores would charge excessive prices to the employees for goods, making it impossible for the workforce to get ahead.

Tennessee Ernie Ford's version of the song "16 Tons" was a huge hit in the mid-1950s, selling over twenty million copies. It tells the story of a hardworking coal miner living in a company town, who was basically sentenced to a life of indentured servitude, as his income could not keep up with his basic living expenses.

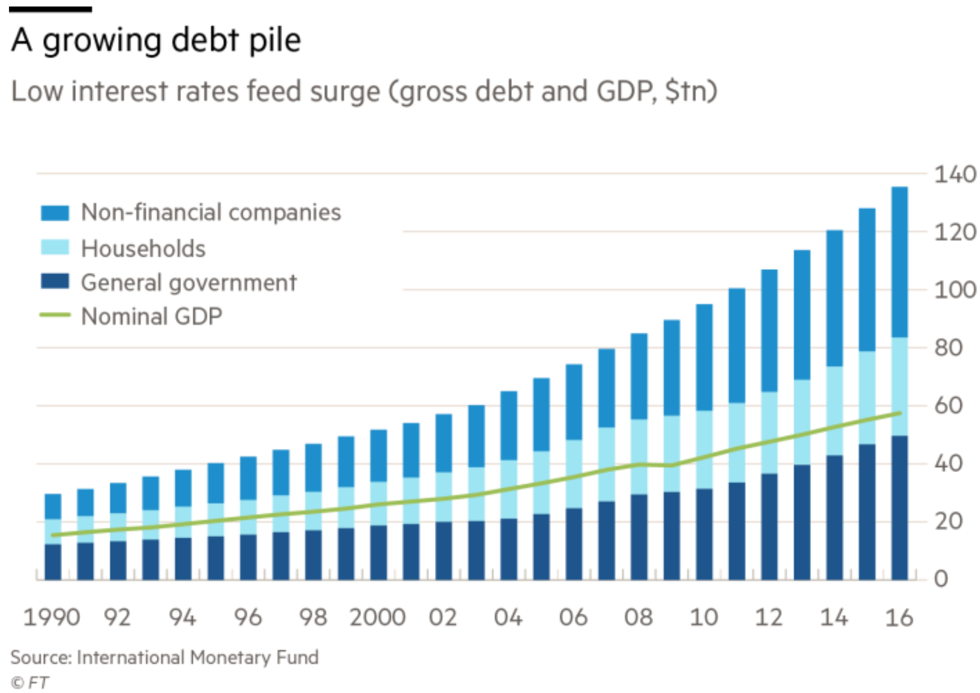
When the financial crisis unfolded, many countries came to the belated realization that their debt levels were unsustainably high. Following previous recessions, government policy focused on increasing spending to "jump start" the economy. This is the foundation of Keynesian economic theory, which posits that governments should run surpluses during economic booms, so that they would have the resources to increase spending and run deficits during recessions.

This time around, many heavily indebted countries did not have the necessary access to capital to fund increased spending. So instead of stimulus programs, they embarked on a long period of austerity in an attempt to improve their financial position. The results were not surprising. Without fiscal stimulus, the recovery has remained a weak one – the weakest, in fact, since WWll.

Slow economic growth has negatively impacted government tax revenues, and almost a decade after the financial crisis, most countries have been unable to significantly improve their fiscal situation, leaving them with too much debt and still susceptible to an economic shock and/or rising interest rates.

Without the support of fiscal stimulus to assist the economy, central banks responded with massive monetary stimulus, in the form of interest rate cuts and quantitative easing. These policies have achieved the desired result – record low interest rates and bond yields. Consumers and corporations acted as anticipated, by loading up on debt as borrowing costs shifted to such low and attractive levels.

As can be seen in the accompanying graphic "**A growing debt pile**," gross debt by the G20 nations has continued to rise as percentage of GDP. (Source: International Monetary Fund - reprinted by the Financial Times)



Here we are, almost a decade after the financial crisis, and the global debt overhang remains relatively unchanged, despite years of economic growth and low interest rates. No wonder the IMF is voicing concern.

Low interest rates have boosted asset prices, giving lenders adequate collateral for their loans. However, a rising debt load leaves borrowers in an increasingly vulnerable position as we enter a rising interest rate cycle.

With debt at such high levels, even a relatively small increase in interest rates can have a significant impact on a borrower's ability to meet their obligations. There would also be an impact on government budgets and corporate profits.

The U.S. Federal Reserve Board is, of course, aware of all of this, and has maintained a go-slow approach so as not to derail the economy. That is the good news. The less good news is that, with so much leverage in the system, even a 1% increase in 5-year bond yields will have a negative impact on the economy.

For example, the U.S. 30-year fixed mortgage rate stands at about 3.9% today, up from 3.5% one year ago. That may not seem like a huge difference, but on a $500,000.00 mortgage, the monthly payment has risen by about $100 per month, and is likely to move higher. This, undoubtedly, is putting pressure on borrowers whose wages have barely kept pace with inflation.

What about investors?

Over the past ten years, asset allocation among institutional investors have shifted dramatically. In 2007, about 80% of the global fixed income index yielded over 4%.[1] At that yield level, traditional fixed income was an important component of most institutional portfolios. Today, less than 5% of global fixed income yields over 4%.[2]

With most fixed income offering such low yields, investors such as pension funds, insurance companies and foundations cannot meet their long-term obligations. As a result, these investors (in fact almost all investors) have been investing in riskier assets in search of yield.

With so much money flowing into assets such as equities, real estate and infrastructure, yields have declined and investors are taking on increased risk. Infrastructure investment is a perfect example. The major pension funds have dramatically increased their exposure to infrastructure projects (airports, toll roads and hospitals, to name a few) over the past decade. Historically, these investments were offering IRRs (internal rates of return) of 8-10%.[3] Today, cash yields are around 5%, with expected IRRs of 6-8% (using leverage and therefore adding more risk).[4]

If investors are accepting such low yields today for these long-term, illiquid investments, is it because they are less risky than in the past? Of course not. Investors who should know better are accepting even lower returns while taking on increased risk – a strategy that rarely ends well. Long-term fixed return investments tend to perform poorly when interest rates are on the rise.

High Yield Bonds

A review of the high yield bond market and our high yield fund is available here: **High Yield Quarterly**.

Final Thoughts

After years of austerity programs and economic growth (albeit at a lower rate than past recoveries), it is concerning that global debt (in relation to GDP) is still rising. In the IMF report that we cited earlier, there were three countries specifically mentioned as being at greater risk due to high debt levels: Australia, China and… Canada[1] (due, in large part, to rising mortgage debt). High debt levels and rising interest rates suggest that we may be in a low-growth world for quite some time.

I find that most investors focus on their **returns**, without really thinking about the **risk** side of the equation. I am the opposite. It is meaningless to look at the potential upside of an investment, without having a very good understanding of the underlying risks. The combination of elevated debt levels and rising interest rates present a significant risk, and we remain conservatively positioned, while still benefitting from owning a great collection of attractively valued businesses.

We welcome the opportunity to discuss our outlook and investments with you.

Sincerely,

Lorne Steinberg
President

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[1]IMF October 2017 Global Financial Stability Report
[2]Ibid.
[3]Schroders: April 2017 Infrastructure financing-an overview
[4]Ibid.