WARATAH

Brad's Musings

James Bund, Double-O-Seven(teen)

As you may recall, the Waratah Income Fund has been shorting government bonds for several years. We do this both to protect against the effects of a rise in interest rates on our interest sensitive equities and corporate bonds, and to express our view that government bonds are excessively overvalued. This strategy paid off handsomely in 2013 but lowered our returns in 2014. One of the reasons for the continued strength in US Treasuries was because they looked like great bargains to investors who were comparing them to the near-zero yields in European bonds. This looked a lot like a classic late-stage bull market thought process where relative value is used to justify ever higher prices. On 13 April 2015, we shorted 10-year German Bunds for the first time. I do not know who bought them from us but they gave us cash in exchange for a 16.7 bps annual return (pre-tax). German Bunds are denominated in Euros, but let us assume a Canadian Dollar equivalent was invested because I like to think in dollars and I have no idea where to find the Euro sign on my keyboard.

Assuming the German government does not default, for a 10-year bond issued at par for $1,000 paying 16.7 bps yield to maturity, in ten years the $1,000 loan will be repaid and the investor will have earned annual interest payments along the way of $1.67. Utilizing the highest marginal tax rate in Germany of 45%, the investor is left with only about $0.92 per year in after-tax income or, if you prefer, a return of 0.1% annually.

For having forgone $1,000 that could have been enjoyed today, to upgrade a vacation, to make improvements to a home, or to invest in equities, the investor will have earned a grand total of $9.17 for having waited, patiently for 10 long years without access to that $1,000. But that's not all, I almost forgot about the greatest power in the universe – compound interest. If the investor reinvests the $0.92 in after-tax interest they receive each year back into an equivalent yielding Bund (assuming the same yields exist in the future), the $9.17 ten year return increases by 3 cents to $9.20. Apparently, the greatest power in the universe is pretty feeble when there is no return to compound.

If you're not yet convinced that owning a German Bund today is the **worst investment ever!** I have two more points to solidify my case. On a recent business trip, I paid $2.59 for a Grande Blonde Coffee just before boarding my plane. My parking bill when I returned from my 2-day trip was $56.50. That $1,000 could buy me 386 cups of coffee or allow me to park for approximately 35 days. If I go to the airport in May 2025 with my $1,000 plus my $9.20 of earned income do you think I will be able to buy more or less Starbucks coffee and on premise airport parking? I am going to be an insolent, stubborn, insistent know-it-all and tell you the answer is a lot less of both and I will cover my ears with my hands and say "na na na na na" if anyone tries to argue with me.

The final reason that Bunds (and all government bonds for that matter) are a lousy investment is because they are risky. At these low levels of interest rates, bond values are very sensitive to changes in interest rates. The longer the maturity, the higher the risk. At a required yield of 5%, the 10-year German Bund we've shorted would decline in price by 32%.[1] A longer duration bond, such as a US 30-year Treasury would fall by 31% if the required yield rose by as little as 2%.[2] With the recent increase in interest rates experienced this year, the US 30 year Treasury experienced a drawdown of 18.1% over a 5-month period.[3] That's a volatility level one would expect to see from equities. Bond investors are playing with fire as far as I am concerned. Bonds earn hardly anything, you lose purchasing power to inflation, and the risk of owning them at current valuations is simply too high. I plan on buying a lot more coffees, some airport parking and hopefully university educations for my three sons in the years to come. That is why I took the $1,000 we received from selling German Bunds and purchased Canadian Apartment Properties REIT (4.3% yield), Canadian National Railway (1.7% yield), Royal Bank of Canada (4.0% yield), Lamar Advertising REIT (4.7% yield) and Manulife Financial Corp (2.9% yield).[4]

If bonds really are the worst investment one can purchase, it must also be true that bonds are the best investment one can sell. Practically speaking, this explains why even companies that don't need cash (Apple, Microsoft….) are issuing debt in record amounts. It's simply too good a deal not to take. I firmly believe that stable businesses that proved their resiliency in the 2008-09 recession should be taking advantage of this low interest rate environment by issuing a lot more debt to buy-back stock or make acquisitions. That sounds risky and, at first glance, seems inconsistent from someone who considers himself to be a very risk-averse investor. It almost seems ironic, but the best way to express an aggressive view towards increased use of debt is to own companies that currently do not have much debt. You actually end up with a more conservative portfolio. I want to own the businesses that have the optionality of utilizing their balance sheets. I am far less interested in owning the companies that have already leveraged up to 4x debt / EBITDA. They've already made the big acquisition, the EPS had its big jump, the stock went up, and it will take some time before they've paid down enough debt to do it again. One of our favourite short selling recipes is to identify those companies that have already leveraged up and are also handicapped with a demonstrated inability to generate meaningful free cash flow. These businesses have no other choice but to access the equity market and print new shares to keep the acquisition machine in motion.

When it comes to governments, the conventional view is that debt is a bad thing and that we should pay it down. We often read that we are burdening future generations with mountains of debt and a collective guilt hangs over society as a result. However, here is an alternative view to consider. For lack of a better term, "stiffing" the next generation has probably been going on as far back as human history and yet I would say that we have done fairly well as a civilization. Maybe it is simply a case of too many people looking at the glass as always being half-empty. Maybe we are only considering the liability that is passed on to the next generation and failing to recognize the asset. I'd like to see some newspaper articles giving thanks and expressing gratitude to all of the politicians and bureaucrats who had the foresight (or dumb luck) to go on a massive, debt-funded infrastructure spend in the post-war period. Imagine a world today where there is no Hwy 401? No St. Lawrence Seaway? No Pearson Airport? Isn't it wonderful that Hwy 401 was built with 1950s dollars? What if construction had not started until the inflationary 1970s? What if we had to build all of that infrastructure in today's dollars? How many more homes and apartment buildings would have to be torn down and their owners compensated if we had to build the 401 today? There isn't enough money in the world to do it and we would simply have to live without it. If I may take the liberty of speaking for my generation here is a great big THANK YOU to the Greatest Generation for winning the war and coming back to build all that stuff that makes my life easier and saves me time that I can spend with my family.

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[1] DBR 0 ½ 02/15/2025 Govt measured at 6/19/2015. Source of data is Bloomberg.
[2] T 3 05/15/2045 measured at 6/19/2015. Source of data is Bloomberg.
[3] US Generic 30 Year Yields rose from 2.22% on 1/30/2015 to 3.216% on 6/10/2015. Source of data is Bloomberg.
[4] Indicated yields as at 6/19/2015. Source of data is Bloomberg.

If there is such a thing as a good time for governments to borrow as much money as they can that time is now. Take a page from the Apple playbook and hit that bid! As a smart person recently pointed out to me, there is a big difference between borrowing to invest in infrastructure and borrowing to invest in consumption. Inflation and Interest rates are at all-time lows. Maybe we should sell some of these obscenely priced, 100-year bonds and build hydro-dams, natural gas pipelines, wind-farms, solar farms, hospitals, schools and electric car refuelling stations. Maybe we should repair our roads, bury the Gardiner Expressway and fix our water systems while we are at it. Governments may not be the best allocators of capital. That is a fair point. But with interest rates at close to zero the return hurdle is very low. Working with the private sector using partnerships and joint ventures is probably the safest way to achieve higher returns for the taxpayer.

While it is true that our economy is not growing at the same rates as it did in the 1950s and 1960s, that is not a reason to avoid investing in infrastructure. The reality is that the level of economic output per person is much larger today and the value of time is at an all-time high. Good returns can be earned as long as the investment improves economic efficiency, lowers costs or saves people time. The Hwy 407 is a great example of a home run infrastructure investment.

It may be that the act of supplying the market with more bonds and then investing the money will spur on a little inflation and get interest rates back to a level that makes sense. The best part is that we will get to benefit from all those investments and the returns they give our society for the next 100 years and our grand children can pay it all back with dollars in the year 2115 when I predict a single Grande Blonde Coffee from Starbucks will cost about $500.

Brad Dunkley

June 24, 2015

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