What's Love Got to Do with It? | January 2023

"What's love but a secondhand emotion?"
Tina Turner

On the fourteenth day of this month, romantics across the globe will celebrate what Plato once called *theia mania*, the divine madness. While the origins of Valentine's Day lie in ancient Rome, the first evidence of it being a day for lovers is in Chaucer's 14th-century poem, Parliament of Fowls. And the oldest Valentine on record was sent a century later by Charles, Duke of Orleans, to his wife during his imprisonment in the Tower of London.

But long before these gentlemen inked their poems, that crazy little thing called love was capturing hearts and minds and inspiring great works of art, literature, and philosophical discourse.

For philosophers, one of the fundamental questions is whether love is an 'appraisal' or 'bestowal' of value. In logical terms, does x love y because y is beautiful, or does x believe y is beautiful precisely because x loves y. For the clowns amongst us, the natural response is, 'how many beers did x have?'

A similar question could be asked of positions in your portfolio. Not that of the number of drinks but of appraisal versus bestowal. Are you objectively evaluating the merits of the investment or are you inferring value because you have become enamoured with it, or simply because you own it?

For those of you wondering if we are really going to try and weave love into an investment commentary. Yes, we are going there.

It's the falling in love.

The first stage of love, the 'falling', is given an inordinate amount of attention and is often the focal point of our stories and movies. It is the phase where we cannot stop thinking about our beloved, and when the object of our affection becomes the model of perfection. And despite the plethora of evidence and billions of lovers that came before us, we somehow have the sensation that what we are feeling has never been felt before.

The 19th-century French writer, Stendhal, referred to this process of falling as 'crystallization,' and used the analogy of a bough being left in the salt mines of Salzburg. Over time, the stick becomes covered in crystals and is converted into a thing of beauty. And it is only when we fall out of love, that the crystals dissolve and the underlying twig is once again revealed.

Stendhal also saw this process of crystallization in gambling, 'stimulated by the thought of…the money you will win' (*On Love, 1822*). The prospect of the gain blinds us from the risks and from seeing the stick for what it is.

Centuries later, neuroscientists would affirm this notion with evidence of investors experiencing increased levels of dopamine when big potential gains are on the table. As per Kabir Sehgal in his book, Coined, 'our brain registers money as a stimulus, so much so that the brain scan of someone about to receive a hit of cocaine is virtually indistinguishable from someone about to gain money.'

Such visceral responses to love and money can elicit particularly risky behaviour, as has been catalogued in countless romantic tragedies and investment horror stories. Such are the perils of falling for the allure of potential.

Like not love.

But falling in love with an investment is a high bar for it to be included in your portfolio. Most of the time we just want to be friends, and sometimes we are just looking for a short fling (even though we all say we are long-term investors).

But just as you overlook flaws in a friend that you wouldn't tolerate in a stranger, you could be overvaluing an asset just because you own it. The endowment effect (or divestiture aversion) is the tendency to appraise items we own above their monetary worth. The price we are willing to pay to acquire something is less than the price we are willing to sell that very same object once it is in our possession.

Status quo also has us preferring to stay in a relationship with a position rather than replacing it. And confirmation bias focuses our attention on data supporting our original investment thesis and disregarding contrary evidence.

Secondhand emotions.

These and numerous other biases have been well documented and catalogued by both the sciences and social sciences. Those secondhand emotions which wreak havoc with our logical decision-making, particularly when it comes to love and money. The difference being the utility of these illogical tendencies across these two realms.

Love is in and of itself irrational. It lives beyond reason and is the mother of all biases. A lover is ready to sacrifice everything for their beloved.

In love's realm, emotions are not only critical to forming bonds of attachment but can be a source of great insights and knowledge. As per Blaise Pascal, 'the heart has its reasons which reason knows nothing of.'

But in the world of investing the heart is a lonely hunter, and being clinical and methodical is to one's benefit. But to do so we must overcome the emotional inner workings of our brains. A battle that begins and ends with acknowledging that we are not just the rational agents of economic textbooks but also the protagonists of love stories.

And with Valentine's approaching, what better reminder does one need of our emotional and irrational selves. For even the shrewdest and most calculated of investors have done some pretty crazy things in the name of love.

The Month of January.

Credit.

The new-found love for fixed income has seen bond funds attract large inflows forcing portfolio managers to scramble to put money to work. Matters were not helped with only $10.55 bn of new deals in January (compared to $12 bn last year). Banks continued to dominate new issuance (68%) with the remainder split between utilities, autos, and retail issuers. There was robust demand for the new supply, as deals were 2.75x oversubscribed, and notably, Metro's 10-year deal was 12x covered.

The strong demand for bonds, light supply, and positive macro tone was supportive of credit. And with dealer inventories depleted, spreads had no where to go but tighter. While January saw domestic credit keep pace with the rally south of the border, Canadian investment-grade spreads remain attractive on a relative value basis.

- Canadian spreads narrowed 12 bps to 150 bps
- US spreads narrowed 13 bps to 117 bps

Interest Rates.

Signs of disinflation sparked optimism that rate hikes were about to end. The Bank of Canada delivered a 25 bps hike and announced a pause to assess the impact of 425 bps worth of rate hikes on growth and inflation.

The Federal Reserve also raised rates by 25 bps but indicated that at least two more 25 bps increases are needed before a potential pause. Investors were happy that central banks are nearly done and moved to drive yields lower on hopes that rate cuts will start later this year.

Sovereign yields:

- Canadian 2y finished at 3.75% (-30 bps) and the 10y at 2.91% (-38 bps)
- US 2y finished at 4.20% (-23 bps) and the 10y at 3.51% (-37 bps)

The Funds.

Algonquin Debt Strategies Fund.

The combination of spreads narrowing, and an attractive portfolio yield set us up for a good month. The Fund also had the additional benefit of outperformance in bank bonds, to which we have a concentrated exposure.

Portfolio Metrics:

- 9-10 % yield
- IR Duration 0-1y
- 2yr average maturity
- Average credit rating: BBB+

	1M	3M	6M	YTD	1Y	3Y	5Y	SI
X Class	2.40%	5.52%	5.42%	2.40%	1.29%	2.39%	3.25%	7.90%
F Class	2.42%	5.44%	5.2%	2.42%	0.79%	1.76%	2.56%	NA

* As of January 31st, 2023

The Algonquin Debt Strategies Fund LP was launched on February 2, 2015. Returns are shown on 'Series 1 X Founder's Class' since inception and for 'Series 1 F Class' since May 1st, 2016 and are based on NAVs in Canadian dollars as calculated by SGGG Fund Services Inc. net of all fees and expenses. For periods greater than one year, returns are annualized.

Algonquin Fixed Income 2.0

Interest rates continue to move in large ranges. After having added duration during the last two days of December, we used the drop in yields in January to lower exposure. We think that yields will continue to move in wide ranges which will allow us to be dynamic with duration.

On top of the rally in rates, the fund also benefited from the rally in credit and the interest earned.

Portfolio Metrics:

- 7-8% yield
- 3y duration
- Average maturity: 3y
- Average credit rating: A-

	1M	3M	6M	YTD	1Y	2022	2021	2020
F Class	3.03%	6.32%	3.32%	3.03%	-1.52%	-6.15%	2.42%	10.53%

As of January 31st, 2023

Looking Ahead.

Higher yields and the prospects of central banks pausing to assess the path of inflation have rekindled the romance with fixed income. Portfolio managers are flush with cash and struggling to put money to work. New issues are many times oversubscribed and appear to be purchased largely with cash on hand. Dealers appear to have very little inventory in their warehouses to satiate the pickup in demand.

While we are also enamoured by bonds, we do not think this is the era of ‘free love’ defined by the sixties. Instead, one needs to be more selective about one’s paramours, so perhaps this is more like the eighties.

The deeply inverted yield curve suggests that investors believe central banks will be cutting rates by the summer. When we look at long-term rates we see little room for them to fall further even during a rate-cutting cycle. We even think it is possible to see them move higher should inflation prove to be a bit more persistent than anticipated.

This time last year we told people that ‘duration was portfolio insurance that was not needed.’ Today we think there is value in duration, however, the path for inflation will likely involve numerous plot twists that startle the bond market. As such, the yield level at which one extends duration will likely determine the difference between a good or ‘ho-hum’ result.

The credit markets are mixed in terms of building a recession risk premium. High yield and US investment grade bonds appear to be optimistically valued when compared to domestic investment grade companies. With the future path of the economy proving difficult to predict, one needs to consider the nuances of issuer quality before purchasing debt.

We believe that high-quality Canadian banks, telcos, and energy infrastructure offer attractive value since their spreads remain significantly higher than their long-term averages. These securities thus offer the trifecta of value, liquidity, and security.

The above is a long-winded way of saying 'bonds are good, but some are better than others.'

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