Nicola Update into REITS, High Yields and Preferred Shares

Correlations have all gone to 1 for the time being and all sectors in the market are being hit hard simultaneously. Canadian REITs, Preferred shares, and high yield bonds have not been immune to the COVID-19 sell off. The unprecedented economic shock of the shut down of cities coupled with an oil price war have ravaged almost every asset class.

The velocity of the sell-off has been equally remarkable. Historically low levels of interest rates have led to large amounts of leverage in the system. The deleveraging of investors has led to dramatic swings in equity markets on a daily basis. ETF's which have democratized investing making assets easier to buy over the past decade also make assets easier to sell, exacerbating the situation. Finally, bank traders who historically have provided liquidity to markets and helped stabilized pricing are being handcuffed. Banks have skeletal staffing on their trading floors or have traders working at home, and they do not have the bandwidth to support markets.

Year to date (as of March 23rd) the iShares S&P/TSX Capped REIT Index ETF is down -41.5%, BMO Laddered Preferred Share Index ETF is down -37.4%, and iShares iBoxx High Yield Corporate Bond ETF is down -21.3% in local currency terms. The immediate problem that we face is that investors appear to be liquidating whatever risk exposure they have across the board.

If we are investing money for the next 3-5 years it appears to be a great buying opportunity. Over the coming months and quarters, we will be adding to parts of the market that have dislocated from their fundamental values. We feel we have time on our side and there is no rush to rebalance. As prices may be dislocated for an extended period of time and we do not believe we can time the bottom. The distribution of these investments means that we will get paid a high level of dividend or interest income even if the price continues to fall and providing a cushion to returns.

We are looking to purchase cash flows of these companies (in the form of dividends and interest) at significant discounts to where they were priced last month. Depending on how deep and protracted this environment lasts these distributions maybe cut but by focusing on companies with lower leverage, investment grade companies, or companies with higher quality earnings, we believe we are better positioned to weather the storm.

We believe our REITS, preferred shares, and high yield bonds funds offer these characteristics.

REITS

- Often the price of a REIT trades higher than the value of the real estate they own (net asset value or NAV). The reason for this is that for many investors, REIT's are much easier and cheaper to acquire than a building and they offer substantially more diversification and liquidity. Currently REITS are trading at greater than -40% to their NAV which is lower than the -27% seen during the Great Financial crisis of 2008.

- The pullback offers a deeply discounted entry point and an opportunity to buy a steady income stream at a reasonable price. We feel the yields now are good compensation to earn while we wait for cooler heads to prevail. Despite Government of Canada yields moving drastically lower AFFO Yields (adjusted funds of operations) of REITS have moved from 4.9% to 7.0%.

- Riocan and H&R REIT are bellwethers for the REIT industry with a long track record and low leverage. Riocan and H&R REIT have seen their yields move from 5.4% and 6.5% respectively at the beginning of the year to 11.6% and 18.3%.

Here are five REITs and their distribution yields as of December 31st and March 23rd.

	Distribution	Price Dec 31st, 2019	Yield	Price March 23, 2020	Yield
Riocan	1.44	26.76	5.4%	12.45	11.6%
H&R REIT	1.38	21.1	6.5%	7.56	18.3%
Allied Properties REIT	1.65	52.07	3.2%	31.93	5.2%
CAP REIT	1.38	53.01	2.6%	37.85	3.6%
Boardwalk REIT	1.00	45.93	2.2%	16.25	6.2%

<u>Preferred Shares</u>

- The sell off in preferred shares has led to the preferred share rate reset market currently paying 8.5% in dividends or 11.1% on an interest equivalent basis for companies that are investment grade rated and have very low probability of defaulting. Furthermore, these investment grade rated companies need to cut their dividends to zero before they can suspend payment to preferred shares. There has not been a missed coupon in the space for investment grade companies since 1991.

- The market is pricing in Government of Canada interest rates to go to 0.25%. With interest rates at or near zero, it is difficult to find income from investment grade credit. Lower interest rates force investors to look for yield in other places other than government bonds.

- Over 20% of the preferred share market is in the energy sector. With the oil price war and oil in the $20 range, all energy companies have sold off significantly. This is the case of the baby being thrown out with the bath water. Enbridge yields moved from 6.2% at the start of the year to 11%. For Enbridge, 98% of their business is contracted and utility-like with no commodity exposure. We have been adding to positions such as Enbridge during the sell off to take advantage as people sell all energy names.

Here are five preferred shares and their distribution yields as of December 31st and March 23rd.

	Distribution	Price Dec 31st, 2019	Yield	Price March 23, 2020	Yield
TC Energy Corporation Series 9	0.94	16.51	5.7%	9.96	9.4%
Enbridge Inc. Series 3	0.93	14.94	6.2%	8.45	11.0%
Brookfield Assets Mgmnt Series 32	1.27	20.54	6.2%	12	10.6%
Toronto-Dominion Bank Series 1	0.92	17.56	5.2%	10.85	8.5%
Brookfield Office Properties Inc. Series N	0.95	16.52	5.8%	7.95	11.9%

High Yield

- High yield credit spreads are over 10%. There have been 45 examples of when high yield spreads have crossed beyond 8%. On a 2-year horizon, an investor has made money 44 out of 45 times. The median annualized return over the next 12, 24, and 36 months for high-yield bonds as spreads cross 8% is 24.1% 18.7%, and 14.8%. In fact, there have been 25 examples of when spreads crossed beyond 9% and within a time frame of a year, an investor has never lost money when spreads have crossed this mark.

- All high yield bonds have sold off significantly, with the most liquid and shorter duration bonds at times suffering more. This is due to a liquidity crisis as investors sell all risk assets and move into cash. This has caused the dislocation to occur most in the highest quality portion of high yield.

- High yield names like Petsmart are now yielding 16.8% while at the start of the year it was yielding 8.9%. The stockpiling of food has not been restricted to people. Pet owners have been buying in bulk for their family pets as well and Petsmart is the marquee name in for pet stores with an online presence and an enduring franchise.