AGF INSIGHTS

A Fundamental Bond Manager and Two Equity Quants Walk Into a Bar

Well, maybe not an actual bar these days, but that hasn't stopped them from leaning on each other's expertise over the past year. Here's how their collaboration is helping dissect the current macro environment and leading to more informed investment decisions across asset classes.

Stephen Duench
Vice-President and Portfolio Manager

Andy Kochar
Portfolio Manager and Head of Global Credit

Abhishek Ashok
Analyst

The three of you working together so closely might be a surprise to some who view your investment approaches as being wholly distinct. Why does it make sense from each of your perspectives?

Stephen Duench (SD): Agreed. It might seem odd for a fundamental credit manager like Andy to collaborate with quants like Abhi and I. We obviously have very different styles and invest in different asset classes. But if our sector or factor analysis comes to the same conclusion as Andy's own research as it relates to the macro environment, then it only strengthens our conviction about a position or trade each of us might be considering.

Andy Kochar (AK): Relative equity factor performance explains so much about the market regime an investor finds herself in, whether it's rates, foreign exchange or, in my case, credit. In fact, no matter the company, credit risk and equity risk premiums go hand-in-hand. Therefore, Stephen and Abhi's factor work is often an excellent confirmation of what I'm seeing within my world and when that happens, it helps me figure out what to do next within the regime that's upon us. Gauging these market conditions gives me greater confidence with my decision to right-size a specific bet in the portfolio as well as get the timing right. This could be tied to allocations in investment grade, high yield, and convertible bonds, or dialing up or down interest rate sensitivity, or the weighting of cyclicals versus defensives. It may also help me determine allocation from a risk on/risk off perspective and there have been numerous occasions where my research has jibed with Stephen and Abhi's factor analysis, and collaborating with them has become very important to my investment process.

> We've recently been analyzing sector and factor performance in the context of inflation expectations.
>
> **– Abhishek Ashok**

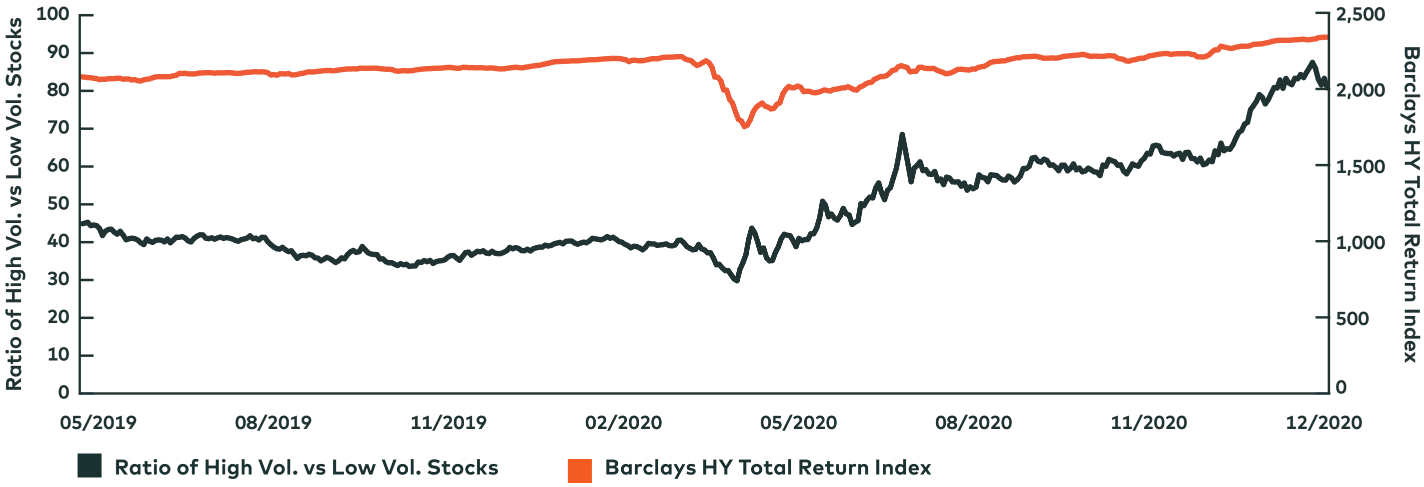
Abhishek Ashok (AA): Working with Andy – and frankly other fundamental managers and analysts on AGF's broader Investment Management Team – also forces us to look at the data a little differently than perhaps Stephen and I would otherwise. For instance, we've recently been analyzing sector and factor performance in the context of inflation expectations, and Andy suggested we do so by looking at the spread between short and long-term expectations and periods of inversion and/or steepening, as opposed to just pinning the research to the more generic yield curve for the same purpose. That's not to say our way of doing things was wrong, but analyzing a data point through a difference lens is a clear benefit that can act as a multiplier effect in terms of how the information is used and by whom.

> Many highly shorted stocks also happen to be distressed companies and as the former kept on rallying into the fourth quarter of 2020, so did the distressed credit market.
>
> **– Andy Kochar**

What are some good examples of your collaborative research during the past year of the COVID-19 pandemic?

AK: One of the best examples of how Stephen and Abhi's work has helped me make better decisions dates to the market turmoil that took place at the outset of the COVID-19 pandemic a little over a year ago. Soon after the crisis began, there was a huge spike in the implied credit default rate to 14% (based on a 12-month forward-looking basis), which was the highest it had been since the Global Financial Crisis in 2009. To me, this was extreme fear of the type that usually augurs well for an eventual upturn in risk assets like credit and equities. But it was the fact that this fear was also evident in the quantitatively significant widening performance spread between high- and low- volatility stocks that helped convince me that the selloff was nearing an end. Of course, as it turns

Looking for Connection



Source: Bloomberg as of May 3, 2021.

out, that was the right call and both credit and equity markets started to rally a lot sooner than others may have anticipated. Another excellent example of this collaboration is the relationship between credit and the most-shorted stocks versus the least-shorted stocks. Many highly shorted stocks also happen to be distressed companies and as the former kept on rallying into the fourth quarter of 2020, so did the distressed credit market. More importantly, the strength of this trend – and knowledge of it – helped inform my decision to stay with the distressed credit trade into the first quarter of 2021. In other words, the factor work done by Stephen and Abhi rightly kept me in the trade for longer than I may have been otherwise.

SD: More recently, we've been collaborating with respect to Purchasing Manager Indexes (PMIs). And this has been interesting because it shows how the analysis needs to be interpreted in each of our own unique ways to make it worthwhile. It's well known that PMIs bottomed in the spring of 2020, but it may not always be well understood how sectors or factors historically react as the economics continue to improve. For instance, it's generally been the case based on our research that the early stage of a PMI rebound coincides with a sharp rally in cyclical parts of the market as well as factors like value or high volatility. In fact, that's exactly what happened off the 2020 low and into the end of last year, and knowing that, both Andy and I tilted our respective portfolios towards energy and financials to take advantage. But fast forward to now and our reasoning has changed to varying degrees. At this stage, PMIs are still expanding, but are also well off the bottom and much closer to a top – -and that typically means the easy money is off the table for cyclicals. But our work has shown that a "sideways" but still strong PMI can be quite bullish for the cyclical trade, albeit the opportunities to benefit from it are likely more limited and/or less attractive from a valuation standpoint as time passes. So, from my perspective – and Andy's will be different – I'm still heavily weighted toward cyclical equity sectors, but I'm high-grading my portfolio to ensure that what I continue to own within these cyclicals tilts more towards higher quality names.

AK: This is an important point. While Stephen, Abhi and I may all agree on what rising PMIs are telling us, how we choose to react to the analysis will be different in part because of the asset class we manage. Remember, credit tends to be a leading indicator to stocks so unlike Stephen on the equity side, my portfolio is now underweight energy and financials, which both seem expensive relative to the rest of the credit market.

What about the inflation example Abhi mentioned earlier?

AA: Inflation – or at least the expectation of it – is obviously another big issue right now. So, as noted earlier, Andy recently asked us to run some numbers showing how equity sectors and factors typically perform three to six months before and after inflation expectations invert, meaning short-term inflation expectations exceed longer-term expectations. And what we found is that markets tend to be risk-on or hyper-cyclical before inversions, but almost the exact opposite three to six months afterward as inflation expectations come off.

AK: Knowing this information gives me a better sense of where in the credit capital structure I want to focus my attention. By that, I mean it's helpful from a portfolio construction standpoint, not in terms of security selection. I need to make sure I have the right industry exposure, the right credit exposure, and the right foreign exchange exposure if I'm to do my job properly. And it's important to note that credit markets are very inefficient in relation to equity markets, so one of the advantages of leveraging Abhi and Stephen's research is that it is based on real-time data, which means I can be a bit more responsive to the macro environment than I might otherwise be.

> Being able to share information...provides an opportunity to hear different perspectives on macro trends that are evolving.
>
> **– Stephen Duench**

Any final thoughts?

SD: There's also an intangible at play here too. Being able to share information with Andy – or someone else on our Investment Management Team with a different approach or mandate – provides an opportunity to hear different perspectives on macro trends that are evolving. Remember, it's one thing to research how equity factors might perform if inflation expectations tap out at 2% or 3%. Our job also requires us to figure out which of these two scenarios seems most probable, and it's at least in part by exploring different viewpoints that each of us can draw our conclusions.

Stephen Duench, CFA®

Vice-President and Portfolio Manager

As Vice-President and Portfolio Manager, Stephen Duench is a key contributor to AGF's quantitative investment platform, AGFiQ. AGFiQ's team approach is grounded in the belief that investment outcomes can be improved by assessing and targeting the factors that drive market returns.

Stephen is the lead Portfolio Manager of the AGFiQ Dividend Income Fund and AGF Canadian Large Cap Dividend Fund and is central to the creation and support of AGFiQ's portfolio management tools, analysis and applications across both Canadian and global mandates.

He began his career with AGF as part of the Highstreet Investment Management* team. Stephen earned an Honours degree in Financial Mathematics from Wilfred Laurier University and is a CFA® charterholder.

*Highstreet Asset Management Inc. is a wholly-owned subsidiary of AGF Investments Inc.

Andy Kochar, CFA®

Portfolio Manager and Head of Global Credit

Andy Kochar is a principal member of AGF's Fixed Income Team and serves as the firm's head of global credit. Using a cross-asset framework, Andy is responsible for the research and allocation of credit risk across all of AGF's fixed income portfolios.

He previously served as Associate Portfolio Manager for AGF's credit-oriented portfolios from 2013 to 2018. Prior to that, for more than five years, Andy served as Investment Analyst, Credit Research at Acuity Investment Management, which was subsequently acquired by AGF in 2011.

Andy earned a B.A. in Economics (Cum Laude) from York University. He is a CFA® charterholder and member of CFA Society Toronto.

Abhishek Ashok, M.A., MFE, CFA®

Analyst

As an Analyst, Abhishek Ashok is involved in developing and interpreting quantitative tools to enhance the investment management process, developing content for presentations and commentary, providing data management and process support for AGF's quantitative platform, AGFiQ. Abhishek began his career with AGF as part of the *Highstreet Investment Management team and has progressively taken on more responsibility to expand his role on the investment team. Abhishek is a CFA® Charterholder, and earned a Master of Financial Economics from Western University, MA in Economics from York University, and a B.Sc in Economics and Management from Purdue University.

*Highstreet Asset Management Inc. is a wholly-owned subsidiary of AGF Investments Inc.

For more information, visit AGF.com

Publication date: May 11, 2021

FUND1123-05-21-E