November 10, 2021

Optimising Fixed Income

Webinar: Franklin Bissett Investment Management and Brandywine Global

In this webinar, Tom O’Gorman, Director of Fixed Income for Franklin Bissett Investment Management, and Brian Giuliano, Client Portfolio Manager with Brandywine Global, discussed the forces shaping the economic recovery and fixed income markets in Canada and worldwide. These are the key takeaways.

The great inflation debate

The COVID-19 pandemic created a macroeconomic bust which has been followed by the current boom, said Giuliano. While much of the current inflation should resolve over the next couple of quarters, it’s too soon to determine what will happen next. Their base case calls for somewhat higher inflation rates over the next couple of years, though not as rapid as now. Over the longer term, trends that were evident before the pandemic, such as demographic changes and the debt burden, are disinflationary. Wage raises, on the other hand, are inflationary. If current wage pressures are just a temporary consequence of the pandemic-driven lockdowns, they may resolve fairly quickly; however, baby boomers have been leaving the workforce at higher levels than anticipated, which could result in more sustained labour shortages. With economic growth generally strong, some central banks such as the U.S. Federal Reserve (Fed) are pricing in rate hikes for next year. But if inflation recedes in a year, would central banks raise rates into that? It’s too soon to tell. Giuliano noted that the yield curve is backing up and the back of the curve is falling, indicating that the longer-term trajectory is less optimistic than people think.

Canada a slightly different story

Rather than traditional cost-push forces, today’s inflation rate is the result of a supply shock, said O’Gorman, which will not be resolved by raising rates. While sharing many of the larger trends with the United States, Canada’s situation is a bit more nuanced. Markets have been aggressively pricing in multiple rate hikes, but the Bank of Canada (BoC) believes the rate of inflation will recede.

In any case, rate hikes will not solve Canada's severely imbalanced economy, where the obsession with housing is accompanied by high levels of household debt. If the BoC moves more aggressively than the Fed, the Canadian dollar will be far less competitive. Dramatically higher rates would also create consumption problems; paying more to service a mortgage means less money to spend elsewhere. In O'Gorman's view, the market has gotten ahead of itself and needs to reprice. To reconcile the difference between market expectations and the economic reality, their portfolios are long the U.S. dollar and short- to- medium-term duration.

Global opportunities for active managers

In this difficult environment, return-seeking fixed income is challenging and requires active management, said Giuliano. In the Franklin Brandywine Global Sustainable Optimiser Fund, the portfolio managers adapt income and risk exposure to the environment. They have moved from an opportunistic strategy over the past 12-18 months to being more selective as spreads are tight and trading is very expensive. They take the multisector approach to fixed income a step further than most traditional fixed income managers with the ability to "tap on the brakes" using high-quality government bonds to generate return and balance risk. Duration in the fund can range from 0 to 10 years. Giuliano maintains investors should not have to give up the diversification benefits of bonds. In this fund, more consistent outcomes and attractive nominal returns act as a counterweight to portfolio risk.

In Canada, security selection is key

Canada does not have a true multi-sector fixed income market, said O'Gorman. In Franklin Bissett's Core Plus model, they have taken the narrow, undiversified Canadian landscape and added a "plus" in the form of U.S. securities that provide less correlation with traditional fixed income. In this way, they can buy industrial names that generate better risk-adjusted returns. In their portfolios, swings in duration are more modest than in the Optimiser fund, but they use larger corporate swings for a degree of downside protection. They remain overweight credit and like high yield and levered loans. The focus has shifted to security selection, said O'Gorman, as the easy money in allocation has been made. In a historical context, the credit overweight is now expensive, so they use hedges such as put options on credit indices, U.S. investment grade and U.S. high yield. Other hedges include currency—they are long the U.S. dollar—and duration. Although the first quarter of this year was difficult for the strategy, over time fixed income will earn the yield back, which can be seen with returns near-flat to positive on a one-year basis.

Risk considerations: keep an eye on China

China has become a pillar of the global economy. Over the past few quarters, however, China's growth has been slowing, hindered by more regulatory interventions, a crackdown on for-profit education and the material property sector slowdown, which alone accounts for almost 25% of the country's GDP. With these disinflationary pressures slowing growth, foreign capital is skittish and corporate bonds have been trading as a distressed asset. Currently they do not see much contagion, said Giuliano, but if growth continues to slow, it could ripple out to the rest of the world.

Uncertainty is the only certainty

Globally, we have a really good story in the world's response to the pandemic, Giuliano noted, but many unknowns are depressing consumer confidence. They have been spending, but will that continue once the excess from pent-up demand is spent down? If predicting economic outcomes was hard prior to the onset of the pandemic, O'Gorman said, it's even harder now. This is a difficult environment, with more than the normal uncertainty. It's good for active managers because of all the levers they can use, but taking a long-term view is important. Investors can get badly hurt trying to time the markets.

Franklin Bissett Core Plus Bond Fund

This flagship five-star Morningstar-rated[1] fund seeks a high current income and some long-term capital appreciation by investing primarily in Canadian federal and provincial government and corporate bonds, debentures and short-term notes. The fund maintains an overweighted position in high-quality corporate and provincial issues, an underweighted position in Canadian federal bonds and may invest in foreign securities. The strategy is also available in Franklin Liberty Core Plus Bond ETF (FLCP).

Franklin Bissett Short Duration Bond Strategy

This four-star Morningstar-rated[2] fund seeks a high current income and preservation of capital by investing primarily in Canadian fixed-income securities including Canadian federal and provincial government bonds, corporate bonds, debentures and short-term notes. The fund may also invest in securities backed by mortgages or other financial assets, and dividend-paying shares of Canadian companies. The fund may invest in foreign fixed-income securities. The average weighted term-to-maturity of the fund's investments is five years or less. This strategy is also available in Franklin Liberty Short Duration Bond ETF (FLSD).

Franklin Brandywine Global Sustainable Income Optimiser Fund

This fund seeks current income, liquidity and modest capital appreciation by investing primarily in bonds issued by Canadian federal, provincial and municipal governments and government agencies, including mortgage-backed securities and real return bonds. The strategy is also available in Franklin Brandywine Global Sustainable Income Optimiser Active ETF (FBGO). The US version of this fund is a five-star Morningstar-rated[3] fund.

Franklin Bissett Investment Management

Franklin Bissett offers Canadian investors a legacy of expertise in Canada's capital markets. Founded in 1982, the company has manage institutional, high net worth and retail assets as part of Franklin Templeton since 2000.

Brandywine Global Advisers

Brandywine Global is a mid-sized boutique investment firm managing global assets for institutional, high net worth and retail clients for over 35 years. Founded in 1986, the firm has been a specialist investment manager of Franklin Resources, Inc. since July 31, 2020.

Important Legal Information

This material is intended to be of general interest only and should not be construed as individual investment advice or a recommendation or solicitation to buy, sell or hold any security or to adopt any investment strategy. It does not constitute legal or tax advice.

The information is not a complete analysis of every aspect of any market, country, industry, security or portfolio. Statements of fact are from sources considered to be reliable, but no representation or warranty is made as to their completeness or accuracy. Because market and economic conditions are subject to rapid change, opinions provided are valid only as of the date indicated. The views expressed may not be relied upon as investment advice and are not share class specific.

Data from third party sources may have been used in the preparation of this material and Franklin Templeton ("FT") has not independently verified, validated or audited such data. FT accepts no liability whatsoever for any loss arising from use of this information and reliance upon the comments, opinions and analyses in the material is at the sole discretion of the user.

All investments involve risks, including the possible loss of principal. Investments in foreign securities involve special risks including currency fluctuations, economic instability and political developments. Investments in emerging markets, of which frontier markets are a subset, involve heightened risks related to the same factors, in addition to those associated with these markets' smaller size, lesser liquidity and lack of established legal, political, business and social frameworks to support securities markets. Because these frameworks are typically even less developed in frontier markets, as well as various factors including the increased potential for extreme price volatility, illiquidity, trade barriers and exchange controls, the risks associated with emerging markets are magnified in frontier markets. Equity and Fixed Income prices fluctuate, sometimes rapidly and dramatically, due to factors affecting individual companies, particular industries or sectors, or general market conditions.

Franklin Bissett Investment Management, part of Franklin Templeton Investments Corp.
Brandywine Global is a specialist investment manager of Franklin Resources, Inc.

[1] Source: Morningstar Research Inc., as of September 30, 2021. All rights reserved. The information contained herein is proprietary to Morningstar and/or its content providers; may not be copied or distributed; and is not warranted to be accurate, complete or timely. Neither Morningstar nor its content providers are responsible for any damages or losses arising from any use of this information. The Morningstar Risk-Adjusted Rating, commonly referred to as the Star Rating, relates the risk-adjusted performance of a fund to that of its category peers and is subject to change every month. The Star Rating is a measure of a fund's annualized historical excess return (excess is measured relative to risk-free investment in Canadian Government Treasury Bills) adjusted for the fund's historical risk. The overall Star Rating for a fund is a weighted combination of its three, five, and ten year ratings. Overall ratings are adjusted where a fund has less than five or ten years' history.A fund scoring in the top 10.1 to 22.5% 10% of its fund category receives 4 stars. Franklin Bissett Core Plus Bond Fund is rated within the Morningstar Canadian Fixed Income category. All performance data refers to Series F units. Please refer to www.morningstar.ca for more details on the calculation of Morningstar Risk-Adjusted Ratings. For each of the 3, 5 and 10 year performance periods, there were in total 457,392 and 202 funds, respectively, in the Morningstar Canadian Short Term Fixed Income category. Please refer to www.Morningstar.com for the 1-year information.

[2]Source: Morningstar Research Inc., as of September 30, 2021. All rights reserved. The information contained herein is proprietary to Morningstar and/or its content providers; may not be copied or distributed; and is not warranted to be accurate, complete or timely. Neither Morningstar nor its content providers are responsible for any damages or losses arising from any use of this information. The Morningstar Risk-Adjusted Rating, commonly referred to as the Star Rating, relates the risk-adjusted performance of a fund to that of its category peers and is subject to change every month. The Star Rating is a measure of a fund's annualized historical excess return (excess is measured relative to risk-free investment in Canadian Government Treasury Bills) adjusted for the fund's historical risk. The overall Star Rating for a fund is a weighted combination of its three, five, and ten year ratings. Overall ratings are adjusted where a fund has less than five or ten years' history.A fund scoring in the top 10.1 to 22.5% 10% of its fund category receives 4 stars. Franklin Bissett Short Duration Bond Fund is rated within the Morningstar Canadian Short Term Fixed Income category. All performance data refers to Series F units. Please refer to www.morningstar.ca for more details on the calculation of Morningstar Risk-Adjusted Ratings. For each of the 3, 5 and 10 year performance periods, there were in total 238,201 and 89 funds, respectively, in the Morningstar Canadian Short Term Fixed Income category. Please refer to www.Morningstar.com for the 1-year information.

[3] The Morningstar Rating™ for funds, or "star rating", is as of September 30, 2021 and is calculated for managed products (including mutual funds, variable annuity and variable life subaccounts, exchange-traded funds, closed-end funds, and separate accounts) with at least a three-year history, and subject to change monthly. Current monthly ratings can be found at leggmason.com. Exchange-traded funds and open-ended mutual funds are considered a single population for comparative purposes. It is calculated based on a Morningstar Risk-Adjusted Return measure that accounts for variation in a managed product's monthly excess performance, placing more emphasis on downward variations and rewarding consistent performance. The top 10% of products in each product category receive 5 stars, the next 22.5% receive 4 stars, the next 35% receive 3 stars, the next 22.5% receive 2 stars, and the bottom 10% receive 1 star. The Overall Morningstar Rating for a managed product is derived from a weighted

average of the performance figures associated with its three-, five-, and 10-year (if applicable) Morningstar Rating metrics. The weights are: 100% three-year rating for 36-59 months of total return, 60% five-year rating/40% three-year rating for 60-119 months of total returns, and 50% 10-year rating/30% five-year rating/20% three-year rating for 120 or more months of total return. While the 10-year overall star rating formula seems to give the most weight to the 10-year period, the most recent three-year period actually has the greatest impact because it is included in all three rating periods. Ratings do not take into account the effects of sales charges and loads. Class A, I and IS shares of the Fund were rated against 271, 237, and 128 Multisector Bond funds over the 3-, 5- and 10-year periods, respectively. With respect to these funds, Class A, I and IS shares of the Fund received Morningstar Ratings of 5, 5, and n/a; 5, 5, and n/a; 5, 5, and n/a stars for the 3-, 5- and 10-year periods, respectively. Ratings shown are for the highest and lowest rated share classes only, when available. Morningstar Rating is for the specified share class(es) only; other classes may have different performance characteristics. A 4- or 5-star rating does not necessarily imply that a fund achieved positive results for the period.

© 2021 Franklin Templeton Canada. All rights reserved. Franklin Templeton Canada is a business name used by Franklin Templeton Investments Corp.