



**Frédéric Kibrité**

Vice President and Director,  
ALM Portfolio Management,  
TD Asset Management Inc.

**Dennis Woessner**

Vice President and Director,  
U.S. Fixed Income,  
Epoch Investment Partners, Inc.

**Curtis Schimmelmann**

Vice President,  
ALM Portfolio Management,  
TD Asset Management Inc.

**Marisa Jones**

Vice President and Director,  
Investment Grade  
Credit Research,  
TD Asset Management Inc.

## Buy-and-Maintain Credit Strategies for Better Long-term Outcomes

The Canadian corporate bond market has a number of special characteristics. In any given year, Canadian corporate bond investors can expect about half of all new bonds brought to the primary market to be by financial issuers. Long bond investors are even more challenged. Driven by index composition, the long bond opportunity set is comprised of almost 80% energy and infrastructure bonds. Furthermore, seeking long bonds in the secondary market often involves chasing costly bond issues brought to market decades earlier that have been tucked away against liabilities by sticky portfolios at life insurance companies.

The high levels of concentration in the Canadian corporate bond market can present challenges for those seeking to access liquidity in particular bond issues. Investors shouldn't passively accept these shortfalls, nor should they look to the return of their indices as a measure of successful corporate bond investing. Rather, it is important to remember what institutional investors are really seeking with their corporate bond allocation.

Institutions such as pension plans, insurance companies and endowments and foundations are sophisticated long-term investors. Their main investing objective is to be able to meet a future obligation with a high degree of certainty at a reasonable cost. The incremental risk-adjusted returns delivered by corporate bonds, which are typically higher than government bond returns, can often be an important source of compensation for investors.

When seeking this compensation, a skilled manager should employ independent credit research, active security selection, active sector diversification and ongoing portfolio maintenance. This type of management is often referred to as buy-and-maintain investing. Through this high-conviction corporate credit strategy, investors can make a corporate bond allocation that meets their goals.

## Buy-and-Maintain Investing

At TD Asset Management Inc. (TDAM), we take a three-pronged approach to buy-and-maintain investing. We perform extensive independent credit research, we employ strategic portfolio construction and management, and we look beyond the Canadian public market for strategy enhancements.

### 1 Extensive and Independent Credit Research

Buy-and-maintain credit investing begins with extensive independent credit research. The strength of the credit research process provides confidence to support longer holding periods, thereby reducing transaction costs and preserving capital. Over 20 full-time professional credit analysts perform the credit research process at TDAM.

#### Characterizing Corporate Credit Risk

When evaluating corporate credit risk, our analysts examine factors such as a company's history of maintaining a consistently satisfactory financial position, stability of revenue, earnings strength, cash flow, operating and financial leverage, bank-line liquidity and access to capital markets. We also analyze the company's long-term business outlook. We primarily focus on free-cash-flow generation and an issuer's ability to make timely coupon and principal repayments.

Following our primary financial statement analysis, we conduct a series of meetings with company management to help ensure that we are completely comfortable with the components of the financial statements, accounting methodologies and consistency of messaging from business leaders.





## Structure of the Transaction

Understanding the structure of a corporate bond issue requires conducting a detailed initial examination of the trust indenture, which is expected to reveal any special features or covenants. We also note where our investors rank in the corporate structure with respect to the seniority of the debt and what security is available to us as the bond holder.

## Figure 1: Extensive and Independent Credit Research

### Components of Analysis

#### Corporate and Industry Analysis

- Business and financial position
- Volatility of revenue
- Operating leverage
- Financial leverage
- ESG
- Access to capital
- Relationship with management

#### Structure of the Transaction

- Examination of indentures and covenants
- Assessing the seniority of debt
- Cash flow waterfalls
- Security

### Our Differentiators

#### Avoid errors of omission and imagination

#### Credit Research

#### Research independence

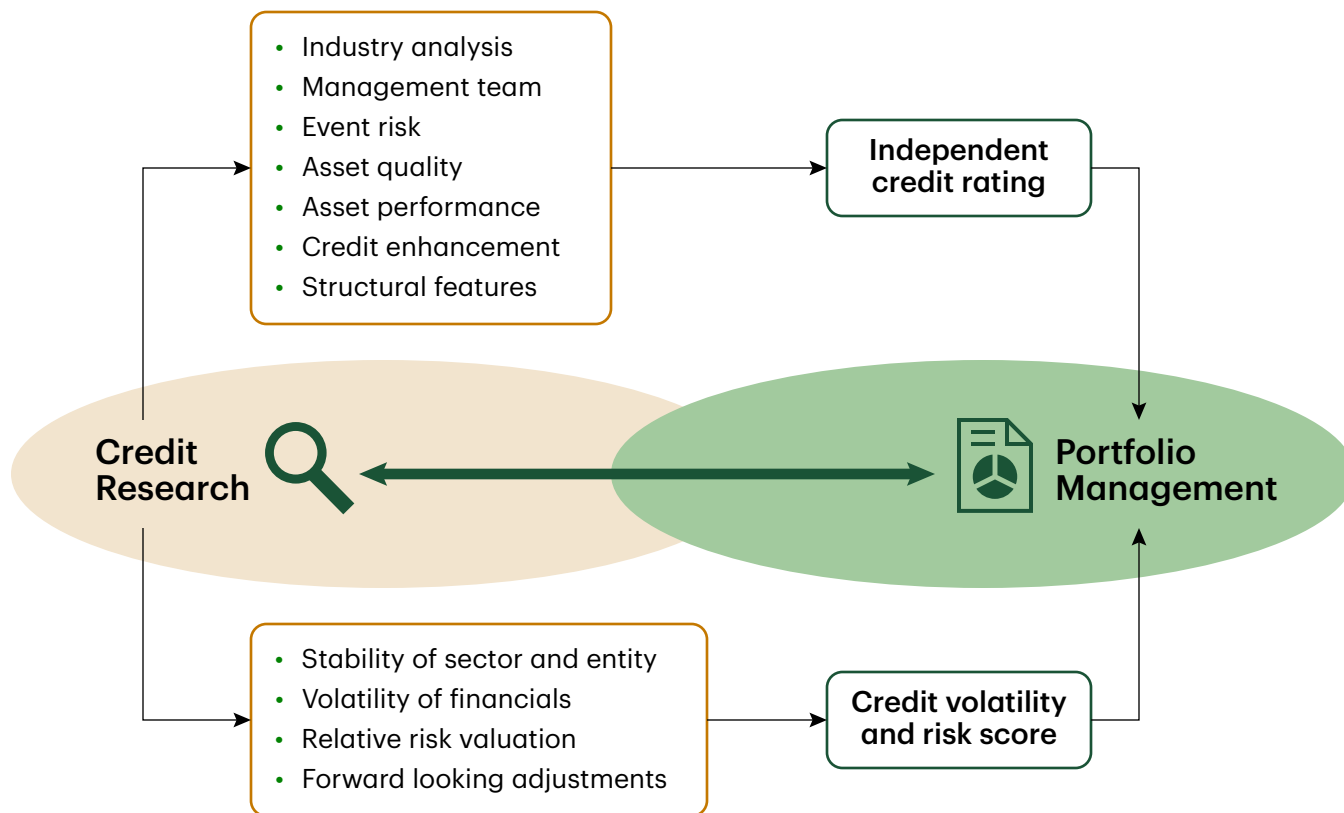
#### Well-defined accountabilities

Source: TD Asset Management Inc.

## The Credit Approved List

We have developed our own proprietary internal credit ratings methodology that is independent of the rating agencies. TDAM's Credit Committee — whose members consist of senior credit research analysts, risk managers and our Chief Investment Officer — ensures the integrity and thoroughness of the research process. The Credit Committee team has sole authority to add or remove securities from the TDAM Credit Approved List and this decision cannot be overruled by any portfolio manager. Only issuers on that Approved List are eligible for inclusion in a buy-and-maintain portfolio.

**Figure 2: Collaboration Between Credit Research and Portfolio Management**



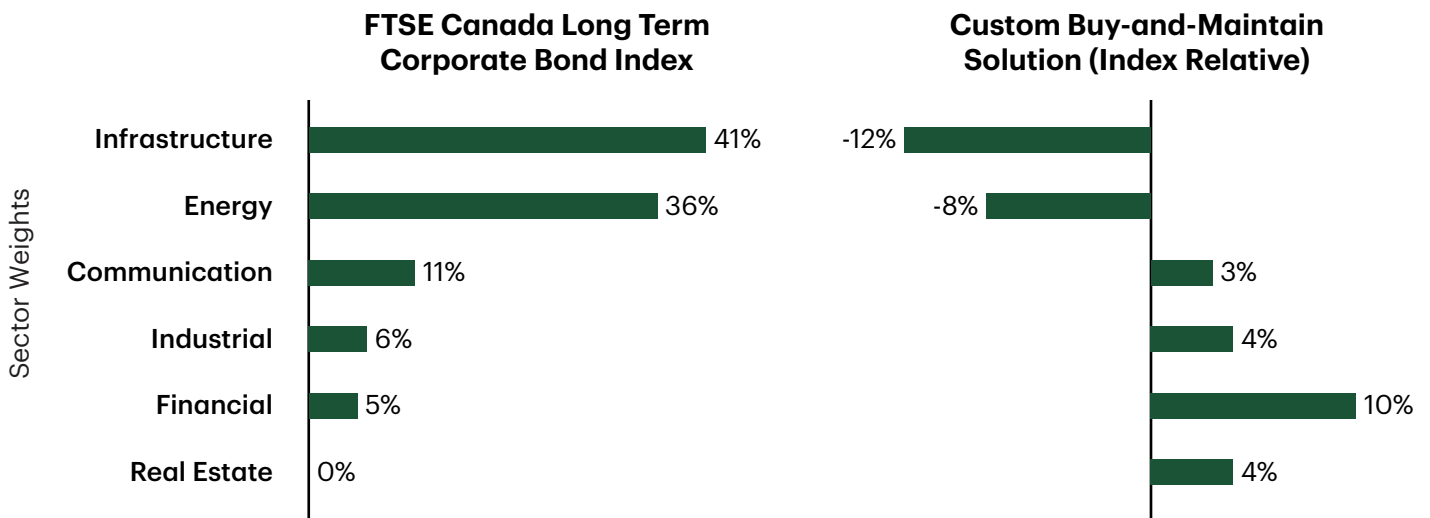
Source: TD Asset Management Inc.

Once an issuer is added to the Credit Approved List, analysts follow quarterly earnings calls and perform a deep dive analysis of it annually — or immediately if there is a material change that can be either macroeconomic or issuer-specific. Our industry specialists monitor the internal ratings and the factors driving relative value within their sectors and communicate their views to the portfolio managers on an ongoing basis.

## 2 Strategic Portfolio Construction and Maintenance

Our approach to buy-and-maintain portfolio construction helps ensure that our clients do not passively accept the sectoral concentrations within the corporate bond markets. Instead, relying on our proprietary credit research, we construct portfolios selecting issues from the TDAM Credit Approved List. We generally overweight sectors underweighted in the index and we underweight sectors overweighted in the index. By focusing on the aggregate corporate exposure (duration times spread), we can achieve an aggregate credit experience that is similar to an index, but has an inherently better diversified set of sectoral exposures, better liquidity profile and potentially greater tail risk protection.

**Figure 3: Bond Index Industry Sector Characteristics versus Custom Buy-and-Maintain Solution**



Source: TD Asset Management Inc., FTSE Global Debt Capital Markets Inc. As of December 29, 2023. Numbers may not add due to rounding.

Occasionally, portfolios may be marginally tilted to sectors preferred by the portfolio management team. This sort of portfolio maintenance is the result of the ongoing discussions between credit sector analysts and portfolio managers.

On behalf of our institutional clients, at TDAM we have been managing segregated buy-and-maintain strategies for decades. For these clients, the selection of bond tenors are typically geared to align with a funding obligation, which usually makes the coupon and maturity pattern of market indices irrelevant. With portfolios actively structured to diversify away from these indices, our clients realize that returns different from the index are to be expected.

For clients seeking corporate bond exposure as a building block within a broader solution, we have found that credit portfolios which are constructed to match a benchmark's duration and yield-to-maturity can allow for a clear communication of both interest rate sensitivity and yield expectations. In this way, credit portfolios can be mixed and matched with other portfolio allocations to help achieve a specific goal.

To this end, we have extended our buy-and-maintain approach to two pooled fund trusts: The TD *Emerald* Canadian Short-Mid Corporate Bond Pooled Fund Trust and the TD *Emerald* Canadian Long Corporate Bond Pooled Fund Trust. Similar to our segregated solutions, these funds use a buy-and-maintain style with relatively low portfolio turnover. The two funds aim to help clients construct high-conviction, value-oriented fixed-income portfolios with the objective of delivering yields similar to those of the FTSE Canada Corporate indices, but with better diversification.

### 3 Beyond Canadian Public Credit

Some of our clients seek to enhance their solutions by extending their opportunity set to include the U.S. public corporate bond market and/or private credit markets. This is often done as a buy-and-maintain strategy enhancement for additional diversification and/or additional yield opportunities.

#### U.S. Public Credit

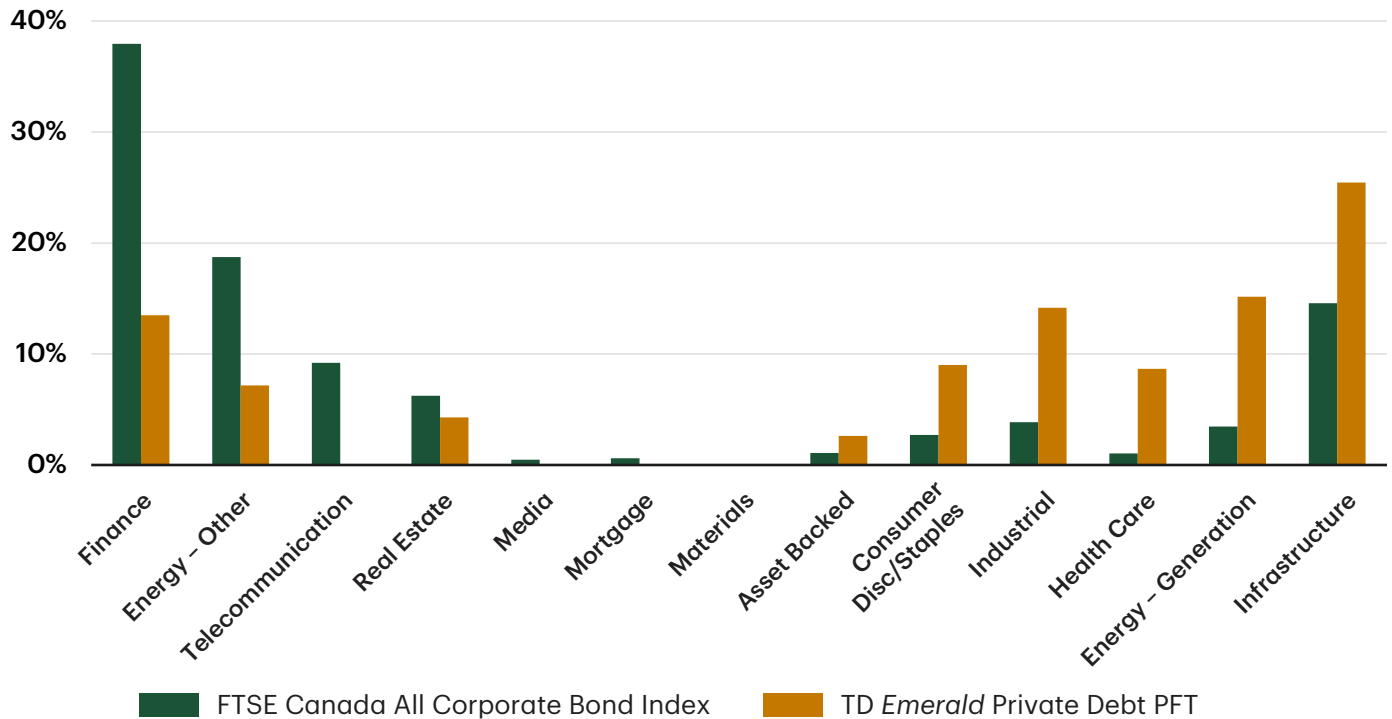
The philosophy underlying buy-and-maintain public credit strategies extends beyond Canadian borders. The U.S. fixed income market offers institutional investors an even wider range of opportunities with various types of securities available. The U.S. has a broader and deeper pool of issuers across sectors, including sectors which are minimally represented in the Canadian market or absent from it, such as consumer discretionary, media and technology. This provides a broader menu for additional diversification, liquidity and yield pick-up potential.

#### Private Credit

Due to the illiquid nature of private credit, portfolios financing mortgages and private debt investments call for a patient buy-and-maintain approach to harvest strategic risk premiums over time. With private credit, using a robust credit research process is paramount. At TDAM, we have three funds which provide access to the private credit market for buy-and-maintain investors: the TD Greystone Mortgage Fund, the TD *Emerald* Private Debt Pooled Fund Trust and the TD *Emerald* Long Private Debt Pooled Fund Trust. The private debt market covers a wide spectrum of securities, which is why for buy-and-maintain portfolios we focus on high quality geographically diversified private deals, as opposed to higher risk, higher octane offerings.

#### Figure 4: Sector Concentration

TD *Emerald* Private Debt PFT vs. FTSE Canada All Corporate Bond Index



Source: TD Asset Management Inc., FTSE Global Debt Capital Markets Inc. As of December 31, 2023.

## Conclusion

The nature of the Canadian corporate bond market can make it challenging for outcome-focused investors to prudently construct a portfolio that meets their future obligations. The good news is there are solutions. Institutional investors of all sizes can use buy-and-maintain credit strategies with flexible implementation. Smaller mandates can access pooled fund structures to gain immediate access to a diversified pool of securities, while larger investors can achieve additional customization through segregated mandates. ■

# Solutions



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