Un-Yielding Duration & What To Do About It

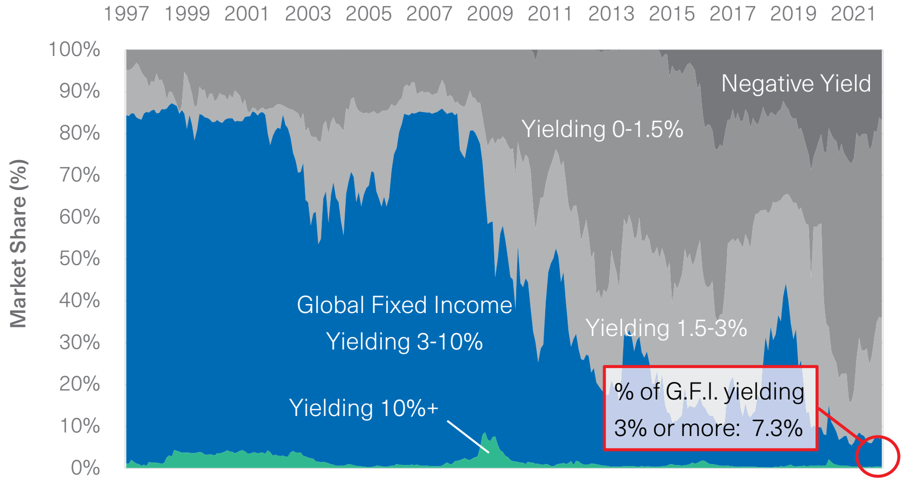
Fund in focus: Brompton Flaherty & Crumrine Investment Grade Preferred ETF (BPRF, BPRF.U), Brompton Flaherty & Crumrine *Enhanced* Investment Grade Preferred ETF (BEPR), Symphony Floating Rate Senior Loan Fund (SSF.UN)

On September 30, 1981 the 10-year US Treasury yield peaked at 15.8%, turned a corner, and began its 40+ year descent to sub-1% levels.[1] Looking back it's hard to believe that in 1981 the U.S. Treasury (the safest credit in the world) had to pay almost twice as much to borrow funds as the riskiest corporate borrower does in 2022 (CCC-and-lower US High Yield Bond yields currently average 8.8% p.a.).[2]

That long period of declining interest rates made fixed income investing a lucrative experience. Not only was high income available from lower-risk corporate and government bonds, but as rates continued to decline, fixed income also provided strong price returns. This is because of "duration" which is a feature of fixed-coupon bonds that measures the impact of changing market interest rates on bond prices. As market rates decline, bonds that pay coupons at higher-than-market-rates become more valuable and accordingly trade higher in price.

Today, fixed income investing has become much more challenging and far less lucrative. Income is much harder to find today. As of December 2021, less than 7.3% by market weight of the constituents of the Global Fixed Income Markets Index (representing the entire range of government and corporate bonds available for global investors to purchase) were yielding 3% or more.[3]

Global Fixed Income Market Share - Grouped by Yield Range



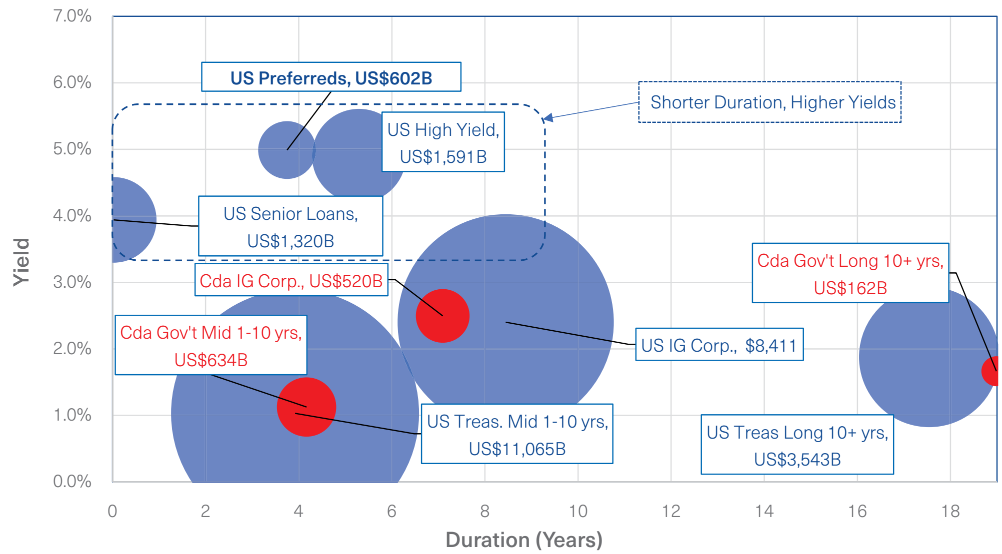
Source: Bloomberg, Ice BofA ML Indices

Investors seeking a reasonable level of income now have to go lower on the credit scale, or longer on term, than they ever have. Low-credit-quality fixed income provides higher coupons but also typically comes with higher risk. Luckily the credit environment today is thought to be reasonably benign, with improving prospects.

The greater risk today is duration, which provides a price return tailwind during falling-rate periods, but can have a crushing impact on bond prices when investors demand increasingly higher yields. US and Canadian investors are expecting several increases in Central Bank rates in 2022 which should result in higher yields in general and lower trading prices for fixed income investments. For most investors, simply avoiding fixed income and duration risk entirely is not an option. Investors need income and the portfolio diversification that bonds provide, and client suitability rules often require Investment Advisors to buy fixed income for clients, regardless of the interest rate environment.

Although the outlook is challenged for fixed income, there are pockets of the market that offer solutions for investors seeking income and looking to avoid interest rate risk. US Preferreds offer high-quality credit and coupons in the 5% range, with short duration. Senior Loans and certain High Yield Bonds offer similar higher yield and shorter durations, although credit quality is lower.

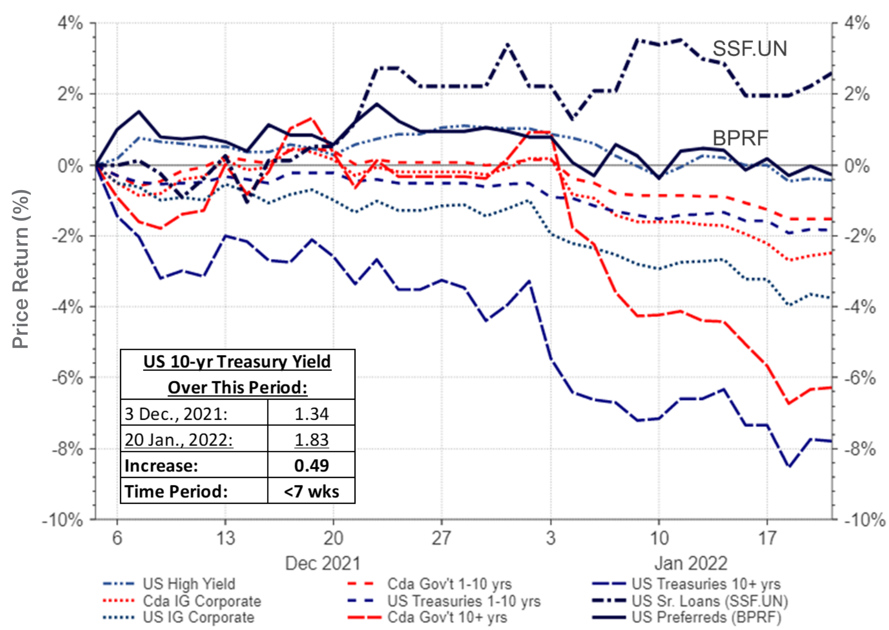
US Preferreds, High Yield & Senior Loans Offer Attractive Yield and Lower Duration[4]



Source: Refinitiv Datastream, S&P Global, Flaherty and Crumrine Inc. (December 31, 2021)

2022 has already demonstrated how lower-duration, higher-yielding fixed income can protect investors in rising rate periods. The U.S. 10-year Treasury yield has increased sharply recently, spiking almost 0.5% in less than seven weeks. The graph below gives the price-return-only performance of major North American fixed income categories over the period, without considering the additional return that yield provides (which in the case of U.S. Preferreds, Senior Loans, and High Yield Bonds can be substantial, with yields in the range of 4-5%). U.S. Preferreds, Senior Loans and High Yield Bonds did what they are supposed to do in rising-rate periods: preserve capital for investors due to lower interest-rate sensitivity, while providing attractive income. In the chart below, we show actual returns of our U.S. Preferred ETF (BPRF) and our Senior Loan Closed-End Fund (SSF.UN), alongside other asset classes which are represented by indices.[5]

Major Fixed Income Categories: Price Return
(Dec. 3, 2021- Jan. 20, 2022)



Source: Refinitiv Datastream (January 20, 2022)

Brompton's Approach

US Preferreds are liquid, have high credit quality on average, and offer yields that are higher than Canadian Preferreds and more than double the yields on US Investment Grade bonds. Brompton Flaherty & Crumrine Investment Grade Preferred ETF (BPRF, BPRF.U) and Brompton Flaherty & Crumrine *Enhanced* Investment Grade Preferred ETF (BEPR) offer ways to invest in the US Preferred share market with the benefit of active management by the longest tenured US preferred share specialist, Flaherty & Crumrine Incorporated.

Senior Loans have the highest priority of claim for repayment, attractive yield in a low-rate environment, lower volatility compared to corporate bonds and equites and have lower interest rate sensitivity compared to traditional fixed income asset classes. Symphony Floating Rate Senior Loan Fund (SSF.UN) invests in an actively managed, diversified portfolio consisting primarily of short-duration floating rate senior corporate instruments, including Senior Loans and other senior debt obligations of North American non-investment grade corporate borrowers.

[1] Refintiv Datastream, United States Treasury, as at 12/31/21.

[2] Refinitiv Datastream, ICE BofA CCC & Lower US High Yield Index, as at 1/18/22.

[3] Ice BofA Indices – Global Fixed Income Markets Index; Bloomberg, as at 12/31/21.

[4] "US Senior Loans" is represented by S&P/LSTA U.S. Leveraged Loan 100 Index. "US Preferreds" is comprised of 50% of the ICE BofA 8% Capped Hybrid Preferred Securities Index (P8HO) and 50% of the ICE BofA 8% Capped Corporate US Capital Securities Index (C8CT) prior to 4/30/2012, and thereafter of the ICE BofA 8% Constrained Core West Preferred & Jr Subordinated Securities Index (P8JC). "US High Yield" is represented by ICE BofA US High Yield Index. "Cda IG Corp" is represented by ICE BofA Canada Corporate Index. "Cda Gov't Mid 1-10 yrs" is represented by ICE BofA 1-10 Year Canada Government Index. "US Treas. Mid 1-10 yrs" is represented by ICE BofA 1-10 Year US Treasury Index. "US IG Corp." is represented by ICE BofA US Corporate Index. "Cda Gov't Long 10+ yrs" is represented by ICE BofA 10+ Year Canada Government Index. "US Treas Long 10+ yrs" is represented by ICE BofA 10+ Year US Treasury Index.

[5] "US High Yield" is represented by ICE BofA US High Yield Index. "Cda IG Corporate" is represented by ICE BofA Canada Corporate Index. "US IG Corporate" is represented by ICE BofA US Corporate Index. "Cda Gov't 1-10 yrs" is represented by ICE BofA 1-10 Year Canada Government Index. "US Treasuries 1-10 yrs" is represented by ICE BofA 1-10 Year US Treasury Index. "Cda Gov't 10+ yrs" is represented by ICE BofA 10+ Year Canada Government Index. "US Treasuries 10+ yrs" is represented by ICE BofA 10+ Year US Treasury Index. "US Senior Loans" refers Symphony Floating Rate Senior Loan Fund. "US Preferreds" is represented by Brompton Flaherty & Crumrine Investment Grade Preferred ETF.

BROMPTON FUNDS

VALUE

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