TD Asset Management

TDAM PRIMER

Considerations in the current fixed income environment

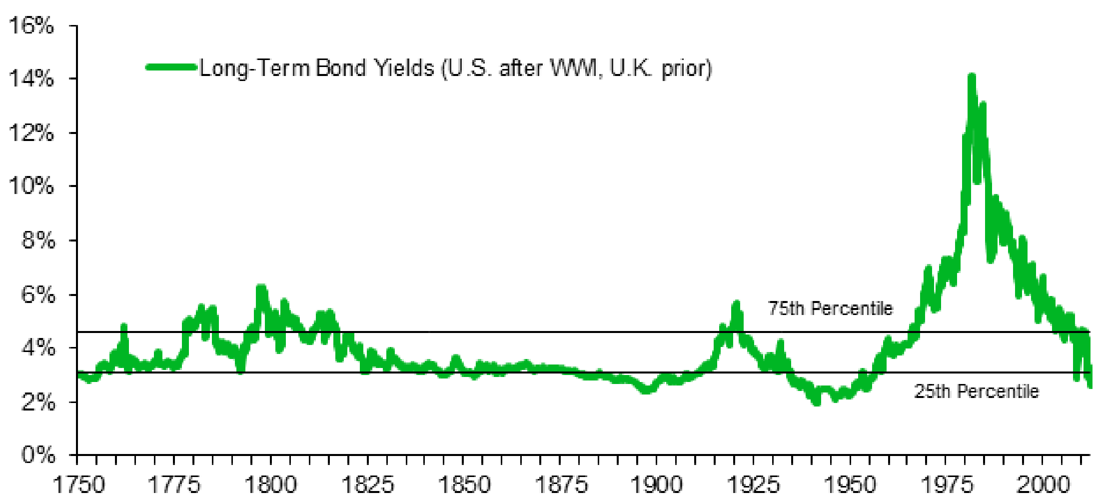
June 2015

Despite challenges for fixed income investors, opportunities to preserve capital and seek additional return remain — even in the current low interest rate environment. Specifically, TD Asset Management Inc.'s fixed income team ("we") believes that moving from a passive solution to an active one may assist our clients in meeting their objectives. We outline our rationale below.

The changing fixed income landscape

As interest rates declined steadily over the past 30 years, fixed income investors almost universally benefitted from the resulting bull market, whether they were active or passive investors. However, fixed income investors are unlikely to enjoy the same tailwinds. Going forward, we anticipate that clients with actively managed portfolios may be better able to take advantage of opportunities and mitigate risks.

Historical Bond Yields

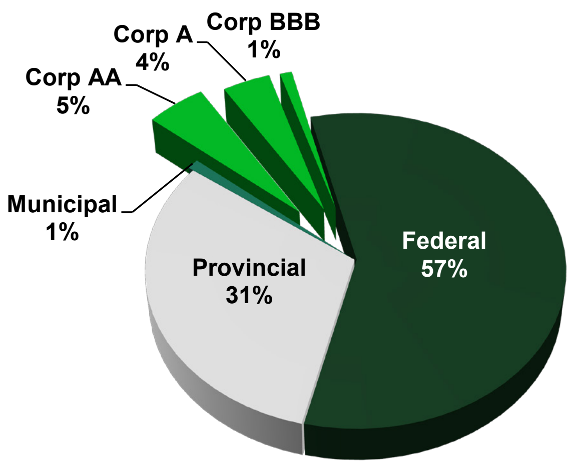


Source: Statistics Canada, Bloomberg. Data as at May 31, 2015

An evolving credit universe

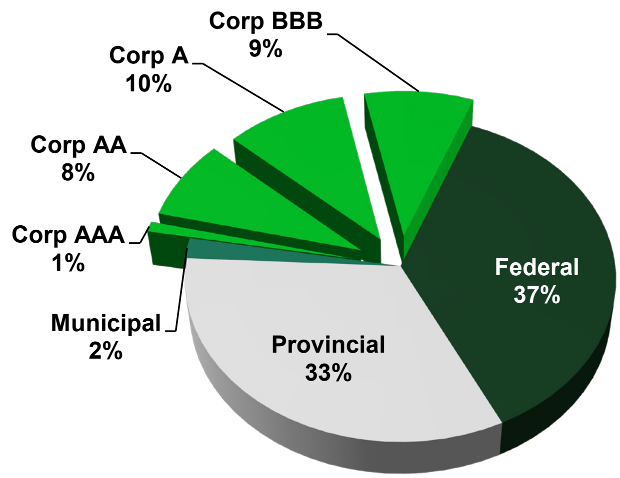
When the benchmark index for the Canadian fixed income universe, the FTSE TMX Canada Universe Bond Index ("the Index"), was created in 1979, it was chiefly made up of government-guaranteed securities. However, the composition of the Index has changed over its lifetime; most notably over the past 20 years. During the past two decades, government debt issuance declined as the federal government's operating budget improved, and corporate debt issuance grew as companies took advantage of lower real interest rates and lower issuance costs. As shown in the graphic below, the composition of the benchmark has shifted to reflect these changes. In 1993, the benchmark included 90% government securities and only 10% corporate securities. Today, corporate bond exposure in the Index is close to 30% while the exposure to 'A' and 'BBB' corporate securities is approximately 20%.

FTSE TMX Canada Universe Bond Index



1993

Total Corporate 9.6%



2015[1]

Total Corporate 28.3%

[1]Data as at May 31, 2015
Source: FTSE TMX Global Debt Capital Markets Inc.
Note: Numbers may not add due to rounding.

Twenty years ago, passive investors were invested primarily in government-guaranteed securities, but because of the evolution of the benchmark, they are currently exposed to a significant amount of corporate credit. Passive investors are unable to select which or how much corporate credit they invest in; by definition they invest to track the entire universe of corporate bond issuances and are exposed to all the inherent risks. We believe that corporate credit can add significant value to portfolios; however, it must be properly managed. For example, our actively managed portfolios use the results of our extensive independent research and select specific corporate issues to help ensure clients are appropriately compensated for any associated risks.

Protecting capital in a rising interest rate environment

For some time, TD Asset Management Inc. ("TDAM") has been of the view that high levels of debt across the developed economies are creating an environment of slow economic growth, particularly relative to previous recoveries. However, within this context of slow growth, data in the U.S. has been improving as it benefits from jobs growth, continued improvements in the housing market and a resilient consumer.

Amid this slow global growth, central banks provided an unprecedented level of accommodation, which helped to depress bond yields to historically low levels. But after navigating several years of record-low interest rates, many investors have begun to turn their attention to a possible rise in interest rates and are interested in understanding how best to position themselves. There are two primary approaches to help protect capital within a portfolio:

- Reduce the portfolio's sensitivity to interest rates
- Increase yield, which provides a cushion that can help to offset the impact of rising yields

Active management can utilize both of these approaches to navigate through challenging market environments.

Navigating through the current environment with active management

We believe that the timing of rising rates is the least predictable source of added value; however, given the low levels of yields and a modest improvement in global growth, we believe there is a higher probability of rising rates than falling rates. Given TDAM's macro outlook the fixed income team expects a Bear Hump scenario to unfold over the medium term, with yields in the middle of the curve rising to a greater degree than those at the short and long ends. We believe that muted inflation expectations coupled with strong demand from institutional clients, such as pension plans and insurance companies, will continue to provide support to the long end of the yield curve while the middle portion will reflect more robust economic growth projections and, consequently, expectations for higher short-term interest rates.

To help protect our clients' capital in this environment, we are reducing our active portfolios' sensitivity to interest rates by:

- Strategically positioning the portfolio interest exposure along the yield curve
- Emphasizing securities that provide a higher yield, such as corporate securities. Securities with little or no spread (such as federal bonds) are more sensitive to interest rate changes due to their low coupons, and they are likely to underperform in a rising rate environment. We also believe that, in the event of rising rates driven by economic improvement, credit spreads may tighten, which would benefit corporate bonds.

Illustrative analysis

To illustrate the differences between passive and active portfolios, we conducted stress tests for a variety of changing interest rates scenarios. Below we show the impact of several scenarios on the benchmark and two of TDAM's active core bond strategies. While we expect that a Bear Hump scenario is the most likely to unfold in the medium term, the analysis demonstrates that our active solutions are strategically positioned to potentially outperform the benchmark in all rising rate scenarios, including:

- 100 basis point parallel yield curve shift
- Bear Flattener (i.e. short-term rates rise while the long portion of the curve is anchored)
- Bear Hump (i.e. the middle portion of the curve rises)
- Bear Steepener (i.e. short-term rates are anchored and the long portion of the curve increases)

Market Strength & Direction[1]	Passive Solution	Active Solutions	
	FTSE TMX Canada Universe Bond Index	TD *Emerald* Active Fixed Income Fund	TD *Emerald* Canadian Core Plus Bond PFT
Duration (years)	7.38	6.90	6.86
Yield	1.90%	1.98%	2.23%
Scenario	**2 Year Horizon Annualized Return[1]**		
+100 bps Parallel Shift	-0.41%	-0.26%	-0.11%
Bear Flattener	1.86%	1.81%	1.94%
Bear Hump	0.26%	0.37%	0.48%
Bear Steepener	-0.62%	-0.44%	-0.27%

[1]The horizon returns incorporate the benefits of incremental income as we assume the interest rate shock occurs 6 month from start date. We also assume that the portfolio is held for two years. The horizon returns provide an indication of the impact of price changes caused by yield curve movements, net of the income generated from holding the bonds for the period. Characteristics as at May 31, 2015. Source: FTSE TMX Global Debt Capital Markets Inc.

Summary

As tailwinds dissipate, TDAM expects assets to provide more modest returns than investors have enjoyed over the past few years. It also expects that volatility will increase and continues to be mindful of a variety of macro-economic factors, including slow global economic growth, elevated sovereign debt levels, demographics and inflationary/disinflationary pressures.

No doubt there are challenging times ahead for fixed income investors. In addition to navigating a more challenging market environment, the evolving composition of the benchmark may mean that investors also need to mitigate the risks of increased passive exposure to corporate credit. Portfolios such as passive solutions with strict constraints relative to the benchmark may be less able to tactically adjust to protect themselves and may be unable to fully mitigate the risks associated with their credit exposure.

On the other hand, actively managed strategies with broader guidelines can seek to strategically position portfolios to moderate the effects of changing rates, take advantage of opportunities and strive to ensure that investors are appropriately compensated for their level of risk exposure.

At TDAM, we believe that the unique needs of clients should determine the ideal solution for them. As a leader in active and passive investment management, we remain focussed on designing, constructing and implementing customized investment solutions based on understanding our clients' priority of objectives and the opportunity set available in the marketplace. ■
