



Finding the Right Fit with Commercial Mortgages

Key Takeaways:

- Commercial mortgages provide strong risk-adjusted return potential
- Investors can implement mortgages as a stand-alone investment or directly integrate mortgages into their bond strategy
- The use of mortgages can be tailored to fit unique needs

As the number of alternative investments available to investors grows, it helps to examine how each fit within an asset allocation framework. Direct commercial mortgages (“commercial mortgages”) are private investments, which provide fixed income exposure

secured by real estate holdings. As an alternative investment that is also fixed income, commercial mortgages can be integrated into portfolios in a variety of interesting ways, including:

- As a stand-alone asset class
- As a value-add to fixed income

By exploring the characteristics that commercial mortgages provide as both a stand-alone asset class and value-add to fixed income, investors can tailor their exposure to best meet their unique investment objectives.

Characteristics of Mortgages

Most homeowners know the basics of a mortgage. It is a financial and legal instrument that secures the repayment of a loan by way of a registered charge against the underlying real estate. The borrower agrees to repay the loan, with interest, on a predetermined schedule.

In its simplest terms, a commercial mortgage is a mortgage on a property other than a single-family residence. It includes loans secured by office, retail, industrial and multi-unit residential rental properties. The underlying real estate for a given loan can be at various stages in its lifecycle, from an income-producing property to a parcel of land for future development.

Commercial mortgages offer higher yields than comparable publicly traded bonds due to a uniqueness premium. The uniqueness premium is a function of the additional yield that the borrower pays to investors to compensate for the mortgage's reduced liquidity profile and the level of complexity of the borrower's needs. Institutional investors have capacity for liquidity risk within their risk budget, given their long-term horizons

and generally modest, well understood near-term liquidity needs. Additionally, the more highly tailored the transaction, the higher the uniqueness premium and the greater the yield for investors. This is a function of the terms of a commercial mortgage being negotiated directly, which provides the ability to dictate conditions that allow investors to become price makers rather than price takers. Commercial mortgages also offer diversification into the real estate asset class, but with the advantage of greater security. Changes in property values or reductions in income affect property owners before debt holders. Equally important, lenders are registered on the property title and are first in line relative to equity/property owners in the event of default or bankruptcy.

As a fixed income instrument, commercial mortgages can offer enhanced yields and a lower duration profile, as seen in **Figure 1**. This combination creates an attractive proposition for investors seeking an absolute return strategy "beta" or a value added "alpha" lever to add to existing fixed income programs.

Figure 1: Direct Commercial Mortgages vs. Publicly Traded Debt

As at December 31, 2020	Yield (%)	Duration (years)	Yield/ Duration
Mortgage Backed Securities	1.09	4.27	0.26
Corporate Bonds	1.71	6.99	0.24
Commercial Mortgages	3.65	2.48	1.47

Source: FTSE Global Debt Capital Markets, TD Asset Management. Indices used are FTSE Composite MBS Index and FTSE Corporate Bond Index. Commercial Mortgages is TD Greystone Mortgage Fund.

Structure

We believe that having an open-ended pooled fund structure with commercial mortgage holdings can help facilitate liquidity, as it provides transferability of ownership between existing and new investors without having to market the underlying mortgage loan investments. This is an important consideration in meeting investor cash flow needs or if investor re-balancing is required.

A pooled fund's portfolio of mortgages with diversified maturities, consistent principal and interest payments, serves as a source of funds with which to redeem unit holders upon request. In addition, the secondary mortgage market has matured significantly in Canada, as mortgage bankers and brokers have become effective facilitators of loan purchases and sales transactions, should such transactions become necessary.

Commercial Mortgages as a Stand-Alone Asset Class

Investors seeking mortgages as a stand-alone asset class may do so for two primary reasons:



As an absolute return alternative investment



As a lower duration fixed income portfolio that enhances yield

An Alternative Asset Class Exposure

Alternative investments continue to gain popularity among institutional investors due to their risk reducing and potential return enhancing benefits versus equities and traditional fixed income products. Commercial mortgages provide this through the yield premiums discussed above and a low correlation to other asset

classes, especially to equities. Lower correlations indicate that commercial mortgage returns are less dependent on the returns of other asset classes (**Figure 2**).

Figure 2: Correlation of Stocks, Bonds and Commercial Mortgages

	Standard Deviation (%)	Universe Bonds	Corporate Bonds	Global Equities	Commercial Mortgages
Universe Bonds	3.80	1.00	0.83	-0.10	0.82
Corporate Bonds	3.80	–	1.00	0.20	0.67
Global Equities	13.70	–	–	1.00	-0.22
Commercial Mortgages	2.00	–	–	–	1.00

Source: FTSE Canada Universe Bond Index, FTSE Canada Corporate Bond Index, MSCI World (C\$), Representative Mortgage Returns, FTSE Canada Mid Term Overall Bond Index + 60% FTSE Short Term Overall Bond Index Monthly data from Dec 31, 1998 to Sep 30, 2019.

The lower correlation and diversification benefits versus equities are evident in both bonds and commercial mortgages. Commercial mortgages also exhibit lower historical volatility than universe bonds, corporate bonds and equities (**Figure 2**), which often leads to their use as an absolute return strategy.

It may seem counter intuitive, but these increased yields can be achieved without increasing volatility. Public bonds are unsecured obligations and have standard trust indentures. Commercial mortgage underwriters have more control over what terms and conditions are included in the transaction, such as financial covenants, reserve accounts, assets pledged as security, reporting requirements, etc. As a result, properly structured commercial mortgages tend to have stronger covenant and security packages than publicly traded investment

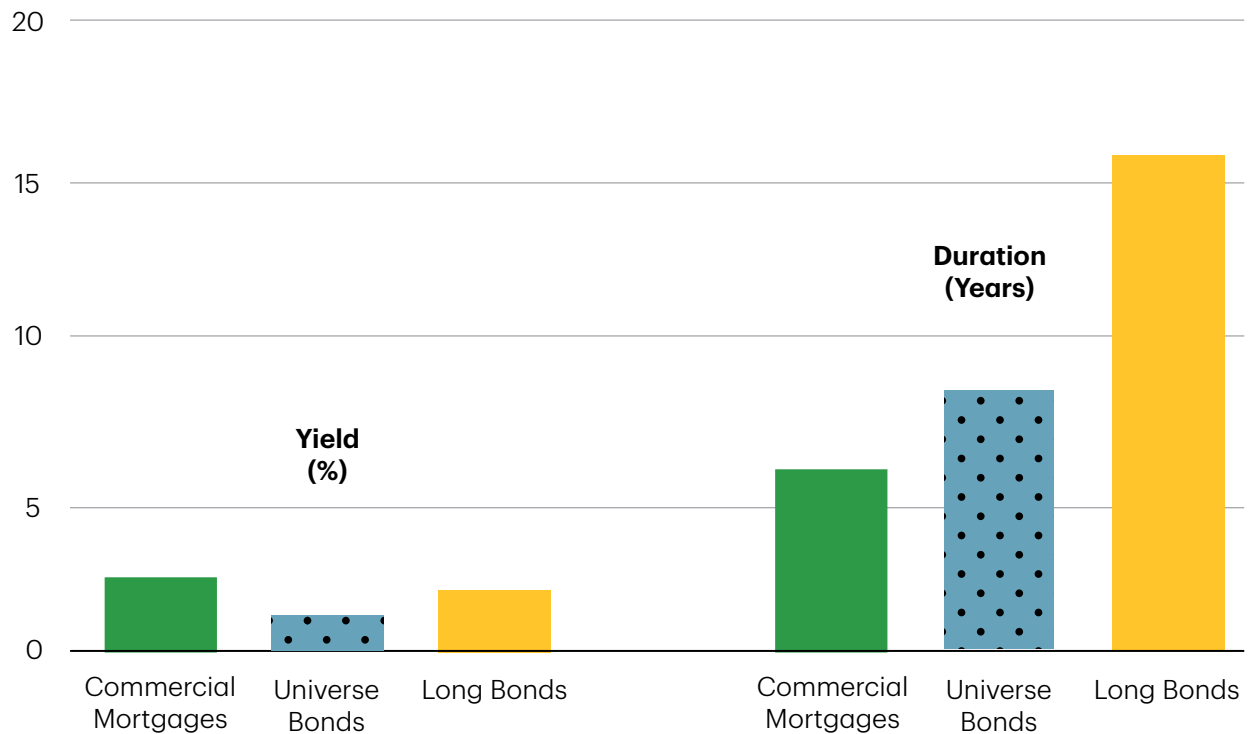
grade bonds and commercial mortgage-backed securities (“CMBS”). The protective nature of direct commercial mortgages relative to corporate bonds and CMBS exacerbates during times of borrower distress. Private commercial mortgage holders can directly negotiate with the borrower while corporate bond and CMBS lending involves fragmented ownership of the loan, compromising the ability to directly negotiate with the borrower and the ability to enforce the lien in order to protect investors. While market wide private commercial mortgage default and loss history is difficult to aggregate due to the private nature of the asset class, enhanced investor protection has been demonstrated by the TD Greystone Mortgage Fund (the “Fund”) experiencing zero losses by way of default since the Fund’s inception in 2007.

Higher Yields and Lower Interest Rate Risk

The lower duration profile of commercial mortgages versus universe bonds is attractive for those looking to reduce interest rate sensitivity while enhancing the yield of their fixed income portfolios. Commercial mortgage strategies can reduce interest rate sensitivity by underwriting floating rate mortgages that have

floors. This protects investors from lower income levels if interest rates were to drop while also allowing for higher yield capture if interest rates increase. As shown in **Figure 3**, commercial mortgages provide a lower duration profile than universe bonds, accompanied with a higher yield than long duration bonds

Figure 3: Raising Yield, Lowering Duration

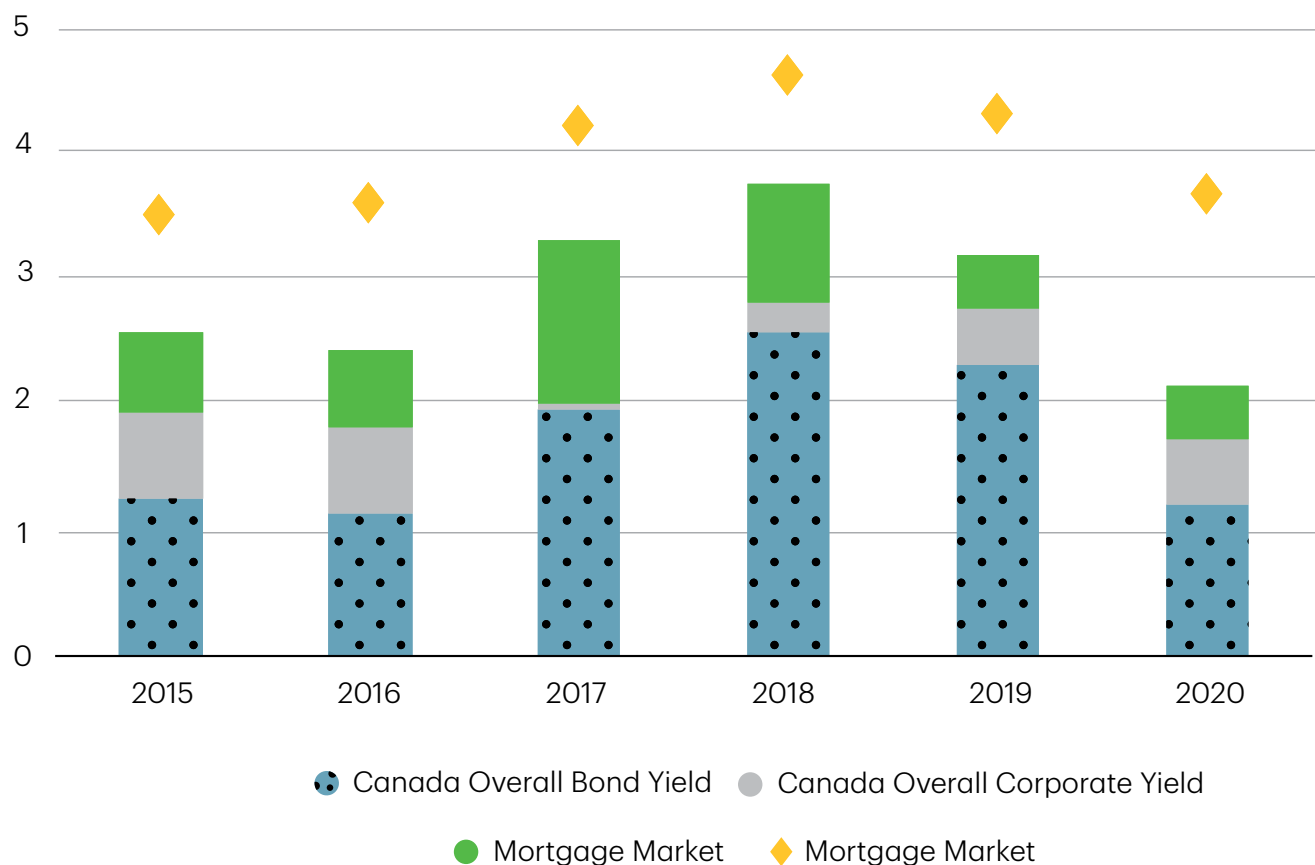


Source: FTSE Global Debt Capital Markets Inc, TDAM. Commercial Mortgages is TD Greystone Mortgage Fund. As at Dec 31, 2020.

Strategies

Commercial mortgages have shown strong performance in a low-yield environment as shown in **Figure 4** below. This is a very important advantage for income-oriented investors.

Figure 4: Yield Comparison



Note: Duration matched to Greystone Mortgage Fund. Rolling 12 month period ending March 31, 2020.

Source: FTSE Global Debt Capital Markets Inc., Mortgage Market is 5-Year RBC Commercial Mortgage Yield, TDGMF is TD Greystone Mortgage Fund, BMO Capital Markets Capital Markets Rolling 12 month period ending March 31, 2020.

The consistent yield premium of the Mortgage Market is shown by the elevated grey portion of the bar charts above. We also observe the yield of the Fund is consistently higher than the commercial mortgage market. The yield premium above the mortgage market can be attributed to the Fund's information advantage derived from being fully integrated into a commercial real estate investment platform, its ability to lend across the entire real estate life cycle and source off-market transactions while also returning all processing fees paid by borrowers to the Fund.

Many investors find the yield enhancement attractive and may wish to integrate commercial mortgages into fixed income allocations without lowering overall duration. We believe that commercial mortgages can also be utilized as a yield enhancing sector within short-term, core, long-term or liability-matching fixed income portfolios.

Commercial Mortgages as a Source of Value-Add to Fixed Income

Fixed income portfolios with longer average durations than commercial mortgages can benefit from the yield enhancement through substituting commercial mortgages for short-term holdings. For example, investors retaining a FTSE Canada Universe Bond Index policy benchmark can allow for commercial mortgages within the investable opportunity set, as opposed to allocating to them as a stand-alone investment.

While the overall duration of the universe bonds is longer than for commercial mortgages, there are significant short- and mid-term (corporate/provincial)

exposures within the universe that can be replaced by commercial mortgages for yield enhancement (**Figure 5**). In this context, we believe a core portfolio manager can incorporate commercial mortgages as a sector allocation decision similar to the use of corporate and provincial bonds. There is also a credit benefit relative to corporate bonds, as the collateral for commercial mortgages (namely, the underlying real estate) is stronger than unsecured corporate debt.

Figure 5: Universe Bond Index Components

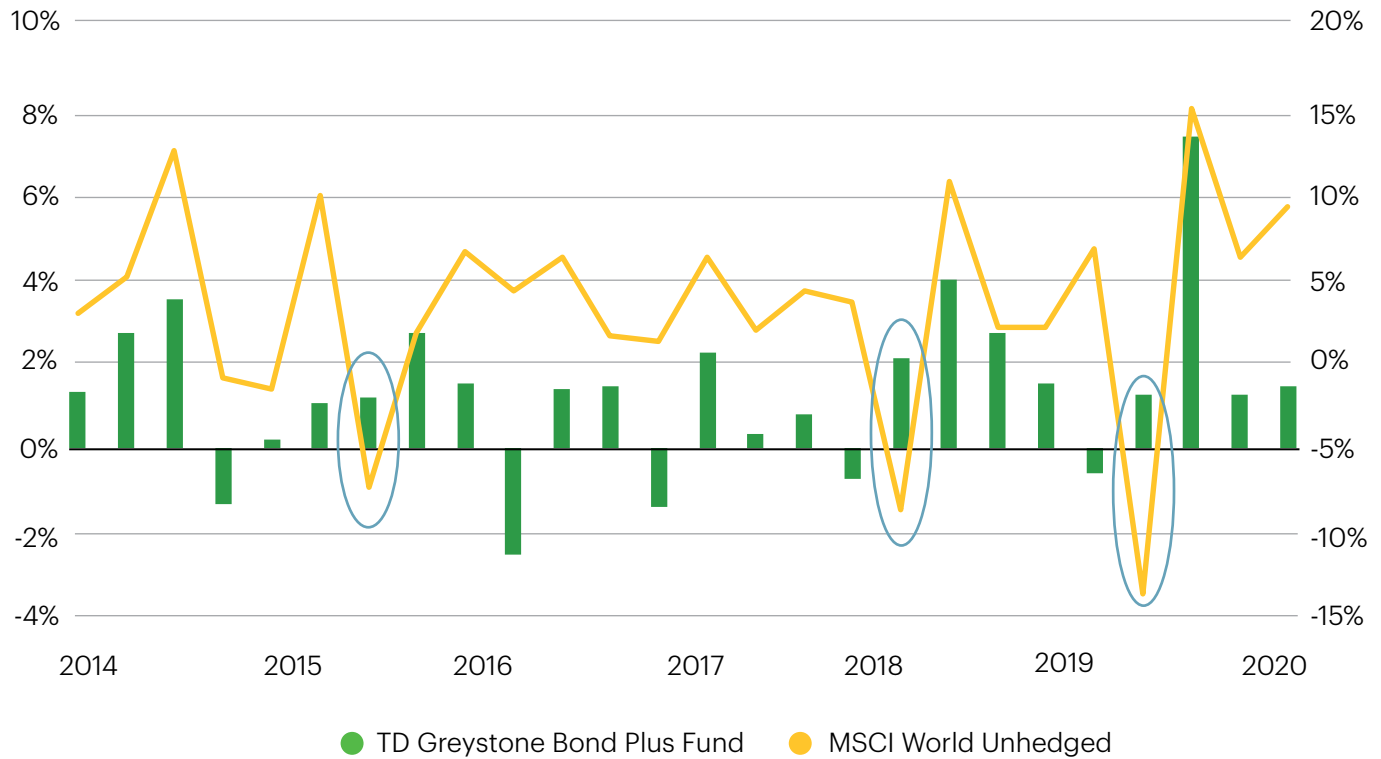
As at March 31, 2020	Yield (%)	Duration (years)	Weight (%)
Short	0.50	2.80	41.20
Mid	1.10	6.90	25.10
Long	2.00	16.20	33.70
Universe Bonds	1.20	8.40	100.00
Commercial Mortgages	3.65	2.48	-

Source: FTSE Global Debt Capital Markets. Indices used are FTSE Composite MBS Index and FTSE Corporate Bond Index, Commercial Mortgages is the TD Greystone Mortgage Fund.

To understand the impact of commercial mortgages in a fixed income context, we can examine the performance of a portfolio that integrates mortgages as described above. The TD Greystone Bond Plus Fund, replaces short- and mid-term corporate components from the FTSE Universe Bond Index with commercial mortgages. The performance of this strategy is shown as the

green bars in **Figure 6**. While the generally consistent positive performance of a Bond Plus strategy that integrates commercial mortgages is evident, the strong performance during periods of equity stress, circled in the **Figure 6** below, indicates the strategy provides stability to overall portfolios during periods of market stress.

Figure 6: Bond Plus: Integrating Mortgages Diversifies Against Equities



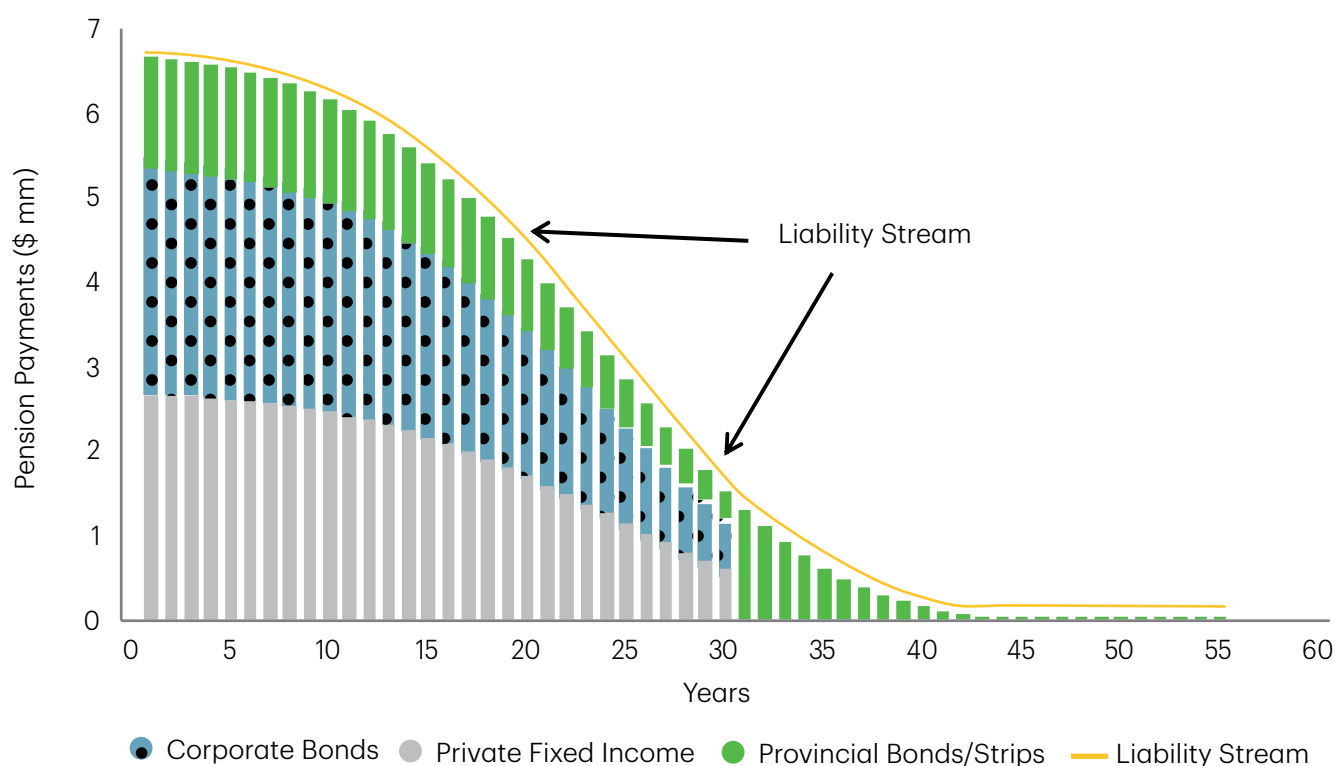
Source: TDAM, TD Greystone Bond Plus Fund, MSCI World Index Unhedged (\$CAD).

Strategies

Given historical return patterns and current yield enhancements from commercial mortgages, we would expect a core fixed income portfolio to gain an additional 30-50 basis points from integrating commercial mortgages, over and above the expected value added from active management. Short-term fixed income portfolios provide a closer match to the duration of commercial mortgages, and therefore can integrate a larger weight to commercial mortgages without deviating from benchmark interest rate risk, allowing for 1% of yield enhancement in our view.

Longer duration portfolios can also benefit from a similar structure. For example, defined benefit plans that match their fixed income to custom liability profiles can integrate mortgages as a yield enhancement for shorter dated exposures. **Figure 7** illustrates a structure where a defined benefit program matches its liability stream with a custom fixed income portfolio. In a custom approach, the fixed income portfolio matches both long-term and short-term cash flows, the latter of which can be substituted with commercial mortgages, labelled as Private Fixed Income below.

Figure 7: Mortgages within a Liability Matching Fixed Income Portfolio



Source: TDAM. For illustration purposes only.

Defined benefit pension plans looking to de-risk through annuitization can also integrate private commercial mortgages through a do-it yourself (DIY) annuity portfolio. Visit here: <https://www.td.com/ca/en/asset-management/documents/institutional/pdf/INST-DIY-Annuity-Portfolios-EN.pdf>.

Additional Considerations

Looking at mortgages through a fixed income lens reveals multiple uses to enhance yield and prospective returns. Short maturity bond investors benefit from a similar duration profile between commercial mortgages and their portfolio. Depending on the investor's liquidity needs, the amount of commercial mortgage exposure can be integrated between 0% and 50% of a short-term portfolio and still allow for management against the profile of the FTSE Canada Short Bond Index. Investors wishing to integrate commercial mortgages

within universe bond portfolios also benefit and, in our experience, a commercial mortgage weight of up to 30% still allows for effective risk management versus the index. Finally, longer maturity investors are not precluded from the benefits of an integrated commercial mortgage allocation. The degree to which short-term cash flows can be substituted for mortgages will depend on each defined benefit plan's liability profile and liquidity needs (see Figure 8).

Figure 8: Integrating Mortgages with Fixed Income Portfolios

Term	Recommended Policy Range	Yield Pickup
Short	0-50%	0-100 bps
Universe Bonds	0-30%	0-50 bps
Liability Matching	Custom	Custom

Source: TDAM. For illustrative purposes.



Conclusion

Commercial mortgages provide the benefit of a high-quality, low duration yield enhancement and can play many roles within institutional portfolios. On a stand-alone basis, the lower volatility and higher yield can be used as an absolute return exposure or an effective tool to shorten duration, without giving up yield.

Investors can also benefit by integrating commercial mortgages into their existing fixed income policy benchmarks. This can be accomplished by utilizing

commercial mortgages as an additional sector lever that can be deployed as a substitute for shorter-term fixed income exposures.

Commercial mortgages can be tailored to each investor's need – there are no set rules for optimal use. Due to the unique characteristics of commercial mortgages, we believe they warrant consideration by investors and could be a beneficial component to institutional portfolios. ■

Conclusion

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