MACKENZIE Investments | CONFIDENCE IN A CHANGING WORLD

Is it Time for a New Fixed Income Approach?

Key Takeaways

- Many tried and true fixed income portfolio strategies that advisors have been using may not be able to deliver on investor objectives going forward
- In a low-yield environment, fixed income portfolios consisting only of core bond strategies are even more vulnerable to rising interest rates
- We recommend incorporating a broader array of fixed-income asset classes, building portfolios with "core" and "plus" components, and being vigilant about risk management

Fixed-income investing is at a crossroad. Bond strategies that have served investors well for several decades are now poised to fall short in delivering on some or all of the traditional objectives for fixed-income allocations: to provide an income stream, preserve capital and mitigate equity volatility. We believe this is an opportunity to re-examine existing fixed-income strategies, evaluate the risks inherent in these strategies, and transition investors to portfolios better suited to the current and future environment.

Traditional strategies for bond investing face a variety of challenges. Advisors accustomed to assembling a portfolio of high-quality Canadian government (Federal and Provincial) and corporate bonds now find dealer inventories light and frictional costs high. The return on GICs is not keeping pace with inflation, such that the after-tax real return to GIC investors is actually negative. Passive fixed-income investments – attractive in this low yield environment – may eventually lose the tailwind that a multi-decade secular decline in interest rates has provided and will potentially be exposed as the large pools of unmanaged risk that they are. Some additions to fixed income portfolios such as preferred shares, high yield and convertible bonds have helped boost income, but on their own are unlikely to provide stability to the portfolio when equity markets are weak due to their higher correlation with risky assets.

Even core Canadian bond funds are at risk of disappointing investors who have come to rely on them as a single solution to the objectives of income, capital preservation and portfolio diversification to mitigate equity risk. The current low-yield environment has meant that the yield per unit of duration in these funds has decreased significantly. Another way of saying this is the upside/downside profile has become skewed to the downside. The yield generated may not be sufficient to offset the price decline associated with higher interest rates, potentially resulting in a negative total return on the bond portfolio. For investors conditioned to think of their bond portfolios as safe havens, this could be an unwelcome surprise.

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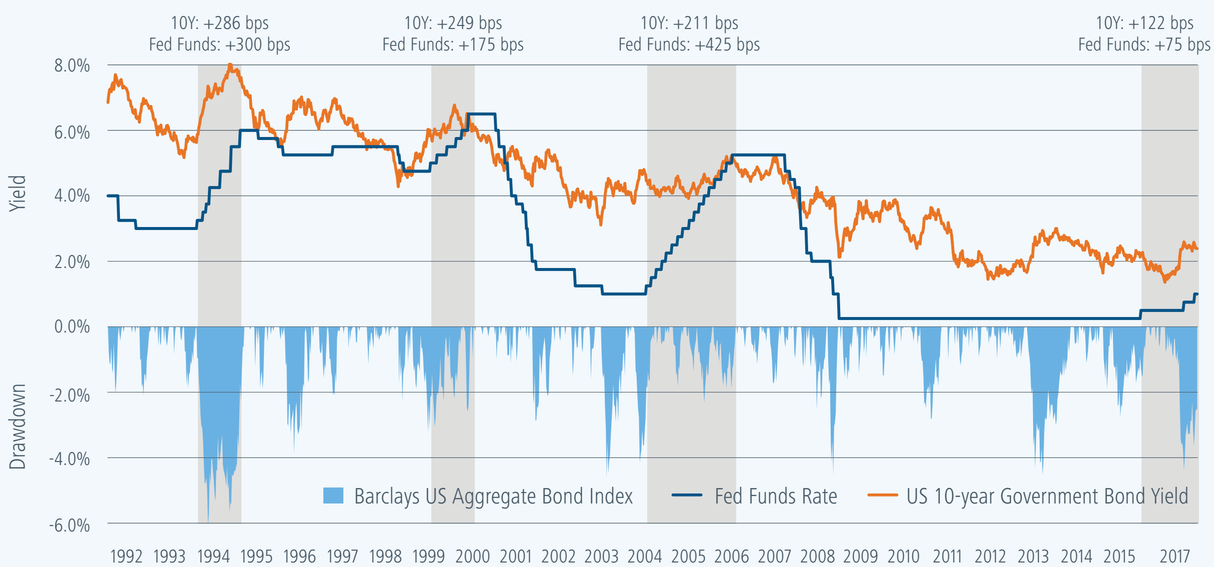
What do rising US rates mean for my bond portfolio?

It depends. Most investors have at least textbook familiarity with the concept that higher yields mean lower bond prices, but several factors typically affect how a bond portfolio weathers a period of rising rates:

- the starting point in yields
- the shape (steepness) of the yield curve
- the pace and extent of rate hikes
- the portfolio's duration

The following chart shows 25 years of drawdowns for the Bloomberg Barclays US Aggregate Bond Index (an investment grade bond index) along with the 10-year government bond yield and the Fed Funds rate. The grey shading indicates periods when the Fed raised rates.

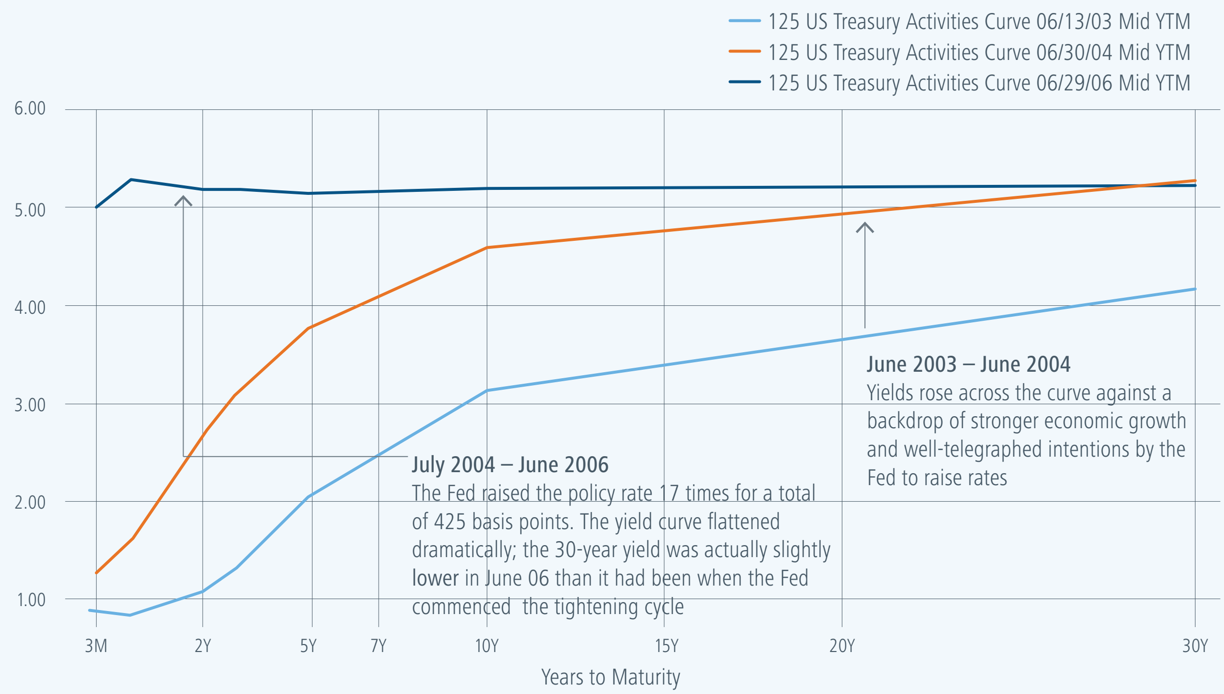
US Aggregate Bond Index Drawdowns vs. US 10-Year Yield and Fed Funds Rate



Source: Bloomberg, Morningstar Direct

Not surprisingly, most of the larger drawdowns occurred either in anticipation of, or concurrent with, Fed rate hikes. However there are a couple observations from the chart that may seem counterintuitive. Note that the most dramatic tightening cycle from 2004-06 corresponded with somewhat benign and short-lived drawdowns. Why wasn't a period during which the Fed raised rates 17 times worse for bond portfolio returns? On the other hand, note that more recently, smaller increases in yields have been triggering significant drawdowns. Why?

Breaking down the 2004-2006 rate hike cycle



One full year prior to the first Fed rate increase in June 2004, yields in the US started to rise. The 30-year bond yield jumped 119 basis points (bps) to 5.36% by the end of July 2003. It then remained essentially pegged at that level while the Fed raised rates 17 times (a total increase of 425 bps), finishing in June 2006 when the Fed Funds rate reached 5.25%.

At that point, the 30-year US Treasury yielded 5.25%, which was 11 bps below the yield at the end of July 2003. Bond investors generally still experienced positive total returns as the yield curve flattened. The Barclays US Aggregate Bond Index total return was 4.1% in 2003, 4.3% in 2004 and 2.4% in 2005. (Source: Morningstar Direct).

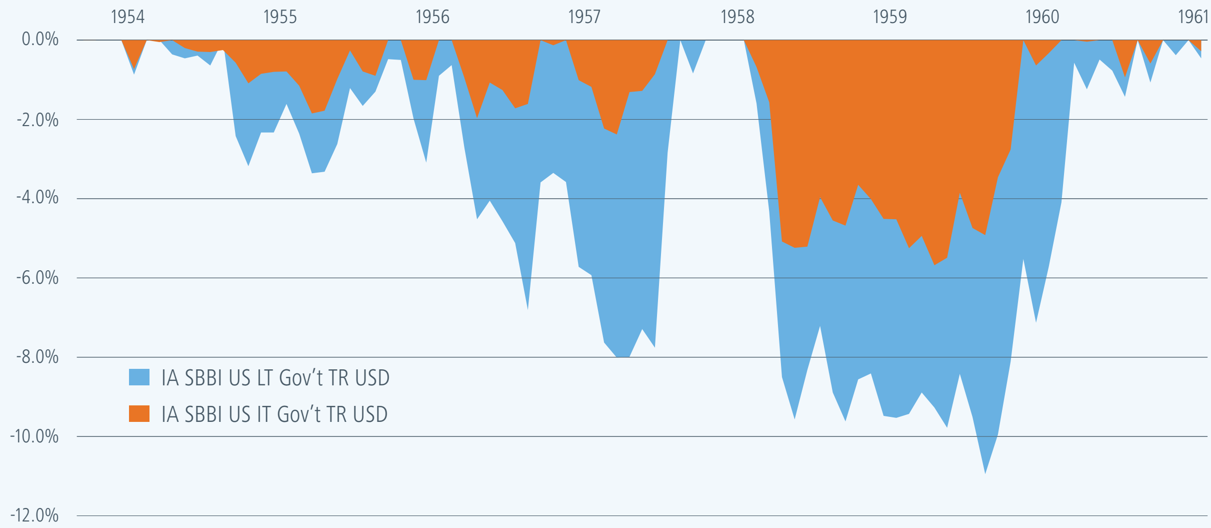
Why do drawdowns seem to be getting worse on smaller increases in yields?

As we noted earlier, progressively smaller increases in yields have been precipitating more severe and lengthy drawdowns. Features of the recent environment, including a low starting point in yields and relatively flat yield curves, are contributing factors to this. The low starting yields mean that there is little cushion to absorb negative price returns as bond yields rise. In addition, some of the more recent and unconventional central bank policies, such as asset purchases known as "quantitative easing", could send the whole yield curve higher (not just short-term policy rates) as they are tapered or unwound.

In terms of impact on bond portfolios, you need to go back to the mid-1950s to find an environment comparable to what we're facing today (see graph on page 4). In June 1954, yields were low and the yield curve was fairly flat with a 182 bps spread between the 1-year and 20-year bond (note the US Treasury first issued 2-year and 30-year bonds in 1976 and 1977, respectively). The Fed Funds rate rose gradually from about 0.80% in 1954 to around 4% in 1960, falling briefly during 1958 as the economy went into a mild recession (Source: Federal Reserve Bank of St. Louis). The 20-year bond yield never dipped back to the 1954 lows of around 2.60%, and reached about 4.40% in early 1960.

Analysis of the indices available for that timeframe suggests that it was not the depth of the drawdown as much as the time to recovery that was notable. The low starting point in yields and their gradual but sustained increases meant bond portfolios could have been under water for several years.

Drawdown of IA SBBI US Intermediate-term and long-term Government Bond Indices



Source: Morningstar Direct

So what lessons should we draw from history?

We could see a similar experience as in 2004-06 unfold from here. A repricing of growth and inflation expectations and a subtle shift in central bank policies triggered the rise in yields during the latter half of 2016. But if growth and inflation don't materialize, the "lower for longer" argument may take hold again and we may not see yields rise much more from here. That's one possible scenario.

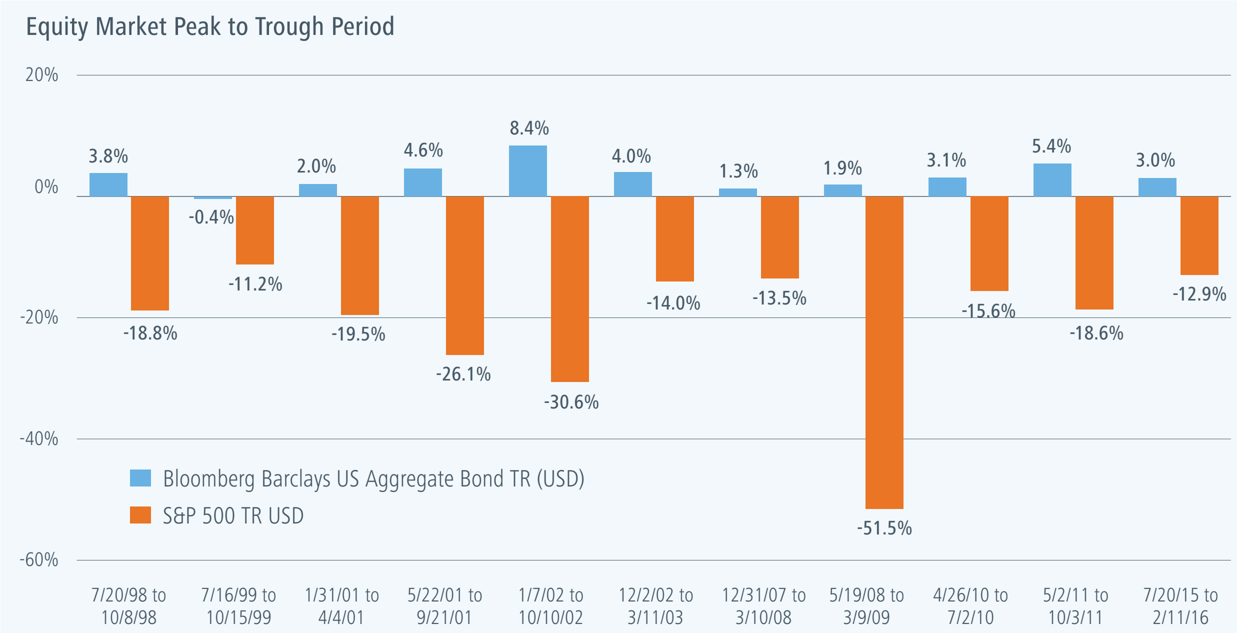
On the other hand, if growth improves, central banks continue reversing their accommodative policies through both policy rate hikes and the tapering of quantitative easing programs, and more populist political agendas take hold in many parts of the world, there may be more upward pressure on the yield curve than we have seen in some time. With the low level of starting yields, core bond portfolios are perhaps more vulnerable to sustained losses than they have been in many years.

With all this risk, why invest in bonds at all?

In an environment where rates may be rising, many investors might question owning bonds at all.

Maintaining some allocation to high-quality fixed income investments is still an important part of diversifying a portfolio's equity risk. Particularly during times of equity market stress, high credit quality bonds tend to benefit from the increased demand for safe haven assets. The chart "Equity Market Peak to Trough" on page 5 illustrates the total return on the Bloomberg Barclays US Aggregate Bond Index during peak-to-trough periods when the S&P500 fell 10% or more. You can see the stabilizing effect that these assets have generally had on a portfolio containing equities.

There are also a variety of asset classes within fixed income that can augment a traditional core bond portfolio and help investors meet their portfolio goals while remaining aligned to their risk tolerance. We discuss some of these strategies below.

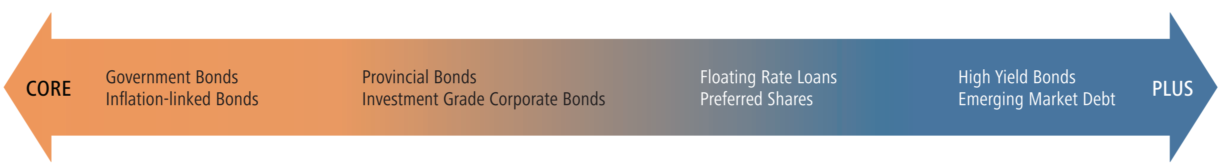


Source: Morningstar Direct

How should I approach fixed income investing for the future?

We believe there are three main principles for constructing fixed income portfolios that will help investors navigate a challenging interest rate environment.

1. Expand the opportunity set of fixed income investments, allowing the creation of diversified portfolios with desired risks.



Fixed income investments exist along a spectrum of risk of principal loss and corresponding yields. "Core" fixed income is typically defined as developed market sovereign government bonds, investment-grade provincial, municipal and corporate bonds, and high quality asset-backed securities. "Plus" assets include bonds and loans that either contain higher credit risk or are lower in the capital structure of a company. Incorporating a broader array of fixed-income assets into a portfolio effectively pushes the portfolio out the efficient frontier. In other words, the portfolio can achieve a higher expected return for the same level of risk.

This is the crux of the rationale for adopting a "Core Plus" fixed-income approach. Diversifying core and plus assets geographically can further enhance a fixed income portfolio's risk/return characteristics.

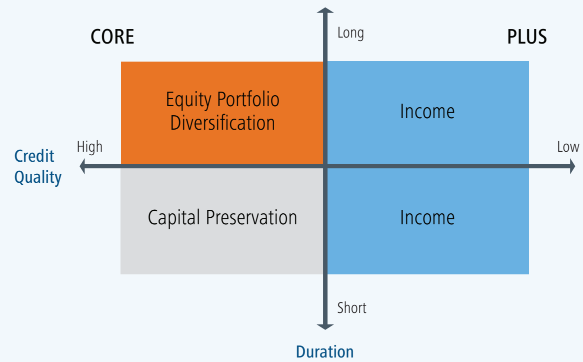
2. Define more specific investment objectives for bond portfolios and prioritize among income generation, capital preservation and equity market diversification.

Core fixed-income assets are high credit quality and, therefore, price movements tend to be driven primarily by moves in interest rates. These high quality government and corporate bonds, especially those with higher duration, also tend to be the most negatively correlated with equities in times of equity market stress. High quality bonds with low duration will provide the low volatility and protection of capital that some investors want. However, they tend to provide a smaller stabilizing effect on an overall portfolio when equity markets are weak.

"Plus" fixed-income assets tend to contain more credit risk and so, to compensate, offer the investor additional yield. These assets tend to have a higher correlation with equities and a lower or even negative correlation to core fixed-income assets.

By more narrowly defining an investor's priorities and objectives for their fixed income portfolios, a financial advisor will be able to size the "core" and "plus" allocations appropriately for each client (illustration to the right).

Defining Port folio Objectives to Determine "Core" and "Plus" Allocations



3. Transition to investment strategies designed to meet portfolio objectives while valuing and managing portfolio risks.

Once portfolios have been assembled that include the desired characteristics, active management of risk is paramount. Tactical duration and yield curve positioning, rigorous fundamental credit research and tail-risk management strategies can all help protect capital and achieve superior risk-adjusted returns.

Summary: Portfolio construction through a Core Plus lens

With fixed-income investing at a crossroad, change can seem daunting, especially when it involves a complex universe like fixed income markets. And no one can pinpoint the absolute inflection point in bond yields until it appears in the rearview mirror. So we believe this is the time to start exploring a wider array of fixed income solutions, and viewing fixed-income portfolio construction through a "Core Plus" lens, with an eye on risk management. Ultimately, this approach will enable advisors to transition their clients to portfolios that are better able to weather a volatile interest rate environment and meet their investment objectives.

Additional information about "Core Plus" can be found at mackenzieinvestments.com/income

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