May 2013

Death of bonds?

By Alfred Lam, CFA
Vice-President and Portfolio Manager, Investment Consulting

We have recently provided updates on the economy and the stock market since both have been quite volatile. Many of our clients may also be wondering about the bond market. Recently, investment guru Warren Buffett commented on the CNBC financial news network that bonds are a "terrible" investment and that owners of long-term bonds may experience significant losses when interest rates eventually rise.

This month, we want to discuss both the opportunities and the risks of investing in bonds. Before examining the opportunities, let's review the risks of owning bonds. To start, a bond is a contract between a lender and a borrower. The borrower is obligated to pay the lender interest, usually on a regular basis, and repay the principal at the end of the term. A key risk is default, which is the risk that bond investors may not get all of their principal back if the borrower runs into financial trouble. This risk is usually low if the borrower is a government, because government has the unique power to print money and levy taxes. On the other hand, businesses do not have the same luxury – they rely on future operating cash flows to meet their interest and debt repayment obligations. With proper risk management by professionals, the default risk of corporate bonds is usually manageable.

The other major risk with bonds is interest rate risk which arises from fluctuating interest rates. Canada's central bank, the Bank of Canada, influences short-term interest rates by raising and lowering the target for the overnight rate, the rate at which major financial institutions borrow and lend one-day (or "overnight") funds among themselves.

All bonds in Canada, whether government or corporate, trade in relation to the overnight rate, which is currently 1%. Each bond's interest rate is largely dependent on the length of the term and the risk profile of the borrower. Investors demand higher interest from higher-risk borrowers.

If you had lent money to the Government of Canada by investing in a five-year government bond on April 30, for example, the rate offered to you would have been about 1.16%. This rate is little more than the current overnight rate, reflecting the fact that bonds from our federal government currently carry low risk, and that the loan is for a relatively short period.

Now if an individual were to borrow from a local bank for five years, the rate would not be 1.16%. It would be much higher. This is because an individual is considered to be a greater risk compared to a borrower such as a government.

Interest rates are constantly reset in the markets, and are influenced by factors such as expectations regarding economic growth and inflation. All else being equal, lenders are worse off to lend today if they could lend tomorrow at a higher interest rate. This is because bond prices decline when short-term rates rise. Bonds that have longer maturity dates are more sensitive to rate changes as lenders will have to wait until maturity before reinvesting to benefit from the new higher market rate. Meanwhile, the lost opportunity to collect the new higher interest income is reflected in a lower price for existing bonds. A rise in rates could leave current bondholders with a capital loss.

Interest rate risk is a major concern in today's environment because rates have declined to multi-decade lows. A bond that you buy today locks you in at a low rate. While it's generally expected that rates will eventually rise, no one knows the timing and the magnitude. But there is also an opportunity cost of not investing. The media began talking of a "bond bubble" in 2009, suggesting that bonds had become highly overpriced by the market. However, if you had held cash instead of a typical diversified basket of bonds (as represented, for example, by the DEX Universe Bond Index) over the past four years, you would have given up a 20% return.

As your investment manager, we have been managing risks diligently on your behalf. This includes managing interest rate risk in the bond portion of your portfolio. Over the last few years, we have made a few changes to take advantage of developments in the bond market. These adjustments include:

1. Increasing allocations to corporate and emerging country bonds. Prices of these bonds are less sensitive to interest rate moves but fluctuate with their credit quality. During the past few years, these prices have appreciated as their credit quality and the global economy have improved.
2. Investing in foreign government bonds that offer exposure to different interest rate policies. For example, Australia was the first major country to get out of recession and the first to raise rates. As a result, it had lower interest rate risk compared to other countries.
3. Maintaining some exposure to stocks in all recommended portfolios to help offset interest rate risk. In general, rate hikes indicate the end of recession and are positive for stocks. By owning both bonds and stocks, we are managing the downside volatility presented by each asset class.
4. Lastly, and most importantly, by owning a diversified basket of bonds with different maturity dates. This allows us to reset our rates quicker as rates rise. In general, our bond manager prefers shorter-dated bonds. This has positioned the portfolios to help offset losses as rates rise.

The declining interest rate cycle in place since 1980 has generated very strong performance by bonds. But those returns are not likely to repeat any time soon. The days when you could invest in just one asset class, that being bonds or GICs, and collect 10%, 8%, or 6% interest annually are over for the foreseeable future because rates have been reset lower. To earn an acceptable return in today's low interest rate environment requires investing in more than just one asset class. While both stocks and bonds on their own can be risky, you may be surprised by the benefit of mixing the two together as part of a diversified portfolio.

Combined top 15 equity holdings as of April 30, 2013 of a representative balanced United Financial portfolio with alpha-style equity exposure:*

1. Atco 2. Empire Company 3. E-L Financial 4. AltaGas 5. Canadian Utilities	6. Sumitomo Mitsui Financial 7. BlackBerry 8. Mitsubishi Estate 9. Power Financial 10. Mitsui Fudosan	11. Pason Systems 12. Jean Coutu 13. Samsung 14. Sanofi 15. Microsoft

Combined top 15 equity holdings as of April 30, 2013 of a representative balanced United Financial portfolio with value-style equity exposure:*

1. Toronto-Dominion Bank 2. Royal Bank of Canada 3. Microsoft 4. Potash Corp. of Sask. 5. Schlumberger	6. Suncor Energy 7. Boeing 8. Ventas 9. CIBC 10. Roche	11. United Health Group 12. Apple 13. Blackrock 14. Simon Property Group 15. Novartis

*Approximately 37% fixed-income, 7% enhanced income, 49% equities and 7% global real estate.

To see the top 15 holdings of the individual United Pools or of the United equity Alpha mandates, please visit the United Financial web page by right clicking on this link and selecting "open web link in browser": http://www.assante.com/wp/optima/financials.jsp#united15.

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