Caution Ahead: Why Bonds May Soon Become Much Harder to Manage

Description

If there’s one topic that frustrates income-oriented investors, it’s the elusive search for yield. The zero interest policy of various central banks has provided investors with an unenviable Hobson’s Choice.

One, they can accept puny yields on fixed-income investments that may not even keep up with inflation. Or two, they can do what central bankers want them to do—take on more risk in order to boost their yields.

At a recent conference in Chicago held by BMO Global Asset Management, a session was held on precisely this topic. BMO vice president and portfolio manager Chris McHaney reminded financial advisors that six years after the financial crisis, yields on core fixed-income investments still linger below 2% per annum. The yield curve remains flat, so investors get only a small boost in yield by committing to longer durations. Extending it by three or four years may get you only a 50-basis-point boost in yield.

Then there’s the uncertainty of imminent rises in interest rates, which the Federal Reserve could unleash as early as June. The unknown is exactly when this will occur, and by how much, McHaney said.

Bond investors: trouble ahead?

In a subsequent interview I conducted with Som Seif, president of ETF-maker Purpose Investments, Seif warned that bond investors could get “hurt really badly” in the coming years. This may come as a surprise, since “the last 35 years was a period when it was easy to be a bond investor.” Over that time, bonds provided an annualized return of 8.5%, about the same as equities. But those bond returns came partly from capital gains as interest rates mostly declined over that period, a circumstance not likely to be repeated over the coming decades.

“Bonds are supposed to play defence and manage risk, offsetting equity risk,” Seif explained. In the past, investors were spoiled by the fact that “your defence has been scoring goals”—great returns generated by bonds as rates fell, and with a third of the risk of equities.

Seif predicts that this supposedly “safe” asset class—bonds—will be the hardest part of investor portfolios to manage the next 20 years.

Possible responses to this dilemma

One response to this dilemma is to move from low-yielding bonds to higher-yielding equities: dividend-paying stocks, real estate investment trusts, preferred shares, and so forth. This entails possible capital risk, but then again, so do bonds. If interest rates spike up and you’re locked into longer-duration fixed-income investments, those too can expose your capital to loss.

Another possible response is asset allocation: move from the usual “balanced” mix of 60% stocks to 40% bonds to something more like 70% stocks/30% bonds. Going forward, the 10-year future return of a 10-year government bond is 2%. Assuming a diversified bond portfolio returns between 2% and 4% (say an average 3%) and equities keep generating 7-9%, an asset allocation of 60% stocks to 40% bonds may generate perhaps 5% a year, Seif estimates; considerably less than the 8% annual return enjoyed the last 35 years.

A third response is to increase risk in the bond portions of portfolios by embracing international bonds, high-yield bonds, corporate bonds, and real return bonds (inflation-linked). You can also extend maturities on provincial, federal and corporate bonds. BMO’s McHaney calls this “tactical asset allocation for fixed income.” He says ETFs are “great to isolate specific exposure” to these various sectors of the fixed-income universe.

The allure of ETFs

Fixed-income ETFs provide not only diversification, but also make institutional pricing available to retail investors. There are now a hundred fixed-income ETFs trading on the Toronto exchange alone. BMO itself has a daunting inventory of fixed-income ETFs, with short-, mid-, and long-bond versions of corporates, provincial, and federal issues.

Investors seeking income, but not willing to take on “duration risk” can consider ETFs that strip out credit risk and minimize duration risk. McHaney mentioned the **BMO Floating Rate High Yield Fund** (TSX:ZFH) or **BMO Covered Call ETFs** in sectors like Canadian banks (TSX:ZWB) or Utilities (TSX:ZWU).

Choosing among these options is tricky, though, and most retail investors would need help from a financial advisor. But there is another route.

Actively managed bonds

Seif sees a role for active management of bond portfolios. His solution is PBD, the Purpose Total Return Bond fund: it consists of high-yield bonds, investment-grade corporates, Canadian government bonds, and U.S. high-yield bonds hedged back into the Canadian dollar. But it’s managed with a momentum overlay. “When prices are good you want to be long corporate bonds or high yield, but when momentum goes against you, you go to cash. Cash becomes strategically important.”

It so happens that PBD uses BMO’s fixed-income ETFs as its underlying building blocks. As of mid-April it was two-thirds in the **BMO High Yield U.S. Corporate Bond ETF Hedged to CAD Index ETF** (TSX:ZHY

), 30% in the **BMO Mid Corporate Bond Index ETF** (TSX:ZCM), and 3% in the **BMO Mid Federal Bond Index ETF** (TSX:ZFM). The management fee is 0.45%, but the management expense ratio will be considerably higher.

A caveat…

However, fee-only advisor Fred Kirby would like to see a longer track record for PBD. Its duration is 4.8 years, so for now he prefers some of Seif's older products now in the iShares stable; the **iShares 1-5 year Laddered Corporate Bond Index ETF** (TSX:CBO) and the **iShares 1-5 year Laddered Government Bond Index ETF** (TSX:CLF) have durations between two and three years and have high-quality holdings.

For those who want more yield than a high-interest savings account ("and risk due the certainty of rates increasing, it being just a matter of when and by how much") either iShares ETF could work, as would the **Vanguard Canadian Short-Term Bond ETF** (TSX:VSB), Kirby says.

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1. Dividend Stocks
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1. TSX:CBO (iShares 1-5 Year Laddered Corporate Bond Index ETF)
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