The Top 3 Canadian Bond ETFs to Buy for a Balanced Investment Portfolio

Description

Called me old fashioned, but I strongly believe in a fixed-income allocation for all portfolios, even in those of very aggressive young investors. Holding investment grade bonds with a low to negative correlation with stocks provides a boost to risk-adjusted returns over time.

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That being said, we have to acknowledge the current macroeconomic environment — one that is characterized by high inflation and rising interest rates. In this case, some types of bonds are more ideal than others. Want to find out which ones are the best buy right now? Keep on reading.

A brief primer on bonds

An allocation to bonds does two things in a portfolio: it lowers volatility and reduces drawdowns. Your portfolio value will fluctuate less, and the peak-to-trough losses it incurs during a crash will be lower than a 100% stock portfolio.

Most bonds (especially government ones like U.S. Treasuries) are also uncorrelated with stocks. When stocks fall, these bonds tend to rise, making them excellent hedges. This is called the "flight to quality," which is caused by investors panic-selling stocks and buying bonds en masse.

Candidate #1: A government bond ETF

Our first candidate is **iShares Core Canadian Government Bond Index ETF** (TSX:XGB). XGB provides exposure to federal, provincial, and municipal bonds with a weighted average maturity of 11.18 years and a current distribution yield of 2.42%. The ETF costs a management expense ratio (MER) of 0.27%.

Being comprised of government bonds, XGB is effectively immune to default risk. Default risk is when the party issuing the bond can't pay back the coupon or principal because they're broke. With Canadian government bonds, default risk is a non-issue (thus, the term "risk-free asset").

XGB has an effective duration of 8.46 years, which is a measurement of its sensitivity to interest rate changes. Bond prices are inversely related to interest rate movements. In this case, a 1% increase in interest rates will cause XGB to drop roughly 8.46%, and vice versa. This might not be desirable for some investors.

Candidate #2: A short-term corporate bond ETF

Whereas XGB was comprised solely of government bonds, **Vanguard Canadian Short-Term Corporate Bond Index ETF** (TSX:VSC) only holds short-term, high-quality debt securities from companies, which gives it a higher yield of 2.61%, despite its lower maturity of 3.4 years. The ETF has an MER of 0.11%.

Corporate bonds have default risk. If the issuing company goes bankrupt (as some tend to do during a stock market crash or recession), their bonds become worthless. That is why corporate bonds lose value during a market crisis, albeit not as much as stocks, but make up for the risk with a higher yield.

However, VSC does have a much shorter effective duration of 2.7 years. In this case, a 1% increase in interest rates will cause VSC to only drop roughly 2.7%, and vice versa. If you're concerned more about interest rate risk more than default risk, VSC might be the better buy.

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Candidate #3: An aggregate bond universe ETF

If all this talk of interest rate and default risk has you glazing over, there is a set-it-and-forget-it, "lazy" option out there: **BMO Aggregate Bond Index ETF** (TSX:ZAG). ZAG simply chooses to hold the entire investment-grade Canadian bond market and with both government and corporate bonds.

ZAG currently has a duration of 7.73 years, which makes it less sensitive than XGB when it comes to interest rate changes. It also has a higher yield of 3.46% compared to VSC, thanks to its inclusion of longer-term government and corporate bonds. This makes it an excellent all-around choice for most investors.

Best of all, ZAG has the lowest MER at just 0.09%. This makes it a great all-in-one bond fund — perfect for complementing a globally diversified stock portfolio. If you don't want to tinker with your bond holdings too much or keep up with research, buying and holding ZAG for the long term is the way to go.

CATEGORY

1. Investing

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1. TSX:VSC (Vanguard Canadian Short-Term Corporate Bond Index ETF)
2. TSX:XGB (iShares Canadian Government Bond Index ETF)
3. TSX:ZAG (BMO Aggregate Bond Index ETF)

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