Higher Yields Are Bringing Investors Back to Fixed Income

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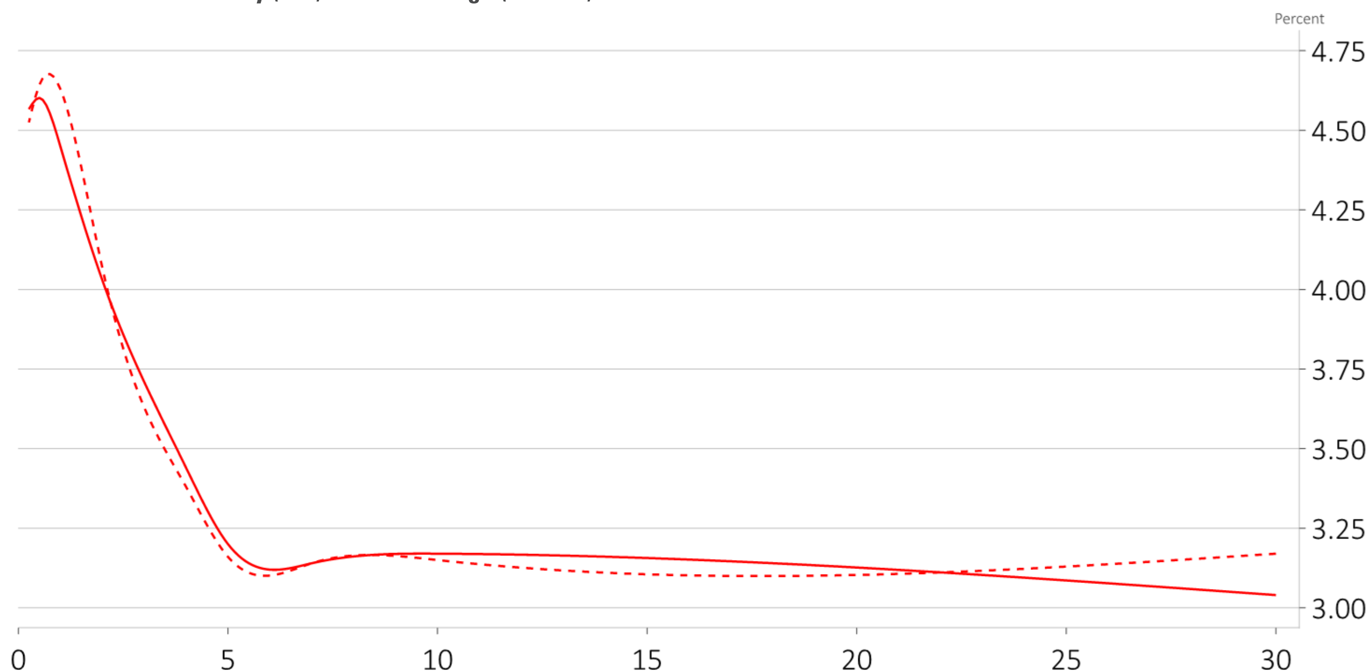
Following a forgettable year in 2022, most asset classes began 2023 on a very strong footing as investors rightly took the view that the bulk of the rate hikes needed to combat decades-high inflation were in the rear-view mirror.

Canada: 10-year rate

Source: iA Investment Management, Macrobond, as at March 9, 2023.

Bonds in particular have seen a strong turnaround. While last year's rate hikes wreaked havoc on asset valuations, the associated increase in bond yields generally meant new-issue coupons at levels last seen before the 2008 crisis. Depending on term to maturity, Government of Canada bonds and U.S. Treasurys are currently yielding 2.5–4% and 3.5–4.5%, respectively. Investors will get an additional 100+ basis points for corporates, which means coupons of about 6% on some investment grade issuers.

Canada: Yield curve today (full) vs. 1 month ago (dashed)



Source: iA Investment Management, Macrobond.

And since the yield curve is inverted, investors are in the unusual position of receiving higher yields as they shorten their term to maturity. These tall yields have many investors scrambling to add more fixed-income exposure, with FOMO – fear of missing out – becoming the rallying cry to get ahead of an eventual central bank pivot that will bring yields back down (more on that later).

The key question becomes, how do we best position ourselves to benefit from the fundamental changes that transpired in the global bond market last year, especially in the event that higher yields prove temporary?

In this paper, we examine a few different ways of tapping into today's relatively stronger yields, and identify the strengths and weaknesses of each approach. In the Appendix we explain a number of key concepts for readers who are new to fixed income or could use a refresher.

Yields bounce back from historic lows

The past decade was quite challenging for fixed income. The post-2008 central bank focus on furnishing liquidity to keep the global financial system humming along and the world economy on life support meant a prolonged period of zero or near-zero interest rates. In Europe, rates actually fell into negative territory.

Disconcertingly, every time the central banks tried to pull some liquidity out of the system – both to give themselves room should monetary policy stimulus be needed in the future and to try to keep inflation at bay – the markets recoiled, triggering the so-called Fed put. Central banks even went so far as to buy their own sovereign bonds as well as the bonds of domestic corporate issuers to keep yields low, in what was termed quantitative easing.

Central banks' focus on cheap money meant bond investors were left with much of the burden of keeping the financial system afloat. Granted, inflation was next to non-existent in the decade leading up to the global pandemic, but this was small comfort to retirees and business owners whose livelihoods relied on steady payments from their fixed-income holdings. In the worst case, investors were paying bond issuers to simply hold their money and in return were getting back less than what they started with. Some investors opted to increase credit or maturity risk so they could access yields or coupons that were more in line with their needs. But with sovereign yields now above 3%, the options available to fixed-income investors are more appealing.

GICs

Interest rates on GICs above 4% or 5% may appear as a long-awaited gift after years of barely getting more money back than what you put in. GIC investments entail minimal risk, no fees if held to maturity, and no variability in rates during the holding period, provided you purchase a fixed-rate product.

But GICs have some important drawbacks. To begin with, the return on a fixed-rate GIC is limited to its coupon level and therefore cannot account for changes in inflation or variations in yields in the fixed-income market. Moreover, given the relatively low risk profile of GICs, the initial yield is less appealing than what you can get from provincial or corporate bonds.

There is also reinvestment risk, which refers to the possibility that interest rates may be lower when the GIC matures, a problem that becomes particularly pronounced if the bulk of your money is tied up in a limited number of products that mature around the same time.

Finally, GIC ownership can be a real problem if you need your money prior to maturity, as the issuing institution will likely charge a steep fee to buy it back (the fee will be determined in part by interest rates at the time of sale).

Buying bonds directly

As mentioned, provincial, municipal and corporate bonds typically offer higher yields than GICs, but nothing comes for free. Several factors must be considered when purchasing bonds directly, such as commissions and the need to maintain a brokerage account.

Most retail bond orders are a fraction of the size of orders placed by pension funds and other institutional investors. As a result, trading commissions will take a bigger chunk out of the individual investor's overall return.

Furthermore, once you leave the relative safety of GICs, credit risk becomes an issue. Obviously, a country like Canada, with its AAA rating, presents little credit risk to buyers, but its yields are lower as a result and buying these bonds will entail some of the same risks associated with GICs (reinvestment risk, inflation risk, and interest rate risk).

Investing in provincial, municipal and corporate bonds will generally mean higher yields, but credit risk will become more of an issue. Anything rated BBB or above is considered investment grade, but ratings change over time and are influenced by factors such as issuer-specific, industry, economic, and business risk. As a result, just as with buying equities, direct bond investing requires a very high level of sophistication as well as continuous monitoring of conditions related to specific issuers.

Once we move below bonds rated BBB, we enter what is termed non-investment grade, high yield or junk bond territory, which introduces a wide array of very complex risks. Selecting individual securities in this part of the market requires professional-level expertise and should not be attempted by non-specialists.

Exchange-traded funds (ETFs)

Bond ETFs are usually well diversified since they are typically based on a broad index or benchmark that has exposure to a wide range of issuers. In addition, commissions are more straightforward and similar to equities, while liquidity is usually not a problem (although pricing can be an issue in times of market stress).

ETFs are generally intended for more sophisticated investors as daily price moves are influenced by underlying market conditions. Consequently, bond ETF investors should have a solid grasp of the economy, the rates markets, geopolitical events, and so forth. Investors should also be cognizant that ETFs trade on price, not yield. The value of your investment goes up and down like stocks and is marked to market, even though the underlying constituents are bonds. In addition, since an ETF is purchased as a pre-built portfolio, there is no way for the investor to modify its holdings.

While passive ETF fees are generally much lower than active mutual funds, ETFs may include securities that most investors would rather not have exposure to, which in the long run may end up costing more than the fee savings. These problems are typically more pronounced with corporate bond or high-yield ETFs.

Mutual funds

Bond mutual funds (including segregated funds) address a number of the concerns cited above, but they have their own risks.

With bond funds, retail investors can access the market as if they were an institutional investor and therefore benefit from the size advantage, which diminishes the negative impact of commissions. Buying in size can also allow bond funds to achieve better pricing beyond

commissions, as fund managers may purchase bonds in bulk and then distribute them across various mandates. Because of the size of their portfolios, bond fund managers are typically invited to participate in new-issue transactions, allowing them to benefit from any price concessions that are offered prior to a bond's inclusion in an index. With bonds in particular, retail investors are generally excluded from direct participation in the new-issue market.

Similar to ETFs, bond funds generally have a level of asset diversification that retail investors cannot replicate on their own due to size constraints and commission costs. There is also a wide variety of fund options available, so investors can tailor their choices to meet their risk, asset or economic exposure criteria. Portfolio positioning can easily be adjusted in response to changing economic conditions or personal circumstances.

What's more, with the growing quantitative sophistication of institutional investors, bond funds now benefit from processes such as portfolio optimization, giving fund managers the opportunity to outperform an index by zeroing in on bonds with the best performance potential based on historical statistical testing. And benefiting from the expertise of a portfolio manager is really why someone would purchase a bond fund in the first place. Whether it is through quantitative methods, fundamental analysis, technical analysis, or a combination of all three, professional portfolio management offers a more comprehensive approach to asset selection. This process is intended to add value beyond passive or minimally managed investing, which accounts for the higher management fees relative to ETFs.

Bond funds address concerns around reinvestment risk by trading every day and putting coupon and maturity payments back into the market along with new investor inflows. Those constant reinvestments permit portfolio managers to regularly reposition their funds to reflect changing conditions in the credit or rates markets, extending/shortening duration or increasing/decreasing credit risk. What's more, given their larger size, bond funds can utilize derivative products to enhance performance by temporarily adding risk or creating protection.

As mentioned, bond funds have their own risks. They trade on price, like ETFs, and can go up or down depending on market conditions. We only have to look back to 2022 to see the value-damaging impact a rising-rate environment can have on bond fund valuations.

But bond funds have an advantage when it comes to reinvestment risk exposure. Unlike GICs, bond funds have the benefit of rolling reinvestment exposure to both higher coupons and higher yields, depending on the bond (new issue or secondary market). An added benefit is after-tax returns, which are a mix of coupon income and capital gains/losses. Equally important is that, outside the past couple of years, it is extremely rare for bond indexes to suffer losses two years in a row, so even a bad year offers an opportunity for averaging down and participating in the recovery rally.

The path forward

We believe bond yields in Canada likely peaked late last fall when the 10-year crested above 3.6%. Inflation is clearly on its way down, but we are not out of the woods yet. We do not fully embrace the market's expectation that the Bank of Canada and Federal Reserve will pivot this year, even though recent troubles with U.S. regional banks and Credit Suisse show rising rates are adversely affecting the financial system. We also see potential for yields to temporarily climb back towards recent highs once the current market turmoil subsides, especially given sticky inflation and strong jobs numbers.

We still expect policy rates in the U.S. to peak above 5% and stay there for the remainder of 2023, or close to it. Inflation is well above the desired 2% level, and central bankers on both sides of the border have emphasized that getting inflation under control is their primary goal.

In this context, we believe bond funds offer the best solution to take advantage of currently higher rates. We do not believe yields will follow a straight path downward, permitting bond fund managers to add yield with their regular cash inflows. In addition, as yields decline – which we believe will be the case over the next couple of years – bond funds will benefit from both the currently higher coupons being issued and the capital gains resulting from the related rise in bond values. We are strong believers in the difficulty of market timing and think that mutual funds are better positioned to mitigate that risk. Moreover, investors can create their own market timing risk protection by enrolling in an automatic mutual fund purchase program.

Bond and GIC yields are higher than what we have seen in a while, but reinvestment risk becomes more pronounced as yields decline. We view the outcome of the current market conundrum as binary – either inflation

comes down and central banks begin to ease off on rates, or inflation remains elevated and they keep rates higher for longer, which would induce a recession and compel them to lower rates. Either way, rates are likely heading lower over the next couple of years – barring a geopolitical event that sparks inflation, similar to Covid or Russia's invasion of Ukraine.

We believe outperformance in fixed income over the coming months will stem in part from curve positioning. With a level of curve inversion not seen in a couple of generations, we believe bond fund managers are best positioned to benefit from trading the curve using steepener or flattener strategies, for example – as compared with individual investors using GICs or direct bond ownership, or even trading bond ETFs that are situated on different parts of the curve. And should we experience slowing economic conditions later this year, the credit appraisal expertise of corporate bond fund managers will become increasingly important.

APPENDIX

Fixed Income 101: Key Concepts

Coupon versus yield

Most bonds are comprised of two components: principal and a coupon. The principal is the face value of the bond upon maturity (i.e., the amount you get back from the issuer). The coupon is an annual amount, in percentage terms, that the issuer agrees to pay (usually semi-annually) while the bond is outstanding. For example, if you own $100,000 in principal of a bond with a 5% coupon, you will typically receive $2,500 cash from the issuer every six months while the bond is outstanding. If interest rates do not change, the price of the bond will remain at par ($100 per $100 owned) and the effective annual yield of the bond is 5%.

However, if interest rates do change and you intend to sell the bond before maturity, then the value of the bond also changes. When interest rates go up, your 5% coupon is no longer as attractive, and you must give a potential new buyer some of your principal to compensate. Say you own $100,000 of a 1-year bond with a 5% coupon and interest rates go up to 6%. In order to provide the new buyer a 6% yield, you must give them roughly $1,000 of your principal, thereby dropping your price down to $99 per $100 face value. The further away your bond is from maturity, the more principal you will have to give the new buyer to make sure the 6% yield is met. Conversely, if interest rates go down to 4%, then you can keep roughly $1,000 of the coupon payment and the value of your bond is $101 per $100 face. In this situation, the value of your bond would increase with time to maturity.

Capital gains versus interest income

There are tax consequences associated with changes in a bond's value. In Canada, the coupon payment made by an issuer is fully taxed as interest income. By comparison, the amount by which a bond is purchased below par value (e.g., $99 per $100) is determined to be a capital gain, while any price above par (e.g., $101 per $100) is a capital loss.

Duration

Duration is an essential concept for anyone looking to understand the bond market. While some equate duration with time, it is not that simple. There are different methods to calculate duration, but for our purposes we can think of it loosely as a risk-adjusted measure of time (e.g., taking coupons and current price into consideration, how many units of duration would be required for the cash flows generated by the bond to recoup the price paid?). Duration captures the movements in a bond's price as interest rates change, and the sensitivity of its price to those rate changes. For example, the longer the duration of a bond, the greater the impact a change in interest rates will have on its price. In addition, the higher a coupon, the less impact a change in interest rates will have on duration and price.

Yield curve

The yield curve is a graphical representation of the yields of different bond maturities. In the case of sovereign issuers, yield curves generally plot maturities from two to 30 years. Numerous academic theories attempt to account for the shape of the yield curve. For instance, rational expectations theory incorporates notions of future inflation and maturity risk. In essence, bond investors need to be compensated for

the fact that the future value of their bond holdings will be partially eroded by annual inflation (i.e., a dollar 10 years from now can buy less than a dollar today), or the possibility that the entity they lent their money to will become insolvent (i.e., the longer you lend out money the greater the risk you may not get it back). As a result, a yield curve typically slopes upward to the right, meaning bond yields rise at each point along the curve as time to maturity increases, since investors want to be compensated for inflation and repayment risk. At the same time, the slope of the curve between each maturity point can change (i.e., be steeper or flatter) depending on demand and supply conditions that exist in each part of the curve. But overall, the curve generally rises as maturities increase.

Inverted yield curve

In the case of yield curve inversion, which we are presently witnessing, the market is indicating its expectation for inflation to decrease over time and for central banks to lower interest rates. Yields in the shortest parts of the curve are currently highest since policymakers have aggressively raised rates to quell inflation (also called tightening of monetary conditions). As we proceed along the curve from two to 10 years, yields decline and then begin to level off the further out we go as the regular features of rational expectations begin to kick in. The bond market is saying it does not believe current high inflation will last too long – maybe only a year or two.

Fed put

Refers to the widely held view that the Federal Reserve will loosen monetary conditions to help prevent rapidly declining financial markets from falling too far.

Steepener versus flattener

Remembering that bond prices and yields move in opposite directions, we can observe that in a curve steepening scenario the slope between two parts of the curve increases, either because the longer-dated yield rises (bear steepener as the bond's price goes down) or the shorter-dated yield declines (bull steepener as the bond's price goes up), or both at the same time. Conversely, in a flattening situation, either the yield of the longer-dated maturity declines (bull flattener as the bond's price goes up) or the yield of the shorter-dated maturity rises (bear flattener as the bond's price goes down), or both. There are numerous ways to profit from these scenarios, such as owning shorter-dated bonds in the case of a bull steepener while short selling longer bonds against that position (e.g., 2s–10s steepener), or buying long bonds in a bull flattener and short selling shorter-dated bonds against that position (e.g., 5s–30s flattener).

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