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New risks for fixed-income

By Megan Harman | Investment Executive, Mid-November 2017

With interest rates beginning to inch higher after ultra-low levels over the past several years, generating decent returns from a fixed-income portfolio remains a challenge

Fixed-income plays an important role in a retiree's portfolio. This asset class's relative predictability, compared with the potential volatility of equities, provides comfort. However, in an environment of low interest rates that are just beginning to rise, the fixed-income portion of a portfolio now carries extra risks and challenges.

A globally diversified approach to fixed-income investing is key to managing risk while generating worthwhile returns for retired clients, says Darcy Briggs, vice president and portfolio manager with Franklin Bissett Investment Management, a division of ***Franklin Templeton Investments Corp.***, in Calgary: "We believe a well-diversified, low-correlated type of fixed-income portfolio is best for all types of environments."

With interest rates at ultra-low levels for the past several years, generating a satisfactory level of return from fixed-income investments has been a challenge. Now, interest are rates beginning to inch higher. The Bank of Canada (BoC) increased its benchmark interest rate twice in recent months, and more hikes are anticipated.

The prospect of higher interest rates is welcome among retirees who have been frustrated with the dismal return on many fixed-income investments in recent years. But rising interest also may take a toll on clients' existing fixed-income holdings, because bond prices often decrease when rates rise.

"Within a year or two or three, you're likely to see stronger returns [on new bonds]," says Adrian Mastracci, senior portfolio manager with ***Lycos Asset Management Inc.*** in Vancouver. "But that means that if you hold bonds [now], you may lose some capital."

Briggs anticipates that the BoC will increase its key interest rate once more in the short term. Beyond that, he says, interest rates are likely to remain near their current levels for some time, until there's a meaningful rise in inflation.

"We don't think interest rates are on a steady march higher," Briggs says. "I think we're getting close to what we may consider to be a peak for the time being."

Nonetheless, positioning your clients' portfolios for the possibility of interest rate increases is a good idea now.

Diversification is key to managing risk, according to Daniel Solomon, chief investment officer and portfolio manager with NEI Investments, a division of Toronto-based ***Northwest & Ethical Investments LP.*** Because Canada's fixed-income market is too small to allow for proper diversification, he says, looking internationally for investment opportunities is crucial: "Canada's fixed-income market has simply too much interest rate risk and not enough diversification. Being globally diversified is safer."

Branching outside Canada opens up a much wider variety of government and corporate bonds, as well as certain categories of assets that carry the potential for higher returns and are less common in Canada's market, such as high-yield bonds and inflation-linked bonds. Emerging-market bonds and the opportunity to manage currency also present some attractive global opportunities for fixed-income investors, according to Solomon. Mutual funds such as NEI Global Total Return Bond Fund provide options for retired clients to invest in a globally diversified basket of fixed-income securities, he adds.

Corporate bonds also can be an attractive option, as they can act as a cushion against an unexpected move in interest rates, Briggs adds. Rising interest rates generally reflect stronger economic performance, which can improve financial performance and bolster the creditworthiness of corporate bond issuers.

As a result, corporate bond prices typically depreciate at a much slower pace than government bonds when interest rates rise and, in some cases, corporate bond prices will increase.

Although some retired clients may view guaranteed investment certificates (GICs) as a safe option these days, Solomon cautions against using them. With GIC rates at such low levels after accounting for taxes and inflation, many clients will lose money.

"Most of the time, you end up with a negative return," Solomon says. "That's not a way to grow money."

Abandoning fixed-income in favour of equities, however, may not be advisable, even if clients are unhappy with fixed- income's returns. Maintaining an asset allocation throughout retirement that reflects the client's risk tolerance is key.

"There's a tendency at this time in the [business] cycle for investors to become overly greedy, wanting more returns," Solomon says. "However, when a downturn comes, they realize that their risk appetite was lower than they thought it was."

For clients who are waiting for higher interest rates before wading back into the fixed-income market, Mastracci recommends taking a gradual approach and buying some each year rather than jumping in all at once.

"Jump in slowly," he says. "Do it over three years or five years."