Fixed Income Investing in a Zero Interest Rate World

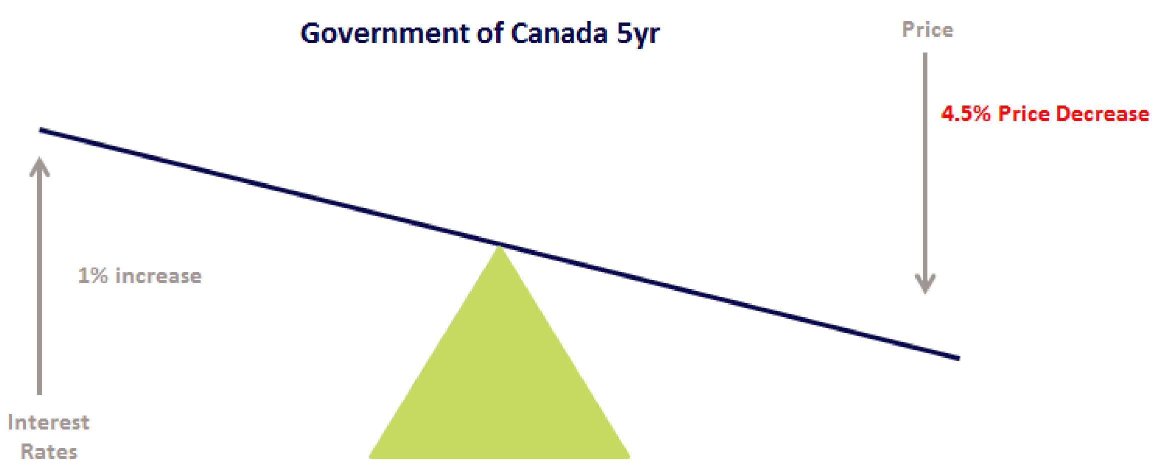
*By **Andrew Torres**, CEO, Lawrence Park Asset Management*

April 2016

Canadian investors are turning their backs on traditional fixed income investments as a core component of their portfolios — should advisors be concerned?

Let's face it, with the Canadian 5-year government bond yielding just 0.8% or less than your annual management fee, the excitement generated from both advisor and client is negligible.   And with Canadian core inflation currently averaging above 2%, investing in bonds virtually guarantees an erosion of your client's capital.

Worse still, these so-called "safe" fixed income investments actually carry some risk despite being guaranteed by the Government of Canada. A 1% rise in prevailing yields would cause a 4.5% price drop – worse if you own a bond with more than 5 years to maturity.



Interest rates are the key to this whole discussion and while we all have our theories around central banks and whether rates are moving up or down month-to-month, in the long-term do you really want to bet on market rates staying near zero forever?

I don't think so.

With traditional investment funds, there are three key ways to improve your prospective fortune when it comes to fixed income investing.

First, you can extend the duration of your portfolio to increase the yield, which basically means buying longer-dated bonds. Don't like 0.8% thrown off by the 5-year bond, move your client up to the 10-year bond at 1.5%, or go for broke and buy the 30-year bond at 2.1%. Of course, if you buy the 30-year bond and yields rise by 1% you're looking at an 18% drop in price. Ouch.

Second, you could boost your client's income by investing in bonds in other currencies, but that means adding currency risk to interest rate risk; with foreign exchange rates even more volatile than interest rates, it's an uphill battle. And frankly, at the moment, there's not much yield anywhere in the world.

Finally, you can lump credit risk on to the pile by buying corporate bonds or other types of debt which offer a credit spread to government bonds. The trouble is you need to go far down the credit spectrum to pick up meaningful yield. And default risk becomes a very real risk – just ask the owners of NorTel or Enron bonds.

So what's my Alternative?

Of course some investors would simply choose to sell their bond holdings and rely on equities for both income and growth. But that's not an option for everyone, either because suitability rules won't allow it or because the client doesn't really have the stomach for the volatility.

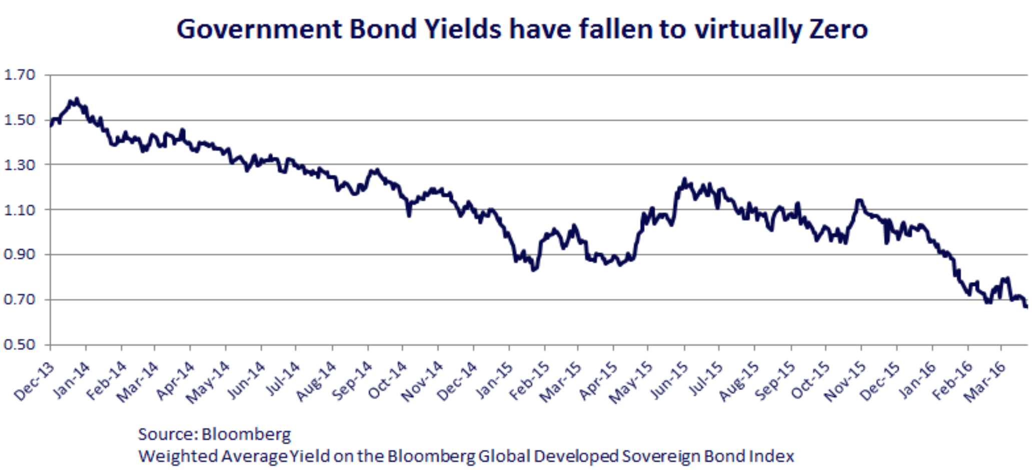
Alternative Fixed Income funds operate in the relative safety of bond markets, but use different techniques to generate yield and return while reducing or eliminating many of the risks of traditional funds. For example, an alternative bond fund can invest in foreign currency bonds but hedge out the FX risk. It can short-sell government bonds to protect against rising yields. And it can use borrowed money to purchase investment-grade bonds (similar to buying stocks on margin) to enhance yield without relying on junk bonds where the risk of default is high. In Canada, mutual fund rules generally do not allow these types of strategies, because the rules were written back in the 1970's before the era of globalized capital markets.

Alternative Fixed Income funds fall into the category of *Liquid Alternatives* because it operates in the public debt markets where bonds are traded every day and transparency is high. Generally, funds such as these can be redeemed month-to-month; there is no locked-in commitment that you might see in a private debt or equity fund. The fund is diversified across a broad range of sectors, rather than having a high concentration in one sector such as a mortgage or real-estate fund.

Investment-grade alternative bond funds are a useful substitute for investors who are concerned about the interest rate risk in their traditional fixed income portfolio, rising default rates in their high yield portfolio, or liquidity risk in their private market holdings.

More importantly, Canadian alternative bond funds have generally performed well, with very competitive aggregate returns relative to stocks or high yield bonds. And they do so with very low volatility – so you can rest easy at night.

Whatever risk you're concerned about, consider diversifying with an alternative bond fund. In this era of zero yields you'll be glad you did.



Andrew Torres is the Founder and Chief Executive Officer of Lawrence Park Asset Management, an alternative fixed income manager based in Toronto. Andrew is a 25 year veteran of Canadian and international bond markets, and was a former Vice Chair at TD Securities in charge of global credit trading.

For more information regarding this article or Lawrence Park Asset Management, please contact:

Kathleen Biggs
Director, Business Development
Lawrence Park Asset Management
kathleen.biggs@lawrenceparkam.com
416-646-2180

Leyland Gordon
Director, Business Development
Lawrence Park Asset Management
leyland.gordon@lawrenceparkam.com
416-646-2180