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INVESTMENT RESEARCH

REACHING FOR YIELD MAY BE HAZARDOUS TO YOUR FINANCIAL WELL-BEING

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The first rule of fixed income investing is to preserve your capital. The second rule is to earn a return on that capital.

We believe that we have entered a period of rising bond yields. The U.S. economy has recovered to the extent that the Federal Reserve Board has begun to reduce its purchase of long-term U.S. bonds and mortgage-backed securities.

Despite the rise in bond yields last year, they still remain low by historical standards. Corporate borrowers are delighted to be able to raise funds so inexpensively.

Fixed Income investments are core assets for investors, especially for retirees who need a steady stream of interest income. In order to increase their income, yield hungry investors are taking on more risk than warranted in two ways:

1) Buying longer-term bonds in a steep yield curve environment.
2) Investing in below-investment grade bonds or "junk" bonds.

Turning to the first method, there is a dangerous illusion of long-term bonds yielding far more than short-term bonds since we are in a steep yield curve environment. The axiom is that the longer the term and duration of a bond, the more susceptible it is to capital losses from rising yields. The following table indicates this vulnerability:

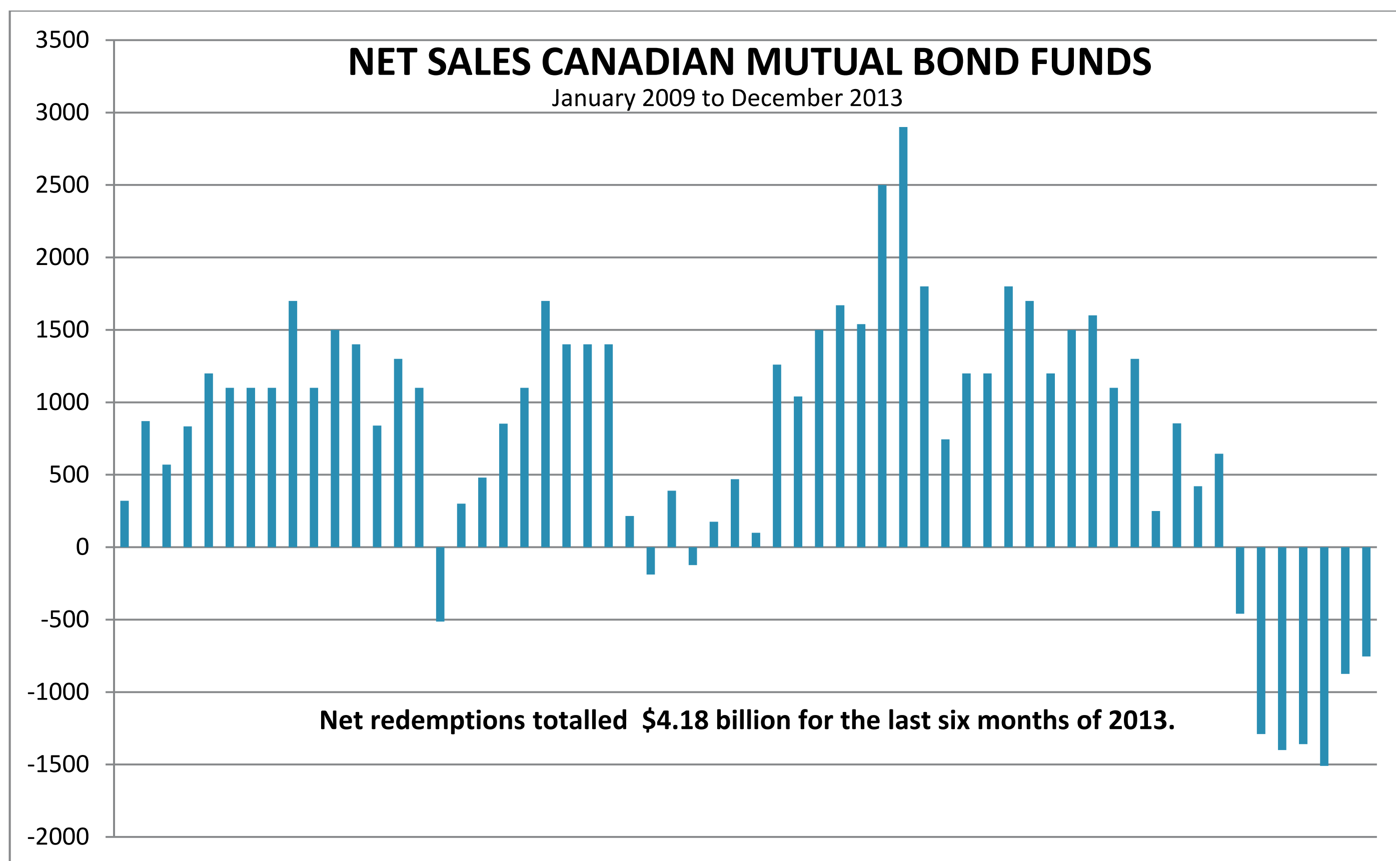
Bond	Yield	Rise in Yield for 0% Return Over One Year (in Basis Points)	Change in Value from a Rise of 100 Basis Points in One Year
Canada 1.5% 2/1/2017	1.15%	58	-0.80%
Canada 1.5% 9/1/2017	1.25%	51	-1.20%
Canada 1.25% 9/1/2018	1.51%	44	-1.90%
Canada 3.75% 6/1/2019	1.60%	41	-2.24%
Canada 1.5% 6/1/2023	2.29%	30	-5.20%
Canada 4% 6/1/2041	2.86%	16	-12.91%

Source: Bloomberg (January 31, 2014)

As one can see, most if not all of the extra income obtained from buying longer-term bonds can be eliminated with just minor upward movement in yields.

The second method involves investing in non-investment grade corporates or "junk" bonds. They may have performed well over the past three years, but returns have fallen to 5.4% in 2013, as measured by the DEX Index. They did produce a positive return of 1.1% for January however. At current yield spreads over Government of Canada bonds, junk bonds are more susceptible to rising yields, which would impact their returns. This is not the time to be dabbling in low grade corporate bonds for returns that may not be worth the risk. For example, on January 31, the High Yield ETF (XHY.T) yielded 5.25% to maturity, a mere 2.94% above the yield on 10-year Government of Canada bonds.

Investors have begun to flee the bond market as can be seen in this chart:



Source: The Investment Funds Institute of Canada

The pattern was similar in the U.S. where investors redeemed $70 billion of bond mutual funds alone.

It is imperative that investors preserve capital now. This can be achieved by investing in investment grade corporate bonds of four and five years and rolling down the yield curve with them. As these maturities shorten, their yield drops, which helps to maintain their value.

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