Scotia Wealth Management™

GPAG Fixed Income

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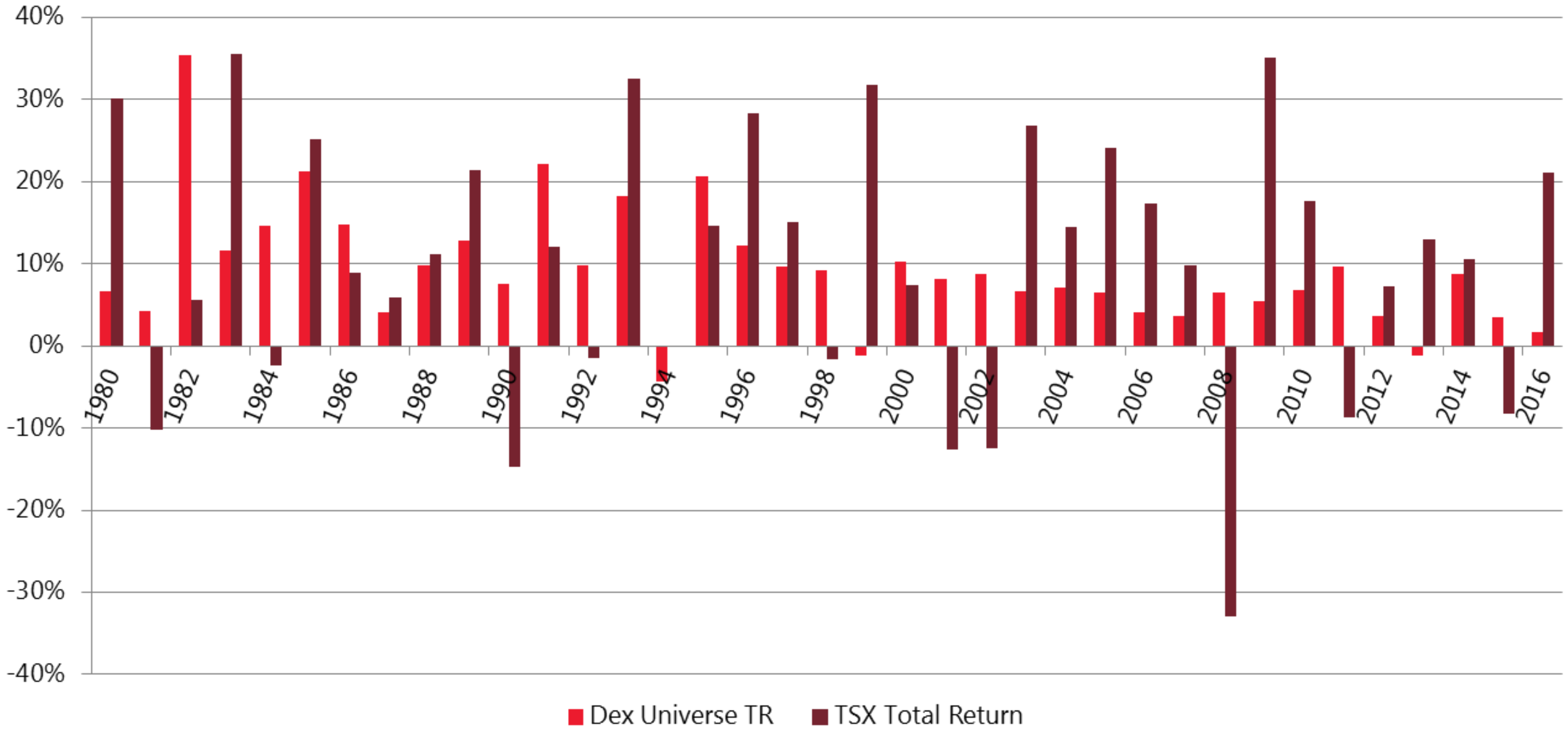
Topics Covered

- Fixed income vs equity returns
- What drives prices
- Prices vs yields
- Spreads
- Strategies
- Current Outlook
- Themes

Equity vs Debt: Why Include it in portfolios?



Source: PC Bond, Bloomberg

For Information Purposes Only

What Drives Fixed Income Performance?

< Yields

- Prices and yields move in opposite direction:
  - Yields higher, prices lower
  - Yields lower, prices higher
  - Think about it like a see-saw!

What Drives Fixed Income Performance?

< Spreads:

- Difference between yield on fixed income product (bond) and some benchmark bond with similar maturity
  - 10-Year Corporate Bond Yield: 2.86%
  - 10-Year Canada Government Yield: 1.74%
  - Spread: 1.12%
- Measure of the price of risk: how much extra yield do I need to take on more risk?
- The higher the risk of a bond, the more yield I require, and the higher the spread

	Index Yield	Government Index Yield	Spread
Provincial	2.56%	1.69%	0.87%
A-Rated Corporate	2.73%	1.69%	1.04%
BBB-Rated Corporate	3.22%	1.69%	1.53%
High-Yield Corporate	6.01%	1.69%	4.32%

Source: PC Bond, Bloomberg

- The price of risk – spread – changes over time and can contribute to performance
- Spread decreases: bond outperforms vs benchmark
- Spread increases: bond underperforms vs benchmark

What Drives Fixed Income Performance?

< Spreads

- Illustration: Spread Decrease

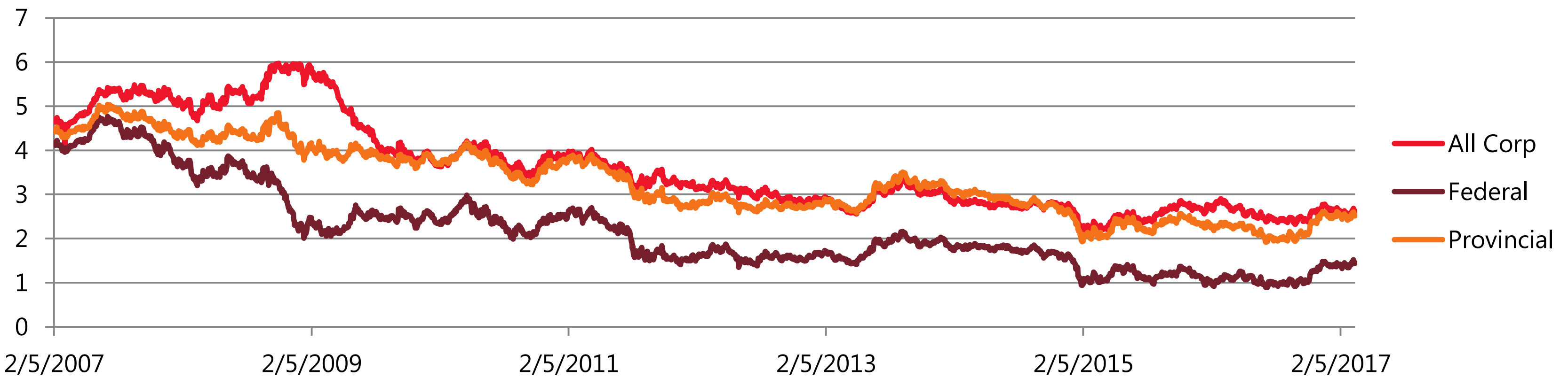
	Today		Tomorrow		
	Yield	Price	Yield	Price	Return
5-Year Corporate Bond	2.00%	$100.00	1.50%	102.39	2.39%
5-Year Government Bond	1.00%	$100.00	0.75%	101.22	1.22%
Spread	1.00%		0.75%		

- Illustration: Spread Increase

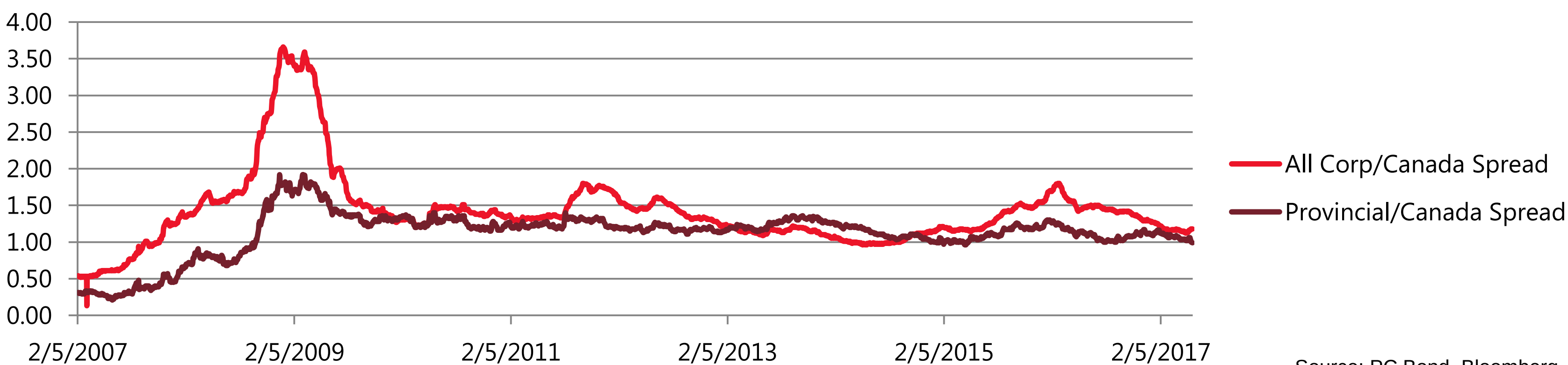
	Today		Tomorrow		
	Yield	Price	Yield	Price	Return
5-Year Corporate Bond	2.00%	$100.00	1.75%	101.19	1.19%
5-Year Government Bond	1.00%	$100.00	0.50%	102.46	2.46%
Spread	1.00%		1.25%		

What Drives Fixed Income Performance?

< Historical Yields



< Historical Spreads



Source: PC Bond, Bloomberg

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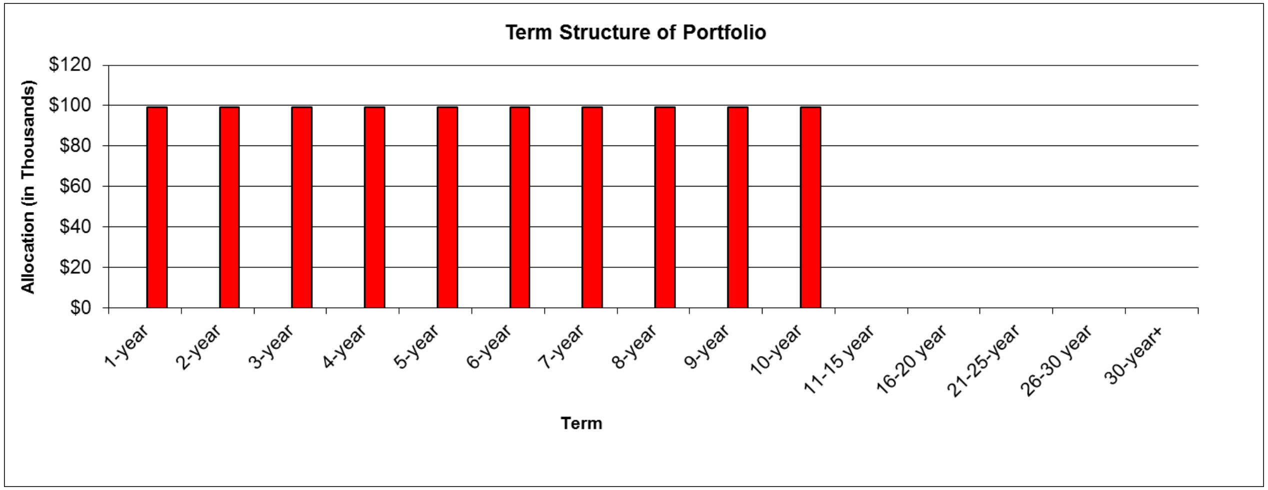
Fixed Income Investment Strategies - Ladder

< **What is a laddered fixed income strategy?**

- Same amount of principle maturing every year



- Minimizes impact from interest rate changes while benefitting from longer-dated yields
- Reinvest equal amount of portfolio every year

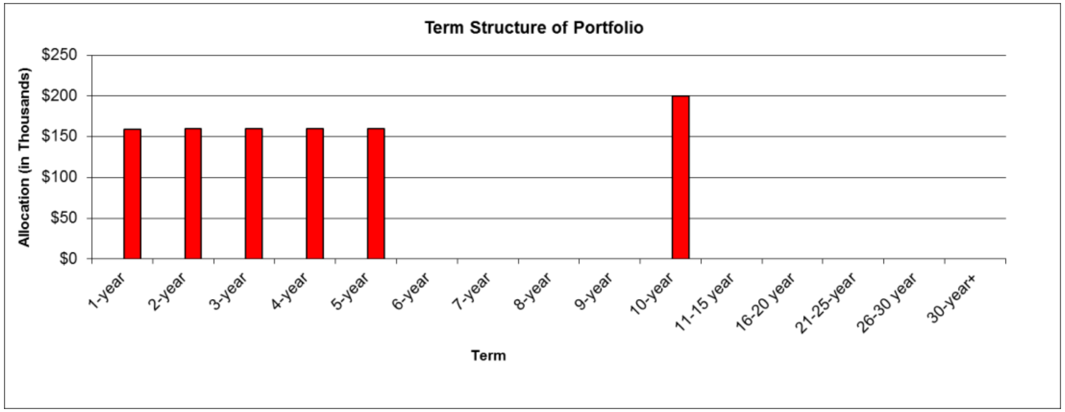
Fixed Income Investment Strategies - Ladder

- If rates increase: portfolio value will decrease, but reinvestment will be at new higher rates (lower prices)
- If rates decrease: portfolio value will increase, but reinvestment will be at new lower rates (higher prices)
- Average portfolio duration for a 10-year ladder: ~5 years
- Average duration of the market: ~7 years
- Less interest rate sensitive than the overall bond market, thus:
  - Tends to underperform when rates decrease
  - Tends to outperform when rates increase

< **Good long-term, passive strategy**

Fixed Income Strategies – Core Plus

- **What is a Core Plus strategy?**
- Two Parts:
  - Core: short/medium term corporate bond ladder with higher coupons
  - Plus: longer-dated, highly liquid, low risk positions to capture yield movements



- Better for those who want to take a more active approach to fixed income
- Core holdings act as passive ladder, plus holdings are actively traded
- Core holdings earn base return with coupons
- Plus holdings increase total return of portfolio
- Can also be achieved with ETFs
  - Short corporate ladder
  - Long government bonds

Current Outlook

- **Interest Rate Defensive**
  - -We expect rates to rise over the next 12-18 months
  - Prefer to be duration defensive
  - Floaters help shorten duration
  - Index duration ~7 years
  - Recommend portfolio duration ~5 years
- **Credit Overweight**
  - Monetary policy continues to be accommodative
    - Still below the neutral rate
  - Expect the output gap to continue to close over the next 12-18 months
  - Expect corporate debt to outperform government debt
  - Cyclicals overweight
  - Use provincial debt as government allocation

Investment Themes

< **Fixed/Floaters**

- Subordinated debt of banks and insurance companies
- Offer higher yields than senior debt, BUT…
    - Have unique coupon structure and call feature
    - BEFORE the call date; pays fixed coupon
    - AFTER the call date: pays floating coupon
- Key: Will company call the bond at the call date?

< **GICs**

- Senior debt from banks
- Term deposit, thus not liquid
- Comparable rates to deposit notes in market

< **Bail-in/NVCC**

- NVCC = Non-Viable Contingent Capital
- Provides for conversion of bank subordinated debt into equity if:
    - Bank takes government bailout
    - Regulator deems the bank to be “non-viable”
- Will trade wider than comparable “non-nvcc” bond
- Soon coming to bank senior debt

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