Spotlight on Fixed Income

> The Bank of Canada, in a widely telegraphed move, raised interest rates on July 12 for the first time in seven years, following the lead of the U.S. Federal Reserve which has already raised rates several times since the end of 2016.

A Bonding Experience

Although this move was not a surprise to the markets, due to the long period of time since the last interest rate hike, many investors are wondering how this will impact their portfolios. With this in mind, we take a closer look at the fixed income asset class, its role in a diversified portfolio and the potential impact of rising interest rates on certain investments.

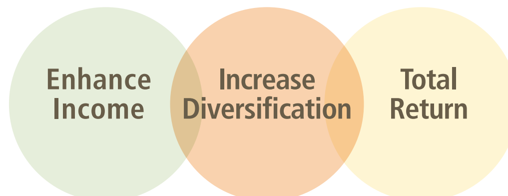
An Introduction to Fixed Income

The fixed income asset class is not only about providing regular income from bond payments, but also provides stability and diversification to portfolios. Traditionally used as a counterbalance to the volatility of equities, fixed income hasn't been as popular with investors used to a low interest-rate environment.

Fixed income is a broad asset class that includes bonds, treasury bills, GICs and other securities. Bond investors will typically focus on the preservation of their capital, while receiving regular interest payments. In recent memory, these interest payments have been generally lower based on historical standards. Yet, as the global economic picture improves, and with central banks raising interest rates, this could be a great time to take another look at fixed-income and how it can work in a diversified portfolio.

A Selection of Fixed Income Asset Classes

There are numerous speciality fixed income asset classes that have the potential to **enhance income, increase diversification** and generate a more **attractive total return** in a portfolio. Within and across each asset class, portfolio managers may actively manage term (i.e. duration), credit quality and security selection to navigate market conditions and help achieve a fund's investment objective.



Bonds and Interest Rates: An Inverse Relationship

Bonds and interest rates have an inverse relationship. In other words, when rates rise, bond prices typically fall and vice versa. When new bonds are issued, they traditionally carry a coupon rate at close to the going market interest rate. Like any retail purchase, investors compare existing bonds to new bonds that are issued. The question is how much will they pay for a bond with a coupon rate that is lower (or higher) than the going rate.

DID YOU KNOW?

For example, a bond selling today for $1,000 and paying an annual payment of 3% may only be worth $960 if interest rates rose to 4%, as investors would rather pay the "full price" to earn a higher rate of interest. To entice them to buy a lower interest bond, the price would have to decline to compensate them for the lower interest payment.

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Diversification Matters

Like the stock market, no single asset class consistently leads the pack, and the best and worst performers can change from one year to the next. A diversified portfolio of different fixed income asset classes lets investors participate in potential gains while dulling the impact of those that have underperformed.

On an individual basis, speciality fixed income asset classes, such as high yield bonds or emerging market debt, carry additional risk. When used in combination with more traditional bonds and equities, specialty fixed income asset classes can help to build better risk-adjusted portfolios.

TECHNICALLY SPEAKING

Duration represents a bond's price sensitivity to interest rate fluctuations. The longer the duration, the more sensitive a bond's price is to interest rate changes.

Investment Return (%) — HIGHEST to LOWEST

	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016
HIGHEST	5.1%	31.1%	35.3%	12.3%	10.2%	17.8%	14.5%	9.7%	16.7%	10.3%
	4.5%	10.6%	28.5%	8.8%	8.3%	16.9%	3.9%	9.3%	16.2%	9.7%
	4.1%	9.0%	16.2%	7.3%	8.2%	6.2%	3.1%	9.0%	3.8%	3.7%
	1.8%	0.2%	10.3%	6.5%	7.7%	4.9%	0.8%	8.1%	3.6%	3.4%
	-7.1%	-8.6%	1.6%	4.6%	5.7%	2.7%	-2.0%	7.6%	2.7%	0.9%
LOWEST	-12.5%	-13.8%	-9.2%	0.0%	5.0%	2.0%	-4.8%	5.0%	1.3%	-1.5%

Source: Bloomberg. Annual total returns in Canadian dollars.

ASSET CLASS	INDEX
Government Bonds	DEX All Government Bond TR Index
Corporate Bonds	DEX All Corporate Bond TR Index
Mortgages	DEX Residential Mortgage Market Index
High Yield Bonds	Barclays Global High Yield TR Index (CAD)
Emerging Market Debt	JPM EMBI Global Diversified Hedge TR Index (CAD)
Global Bonds	Barclays Global Aggregate TR Index (CAD)

Effective shock absorbers

Bonds have typically offered better downside protection and greater return certainty than equities and, when held to maturity, a purchaser knows how much money to expect (except in the event of a default, which is unlikely for most high quality bonds). Over time, the performance of bonds also tends to be different than equities, making them valuable from a diversification standpoint when managing portfolio volatility. In general, bonds perform better when equities are struggling, and vice versa, which helps "absorb the shock" to investment portfolios in times of challenging markets.

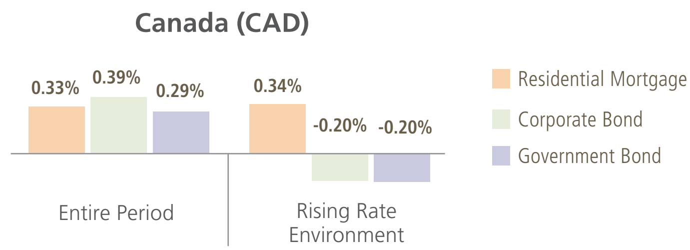
Active management

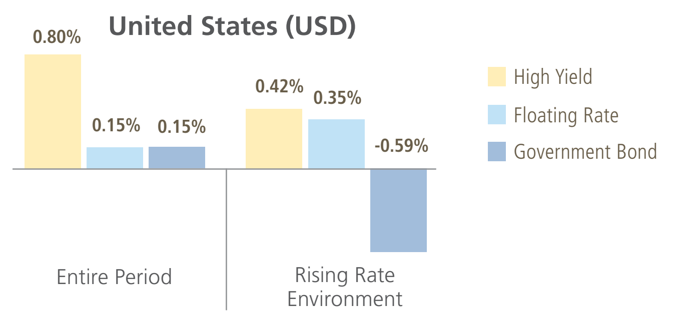
Actively managed bond strategies tend to incorporate a wide array of tools in an effort to protect portfolios from sensitivity to interest rate changes and to drive incremental returns. These tools may include the use of floating rate notes to capture short-term rising rates, reducing average term to maturity (which lessens interest rate sensitivity), adjusting credit exposure (i.e., in corporate and high-yield bonds) and, where possible and appropriate, using derivatives such as bond futures.

While return expectations from bonds may need to be reset as interest rates appear to be gradually reversing course off their historic lows, investors should not lose sight of the other benefits bonds offer — namely, the predictable income they produce and their role as effective shock absorbers in a diversified portfolio. In times of heightened market volatility, they tend to offer better downside protection and, for many investors, can continue to serve as a key component of a well-diversified portfolio.

Rising to the Challenge

A look at the performance of various fixed income asset classes over the past 10 years reveals that not all bonds are impacted equally by the ebb and flow of interest rates. Floating rate bonds and residential mortgages fared better during periods of rising rates, while government bonds provided solid returns over an entire market cycle.





Source: Morningstar, Bank of Canada. Monthly returns for the period from January 2007 to December 2016 for the following indices: in Canada, 1) Residential Mortgage: DEX Residential Mortgage Market Index, 2) Corporate bond: DEX All Corporate Bond Index, 3) Canadian Government Bond Index: DEX Government Bond Index, in the USA, 4) High yield: Citigroup High Yield Market Index, 5) Floating rate: Bank of America Merrill Lynch ABS Master Floating Rate Index, 6) U.S. Government bond: Barclays Aggregate Bond Treasury. Rising interest rate environment in Canada is defined as a period in which the month over month average CDN Treasury Bill 3-Month Auction Rate rose by greater than 25 bps. In the U.S., a rising interest rate environment is defined as a period in which the month over month average U.S. Treasury Bill 3-Month Auction Rate rose by greater than 25 bps.

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