



Bailing on bonds?

Why now is not the time to turn your back on bonds

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At a glance

- Rising interest rates slow the economy and can potentially lead to a recession. Going forward, if history is any guide, fixed income can offer strong advantages to conservative investors in a recessionary scenario.
- With bond yields nearing 5% today, it is a great opportunity for conservative investors to capitalize on higher income.
- Active fixed income managers can add value as the cycle turns, utilizing credit currency and duration strategies.

The double-digit pullback in stock markets around the world dominated headlines this year. The attention paid to the selloff is hardly surprising, particularly during times of economic challenges. However, the story in fixed income appears to be much more newsworthy. This year's negative double-digit returns are historically unique and a poignant challenge for the most conservative investors.

Against this backdrop, it is natural for conservative investors to rethink their investment in bonds and want to reallocate those funds elsewhere, like cash or Guaranteed Investment Certificates (GICs). Many have sold investments, fearing continued negative returns

and are unsure of what to expect moving forward as we face the real prospect of a recession. This paper will discuss how bonds work, why we have experienced negative returns, and why investors should consider remaining invested in fixed income.

How do bonds work?

Fixed income securities (bonds) have similar properties to a loan. When you purchase a bond at inception, you are essentially loaning a principal amount of money to a

government or company in exchange for regular interest payments followed by a return of your initial principal amount at maturity.

Interest rates & bond prices



There are various factors that influence a bond's value with the most prevalent being interest rates. For a basic bond, the interest payments (coupons) remain the same throughout the life of the bond and when this coupon is equal to market interest rates, a bond is priced at

par (usually \$100). When interest rates rise however, newly issued bonds at higher coupons will look more attractive. As a result, previously issued bonds will lose value and trade below par (under \$100). The opposite is true when rates decline.

Why has fixed income performed poorly?

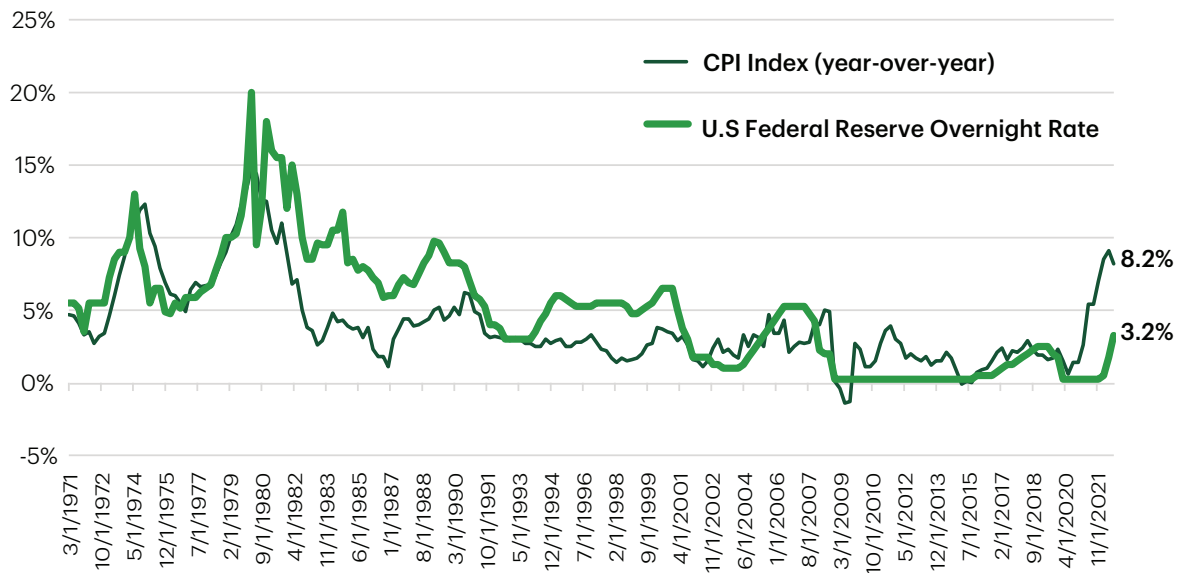
With the understanding of how bonds function, we can dig deeper into what has happened this past year that has left bonds in the red. **Inflation** accelerated through the end of 2021, and by mid-2022, it had reached 9% year-over-year, a level not seen since the 1970s.

High inflation is a headwind to fixed income because it leads to a high correlation between stocks and bonds which weakens their diversification advantage in

balanced portfolios. Secondly, it erodes the purchasing power of fixed income cash flows.

Because inflation remains well beyond central bank targets, central banks have aimed to slow the economy through **higher interest rates** which in turn pulls down bond values. As we will see in the next section, a slowing economy is when bonds have historically provided the most benefit to a balanced investor's portfolio.

Central banks raising rates to combat inflation



Source: Bloomberg Finance L.P. Data as of September 30, 2022

The correlation between equities and bonds: During inflationary periods, equity and bond performance become more correlated



Source: Bloomberg Finance L.P. Data as of September 30, 2022. The chart represents the 5 year rolling correlation between bonds represented by the U.S Treasury Bond Index and equities represented by the S&P 500 Index

Why now is not the time to abandon fixed income

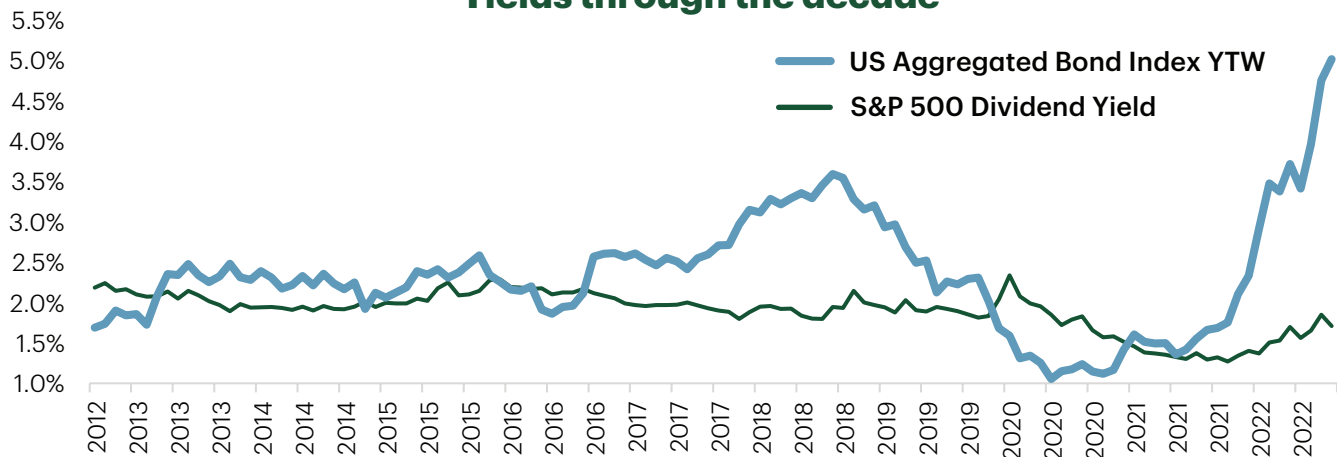
High and attractive levels of income - Despite this year's plunge in fixed income returns, the asset class still holds value within a diversified portfolio. With aggregate bond yields nearing 5%, this is an impressive source of income for conservative investors. Much higher than dividends or fixed income yields over the past decade.

Bonds are also unique in that, if there is no default, regardless of how rates move, a bond's principal along with periodic interest payments will always be received (unless a default¹ takes place). These interest payments

can also be reinvested allowing for compounding interest returns.

This is particularly important for long-term investors as the losses faced this year can be recouped (through interest payments and potentially capital appreciation). In the meantime, the income from their portfolio will be re-invested in bonds with higher coupons and yields and this will improve the income generating potential of their portfolio.

Yields through the decade



Source: Bloomberg Finance L.P. Data as of October 31, 2022

Fixed income outperforms in recessions and market crises - Rising rates slow the economy and can potentially lead to a recession. This may sound like bad news, but for bond investors, it presents an opportunity. Historically, bonds have outperformed in times of economic slowdown. Bond yields tend to fall as inflation and growth decline during a recession. Falling yields and a flight to safe assets (away from more riskier assets like stocks) supports fixed income returns.

In the five biggest equity market crashes of the last 50 years, U.S. Treasuries outperformed stocks by a large margin and in most cases had strong positive absolute returns. When it mattered most, they exhibited their defensive role in a balanced portfolio.

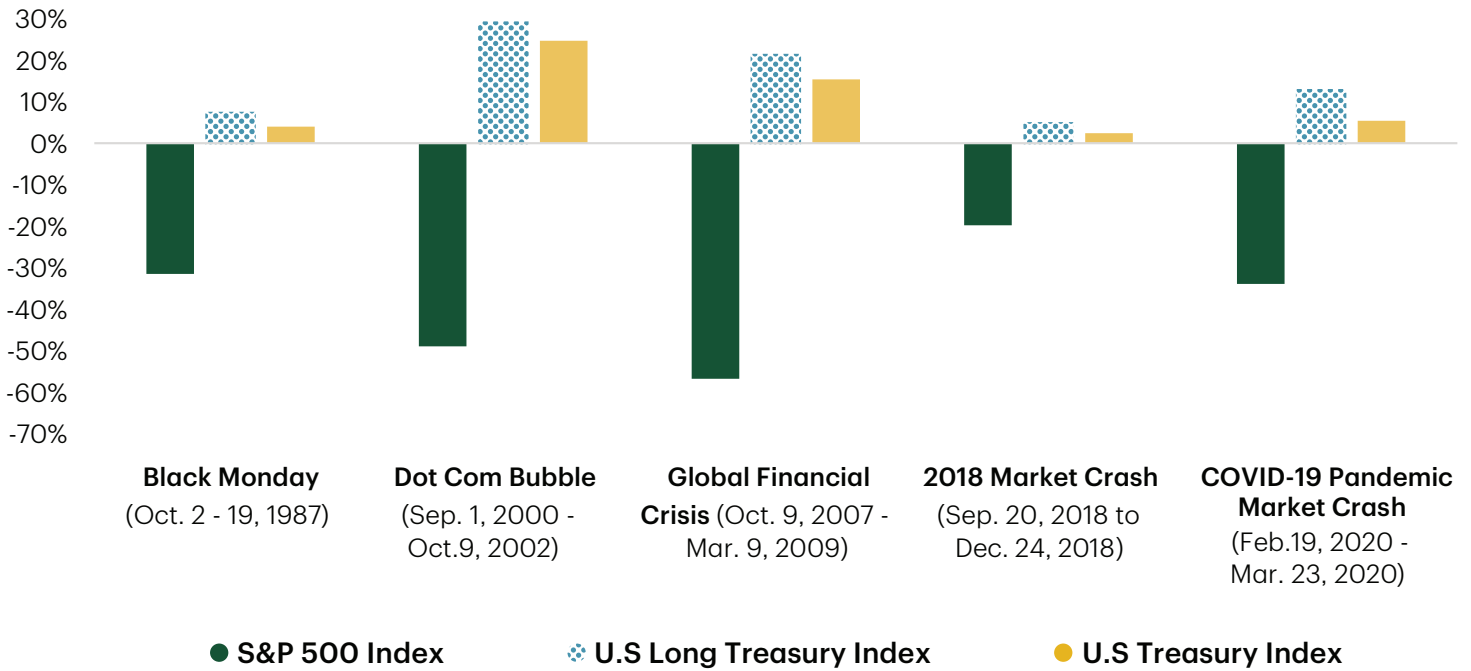
Going forward, with history as a guide, fixed income may offer strong advantages to conservative investors in a recessionary scenario.

Market Downturns	BBG US Treasury Bonds vs S&P 500 Outperformance	PMI (Index Level Pts Change)	Inflation (% Difference)
1/31/2020 - 4/31/2020	16%	-9.80	-2.16
11/30/2007 - 6/31/2009	47%	-5.20	-5.73
2/28/2001 - 11/31/2001	14%	2.00	-1.64
6/30/1990 - 3/30/1991	4%	-8.50	0.22
6/30/1981 - 11/31/1982	29%	-11.50	-4.96
12/31/1979 - 7/31/1980	-5%	-9.80	-0.16
10/31/1973 - 3/30/1975	33%	-34.60	2.45
Average:	14%	-11.06	-1.71

Source: Bloomberg Finance L.P.

¹A bond default occurs when the issuer of the bond fails to make interest or principal payments within the specified period.

Fixed income outperforms in recessions and market crises



Source: Bloomberg Finance L.P.

Tax advantages - Fixed income yield is a mix of coupons paid to the investor and the bond price moving to par (flat) as it reaches maturity. As a result, part of the fixed income returns one can expect is capital gains and not entirely income (unlike deposit-based investments) and as a result, fixed income can be a tax advantaged way to invest for conservative investors since some of the returns are taxed more favourably compared to deposit based investments.

Active management - Active managers do not just invest in a broad index but are selective in the fixed income positions they take. Views on overall interest rate risk (duration), the distribution of that risk, the credit exposure (corporate vs. government), and foreign

exchange moves can all add incremental performance and income to an active fixed income fund.

This means that active fixed income managers can preserve capital and seek to add value through the cycle. (1) Prudent credit selection should result in a portfolio that can weather the business cycle better and minimize credit events. (2) Duration calls can allow the portfolio to perform when yields begin to fall. (3) Additional levers such as currency and sector allocation can also protect capital and add value.

Historically, bonds have outperformed in times of economic slowdown

Fixed income's role never changed

Despite these new challenges, it's important to keep in mind that fixed income's original task of being a portfolio's backstop has not changed. Having well balanced, protective, and liquid fixed income investments can help investors assume more risk in search of potentially higher return growth assets like

equities and alternatives. Prudent active management within fixed income is even more important now as it can help investors access new return streams and potentially higher yields without taking excessive risk in a search for yield. ■

Opportunity

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