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

<table>
<thead>
<tr>
<th></th>
<th>Index Yield</th>
<th>Government Index Yield</th>
<th>Spread</th>
</tr>
</thead>
<tbody>
<tr>
<td>Provincial</td>
<td>2.56%</td>
<td>1.69%</td>
<td>0.87%</td>
</tr>
<tr>
<td>A-Rated Corporate</td>
<td>2.73%</td>
<td>1.69%</td>
<td>1.04%</td>
</tr>
<tr>
<td>BBB-Rated Corporate</td>
<td>3.22%</td>
<td>1.69%</td>
<td>1.53%</td>
</tr>
<tr>
<td>High-Yield Corporate</td>
<td>6.01%</td>
<td>1.69%</td>
<td>4.32%</td>
</tr>
</tbody>
</table>

- 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

Source: PC Bond, Bloomberg
What Drives Fixed Income Performance?

- **Spreads**

  - **Illustration: Spread Decrease**

    |                      | Today       | Tomorrow   | Return |
    |----------------------|-------------|------------|--------|
    |                      | 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   | Return |
    |----------------------|-------------|------------|--------|
    |                      | 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
For Information Purposes Only
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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