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## FUND MANAGER'S CORNER

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### **Bonds: boring is good**

By Patrick O'Toole  
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You would think that after 10 years of outperforming stocks, investors would realize that bonds aren't a sleepy and boring asset class. You only need to look at what happened to bonds during the credit crisis. Each day offered a menu of fear, excitement, disappointment, and elation. That makes my job as a fixed-income portfolio manager for CIBC Global Asset Management so exciting and fun – but also stressful – requiring the juggling of so many balls each day.

When I join the daily fixed-income team morning meeting each day, I have to know what is going on in the world. I am expected to be up to date about what is happening with the economy in the United States, Canada, and the rest of the world regarding monetary policy – interest rates, fiscal policy – government taxing and spending, inflation, and about business in each industry and sector.

As conditions change, we modify our strategies for expected changes in interest rates and our mix of government and corporate bonds. We strive to ensure that we are always balancing potential opportunities with the risks that are in the marketplace.

When we look at corporate bonds, our analysts perform careful bottom-up analysis of each company, assessing its creditworthiness and financial condition and examining the structure and covenants of each individual bond. We want to be confident that we're buying sound investments for our clients.

The indicators that we watch show that the economy is improving, but all of the problems haven't been solved. It should be a long, hard haul before the global economy fully recovers.

Generally, when the economy goes through a downturn – from whatever cause – we see the banks retrenching. Once profits begin to recover and they can begin to write off their bad loans, banks start lending again.

The credit crisis last year was pretty scary for investors. Even bond investors like me, who are supposed to be cautious and vigilant, were spooked by the events of what some people are calling the Great Recession. It wasn't just banks and the investment houses that felt the impact of the unusual economic downturn. People in all walks of life felt the shock from the contraction in the banking sector, the collapse in house prices, and the fallout from job cuts.

The banking system needs further repair before we can really say things are back on an even keel. Banks are starting to do that already by taking advantage of the extremely low short-term interest rates. They can borrow at that rate and invest in higher-yielding, longer-term assets, including bonds. We've already seen their profits improve, largely as a result of this strategy.

What that means for our bond strategy is that short-term interest rates should rise somewhat, but will likely remain lower than seen in prior cycles to give the financial system time to recover. We expect inflation to remain low so longer-term interest rates will be even less likely to rise to levels seen in previous cycles.

## **Back to bonds**

So what do you do in an environment where the stock markets have gone through two collapses in the past decade, and there is no comfort that that stocks are ready to recover yet? It's back to boring old bonds. Bonds represent less in most portfolios than stocks, real estate, insurance and pension assets, consumer durables, and cash holdings. They may be the smallest component of assets individuals hold, but they provide stability and income, which is increasingly attractive to an aging population that has become less enamored of stocks.

People think that bonds are boring because they carry no risk. In fact, some people think bonds behave like Canada Savings Bonds – always redeemable at par and paying a regular coupon. But bonds fluctuate in price just like stocks do. The primary danger for bonds is a sharp, sustained resurgence of growth that could stoke inflation fears and drive longer-term interest rates higher. We are following that possibility, but we think the fallout from the credit crisis should curtail that eventuality, particularly for the world's developed countries.

Let me turn back to the factors that I think about every day and give you a flavour for what we are considering now:

## **The world economy**

The fallout from the credit crisis will mean different things to different countries. The developed world – Canada, U.S., Europe, Japan – are facing challenges from aging populations and high debt consumer and government debt levels. The result is likely to be slower economic growth as debt is reduced, leading to less inflationary pressures. For the various asset classes, it means interest rates remain lower than in recent cycles, and stock prices see smaller gains.

The emerging world – China, India, Brazil, etc. – is different. Their demographics are different, with younger populations, and they don't have anywhere close to the debt levels of their Western counterparts. Their economic growth path looks brighter, their inflation and interest rates will probably be higher, and their stock markets look more attractive.

## **Interest rates**

When people hear that I am a bond portfolio manager, they ask me if interest rates are going up or down, because they are concerned about what to do with their mortgage renewals. The changes in bond yields results in direct changes for the daily level of interest rates that you see. As a bond manager, I care about interest rates, because it affects each person in their daily lives. The rate you pay on your mortgage, car loan, credit card, or the rate you're getting from your bond funds and other investments is a direct result of what we do every day as bond managers.

Today, we see different things going on for interest rates. In Canada, the Bank of Canada may raise short-term interest rates gradually over the next year or so as the economy gradually improves. But longer-term yields, those beyond 10 years, are expected to remain fairly stable as inflation remains contained and as the economy continues to grow, but at a more gradual pace than we've been accustomed to in the past few decades.

So you'll likely see your mortgage rates move up a bit more, but you'll also get a bit more from your investments.

## **Government spending and taxation**

During the credit crisis, lending came to an abrupt halt. The financial system was becoming paralyzed, so governments and central banks stepped in as the lenders of last resort. Whether we like it or not, it was needed to keep the economy from experiencing a deep, prolonged recession, if not an outright depression.

Now that the economy is showing signs of improvement, some of the stimulus that governments were providing is likely to be removed. So look for a push towards less deficit spending and higher taxes to help get budgets back in balance in coming years.

## **Inflation**

Considering all the stimulus provided by governments and central banks, it's tempting to believe that rising inflation is a given. But because of slow growth and pressures for low wages, we don't expect any serious, sustained move higher in inflation. The massive overhang of available workers, particularly in the U.S., means that the unemployment rate will remain stubbornly high, helping suppress the potential for higher inflation.

Slow growth and slow inflation should be with us for a while.

## Corporate prospects

The extra yield, or the spread, that corporate bonds offer over government bonds is still attractive, even though it has fallen considerably in the past year. In fact, corporate spreads are still at levels that prevailed near the peaks seen in prior credit crises.

Our expectations for the economy should lead to improved corporate profitability, making it easier for companies to cover their interest payments, and to reduce the supply of new corporate bonds. A period of positive growth, stable inflation, and higher short-term interest rates thus currently makes corporate bonds an attractive alternative to government bonds.

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