Investment Controls and the Risks They Create

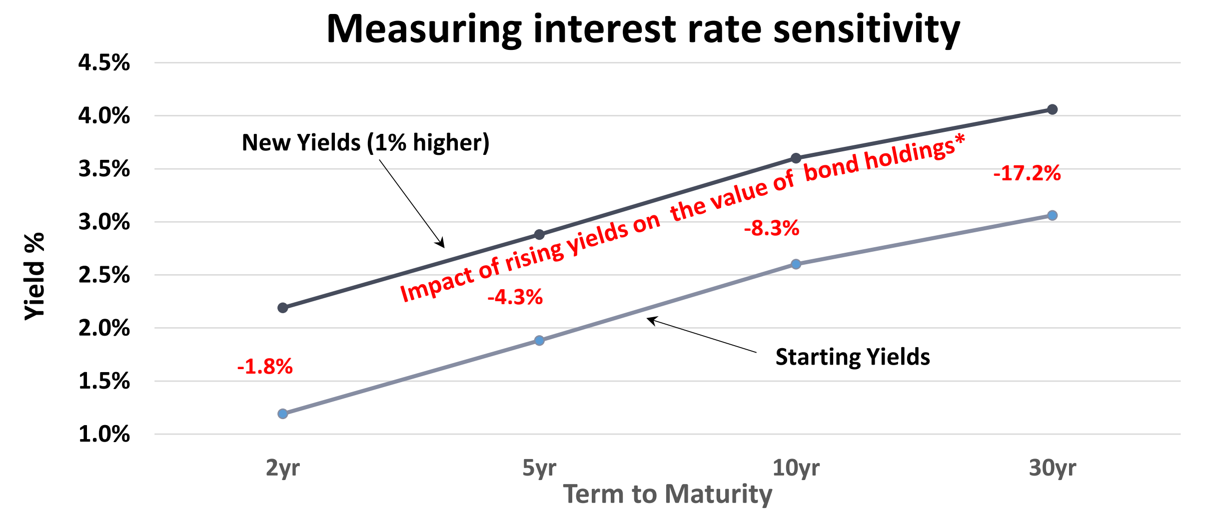
In the eyes of many investors, bonds are the "boring" asset class in a portfolio. They look at fixed income management primarily from a defensive perspective, focusing on principal preservation, reliable income and diversification. Equities, in contrast, might be classified as the "fun" asset class, with the potential they offer for significant capital gain – the fun lasts until the inevitable drawdowns are incurred, but equity investors know these risks when they step in. A quote from the Statement of Investment Policies and Procedures of a well-known labour group's pension plan captures the misery of managing the fixed income side of the portfolio: "Debt investments generally reduce funding risk in the short-term due to lower volatility, but increase funding risk over the long term due to lower expected returns". In other words the risk category adds little value other than its contribution to portfolio stability. Brutal!

With low expectations comes low tolerance for risk. Investment guidelines for allocations to bonds often allow for investment grade issuers (generally BBB- or higher) only to mitigate the probability of losses due to default. A search for the highest yielding investment grade bonds in Canada maturing in under 10 years will be challenged to find a security yielding above 4%. Unfortunately, tightening investment controls also caps potential returns.

It could be worse – yields could rise. The chart below highlights the impact of adding 1% to yields for bonds of various maturities. For example, adding 1% to the yield on a 10 year par bond, increasing it from 2.49% (the yield for the current 10 year Government of Canada bond) to 3.49%, would reduce its value by 8.5%.

Considerable diversity exists among alternative fixed income strategies. Preconceptions on the need for tight controls may create more problems than they solve.

At Cortland Credit our team has deep expertise in the global debt markets and would look forward to your comments – send us your insights on what's happening in the chart below and any questions on how to invest in the fixed income markets when rates are low and potentially rising.



*: Numbers in red present the percentage impact on bond prices at each maturity after adding 1% to respective yields.

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