Mutual Fund News

How to diversify your fixed income

With a little more risk, higher yields are possible ... but watch the details, experts warn

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While the equity tap has been turned on, at least south of the border, many in the industry here say a large group of investors are still too wary to take the plunge. The trick for those who are sticking to fixed-income investments, the experts say, is to look beyond what they know - government bonds - and move into fixed-income alternatives with better yields.

Even for investors who are making their way back to the equity markets, bonds and other fixed-income investments keep your portfolio diversified.

While in the United States, investors put a record $77.4-billion (U.S.) into equity mutual funds and ETFs in January, according to TrimTabs Investment Research, "I still think people are a little bit gun shy with equities," says Rob Edel, the chief investment officer of Vancouver-based Nicola Wealth Management.

For investors with fixed-income holdings, the major issue, says David Richardson, vice-president at RBC Global Asset Management, is that they need to diversify that part of their portfolios - to consider corporate bonds, high-yield debt, emerging market bonds or convertible debt.

Investors need to be realistic about what they can and can't get from fixed-income investments, says Jim Gilliland, head of fixed income at Vancouver-based Leith Wheeler Investment Counsel Ltd.

They can't expect returns that they got even five or 10 years ago, he says. Consider long-term Government of Canada bonds, the baseline for investments that people see as risk-free. With current yields of 2 to 2.5 per cent, you're "barely keeping place with inflation," Mr. Gilliland says.

What investors can expect - the reasons people are interested in fixed income in the first place - are income generation and reduced risk, especially as a diversifier in a portfolio heavy with equities.

"Fixed income is one of the few asset classes that does well in economic distress," Mr. Gilliland says. "It can form a very powerful ballast that's protecting you during those very volatile periods."

As for income generation, Mr. Gilliland suggests looking at fixed-income alternatives and weighing the risks versus yields.

Corporate bonds in Canada, he says, are dominated by the banks and tend to have five-year average maturity. Comparable shorter-term Government of Canada bonds would yield about 1.5 per cent, and bank corporate bonds, which he says are high-quality credit, would yield about 2.5 per cent.

In the case of high-yield corporate bonds that are below investment grade (a credit rating below BBB), yields are higher - in the 5- to 5.5-per-cent range - but so is risk. Mr. Gilliland advises that investors consider these bonds more like equities and compare them to other income-producing assets, such as preferred shares or dividend-paying stocks.

He warns that many high-yield corporate bonds also took a price dive in 2008 - "you may have had a bond that yielded 5.5 [per cent], but its price declined so much that the realized returns were actually negative in that time period."

Nicola's Mr. Edel says investors have to consider interest rates in buying bonds, since the value of a bond falls as interest rates rise. "Right now, there's nothing really that tells you there will be a sharp move higher in interest rates, [but] definitely over the next 10 years, I think they will."

In anticipation of a potential interest-rate increase over time, Nicola Wealth Management has short-term bonds in its bond fund, and a manager who just looks at interest-rate risk.

In the case of investment-grade corporate bonds, Mr. Edel says, if interest rates move up because of a stronger economy, the bond may get hurt on the interest-rate risk side "but would gain because the credit spread will narrow."

Mr. Richardson says investors should also consider convertible debt, typically corporate debt that can be converted into stock. "You lose some of the upside in up markets for the protection to the downside in down markets."

The reason for considering all fixed-income options is that investors protect themselves against interest-rate hikes and shifts in the global economy, he says.

Mr. Gilliland adds that investors looking at fixed-income alternatives also consider dividend-paying equities and preferred shares as a way to generate income.

To do so, investors should look at stocks with consistent dividends and a history of dividend growth.

Mr. Gilliland warns fixed-income investors to pay attention to the fees they are paying if buying ETFs and bonds. Too often, people are paying up to 2 per cent in a management expense ratio, which wipes out a lot of returns possible in fixed income.

Also, he says, be aware of claims of high yields: "If it's too good to be true, [the fund] is engineering some way of getting that higher yield."

There are only a few ways that funds can generate higher yields: by taking on more risk, or by returning capital - "taking your capital and giving it back to you in terms of distribution," thereby reducing your investment.

Either way, know why it is that you're getting higher-than-normal returns.

In fixed-income markets, like others, "there's certainly no such thing as a free lunch."

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EQUITY-SHY

Despite some movement toward equities, retail investors are still favouring fixed-income products, says David Richardson, vice-president at RBC Global Asset Management.

At RBC, most fund sales are in portfolio programs, in which investors can pick a profile that represents their tolerance for risk - very conservative, conservative, balanced, growth and aggressive growth.

In 2006, Mr. Richardson says, investors mostly chose balanced or growth funds. Eighteen months ago, the bulk of the sales were in conservative or very conservative; over the last three months, most sales were in conservative and balanced.