# FIXED INCOME IN A RISING RATE ENVIRONMENT

**MARCH 2014**

## INTRODUCTION

This is the third update we have provided since we published the report “Fixed Income in a Rising Rate Environment” in February 2011. The purpose of these updates are to provide our clients with an overview of the fixed income landscape and to discuss the current positioning of the fixed income component of client portfolios.

2013 was a difficult year for fixed income. The price of bonds fell as we witnessed a substantial rise in yields during the year. Bonds, as represented by the DEX Universe Bond Index exchange traded fund or ETF (ticker XBB on Toronto), returned -1.50% in 2013. Since 1994, there have been only two other negative calendar year returns for the DEX Universe: -1.14% in 1999 and -4.0% in 1994.

In light of negative returns, general market expectations for interest rates to rise, and negative press coverage of bonds, one may ask why anyone should own fixed income at all. Despite the risk of rising rates, we believe that fixed income is a core component of client portfolios. When properly constructed, fixed income portfolios provide consistent income, act as a store of value, and are a hedge against equity market down-turns and the risks of systemic crises such as the one experienced in 2008-2009.

## PERFORMANCE

In the past six years, our fixed income portfolio has provided clients with higher returns than the benchmark with similar volatility. In addition, as demonstrated in 2013, we feel our portfolio is in a better position to protect capital in case of a rise in interest rates.

| | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 |
|---|---|---|---|---|---|---|
| Portfolio Returns ** | 6.74% | 10.92% | 10.64% | 6.02% | 6.90% | 3.51% |
| iShares Dex Universe Bond Index EFT Return * | 6.10% | 5.00% | 6.40% | 9.40% | 3.30% | -1.50% |
| Alpha (portfolio less index return) | 0.64% | 5.92% | 4.24% | -3.38% | 3.60% | 5.01% |

| | |
|---|---|
| Portfolio Average Return ** | 7.46% |
| iShares Dex ETF Average Return* | 4.78% |

* Source: iShares Dex Universe Bond Index ETF (ticker XBB – TO) December 31, 2013. Distributions are re-invested.
** Source, Factsheets of constituent investments as of December 31, 2013

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# HOW ARE WE DIFFERENT?

## Our Approach versus traditional "Bond Ladders"

It is common for investors in Canada to own a 1 – 10 year Government and investment grade bond ladder, a ladder of GICs, or an ETF to represent the Government and investment grade Canadian bond asset class.

The Jefferson-Steele team takes a broader approach to fixed income investing. We feel that investing only in Canadian Government and investment grade bonds would be analogous to investing only in Canadian large capitalization equity for an equity investor. Thus, Canadian Government and investment grade bonds are one of several components to our strategy.

We maintain a core position in Canadian Government and investment grade corporate debt for the following reasons:

- We see these components as a key store of value and a hedge against equity market downside risk and the risk of systemic crises.
- Consistent income.
- Interest rates do not have to fall very far for a long duration bond portfolio to provide high single digit returns.
- In addition to Canadian Government and investment grade bonds we add the following components to client portfolios:
- Global Bonds: Yields in certain parts of global bond markets are materially higher than in Canada. We believe the risk / return profile of parts of the global bond market, such as select emerging markets, is excellent. Currency hedging is a key skill of global bond managers and analysis of this skill is a key component of our due diligence process.
- High Yield bonds: We prefer to use hedged high yield bond managers over using "long only" managers, picking individual bonds, or high yield bond ETFs. This approach can result in lower returns in a bull market for high yield bonds but has demonstrated, in periods such as 2008, the ability to protect capital. We believe that this capital protection element is of paramount importance. Hedged high yield has demonstrated that it can protect capital and make money in a rising rate environment, because it can profit from interest rate volatility as well as interest rate direction.
- Canadian Commercial Mortgages: Investors in this asset class receive a liquidity premium and an interest rate spread over investment grade bonds of similar credit quality. We feel that the security given by a first or second charge on a commercial building is better than a "promise to pay" given by corporate bond issuers. The short duration and demonstrated positive returns in rising rate environments in the past 5 years also make portfolios of commercial mortgages attractive.

The above components have demonstrated correlations from below one to slightly negative over the last 5 years which increases diversification and reduces portfolio volatility.

## CURRENT POSITIONING

Our current portfolio addresses the current risks facing fixed income investors by having: lower duration and higher yield than the benchmark, inflation protection components, credit hedging and global diversification.

We reduced our weighting to Floating Rate Loans effective December 31, 2013. We feel the space has become crowded and the risk/reward relationship has deteriorated. We have heard consistent commentary from Portfolio Managers in this space that the quality of New Issue Loans has continued to deteriorate as demand has outstripped supply.

| FIXED INCOME ASSET CLASS | TRADITIONAL WEIGHTS * | PORTFOLIO CORE WEIGHTS | PORTFOLIO CURRENT WEIGHTS |
|---|---|---|---|
| CDN Government & Investment Grade | 100% | 30% | 25% |
| Global Government & Investment Grade | 0% | 10% | 13% |
| CDN Mortgages and Mortgage Securities | 0% | 30% | 32% |
| Hedged High Yield & Floating Rate Loans | 0% | 30% | 30% |

* as represented by iShares Dex Universe Bond Index ETF (Ticker XBB – TO) December 31, 2013

| PORTFOLIO RISK METRICS | DEX UNIVERSE BOND INDEX ETF * | CURRENT PORTFOLIO ** |
|---|---|---|
| Duration | 6.69 | 2.6 |
| Weighted Average Term to Maturity | 9.60 | 5.95 |
| 12 month Trailing Yield | 3.32% | 5.49% |
| Standard Deviation (3 year) *** | 3.40% | 3.48% |
| Weighted Average Yield to Maturity | 2.74% | 4.62% |

* Source: iShares Dex Universe Bond Index ETF (Ticker XBB – TO) December 31, 2013. Distributions are re-invested.
** Source: Factsheets of constituent investments as of December 31, 2013
*** Summed standard deviations of portfolio constituents. Correlations between portfolio constituents assumed to be one.

Please feel free to contact us if you would like to discuss this update in further detail or if you have any questions.