

June 14, 2010

Canadian Bond Yields

	Dec. 31 2009	June 14 2010	
Canada 5-yr	2.77	2.76	↘
Canada 10-yr	3.61	3.44	↘
Prov. Ontario 5-yr	3.15	3.18	↗
Prov. Ontario 10-yr	4.26	4.11	↘
Prov. Quebec 5-yr	3.09	3.14	-
Prov. Quebec 10-yr	4.39	4.23	↘

Source: Bloomberg

Equity Index Returns

% Change	2010 in local currency	2010 in C\$	
S&P/TSX	-0.8	-0.8	↘
S&P 500	-2.7	-3.5	↘
Russell 2000	2.8	2.0	↗
MSCI EAFE	-6.6	-15.4	↘
MSCI EAFE Small Cap	-1.2	-8.7	↘
MSCI Emerging Markets	-5.7	-9.5	↘

Source: Bloomberg

Securities from the Midfield.

For decades, the golden rule of managing portfolio risk has been to start by deciding on the split between safe assets (government bonds) and risky assets (equity). But what about the asset classes that share some characteristics with both stocks and bonds? Let's review some of the key features of three asset classes that stand at midfield between government bonds and equity.

Real Estate Investment Trust (REIT) units are equity securities that were packaged in a legal structure that is different from ordinary corporations. They offer an expected return resembling that of common stocks, but also tend to deliver this return in the form of a regular income, like bonds. In the event of bankruptcy, REIT unitholders are expected to recover only a small portion of their investment because they only have a claim to what's left over once creditors have been repaid. In short, the risks and returns of REITs are similar to those of equity securities.

Corporate bonds generally come in two flavors. **Investment-grade corporate bonds** have a high credit rating (AAA, AA, A or BBB) and a low risk profile. However, defaults are still possible. For example, Enron, Worldcom, and more recently, Lehman Brothers were all considered to be investment-grade at the time of their default. But when corporate bonds are bundled into a diversified pool, they are only a little riskier than government bonds, due to their low default rate, but they have a slightly higher yield.

Speculative-grade bonds, better known as **high-yield bonds**, are the second type of corporate bond. These securities carry a weak credit rating (BB or weaker) and default frequently. Over long holding periods, defaults are likely to cost investors an average of about 3% per annum. Therefore, the market demands a substantially higher yield to cover default losses and to obtain a premium for the extra risk involved with high-yield bonds. Once again, diversification is the key to capturing this risk premium without running the risk of it being overwhelmed by a few defaults. But even with extensive diversification, high-yield bonds carry risk and return levels that are similar to equity, albeit more moderate.

In conclusion, REITs, investment-grade corporate bonds and high-yield bonds all share some characteristics with safe government bonds and risky equity securities. But while investment-grade bonds should be classified as a "safe" asset class, REITs and high-yield corporate bonds are better categorized as "risky" assets. This doesn't however mean that they should be avoided outright. PWL Capital's portfolio managers have the expertise to include these asset classes where appropriate, to build better-diversified portfolios and generate additional income for investors.

Raymond Kerzérho, Director of Research