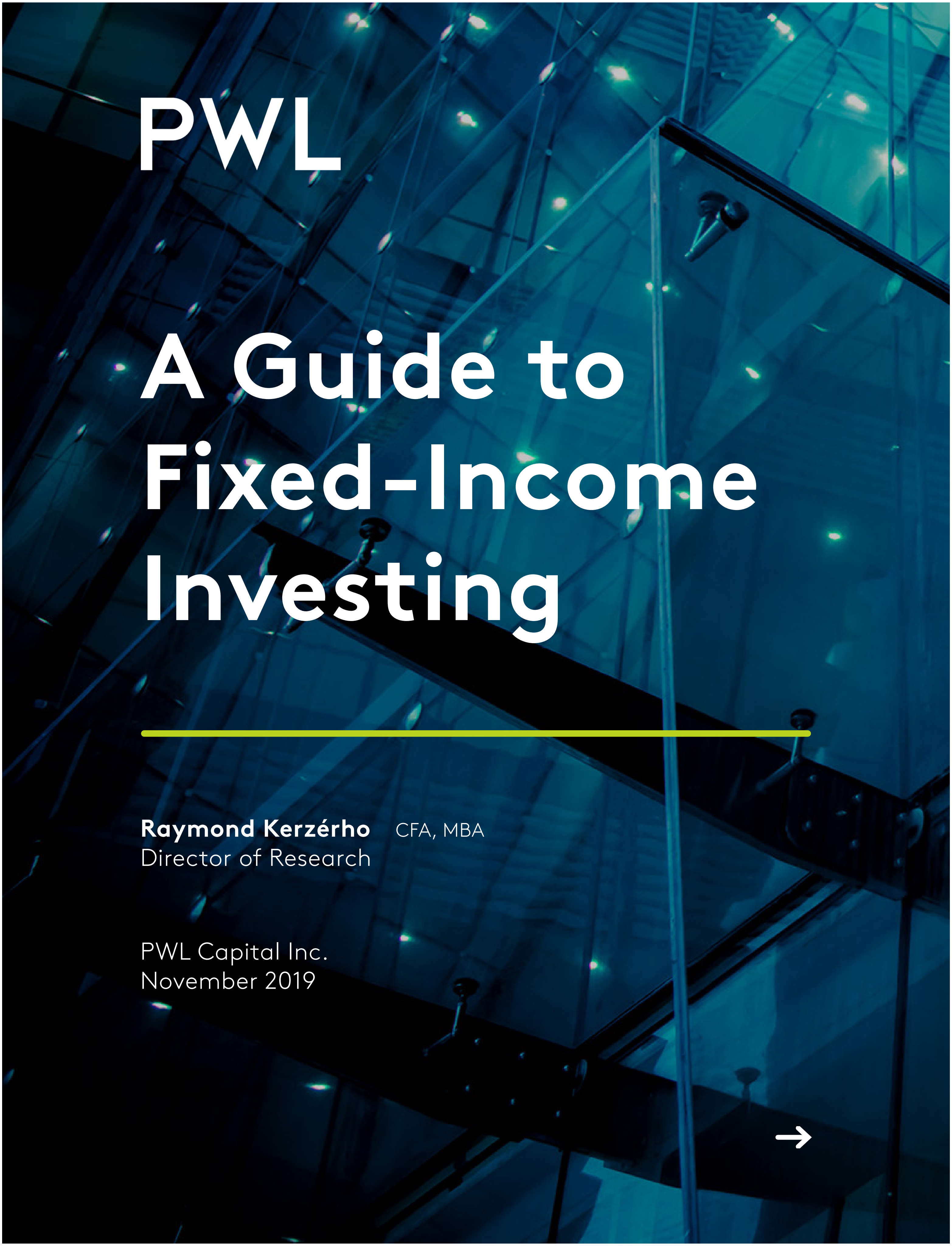

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A Guide to Fixed-Income Investing

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This report was written by Raymond Kerzérho, PWL Capital Inc. The ideas, opinions, and recommendations contained in this document are those of the author and do not necessarily represent the views of PWL Capital Inc.

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3. Bond Risks

While bonds are generally less risky than stocks, they do face risks of their own. Let's look at these risks and their associated premiums.

a. Interest Rate Risk / Term Premium

As explained in the previous section, the longer is the duration of a bond, the more sensitive it is to changes in yield. In other words, longer bonds are riskier.

There are few certainties in finance. One of them is that longer-maturity bonds offer a higher yield than shorter ones most of the time. In the last 30 years, 10-year federal government bonds have yielded more than have 2-year securities 92% of the time. The former are roughly 4 times more volatile; it is to be expected that they will yield more.

This positive difference in yield between long- and short-dated bonds is called the "term premium."

b. Credit Risk / Credit Risk Premium

Corporate, provincial and municipal bonds have a higher default risk than federal government bonds (which are often considered credit risk–free). Even though so-called "credits" rarely default (except for speculative-grade securities), they offer a higher yield. This difference in yields is called the credit risk premium or credit spread.

c. Liquidity Risk

Liquidity risk applies primarily to corporate bonds and other "credits." Corporate bonds are far less liquid than Government of Canada securities. While the latter securities are few and well structured, the market for corporate bonds is highly fragmented, with a multitude of issues. This liquidity risk, in addition to default risk, explains the credit premium for the most part.

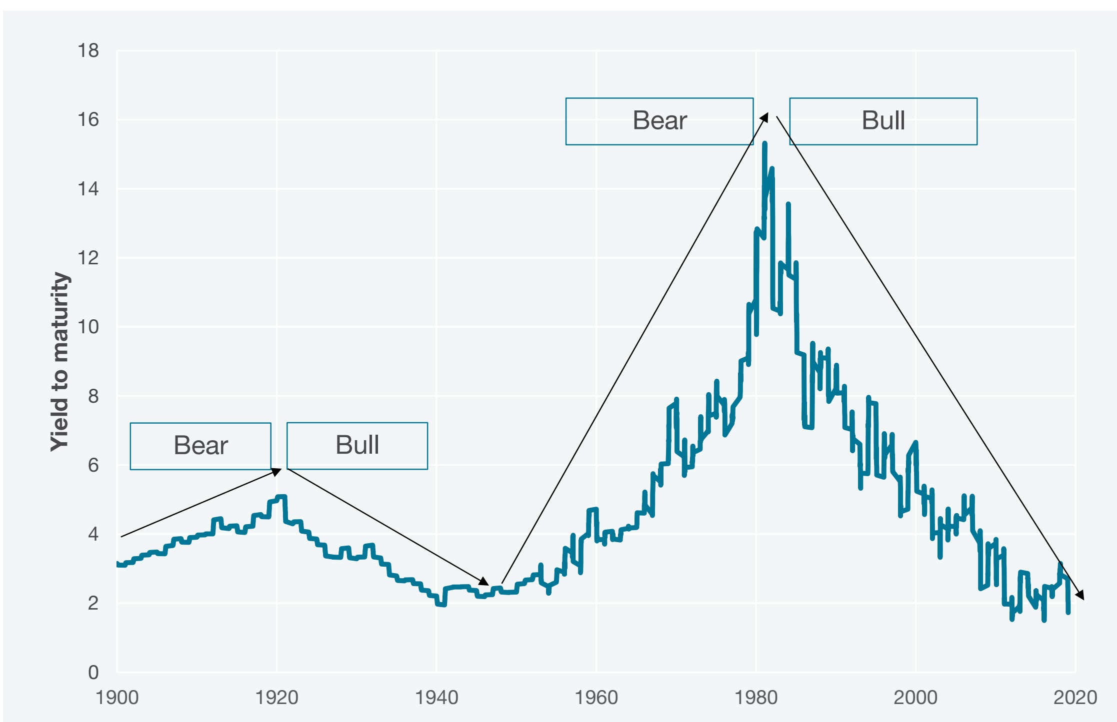
d. Asset-Liability Mismatch Risk

Bonds are often labelled as a risk-management asset class. Financial institutions are familiar with the notion of selecting bonds with maturities that match those of their financial engagements. In some instances, individual investors can do the same when they have a specific goal, for instance purchasing a secondary home, paying for university tuition or planning for retirement income. On the other hand, if asset maturities are very different from the schedule for the use of funds, a shortfall can occur. For example, if someone who is saving and investing to finance the purchase of a cottage 3 years from now invests in 10-year bonds, a large capital loss could defer or derail the project. Using 3-year bonds at par, the investor knows the principal will be received in a timely manner, with zero gains or losses.

e. The Cycle of Bond Investing

Another risk that is seldom discussed is the cycle of fixed-income investing. While a full equity market cycle is often no more than 10 years from the beginning of a bear market to the end of the following bull market, bond cycles are much longer: there has been only two complete cycles in the last century. We are currently in the bull phase of the post-war bond cycle: after 36 years of underperformance, from 1946 to 1982, bond yields have mostly declined since 1982, leading long-duration bonds to outperform. Keep in mind that a decline in yields drives bond prices upwards. As a result, bonds have been appreciating most of the time since 1982. While we can't predict when the current positive environment for bonds will end, 37 years of abnormally high returns may have created a false sense of comfort with longer-dated issues. Portfolio managers must take that risk into account.

Chart 3: U.S. Treasury Bond Yield Cycle 1900–2019[1]



Source: Yale University

[1] Bear and bull market dates are documented with: Homer, S., Sylla, R., A History of Interest Rates, Wiley, 2005

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