PWL

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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5. Bond Portfolio Management

a. Active Strategies

The active management of equity portfolios requires that the manager be able to anticipate what the market will do. The same principle applies to active bond portfolios. Active bond management also relies on the assumption that markets are inefficient, which is a fancy way of saying that bond prices are wrong. Outperforming with active strategies suggests that interest rates and changes in the creditworthiness of bond issuers can be predicted.

i. Duration calls

As discussed in section 2, the duration of a bond measures how long you'll wait on average to get back the money you are owed. The longer it takes, the more volatile the bond's price is. Keep in mind that if you buy a 30-year bond, you're locking in your money for that period of time. You can sell the bond before maturity, but you will then have to accept whatever the market is willing to pay at that point in time.

Usually, bond managers work with a target duration. It will often be the Market Index duration. In Canada, the most widely used bond benchmark is the FTSE Canada Bond Universe Index, which has an average duration of eight years. A "duration call" rests on a forecast of the general direction of bond yields. If managers expect yields to fall, they will increase the duration of the portfolio above target to benefit from extra capital appreciation. If, by contrast, they anticipate a rise in bond yields, they will shorten the duration of the portfolio below the target to reduce capital losses. In either situation, if the prediction is correct, the portfolio will likely outperform the index.

ii. Yield curve calls

There are many ways to achieve the target duration of a portfolio. If someone is looking to invest for a duration of eight years, this can be done by buying many securities with a duration close to the target (a bullet strategy). It can also be done by investing with a combination of bonds with very short and very long durations (barbell strategy). There are infinite possible combinations. A yield curve call requires that a forecast be made about which maturities will perform best in the future and that the portfolio be positioned to take advantage of this forecast.

iii. Credit selection calls

Credit spreads tend to be wider for securities with a higher default risk. Corporate bonds issued by a company whose financial position is improving (a rise in earnings, a major new contract, the fall of a major competitor) will see its credit spreads narrow. The narrowing of credit spreads will drive bond prices up: the bonds from this issuer are going to outperform. Credit selection calls are about selecting the bonds from the issuers with the best financial outlook.

iv. The evidence on active bond investing

Many people believe that while the stock market is unpredictable, the bond market is somehow different, and that, as a result, active management is effective for bonds. An article published by Standard and Poor's in 2019[2] suggests otherwise: the authors studied active bond pools offered to pension funds and other institutional clients in the U.S. over the 10-year period ending December 31, 2018. Gross of fees, the majority of actively managed funds failed to outperform the benchmark index in 9 of 17 categories. After fees, active funds underperformed in 10 of 15 categories. In a nutshell, the evidence points out that opting for active rather than passive fixed-income funds is likely to reduce returns.

b. Passive Strategies

In contrast to active management, passive bond management assumes that security prices are mostly correct; therefore, it focuses on replicating the market structure and on controlling costs.

i. Bond indices

The most-used bond indices are constructed along the same principles as their equity counterpart: all publicly traded bond issues above a minimum size threshold are included in the index and are weighted according to their free-float market value. The best-known Canadian bond index is the FTSE Canada Universe Bond Index.

Bond indices can be sliced into sub-indices that focus on a particular characteristic. For example, the above index can be split into short-term (one- to five-year maturities), mid-term (five to ten years) and long-term (over ten years) sub-indexes. The index can also be split by type of issuer: federal government, provincial governments and corporations. Finally, the index can be split with a

[2] Liu, B., Preston, H., SPIVA® *Institutional Scorecard: How Much Do Fees Affect the Active versus Passive Debate?*, Standard and Poor's, 2019

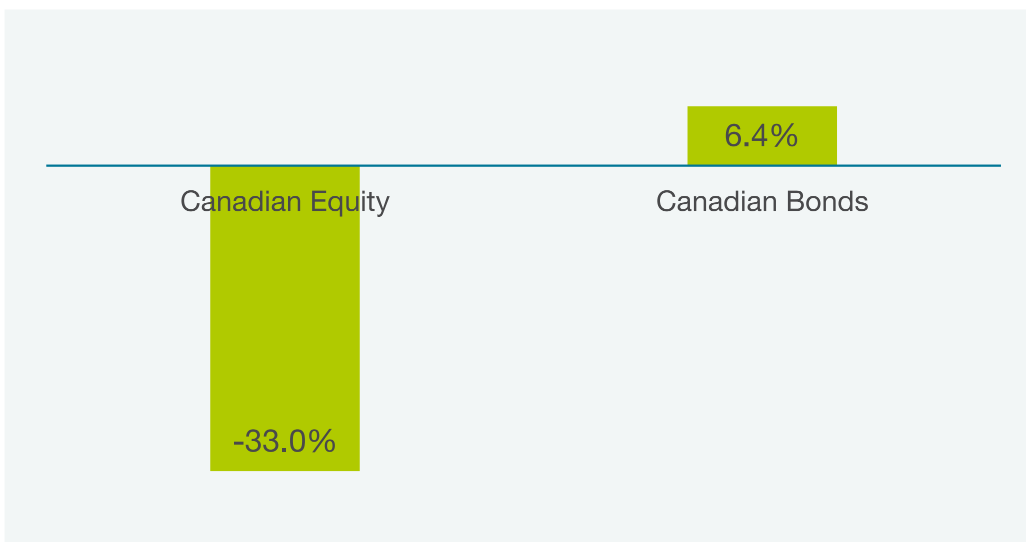
combination of maturities and issuer type. For example, a short-term corporate bond index would include all liquid corporate bonds with maturities ranging between one and five years.

ii. The logic of passive bond investing

Investing passively with bonds does not differ much from doing it with equity: it rests on the well-documented assumption that, at any given point in time, the market does a good job of putting the right price on securities, and that, as a result, the vast majority of active managers fail to consistently outguess the market. Therefore, the most efficient way to manage a portfolio is to capture the market's rate of return.

Some active managers argue that passive bond portfolios are dangerous because the largest borrowers are also the most indebted, and therefore, heavily weighted in bond indexes. To our knowledge, this claim is not backed by evidence. For example, in 2008, when credit stress was at a post-war high, the FTSE Canada Universe Bond Index performed well, with a 6.4% return.

Chart 4: 2008 Canadian Stock and Bond Index Returns[3]



Source: Morningstar

[3] Canadian equity is measured by the S&P/TSX Composite Index and Canadian bonds are measured by the FTSE Canada Universe Bond Index.

iii. How have passive Canadian Bond ETFs performed so far?

Another argument that is routinely put forward against passive funds is that, since they nearly match the market rate of return (after fees), they offer a mediocre performance. To verify that assertion, we've looked at the returns of the Canadian Bond ETF with the longest history: the iShares Core Canadian Universe Bond Index ETF (ticker: XBB). Here are the facts: when compared to its peers (other Canadian bond funds), this ETF ranks in the first quartile over 1, 3, 5, 10 and 15 years. More precisely, over 15 years, this ETF outperformed 87% of the fund universe.[4] Since XBB has served as the blueprint for other best-selling bond ETFs, we conclude that this argument about the underperformance of passive bond ETFs is a myth.

c. Conclusion

We have read countless times that active management does not work for stocks, but it does for bonds. In our experience, these claims are not backed by evidence. It is true that the performance of active management is not as dismal for bond funds as it is for equity funds. Nevertheless, active fixed-income funds tend to underperform over time. By contrast, passive bond ETFs provide extreme diversification at a low cost in a highly fragmented market. Bonds are no more predictable than stocks. Empirical evidence shows that the performance of low-cost passive bond ETFs is extremely hard to beat.

[4] Sources: Morningstar and Fundata. Data as of August 31 2019.

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