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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7. The Strategic Role of Fixed Income in a Diversified Portfolio

Bond yields have been stuck at extremely low levels for over a decade. At the time of writing, 10-year Government of Canada bonds are yielding less than 1.5%. In most European countries, bonds yields are negative. Why do investors still buy bonds? The simple answer is this: in times of high stress in the market, high-quality fixed-income securities hold their value.

Investors can reduce the volatility of their portfolio by increasing the number of stocks they hold, due to the imperfect correlation across securities. For example, as of August 2019, the average 250-day volatility of the S&P/TSX Composite Index was 10%, as compared to an average of 31% for its constituents. However, during periods of high stress in the stock market, bonds are an indispensable tool for risk management. Since the timing of these high-stress periods is unpredictable, most investors hold bonds at all times.

Another important fact is that high-quality bonds behave as a safe haven in times of high stress, that is, they tend to appreciate when investors need it most: when stocks plummet. Bottom line: investors keep holding bonds despite the low yields because they act as a floor on the value of their portfolio when stocks plunge. Table 4 displays the returns on bonds during the nine bear markets for Canadian equity since 1956. Bonds have delivered positive returns seven out of nine times.

Table 4: The Performance of Canadian Bonds during Bear Markets in Canadian Equity from 1956 to 2019

Contraction Start Date	Contraction End Date	Canadian Equity	Canadian Bonds
1957-05-31	1957-12-31	-26.9%	6.9%
1969-05-31	1970-06-30	-25.4%	2.1%
1973-10-31	1974-09-30	-35.0%	-9.8%
1981-06-30	1982-06-30	-39.2%	11.3%
1987-07-31	1987-11-30	-25.4%	2.1%
1989-12-31	1990-10-31	-20.1%	2.5%
1998-04-30	1998-08-31	-27.5%	-0.1%
2000-08-31	2002-09-30	-43.2%	18.5%
2008-05-31	2009-02-28	-43.3%	3.8%

Source: Morningstar

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