LEITH WHEELER INVESTMENT OUTLOOK

Leith Wheeler
INVESTMENT COUNSEL LTD.

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All You Ever Wanted To Know About Bonds… But Were Afraid We Would Tell You!

Yield up, price down? A bond primer.

Bonds generally pay an interest rate, or coupon, for a specified period of time. An example would be a 4% coupon bond, bought for the **price** of $100 that matures in one year. It will pay a $4 coupon and return the $100 investment at the end of year one. The **yield** would be 4% ($4 coupon on a purchase price of $100). So far, so good.

Now let's look at why bond **yields** and **prices** move in the opposite direction. Let's say that all other investors now need a **yield** of 5%. Suddenly, your bond does not pay enough coupon income. For other investors to earn a 5% **yield**, the **price** they would pay for your bond has to decline to $80 (the $4 coupon divided by a purchase price of $80 = 5%), a big price drop! The situation can be the other way around as well. If the **yield** that all other investors require is less than 4%, your bond with a 4% coupon becomes more attractive, so its **price** will rise above what you paid for it. Of course, these price gyrations become less important if you hold the bond until maturity because you will get your $100 back.

Why own bonds? Portfolio considerations.

Bonds don't make good cocktail party stories, but they do provide safety of capital and liquidity to a portfolio. In addition, the coupons paid on bonds provide a steady stream of income. Our bond portfolios invest in diversified mix of high-quality notes and bonds issued by the Canadian federal and provincial governments, and by corporations.

How do we manage bonds? Our philosophy and process.

Now that we know how a bond works and why we might own them, let's talk about the bond investment process. We believe that price movements in the bond market can be irrational in the short run as there tends to be a huge amount of "noise" (just like the stock market) that can move yields and prices out of line. Where does this noise come from? There are thousands of bond traders around the world that have to do something other than just stare at their computer screens all day. So what do they do? They react to every bit of information they see, no matter how irrelevant in the long run, by buying and selling bonds in an attempt to make short term profits. Our investment process is very different as it focuses on the long term and is based on a well researched, fundamental approach with a disciplined implementation.

The starting point for our process is an economic forecast. Unlike the talking heads on T.V. that focus on "news" we do a thorough evaluation of the economy, central bank policies, market developments, and political events. This is distilled down into a forecast of where we see interest rates heading over the next six months to three years. From this, we determine whether bonds are "cheap" or "expensive". By now you know that we prefer "cheap".

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We use various strategies in our bond portfolios. With regard to interest rates, we alter the term to maturities of the bonds in our portfolio to protect capital when bond prices are expected to fall and earn capital gains when bond prices are expected to rise. Our other main strategy involves investing in provincial bonds and corporate bonds to earn extra yield when our assessment of the risk is favourable.

How low can yields go, and are they worth it? Our outlook and strategy.

Let's face it - bond managers see the world differently! They like a gloomy economic forecast because slower economic growth is accompanied by lower inflation, falling interest rates, and rising bond prices. Bond managers have been granted their wish for a long time as bond yields have been falling, on average, for over two decades. This has been great news for bonds in the past but has become a problem now that bond yields are in the low to mid single digits.

Do we love bonds at these yields? No. Does this mean that we should avoid bonds? Certainly not! Although we expect yields to remain low because economic growth will be on the low side and inflation will stay in check, bonds remain the safe and liquid part of a portfolio. In addition, in a world of lower inflation, returns for all assets are likely to be lower, with riskier assets such as equities expected to provide returns in the high single digits. So, while bond yields are low, they can still provide about half the expected returns compared to much riskier assets.

What is the yield curve and what is it telling us?

If you have managed to stay with us this long, you are obviously more interested in bonds than you would ever admit! The yield curve shape or slope refers to the difference in yield between short term and long term bonds. The yield curve becomes inverted when the slope is negative, i.e when short term yields are higher than long term yields.

So why is the media talking about an inverted curve so much? Have they become fascinated with bonds? The real reason for this obsession is that the yield curve has historically been a good predictor of recessions. Over the last 30 years, all U.S. recessions have been preceded by an inverted yield curve.

Is the yield curve inverted? Short term yields have increased, and long term yields have decreased, to the point where the yield curve has flattened dramatically to just a small positive slope. The good news is that history tells us that it has to invert and stay that way for at least a month before signalling a recession starting a year or so later. At this time we do not expect the yield curve to become extremely inverted, so we believe that a recession is unlikely to occur.

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