Leith Wheeler
INVESTMENT COUNSEL LTD.

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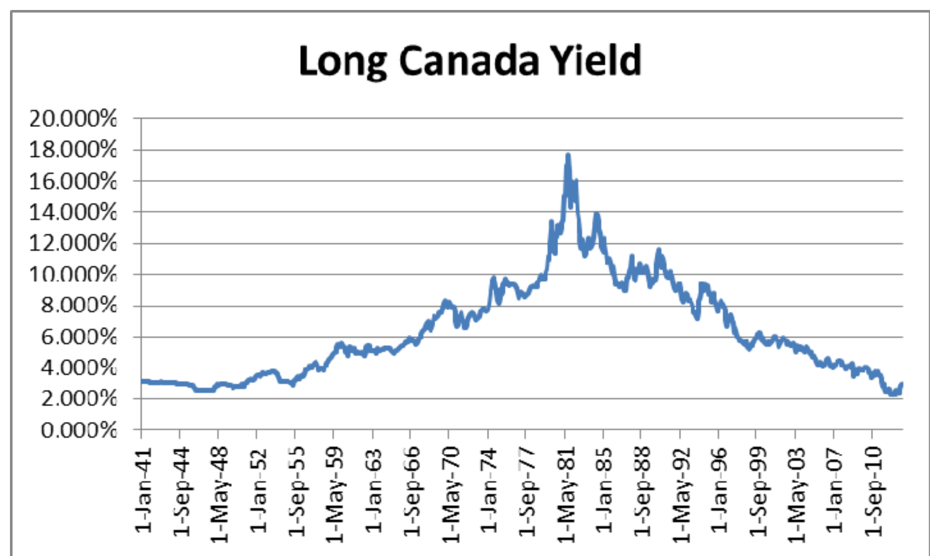
INVESTMENT OUTLOOK

Impact of Rising Interest Rates on Fixed Income

With the recent rise in interest rates, many investors have expressed concern over their fixed income investments. For instance, are we beginning to see an unwinding of the great bond bubble that will lead to many years of negative returns? Should an investor hold any bonds and if they do, should they be the shortest term to protect the capital value?

We believe that fixed income investments still play a role in almost all client portfolios. However, the exposure to bonds needs to be taken in the context of a client's overall investment portfolio, their tolerance to risk, and the interest sensitive nature of other holdings in their portfolio.

Interest rates have been in a long term decline since peaking in 1982. Indeed, most investors have never experienced anything other than falling interest rate during the last 32 years of investing!



Source: Bloomberg and Bank of Canada

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Interest rates have been at historic lows for the past several years, in part due to Quantitative Easing, the U.S. government's bond-buying program designed to support the economy. More recently, rates were driven higher by comments made by the US Federal Reserve ("The Fed") in which they outlined a formal exit strategy for this unprecedented monetary stimulus. For the first time, the bond market was given a clearer picture of the potential reduction or "tapering", from the Fed's bond buying program.

So what did the Federal Reserve say? The main unconventional tool the Fed has been using is asset purchases, currently $85 billion per month. Economic conditions are expected to warrant a tapering of the purchases most likely to $65 billion per month in September of this year. From there, if economic growth accelerates to the 3% range, the Fed plans to continue reducing the rate of purchases and end them completely by mid-2014. At that point they expect the unemployment rate to be around 7%. Assuming constant 3% growth, the unemployment rate should continue to drift down in the latter part of 2014 and the first part of 2015, reaching the Federal Reserve's threshold of 6.5% by sometime in 2015.

Recent comments have made it clear that the Federal Reserve views this 6.5% rate as a precondition to increasing rates rather than a trigger. So assuming these growth expectations are met and inflation is in the upper range of the fed's target, they expect to begin normalizing interest rates in 2015 with short term rates expected to rise to .75-1% by the end of 2015. The key takeaway is that rising rates are not imminent. They are likely 2-3 years out, and when they arrive, the increase will most likely be quite tempered given the outlook for inflation.

So what does that mean for a bond portfolio?

We believe that fixed income investments will always play a critical role in portfolios because of the diversification benefits they provide. However, given the inverse relationship between bond prices and interest rates, when rates rise, it is true bond prices will decline. That said, Investors should not panic and sell bonds without fully understanding the characteristics of their bond portfolio. What might be surprising is how the pace of rising interest rates will affect bond portfolios. When it comes to rate increases, time can be your friend.

First, we need to consider the important concept of "duration" - a measure of a bond's sensitivity to interest rates. This is a complex calculation that includes the yield, final maturity and other features of the bond. The larger the duration, the more sensitive the bond price will be to changes in interest rates. Another important factor is how long it takes for rates to move up. Duration only measures the effect of a one-time change in interest rates. In reality, rates won't move all at once; they will likely increase slowly over several years.

In the following table, we look at two scenarios of rate increases over the next 2 and 4 years and compare the sensitivity of the DEX Bond Universe to a shorter duration portfolio similar to one of our private client bond portfolios. As one can see the pace of interest rate increases and differences in duration have a very meaningful impact on the portfolios. If we assume a steady increase in interest rates of 1% (across all terms to maturity) over the next 2 years a shorter duration portfolio will actually increase in value by 2.2% while a longer duration portfolio will decrease in value by 0.3%. Why is this the case? Bonds continue to pay the "coupon" or interest stated on the bond at the time of issue, while interest rates change. So depending on how long it takes for rates to rise, the capital loss on the bond portfolio will be offset by the income from the coupons. As well, in each quarter, the starting yield will be higher, offsetting the duration losses further.

What happens if we have four years of consistent rate increases of 1% (across all terms to maturity) per year? At the end of four years the DEX Bond portfolio will have lost a total of 7% while the shorter duration income portfolio will have actually increased in value by 2%.

Cumulative Returns		
Over 2 years	**Income Portfolio (Duration of 4.3 years)**	**DEX Portfolio (Duration of 6.8 years)**
1% cumulative increase	**+2.2%**	**-0.3%**
2% cumulative increase	**-1.1%**	**-5.8%**
Over 4 years		
2% cumulative increase	**+6.6%**	**+1.5%**
4% cumulative increase	**+2.1%**	**-7.0%**

Bonds still serve a purpose in an overall portfolio as they are one of the only asset classes that often move in the opposite direction of equity markets in bad times. So bonds can provide liquidity and hold up the value of your overall portfolio when equity markets are sinking. To protect your bond portfolio against rising interest rates, it is important to maintain a low duration, but also keep in mind it is not only the amount of the rate increase but also how long it takes the increase to happen that will affect your bond returns.

So what about preferred shares?

Preferred shares are of particular interest to taxable clients as the income from the dividends on preferred shares is typically taxed at approximately half the tax rate of the interest income from bonds.

Not all preferred shares are created equal, and various types of preferred shares will have different interest rate sensitivities.

Perpetual Preferred Shares will have the highest sensitivity to rising interest rates. These types of preferred shares generally have no maturity date and will pay a fixed dividend for as long as they remain outstanding. With no maturity date, these types of preferred shares will have a long duration and an interest rate sensitivity similar to a long (30 year) bond.

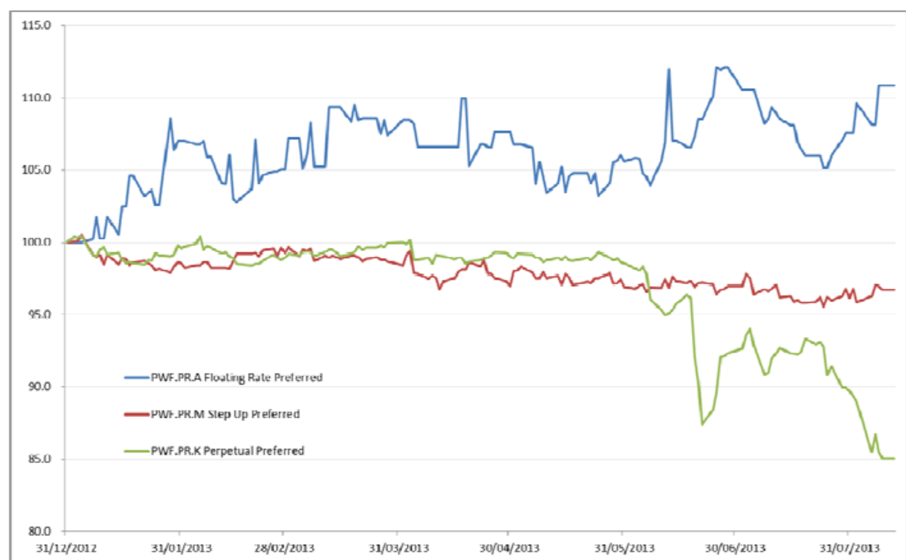
Step-Up Preferred Shares or Rate Reset Preferred Shares pay a fixed dividend for a specific period of time (generally 5 years). At the rate reset date the issuer has the opportunity to "call the preferred share" and give the investor back the "redemption" price (generally $25.00). If the preferred share is not called by the issuer then the investor has the option of locking in a fixed dividend rate or a floating dividend rate for the next 5 years. The fixed rate would be locked in at a premium over the 5 year Government of Canada Bond (currently 1.77% on Aug 8/2013). The floating rate would be locked in at a premium over the 90 day Government of Canada T-Bill rate (currently 0.99% on Aug 8/2013). The rate premium ranges from approximately 1.0% to 4.8% depending on the issuer and economic conditions prevalent at the time of issue. These types of preferred shares will have less interest rate sensitivity than Perpetual Preferred Shares and will be similar to a 1 to 5 year bond.

Floating Rate Preferred Shares pay a dividend that "floats" or changes with the prime rate. The actual dividend is usually from 70% to 100% of the current prime rate (3%), depending on the issuer. This type of preferred share will exhibit minimal sensitivity to rising interest rates as the investor has the certainty of an increasing cash flow as interest rates rise.

For our clients that hold preferred shares, we are currently overweight the universe of Step Up Preferred shares.

The graph below shows an example of Power Financial which has issued all three types of preferred shares discussed above. The effect of the recent 'Stress" test in May/June, where 10 year government of Canada bond yields increased from 1.8% to 2.5% can be seen in the relative price performance.

Power Financial Preferred Shares



Source: Bloomberg

In any type of fixed income investing, avoiding losses as interest rates increase requires sitting in cash which offers a negative real return today. When rates will increase, how quickly and by how much they will increase, and how much of the rate increase is already priced into various asset classes is the great unknown.

Conclusion

For clients that are looking for reasonable income and less interest rate risk, we suggest an income model that combines higher quality short and mid-term corporate bonds with preferred shares (weighted preferentially to Step Up's). However, for clients that are looking for diversification and some degree of equity risk offset, we would suggest a universe type bond product that provide some exposure to 10-30 year governments.

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