GET THE MOST OUT OF FIXED INCOME

A major fixture in portfolios for decades, fixed income has traditionally been an asset loved by investors. But is the love affair coming to an end in today's low interest rate environment? Fixed income has more to offer, but it requires investors being open to new ideas and opportunities.

Attractions and Concerns

Investors have long been attracted to fixed income for good reasons — strong consistent returns and risk management.

In today's environment, concerns over low bond yields are pushing away investors, fearful of the impact on future total returns.

But the finite life of a bond, implying a return "guarantee" is one characteristic bringing them back into favour. Another factor is the ability to access a range of fixed income securities; from the safety of government issues to more volatile higher yielding bonds.

Fixed Income must also counter the attraction investors have to other investments including the diversification merits of alternative investments and the prospect of higher returns gained from equities.

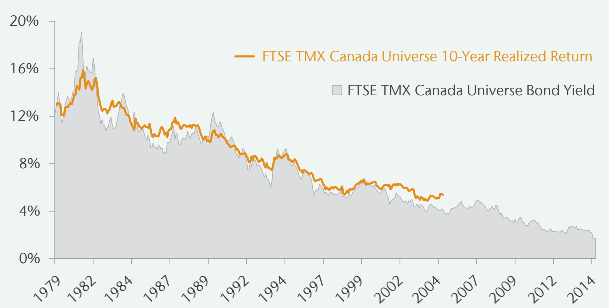
However, these investments are not without their own challenges. Alternative investments come with greater complexity and cost and investors seeking higher returns through equities can be sensitive to increased volatility.

Return Guarantee

Chart 1 displays the yield of the FTSE TMX Canada Universe Bond Index from 1979 to early 2015, a period when yields reached as high as 19% and declined to below 2%.

Also shown is the actual 10-year index return which is consistent with the yield at the start of the period. The selection of a 10-year return coincides with the average term of the universe bond index.

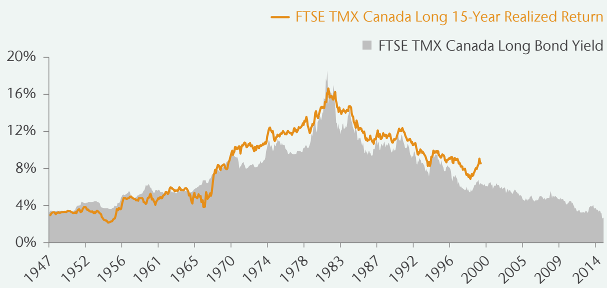
Chart 1 – Universe Bond Yields and Returns



Source: CC&L Financial Group and secondary sources

Chart 2 shows a similar analysis for long bond yields, extending back to 1947.

Chart 2 – Long Bond Yields and Returns



Source: CC&L Financial Group and secondary sources

The first half of this period saw yields rise followed by a long secular decline; a trend which has been experienced not only in Canada but globally.

For the long-bond index, using a 15-year rolling return supports that current yields provide a reasonable prediction of returns in both rising and declining yield environments.

While today's expected fixed income returns are not high in absolute terms, they do provide an element of certainty for long-term investors.

Looking forward, current yields allow investors to assess risk and return opportunities. A rise in bond yields will result in a rise in expected long-term fixed income returns and when yields fall, expected returns would also decline.

Risk and Reward Perspective

If presented with three fixed income investments, valued at $5, $10 and $15 and you knew that tomorrow two of the investments would be valued at $0 and one at $35. Would you invest?

Often when investors are presented with a new investment opportunity, the risk and reward traits are presented specifically for that investment. In our example, the prospect of investing in securities that could drop to $0 can be daunting.

However, if all three investments are considered as a total portfolio, the risk and reward dynamics look quite different. Buying all three fixed income investments necessitates spending $30 in order to receive a guaranteed $35 the next day, which changes your risk and reward perspective.

When assessing new fixed income opportunities, it is beneficial to review the risk and reward in the overall context of the portfolio, rather than in isolation.

Range of Opportunities

In the current economic environment, investors of multi-asset portfolios invested 60% in a range of equities and 40% universe fixed income, may not be excited by expected fixed income returns, despite the inevitable diversification benefits.

Getting the most out of your fixed income portfolio requires a willingness to consider other investment opportunities in the fixed income tool kit, such as:

- High yield debt — corporate debt rated below investment grade,
- Global bonds — capturing a wide array of local and foreign investments, and
- Core plus fixed income — a catch-all of a variety of bonds.

A universe or core fixed income mandate is largely comprised of investment grade bonds which provide risk management benefits to multi-asset portfolios due to their low correlation to equities.

When adding a "plus" element into the fixed income mix, it's important to be mindful of the relationship the "plus" component has with other assets in a multi-asset portfolio.

The core plus category is therefore best considered in two segments: correlated core plus, where assets can be correlated to existing portfolio assets and uncorrelated core plus, where there is little or no correlation.

Some of the common investments in the correlated category include: US mortgages, emerging market debt and high yield.

For example, a portfolio including high yield bonds provides additional yield, but at a cost. High yield bonds tend to be positively correlated to the existing equities in the portfolio. When equity markets decline, high yield bonds will tend to underperform traditional universe bonds.

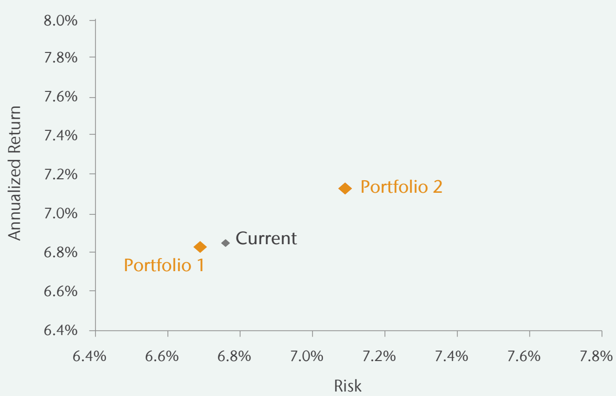
Uncorrelated core plus strategies are designed to provide additional return with little or no correlation to other markets, but they maintain the matching and diversification properties of traditional fixed Income — see example in the box titled Uncorrelated Example.

Enhance Expectations

Chart 3 demonstrates the expected return and risk of a portfolio invested in 60% equity and 40% universe bond fixed income[1].

The portfolio is expected to return 6.8% with similar risk.

Chart 3– Expected Risk and Return



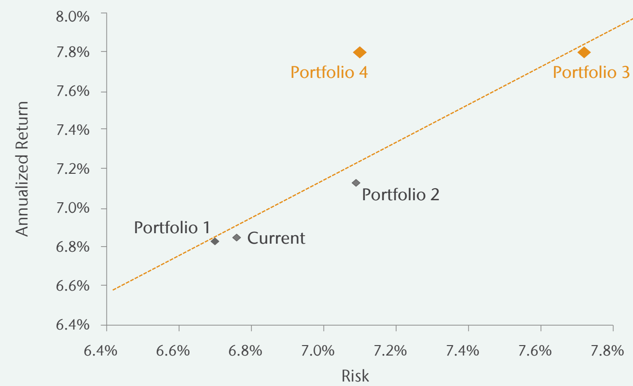
Source: CC&L Financial Investment Management and secondary sources

In conjunction with returns for the current portfolio are Portfolio 1 and Portfolio 2, where 10% of the universe bond allocation has been replaced with an allocation to global and high yield bonds, respectively.

For Portfolio 1, the risk is reduced, as is the expected return. For Portfolio 2, the return is higher, but so is the risk.

Chart 4 introduces core plus mandates. Portfolio 3 has replaced universe bonds with 30% correlated core plus[2] and 10% high yield, while Portfolio 4 has 30% uncorrelated core plus with 10% high yield.

Chart 4– Expected Risk and Return

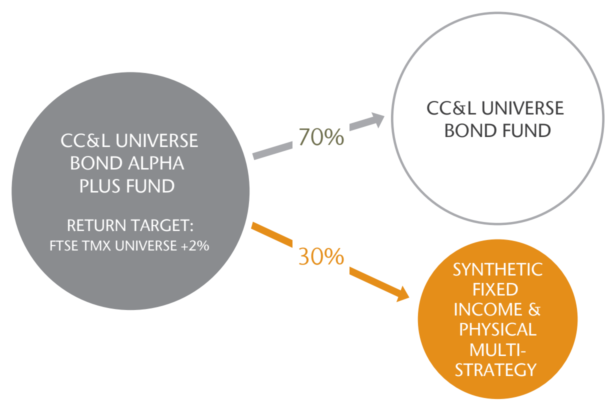


Source: CC&L Financial Investment Management and secondary sources

Also expressed is the risk and reward line, highlighting that Portfolios 1, 2, and 3 have moved consistently along the more return for more risk spectrum, while Portfolio 4 (with uncorrelated core plus) is above the line.

Uncorrelated Example

An example of an uncorrelated strategy is the CC&L Universe Bond Alpha Plus Fund, which targets 2-3% above the FTSE TMX Universe Index.



The majority of the assets (70%) are invested in a traditional active fixed income fund, while the remaining 30% fixed income exposure is gained synthetically, and earns the return of the index.

This structure frees 30% of physical assets to invest in an uncorrelated source — in this case, multi-strategy market neutral funds that capture alpha from a range of active strategies designed to limit market exposure.

The uncorrelated core plus portfolio has an expected return almost 1% p.a. higher than the current portfolio but the risk has increased from 6.8% to just over 7%.

While the risk profile is similar to adding a 10% high yield allocation to a portfolio as illustrated in Portfolio 2, Portfolio 4 has maintained many of the matching characteristics associated with a universe bond mandate. The same uncorrelated structure can be applied to a mandate benchmarked to the long bond index.

Achieving an additional 1% p.a. through investing in equities would require adjusting the asset mix from 60% equity/40% fixed income to approximately 80% equity/20% fixed income and thereby triggering an increase in risk from 6.8% to approximately 9%.

Replacing fixed income assets that have a low correlation to equities with additional equities would result in sacrificing the portfolio's diversification benefits, which substantially increases the risk profile.

Fatal Attraction of Fixed Income

Rather than becoming preoccupied with risk at an individual investment or asset class level, the focus should be on risk and return at the total portfolio level to be able to fully appreciate the benefits of new fixed income opportunities.

Fixed income is a finite investment, which for long-term investors implies the current yield provides a level of return "guarantee". Additionally, fixed income continues to offer valuable diversification and risk management characteristics.

In the current low interest rate environment, fixed income markets offer a range of risk and return opportunities with the potential to add value, but with little change in the total fund risk profile.

1. The expected returns are target returns only. There is no guarantee that such return will be achieved.
2. The target returns for the core plus correlated fund were based as a proxy on historical returns for an actual fund, adjusted for the environment CC&L Investment Management Ltd. expect going forward.

For more information on investing for the next decade contact:

Peter Muldowney
Senior Vice President, Connor, Clark & Lunn Financial Group
pmuldowney@cclgroup.com | 1- 416-304-6810

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