

WHAT'S THE  
**BUZZ** about **BONDS?**



## A CLOSER LOOK AT THIS INCREASINGLY POPULAR ASSET CLASS

Bond-oriented mutual funds have become very popular over the last few years. There are a number of reasons for this, but one trend stands above the rest: with equity markets showing considerable volatility, a large number of mature investors are shunning high-risk asset classes.

**M**any investors turn to bonds to add an element of stability to their portfolios and to help protect their savings from downside risk. Others choose bonds since they typically pay regular income and won't decrease in value if held to maturity. Some investors purchase bonds in the hope of achieving a combination of stability, regular income and potential capital gains.

Depending on your investment needs and overall tolerance for risk, there are a number of bond options worth considering.

### CAN BONDS OUTPERFORM STOCKS?

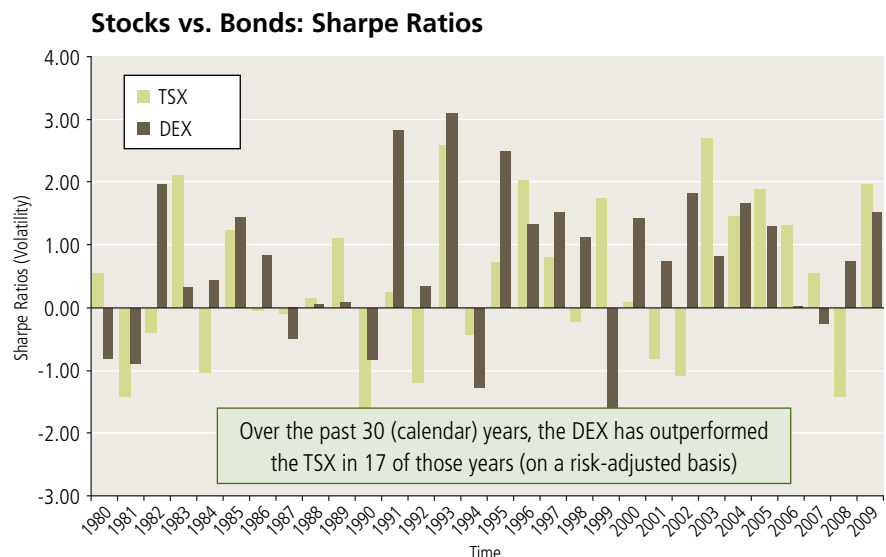
The following graph shows that, over the last 30 years, there have been 17 historical periods during which bonds outperformed the S&P/TSX Composite Index on a risk-adjusted basis.

### WHAT IS A BOND?

Bonds are essentially loans that can be issued by many sources, but the most common are governments and corporations. When you purchase bonds, you are lending your money to the entity from which you bought the bonds. In return, you

receive a fixed rate of interest over a set period of time.

Bonds are like stocks in that they are both traded on secondary markets. Therefore, you can buy bonds after they were originally issued and sell bonds before they mature. Bond prices are subject to volatility in relation to market conditions.



Source: Globe HySales, January 1, 1980 to December 31, 2009, for the DEX Universe Bond Index (bonds) and S&P/TSX Composite Index (stocks). For illustration purposes only. Past performance is not indicative of future performance.



## CAN I LOSE MONEY INVESTING IN A BOND FUND?

Many people have trouble understanding how it is possible to lose money by investing in a bond fund. Here's how this could happen.

In general, interest rates rise and fall in response to economic developments, and a bond's yield can fluctuate based on these changing rates. If inflation is rising,

a central bank will raise interest rates. If you are invested in a bond fund at the time of the rate increase, the value of your investment will likely fall. The reason for this is because the bond market will now pay investors a higher rate of interest for the loan. If you wanted to sell your bonds in the market

## BONDS – A BROAD PALLET TO CHOOSE FROM

As suggested by the size of the global bond market, there are many different types of bonds to choose from. The following table provides a high-level summary of the different types of bonds that mutual funds frequently invest in and lists their general characteristics.

TYPE OF BOND	PRINCIPAL CHARACTERISTICS	LEVEL OF RISK FOR A GIVEN TERM TO MATURITY
<b>Federal government</b>	<ul style="list-style-type: none"> <li>• Issued by the federal government</li> <li>• Safe since they are backed by the government's ability to print money and collect taxes</li> </ul>	Very Low
<b>Real return</b>	<ul style="list-style-type: none"> <li>• Issued by the federal government</li> <li>• Designed to offer protection from inflation</li> </ul>	Very Low
<b>Provincial government</b>	<ul style="list-style-type: none"> <li>• Issued by provincial governments to fund development</li> <li>• Safe since they are backed by the government's ability to collect taxes</li> </ul>	Low
<b>Municipal government</b>	<ul style="list-style-type: none"> <li>• Issued by municipal governments to fund local development</li> <li>• Generally safe since they are backed by the government's ability to levy property taxes</li> </ul>	Low – Moderate
<b>Floating rate</b>	<ul style="list-style-type: none"> <li>• Secured loans made by banks to companies</li> <li>• The interest paid on the loans adjusts periodically, based on changes in widely accepted market reference rates</li> </ul>	Moderate
<b>Corporate</b>	<ul style="list-style-type: none"> <li>• Issued by corporations to fund expansion and other expenses</li> <li>• May pay higher yields to compensate for higher risk</li> </ul>	Moderate – High
<b>Foreign government</b>	<ul style="list-style-type: none"> <li>• Issued by foreign governments</li> <li>• Backed by that country's ability to collect taxes</li> <li>• Higher risk since the value of the investment is subject to currency and sovereign risks</li> </ul>	Moderate – High
<b>High-yield</b>	<ul style="list-style-type: none"> <li>• Issued by less stable companies to fund expansion and other expenses</li> <li>• Typically pay higher yields than corporate bonds</li> </ul>	High
<b>Emerging market</b>	<ul style="list-style-type: none"> <li>• Issued by foreign governments in emerging markets</li> <li>• Backed by that country's ability to collect taxes</li> <li>• Higher risk since the value of the investment is subject to currency and sovereign risks</li> </ul>	High

Note: Risk levels are approximations made for illustration purposes only.

after the increase, you would have to accept less money for your bonds since the market has adjusted itself to accept a higher rate of interest.

The opposite is also true. If a central bank decides to lower rates, the value of your investment would increase since your bonds would likely pay a higher rate of interest. To adjust for this, the market would pay a premium on the value of your bonds if you decided to sell.

Other factors that can influence interest rates beyond central banks include the bond market's expectations for inflation and future short-term interest rates, as well as the perception of investment risk. Also, supply and demand within the credit markets can influence prices.

## **BONDS FOR ALL SEASONS**

Choosing the right bond fund will likely depend on your financial situation and your investment objectives. Many investors fall into one of the following categories.

### **INVESTING FOR INCOME AND STABILITY**

If your priorities are to generate income and capital preservation, you may want to consider looking for mutual funds that invest in bonds that are issued by the Canadian government. By investing in securities denominated in Canadian currency, you won't have to worry about exposing your savings to swings in foreign currency values. Also, look for a fund that invests in short-term bonds, with less than one year to maturity. Short-term bonds can be less volatile than long-term or mid-term bonds if interest rates rise.

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## **OTHER FACTORS THAT CAN INFLUENCE INTEREST RATES BEYOND CENTRAL BANKS INCLUDE THE BOND MARKET'S EXPECTATIONS FOR INFLATION AND FUTURE SHORT-TERM INTEREST RATES, AS WELL AS THE PERCEPTION OF INVESTMENT RISK.**

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### **INVESTING FOR HIGHER INCOME AND THE POTENTIAL FOR CAPITAL GAINS**

If you are looking to generate higher levels of income and willing to take on a bit more risk, consider investing in a high-quality corporate bond fund. Mutual funds that invest in high-quality corporate bonds are generally quite stable and typically pay a higher rate of

interest than mutual funds that invest in government bonds with similar terms to maturity.

### **INVESTING FOR HIGHER RETURNS**

If you are willing to take on even higher levels of risk, you may want to look at mutual funds that invest in high-yield bonds and/or emerging market bonds.

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## FLOATING RATE LOANS HAVE THE POTENTIAL TO OUTPERFORM TRADITIONAL FIXED-INCOME SECURITIES IN RISING INTEREST RATE ENVIRONMENTS.

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High-yield bonds are debts issued by companies that may be in financial difficulty or that operate in high-risk businesses. To attract investors, they often pay higher rates of interest.

Similarly, emerging market bonds may be considered higher risk than bonds issued by stable countries and may therefore pay higher levels of interest. There is also the potential to benefit from changes in foreign currency values. For example, a mutual fund that invested in U.S.-denominated emerging market bonds would rise in value if the value of the Canadian dollar fell relative to the U.S. greenback.

Bond fund managers who oversee high-yield and emerging market bond portfolios frequently trade these securities in anticipation of changes in interest rates and currency values. Trading these securities provides potential capital gains (or capital losses), which can increase the level of tax efficiency of your investment returns.

### **SPECIALTY BONDS**

If you are concerned that interest rates will rise in the near future, consider mutual funds that invest in real return bonds or floating rate loans. Real return bonds are issued by the government, and their rate of interest can change in response to changes in the Consumer Price Index (CPI). If inflation begins to rise, the government will increase the amount of interest paid by real return bonds to compensate investors.

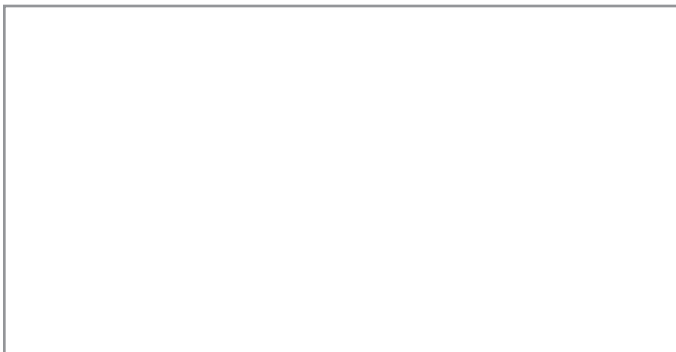
Floating rate loans are secured loans made by banks to companies. The loans are called “floating rate” because the interest paid on the loans adjusts periodically, based on changes in widely accepted market reference rates. This adjustment mechanism enables floating rate loans to increase interest payments as interest rates rise. Therefore, floating rate loans have the potential to outperform traditional fixed-income securities in rising interest rate environments.

Determining which type of bond fund is best for you will depend on a number of factors, including your need for income, tolerance for risk and the role the investment will play in your portfolio. You may find that in order to meet your needs, you should consider investing in a diversified portfolio of bonds that includes government, corporate, high-yield and emerging market securities. •

### **SPEAK WITH YOUR ADVISOR**

To determine the best approach, please speak with your advisor. He or she can review your current portfolio of investments and recommend the types of bond funds that may be right for you.

# Solutions



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