Fixing Your Bond Portfolio

Fixed income is the **fastest growing segment** of the ETF market

Source: Bloomberg June 2021

Adjusting fixed income allocations has become increasingly important in today's environment. Investors are actively managing their fixed income portfolios, as market volatility continues and rates remain low. Exchange traded funds (ETFs) have provided an excellent tool to help manage issues around declining bond inventories and liquidity constraints in the market. While still providing an effective hedge against equity corrections, the two traditional roles of bonds, income generation and capital protection, are top of mind due to market uncertainty and changing sentiment among central banks.

When investors consider interest rate risk, some will adjust duration under the assumption that interest rates move in a parallel manner, in other words that all yields move up and down by the same amount. In reality, beyond parallel shifts, yield curves can steepen, flatten, or twist as short-term, mid-term and long-term rates are influenced by differing factors. In addition, credit spreads can tighten or widen and currency can impact a portfolio.

Within bonds, ETFs represent both core positions and satellite exposures, where fixed income is the fastest growing segment of the ETF market. We have also witnessed a growing popularity of active fixed income ETFs, giving investors more choice where active management offers professional asset allocation and expertise while adding global exposure. Typically, we are seeing **passive** ETFs used when an investor has confidence in their views, and adding **active** global fixed income ETFs where they have less expertise.

The spread of COVID-19 and resulting economic hardship has resulted in unprecedented monetary stimulus from governments and central banks. The U.S. Federal Reserve Board ("the Fed") is expected to maintain its accommodative monetary policy over the short term. With yields remaining low, this environment makes net fixed income returns a critical consideration. Passive ETFs lead the way as low cost solutions and active ETFs are effectively priced compared to traditional investments, typically leaving more returns in an investor's pocket.

Longer term rates have started to rise, adding volatility to fixed income markets

Source: Bloomberg June 2021

ETFs have become leading portfolio construction tools for investors providing:

- Low Cost Exposures
- Efficient Trading
- Enhanced Liquidity
- Diversification

The framework below can help navigate fixed income investing, distilling a complex market down to a few key considerations.

1. Active, Passive or a Blend?

With the launch of active fixed income ETFs, investors will typically follow three paths: passive portfolios for confident investors or efficient market believers, mixed active and passive portfolios for less confident investors, and active portfolios for unsure investors, and enhanced global exposure.

Fee conscious investors typically will favour passive. Investors who believe in out performance will generally favour active.

2. What is your level of conviction over the next year?

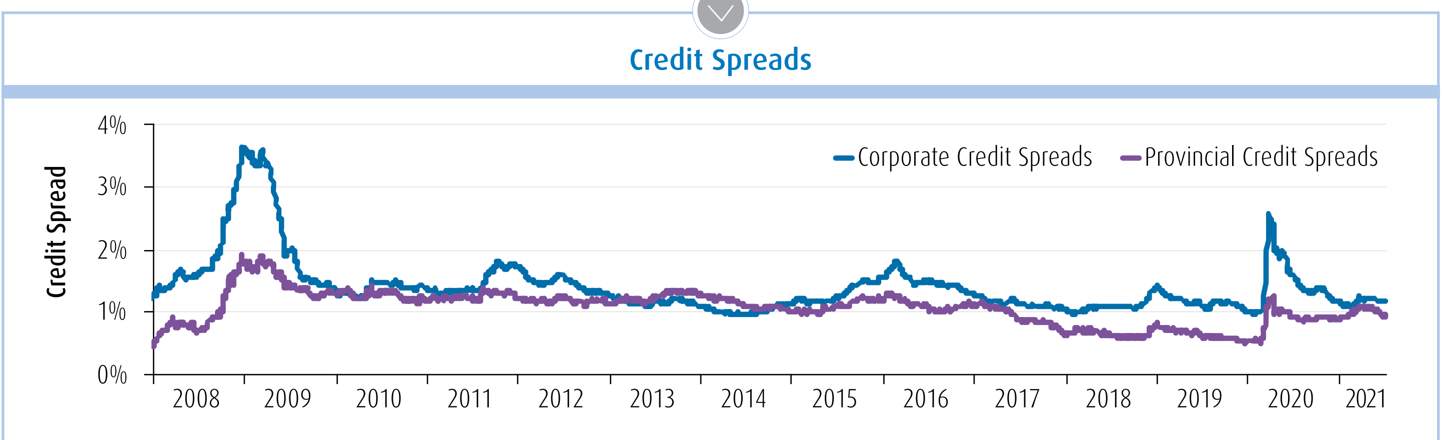
Confident investors will have a view that either stands with or against expected policy moves. *Uncertain investors* have seen how political and monetary decisions have held sway over the fixed income market. Uncertain investors will only feel confident in one thing – that there are more surprises ahead.

Investors with confidence in global leadership and the potential recovery and return to global growth will put higher weights in satellites and include corporate bonds. Investors with limited confidence will do the opposite. Those in between, are typically best off with broad exposures.

Source: BMO Global Asset Management

Using a core and satellite approach, higher conviction leads to higher weights in the satellites, whereas more uncertainty leads to more weight in the core.

Credit spreads have tightened considerably since the March downturn



Source: Bloomberg as of July 30th 2021. Difference between Canadian mid-term corporate yield and Canadian mid-term federal yield.

3. What is your view on the economy?

Constructive investors will believe that while we have had a tough year, the vaccine is providing optimism that we are on our way to recovery. A concerned investor would feel we are not out of the woods yet, and may expect the long term impact is yet to be felt and look for a more defensive positioning.

Positive investors expect economic conditions to further improve in Canada and the U.S., where markets continue to view impediments as only speedbumps along the way. *Nervous investors* will look at increasing trade related protectionism, heightened real estate markets and interest rate uncertainty as the impetus to a slow down.

A more constructive view should result in a higher weight in corporate bonds, and higher conviction would include high yield bonds and preferred shares. Keep in mind that the market prices in expectations.

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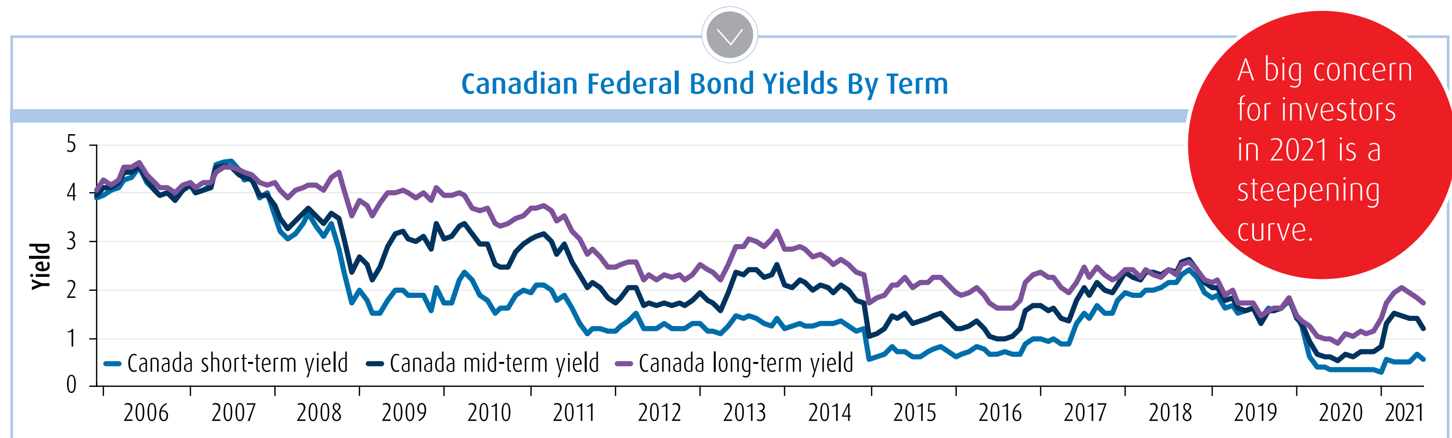
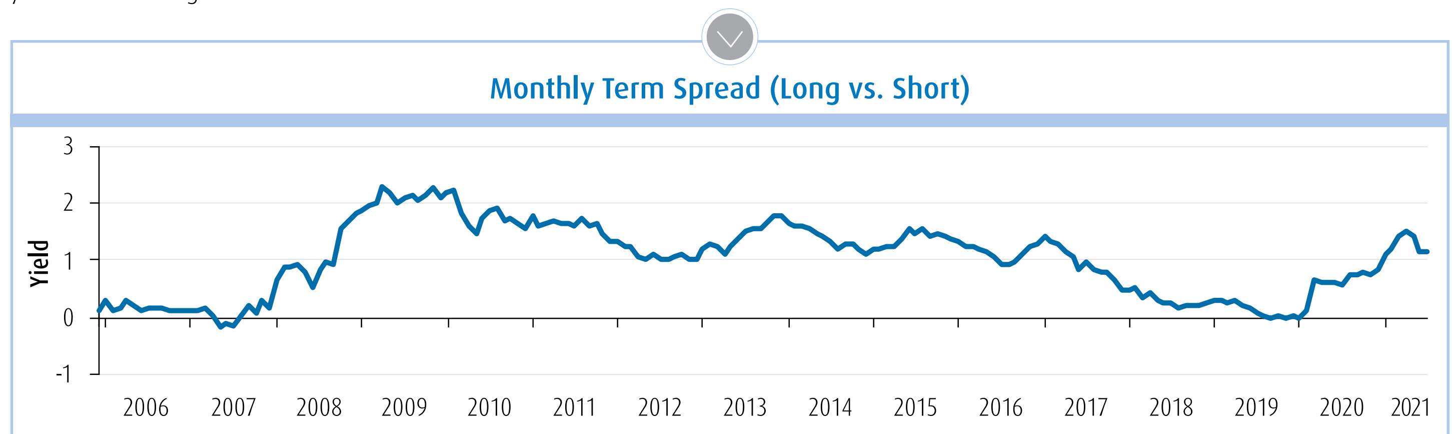
4. Yield Curve Shifts

When investors think about shifts in the yield curve, they often believe that the short, mid and long-term curve generally move in the same direction. Viewed over the long run we can see their relationship.



Source: Bloomberg as of July 30th 2021.

In reality, looking at shorter periods yield curves do not move in tandem with one another. Below highlights the difference in the yields of the long and short-term curves.



Source: Bloomberg as of July 30th 2021, using Canadian federal bond yield.

A. How do you anticipate that central banks will act this year? (Short-term view)

Certain central bank moves are priced into the market based on aggregate investor expectations.

In recent years, the market has become increasingly focused on monetary policy making bond yields more erratic as investors try to anticipate the next move of the central bank and the pace at which it will implement its policy. Additionally, the political environment is becoming more unpredictable, which further compounds interest rate volatility. With the duration of the overall Canadian fixed income universe having increased in recent years to 8 years, full market investors are increasingly exposed to longer duration.

Source: Bloomberg June 2021

A *hawkish view* would expect surprise rate increases and would therefore limit short-term bond exposure while at the same time recognizing that the economy would continue to expand, benefitting long-term bonds and credit. A *dovish view* would bias to short-term bonds and government bonds, based on flattening overnight yields and a slower economy.

Source: BMO Global Asset Management

Continued

B. What is your view on the economic cycle and inflation? (Long-term view)

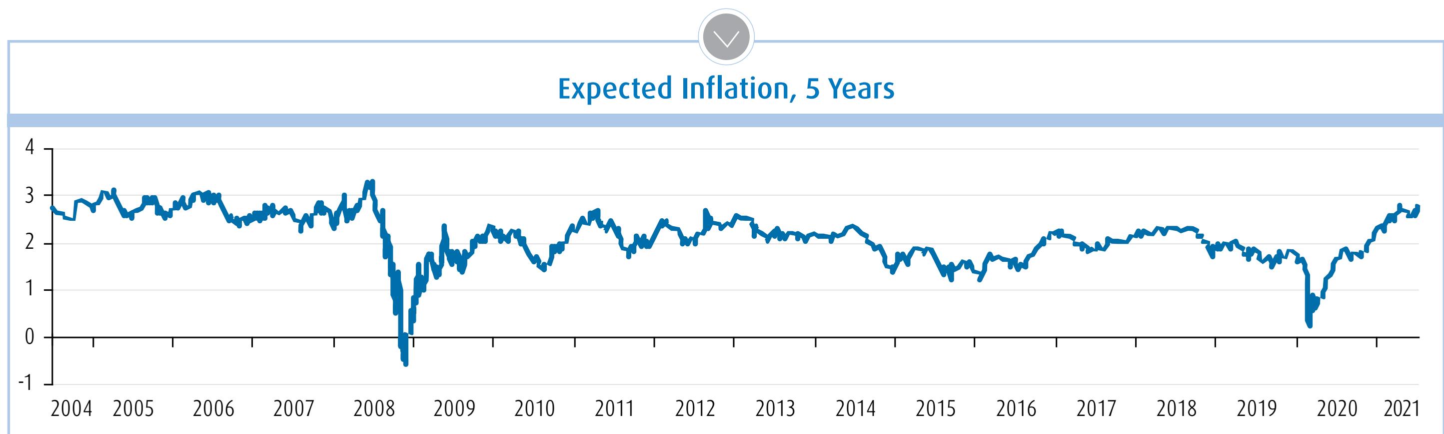
Positive investors would consider the lack of wage increases as an indicator of further expansion, and the high level of debt as a sign of a gradual unwinding of leverage. *Nervous investors* would feel that wage growth is around the corner as employment increases, that inflation is inevitable, and that the economy will continue to face challenges.

The unique nature of the COVID-19 recession, with stock markets reaching new highs as many small businesses struggle to survive, may have you wondering where we are in the economic cycle. Investor optimism is high to start the year, with equity, commodity and bond markets all pricing in a strong recovery yet there are still many unknowns.

While inflation has been muted in the last decade, it may become a growing concern as the year progresses. The Fed's policy shift to target longer-term averages of inflation rather than short-term is only one of the potential catalysts. Increased monetary stimulus, alongside a rise in energy, commodity and materials prices are also signaling a rise in expected inflation.

***Positive investors* will maintain credit exposure while potentially including some insurance via Federal and Treasury bonds. *Concerned investors* will reduce credit exposure, or at least improve the overall credit quality of their portfolio.**

Long term bonds are typically driven by economic and inflation expectations. Owing to the recent updates on vaccine development, and the optimism that comes with that, the yield curve has steepened with longer-term rates moving.



Source: Bloomberg as of July 30th 2021.

5. Other considerations?

Currency – investors typically concentrate on domestic exposures for fixed income, U.S. and global bonds can offer both diversification and currency return opportunities. Typically, investors will have a view on CAD/USD and can benefit from currency momentum. Keep in mind that adding currency risk can greatly impact the volatility of a fixed income portfolio.

Market exposure – while fixed income markets are generally correlated, as the actions of the U.S. Federal Reserve and U.S. economy have far reaching global implications, investors can still benefit from outperforming economies and understanding the sector differences across markets.

Black swan events – investors concerned about market confidence can consider adding U.S. treasuries as a flight to safety trade.

Income needs – investors needing extra income can consider a higher allocation to corporate bonds, high yield bonds, and preferred shares, understanding the different risk profiles of the exposures.

Inflation protection – investors concerned about inflation can consider Canadian real return bonds or U.S. TIPs bonds.

Pricing inefficiencies – investors may identify return opportunities or mispriced risk across segments of the yield curve, using precise exposures through short-term, mid-term and long-term ETFs.

Tax efficiency – investors in taxable accounts can consider ETFs that use derivatives or invest in lower coupon bonds.

A sample portfolio below follows this decision framework.

1. Active, passive or blend?

Investors will typically follow three paths: passive portfolios for confident investors or efficient market believers, mixed active and passive portfolios for less confident investors, and active portfolios for unsure investors, and enhanced global exposure.

Look to active blends
ZCPB: 40%
ZMSB: 40%
ZGSB: 20%

Look to broad exposures
ZAG/ZDB
25-40%

2. What is your level of conviction over the next year?

As investors we are fixated on the daily news, both for market impacts and for the entertainment of it all. We can't escape the daily headlines. A typical investor will have formed a strong view favouring satellites. An uncertain investor can leave the decision making in the hands of active professionals.

3. What is your view on the economy?

We see the headlines, but is bad news anything more than a speedbump? A typical investor favours corporate bonds, based on the yield pickup and continued economic growth.

Look to credit
ZAG/ZCM/ZHY
10-20%

Look to short-term
ZPS/ZTIP
10-20%

4a. How do you anticipate that central banks will act this year? (Short-term)

Central banks are set to spend 2021 maintaining their ultra-easy monetary policies with short-term rates not expected to rise until 2022 or 2023.

Source: Bloomberg June 2021

4b. What is your view on the economic cycle and inflation? (Long-term)

Long-term rates are rising as the curve steepens. You may still want some duration as equity volatility protection. A typical investor is split – Investors may feel we are entering a recovery phase, but how fast will it come? Is inflation a real threat, or will be be a slow burn?

Look to long-term protection with a currency overlay
ZTL/ZFL/ZTIP
10-20%

To view BMO's full suite of fixed income ETFs, click here for the ETF Roadmap

For BMO ETF Fixed Income solutions please visit bmoetfs.ca

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