BMO Exchange Traded Funds

Views from the Desk

Protecting a Bond Portfolio Against Rising Rates

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Over the last six weeks, bond yields have experienced a significant rise. As of March 23, 2021 the U.S. 10-year which is now 1.62% is 56bps higher than the end of January, while the Canadian 10-year currently sits at 1.49%, 60bps higher over the same period.

U.S. and Canadian Bond Yields Have Experienced a Significant Rise

Source: Bloomberg (March 23, 2020 to March 23, 2021)

The recent rise in bond yields has been due to a number of reasons:

- Growing optimism of an eventual economic re-opening which gained further strength in early February based on the real life efficacy rates of the Pfizer vaccine in Israel.
- Concerns about rising inflation/reflation risks caused by monetary and government stimulus, which is further exacerbated by supply/demand imbalances.
- Expectations of an eventual tapering of monetary stimulus and/or asset purchase programs by the U.S. Federal Reserve ("Fed").
- With low rates, investors have been forced out of cash and a steepening yield curve has forced investors to rotate from bonds to equities, causing a further steepening in the yield curve.

Year to date, the *FTSE/TMX Canadian Bond Universe* is down -5.0%, whereas the *S&P/TSX Composite Index* has gained 7.7%[1]. While we anticipate equities to outperform this year, the pace of decline in bonds and gains in equities will eventually moderate. This will likely be dependent on when the rise in bond yields starts to lose momentum, which can be caused by a number of the following reasons.

- Bond yields reach a level, where asset allocators see value and take risk off the table by rotating from equities, back into bonds.
- Yields move too high and to a level where it chokes off demand loans and mortgages, thus stalling the economic recovery. In which case the Fed likely intervenes, by flattening out the yield curve vis-à-vis an Operation Twist (buying less short-term bonds and more long-term bonds) without necessarily changing the size of its asset purchases.
- The vaccine rollout is stalled, delaying an eventual reopening, leading to a risk-off sentiment and a demand for bonds thus causing yields to regress lower.

[1]Source: Bloomberg (as of March 23, 2021)

One or a combination of these three aforementioned scenarios will likely cause the increase in bond yields to moderate at some point this year, which means that investors still need to have exposure to duration risk in a portfolio to offset a potential moderation of equities and provide overall stability. Over the shorter-term however, we believe yields will continue to rise and as such, investors can look for ways to mitigate the negative impacts of duration risk without eliminating it in a portfolio.

- Investors can maintain the majority of their bond portfolio in a core bond position like the BMO Aggregate Bond Index ETF (ZAG), while also reallocating some of their fixed income exposure to rate reset preferred shares and short-term U.S. TIPS (Treasury Inflation Protected Securities).
    - 85% BMO Aggregate Bond Index ETF (ZAG):
        - This provides investors with a core bond exposure. When yields eventually moderate, the duration exposure could provide a safeguard against equity market risk.
    - 10% BMO Laddered Preferred Share Index ETF (ZPR)
        - Rate reset preferred shares perform well in a rising interest rate environment, given their dividends reset to higher interest rates.
        - The asset class has undergone a structural change, which is favourable for the prices of preferred shares as issuers have been raising capital via Additional Tier 1 Capital bonds (AT1) and using the proceeds to redeem outstanding preferred shares at par value.
    - 5% Short-Term U.S. TIPS Index Hedged to C$ ETF (ZTIP/F)
        - By focusing on the short-term, investors avoid the duration risk that comes with longer-term U.S. TIPS.
        - By hedging currency, investors can isolate just the inflation component without the noise of currency.

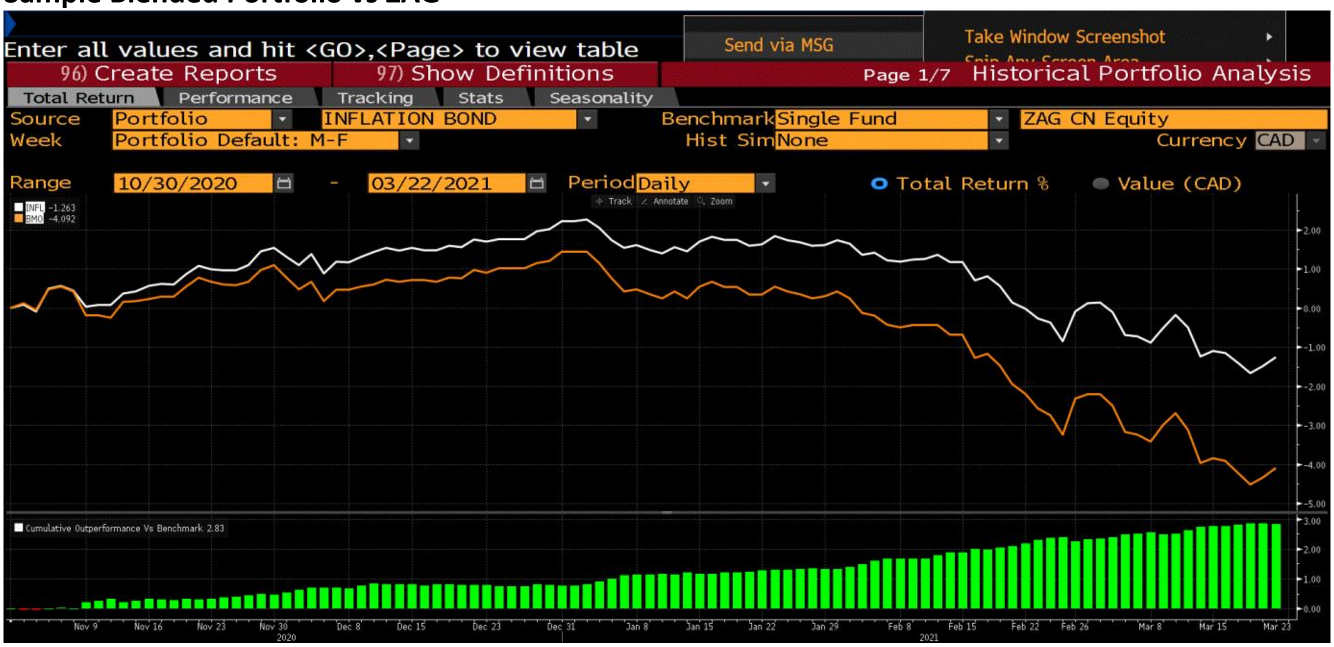
Sample Blended Portfolio

Ticker	Name	Weight	Fee	YTM	Duration
ZAG	BMO Aggregate Bond Index ETF	85.0%	0.08%	1.73%	7.93
ZPR	BMO Laddered Preferred Share Index ETF	10.0%	0.45%	5.00%	2.50
ZTIP/F	BMO Short-Term U.S. TIPS Hedged to C$ Index ETF	5.0%	0.15%	0.33%	2.72
	Portfolio	**100.0%**	**0.12%**	**1.99%**	**7.13**
	Difference vs ZAG		*0.04%*	*0.26%*	*-0.80*

Source: BMO Global Asset Management

Since optimism of an economic reopening gathered strength on the back of the Pfizer vaccine news in early November, the blended portfolio has been able to minimize the impacts of rising yields on fixed income.

Sample Blended Portfolio vs ZAG



Source: Bloomberg (October 30, 2020 to March 22, 2021)

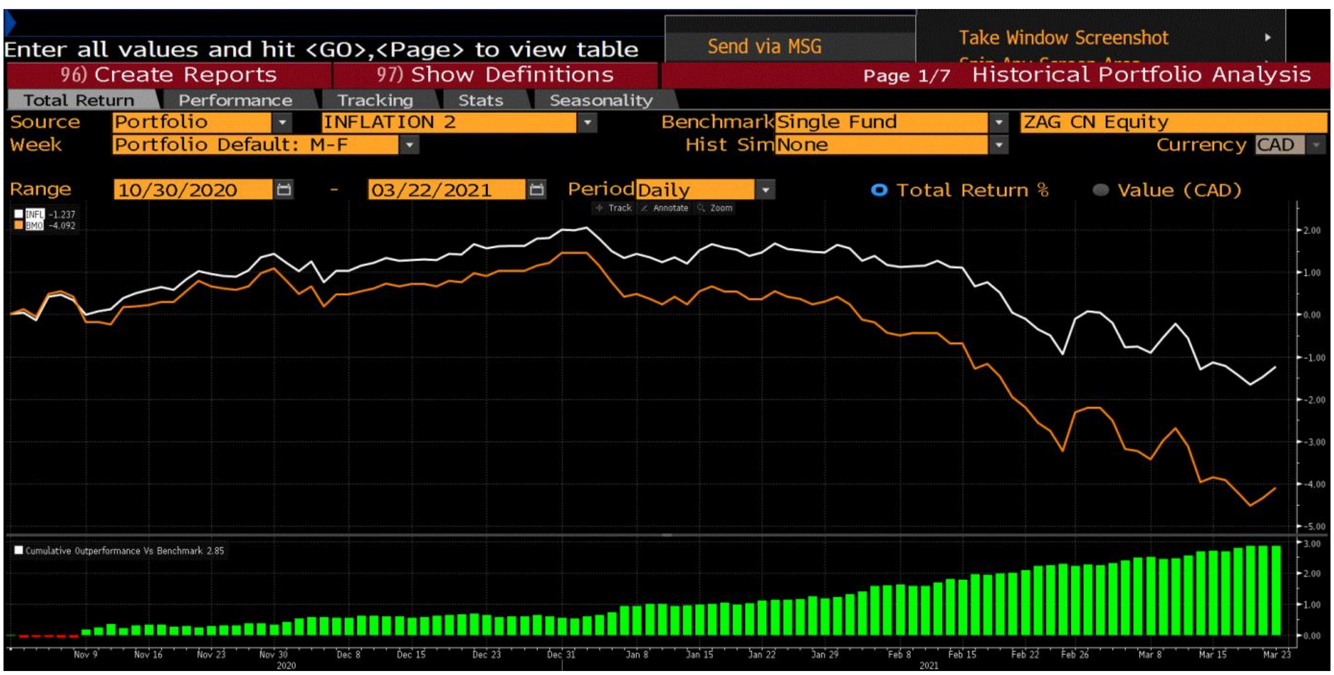
To further enhance yield, investors can re-allocate another 5% of a portfolio to the BMO Premium Yield ETF (ZPAY). While ZPAY is not a pure fixed income mandate and can hold equities, it is comprised of T-Bills, and simultaneously writes call and put options to collect option premiums. While ZPAY does not have a limit on equities, it typically holds between 25%-50% in equities during normal market conditions. This ETF allows for the blended portfolio to not only enhance yield but to further diversify its return stream.

Sample Blended Portfolio 2

Ticker	Name	Weight	Fee	YTM	Duration
ZAG	BMO Aggregate Bond Index ETF	80.0%	0.08%	1.73%	7.93
ZPR	BMO Laddered Preferred Share Index ETF	10.0%	0.45%	5.00%	2.50
ZTIP/F	BMO Short-Term U.S. TIPS Hedged to C$ Index ETF	5.0%	0.15%	0.33%	2.72
ZPAY/F	BMO Premium Yield Hedged to CAD ETF	5.0%	0.65%	6.30%	0.50
	Portfolio	**100.0%**	**0.15%**	**2.22%**	**6.73**
	Difference vs ZAG		*0.07%*	*0.49%*	*-1.20*

Source: BMO Global Asset Management

Sample Blended Portfolio 2 vs ZAG



Source: Bloomberg (October 30, 2020 to March 22, 2021)

Weight: is the allocation of a position relative to the entire portfolio.

Duration: is a measure of the sensitivity of the price of a bond or other debt instrument to a change in interest rates.

Yield to maturity (YTM): is the total return anticipated on a bond if the bond is held until it matures.

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