Assante
WEALTH MANAGEMENT

Assante Capital Management Ltd.
Member – CIPF

Janine Purves, CFP
Senior Financial Advisor

9130 Leslie Street, Suite 302
Richmond Hill, Ontario L4B 0B9

T: (905) 707-5220 Ext. 22
F: (905) 707-1035
Toll Free: 1-866-526-4636
E-mail: jpurves@assante.com

Fixed Income: What Can We Do for Income?

Written by Janine Purves, May 2011

At times of low interest rates and much uncertainty within the economy, many are having a hard time looking for Fixed income. How can you get some income flow, yet not take the risk of the equity markets.

Those that are drawing income from their investments are very challenged in continuing to look for other options. As our markets and products evolve, items do come that provide options, however, it's always important to recognize, no matter what, there are never any guarantees.

With the changes of the markets of late, it's important to recognize the nature of the risk of each investment. Its' also important to recognize the potential for growth and loss. Last, ensuring you help to keep up with inflation is a newer challenge. While we're told, it's still in the 2-3% range, many of us believe that the true inflation rate is higher than that.

First, let's understand how bonds work in increasing rate environments. Many are fearful that bond values will drop when interest rates go up, and this can be true in the short-term, but not when held to maturity. Let me explain. There is an item worth $100 that pays 5% interest maturing in 1 year. If the interest rate goes up to 6%, you do not want to pay $100 for this same item. You would be willing to pay approx.. $99 for this same item, so it can yield you 6%; the 5% interest it pays plus the $1 you would earn between now and maturity. This is simplified, but it identifies the challenge with the bonds as they trade based on where interest rates are now and where they are trending. The reality is if somebody already owns the bond, the purchase price is important and the income flow it is generating, and the maturity. Like stocks, bond prices can fluctuate in between.

The industry is shifting, and indexes and funds, while not preferred many years ago, may offer good value. The way the bond market is shifting, and the overall size (it's very large, about 10 times the size of the stock market), actually means that when purchasing an individual bond, you often pay a much higher premium than a pension fund or manager that is purchasing this same product in the millions. This challenge is even more difficult when yields are at low levels as we see now. There is little room for additional costs.

How can you find income ideas to complement your portfolio?

First, ensure you are on track and know what fixed income proportion you should have. While fixed income is generally more stable, it seldom grows at the same long term rate of equities.

Second, keep in mind that cashflow needed for 1 year should be in a very low risk income item, such as GIC's, or high interest savings. I generally recommend up to 2-3 yrs in lower-risk items so there is little market risk for the shorter-term money.

Third, look at income flow and what you need, and how some beyond the immediate can be achieved by different complementary items.

Here are some ideas that can be considered as "fixed income complements".

Many new fixed income indexes are available. ETF's (Exchange traded funds) are generally low cost and the fixed income market has expanded tremendously in this area of late. Here are some areas of interest. Please recognize each brings it's own risk and all ideas should be discussed with your financial advisor.

Short-term High Yield index by Claymore. CSB. This offers exposure to "higher-yielding bonds, but those that mature within 1 year". This keeps the risk lower than traditional high yield bond options because the maturity date is so close. Please keep in mind that high yield bonds tend to bring more volatility than traditional government bonds, and should be purchased with caution.

There are also Real Return Bonds. These are bonds that increase the rate they pay as interest rates rise. The benefit here is that the price and yield will tend to keep up with inflation. Therefore, in the ideal situation, the market value of the bonds stays more level. However, this is one case where supply is quite limited, and therefore, the price tends to fluctuate more, especially in the past year.

Newer opportunities now exist in Emerging Market Bonds. This is an area that had virtually no opportunities for investors in Canada until the past year. We think of emerging markets as more risky, but most bonds held in these options are "investment grade" and the average yield of most of these indexes and funds is in the 6-7% range. It's very important to recognize that when investing in global opportunities there will be fluctuation due to currency. Therefore, if currency valuations are not hedged, then additional volatility may be experienced. Today, in Canada there are 3 Emerging Market Bond ETF's, and a number of Emerging Market Bond mutual Funds, including AGF, Trimark and RBC.

Another area that's recently entered the markets, is the Floating Rate Income funds. Currently, there are 3 offered on the market, and they focus on holding loans that are based on a floating rate interest. Periodically, these loans are re-priced as interest rates change. The benefit here is as rates go up, so does the interest collected on the loan, thereby offsetting the standard price depreciation. Here the challenge is supply. This is a more common investment option in the US, and really only recently took hold in Canada, with Manulife, Trimark and Guardian offering this type of exposure.

Other areas that are traditionally considered equity that can help offset low fixed income yields are "Infrastructure", REIT's, and Preferred shares. Each of these has strong income flow for equities, and historically has been less volatile than traditional stocks, but offers it's own challenges. Preferred shares can also depreciate with increasing rate environment. Also, most of the preferred shares on the market today, are perpetual. This means that they may never have a maturity or "call-in" date. They can offer better tax treatment, as the income is usually paid in dividends, but this must be reviewed along with the rest of your portfolio. Real Estate, while desirable, some believe is pricey. Infrastructure has already had a good run, but has proven stable through many more volatile periods and the better than average income flow often helps. Never forget that history may not be repeated and volatility comes when we least expect it.

REIT, Real Estate Income Trusts are the one trust unit that still has preferential tax treatment, but while it has good income these areas have also had a good run, and can bring considerable volatility as well.

There will always be new ideas, but the challenge is to ensure you have the best balance for you and get the income you need to live the life you want!

Janine Purves, CFP, CSA a Senior Financial Advisor with Assante Capital Management Ltd., works with individuals and business owners in wealth creation and management. Assante Capital Management Ltd. is a member of the Canadian Investor Protection Fund and is registered with the Investment Industry Regulatory Organization of Canada. This material is provided for general information and is subject to change without notice. Insurance products and services are provided through Assante Estate and Insurance Services Inc. For future questions about this article, or a complementary copy of "Retirement Stress Test" contact Janine at (905)707-5222 x22 or e-mail jpurves@assante.com.