

## Managing for Rising Interest Rates

By Ric Palombi, CFA

*Portfolio Manager Fixed Income*

Everyone is vulnerable to inflation and higher interest rates to some degree. The closer you are to retirement and the more your investments are geared to generating income, the more sensitive you will be to erosion of income and purchasing power caused by inflation and rising interest rates.

Most Canadians will be aware that Bank of Canada Governor Mark Carney has warned several times in recent weeks that:

1. Interest rates have nowhere to go but up; and,
2. Current rock-bottom rates cannot be maintained if and when a global recovery begins to drive inflation.

As the man with his finger on the trigger of the interest rate gun, Carney's warnings certainly carry weight. And this leaves investors to wonder how they should respond.

### Bond Market in a Transition Phase

Wheat prices are rising, corn prices are near all-time highs and North Sea Brent crude oil is approaching \$100 per barrel. Headline inflation, the inflation metric that includes all essential goods and services, is trending upward. Meanwhile the core inflation rate, which strips out the most volatile prices and on which governments base central-bank interest rates, is holding fairly flat - so far. But as the cost of commodities rise, the core inflation rate and prime interest rate are bound to be pushed upward as well.

Current prices show that the bond market is now in a transition phase in which experts are expecting central banks, sooner or later, to raise interest rates in order to damp down inflationary pressures. Inflation is still tepid, but investors are starting to move to protect their money. Various indicators show that some 65 basis points (0.65 per cent) of inflation have already been priced into market expectations.

Three-year, fixed rate government bonds are now yielding about two per cent. But some floating-rate corporate bonds, which are geared to interest rates and which had been paying 1.5 per cent, are now offering closer to a 2.15 per cent yield. Purchased now, and with proper credit analysis on the corporate issuer, floating-rate bonds represent discounted protection against potentially higher interest rates and inflation in the future.

Real return bonds (RRBs) also protect an investor's portfolio against future inflation. Pegged to headline CPI (Consumer Price Index), which includes both food and energy, RRBs ensure your purchasing power is maintained, regardless of the future rate of inflation. And this inflation protection applies to both interest and principal.

### Your Hedge Against Inflation

The answer to the question of when to hedge is - now, before inflation is upon us in force. If you have a portfolio with a typical 60%/40% split between stocks and bonds, it's likely that close to 40 per cent of your portfolio is fixed-income products vulnerable to any inflation and interest rate rise. And if rates start going against you, your capital and your purchasing power will be compromised.

Accordingly, McLean & Partners has been prudently buying floating rate preferred bonds and floating rate preferred shares for some time, building in protection for clients from inflation and higher interest rates.

	<u>1 Year</u>	<u>2 Year</u>	<u>3 Year</u>
McLean & Partners Bonds	7.11%	13.42%	7.06%
DEX Universe	4.35%	6.35%	5.81%
McLean & Partners Preferred Shares	13.93%	26.72%	13.91%
S&P/TSX Capped Preferred Share Index	8.98%	15.55%	4.67%

Source: RBC Dexia, to Jan 31/2011

### In Summary

Active management is a key part of protecting a bond portfolio from inflation and other market conditions. We employ different methods (such as credit analysis and interest rate anticipation) and respond proactively to macro economic changes and market conditions to position client portfolios for an optimum risk/reward balance.

If your portfolio has bond exposure you may very well benefit from a review and second opinion. Feel welcome to contact us at (403) 234-6103.

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