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# Keys to Success in the Fixed-Income Market

BY RUSS MACKAY

*How to outperform the market with less risk.*

Investors with cash on hand, either as they approach retirement or for reasons such as a major asset sale, will be looking for investment performance from the fixed-income market.

McLean & Partners is ranked number one bond manager in Canada over the last nine year period, and we share three key elements for success when it comes to fixed-income investing.

## **An Active Approach**

The first key to success in fixed-income investing is taking an active approach to managing your portfolio.

Bonds offer a fixed coupon yield) over a fixed number of years (term). But as the economy goes through cycles, the market price of a bond fluctuates, based on changes in interest rates and resulting investor sentiment, offering yield-to-maturity and total return.

The fluctuating market price of the bond, compared with its yield to maturity, provides an indication of whether it should be held or sold, and its ultimate performance. Since the price is affected by both interest-rate movements and the credit quality of the issuer, better success occurs if you can anticipate rate and credit-quality changes and actively adjust your portfolio; in advance. To account for interest-rate movements, you will want to shorten or lengthen the duration of your bonds.

If you expect short-term interest rates to rise, like what happens when the Bank of Canada wants to cool down a hot economy, then you would prefer to move out in term. This move reduces exposure to interest rate increases that would make short-term bonds with their fixed rates significantly less valuable. Remember that when interest rates rise, bond prices decline.

Conversely, when the economy begins to slow down, and governments are expected to move short-term interest rates lower, shifting to longer-term duration is warranted because this is when prices for those longer-term bonds with higher yields will increase.

Credit quality also plays a role in maximizing opportunities. Investment grade bonds are rated from BBB to AAA+. The highest ratings go to bonds issued by governments and government agencies, followed by corporations. The highest interest rates go to the lowest-rated bonds, in order to compensate for risk.

When the economy is in expansion mode, there is less perceived risk in the market generally, and a smaller interest rate differential ('spread') between grades of bonds. When spreads are expected to narrow, it may be advantageous to acquire bonds issued by corporations with the best fundamentals. These pay higher rates with only modestly increased risk and their prices are likely to rise.

Generally, when a downturn is expected and spreads can be anticipated to widen, active investors should move to higher-rated government and corporate bonds. Moving ahead of the market gives a bondholder exposure to the price increase.

It is also important to note that a bond issuer's rating may change. Whether it is a government or a corporation, changes in that entity's credit worthiness will affect its future bond price and, ultimately, the opportunity for return to investors. This makes it important to monitor the credit ratings of all the issuers in a portfolio.

Rule # 1 – adjusting your bond portfolio in advance of interest rate changes and credit quality changes can improve your success in fixed-income investing.

### **Types of Products**

Companies and governments issue a variety of fixed-income investments, depending on conditions in the market and their own borrowing needs. Governments and corporations issue fixed-yield bonds, as well as floating-rate bonds tied to interest rates and real-return bonds that provide a return tied to the rate of inflation.

Banks and corporations issue fixed- and floating-rate bonds, perpetual bonds and preferred shares. They also offer derivatives such as asset-backed securities, mortgage-backed securities and commercial mortgage-backed securities, all of which link returns to certain market fundamentals.

Market prices of all these fixed-income securities fluctuate constantly in reaction to world events and economic realities and only active portfolio managers can consistently capture these opportunities.

Rule #2 - Balanced portfolios need a judicious mix of fixed-income securities, and that mix must be continuously adjusted ahead of changes in the market.

### **Access to Opportunities**

The final key to success in fixed-income investing is access to the right opportunities. Unlike stocks, there is no 'big board' for bonds. Instead, there are trading desks overseen by human beings. When they have a new issue to sell, they call institutional investors first, often times selling out completely before opening up to retail investors.

Equally importantly, each major brokerage firm has its own bond department, and retail investors with such firms are typically limited to the inventory flowing through their brokerage.

The key to ensuring that you are well connected to the important gatekeepers of opportunity is to invest through an independent firm with strong connections to multiple trading desks.

Rule #3 - The more independent the investment firm and the wider its network of relationships, the better your access to opportunities.

### **Summary**

Bonds can be purchased and held to maturity, and that's sometimes the best course of action. But it's not a complete strategy for fixed-income investing. These supposedly passive investments are actually where the greatest vigilance is called for and where an active approach is most vital to protecting and building wealth. For the individual investor, this means success lies in choosing an investment counselor or wealth manager who is simultaneously well connected and independent and who is committed to the depth of analysis necessary to support an active approach to the market. There are an abundance of opportunities in fixed income for those willing to invest the resources necessary to outperform the market.

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