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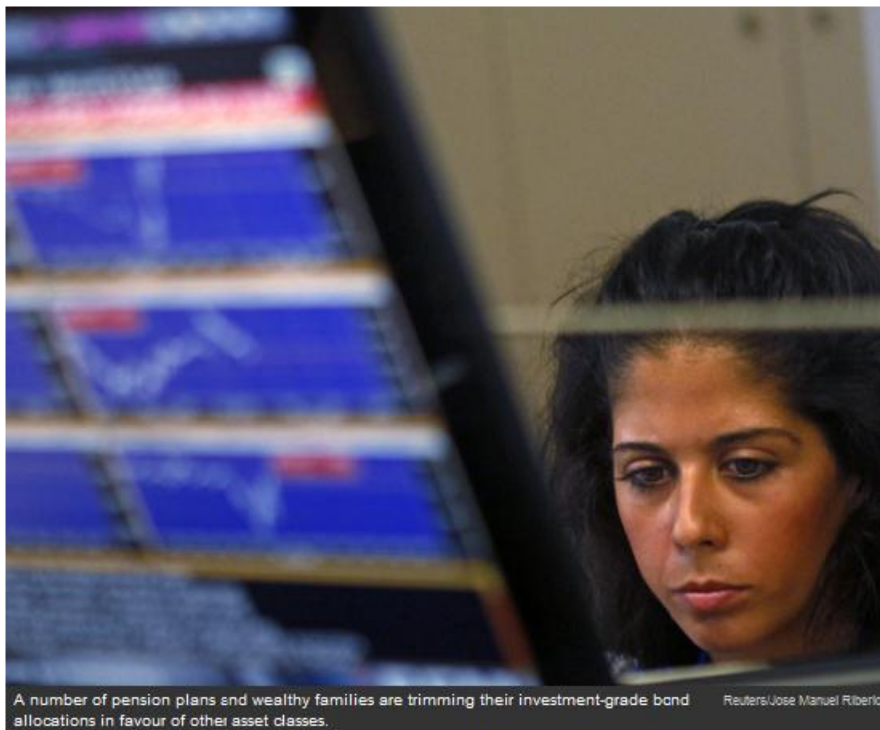
Why wealthy investors are cutting back their bond holdings

Michael Nairne, Serious Money



A number of pension plans and wealthy families are trimming their investment-grade bond allocations in favour of other asset classes. Reuters/Jose Manuel Riberio

Month after month, investors have been dumping their equity funds and loading up on bond and balanced funds. Who can blame them? Since late 2007, stocks have given them the rollercoaster ride of a lifetime, at the end of which the S&P/TSX Composite and S&P 500 produced average annual returns of -0.3% and 1.4% respectively. In comparison, Canadian bonds earned a comforting 6.7% per annum (based on the DEX Universe index).

Yet, at a recent institutional investors' conference, a number of pension plans and wealthy families reported that they were doing the opposite — trimming their investment-grade bond allocations in favour of other asset classes. Unlike many retail investors whose knee jerk reaction is to stampede into the most recent strong-performing asset class, sophisticated investors are more analytic. Here are the key ideas behind the move from bonds:

Get real Thoughtful investors avoid what behavioral finance experts call the "money illusion" — the tendency to think of money in nominal rather than inflation-adjusted or real terms. Today's 10-year Canada bond with a yield of less than 2% is actually offering a slightly negative yield once you net out the Bank of Canada's targeted inflation rate of 2% per annum.

Take a long-term view No one has a crystal ball when it comes to short-term performance. However, history offers insight into the prognosis for longer-term bond returns. Over the past 140 years, low bond yields have always led to subsequent low bond returns.

With current bond yields at dismal levels not seen since the Second World War, long-term return prospects for bonds are modest. The only exception is a scenario of Japanese-like deflation and falling rates, which, at this point, is relatively unlikely. Earlier this year, the Vanguard Investment Strategy Group estimated that the odds of interest rates rising over the next decade versus remaining stagnant or declining were about 4 to 1.

Avoid taking too much risk for too little return Many investors are unaware that as yields have fallen, the reward-to-risk ratio for bonds has plummeted. In January 2000, a 10-year Canada bond yielded approximately 6.5%, while its duration, a measurement of its price sensitivity to interest rate changes, was about 7.0. At this duration, if interest rates rose by 1%, the price of the bond would decline about 7%, but this price loss would be offset over the subsequent year by the 6.5% yield.

Today, a 10-year Canada bond yields approximately 1.8% and has a duration of 8.4. A 1% increase in interest rates will result in a price decline of more than 8%, after which it will take more than four years for an investor to recoup his losses. That is a long, long time to just break even.

Sadly, many retail investors are unaware of the relationship between interest rates and bond prices. A survey in the United States found that only 28% of respondents correctly answered the question "If interest rates rise, what will typically happen to bond prices?" Of the respondents, 37% said they didn't know, 10% stated there was no relationship, and 18% erroneously thought bond prices would rise if interest rates rise.

Beware of that tax drag Today's low interest rates result in excessive taxes on bonds held in non-registered accounts due to the mismatch between the tax treatment of coupon income and capital losses on bonds bought at a premium to face value.

Know that inflation can pound bonds Inflation during and after the Second World War shattered the real returns for bonds. From 1940 to 1981, U.S. intermediate term bonds suffered a cumulative real loss of over 40% from chronic inflation.

High-quality bonds play an important role in a portfolio since they act as both an anchor of stability and a deflation hedge. No one should abandon this important asset class. However, many investors may want to trim their allocations to avoid coming down with a future case of the "bond blues."

-Michael Nairne, CFP, RFP, CFA, is the president of Tacita Capital Inc., a private family office and investment counselling firm in Toronto. Visit tacitacapital.com