INVESTMENT EXECUTIVE
CANADA'S NEWSPAPER FOR FINANCIAL ADVISORS

Corporates' rich returns

Is the risk versus governments worth it?

December 2011 Print Edition

By Michael Nairne

With interest rates on government bonds at levels not seen since the Second World War, many financial advisors are assessing investment-grade and high-yield corporate bonds for their clients' portfolios. In turn, the research team at Tacita Capital Inc. has reviewed research on corporate-bond performance and analyzed several bond indices.

IG and HY corporate bonds possess a broader spectrum of risks than seen for Canadian government bonds, primarily related to interest rate and reinvestment risks, including credit spread, downgrade, default, call, liquidity and issuer risks.

For these risks, IG and HY corporates offer a higher yield. From January 1987 through October 2011, the BarCap U.S. Corporate IG and BarCap U.S. Corporate HY indices had average annualized yields of 6.9% and 11.1%, respectively, vs the 5.3% annual yield of the BarCap U.S. Treasury index. This works out to yield premiums of 1.6% and 5.8%, respectively; it is these yield premiums that can be so tempting.

Investors, however, don't fully earn these yield premiums. Credit downgrades or higher spreads, if accompanied by sales, or actual defaults and credit losses can result in capital losses that erode much of the premiums. During the same period, the annualized returns of the BarCap U.S. Corporate IG and BarCap U.S. Corporate HY indices were 7.7% and 8.5%, respectively, vs the

6.9% annual return of BarCap U.S.Treasury index. The realized return premiums for IG and HY bonds — 0.8% and 1.6%, respectively — were materially lower than the corresponding yield premiums.

A study covering both IG and HY non-financial corporate bonds in the U.S. from 1866 to 2008 found that the average annual default rate was approximately 1.5% of the par value of bonds. Net of recoveries on liquidation that ran about 50% of par value, annual credit losses were approximately 0.75% per annum. Corporate defaults clustered in specific periods, particularly after technology-induced booms. The soaring default rates of railway bonds in the 1870s and telecommunications bonds in the past decade are examples.

Moody's Investors Service Inc. estimates similar annual credit losses of about 1% of rated issuers from 1982 to 2010. However, IG bonds have dramatically lower credit losses than HY bonds. Annual credit losses for IG bonds averaged a minuscule 0.06% vs 2.78% for HY bonds.

Credit losses on Canadian corporates are similar to those seen in the U.S. A study covering 1980 to 2005 found no losses on AA- or A-rated Canadian corporates and only a 0.5% annual loss on BBB-rated bonds. A study covering 1989 to 2003 found credit losses in Canada and the U.S. are generally the same in both categories.

Overall, investors in Canadian corporate bonds have been rewarded. Since 1998, according to BoA Merrill Lynch indices, one- to 10-year Canadian IG and Canadian-issuer HY bonds have had annualized returns of 6.1% and 7.1%, respectively, vs the 5.5% return of one- to 10-year Canadas.

Keep the risks of corporates in mind when evaluating current yields. Diversification is critical. This can be achieved through a variety of exchange-traded funds covering various spectrums of the Canadian IG market. Only actively managed funds are available in the HY market. **IE**

Michael Nairne is president of Tacita Capital Inc. of Toronto, a private family office and investment counselling firm. The firm, its principals, employees and clients may own securities mentioned in this article.