INVESTMENT EXECUTIVE
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Tactics for boosting yield

Advisors should be aware that some products could introduce more risk into client portfolios

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Today's abysmally low interest rates and incredible market volatility have sent many financial advisors on the hunt for yield in a variety of fixed-income and equities investment vehicles.

The pursuit of higher yield, however, can easily introduce new risks into a portfolio that are masked until changing economic or monetary conditions trigger their appearance.

With short-term bonds offering paltry yields in the 1%-2% range, some advisors are extending maturities to improve yields. This, however, adds interest rate risk to portfolios.

Although this risk has been well rewarded over the past few years, as interest rates have declined to levels not seen since the Second World War, rates also can move upward.

This heightened risk is evident in the comparison of drawdowns in 1994, when interest rates surged upward. Whereas the DEX short-term bond index dropped by 6.1%, the greater interest rate risk of the DEX mid- term and long-term bond indices led to losses of 12.2% and 16.4%, respectively.

This greater risk is also manifested in the frequency of drawdowns. Since December 1979, Canadian short-term bonds have had only one drawdown in excess of 5%, while mid- and long-term bonds have had six and seven such drawdowns, respectively.

Another tactic for increasing yield is to shift from Canadian government bonds into Canadian corporate bonds. The DEX all-corporate bond index is currently yielding slightly more than 3%, which is more than one percentage point higher than the DEX all-government bond index.

Yet, with the DEX all-corporate bond index's weighted average duration approaching six, that index incorporates almost as much interest rate risk as the government bonds. And Canadian corporate bonds do not provide the same level of portfolio diversification as do government bonds.

It's also worth noting that in the second half of 2008, Canadian government bonds had a return of 6.4% while corporate bonds lost 1.4%.

Advisors stretching into the high-yield bond market for returns should be aware these bonds have a meaningful component of equity-like risk. This results in a much higher correlation to the equities market than investment-grade bonds, greater volatility and larger drawdowns. Over the past 14 years, the Bank of America Merrill Lynch high-yield Canadian issuers index had a 0.42 correlation with the S&P/TSX composite index, almost twice the 0.22 correlation of the investment-grade DEX universe index.

Canadian high-yield bonds were more than twice as volatile as investment-grade bonds over the 14-year period and suffered three drawdowns in excess of 10%, with the worst a 15.9% loss from August 2008 to January 2009.

Canadian preferred shares, which sport both higher yields and tax advantages, have become another hot asset class. Yet, preferred shares are really a hybrid debt/equity instrument. With a correlation and volatility profile similar to high-yield bonds but with a pronounced financial-sector exposure, the S&P/TSX preferred share index endured a 27.9% drawdown from March 2007 to November 2008.

Stocks with high dividend yields are also another popular recommendation. These stocks are no panacea — the Dow Jones Canada select dividend index has still seen about 80% of the volatility of the overall market in the past six years and had suffered a drawdown of 33.8% during the credit crisis. This index also has underperformed the overall market on both an absolute and a risk-adjusted return basis.

Advisors stretching for yield may be adding new risks to their clients' portfolios, and it is important that they communicate this clearly to their clients. **IE**

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