Managed Investments

Investment Manager Research

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Finding Yield in a Low Yielding World

Fixed income still has a role in a well-diversified portfolio and Canadians have typically sought exposure to fixed income within the domestic bond market. However with Canadian yields at very low levels, investors are increasingly looking outside Canada's borders for incremental yield in the current low yielding world.

To better understand where yield opportunities can be found in fixed income, we asked several fixed income management teams to provide their perspective on fixed income markets and where they see opportunities. The firms that we spoke with were **TD Asset Management (TDAM), Pacific Investment Management (PIMCO), Manulife Asset Management, Signature Global Advisors, Phillips Hager & North (PH&N), Dynamic Funds and Fidelity Investments Canada.** The information provided by the investment managers are reflective of their opinions as of the date of the article and are subject to change.

Unless otherwise indicated the comments provided were from the firm's investment team.

In the current environment, where do you see yield opportunities in fixed income?

TDAM: Now is not the time to reach for yield in the portion of the portfolio that should provide diversification and stability. Central banks remain accommodative, and investors' belief in the liquidity and support they are providing has driven asset price growth. However, if investors lose confidence in central banks' ability to effect meaningful change, a risk-off sentiment would likely take hold, leading to increased investment in perceived safe-haven assets such as government bonds and the U.S. dollar. We do see some opportunities for yield pick-up in high-quality investment grade bonds. While absolute yields are very low, investment grade spreads over government bonds are reasonable. High yield bonds have seen spread widening driven by widening in the energy sector and select pockets of stress. We anticipate default rates to rise particularly in commodity sectors and are concerned with the potential for limited liquidity in high yield. However, we have been cautiously adding to select positions in non-commodity related bonds that have sold-off alongside commodity related issues. We would stress that a selective approach would be required, and position sizing should reflect the current backdrop for high yield.

Dynamic (Michael McHugh): Mitigating volatility from yield moves or deteriorating credit quality allows us to focus on reducing capital losses and diversifying our sources of return to generate a reasonable stream of income for our investors, net of all fees, despite the low yield environment. With this in mind we are looking to buy more high-quality investment grade issues since spreads have increased. They are better able to weather expected increases in volatility with better liquidity and protection as compared to lower rated issues. We are also maintaining positions in select BBB-rated issuers as spreads have increased due to heavy BBB supply.

Fidelity: The investment team's fundamental outlook for the U.S. economy along with the U.S. high yield market remains positive. The team expects to see slow growth across the developed economies with little inflationary pressure, which should enable margins and profitability to continue to grow. The team expects heightened volatility around risk asset classes to continue over the course of 2016 due to uncertainty around a slowdown in China, weak emerging markets, investors' lack of confidence around economic and market policies globally, and geopolitical tensions. The major risk the team will be monitoring closely is how any or all of these factors could lead to a fundamental slowdown in the U.S. economy.

Manulife (Dan Janis): It is our view that higher volatility will continue into the first part of 2016 across all asset classes (fixed income, equities, commodities, and foreign exchange) as markets digest the first rate hike by the U.S. Federal Reserve and low commodity prices continue to put pressure on certain sectors of the credit markets. We continue to embrace credit risk in the portfolio but have been de-risking and reducing our non-investment grade corporate exposures, recognizing that sector, quality and issuer selection are more important factors today than they were earlier in the credit cycle. Also, we have been adding to our commercial mortgage-backed, asset-backed and municipal bond exposure, which provides diversification away from pure corporate risk. We are being selective in our emerging markets exposures, recognizing that there will be wider performance deviations across countries, qualities and currencies moving forward.

PIMCO: Two things are very important regarding an income strategy. One is investing in assets that will generate attractive income that we think will perform well if economic growth is stronger than expected. Another is investing in assets that we believe will provide some good downside protection if economic growth is weaker than expected. In the higher yielding component of the portfolio, the asset class we find to be most attractive is U.S. non-agency mortgage-backed securities due to their reasonable yield and potential capital appreciation if housing prices go up by more than expected. In the higher quality part of the portfolio, we view Australian interest rate duration to be attractive and providing the portfolio with some downside protection. We think that there is potential for a slowdown in Chinese growth, which could be negative for commodity prices, leading to slower growth in Australia and prompting its central bank to lower interest rates.

PH&N: Our continual re-evaluation of potential return-for-risk is integral to portfolio positioning as the market cycle advances. Our risk budget favours high quality credit strategies that have been reliable contributors to value added over time. Between provincial bonds and high-quality investment grade corporate bonds, our preference remains tilted toward provincial bonds due to their attractiveness from a reward-for-risk standpoint. Within provincial bonds we have a preference for mid- to longer-term Ontario securities. Within corporate bonds, we continue to have a more defensive bias. An emphasis on high quality credit strategies remains a key driver of the portfolio's yield profile compared to that of the benchmark. Even if interest rates were to stay at low levels for a prolonged period of time, the extra yield from credit strategies should be a helpful tailwind for future performance.

Signature: Yield opportunities in today's markets are becoming selectively available. The markets are still relatively liquid, with opportunistic investors succeeding with lower bids as sellers capitulate. One area where we are seeing liquidation-type activity is in "fallen angels" – commodity bonds that have been downgraded from investment grade. These bonds are entering the high-yield bond market at low prices, and there are some interesting trading opportunities as we expect that future returns will be driven more by price action than by yield.

What is your outlook for fixed income and return expectations for your fund over the next 12 – 18 months?

TDAM: Accommodative central bank policies and strong investor demand have combined to depress bond yields to very low levels. We expect bonds will deliver coupon-like returns, with lower volatility than equities. However, we believe bonds have a role to play in investor portfolios offering significant and essential diversification. Corporate bonds offer a yield advantage that can provide investors with income, and government bonds provide diversification and stability.

Dynamic (Michael McHugh): We expect bond yields to remain historically low, around levels defined over the last three years. Looking forward we expect high levels of volatility in the bond market linked to valuations, liquidity and investor sentiment in response to unfolding economic, policy, financial and credit conditions. We would expect investor sentiment towards fixed income to be negatively impacted should yields or credit spreads rise enough to generate capital losses.

For investors who place a priority on reducing downside risk in their bond portfolios it will remain important to be aware of valuations and the level of risk embedded in their bond holdings. We expect there will be periods throughout the year to increase portfolio risk, both duration and credit exposure, at better valuations. A dominant theme guiding investment strategy will remain higher quality and liquidity.

Fidelity: Valuations for the high-yield market have become attractive, with spreads at levels the market hasn't seen since the summer of 2011. The investment team is currently finding good investment opportunities in the energy sector providing that care is taken in selecting companies that have strong balance sheets, low leverage and consistent earnings growth to ensure that ample liquidity is available. Specifically, the team believes that pipeline and refinery companies whose earnings are less dependent on the price of oil but rather on the volume of flows are well positioned to add relative value when oil prices start to stabilize. This combination of better than average fundamentals and attractive valuation means high-yield is setting up for a positive 2016 with the potential for mid to high single digit returns but with higher than average volatility. Given that most of the high yield market trades in U.S. dollars, investors may want to consider using currency neutral versions of funds for their high yield investments.

PIMCO: Speaking to Canadian investors, what they earned in high quality fixed income is basically the yield on the securities. The yield on a five-year Government of Canada bond is around 60 basis points and on a 10-year it's around 1.1 percent. So we think that a reasonable return expectation in Canadian fixed income is low single digits. Broadening out the opportunity set to include the entire fixed income universe and giving an active manager the flexibility to tactically allocate during different market climates can help improve an investor's risk-adjusted return.

PH&N: We continue to forecast sluggish but positive economic growth despite a volatile market environment. While we expect a low-for-longer yield environment to persist, we continue to forecast moderately higher government bond yields over the medium term, a view that is not materially different from that which is implied by bond market valuations. We are positioned with a modest short duration bias relative to the benchmark to protect capital if interest rates were to rise. Interest rates are expected to remain volatile over the near term; therefore, we will remain tactical in adjusting duration and positioning across the yield curve as interest rates fluctuate.

Manulife (Dan Janis): We anticipate that the U.S. economy will continue to grow at a moderate pace in the year ahead, outperforming most of its developed market peers. We believe that Treasury yields will rise over time, however, external factors, such as foreign economic growth, monetary policies and relative yield levels across developed markets, may keep long-term rates in the U.S. lower for an extended period of time. Across Europe, China and Japan, we would expect further easing policies in 2016 to bolster growth and attempt to increase inflation, which remains below target levels in most parts of the world. Given the absolute level of yields, we would continue to maintain a slightly lower duration bias.

Signature: Global growth expectations have continued to trend downward on the back of concerns emanating from China and commodity-based economies. Although the U.S. Federal Reserve (Fed) raised interest rates by 25 basis points in December, the market does not believe that the Fed will raise rates four times in 2016. Most bond investors believe the U.S. and global economy is too weak for the Fed to raise rates at its indicated pace, and developed market benchmark 10-year yields are in decline.

We believe we are closer to the end of the sell-off in corporate credit than the beginning. With low prices and high spreads, outside of another financial crisis akin to 2008 – which we don't see as a probable base case – the corporate credit market still presents an attractive entry point for investors with a two to three year view. There is more upside than downside, even if default rates increase and spreads widen from here.

How to Access the Managers:

With domestic fixed income yields expected to remain low for an extended period of time, working with a professional money manager that has the flexibility to seek yield opportunities beyond Canadian borders is worth considering. The table below provides a list of mutual funds from the firms we spoke with that have the ability to step outside of Canada for a portion of their fixed income allocation.

Fixed Income Mandates

- TD Canadian Core Plus Bond
- Fidelity American High Yield
- Manulife Strategic Income
- PH&N Canadian Total Return Bond
- PIMCO Canadian Total Return Bond
- PIMCO Monthly Income

Balanced & Income Mandates

- TD Income Advantage Portfolio
- TD U.S. Monthly Income
- Dynamic Strategic Yield
- Fidelity Monthly Income
- Fidelity U.S. Monthly Income
- Signature Diversified Yield II
- Signature Income & Growth
- Signature High Income

For questions regarding information contained in this article or any managed investments, please contact your TD Investment Advisor.

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