

## Canoe

## BONDS AND INTEREST RATES: WISDOM VERSUS REALITY



When economist John Kenneth Galbraith was looking for a way to describe widely-held ideas that were fundamentally flawed, he landed on the following: "I shall refer to these ideas henceforth as the conventional wisdom."

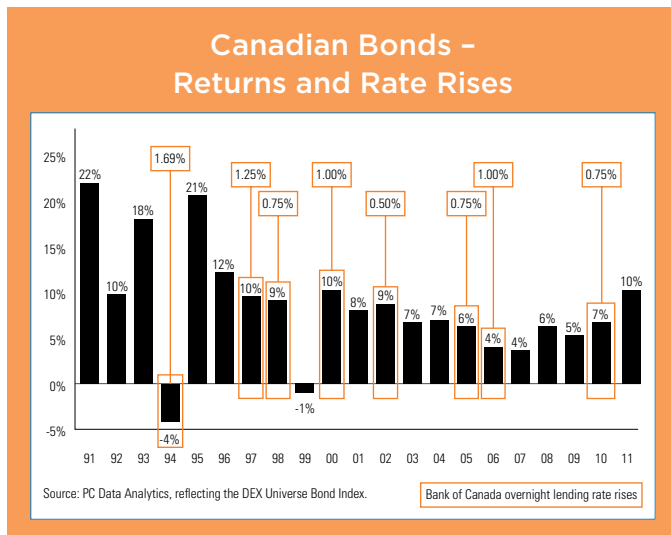
There are three "conventional wisdoms" which exist with bonds and interest rates. We believe it's important to challenge these "wisdoms". We're putting money to work today and finding attractive yields that many investors are foregoing by following conventional wisdom.

### Conventional Wisdom 1:

#### Now is not the time to invest in bonds

Current consensus thinking is that interest rates are set to rise in Canada. And because bonds prices fall when rates rise, the best investment strategy is to avoid bonds.

In 2010 however, the Bank of Canada increased interest rates on 3 occasions by a total of 75 basis points (0.75%). The basket of bonds with varying maturities, known as the DEX Universe, was up 6.74% in that same period.

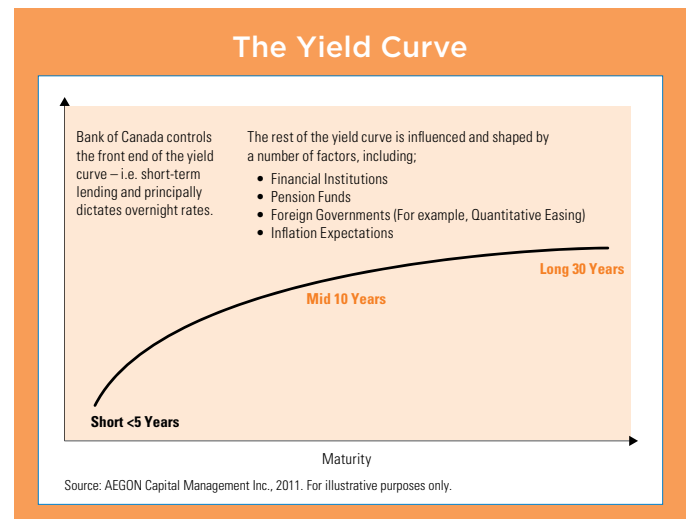


**REALITY:** As we've recently seen, timing the bond market is like timing the stock market. Bond yields have actually fallen and prices risen, despite much talk of the opposite happening!

### Conventional Wisdom 2:

#### The Bank of Canada dictates the cost of borrowing

The BOC's interest rate policy only influences the shorter end (the overnight rate) of the yield curve and becomes more muted the farther out in maturity you go. Anything beyond 5 years (like your mortgage rate) is influenced by institutional/investor demand, the actions of foreign governments, inflation expectations and the level of stability in global markets.



**REALITY:** A wide range of factors impact the yield curve, with the Bank of Canada's interest rate policy only affecting overnight and short-term rates.

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**Conventional Wisdom 3:*****There's no safe haven, should interest rates rise***

Corporate bonds are far less sensitive to interest rate movements than government bonds.

For example, if rates were to rise 1% – a huge increase at this juncture and not expected – government bonds would take the biggest hit falling to \$92.30, or minus 7.7%. In contrast, corporate bonds would drop to \$96.46 or negative 3.5% as they are less impacted by rate increases.

When you factor in the higher coupon, and spread compression, attached to say, a 10 year Rogers Bond, the 12-month return stands at plus 1.26%, versus government bonds, which fall 5.3% including the coupon.

**Hypothetical 1% Rise Across the Yield Curve**

	Jan 1 2012 price (coupon)	Jan 1 2013 price (coupon) post 1% rise	12 month return (%)	12 month return (%) plus coupon
10 Year Government of Canada Bond	100 (2.40%)	↓ 92.3 (2.40%)	-7.7%	-5.3%
Rogers investment grade corporate bond (50 bps Compression)	100 (4.80%)	↓ 96.46 (4.80%)	-3.5%	+1.26%

THE POWER OF THE COUPON – HELPS OFFSET A RISING RATE ENVIRONMENT

Source: AEGON Capital Management Inc., 2011.  
For illustrative purposes only.

**REALITY:** Corporate debt is in much better shape to withstand an interest rate rise than government debt, because of the additional yield offered. Don't forget about the power of the coupon!

**Canoe Financial's approach to bond investing**

- Canoe has partnered with AEGON Capital Management to manage the Canoe Bond Advantage Fund and Class, the Canoe Enhanced Income Fund and Class, as well as the Canoe Equity Income Class.
- AEGON manages more than \$6.5 billion CAD in debt investments primarily for institutions and insurance companies.
- The Canoe Bond Advantage fund is based on the AEGON imaxx™ Canadian Bond Fund, which outperformed 94% of competitor funds in its category for performance in 2011. (Source: Morningstar)
- The majority of portfolio assets are invested in the Canadian corporate bond market, with in-depth research, enabling Portfolio Manager Marc Goldfried to identify companies and corporate bonds that offer the greatest potential for higher returns.
- Mr. Goldfried does not try to anticipate interest rates, but instead employs a duration neutral strategy.
- Bonds rated below investment grade (BBB-) are not considered and the portfolio is 100% Canadian dollar denominated.

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