SAFETY can veil risk

Product sales are often driven by performance. That doesn't mean the hottest products are bad, but advisors need to assess their role in the portfolio, and understand the downside risk.

By Dan Hallett

Despite improving fund sales and recovering financial markets, investors continue to direct most of their "long-term" money into the relatively safer bond, income and dividend fund categories. All three—bonds, dividends and trusts—have posted strong performances during the gruelling bear market.

Throughout the bear market, the challenge for advisors has been counselling clients that "it will get better" and "the worst is over." But alas, it didn't get better and the worst wasn't over. Advisors need to keep their clients focused on investment goals, prevent them from making emotion-driven decisions, yet not look like a fool if the market proves them wrong yet again.

Illustration by Isabelle Cardinal

BONDS

"What have you done for me lately?" That's a question on investors' minds, as indicated by fund flows. Net sales of domestic and foreign bond funds have been on fire, accounting for about three-quarters of all net fund sales over the past two years, according to data from IFIC. That means the total of all other categories accounted for just a quarter of net sales—with many fund classes mired in net redemptions.

RISKS

Bonds have performed well during the bear market thanks to the one-two punch of coupon payments (providing steady cash flow) and falling yields (resulting in price appreciation). While they've been a nice place to be over the past couple of

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years, bonds have a risk of their own called duration.

Money has a time value (i.e., a dollar today is worth more than the same dollar in the future). Duration measures the time required to recoup a bond's purchase price. As a rule, for every one-percentage-point change in bond yields, there is a price change in the opposite direction approximately equal to the duration. Since the relationship between bond prices and yields is not linear (i.e., graphically, it's a curve, not a straight line), this is just an approximation.

The Scotia Capital Bond Universe Index has a yield under 5% and a duration of around six years. If interest rates rise further—e.g., 1%—a price decline equal to about the index's yield may result. Such a rise in rates is entirely feasible if the economy settles into "gradual growth" mode—as many analysts believe it will. While the downside potential is far from the punishing losses stocks delivered during the 2000-2003 bear market, rising rates would hand a nasty surprise to investors looking to secure positive returns in the perceived "safe haven" of bonds and bond funds.

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BOND RISK SUMMARY

- Bonds with longer maturities are more sensitive to rate changes than those with shorter maturities. As a bond approaches maturity, its market price more closely tracks its maturity value and hence becomes less volatile.
- Bonds with lower coupon rates are more sensitive to rate changes than those with higher coupon rates. Having more interest paid out semi-annually speeds up a bond investor's payback period (i.e., shortens duration). Along that same line of thinking, strip bonds are very sensitive to rate changes since they pay no periodic interest.
- Bonds with lower credit risk (i.e., higher credit rating) are more interest rate sensitive than those with higher credit risks. Price changes in high-yield bonds resulting from credit up- and downgrades trump the interest rate effect.
- The bump up in price from falling rates is generally higher than the price decline resulting from rising rates. This is due to something called "bond convexity"—the fact that the relationship between changes in bond prices and changes in yield isn't quite linear.

OUTLOOK

Government bonds have provided real returns of between 2% and 3% per year, over the long term, depending on the maturity. For example, real yields on the U.S. five-year Treasury Note have ranged from nearly 9% to about -5% over the past 50 years. The median real yield over that period is about 2.5%—close to the real annualized long-term return such bonds have generated. The Canadian experience has mirrored that of the U.S.

Taking such "normalized" real yields on North American government bonds and adding on the inflation expectation currently prevailing in the bond market would imply "fair value" on government bonds will only be reached after a significant rise in bond yields—to the tune of about 100 basis points.

That kind of increase could easily wipe out the small yields currently offered in North America—which are flirting with sub-zero levels on a real, pretax basis. The summer's price activity among North American bonds—which saw the U.S. 10-year note briefly dipping to 3.07% before bouncing up 120 basis points—has proven that the market will not tolerate very low nominal or real yields for any extended period. Hence, it's important for advisors to realize that bonds might provide little more than a false sense of security until nominal yields finish another stage of upward movement, to reflect pressures in the real economy.

That doesn't mean bonds don't belong in a portfolio, but inflation-protected issues or real-return bonds, high-yield bonds (which are still relatively attractive, though the easy money has been made) and floating preferred shares might, when combined with traditional fixed income alternatives, provide the type of diversification that is required in this market.

DIVIDEND AND INCOME TRUST FUNDS

Dividend funds have been the other major beneficiary of falling interest rates. However, sales of these products have also been buoyed by investors' hunger for more immediate return and growth potential in one package. Ironically, dividend funds (as

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tracked by IFIC) saw 18 months of consecutive net redemptions from April 1999 through September 2000. That was smack in the middle of the tech boom, which saw Nortel Networks soar north of $120 per share. Ever since, dividend funds have seen steadily increasing net sales.

This mixed bag of investment funds tends to invest in three broad classes of equities: common stock, preferred stock and income trusts.

Low interest rates on GICs and anemic bond yields sent investors searching for alternative sources of yield. Income trusts fit the bill, given their fatter yields and generally better tax efficiency. A quick glance at performance during the most recent bear market (shown in Table I) illustrates why high-yield categories have had such wide appeal.

It just so happened that the high-yield securities that were so ignored during the tech boom saw the tables turn in their favour during the bear. While the more recent performance shown in the table below is quite striking, it may provide a false impression of the behaviour of high-yield equity in future bear markets.

RISKS

Sure, high-yield equities fared well in the recent bear, but advisors must be careful not to expect similar relative performance in other market declines. Quite simply, the extent to which an asset class or stock segment outperforms in a bear market depends to a great extent the driving factor behind the free fall.

For instance, remember the summer meltdown of 1998? The TSX peaked near the end of April, later bottoming near the end of August. Table II illustrates how today's bear market saviours lost significant amounts back then.

While dividend and income trust funds fared much better than typical Canadian equity portfolios, there are fundamental differences in those categories today, compared to 1998. First, dividend funds held a greater portion of fixed income in the form of preferred shares. Yesterday's preferred-share-heavy dividend funds have reduced holdings of preferreds in favour of income trusts (and dividend-paying common shares).

Also, there existed just a handful of income trust funds back then, but half of them were more like balanced funds—with substantial holdings in preferreds and bonds. Isolating the few funds that invested entirely in income trusts reveals a loss of 24% during the 1998 summer meltdown—not significantly different from the general equity market.

Hence, the phenomenal popularity of income trusts requires advisors to reinforce the fact that these are equity securities. This is crucial given the myth that has proliferated in various media outlets calling them hybrid securities. A trust is merely another form (instead of a corporation) within which a business is legally held and managed.

In other words, think of a stock that pays out 80% or more of its net income to shareholders. That's all an income trust is, except that its trust structure allows it to flow cash out more tax efficiently. Dividends paid out of a corporation are not deductible. However, cash distributed out of a trust reduces taxable income at the trust level. Most often, enough cash will be paid out such that little or no tax is payable at the trust level—leaving unitholders to pay tax at their respective personal rates.

The high-yield nature of trusts makes them interest-sensitive vehicles. A CIBC World Markets report demonstrates

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TABLE I

March 2000 through March 2003	Total % Return
Median Canadian Dividend	21%
Median Canadian Income Trust	59%
Median Canadian Equity (Pure)	-29%
S&P / TSX Composite	-30%

TABLE II

April 1998 through August 1998	Total % Return
Median Canadian Dividend	-18%
Median Canadian Income Trust	-17%
Median Canadian Equity (Pure)	-27%
S&P / TSX Composite	-28%

Source: Morningstar Canada (PalTRAK 98)

STRATEGIES

How should advisors design client solutions? It all starts with getting back to basics.

Historical fund flows show that most people have poor timing. They buy and sell based on emotions—notably fear and greed. The rush to get into bonds and income trusts is driven by the fear of not wanting to lose any more money. This fear is surely understandable but it shouldn't drive investment decisions.

Advisors aren't totally immune from this reaction since the vast majority of fund sales occur through some "advisor" channel. We've all made mistakes in the past and it's time to break the cycle. We know from other aspects of life that behavioural changes don't just happen. But if clients are already coming to you for help, there is hope.

The most important thing an advisor can do is to document advice in an investment policy statement (IPS). It will make everybody more accountable. You know from your own business planning that talking about goals and writing them down have different results. Documenting goals, implementation strategies and benchmarking progress will go a long way toward making your process more disciplined, keeping clients focused on what counts, and making fewer emotion-driven changes.

Each piece of a portfolio should play a role that is consistent with the goals and objectives noted in the IPS. Hence, the next time a new product comes online, look past the sales pitch and look at a product's fundamental aspects to see how this piece fits into the overall strategy. Expecting it to perform well isn't good enough. Rather, it must have characteristics that make sense in the context of the client's time frame, tax situation, income and liquidity needs, and other relevant aspects.

While past performance (particularly more recently) grabs our attention, be sure to keep focused on the future. Develop a framework for looking forward using the information available today. As noted above with the analysis on bonds, recent performance may not be at all like what the future holds. But history, if studied properly, has a way of grounding us when shorter term events throw us for a loop. It will keep you more disciplined and, in the end, give your clients more consistent returns. *–D.H.*

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that different types of trust have different interest rate sensitivities. Pipeline trusts are more sensitive (i.e., inversely correlated) to the three-month Treasury bill yield as compared to longer term bond yields due to the average term of contracts with shippers. Power trusts and business trusts, on the other hand, tend to be more responsive to interest rate changes on the "long end" of the yield curve (i.e., 10-year maturities or greater). As for funds of income trusts, most will tend to be sensitive to longer term rates, but that will depend more specifically on each fund's makeup and whether (in the case of a closed-end fund of trusts) it uses leverage.

While business trusts are the fastest growing segment of the trust market, the riskier and more cyclical energy and real estate trusts continue to make up a substantial portion of the market.

OUTLOOK

The adage of "higher yield means higher risk" rings true in the trust sector. Remember that trusts are basically stocks paying out 80% to 100% of their earnings. Therein lies the risk. We know that earnings fluctuate along with business fundamentals—which means distributions will be volatile as well.

When a stock pays out half of its earnings, it's much easier to sustain and grow its payout through a full business cycle. However, paying out nearly all of a business's earnings has two implications. First, there is limited room for growth in distributions since little or no business reinvestment is taking place. Second, there is often no cash set aside to cushion periods of lower earnings. Instead, some trusts have borrowed money to sustain distributions in weaker times—effectively paying out well over 100% of earnings in some periods.

That's just not sustainable. Fat yields come at a price—uncertainty. Hence, advisors must be prudent in their inclusion of income trusts (and associated mutual funds) into client portfolios. They are not bonds. They are high-yield equities.

Income trusts are unlikely to follow the destiny of the "dot-bombs," but as distributions are cut, the whole sector may suffer somewhat. Sticking with trusts with lower payout ratios and credible business models (or the money managers to evaluate such things) will soften future price weakness, but can't escape it altogether. AE

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