# A Dynamic Fixed-Income Asset Allocation Strategy for the Post-COVID Era

Written by

**ALBERT NGO, MFE**
Senior Portfolio Manager,
Fixed Income

**IAN FUNG, CFA**
Portfolio Manager,
Fixed Income

## A new era of low yields and rising interest rate risks

The greatest fixed-income bull market in history has seen a four-decade trend of falling inflation, interest rates and tightening credit spreads. Most fixed-income investments performed very well, particularly those with longer durations and meaningful credit components.

Coming into 2021, government bond yields had increased from their pandemic lows, but have been volatile. The increase in bond yields was fast and furious at the start of the year, due to a combination of optimism about the economy reopening and fears of rampant inflation.

Despite a strong increase in all inflation measures, however, the U.S. ten-year government bond yield fell sharply from a high of 1.75% in the spring to a low of 1.16% in early August, retracting almost two-thirds of the increase from earlier in the year. The economic recovery continued into late summer and early autumn. The mismatch between supply and demand widened, with supply bottlenecks and a rise in energy and food prices further driving the recognition that inflation was potentially more long-term than previously expected. With this realization, bond yields quickly rebounded in November when financial markets priced in four Bank of Canada hikes by the middle of next year.

A new era of fiscal and monetary coordination has emerged in which increasing globalization may be replaced by trends toward deglobalization. Increased technological adoption driven by the pandemic has permanently altered the behaviour of many businesses and consumers. Inflationary pressures continue to build, but the durability and sustainability of inflation remains a key debate among market participants.

The year 2021 and 2022 will be characterized by a transition to a new post-COVID reality, with structural shifts that will have important consequences for fixed-income markets, creating both risks and opportunities. Fixed-income investors are likely to continue to struggle with historically low yields for some time, as they have been since the 2008 Financial Crisis – and now they must also position their portfolios for a possible resurgence in inflation and rising interest rates.

## Four strategies for mitigating interest-rate risk

Interest-rate risk is the risk of bond prices declining due to rising interest rates, which play a critical role in fixed-income returns. Conventional wisdom says that when rates rise, bond prices fall and that when rates fall, bond prices rise. But conventional thinking often relies on simplified assumptions. There are effective strategies managing interest rate-risk when interest rates rise.

### 1. Taking on credit risk in corporate bonds

Corporate bond yields reflect a combination of

- the yield on a government bond with the same maturity plus
- the credit spread that captures the default risk of that particular corporate bond issuer.

When the economy improves and interest rates climb gradually, credit spreads typically narrow. Rising rates and narrowing credit spreads have opposite effects on fixed-income returns and tend to neutralize each other. Rising interest rates are negative for corporate bond prices while narrower credit spreads are positive for corporate bond prices. As a result, investors concerned about rising interest rates might consider an allocation to corporate bonds, including high-yield corporate bonds, to mitigate interest-rate risk in a rising-rate environment, while still potentially benefiting from improving credit spreads.

### 2. Reducing interest-rate sensitivity

Interest-rate sensitivity is a measure of how much the price of a fixed-income asset will fluctuate as a result of changes in the interest rate. The bond market refers to this interest-rate sensitivity as “duration,” which is, mathematically, the weighted average time to receive all the bond’s cash flows. Generally, the shorter the maturity or the higher the coupon interest payment, the shorter the duration. An asset allocation strategy involving higher yields and shorter maturities offers the potential to improve returns even as rates rise.

### 3. Floating-rate strategy

Another strategy for dealing with rising rates is to allocate assets to securities that pay an interest rate that is continually reset at a spread above short-term market rates. The yields “float,” or rise and fall, with changes in prevailing short-term market rates, allowing investors to pursue a competitive income stream that keeps pace with changing interest rates. Floating-rate issues generally exhibit less rate sensitivity, offering greater portfolio stability than conventional fixed-rate bonds. There is a strong investment case for floating-rate bonds during the economic recovery phase in the business cycle; at the same time, they also provide a hedge against potential inflation.

### 4. Tactical yield curve positioning

Mathematically, when interest rates rise, bond prices decline. However, different tenors of the yield curve are driven by different factors, and do not all react in an identical fashion in a rising rate environment. For instance, five-year government bonds tend to be driven by rate hike expectations, while ten-year government bonds tend to be driven more by growth expectations and medium-term inflation expectations. Historically, there have been hiking cycles where overnight rates were increasing, while yields on ten-year and thirty-year government bonds declined. Therefore, it is important to understand the outlook for the economy and the reasons for rate increases, as tactical positioning on the yield curve can help mitigate some of the effects of rising rates.

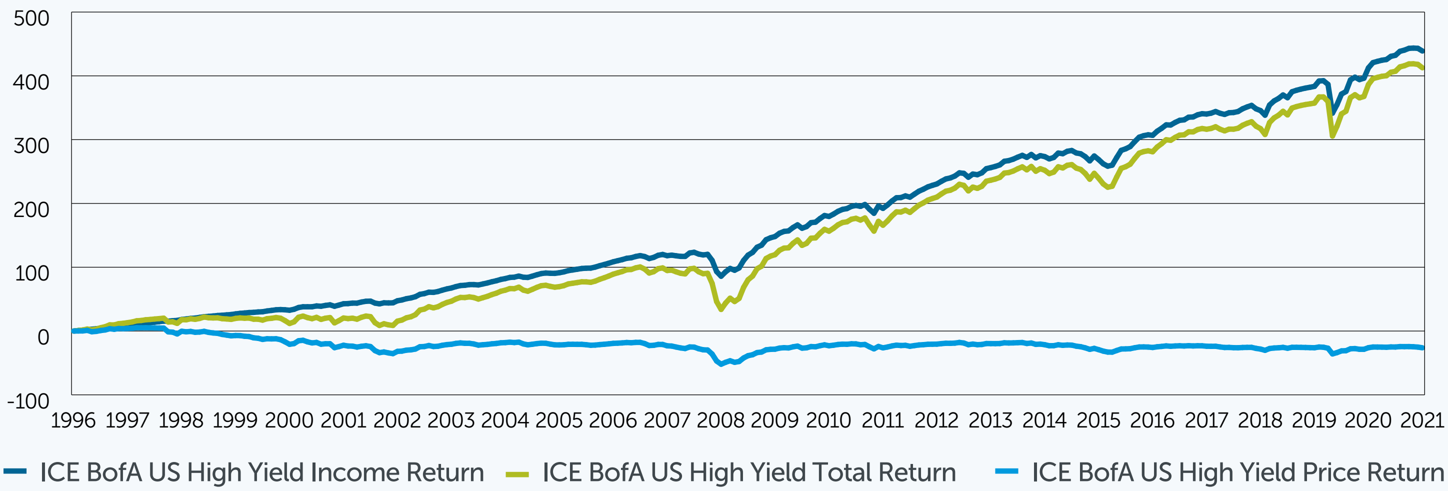
## Searching for yield and the associated risks

In the current market, in which rates for global sovereign bonds are at historical lows and, in many cases, even negative, investors seeking yield have to find alternative asset classes to generate income. Searching for yield usually involves taking more risk in exchange for higher income. What matters the most when searching for yield is understanding and managing the additional risk investors expose themselves to.

### 1. High-yield bonds and credit risk

High-yield bonds offer significantly higher yield than government bonds and many investment-grade corporate bonds, in exchange for a higher probability of default. Despite an average annual default rate at about 4%, high-yield bonds have had equity-like long-term returns, driven primarily driven by high coupon income. Over the last 25 years, the ICE BofA U.S. High Yield Index had an average total return of 6.76%.

**25-year Cumulative Return in USD (%)**




Source: Morningstar Research Inc. as at Nov. 30, 2021.

Credit risk is more prominent in the high-yield market than among government bonds or investment-grade corporate bonds. The U.S. high-yield bond market has evolved into a ~$2 trillion market where companies come to raise capital. There are more than a thousand issuers in the U.S., including Netflix, Tesla, T-Mobile and many Berkshire Hathaway-owned companies, such as Charter and Kraft Heinz – there are plenty of high-quality, blue-chip companies in which to invest in the high-yield sector. Since the high-yield sector generally has a low correlation to other sectors of the fixed-income market, as well as less sensitivity to interest rate risk, an allocation to high-yield bonds may provide portfolio diversification benefits.

### 2. Preferred shares offer a very different type of interest-rate sensitivity

For credit-sensitive investors, preferred shares may provide income advantages, as they are predominantly either investment-grade securities themselves or are lower-rated securities issued by investment-grade companies that typically have offered attractive yields, paying interest with a par value returned to investors when the issuer calls them.

Preferred shares (or preferreds) generally offer better yields than bonds from the same issuer, partly due to their more junior position in the capital structure (lower than bonds but higher than common shares). The yield advantage also stems from the fact that the issuer may be able to suspend or defer payments to holders of preferreds. Preferred yields are typically comparable to those of high-yield corporates, but issuers of preferreds generally have higher credit-quality ratings than high-yield corporate issuers.

Preferreds' higher yields may be appealing, but they almost always come with additional risk, such as higher credit risk than for the issuer's conventional bonds, and interest-rate risk since most have no specified maturity at all, making them perpetual securities.

Preferred shares that feature a fixed-rate coupon are exposed to high interest-rate risk. However, many preferreds feature floating rates or fixed-to-floating rates, which pay a fixed coupon for a pre-set number of years, before resetting every five years at a spread-versus-benchmark rate. With these preferreds, the coupons reset higher when interest rates are on the upswing. The banking sector, the biggest issuer of preferreds, also tends to experience improving profit margins when interest rates rise.

Duration for preferreds are different from duration for conventional bonds, and other features, such as embedded call options, that can make things complicated. It takes an extensive research effort to make sense of it all and position these issues properly in a diversified portfolio.

**3. Convertibles – bonds with some equity characteristics**

A convertible bond can be seen as a part bond and part equity call option. A convertible bond generally pays interest periodically and matures at par (i.e. 100 cents on the dollar) on a specified maturity date. It may also be exchanged for a predetermined number of equity shares of the issuer and if the underlying stock price appreciates enough, the price of the bond will be worth more than par. These hybrid stock-bond securities blend the features of stocks and bonds: they offer stock-like growth potential, along with bond-like income and downside protection. During an equity bull market, which usually takes place in a low-interest-rate environment, convertibles have the potential for price appreciation.

**Convertible Bond Price vs Stock Price**


Companies generally pay less interest by issuing convertible bonds rather than traditional ones; bondholders accept less interest, but gain an option to exchange debt for common shares. The prices of convertibles are driven by the present value of the bond's interest and principal and the value of the equity option.

When the stock price falls, the convertible bond's sensitivity to its underlying stock price will decrease, and the convertible bond price will not decline as much as the equity. The level that will prevent the convertible bond from falling further down is known as the "bond floor," which is essentially the par value of the bond.

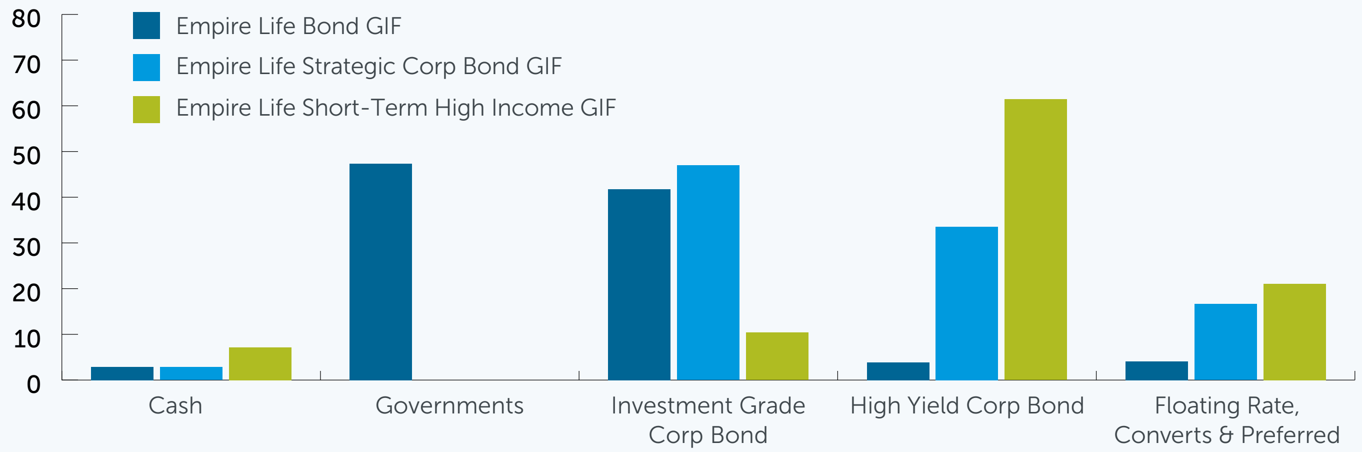
When the stock rises through the conversion price, the convertible bond price will show an increasingly direct relationship with the movements of the stock price.

## Choosing Empire Fixed Income Funds

In the new reality of low interest rates and high inflation uncertainties, the task of building a fixed-income portfolio that provides decent yields – and still offers portfolio stability – has become more difficult. Investors can no longer obtain all the usual fixed-income investment objectives (hedging equity risk, preserving capital, generating income, growing purchase power, etc.) through a single allocation. Fixed-income markets have evolved and increased in complexity, and bond portfolios need to be structured differently.

At Empire, our fixed-income investment team strives to have an optimized allocation strategy by involving a variety of fixed-income sub-categories such as short duration bonds, floating rate securities, high yields corporate bonds, preferred shares and convertible bonds. Empire Life's diversified fixed-income strategies can help investors benefit from this broader toolset and provide new potential to capitalize on opportunities without significantly adding risk.

Empire offers fixed-income products with a variety of asset allocation strategies to help meet investors' objectives.




Source: Empire Life as at Nov. 30, 2021

- For investors with significant equity exposure, Empire Life Bond GIF* is the best hedge for equities, but has the lowest yield and is the most susceptible to rising rates.
- For investors who have significant exposure to investment-grade bonds and are comfortable with additional credit risk, Empire Life Short-Term High Income GIF* (STHI) offers the highest yield and the lowest interest rate risk, but has the highest credit risk.
- Empire Life Strategic Corporate Bond GIF* (ESCB) is positioned in between, with the flexibility to invest in investment-grade corporate bonds, high-yield and convertible bonds and preferred shares.

All these funds provide an opportunity for capital gains through exposure to higher-yielding bonds that trade at a discount as well as fixed income alternatives such as preferred shares and convertible bonds. The choice between these funds ultimately comes down to an investor's highest-priority objective and risk tolerance.



**Speak with your advisor or visit us at empire.ca/fixedincome to learn more.**



**The Empire Life Insurance Company**
259 King Street East, Kingston, ON K7L 3A8

Insurance & Investments – Simple. Fast. Easy.®
empire.ca info@empire.ca 1 877 548-1881

INV-3252-EN-12/21