



Can Bond Investors Benefit from a Rising Interest Rate Environment?

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With short term interest rate increases on the horizon some investors may become concerned about the potential negative impact to their fixed income portfolios. The customary concern is that a rise in interest rates by the Bank of Canada (BOC) can be followed by rising bond yields and falling bond prices, resulting in a negative impact to the investor's total return. This concern may be amplified when an investor holds only a small number of bonds in a typical Canadian buy-and-hold laddered portfolio. Keeping a long-term perspective, however, can alleviate this concern. Although forecasting interest rates is more of an art than a science, we have analyzed a market portfolio's performance under an array of rising interest rate scenarios.

Contrary to popular belief, we've found that a rise in interest rates, over a five to seven year holding period, has the potential to benefit fixed income investors. We believe that investors with a diversified and actively managed fixed income portfolio are more likely to benefit in these conditions, as higher interest rates in the intermediate term overtake the negative impact of short-term declining prices.

Take A Long-Term Perspective

Foremost, investors benefit by approaching a rising rate environment with a long-term viewpoint. An unexpected rise in inflation is one of the biggest risks for fixed income investors. Presently, the BOC inflation target range is 1 to 3 per cent, with the BOC's monetary policy aimed at keeping inflation at

the 2 per cent midpoint. Over the last fifteen years, the BOC has been very successful at maintaining inflation within its target range, providing fixed income managers with a level of comfort regarding the volatility of interest rates. The general consensus is that, notwithstanding another major shock to the system, long-term bond yields would gradually drift up. Short-term interest rates administered by the BOC should trend higher starting mid-to late year 2010 in a systematic manner, making the yield curve flatter.

Rising Rates May Provide Benefits

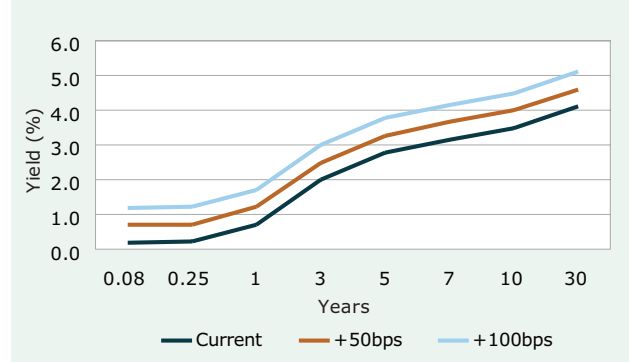
Taking this long-term perspective and the likely possibility of higher interest rates into consideration, we have analyzed two scenarios and the relative rates of return for fixed income investors. To keep our example concise, we examine the impact of a rising rate environment in the Canadian bond market (DEX Universe Bond Index as a proxy) under two scenarios, using the overnight-to-30-year rates and an initially static yield curve subject to a one-time rise in interest rates on day one. After day one interest rates remain unchanged.

'Today' And A Rise In Interest Rates

In the first scenario (see Chart 1), the whole yield curve is shifted up by 50 basis points (bps) and 100 bps. Based on the BOC's monetary policy, the current yield curve is moderately steep. In this setting, we illustrate the effect of a sudden change in the market place, which shifts the yield curve up (we've kept

the shape of the yield curve the same). The result for investors is a short-term relative decrease on their returns in the first year (see Table 1) but, after holding the bond portfolio for an intermediate term (between five to seven years in this case), higher income from longer maturity bonds would provide an increased total return, making up for, and even exceeding the initial short-term impact.

Chart 1': The Current Yield Curve Compared to a 50 bps and 100 bps shift



Source: MFC GIM, data as of February 28, 2010

Table 1': Annualized Bond Returns

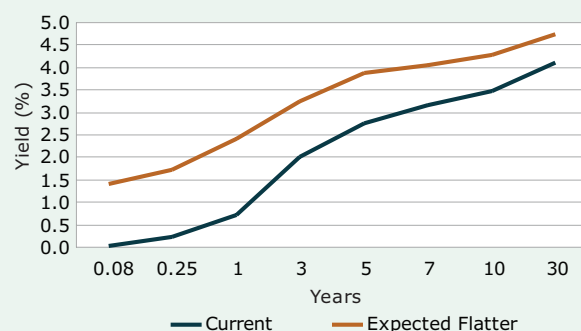
Horizon Years	Current Yield Curve	Current +50bps	Current +100bps
1	3.05%	0.58%	-1.90%
3	3.05%	2.56%	2.07%
5	3.05%	2.96%	2.86%
7	3.05%	3.13%	3.20%
10	3.05%	3.25%	3.46%
30	3.05%	3.45%	3.85%

Source: MFC GIM, data as of February 28, 2010. Based on DEX Universe Bond Index

A 'Flatter' Outcome In A Rising Interest Rate Environment

In the second scenario (see Chart 2), the current yield curve is compared to an expected higher and flatter yield curve.

Chart 2': The Current Yield Curve Compared to an Expected Flatter Yield Curve



Source: MFC GIM, data as of February 28, 2010

If the BOC begins to tighten interest rates later in 2010, this will lead to a flatter yield curve. As the yield curve flattens, the portfolio managers will be able to take advantage of higher yields through active management.

The important "take away" from the analysis of these scenarios is that the long-term effect of rising interest rates can actually be beneficial to bond investors. A rise in interest rates lifts the yield of the portfolio, and all the bonds that are maturing during the holding period, as well as all coupon payments, are reinvested at a higher yield level. This dynamic acts to offset the decrease and, within an intermediate time period, actually provides a higher return to the investor in comparison to an environment in which interest rates do not change.

*Note: The simulations displayed above assume that the rate changed on day one and then stayed constant. Our scenario analysis is performed on the DEX Universe Bond Index as a proxy for the Bond Market Portfolio

The Advantages Of A Broadly Diversified Active Portfolio

Of course, there's even more that can be done to improve returns in a rising rate environment. Active management of a bond portfolio by experienced fixed income professionals can be expected to add further value to the previously outlined scenarios.

Fixed income investors are typically seeking steady income, low volatility and opportunities for moderate

growth. Generally speaking, investors seeking exposure to fixed income employ one of two approaches:

- A laddered bond portfolio, which uses a handful of individual bonds, each maturing on an annual basis over a laddered period of years. This buy-and-hold approach is focused on coupon income which, when paid out, is typically not reinvested into more bonds and may act as a cash drag as uninvested payments reduce total portfolio return.
- A managed bond portfolio that holds a significantly larger, diversified mixture of bonds. This portfolio is actively managed according to the manager's analysis of movements of the yield curve, duration and the attractiveness of each bond through in-depth credit analysis in the overall portfolio. The objective is typically total return, reinvesting coupon payments and optimizing return by taking capital gains within the portfolio, when advantageous.

A Fluctuating Rate Environment

A rising interest rate environment can introduce uncertainty for investors in both a laddered and managed bond portfolio approach. In our opinion, however, a managed approach holds some key advantages over a laddered approach.

The managed product investor has the advantage of a professional portfolio management team

actively adapting the portfolio's duration: shortening duration in anticipation of rising rates, and in reverse, lengthening duration to take advantage of falling rates. For example, MFC GIM offers one of Canada's broadest and deepest North American fixed income teams with over 150 investment professionals managing over C\$190 billion in assets. This type of bench strength allows for considerable resources to focus on added value.

A laddered approach lacks this advantage and can be subject to interest rate risk because of the static approach. The laddered portfolio is typically rebalanced only on an annual basis when bonds mature. This infrequent rebalancing increases the investor's exposure to re-investment risk (the risk of having to pay higher bond prices for replacement bonds when rates fall).

Managed bond product investors also benefit from the capacity of the portfolio manager to change the composition of the portfolio based on the credit environment. A portfolio manager with access to a substantial credit research department, such as MFC GIM's Credit and Investment Research group, with over 70 North American based credit analysts, can confidently manage the proportion of credit exposures in the portfolio in a defensive manner. In addition, the portfolio manager can adjust the portfolio positioning on the yield curve to enhance value.

Table 2: Investors Should Consider the Difference

Considerations	Managed Bond Portfolio	Laddered Bonds
Appropriate Diversification	<ul style="list-style-type: none"> ■ Portfolio typically has more than 20 bonds, diversified by term to maturity and credit quality ■ Full range of securities in the bond universe is available ■ Bonds are added to or removed from the portfolio based on their potential to add value 	<ul style="list-style-type: none"> ■ Selection of credits may be limited, creating concentration risk ■ Small size of invested capital may limit portfolio to one bond per year, resulting in only a handful of bonds
Credit Risk Management	<ul style="list-style-type: none"> ■ A team of full-time professionals adds value. ■ In-depth research and ongoing monitoring reduces risk 	<ul style="list-style-type: none"> ■ Time constraints and lack of research depth may introduce unnecessary risk
Market Access and Pricing	<ul style="list-style-type: none"> ■ Scale of operations and established relationships with the dealer community produce complete product availability and efficiencies in transaction costs and bond pricing 	<ul style="list-style-type: none"> ■ Selection of credit may be limited ■ Cost of transactions may be higher and pricing of bonds less favourable when participating in smaller bond purchases

Investors, in consultation with a professional advisor, should consider these important elements and the additional comparisons (see Table 2 on the previous page) between active bond products and a laddered portfolio approach.

For all of these reasons, MFC GIM believes that an investor should not fear rising interest rates when invested in a well diversified bond portfolio.

Assumptions:

Composition of the Canadian Bond Market (DEX Universe Index) was expected to remain unchanged in relation to the underlying holdings and their respective weights. Duration: 5.9 years, Average yield: 3.05%. Source: MFC GIM, DEX Universe Index, PC Bond (software). All data as of February 28, 2010.



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