



FIXED INCOME REDEFINED FOR A 2% WORLD

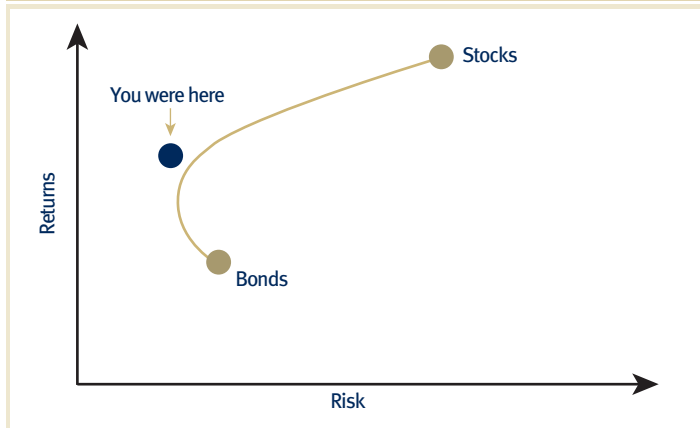


It's a question on the minds of many fixed income investors these days: how should investors think about their fixed income allocation in a world of very low interest rates? Hanif Mamdani, Head of Alternative Investments at RBC Global Asset Management shares his thoughts about the future of fixed income markets as well as a look at some other strategies to combat this low-yield environment.

Why own bonds in the first place?

Hanif Mamdani: Bonds have been extremely effective at diversifying and dampening the risk of a portfolio in recent years. Viewed in a portfolio context, blending bonds with stocks has helped investors achieved very efficient portfolios where risk has been reduced considerably with little or no sacrifice in return. We've had the best of both worlds with traditional high-quality bonds over the past several decades.

Traditional bonds provided ballast to a portfolio while generating decent returns



But are the best days of the bond market behind us?

HM: At some point, the market for government and high-quality bonds will face a much more hostile environment. We sit here today with 10-year yields near 1.5%, which is less than 1/10th of where they were in September 1981. Moreover, 1.5% doesn't even cover current inflation and on an after-tax basis, for most individual investors, the economic rewards of owning a 10-year government bond today are quite poor.

10-year U.S. government yields



Source: Bloomberg

That said, we must keep in mind that although the longer-term future for government bonds may be challenging, as long as there's a serious whiff of deflation out there we could see yields bump along these razor-thin levels for quite some time. But eventually, government bond yields are likely to succumb to the gravitational pull of fair value.

What is fair value for government bonds? Where should yields be?

HM: Very simplistically, when deflation is no longer a threat, one would expect yields on longer-term government bonds to approximate nominal GDP growth. For instance, if in this "new normal" world where the stiff headwinds of deleveraging are a fact of life, 2% real growth may be about all we can muster while the U.S. Federal Reserve is likely to achieve its target of 2% inflation. Adding these two figures results in

an expected nominal GDP growth rate of about 4%. This is probably as good a marker as any as to where 10-year-yields should eventually gravitate to in the longer term.

So then why are government bond yields so low?

HM: Rates are currently submerged so far below normal levels for a few reasons:

- **ZIRP**, as it's known, or the zero interest rate policy by the Fed: By keeping policy rates essentially at zero, the Fed has tethered the entire yield curve far below normal levels.
- **Operation Twist:** This is another manoeuvre whereby the Fed has been selling short-term securities to buy back its longer-term bonds in order to lower long rates. This non-conventional stimulus has lowered the longer portion of the yield curve by perhaps another 1/2%.
- **Risk aversion:** Many investors have been so frightened that they've piled out of risky assets like stocks and sought safety in treasuries as a haven in this environment. This has further submerged yields to an even lower level.

When should we expect government yields to rise?

HM: That really is the million-dollar question and one that is, unfortunately, very hard to answer. What we could see is a gradual move back to equilibrium levels over maybe a three- or four-year period rather than a sharp correction. As you can see below, in a worst-case scenario for bonds, investors would be subjected to a very serious short-term capital loss, but what is more likely to happen is perhaps a gradual adjustment period where high-quality bonds are a constant drag on one's portfolio.

Bonds – projected loss table	
Years to “normalization” (i.e., 4% yields)	Approximate annual return on 10-year government bonds
1	-20%
2	-8%
3	-4%
4	-2%

Source: Bloomberg

As a result, government bonds that used to provide a very good tailwind for returns might in the future produce a steady and long-term headwind. From a correlation standpoint, bonds will likely continue to work as dampeners of portfolio volatility (i.e., zigging when stocks zag) but this diversification may now come at potentially a substantial cost.

Where can investors find sources of reasonably safe yield without the potential headwinds of government bonds?

HM: There are many different options but my group has spent some time analyzing a few key areas such as high-yield bonds, leveraged loans and convertible bonds. As you can see by the chart on the adjacent page, as long as one has a proper investment horizon, these are reasonably reliable sources of yield. They tend not to be perfectly correlated to stocks and, importantly, are actually negatively correlated to 10-year government bond rates.

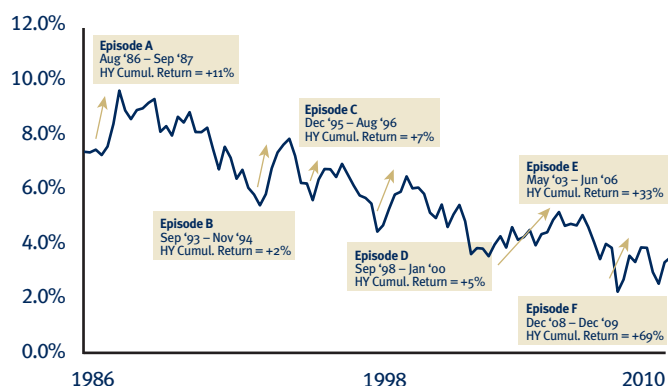
Correlation of returns (1996-2011)							
	Leveraged loans	High-yield bonds	Convertible debt	Hedge fund index	Investment grade	10-year treasury	Large Cap stocks
Leveraged loans	1.0						
High yield bonds	0.8	1.0					
Convertible debt	0.5	0.7	1.0				
Hedge fund index	0.5	0.6	0.7	1.0			
Investment grade	0.4	0.6	0.4	0.4	1.0		
10-year treasury	-0.4	-0.2	-0.2	-0.3	0.6	1.0	
Large-cap stocks	0.4	0.6	0.8	0.5	-0.2	-0.2	1.0

Source: Merrill Lynch, Citigroup, Bloomberg, PH&N

So these options achieve the desirable goal of dampening portfolio volatility while generating positive returns over time. A few words on each of these areas:

- **High-yield bonds:** While not as pristine as investment-grade bonds or government bonds, high-yield bonds have a history of performing remarkably well during periods of rising interest rates. In fact, over the past 25 years, there have been six episodes where 10-year U.S. Treasuries have experienced pronounced bear markets, and in each case the cumulative return on high-yield bonds was positive (in some cases by a substantial amount).

High-yield bonds during rising rate episodes



Source: Merrill Lynch High Yield Master Index

There are several reasons for this: (1) high-yield bonds tend to have shorter maturities (typically 5-7 years), (2) the high current income on a high-yield bond provides a nice cushion against a capital loss, and (3) high-yield spreads over treasuries tend to compress in an environment of robust economic growth as corporate profits surge and default rates remain tame.

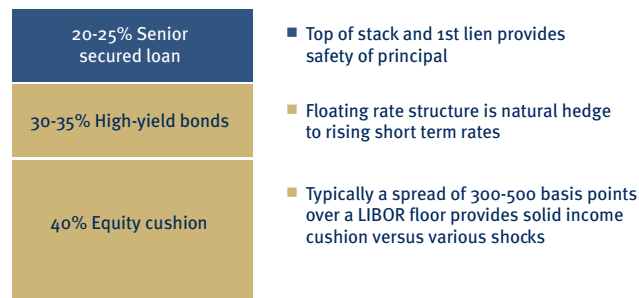
For these reasons, the price of a high-yield bond tends to be surprisingly stable during periods of moderately rising rates. That said, if government yields experience very sharp increases or if high-yield spreads are already at extremely narrow levels, the high-yield market can be more vulnerable to interest rate moves.

- **Leveraged loans:** Leveraged loans are the most senior part of a leveraged company's capital structure and are almost always secured by the assets of the company through a first lien, making them less risky than a typical unsecured high-yield bond. They're also structured typically with 5-7 year terms and have coupons that actually float (or periodically reset) over a short-term yield proxy (like LIBOR, the London Interbank Offered Rate).

This floating coupon is like a built-in form of protection. The key drawbacks of leveraged loans are that they are not as liquid as high-yield bonds and they are harder to source, administer and trade than more conventional bonds. However, despite these technical drawbacks, the leveraged loan market is a very interesting source of opportunity in a rising yield environment.

Leveraged loans are built for rate shocks

Typical leveraged company capital structure



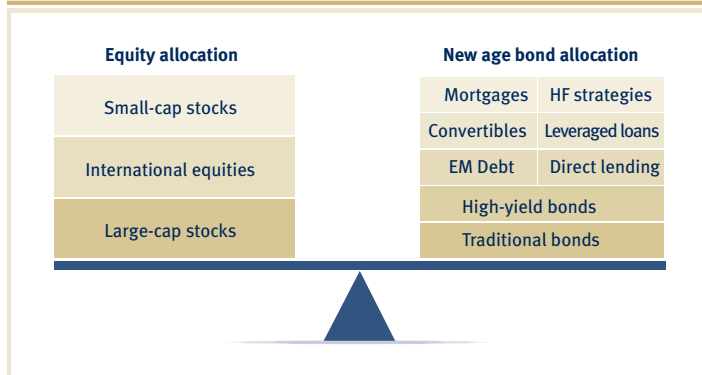
- **Convertible bonds:** Convertible bonds are an overlooked part of the market given their complexity. Yet they are very interesting vehicles for investors because they offer both fixed income and equity-like characteristics through their bond-like structure alongside a valuable conversion option into common equity of a company. This pairing of features can be a potent mix because when the economy is in growth mode and interest rates begin to rise, the stock market typically also tends to rise. So the benefit from the conversion feature can in many cases offset the negative impact of rising rates on the bond portion. As a result, convertibles can be quite stable in an environment of moderately rising rates.

That's a lot to think about. In a nutshell, how should investors think about fixed income going forward?

HM: Clearly investors face a daunting task right now. They're trying to balance investment portfolios in a world where "riskless" bonds have become somewhat risky as removal of the Fed policy safety net at some point could lead to a bear market in bonds, making them an expensive way to balance a portfolio of stocks.

So, rather than relying on a conventional bond solution in this environment, we may want to think about a more enlightened approach to fixed income going forward. In the same way that we've been trained to be very thoughtful about how we construct an equity portfolio – deftly mixing different styles and segments like value, growth, domestic, international, small-cap, large-cap, etc. – maybe we should consider taking the same nuanced approach to constructing a bond allocation.

Balancing stocks with bonds in a 2% world



I call it the “new age” bond allocation, where you retain a healthy dose of traditional bonds (because in a recession there is no substitute for high-quality sovereign bonds) but you can also use other fixed income vehicles and bond-like strategies. There are lots of different options, highlighted in the illustration: high-yield bonds, emerging market debt, convertible bonds, leveraged loans, mortgage products, REITs, utilities and even selected hedge fund strategies. This new age bond composite, I believe, can generate good income, dampen volatility from stocks, and help effectively diversify a portfolio, but with a yield tailwind for the next 3-5 years as opposed to the stiff yield headwind we are likely to experience at some point with conventional high-quality bonds.

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