Manulife Investment Management

Investments Unplugged Episode 81

Macan Nia:

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You know what surprises me about the Peg? It's actually the slushy capital of the world.

Kevin Headland:

Like juice slushy? Like drink?

Macan Nia:

Well, what other slushies do you know of?

In 2022, the long term historical relationship between stocks and bonds broke. For example, in the US the broad US stock market measured by the S&P 500 was down nearly 20%. While the broad US bond market measured by the Bloomberg USAG Index was down nearly 13%. This was the first time since the inception of these indices that both broad-based US stocks and bonds were down more than 10%. It was a historic year but not for good reason. In hindsight, central banks from across the world were slow to react to higher inflation and were forced, in 2022, to raise interest rates at a very fast pace. Since bond prices are inversely correlated to interest rates, as interest rates rose quickly, bond prices declined. Stocks also fell as investors readjusted the value that they were willing to pay and worried that higher interest rates could lead to a recession.

However, silver lining to last year's increase in interest rates is that bonds and Guaranteed Investment Certificates, or GICs, are now offering very attractive yields. Many investors are even questioning whether they're better off in GICs rather than bonds, given the yields are comparable. Investors might be comparing current GIC rates to the volatility and negative returns in bonds last year, and assume that this will be the case moving forward. However, last year's inflation and interest rate environment was extremely rare and we are not likely in the same situation in 2023. Will GICs outperform bonds in 2023 or will bonds revert back to their dominance over GICs? Listen on, this is Investments Unplugged.

Good day. My name is Macan Nia, Co-Chief Investment Strategist at Main Life Investment Management. And as always I'm joined here with my partner in crime, Kevin.

Kevin Headland:

What's going on, Macan?

Macan Nia:

Not too much. How are you?

Kevin Headland:

Good. Monday morning, January 23rd, expecting a snowstorm sometime in the next couple of days. Winter is finally coming, I think.

Macan Nia:

The fact that it's mid-Jan and it's zero degrees in Toronto, I'll take it. I know I was out west in Edmonton, of all places, it was -2, a bombing -2.

Kevin Headland:

I was in Winnipeg and it was -15 of windchill, and that was warm for Winnipeg. Actually, I went out without coat on from the car to the restaurant, it was not so bad surprisingly.

Macan Nia:

You know what surprises me about the Peg? It's actually the slushy capital of the world. Yeah, I know. You can't see Kev's face, but he doesn't believe me.

Kevin Headland:

Like juice slushy? Like drink?

Macan Nia:

Well, what other slushies do you know of?

Kevin Headland:

I thought you meant slushy like on the road slushy, from all the salt and stuff.

Macan Nia:

Well, that for dump for sure... Kevin, it's too cold in Winnipeg for it to get slush. It just started to ice. Anyways, now we digress as usual, but let's bring this back. And while we were out over the past couple of weeks, we've been asking advisors who've been coming up to us and giving compliments on the podcast, which we appreciate, what topics they would want us to cover in the next couple of ones, and one overarching one was the GIC versus bonds discussion.

Many of our clients will be opening up their 2022 statements. They will be looking at the horrible bond performance across the board, and they'll be comparing it with what you can get out of GICs today, and that will range between four and six percent, depending on your financial institution. And we thought that, "You know what? Let's do a reeducation of bonds, and compare the bond opportunity today versus GICs without going into the actual bond opportunity." We've recorded multiple podcasts, written multiple investment notes for the actual data behind it. Read or listen to those. But let's go into the comparison. Kev, what are the two reasons that we own bonds in our portfolio?

Kevin Headland:

I think the two main reasons you want to own bonds or fixing them in a portfolio is one, normally, I'd say not last year, but normally to counterbalance the risks that equities might have, the volatility. And two, especially for retirees providing income, we want to start de-accumulation. Fixed income in the past has been a really good income generator for retirees in a portfolio.

Macan Nia:

Exactly. And over the last, really 20 plus years, it has fit that mold. Now the income component, we've had to take on more risk for that income, i.e. going into high yield before COVID and so on and so forth, but it has that relationship. Now you mentioned typically we had last year, which it bucked the trend, right? So in 2022, when you look at the broad example, you look at the S&P, it was down 19.4%. The US bond market measured by the... This is basically their aggregate index. The Bloomberg USAG index was down 13%. When you look at it in Canada, the TSX was down, I think roughly, 9%. And then the Dex Universe, I think, was down 11%, 12%. So it did not fit that bill and end clients may be wondering, why not?

And it really is pretty simple in the sense that we got COVID, governments were required to restrict our movements, they pumped trillions of dollars. The money supply grew by 25%, led to inflation. Central banks, in hindsight now, I think they would agree, that they were late to start raising interest rates, and then when they had to last year they increased some at a very material rate. US and Canada, the overnight rate went from zero to four and a quarter, four and a half respectively. And let's not go into the nuances of discounted cash flows and so on and so forth, because this topic is already boring enough to begin with.

But all you need to know as an end client is as interest rates go up, bond prices come down. And as interest rates went up materially last year, led to these double-digit declines in bonds. That's what happened in 2022. Let's look at 2023. And Kev, I think the discussion now clients are having is, "Okay, if I can get four to six percent for my GICs and it's guaranteed, why take on the additional risk of going into bonds?" And I think we have three reasons why we think you want to be in bonds over GICs. But what's our team's view in terms of, "Okay, I'm an advisor. My client needs cash in the year, what do I do for the next year?"

Kevin Headland:

Well, if you need cash in one year, you shouldn't be investing in the capital markets at all. You should be either GICs, [inaudible 00:06:50] savings accounts. One year, 12 months is not enough time. And that's why I think for a lot of clients, a lot of portfolios, you want to obviously have a cash wedge to make sure that short term cash is already counted for. It's not about the long term. But I think one of the issues that we have also as humans, especially in investments, is recency bias. Investors, good or bad, in 2021 momentum markets when they're higher, equity markets only go up, let's pile into anything, meme stocks, everything. It's recency bias. We extrapolate the most recent performance to expecting that it's going to continue forever or perpetually. And whoa, same thing [inaudible 00:07:26]

Macan Nia:

Kevin, have couple of drinks to start your Monday morning?

Kevin Headland:

No, I just finished a French presentation for an hour, so my English might not be that great right now

Macan Nia:

You're speaking English.

Kevin Headland:

Yeah, my brain's still working in French, I think. Anyway, and same with the negative, the fixed income and equity markets we've received now. So fixed income for sure, oh my God, the worst fixed income ever. Many investors have never seen negative bond returns for a county year. It's a very rare occurrence and they almost think it's going to continue. So it's like, "Oh, let's get out of this, let's get out of the risk." And it's important to understand that fixed income or investing in bonds is not necessarily a risk. There's price volatility, but if you have a pretty high degree of probability that the company or government you're lending money to by investing their bonds will not default on their obligation, provide you a coupon on a quarterly basis, and also your principle back in maturity, there's actually no real risk in the bonds. It's a price volatility.

And I think that's what we're seeing right now, is people think that there's a lot of risk there, but it's actually not risky. And I think it's important to realize and kind of remember what we're investing in and we got to think about what we're investing for the longer term, and for bonds, 2022 was extremely rare year and we are unlikely to go and see that going forward. We believe that 2023 will likely be a much better year for fixed income than 2022 was.

Macan Nia:

And while the safety of a GIC makes sense for a time period less than a year, those investors have longer time horizon. We would caution using GICs as a proxy for bonds for really three main reasons, and we'll go through them right now. So reason number one, Kev, is Canadian bonds typically outperform GICs. So when you look back at the history of the Canadian bond universe, Canadian bonds have actually outperformed GICs 80% of the time. And I remind, we're getting questions of GICs versus bonds and I'll ask the advisor, "Well, why don't you own GICs as a proxy for bonds today?" And that's the reason, is 80% of the time bonds have outperformed GICs. And we just so happened to be in one of those 20% of the period times last year, which was a function of this once in a generation event that was COVID and the policies that were enacted during it.

Kevin Headland:

Now it's important to, the way we calculate that is we look at the FTSE Canada Universe Bond Index on a 12-month rolling four basis and what that GIC yield was. So we're comparing, in the 12 months, is the JC yield 3%, at the end of that 12 months, what did the FTSE Canada Universe Bond Index return? And that gives us a better idea of how they performed apples to apples, right? It's not necessarily a fair comparison because they're not apples apples, but that's the mentality we're going into. I'm getting 4% for the next 12 months. If I go in the future, if I have a time machine and go 12 months forward, what did my bond fund return? And that's how we calculated. And what we see is, as you said, 80% of the time that bond fund is actually proven to be a better investment than the GIC.

Macan Nia:

And some might say, "Well, you're not comparing apples to apples." Right? GICs are very different than bonds and that is absolutely true. However, the reason we're comparing them or saying they're apples to apples are investors are looking at them from an apple to apple investment perspective. So let's move to the second reason that why you want to own bonds over GICs is the out performance of bonds is typically material versus GICs. If the out performance of bonds was a percent per year, let's say for example, then why would you take on that additional credit risk, duration risks, so on and so forth over GICs? But that's not the case.

And when you look at typical, again going back to Canadian Bond Universe, typically 60% of the time the out performance versus GICs is greater than two and a half percent per year, and 40% of the time it's greater than 5% or more. So it's not immaterial, it's very sizable and not, we're not making any promissory statements, we never do, however, Kev, walk us through if a GICs pay me 4% how, it's very, and we've talked about this in previous podcast, is it's very easy to set the thesis where bond index can be yielding me, or not yielding me, let me rephrase that, total return of high single digits with potential risk to the upside.

Kevin Headland:

Yeah, it's one of the things that when you talk about apples, apples, unfortunately investors do look at it and say GICs versus fixed income, apples to apples. And the one thing that we don't usually compare or we do compare is we compare the yield versus yield, right? I have a 4% GIC, my bond fund is yielding 4%, okay. I just said let's not take on the risk of fixed income.

But what they're not looking as at is the potential capital gains or total return for that bond. We're seeing as a lot of bonds right now are trading well below maturity value, well below par and you're getting that capital gain a potential. And the other thing, also you said, is the mathematics behind returns. This is why it gives us confidence in fixed income, especially this year, is the way mathematics work and what happens often in recession, we believe we are going to be heading into recession at some point this year, or even if we're not, we're seeing yields already come down, especially the long end of the yield curve, the US tenure treasury, is during recessions the 10-year treasury yield tends to fall by a third.

Now, if we took rough estimates of bond math as a very simplistic measure, if you take a 10-year yield yielding three point a half percent, it falls by roughly a third, that's roughly 1%. The duration on a 10-year treasury yield is roughly eight years. So price gain calculation is duration times changing yield. So that's 1% times eight years equals 8%. That's your price appreciation and you still get your three and a half percent yield that you started with. So eight plus three and a half equals 11.5% return on your tenure treasury that was yielding very similar to your GIC at the beginning, but we didn't get that total return in GICs and I think that's a very simplistic way to look at it. But right now, if we believe we're in a slower economic environment where yields should be falling, not necessarily the central bank yields, but the yield curve, the government treasury curve, that could provide very strong tailwinds to fixing and returns relative GICs. Again, if we fast-forward 12 months, what was our return?

Macan Nia:

And then the third reason why bonds, let say Canadian bonds over GICs is there's reinvestment risk for long-term GIC investors. And what I mean by that is, okay, you get your rate and then you lock it in, let's just say for three years. Well, after three years you get your cash back and there's usually a reinvestment risk, which means that interest rates are likely to be lower when you have to reinvest that money and that's one of the negatives of GICs. And look no further than GIC rates today from a mature, like the length of the maturity in terms of what many financial institutions are expecting.

Kevin Headland:

I'll use manual bank as an example. The one year GIC rate pays me 4.55%. Today, the three-year rate pays me 4.1 and the five-year rate pays me 4%. I'll note that these are current rates and could change in the future.

Macan Nia:

So financial institutions are expecting interest rates to decline. When you look at the Bank of Canada as an example in terms of interest rate probabilities for this year, we may get one more 0.25 in the next meeting. They will pause and they'll likely be cutting towards the end of the year. And then for sure next year they'll be cutting much more materially. So there's more likelihood of reinvestment risk for GIC investor versus a bond.

Kevin Headland:

I have to ask the advisor similar question, even ask, they'll have them ask the client that similar question, do you believe that central bank rates will be higher or lower in one year's time, three years' time, five years' time, as much information you can have. When you look at how high rates are now and they haven't been high since before the financial crisis essentially, the answer's often lower. And as you said, that reinvestment risk and if central bank rates are lower, the GIC rates offered by the banks or by other financial institutions will also be lower than there today. And so you have this money coming due in three years, let's say, and now instead of 4% GIC rates there at two and a half and you say, "Well, that's scale, I'll just reinvested that." Yeah, it's lower, it's not great. Or I'll go to bonds, bond returns have been so good, I'll go to bonds.

Well, sometimes the returns are already behind you and again, we have to look forward and see where things are going. So that's a big risk that I don't think a lot of investors understand is that maturity, that reinvested risk that money comes due, I've got to do something with it, I've got to invest it somewhere and 4% look great, two and a half does not. Especially when you look at that, that's barely going to keep pace with inflation at 2% inflation, it's barely going to keep pace. So you could actually be losing your purchasing power. So there's a lot of risks that perhaps people don't think about when they think about GICs.

Macan Nia:

And when we factor these three things together, whether it's Canadian bonds outperformed GICs, the majority of the time the out performance is material and there's reinvestment risk for GICs, we think in 2023 that there is an opportunity in bonds over GICs and that clients shouldn't be looking in the rear view mirror and taking historical performance, one year performance, and extrapolating that forward because we think that investors that are going to be doing that may be disappointed by the GIC return compared to what they would have got from bonds. So maybe, Kev, we'll stop there. I know this is 15 minutes in, one of our shorter ones, but I don't think there's anything else to add unless you think that there's something-

Kevin Headland:

No. I was going to say is I think it's important to ask the questions, right? Don't just take the rates at GICs versus fixing them at phase value. GICs might have a place in a portfolio, but they shouldn't replace fixed income completely. And I think it's important to understand that. Last year was a rare year for fixed income, and the easy answer is, I'm just going to go to GICs, but we might be leaving some gains on the table for fixed income and I think it's important to understand that. Ask the questions. If you have more, you want to understand the issues a little more, the complexities with fixing versus GICs, by all means reach out to your mainly investment manager wholesaler, connect with us, or we can walk through the different risks or opportunities, but don't just take the yield comparison at face value.

Macan Nia:

Yeah, I thought you said that very well, that they GICs do serve a purpose within a portfolio from a cash wedge perspective, but there may be risks from viewing them as a proxy for bonds. Kev, I'm shocked. You haven't even mentioned what happened last night. I thought that you would've given me the gears.

Kevin Headland:

Well, I'm trying to be nice to you. I'm sure it's difficult after watching your Cowboys lose to my Niners last night. So I figured I'd give you a little bit of a day to mourn and I'll bug you tomorrow.

Macan Nia:

This is the humane side of Kevin Headland for 2023. So for as many of you know, Kevin's a big 49ers fan. I am, unfortunately, a big Cowboy fan and obviously my team, surprise surprise to no one that's a Cowboy fan, underwhelmed. So I was cursing my dad all of last night for making me into a Cowboy fan 20, 30 years ago and it's been nothing but misery since, outside of those three Super Bowls. But anyways, now I can see that I'm annoyed by it and we're digressing. So with that, thank you for listening. If you find this podcast helpful, please rate us. The ratings help us move up in the rankings so like-minded individuals like yourselves can be connected with content like this. And again, always appreciate the feedback that we receive on the road. And with that, I'm Macan Nia.

Kevin Headland:

And Kevin Headland.

Macan Nia:

Thank you for listening. Take care.

Kevin Headland:

Take care.

Speaker 3:

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