A Case Study on Avenue's Bond Portfolio Strategy

Why own bonds today? Given the weakness in bond prices and the expectation of higher inflation we thought it would be a good time to review Avenue's Bond Portfolio strategy. This is a debate about maintaining bond investments or holding cash. We still believe the most effective universal strategy is a staggered maturity of mostly corporate bonds. At Avenue, we try not to invest in corporate bonds beyond 10 years and we keep our investments here in Canada.

It is expensive to hold cash due to the persistent level of Canadian inflation. An inflation rate of 2% means that $100 dollars today is only able to buy $98 worth of goods by the end of the year. In 10 years' time, $100 dollars has only about $80 dollars' worth of purchasing power. Owning bond investments, which pay interest, are almost always better than holding cash over the longer term. So any time you sell a bond and go to cash you know there will be a appoint point in the future where you need to buy them back.

The problem with timing the market with this much accuracy it that it requires perfect knowledge of the future. Market timing is also referred to as speculating and if we get the timing wrong it is very expensive. By being in cash we not only lose money due to inflation but the bonds we sold might go up in price and not down. On top of inflation and bad timing there are large transaction costs in the bond market. One mistake can take years to recover from versus just holding the original bond investments, collecting interest payments and riding out the bumps in the market.

At Avenue, we believe there is a big distinction between bonds. Short term government bonds in Canada yield 0.8% and if inflation is 2% then your actual return is still negative. 30-year Canadian government bonds yield 2.3% which is only slightly more return than current inflation but thirty years is a long time. We know there have been periods where inflation was much higher so this becomes a risky bet. A seemingly small increase in yield will have a major short term change in price for longer term bonds. This is really the main way to lose money in the bond market and where most of today's concerns come from.

We believe that Avenue's bond portfolio, with a mix of 5 to7 year maturity Canadian corporate bonds, will give us a 3-4% return on average, over the next few years. This covers the money destroying effects of inflation and the shorter maturity bonds reduces volatility. These returns are not exciting but one of the first rules in bond investing is if the return is not there then don't stretch to look for yield.

Why investing in mid-term corporate bonds is such a good strategy is because they give us the highest yield with the most reinvestment flexibility. If interest rates were to go up significantly in a short period of time the portfolio value could drop slightly as the bond price decline outweighs the value of the interest payments coming into the portfolio. However, bonds are constantly maturing and along with the interest payments, can be reinvested at the new higher rates. Avenue's bond portfolio strategy allows us to compound ahead of inflation and roll through short term price bumps without having to guess the future.