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Fixed income funds attracting those who missed the recovery

But diversification the key to long-term success

A recent investor survey conducted by Franklin Templeton Investments Corp. revealed that 87% of Canadians missed the market recovery in 2009. As a result, many investors are sitting in low-yielding investments; not generating enough after-tax returns to provide an adequate retirement. Fortunately investors are learning that generating a sustainable income stream is critical for long-term success and they've started to search for yield.

Many began the hunt by shifting into fixed income. In January alone, investors moved \$800M into fixed income funds but the current low interest environment has caused confusion with concerns mounting over the potential for higher inflation. All else being equal, rising rates can lead to a decline in bond prices and place income-oriented investors in a precarious position.

In order to mitigate the effects of any short-term pullback in the credit markets, investors should exercise diversification within their fixed income investments. Long-term success is more likely if they apply a multiple-strategy approach by examining the liquidity, credit, and interest rate components of their fixed income investments. Investors will want to ensure they have exposure to an array of good quality bonds of varied maturities, across different sectors and geographies.

Investors don't have to stick with traditional bonds. They can also diversify with real return bonds, which offer a very direct inflation hedge. If held to maturity, Government of Canada Real Return Bonds guarantee returns above the rate of inflation. Principal and

interest payments are adjusted higher with rises in consumer prices; reducing worry about the future income stream of the portfolio.

Another possibility is to consider diversifying sources of yield. According to data compiled by Phillips, Hager & North, returns of income-oriented asset classes vary significantly with changing economic conditions. For instance, when inflation hit 5.0% in 1990, Treasury Bills were the top performing asset class, generating returns of 13.5%. In 1994, T-bills were again the top performers, even though inflation was 0.2%.

Clearly, determining which asset class will outperform in a given year is very difficult as many different factors can influence performance. However, this potential for volatility can be reduced significantly by adding other income investments such as income trusts, preferred shares, and dividend-paying equities.

Income trusts can be a beneficial addition to a portfolio. Trusts offer investors tax-efficient distributions because of their structure, and they increase portfolio diversification possibilities because they are available in a variety of industries.

Investors can also add preferred shares to their income lineup. Preferred shares, which share characteristics of both bonds and common shares, offer a highly predictable income stream via tax-efficient dividends. Although they are subject to interest rate risk, most offer large dividends that provide a level of cushion against potential declines in value.

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Continued from Page 1

As well, investors should review the equity component of their portfolios. Adding top quality, dividend-paying equities can play a substantial role in achieving long term success. According to Credit Suisse, for more than the last 100 years Canadian equities have generated a real return of 5.8% per year. Over time, a considerable part of the total return of a portfolio can be attributed to dividend payment streams, and dividend-paying equities are much less sensitive to interest rate fluctuations.

Like any other investment, all of these income streams come with wide arrays of options and particular factors to be considered if investors are to find the best fit for their portfolios. Research is imperative.

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