



CIBC ASSET MANAGEMENT

# GUIDE TO PORTFOLIO CONSTRUCTION

The role of fixed income

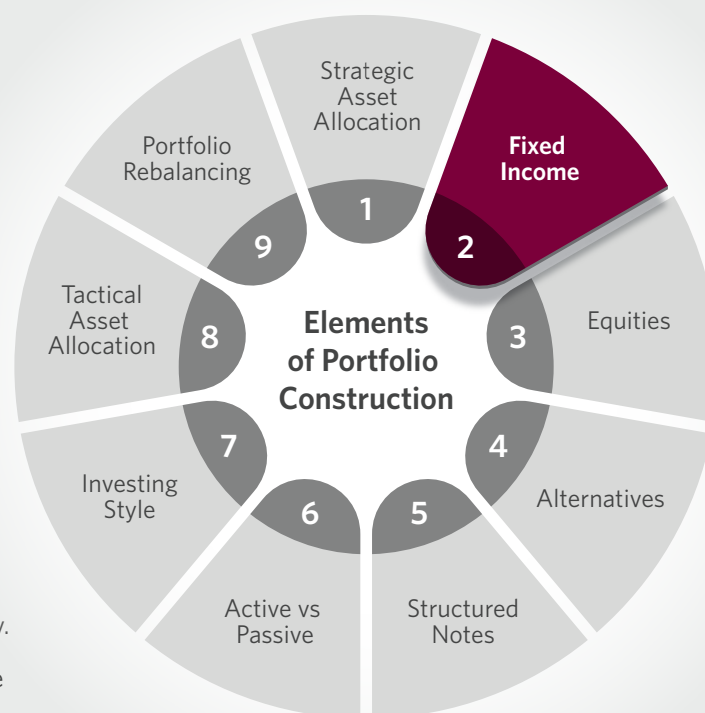


## Guide to portfolio construction

Market and economic uncertainty, combined with relatively low expected returns for many asset classes, are making it harder for individuals and institutions to reach their financial goals. A thoughtfully designed portfolio that helps you embrace market opportunities while preparing for the unexpected has never been more important.

There are several components of a well-constructed portfolio, including a robust strategic asset allocation that's consistent with your long-term goals and objectives. A mix of asset classes such as equities, fixed income and alternatives, and strategies such as tactical asset allocation, active versus passive investing, and portfolio rebalancing all have a role to play.

This guide highlights how fixed income can help improve portfolio performance and help you achieve your ambitions.



## Fixed income—the core of many investor portfolios

Fixed income is a core component of many investor portfolios. With yields in some segments of the fixed income market now at record lows, however, some are questioning its role. In reality, we have been in a low-yield environment for over ten years and fixed income has continued to perform several important functions within portfolios.

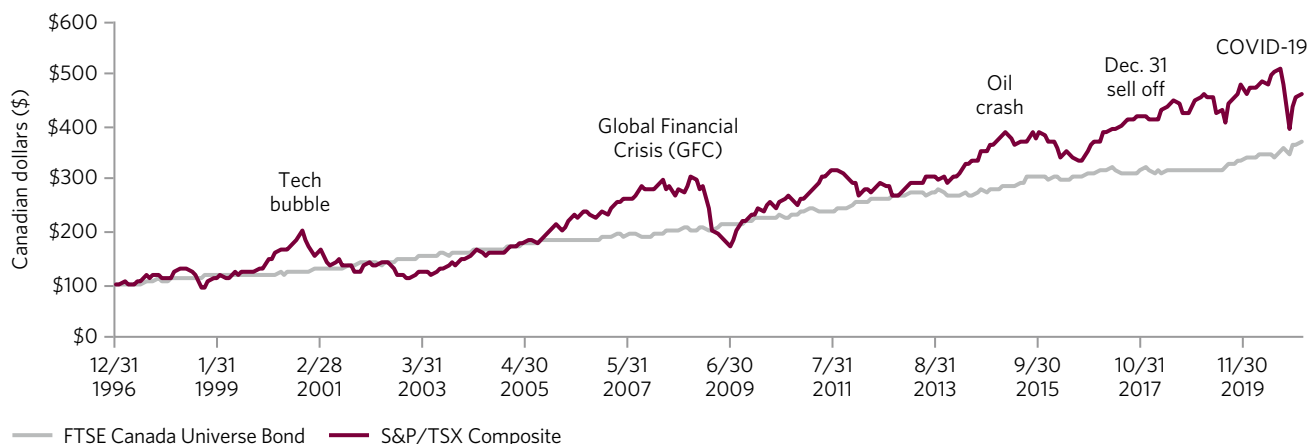
**Explore the key benefits of fixed income within portfolios, including:**

1. A source of predictable returns and income
2. Diversification
3. Capital preservation
4. A source of liquidity
5. A tool to hedge liability risk

## Benefit #1: A source of predictable returns

Fixed income returns are less volatile than publicly-traded equities, and therefore are more predictable (Figure 1). This predictability is important for investors with income needs. In times of market volatility, fixed income can provide much needed diversification and stability.

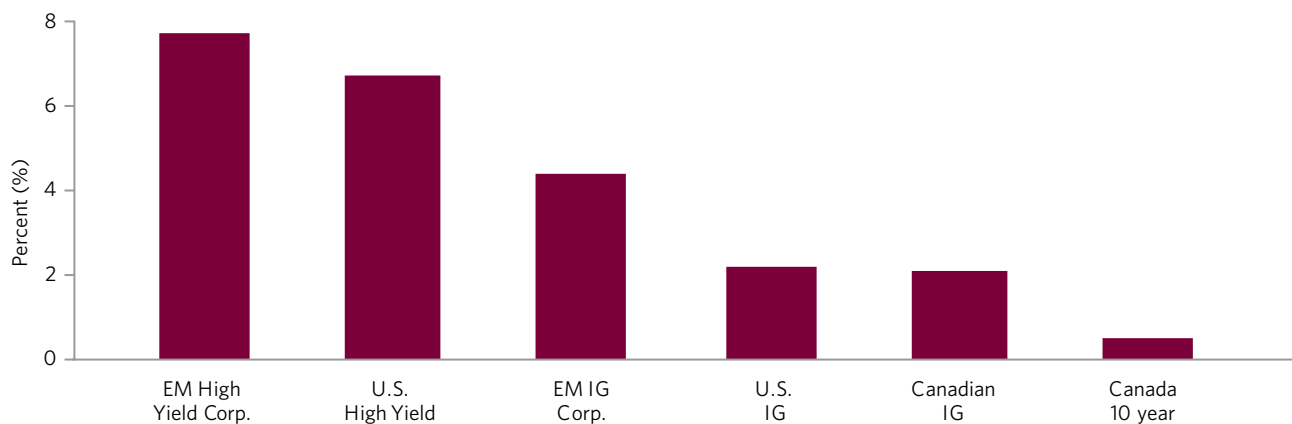
**Figure 1 - Relative stability of fixed income**



Source: Morningstar Direct. Data as at June 30, 2020.

Although interest from fixed income has declined in recent years, a number of fixed income market segments and strategies remain available to help enhance portfolio yield (Figure 2). A skilled portfolio manager can balance allocations to core fixed income with strategic allocations to higher income categories in a way that generates relatively attractive return and income streams, without taking excessive risk.

**Figure 2 - Income portfolio yield**

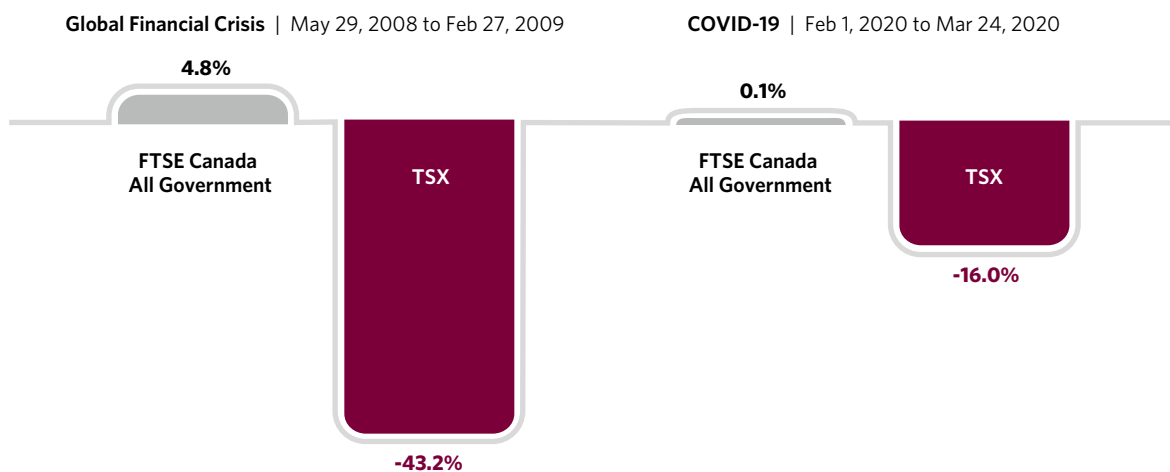


Source: Federal Reserve Economic Data. ICE BofA Indices. Data as at June 30, 2020.

## Benefit #2: Diversification

Every core fixed income allocation should be anchored with exposure to developed market (DM) government bonds. Government bonds have traditionally acted as a good hedge against the adverse impact on portfolio performance of economic downturns; they are considered a safe asset which often appreciates in value when equities prices are falling. Combining an allocation to DM government bonds with exposure to other fixed income segments—corporate, high yield, emerging market, and private debt for instance—is expected to enhance portfolio returns and income. As each of these segments generates return from a different risk source (credit risk or an illiquidity premium are examples), allocations can enhance the diversification opportunity presented by the broad allocation to fixed income.

**Figure 3 - Stock and bond total returns in Global Financial Crisis and COVID-19-related drawdown**



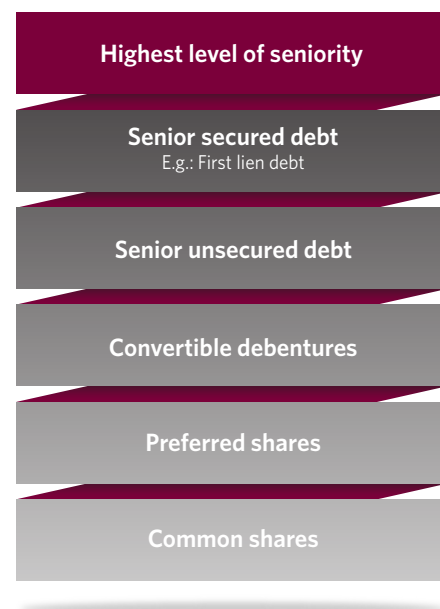
Source: Morningstar Direct.



## Benefit #3: Capital preservation

Fixed income is an important source of portfolio capital preservation. Corporate bonds rank ahead of equity in terms of claims on assets (Figure 4). Bond investors are also promised and receive scheduled interest payments and principal repayments by the issuer. This additional security, along with fixed income's attractive drawdown profile, allows investors to target higher returns in other parts of the portfolio.

**Figure 4 –  
Capital  
structure**



## Benefit #4: Liquidity

Fixed income offers better liquidity than most asset classes. This helps with portfolio rebalancing, as fixed income can be used as a source of capital to fund growth asset classes when growth allocations fall below targeted strategic allocations. Given the lower volatility of fixed income, selling has less impact on potential portfolio growth than selling other asset classes.

## Benefit #5: A tool to hedge liability risk

Future liabilities come in many forms. They could be the retirement benefits a pension plan has committed to pay to pensioners, the university education parents must fund for their children, or retirement living expenses. Fixed income can be used to reduce the interest rate risk associated with these liabilities. The size of liabilities is measured by their present value, calculated using a market interest rate. As interest rates change, so will the present value of liabilities. This creates a risk that the level of interest rates in the future may mean that the value of liabilities is greater than the value of assets that will be used to pay them. This risk can be hedged by matching the interest rate sensitivity of fixed income allocations with the sensitivity of future liabilities.

### Key fixed income considerations:

If you require a source of stable expected return and income, diversification, liquidity and liability hedging, fixed income could be a beneficial component of your portfolio. These attributes can complement your other portfolio allocations and allow you to seek higher-return opportunities elsewhere in your portfolio.

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