Preparing for Rising Interest Rates

By Robert Todd

Over the past decade, we have learned to live with low interest rates. Our chartered banks tout savings accounts offering 0.050% per annum, and they have the temerity to call this 'high interest savings' — even for an account with a million dollar balance! Guaranteed Investment Certificates do not do much better: one bank offers a non-cashable $15,000 GIC locked in for 18 months yielding 1.05% (or up to 1.35% for 3 years). The search for decent investment returns is challenging.

Now, we must learn how to accommodate rising rates, because the Governor of the Bank of Canada recently promised that rates would rise. This question forces us to widen the search for investments that will protect the value of our assets, as well as provide respectable returns. If you are not quite the Indiana Jones of personal investing, and want to preserve assets as interest rates rise, then you may need to adjust your investment strategy to 'the new normal'!

In the past, GICs, Treasury bills, bonds, bond funds and other interest rate based investments were considered essential for capital preservation with some income. As higher interest rates for newly issued investments attract more attention in the market, the yield on investment for older bonds drops since their market value must reflect the increasing interest rate. To make up for a lower coupon (interest) payment, the market price of the bond drops accordingly. This does not protect the value of the underlying asset.

Reviewing carefully with the advice of a trusted Financial Advisor, accepting slightly greater risk, one should look seriously at investments that include a portion of equity, or that include a mixture of 'high yield' or 'non-investment grade' (so-called 'junk') bonds. Over recent years, funds containing such mixed investment types (bonds, preferred shares, and blue-chip dividend paying common shares) have done well under both objectives: preserving assets and improving return on investment.

In the past, preferred shares had been more secure investments, given their position in the ladder of reimbursement between bond holders and common share-holders. However, Canadian preferred shares have not performed to expectation in recent periods of rapid rate declines, making them less attractive as an asset class.

There are newer vehicles in the market which provide capital protection, but offer an unspecified rate of return. A Principal Protected Note, or similarly, an 'Index-Linked GIC', is not a mutual fund type investment, but rather a retail banking product. Upon arrival at term, the value of this asset is based on the value of an underlying basket of stocks.

Another newer product is the Floating Rate Note, which can be available to investors through a mutual fund or an ETF that invests in a consolidated pool of corporate loans. The underlying loans have been made to firms that may or may not be 'investment grade'. Non-investment grade includes loans to firms mostly rated B/BB, with some at BBB or CCC. Lower rated corporate loans have performed well, in part because of their higher coupon rates. Traditionally, loans have outperformed bonds in periods of flat or rising interest rates.

The mixture and the spread of consolidated floating rate loan obligations, whether all investment grade or mixed and lower grades, provides for better risk management, and the loan's 'Senior or Secured' position in the corporate capital structure provides improved status as a worthwhile investment vehicle.

Finally, some mutual fund managers offer a 'covered call option strategy'. This type of fund can provide two sources of cash flow in one instrument. It is based on the purchase of dividend paying stocks, and then selling (or 'writing') 'calls' (future sale contract at fixed price by a determined date) on those stocks (or 'covered'). This strategy can offer better returns, especially in an upward moving market, but limits the upside return available from rising share value. The improved yield is derived from a premium paid from the sale of the options, and also a dividend yield from the ownership of the underlying shares. This is a complex process for an individual investor which is not suitable for 'buy and forget' investors. On the other hand, as a strategy for an experienced portfolio manager of a fund of appropriate portfolio of high yield dividend stocks, this offers increased tax efficient income.

Whatever your risk tolerance, it is useful to speak with a Financial Advisor soon, as the changing winds of the economy, and rising interest rates from the Bank of Canada may change the situation affecting your investments.

Robert Todd was a Director of Tradex from 2002 until 2017. He remains a member of the Tradex Independent Review Committee.