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Mark Yamada / January 01, 2012

Products may appear similar, but are not.

Some ETFs that employ derivatives are receiving critical press and regulatory scrutiny, so we're examining them in this series.

They May Look Similar, But...

Covered-call ETFs with monthly distributions are not income products, even if those distributions seem like dividends or interest. The "yields" from preferred shares or common stocks are different than bond and covered-call yields. Look at the underlying components—bond interest is more reliable than preferred dividends, which are more permanent than common-stock dividends, which are significantly more stable than option premiums.

Time is a bigger factor in evaluating an option than it is for preferred shares. With options, both the expiration date and strike price relative to the market price are critical. Even the sourcing of income is different. Option premium cash flow is considered capital gains and taxed at a higher rate than dividends.

Covered-call ETFs are all the rage: when capital markets are unsettled and yields are low, the promise of higher returns from selling call options against stagnant equity holdings is attractive.

ETFs have democratized access to this tactic. While people need margin accounts to execute covered-call trades themselves, ETFs make this unnecessary. Calls give the owner the right to buy a stock at a predetermined price (strike) for a predetermined time (until expiration). Puts give the right for the owner to sell stock under similar constraints. Puts and calls are exchange-traded derivatives that, while useful in altering risk, can add costs.

What Is A Covered Call?

Buying a stock and selling the right to buy it from you is the principle of a covered call. Do this if you:

- want to sell the stock anyway;
- believe the person is willing to overpay for the right.

Price and time will influence your decision. You must:

- be willing to sell the stock at the strike price within the expiration period;
- think the call buyer is too optimistic for the stock's prospects through expiration; and
- want to protect your position from some price decline.

Covered calls should improve returns in trendless and modestly declining markets, and reduce risk (standard deviation). An example is BMO Covered Call Canadian Banks (ZWB), the covered-call ETF with the most AUM in Canada as of December 19, 2011 (see sidebar, “ZWB protects”).

ZWB Protects With Slightly Less Risk Than ZEB

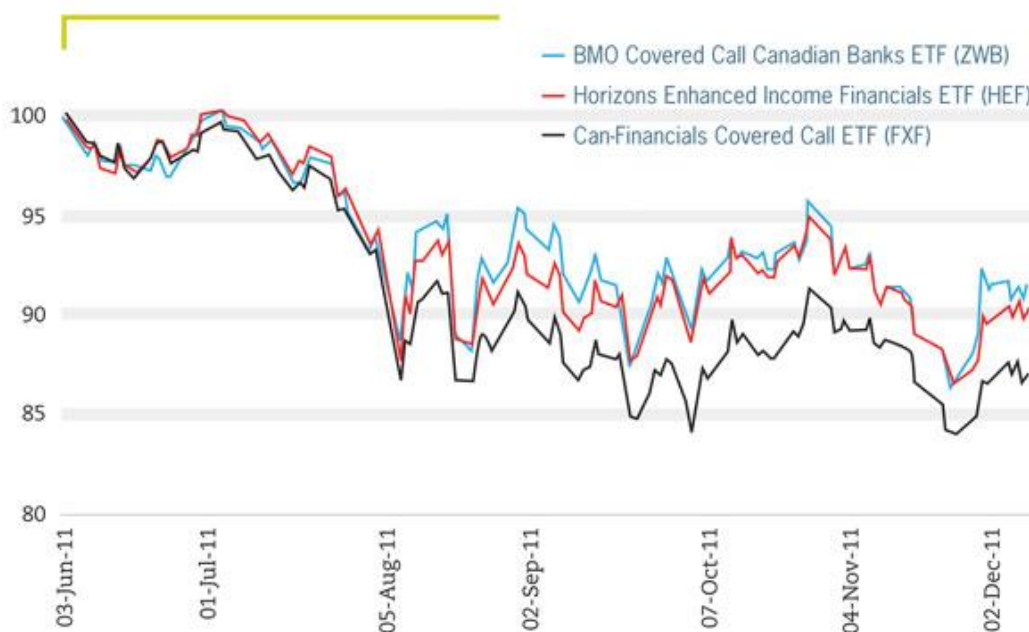
| FEB. 1, 2011 TO DEC. 9, 2011 | ZWB | ZEB |
|------------------------------|--------|--------|
| Total return | -3.75% | -4.33% |
| Standard deviation | 17.46% | 18.27% |

Some ETFs write calls on all holdings (BMO; Horizons Betapro), and some on only 25% (XTF). Some write out-of-the-money (BMO; Horizons Betapro), and some at-the-money (XTF). What are the various risks?

The chart “Three financial services covered-call ETFs”, below, indexes these ETFs from June 3 to December 9, 2011. We can see:

1. Writing against 100% of positions (BMO’s ZWB and Horizons Betapro’s HEF) versus 25% (XTF’s FXF) provides better downside protection;
2. Protection during periods of sharp market declines (July to August) can be difficult. Constrained liquidity and the cost of “rolling down” (buying back short call positions and reselling at a lower strike price) can limit effectiveness.

Three Financial Services Covered-Call ETFs



When markets rise quickly, ETFs with only 25% of positions “overwritten” should provide more upside. The difference between the more conservative at-the-money strike price of XTF—albeit on a smaller portion of the holdings—and the slightly out-of-the money price of BMO and Horizons Betapro is likely to be similar to the difference between the at-the money and 2% out-of-the-money for the CBOE S&P 500 Buy-Write Indexes (see sidebar, “Less risk”).

Less Risk With At-The-Money Index

| | S&P 500 Total Return | CBOE S&P 500 at-the-money Buy-Write Index | CBOE S&P 500 2% out-of-the money Buy-Write Index |
|--------------------|----------------------|---|--|
| Return | 9.6% | 9.6% | 12.7% |
| Standard deviation | 18.2% | 12.7% | 14.5% |

Always Sell Volatility

Call-writing strategies exploit the spread between implied and realized volatility. This is the difference between the fear of losing (puts), the greed of making money (calls), and reality. Over time, selling calls has been more profitable than buying them, because capital markets always fear something. Covered-call ETFs allow investors to exploit pricing inefficiencies and bend risk around their equity underpinnings. ●

Safety Measures For Swap-Based ETFs

Mark Yamada / February 01, 2012



Losing money is a risk inherent in the purchase of any financial product. Therefore, be it a stock, bond, mutual fund or ETF, investors expect correct, timely and complete information.

Indeed, an entire industry has developed around compliance and disclosure. The risk of losing money in ETFs can be broken into three component parts:

- Cost
- Stupidity
- Counterparty/credit

Highest Risk of Losing Money: Cost

One rarely knows the return of an investment beforehand; but the cost of that investment is very calculable, and represents the greatest certainty of reducing capital for any product. Despite this fact, it's stunning how many investors have no real understanding of what they pay for products and services.

Some synthetic ETFs use swaps in their construction. In Canada these include Horizons S&P/TSX 60 Index (HXT) and Horizons S&P 500 Index (HXS).

Part of the cost of these products is the swap fee paid to counterparties to deliver the return of the underlying index.

While the swap fee for HXT is listed as zero, interest and fees for securities lending provide the required revenue. HXS bears a 0.30% fee. Investors should add this to an MER of 0.15% (0.45% total). The management expense ratio for HXT is 0.07%.

These two ETFs offer a particular advantage for taxable investors by providing the total return of the underlying indices, the S&P/TSX 60 (HXT) and the S&P 500 (HXS) respectively. No taxable distributions are involved, so capital compounds unfettered by tax.

Next-Highest Risk of Losing Money: Stupidity

Costs are inevitable, making it the highest risk. Stupidity is the second because even a stupid investor can actually get lucky once in a while.

Leveraged and inverse-leveraged ETFs have been categorized as appropriate only for intraday trading. This satisfies regulators and compliance departments. However, they can be used for much longer-term portfolios but not by dummies who don't read the prospectuses, or who don't bother estimating the volatility drag.

Otherwise intelligent people condemn these vehicles because the idea of compounding returns must conceptually elude them. Leveraged and inverse ETFs use synthetic structures that form a subset of ETFs with embedded strategies.

It's simple: if you don't understand a product, don't use it.

Potential Risk of Losing Money: Counterparty

Replicating an underlying index can be cumbersome. Some ETF sponsors choose to synthetically recreate performance. This involves posting collateral and having a counterparty (in Canada, this means a bank) pledge the return.

The quality of the counterparty and the liquidity and value of the collateral are key concerns for these ETFs.

Synthetic structures involve fees that are classified as trading costs but should be considered an overall cost of the structure.

If one of the major banks fails as counterparty, Canadians will have much more to worry about than just a synthetic ETF. Nevertheless, safeguards limit single counterparty exposure in Canada to 10%. In Europe, there are concerns ETF sponsors are using their own banks as counterparties.

This hasn't happened in Canada yet. The risk of counterparty failure is difficult to assess. However, just because it hasn't happened here doesn't mean it never will—even if collateral in Canada consists of 100% cash.

HXT uses a swap with 10% exposure to National Bank Financial (NBF) as counterparty.

The spread between NBF and Government of Canada bonds is about 1.0% (3-year to 5-year), suggesting a potential credit risk of 0.10%. Add the MER, 0.07%, and the 0.17% compares with iShares S&P/TSX 60 Index (XIU) MER of 0.17%.

HXT's 0.10% lower fee compensates the investor for the added risk. If HXT were structured as an exchange traded note, the entire 1.0% spread should be considered a cost.

Synthetic structures are making useful products available to retail investors in cost-effective packages (see table "Canadian non-leveraged ETFs," below). But synthetic-based ETFs require more scrutiny.

If you don't understand these products or don't want to do the research, you should probably stick with lottery tickets or mutual funds that require less sophistication. A little research will reveal valuable new strategies and products that are well worth the effort.

| ETF Name | Symbol | MV (\$M) | MER (%) | Structure (swap fee) |
|--|--------|----------|---------|----------------------|
| Horizon S&P/TSX 60 Index | HXT | \$326 | 0.07 | Swap (.00) |
| Claymore Advantaged High Yield Bond | CHB | \$290 | 0.56 | Forward |
| Claymore Global Monthly Advantaged Dividend | CYH | \$128 | 0.56 | Forward |
| Claymore Advantaged Canadian Bond Fund | CAB | \$118 | 0.30 | Forward |
| Claymore Natural Gas Commodity | GAS | \$94 | 0.90 | Forward |
| Claymore Broad Commodity | CBR | \$45 | 0.93 | Forward |
| Horizon COMEX Silver | HUZ | \$18 | 0.65 | Forward |
| Horizon Betapro S&P 500 VIX Short Term Futures Bull+ | HVU | \$18 | 1.15 | Forward |
| Horizon COMEX Gold | HUG | \$15 | 0.65 | Forward |
| Horizon S&P 500 Index | HXS | \$11 | 0.15 | Swap (.30) |
| Horizons Winter-term NYMEX Crude Oil | HUC | \$4 | 0.75 | Forward |
| Horizon Betapro S&P 500 VIX Short Term Futures | HUV | \$2 | 0.85 | Forward |
| Horizons Winter-term NYMEX Natural Gas | HUN | \$1 | 0.75 | Forward |



ETF Tips From The Rink

Mark Yamada / March 01, 2012



In hockey, as in portfolio management, offence is not always the best defence. A balanced two-way capability is usually most effective.

Constructing a portfolio, like drafting and coaching a hockey team, demands a fundamental understanding of what it takes to win. Portfolios built strictly to maximize gains are akin to lineups consisting of five forwards.

Any coach knows that's risky. Investment advisors could learn something from hockey tactics, particularly when facing big volatile markets that can slam any game plan into the boards.

Getting the right lineup on the ice at the right time is a coach's primary job. Here are two ideas to help exploit game situations and manage tactically for clients.

Battle for Control

If the puck is in the neutral zone and control is at issue — trendless market, lacklustre economy — a balanced attack with a defensive emphasis may be suitable. One strategy involves a 1-2-2 with one forechecking forward, two supporting forwards and two defensive players back. This approach was popular with Jacques Lemaire when he coached the Wild and Devils. Diversified exposure to global and international economic growth is a good objective for the forechecking forward position. The support can be broad Canadian and U.S. equity exposure (see table below).

1-2-2 Forecheck: Portfolio Strategy A

| Forechecking Forward | Supporting Forwards | Defencemen |
|--------------------------------|--|--|
| iShares MSCI World (XWD) | iShares S&P/TSX Capped Composite (XIC) | Claymore 1-to-10 yr Laddered Gov't Bond (CLG) |
| Vanguard MSCI EAFE (VEE) | Horizons S&P/TSX 60 (HXT) | Vanguard Canadian Aggregate Bond (VAB) |
| BMO International Equity (ZDM) | iShares S&P/TSX 60 Index (XIU) | iShares DEX Universe Bond (XBB) |
| iShares MSCI EAFE (XIN) | BMO Dow Jones Canada Titans (ZCN) | Claymore 1-5-yr Laddered Corp Bond (CBO) |
| | Vanguard MSCI US Broad Market (VUS) | Powershares 1-5-yr Laddered Investment Grade Corp. (PSB) |

There's a lot of choice for defence. Mid-term and laddered options are versatile and broad-based bond ETFs can anchor the blue line. Short-target maturity ETFs like RBC Target 2017 (RQE) and short-term index-based ETFs could act like a hard-checking defence that minimizes risk around the net.

Green Light

When playing opportunistically — low volatility, upward trending stock market, and a positive economic backdrop — coaches may favour an aggressive structure (see “Aggressive 2-1-2” table that follows) with two penetrating forwards on forecheck, supported by a forward and a rushing pair on defence. This tactic makes best use of goal-scoring skills and was favoured by Scotty Bowman with the Habs in the 1970s and Mike Babcock with the current Red Wings. (Ironically, Lemaire played on many Bowman teams!)

Attacking forwards can include aggressive ETFs for broad scoring punch, including emerging markets, growth, and small-cap strategies — think Guy Lafleur and Evgeni Malkin.

Aggressive 2-1-2: Portfolio Strategy B

| Attacking Forwards | Supporting Forwards | Defencemen |
|--|----------------------------|--|
| Vanguard MSCI Emerging Markets (VEE) | Powershares QQQ (QQC) | Claymore Advantaged High-Yield Bond (CHB) |
| iShares Dow Jones Canada Select Growth (XCG) | iShares NASDAQ 100 (XQQ) | iShares US High-Yield Bond (XHY) |
| iShares S&P/TSX Small-Cap (XCS) | iShares Russell 2000 (XSU) | Powershares Fundamental High-Yield Corporate (PFH) |
| Claymore BRIC (CBQ) | BMO NASDAQ 100 (ZQQ) | BMO High-Yield Corporate Bond (ZHY) |
| BMO Emerging Markets (ZEM) | | Claymore Advantaged Convertible Bond (CVD) |
| Claymore Broad Emerging Markets (CWO) | | Convertible Bond XTF (CXF) |
| Horizons North American Growth (HAW) | | iShares JP Morgan Emerging Markets Bond (XEB) |

More concentrated exposure from country, region or industry-specific ETFs is also possible, like BMO Junior Oil (ZJO), BMO Junior Gas (ZJN), iShares Latin America (XLA), Claymore China (CHI), iShares MSCI Brazil (XBZ), iShares S&P CNX Nifty India (XID).

Broadly based exposure to technology-rich NASDAQ or Russell 2000 ETFs offers good support. Rushing defencemen with offensive potential like Bobby Orr, or currently Drew Doughty (Kings) and Kris Letang (Penguins), include high-yield and convertible bond funds (see “Defend Your Portfolio.”).

Defend Your Portfolio



Long-term corporate bond funds may be good for a quick shift if you expect corporate-government yield spreads to narrow — iShares IG Corporate Bond (XIG), BMO Long Corporate Bond (ZLC), Horizons Corporate Bond (HAB) and any of the longer-dated target bond funds RBC Target 2020 or 2019 (RQH, RQG), BMO 2020 or 2025 Corporate Bond (ZXC, ZXD).

This is clearly an aggressive lineup with obvious risks. If the market turns nasty, the portfolio is vulnerable and may be caught “up ice.” The only stopper is the goaltender (cash and cash equivalents). Nimbleness is required to shift sufficient assets to cash if this occurs.

Puck Control

Controlling the puck is important, but not always possible. Similarly, controlling portfolio risk is essential, but sometimes the market dominates — usually on the downside. Having specific tactics for different market environments can be an effective way to respond. ●

Thanks to Dr. Jim Sugiyama, hockey savant, for his valuable contribution to this article.

ETFs And The Neutral Zone Trap

Mark Yamada / April 01, 2012



Previously, we discussed the need for a balanced and aggressive attack during neutral and positive markets. In this article, we examine the neutral zone trap for protecting against a potentially hostile market.

Setting The Trap

When the opposition controls the puck in its own end, the neutral zone trap can be used to counteract the rush before it develops into a major threat. In recent years, capital markets have appeared unpredictable for extended periods. They seem to react to one crisis after another, while dominating investors by keeping them off

balance. Current events, rather than longer term disciplines, seem to be most important.

Both Jacques Lemaire (Devils and Wild) and Guy Carbonneau (Canadiens) have leveraged the trap effectively to thwart attacks. Randy Carlyle, too, used it to coach Anaheim to the 2007 Stanley Cup (Leaf fans can dream on!).

It was so effective that the National Hockey League moved to strictly enforce obstruction rules, while allowing the two-line pass to make the trap less useful (see "Two-line passes," right).

Anything below the blue line is the neutral zone.

Meant to disrupt momentum, players space themselves in the neutral zone in a 1-2-2 formation with one fore-checker looking to take advantage of a turnover.

In a portfolio, this checker can be an aggressive equity fund like a small-cap or an emerging-markets fund that will respond quickly if the market trend suddenly turns positive (see "Fore-checker: smallcap and emerging-market funds," below).

TWO-LINE PASSES CAN APPLY TO INVESTING



Fore-Checker: Small-Cap and Emerging-Market Funds

| Exchange Traded Fund | Symbol | MER |
|--|--------|-------|
| iShares Russell 2000 Index Fund (CAD hedged) | XSU | 0.35% |
| Vanguard MSCI Emerging Markets Index | VEE | 0.49% |
| iShares S&P/TSX SmallCap Index Fund | XCS | 0.55% |
| BMO Emerging Markets Equity Index | ZEM | 0.57% |
| Claymore BRIC ETF | CBQ | 0.67% |
| Claymore Broad Emerging Markets ETF | CWO | 0.71% |
| iShares MSCI Emerging Markets | XEM | 0.82% |

Two forwards block any attack lanes along the boards, forcing the play toward the centre. These players must be ready to strike if they create a turnover.

Broadly based equity positions would serve this two-way function well, perhaps one domestic like XIC or VCE and one global or international like XWD, VEF or ZIN (see “Forward: Canadian Equity,” and “Forward: Global or International Equity,” below).

Forward: Canadian-Equity (Broad Lowest-Cost) Funds

| Exchange Traded Fund | Symbol | MER |
|---|--------|-------|
| Horizons BetaPro S&P/TSX60 Index (swap) | XHT | 0.07% |
| Vanguard MSCI Canada Index | VCE | 0.09% |
| BMO Dow Jones Titans 60 Index | ZCN | 0.16% |
| iShares S&P/TSX 60 Index | XIU | 0.17% |
| iShares S&P/TSX Capped Composite Index | XIC | 0.25% |

Forward: Global Or International Equity

| Exchange Traded Fund | Symbol | MER |
|--|--------|-------|
| Vanguard MSCI EAFE Index (CAD hedged) | VEF | 0.37% |
| iShares MSCI World Index | XWD | 0.45% |
| BMO International Equity Hedged to CAD Index | ZIN | 0.50% |

What About Defence?

The two players on defence delay attackers while their forwards reposition to defend if no turnover can be forced. In a portfolio, these positions will depend on the risk tolerance of the investor.

In a low-interest-rate environment, some return potential is important, but defence is the primary objective. High-yield or convertible bonds are risky, but offer better upside. Pairing with a defensive offset, like a short term/duration or laddered ETF, would provide the right mix of defence with offensive potential. (See “Defence: High-Yield and Convertible Bonds,” and “Defence: Short-Term or Laddered Bonds,” below).

Defence: High-Yield and Convertible Bonds

| Exchange Traded Fund | Symbol | MER |
|---|--------|-------|
| Claymore Advantaged Convertible Bond | CVD | 0.45% |
| iShares DEX Hybrid Bond Index | XHB | 0.45% |
| Claymore Advantaged High-Yield Bond | CHB | 0.56% |
| iShares U.S. High-Yield Index | XHY | 0.60% |
| XTF Canadian Convertible Liquid Universe | CXF | 0.65% |
| Powershares Fundamental High-Yield Corporate Bond | PFH | 0.65% |
| BMO High-Yield Corporate Bond | ZHY | 0.69% |

Defence: Short-Term or Laddered Bonds

| Exchange Traded Fund | Symbol | MER |
|--|--------|-------|
| Claymore 1-to-5 Year Laddered Government Bond | CLF | 0.17% |
| BMO Short Federal Bond Index | ZFS | 0.22% |
| iShares DEX Short Term Corporate Universe + Maple | XSH | 0.25% |
| Powershares 1-to-5 Year Laddered Inv. Grade Corp. Bond | PSB | 0.25% |
| iShares DEX Short-Term Bond Index | XSB | 0.25% |
| Claymore 1-5 Year Laddered Corporate Bond | CBO | 0.28% |
| BMO 2013 Corporate Bond Target Maturity | ZXA | 0.30% |
| RBC Target 2013 Corporate Bond | ROA | 0.30% |
| BMO Short-Term Bond | ZCS | 0.32% |

Mounting a defence in the face of a powerful market onslaught can be a challenge. When volatility picks up, there are few tactics —other than cash or high-quality short-term bonds—that can preserve capital.

Whether or not you have a sense about the kind of market threats ahead, ETFs can be useful players in positioning you correctly to defend and attack. ●

Thanks to Dr. Jim Sugiyama, hockey savant, for his valuable contribution to this article.

ETFs as a Last Line of Defence

Mark Yamada / May 01, 2012



Portfolio managers can learn from hockey. Previously, we've discussed balanced and aggressive attacks for neutral and positive markets, and the neutral-zone trap to defend against potentially hostile markets. This month we address the "chip and chase" and the last line of defence, goaltending.

Low-Volatility Chip and Chase

Playing the puck deep into the opponent's end and quickly pursuing it involves risk. Giving up control may award your opponent with possession. Some risk is mitigated by positioning so deep in the opponents' end. A low-volatility market is perfect for taking such

risks. But you need good speed and solid fore checking.

Gordie Howe and Bobby Hull rarely employed this approach; Jagr, Malkin, and Crosby use it infrequently. However, the Canucks' line of Alex Burrows and the Sedin brothers—who don't mind banging bodies in the corners—are extremely effective in frustrating and wearing down opponents with their "cycle"-type offence.

The "cycle" approach is like identifying uncorrelated asset classes—some will do well, while others won't. Equities, commodities and bonds are three good examples (see "Equities, commodities, bonds," below). Someone should always be open for a shot or a pass.

Equities, Commodities, Bonds

| Broad-based Equities | Broad-based Commodities | Broad-based Canadian Bonds |
|-------------------------------------|-------------------------------|--|
| iShares MSCI World (XWD) | iShares Broad Commodity (CBR) | Vanguard Canadian Aggregate Bond (VAB) |
| Vanguard MSCI US Broad Market (VUS) | | iShares DEX Universe (XBB) |
| iShares S&P/TSX Capped Comp. (XIC) | | BMO Aggregate Bond (ZAG) |

Yet asset correlations aren't static. The relationship between stocks, bonds and commodities will change over time and must be watched carefully, particularly when volatility is high or rising. Other aspects of the chip and chase are similar to the 2-1-2 structure described in the first article of this series (see "ETF tips from the rink,").

Last Line of Defence

Recent market volatility has shown that cash or short-term fixed-income instruments are occasionally the only safe havens. Diversification simply fails to control risk during periods of high volatility.

In a low-interest-rate environment, this is an even more painful realization. If investing time horizons are long—10 years or more—trying to rebalance to a fixed mix may pay off. For some individual investors, however, there is no guarantee asset-class returns will approach the long-term averages that underpin their financial plans in time to skate them back on side. Sometimes, we must rely on that last line of defence—goaltending.

Goaltending has evolved, as have the choices in short-term fixed-income offerings. Today, most goalies use the “butterfly” technique. They spend lots of time on their knees with legs splayed outward to maximize ice-level net coverage.

Glove, blocker and stick skills deflect everything else, making superior mobility and quickness important. Glenn Hall and Tony Esposito were early proponents. One risk is the so-called “five hole” between the legs. Like credit or liquidity risk for a bond fund, this is not normally a concern, but occasionally causes gnashing of a coach’s teeth.

So how should we deal with money-market funds in low-interest rate environments? Forget about them. iShares Premium Money Market ETF (CMR) has an MER of 0.27%, compared to major banks’ money-market mutual-fund MERs of about 0.55%, a bargain if your client has \$25,000 or more to park.

However, it is difficult to justify with annual returns of around 1.0%. Like a vulnerable goaltender on the blocker side (the Leafs’ Jonas Gustavsson) or on the glove side (James Reimer or Ben Scrivens), low net-of-fee returns from money-market funds suggest looking elsewhere for protection and income.

Marty Brodeur, Tim Thomas and Dominik Hasek have successfully used hybrid goaltending styles. Likewise, other ETF vehicles can be used effectively as money-market substitutes but with more risk. Short-term fixed income ETFs are the obvious first choice, but short-term laddered-fixed-income government and corporate ETFs, and short target-maturity ETFs, give advisors even more flexibility (see “ETF vehicles,” below).

ETF Vehicles

| Short-term Fixed Income | Symbol | MER |
|-----------------------------------|--------|-------|
| Vanguard Canadian Short-Term Bond | VSB | 0.15% |
| BMO Short-Term Federal Bond | ZFS | 0.22% |
| iShares DEX Short-Term Bond | XSB | 0.25% |
| iShares DEX Short-Term Corporate | XSH | 0.25% |
| BMO Short Provincial Bond | ZPS | 0.27% |
| BMO Short Corporate Bond | ZCS | 0.32% |

| Short-term Laddered | Symbol | MER |
|---|---------------|------------|
| iShares 1-to-5 yr Laddered Government | CLF | 0.17% |
| Powershares 1-to-5 yr Laddered Investment Grade Corporate | PSB | 0.25% |
| iShares 1-to-5 yr Laddered Corporate | CBO | 0.28% |
| Short-term Target Maturity | Symbol | MER |
| BMO 2013 Corporate Bond Target Maturity | ZXA | 0.30% |
| RBC 2013 Target Corporate Bond | RQA | 0.30% |
| RBC 2014 Target Corporate Bond | RQB | 0.30% |

In low-volatility environments, diversification helps most. Consider equities, commodities and bonds. When volatility increases, stronger defence may be needed. Short-term fixed-income choices, other than money-market, are available to enhance yield; but watch out as costs become more important considerations. ●

Thanks to Dr. Jim Sugiyama, hockey savant, for his valuable contribution to this series.

ETF Wisdom From The Dugout

Mark Yamada / July 05, 2012

“Baseball is 90% mental, the other half is physical.” – Yogi Berra

My parents honeymooned in New York City to take in a couple of Yankees games. So my affinity for the pinstripes is natural.

Yogi was my favourite Yankee. Not only is he the greatest catcher ever, but also, as a kid, I liked his friendly smile. It wasn't until years later that I discovered his propensity for malapropism.

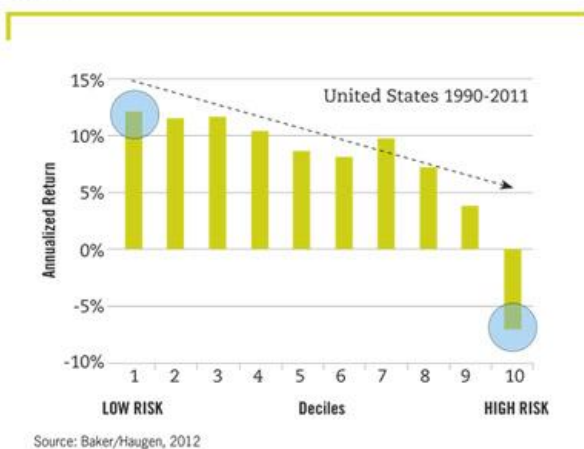
I've often thought the investment business would be a richer place if Yogi went to Wall Street. The investment business is at once simple and complex—a perfect backdrop for Yogi. Prices go up when there are more buyers than sellers and vice versa. Millions of dollars are spent trying to determine what's going to happen before it does. Millions also go into explaining why that research got it wrong.

Risk Equals Return

For investors, the risk-return relationship is very important. We're taught more return comes only with a commensurate amount of risk. Of course, the definitions for risk vary depending on the audience. For most clients, risk is about losing money—absolute loss.

Professionals use standard deviation to describe risk, partly because it can be measured and partly because it's persistent—and therefore somewhat predictable.

LOW VOLATILITY: U.S.



Don't believe me? Daily standard deviation of the S&P 500 has an auto-correlation of 0.67, while the correlation of returns is 0.02. This means today's volatility tells you something about tomorrow's volatility, but today's returns tell you virtually nothing about tomorrow's returns. Hence Yogi's conundrum: if risk is predictable but return is not, how can they be equal?

Low Volatility Strategies: U.S.

In their publication *Low-Risk Stocks Outperform Within All Observable Markets of the World*, Nardin Baker and Robert A. Haugen measured the 24-month volatility of U.S. stocks from 1990 to 2011.

LOW VOLATILITY: Emerging markets



Source: Baker/Haugen, 2012

They then put them into deciles from low-risk to high-risk, and plotted their annualized returns (see “Low volatility: United States,” left). They repeated this calculation monthly during the testing period. A relatively uniform relationship between low volatility and higher returns was the result. This is a surprising result if you believe risk equals return.

Baker and Haugen also measured the 24-month volatility of emerging-market stocks from 2001 to 2011 (see “Low volatility: emerging markets,” left). The relationship between low volatility and higher returns was not as uniform as in the U.S., but does exist.

The frequency of rebalancing (monthly) influences results, but the main point of interest is that an investor loses less money during volatile periods.

Why? My colleague, Ioulia Tretiakova, director of Quantitative Strategies, has an as-yet-untested hypothesis that this is a statistical phenomenon related to volatility drag. In other words, any combination of securities that reduces volatility will show a return benefit, particularly during periods of higher volatility.

Manufacturers are introducing low-volatility ETFs to exploit the “Yogi conundrum” described above. If you compare the BMO Low Volatility ETF (ZLB) with the iShares S&P/TSX Composite ETF (XIC) from the end of October 2011 to the end of April 2012, ZLB appears to have avoided two spikes in market volatility, one in November-December 2011 and another in April 2012 (see “Low volatility: Canada,” below, left).

LOW VOLATILITY: Canada



While far too short a period from which to draw any solid inferences, the price history is instructive. ZLB is actually a low-beta ETF that measures sensitivity to market movement. It could benefit from relabelling.

In Canada, Powershares has also issued low-volatility ETFs using different methodologies. Powershares S&P 500 Low Volatility (ULV) ETF is based on a more traditional calculation of volatility, standard deviation. The Powershares S&P 500 High Beta (UHB) uses beta as the volatility measure, similar to BMO’s ZLB.

There will be new ETFs that use different aspects of volatility and other factors that will benefit investors. We need to continually question how we manage money. As far as investment research goes, “It ain’t over till it’s over.” And for portfolio managers, “It ain’t the heat, it’s the humility.” ●

Is Smart Beta Smarter?

Mark Yamada / August 01, 2012

Alpha ain't what it used to be.



People used to think alpha constituted about half of an institutional portfolio's return (see "Evolution of beta"). Today, beta is credited with more than 75% of return.

Portfolio managers today are more focused on matching fund assets to their liabilities or achieving capital accumulation targets—and less interested in simply maximizing return.

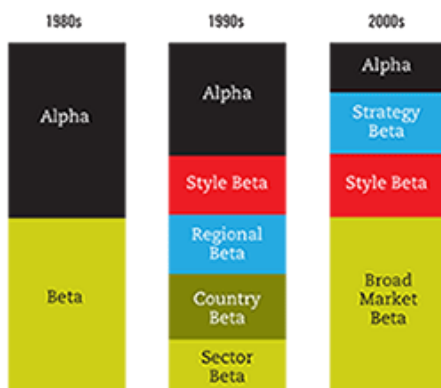
One-third of institutions are using indexing. A Greenwich Associates global survey of 121 institutional investors from corporate, pension, and not-for-profit organizations—including eight Canadian funds—finds passive products already constitute 40% of their assets, with

four-in-10 organizations expecting to be at that level by 2014.

Despite detractors, market-capitalization-weighted indexation (MCW) continues to dominate the passive equity space increasingly populated by ETFs. Critics say MCW exposes investors to overvalued stocks.

Supporters claim MCW reflects the current state of the market and all available information about it. Any other approach constitutes an active strategy with higher costs. Both positions are correct. This is little comfort to advisors looking to build portfolios for clients.

Evolution of beta (source: MSCI)



Indexing strategies exist on a spectrum, from MCW at one extreme to engineered beta at the other, says Northern Trust's John Krieg. Alternative or "smart" beta approaches lie in between. But how smart are they?

Market-cap-weighted

These traditional indices are based on price or capitalization. Equities with a higher price or capitalization receive higher index weights. The assumption: markets are efficient, so all information is priced in. There is a cyclical bias to this approach because some components will be overvalued from time to time.

Although MCW indices represent the market, they may also have a large-cap growth bias (see “Market-capitalization-weighted equity ETFs”).

Market-capitalization-weighted equity ETFs

Market Cap-Weighted Equity ETFs: as at May 31, 2012

| | Symbol | Management fee | Assets \$mil |
|--|--------|----------------|--------------|
| iShares S&P/TSX 60 Index Fund | XIU | 0.17% | \$11,109 |
| iShares S&P/TSX Capped Composite | XIC | 0.25% | \$1,224 |
| BMO Dow Jones Canada Titans 60 Index9 | ZCN | 0.15% | \$815 |
| Horizon Betapro S&P/TSX 60* | HXT* | 0.07% | \$338 |
| Vanguard MSCI Canada Index | VCE | 0.09% | \$47 |
| Vanguard MSCI Emerging Markets | VEE | 0.49% | \$41 |
| First Asset Morningstar National Bank Quebec | QXM | 0.50% | \$29 |

* Horizon Betapro's HXT has a payoff related to the S&P/TSX 60 Index but is constructed using a swap to which default risk is associated.

Smart beta

Fundamental, equal-weighted, and GDP-weighted indices fall into this group. Fundamental approaches either weigh an issue's fundamental characteristic (such as book value or revenue) or decouple index weight from prices like the RAFI series.

Fundamental indices and value-based funds tend to outperform MCW at the same time, affirming a value bias. These are active tilts that can be used independently or in combination with other strategies. Higher rebalancing costs are usually involved.

Equal-weighted indices that are rebalanced monthly offer some performance advantage over value and MCW (according to Plyakha, Uppal and Vilkov, 2012). These indices sever the relationship between price and index weight.

This approach is contrarian—overvalued stocks can be significantly underweight from time to time. The benefit of equal weighted indices comes from the rebalancing frequency, meaning higher transaction costs. Performance is also tied to the nature of the index. In Canada, this suggests a small-cap bias (see “Smart beta equity ETFs”).

Smart beta equity ETFs

| As at May 31, 2012 | Symbol | Management fee | Assets \$mil |
|---|--------|----------------|--------------|
| BMO S&P/TSX 60 Equal Weight Banks | ZEB | 0.55% | \$428 |
| BMO Equal Weight REITs Index | ZRE | 0.55% | \$245 |
| iShares Canadian Fundamental Index | CRQ | 0.65% | \$216 |
| iShares U.S. Fundamental Index | CLU | 0.65% | \$170 |
| (Powershares FTSE RAFI U.S. Fundamental CAD Hedged) | PXU | 0.45% | \$61 |

Engineered beta

Engineered beta occurs when you target specific diversification or volatility goals. Strategies that address specific exposures, attempt to alter volatilities or shape risk include leveraged, inverse, covered-call and low-risk or minimum-variance (see “Engineered beta equity ETFs”).

Engineered beta equity ETFs

| As at May 31, 2012 | Symbol | Management fee | Assets \$mil |
|---|---------------|-----------------------|---------------------|
| BMO Covered-Call Canadian Banks | ZWB | 0.65% | \$753 |
| IPath S&P 500 VIX Mid Term Futures ETN | VXZ | 0.17% | \$530 |
| Horizon Betapro NYMEX Crude Oil Bear Plus | HOD | 1.15% | \$211 |
| BMO Low Volatility Canadian Equity | ZLB | 0.35% | \$11 |
| Powershares S&P Low Volatility | ULV | 0.35% | \$6 |
| First Asset Can 60 Covered Calls | LXF | 0.65% | \$5 |

No single indexing approach provides the answer to every market; combine them to address specific needs like broader diversification or risk control. Smart beta proponents have reasonable arguments, but controlling costs is one of the few things advisors can do to actively impact returns. This suggests lower-cost MCW as the way to go. However, investing style dictates the best approach, so find one in which you have confidence. ●

The Best Ways To Own Canadian Banks

Mark Yamada / September 18, 2012



In August, 12 financial institutions—including CIBC World Markets, Desjardins Financial Group, National Bank Financial, Scotia Capital, and TD Securities—finalized the acquisition of 80% of TMX Group Ltd. It's official. Canadian banks control primary stock exchanges in Canada. But what does this mean for the average investor, and how can we make the most of it?

The good news...sort of

Canadian banks are now too big to fail. If they get into trouble, Canadian taxpayers will have to bail them out.

All parties will officially deny this; however, the implication is that bank credits are effectively as good as Government of Canada (GoC) credits.

So selling 10-year GoC bonds (1.80%) and buying bank bonds (3.40%) will pick up a fair yield spread with nominal, if any, incremental credit risk.

I have always counselled clients to own Canadian bank shares because of their market dominance. Investors can get exposure directly (see "Option 1: Direct exposure") or through ETFs (see "Option 2: ETF exposure").

OPTION 1: Direct exposure

| Stock (Symbol) | Capitalization | % all Banks | Dividend | |
|---|----------------|-------------|----------|----------------|
| | | | Yield | Price/Earnings |
| Royal Bank of Canada (RY) | \$73.2 billion | 25.8% | 4.48% | 16.2 |
| Toronto-Dominion Bank (TD) | \$71.7 billion | 25.3% | 3.64% | 12.0 |
| Bank of Nova Scotia (BNS) | \$59.6 billion | 21.1% | 4.01% | 11.5 |
| Bank of Montreal (BMO) | \$36.7 billion | 13.0% | 4.90% | 9.9 |
| Canadian Imperial Bank of Commerce (CM) | \$30.0 billion | 10.6% | 4.85% | 9.7 |
| National Bank of Canada (NA) | \$12.0 billion | 4.2% | 4.24% | 8.5 |
| TMX Group Ltd. (X) | \$3.5 billion | NA | 3.40% | 16.0 |

OPTION 2: ETF exposure

| Exchange-traded Funds (Symbol) | Bank Exposure | Management Fees | Yield/ Distributions | Price/Earnings |
|--|---------------|-----------------|----------------------|----------------|
| BMO Equal-Weight Banks (ZEB) | 99.3% | 0.55% | 4.39% | 12.9 |
| iShares S&P/TSX Capped Financials (XFN) | 78.6% | 0.55% | 4.2% | 13.0 |
| iShares Equal-Weight Bank and Lifeco (CEW) | 62.8% | 0.55% | 3.98% | 10.8 |
| BMO Covered-Call Banks (ZWB) ¹ | 99.7% | 0.65% | 7.70% ¹ | 12.9 |
| Horizons Enhanced Income Financials (HEF) ¹ | 51.0% | 0.65% | 9.04% ¹ | 12.4 |
| First Asset Can-Financials Covered Call (FXF) ¹ | 25.0% | 0.65% | 7.26% ¹ | 10.6 |
| Horizon Betapro Capped Financials Bull+ (HFU) ² | 75.0% | 1.15% | NA | 13.0 |

¹ Covered-call ETFs ² 2X Leveraged

ETFs offer investors several ways to access Canadian banks. The three ETFs at the top of “Option 2: ETF exposure” offer different degrees of bank exposure. iShares Equal-Weight Bank and Lifeco (CEW) and iShares S&P/TSX Capped Financials (XFN) include life insurance companies that add diversification, but also additional business risk in today’s low-interest-rate environment. Only XFN uses a traditional capitalization-weighted index.

Yield is of increasing importance to many investors. You must exercise caution when considering ETFs employing covered-call strategies (ZWB, HEF, FXF). Distributions are tied, by varying degrees, to option premiums that change with market volatility.

To describe these payouts as yield is somewhat misleading. Yield is considered to be more stable with bonds or preferred shares. Dividends for Canadian banks have, by contrast, been stable and growing.

Horizon Betapro Capped Financials Bull+ (HFU) offers two-times-leveraged exposure to the financial sector. During periods of low volatility, an investor can hold a half position in this instrument and get full exposure, freeing capital to buy other diversifying assets. Avoid this vehicle when volatility is high.

Individual investors

Arrangements limiting competition threaten choice and leave us vulnerable. Canada’s Competition Bureau has chosen to support the major banks and pension funds in retail financial services distribution and secondary market liquidity, rather than opening competition to promote lower prices and better services.

When the market melts down next, we’ll be at the mercy of a narrowing few who will be competing with us to get out. We must rely upon corporate governance, not traditionally a strong suit among Canadian corporations, and on provincial regulators to look out for the interests of the investing public. As investors, we have a real interest in what happens to the new TMX Group Ltd.—although with 20% interest, we are powerless to effect change.

We should be vigilant and encourage adoption of a majority of independent directors, those not related or tied to TMX controlling banks, pension funds and insurance companies. Calls for U.S. banks to separate sources of risk (investment from retail banking) aren’t being heeded here.

Canadian banks are moving in the opposite direction, and being given the right to vertically integrate. Although Canadian banks weathered the last storm better than their U.S. and global counterparts, the principles of risk management are the same worldwide. Canadians should be concerned.

Overall, banks and their subsidiary investment dealer and brokerage firms are primary users of the stock exchanges they now control. The investing public doesn't directly benefit but can participate by buying bank shares.

There is always an issue about which individual bank to own. Some believe it doesn't matter and the risks associated with one apply to them all. However, as business strategies and risk-taking diverge, a case can be made for owning a package of banks, and ETFs offer an effective way to do so. ●

Bearing Up With Bonds

Mark Yamada / October 16, 2012

This is Part 1 of a series.

As a freshman summer student on the U.S. securities desk of a major insurance company, the bond team amazed me. Fixed-income portfolio managers traded with sustained aggression. Michael Bloomberg was still on the Salomon Brothers trading floor so having instantaneous quotes at every trading desk on the planet was still a distant dream.

These bond managers instinctively valued quality, term, duration and coupon spreads between sectors and regularly traded between dealers. Global fixed-income markets today, by contrast, are highly integrated. Information is available to everyone, virtually in real time. Opportunities to exploit inefficiencies still exist, but spreads are generally tighter and tradable mis-pricings more rare.

Institutional investors have long known that adding value to bond indices is difficult. Mercer's Median Pooled Canadian Fixed Income (Universe) Fund, for the five years ending June 30, 2012 and before fees, returned an annualized total weighted return of 7.23% versus the 5th percentile fund just 49 basis points higher at 7.69%. This advantage narrows further for longer time periods, making passive approaches to fixed income investing attractive. With more fixed income ETF offerings, retail investors can follow this lead.

Comparative costs

| Broad-based bond funds | Management expenses |
|--|---------------------|
| Bond Mutual Fund (Median Bank funds) | 1.98% 1.15% |
| iShares DEX Universe Bond Index Fund (XBB) | 0.30% |
| BMO Aggregate Bond Index (ZAG) | 0.32% |
| Vanguard Canadian Aggregate Bond Index (VAB) | 0.20% |

When considering costs in building better bond portfolios, ETFs make logical choices. Fees for bond-based mutual funds are high (see table). And with Government of Canada long-term benchmark bond yields around 2.32%, owning only physical bonds or ETFs makes sense.

Comparative costs

What if interest rates move higher from today's central-bank-induced low rate environment? If rates double from current levels — a parallel upward shift in the yield curve of about 2.34% to 4.68% — the DEX Universe Bond Index would fall about 16%. Funds tracking the DEX Long Term Bond Index, for a similar 2.34% rate increase, would lose over 30%. Yield seekers would be happy but keeping their principal whole during this move is the trick.

Product expansion

Not long ago, Canadian ETF investors had few fixed-income choices. iShares DEX Universe Bond Index (XBB) and Short Term Bond Index (XSB) were primary vehicles, and continue to be. But weak global economies, volatile stock markets and low interest rates have created a demand for protection and yield, and ETF sponsors responded with new products. It's now possible to implement more sophisticated fixed-income strategies, the popularity of passive strategies notwithstanding.

Ladders

Buying bonds with staggered maturities, or laddering, is a straightforward way to manage a fixed-income portfolio. Laddering eliminates guessing about interest rate changes because maturing bonds are rolled forward to capture current rates.

| Pre-Constructed Ladder ETFs | Management Expenses |
|--|----------------------------|
| Bond Mutual Fund (Median Bank funds) | 1.98% 1.15% |
| iShares 1-5 year Laddered Corporate Bond Index (CBO) | 0.25% |
| iShares 1-5 year Laddered Government Bond Index (CLF) | 0.15% |
| iShares 1-10 year Laddered Corporate Bond Index (CBH) | 0.25% |
| iShares 1-10 year Laddered Government Bond Index (CLG) | 0.15% |
| Powershares 1-5 year Laddered Investment Grade (PSB) | 0.25% |

Two ways to ladder with Canadian-traded ETFs are pre-constructed and do-it-yourself. Among the pre-constructed ladders, you may choose between a shorter 1-5 year or longer 1-10 year ladder. If defensive, pick the shorter one. Given the strengthened condition of balance sheets, I currently prefer corporates over governments.

For clients with larger portfolios, consider building a ladder using individual maturity ETFs.

| Do-It-Yourself Ladder ETFs | Management Fee |
|---|-----------------------|
| BMO 2013 Corporate Bond Target Maturity (ZXA) | 0.23% |
| RBC Target 2013 Corporate Bond (RQA) | 0.30% |
| RBC Target 2014 Corporate Bond (RQB) | 0.30% |
| BMO 2015 Corporate Bond Target Maturity (ZXB) | 0.30% |
| RBC Target 2015 Corporate Bond (RQC) | 0.30% |
| RBC Target 2016 Corporate Bond (RQD) | 0.30% |
| RBC Target 2017 Corporate Bond (RQE) | 0.30% |
| RBC Target 2018 Corporate Bond (RQF) | 0.30% |
| RBC Target 2019 Corporate Bond (RQG) | 0.30% |
| BMO 2020 Corporate Bond Target Maturity (ZXC) | 0.30% |
| RBC Target 2020 Corporate Bond (RQH) | 0.30% |
| BMO 2025 Corporate Bond Target Maturity (ZXD) | 0.30% |

Bullets, barbells and butterflies

Ladders won't protect against big changes in interest rates but do provide a systematic way to smooth them out. More active strategies require a specific view about the movement and shape of the yield curve:

Bullets: Target maturity ETFs extend their usefulness beyond components in ladders to bullets. Picking a specific maturity or tight range is useful in matching an investor's liquidity needs and reducing exposure to yield curve changes around the targeted maturity.

Barbells: Holding short- and long-term maturities like 2-year and 20-year bonds at the same time softens the exposure to sharp changes in long-term rates. First Asset has prepackaged barbells for DEX Government (GXF), DEX Corporate (KXF), and DEX All Canada (AXF) Barbell Indexes that use 1-2 year and 10-20 year bonds.

Butterflies: Used in conjunction with long or short positions in mid-term bond positions, barbells can be used to exploit changes in the curvature of the yield curve. Strategies exploiting these shifts are called butterflies with long-term and short-term bonds being the wings.

Three basic components explain bond returns: the level of interest rates, the slope of the yield curve and its curvature. The level of rates and parallel changes in the yield curve account for about 86.6% of a bond portfolio's return and should be the focus of managers' attentions. The slope (or twists) of the curve accounts for 9.8% of the return, and the curvature (or convexity) accounts for approximately 3.6% of the return (so said Frank J. Jones in 1991).

We'll explore these strategies and how to construct and use them in various rate structure scenarios using ETFs in future columns. ●

“Henderson Has Scored For Canada!”

Mark Yamada / November 13, 2012



Paul Henderson’s winning goal in the dying moments of Game 8—a defining moment for Canadian hockey, if not the country—is the only thing most people remember about the 1972 series between Team Canada and the Soviets.

Fixed-income strategies suffer from a similar myopia. Bond prices fall when interest rates go up. What more do we need to know? Plenty.

Most advisors spend more time with stocks than bonds, because equities seem more dynamic, more interesting and in most cases, if working on commission, more lucrative. So, forgetting how to use bonds is explainable.

These days, low interest rates pose a threat to capital in two ways:

- not providing enough coupon income to grow it;
- eroding it when rates rise.

Bonds in balanced portfolios traditionally provide a stable component, lowering overall volatility through diversification.

We’ve discussed laddered bond portfolios before and how ETFs give investors the choice of pre-constructed or do-it-yourself ladders using target-maturity ETFs. Ladders mitigate some volatility from both rising and falling interest rates by rolling forward in a stepped fashion.

So, like Henderson’s 1972 goal, if you remember only one thing about bonds in retail clients’ portfolios, use a ladder. It’s not always a perfect solution, but it’s usually sufficient.

Do the research

Sometimes, it pays to do more research.

One of Team Canada’s problems in ’72 was underestimating the Soviets. Before the series, two scouts declared goalie Vladislav Tretiak a pushover after he allowed 8 goals. Problem was they didn’t bother to find out that Tretiak had been at his stag party the night before. (They were Maple Leafs scouts.)

Buying quality bonds can make us overconfident. If interest rates double from current levels, the DEX Long Term Bond Index can drop 30%. Some bonds offer great credit quality, but you could find yourself in a hole.

Turns out, 86.6% of bond returns are explained by the level of interest rates (the coupon) plus the overall shift in the yield curve according to Frank J. Jones, professor of accounting and finance at San Jose State University.

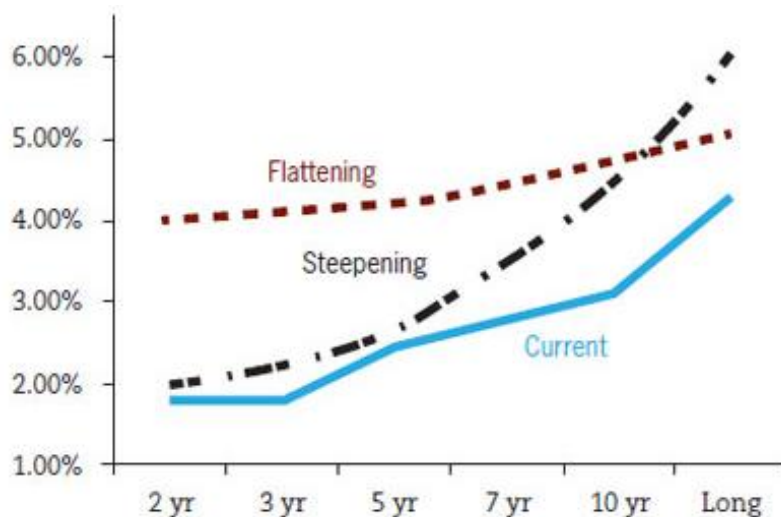
If you want to protect against a significant upward shift, a money-market fund is your best bet. Currently diminutive short-term rates may justify trying other strategies.

Curve flattening

Central banks raise short-term rates when they feel a strengthening economy will create inflationary pressure. Curiously, the Bank of Canada warns about inflated housing prices and personal debt while sticking to a low-interest-rate policy. They're concerned about economic fragility and don't want to crush consumer confidence by raising rates now.

Nevertheless, if short-term (e.g. two-year) interest rates rise faster than long-term interest rates (e.g. 10-year)—something that usually occurs late in economic cycles, rather than earlier—the difference between short- and long-term rates narrows.

Corporate Yield Curve



Source: PUR Investing

This is referred to as a flattening of the yield curve (see chart to the right).

Consider a curve-flattening trade. Sell short a two-year, like RBC Target 2014 Corporate Bond ETF (RQB) with a yield to maturity (YTM) of about 1.79%, or a three-year, like RBC Target 2015 Corporate Bond ETF (RQC) or BMO 2015 Corporate Bond Target Maturity ETF (ZXB).

And, buy long a 10-year, such as RBC Target 2021 Corporate Bond ETF (RQI) YTM 3.11% or BMO 2025 Corporate Bond Target Maturity ETF (ZXD) 3.51%. The absolute level of rates matters less than the difference between short and long rates.

Long-only flattening trade

A long-only approach is to use a barbell-like strategy: buy long a two-year and a 10-year-plus bond ETF, or use one of the prepackaged barbells (see “Table 1: Barbell options,” below). The gains at the long end should offset the losses at the short end, but if the entire yield curve shifts upwards, overall gains will be diminished.

Table 1: Barbell Options

| | Management Fee |
|---|----------------|
| First Asset DEX Government Bond Barbell Index (GXF) | 0.20% |
| First Asset DEX Corporate Bond Barbell Index (KXF) | 0.25% |
| First Asset DEX All Canada Bond Barbell Index (AXF) | 0.25% |

Making the team stronger

Barbells are useful but treacherous. A steepening yield curve (when long-term bond rates rise faster than short-term bond rates) can bite you. You need to mitigate your risk.

For instance, scared they might lose to the Soviets, Vic Hadfield, Gilbert Perreault, Richard Martin and Jocelyn Guevremont quit Team Canada rather than risk humiliation.

Luckily, strong performances by previously unheralded players like Ron Ellis, Bobby Clarke, Serge Savard, Paul Henderson and others made up the difference, leading to a Team Canada win.

Similarly, a barbell can be tweaked with long and short bullets if you think the shape of the yield curve will change a certain way. We will explore these issues next month. ●

Yield Curves and Recessions

Mark Yamada / December 11, 2012



If the U.S. goes back into recession in 2013, stock markets will suffer. So getting a bond strategy right will be very important.

In my previous two columns, we discussed how low interest rates have made bonds super-sensitive to rate changes. We discussed how laddering strategies using ETFs are a conservative all-purpose approach in most circumstances (see [Bearing up with bonds-Oct2012](#)) and how experienced advisors may use barbell strategies to optimize their views about yield curve steepening or flattening (see ["Henderson has scored for Canada! – Nov2012"](#)).

ETFs make implementing fixed-income strategies easy; but which strategy should you use now?

ETFs make implementing fixed-income strategies easy; but which

A last-minute congressional deal that pushes the fiscal cliff back a year or more is the most likely development. This may mean fiscal economic drag of 1.5% to 2%.

In Canada, the risk of recession may be reduced, so the slope of the yield curve should not change much (see chart "Canadian yield curves" that follows). A laddered strategy or a barbell should be fine in this circumstance. However, there is a wide range of possibilities between the worst and best cases and even the likely instance is far from a certainty. The conditions are unprecedented.

Worst Case: Falling Off The Cliff

The worst case is gridlock; no extensions, and the economy tanks. Buying government bonds has always been the correct strategy in these situations of maximum uncertainty (see "Worst-case portfolio," below).

Worst-Case Portfolio

| Government Bond ETFs | Duration | Expenses |
|--|----------|-----------------------|
| BMO Long Federal Bond Index (ZFL) | 14.2 yrs | 0.23% |
| Powershares Ultra DLUX Long Term Government Bond Index (PLG) | 14.1 yrs | 0.28% |
| iShares DEX All Government Bond Index (XGB) | 7.3 yrs | 0.39% |
| iShares DEX Long Term Bond Index (XLB) | 13.7 yrs | 0.39% |
| First Asset DEX Government Barbell (GXF) | 5.1 yrs | 0.20% (mgt. fee only) |

Best Case: Congressional Harmony

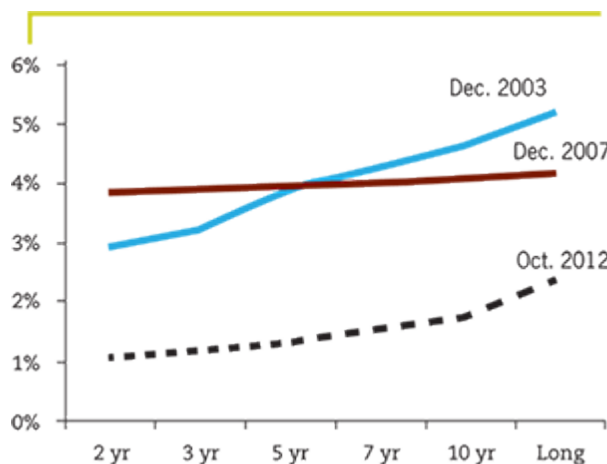
The economy's best hope is for a deal that restores consumer and business confidence in the future. Congress can't do it alone, so this may be the long shot. Improving economic conditions may lead initially to a steeper yield curve.

However, the Bank of Canada has already threatened higher interest rates. So our policies may lean against those of the U.S. at our peril. A steepening trade, or a long-term ladder, may be the best way to position for this initially. A flattening trade or floating-rate ETFs are good defensive approaches if prosperity breaks out and the economy overheats later. Consider liquidity, particularly on short sale trades.

Best-Case Portfolio

| | Sell Short | Buy Long |
|------------|--------------------------------------|--------------------------------------|
| Steepening | BMO 2025 Corp. Target Mat. ETF (ZXD) | RBC Target 2014 Corp. Bond ETF (RQB) |
| Flattening | RBC Target 2014 Corp. Bond ETF (RQB) | BMO 2025 Corp. Target Mat. ETF (ZXD) |

Canadian Yield Curves



Likely Case: Same Old, Same Old

A flattening yield curve, and often an inversion (short rates exceed long rates), are precursors to economic slowdown. Not only does the demand for short-term inventory financing drive up short rates at the end of a business cycle, central banks usually raise rates to lean against inflationary pressures. Ultimately, inventory liquidation triggers the recession that follows. The slope of the current yield curve (see “Canadian yield curves,” right) looks more like the one in 2003 that preceded slowing quarters in 2003-2004—when we had no recession—than the flat one at the end of 2007. Of course, the 2008 crash followed.

Source: PUR Investing

If congressional negotiations are slower than expected (and they likely will be), the economy may sputter, but the yield curve should flatten to signal this. But since central banks have maintained an artificial credit environment, the old rules may not apply. Otherwise the curve should stay as steep as it is currently. In this environment, ladders are again a good strategy because they benefit from yield-curve roll down.

Over time, assuming stable rates, as a bond with a 7-year maturity rolls down to become a 6-year maturity, the coupon remains fixed but yield falls, meaning that the bond's price rises. This cushion provides some protection against rate volatility, something that should be in abundant supply.

ETF users should note that fixed-maturity ETFs are great for this situation, but fixed-term barbells from First Asset (GXF, AXF, KXF) only benefit from this yield-curve roll-down advantage inside the ranges of each barbell: one year-

to-two years at the short end, and 10 years-to-20 years at the long end. They sell the 10-year bonds when they fall under the long-end range.

There is much to consider with bond tactics through year-end and into 2013. While ETFs make implementation easier, picking the right approach isn't simple. A view, good timing and a sense for how rates have moved in the past are requisites to making the right decision.

Special thanks to Edward Orfao, CA, CFA for his bond expertise. ●

