

## How much downside protection do you really have in your portfolio? Here's how to find out

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How do you know if your portfolio, and more specifically your fixed income allocation, is actually doing its job? You won't know by reading the fund name or the marketing materials. You'll need to test it.

Most investors own a version of two buckets: equities for growth, and fixed income for everything else. The latter includes income, safety, and the stability to stay invested when equity markets get ugly. The logic is sound, but the execution for far too many investors has failed.

Years of low interest rates and rising stocks made traditional bonds look boring. Higher-yielding alternatives, like preferred shares, dividend funds, high-yield bonds, and even some private credit, offered more income potential and seemed to be reasonable risks. Many have performed, but most were never fixed income investments.

*There will come a time when it matters.*

The fixed income allocation has one job that supersedes all others: to not behave like equities when equities fall. Income is required. Capital preservation is essential. Ballast - the ability to hold steady or rise when equity markets drop - is crucial too.

Four metrics tell most of the story. Volatility, how much the value fluctuates, should be well below what you'd accept in equities. Correlation to the equity market, or how closely the investment moves with stocks, should ideally be near zero or negative - because different behavior is the whole point. Maximum drawdown - the worst loss experienced over a meaningful period - should be contained. And down capture, the percentage of an equity market decline the investment participates in, needs to be small - negative is best.

The table below applies those four measures to five investments that commonly appear in the fixed income portion of Canadian portfolios, using Morningstar Direct data covering May 2007 to April 2026 - a period that includes the 2008 financial crisis, the 2020 COVID shock, and the 2022 rate shock. The threshold in each column represents the maximum acceptable level for a security to earn a place in the fixed income bucket.

## Testing asset classes

Asset Class	Volatility	Equity Correlation	Max Drawdown	Down Capture
Proposed threshold	< 7.0% std dev	< 0.40 vs TSX	< 12.5%	< 25% vs TSX
Investment-grade bond index (XBB)	PASS 4.6%	PASS 0.19	FAIL -15.6%*	PASS -1.1%
Short-term bond index (XSB)	PASS 2.7%	PASS 0.07	PASS -5.9%	PASS -7.0%
Preferred shares (CPD)	FAIL 10.8%	FAIL 0.56	FAIL -28.9%	FAIL 40.1%
Dividend equity (XDV)	FAIL 12.9%	FAIL 0.86	FAIL -43.9%	FAIL 83.2%
High-yield bonds (HYG)**	FAIL 8.7%	FAIL ~0.66	FAIL -30.9%	FAIL ~51%

Source: Morningstar

The first two rows pass. They are what fixed income is supposed to look like - low volatility, low correlation to equities, shallow drawdowns, and negative down capture. However, XBB carries two caveats: its 2022 drawdown breached the threshold due to interest rate risk when the Bank of Canada rapidly raised rates - which is an argument for active duration management, not for abandoning bonds; and returns from index bond funds have disappointed for more than a decade.

The bottom three rows are the problem. Preferred shares, dividend funds, and high-yield bonds all fail on most or all measures, and by wide margins. The number that might surprise you: the iShares Canadian Select Dividend ETF has a correlation of 0.86 to the TSX 60. It captures 83% of every equity market decline. Its worst drawdown was -43.9%, nearly identical to the equity market's own worst loss over the same period. That renders it unsuitable as a fixed income investment. It is an equity investment with a yield tilt that some mistake as a viable option.

Preferred shares are only marginally better. A correlation of 0.56 to Canadian equities, a drawdown of nearly -29%, and down capture of 40% against the equity market. They pay more than a government bond, but they also fall more than one, precisely at the moments when falling is most damaging.

High-yield bonds occupy the same uncomfortable territory. They are indeed bonds, but bonds with equity-like correlation during credit stress periods - when, again, the protection is most needed and least delivered.

Private credit deserves its own evaluation. It does not appear in the table because its valuations are infrequent, stress-period behaviour is opaque, and liquidity terms require careful scrutiny. Select private credit, in a modest and deliberate allocation, can earn a place in a fixed income portfolio - but only where valuations are conservative and transparent, the underlying assets are well-secured, and the liquidity terms are fully understood. Several Canadian private debt funds have recently suspended redemptions and recorded asset value write-downs. Quarterly redemption windows that cap withdrawals at 5% of assets per quarter should not be mistaken for liquidity.

None of this means these investments have no place in a portfolio. Preferred shares, high yield, and dividend equities all have legitimate roles - in the equity bucket, or as deliberate tactical exposures sized accordingly and assigned a portion of the total risk allowance. Pretending they are fixed income and hoping they behave like it is a strategic asset allocation mistake.

The equity bull market of the past decade made misplaced assets in the fixed income bucket easy to miss. Some are marketed that way, while many are tucked under fund names that seem appropriate. When everything rises, the correlation between asset classes compresses, but the fixed income bucket's job is not tested in bull markets. It is tested when equities fall, like in 2022, which hit both traditional bonds and the yieldy alternatives simultaneously.

*Today's well-constructed fixed income allocation combines deliberate interest rate risk rather than accepting passive or index exposure, with actively managed investment-grade credit, select mortgage strategies backed by real assets and conservative loan-to-value ratios, and a strict liquidity framework with cash available within days, weeks, and months.*

For investors with higher risk capacity and institutional investors, a measured allocation to high-yield and market-neutral strategies should be considered, spending the risk budget as you go. Real asset exposures that generate stable, bond-like income streams like real estate and infrastructure fit too. That kind of allocation can realistically target returns of 6-7% while passing every measure in the table above.

A fixed income allocation that does its job enables you to take more risk where risk is rewarded - in equities. The question to bring to your adviser is not whether your fixed income is paying enough. Start by asking if it is doing its actual job and follow with a review of the expected returns for the suitable funds. The table above is a reasonable place to start that conversation.

Income is important. Ballast and capital preservation are non-negotiable. Most investors have plenty of the first and less of the latter than they presume.

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