Here’s how some market pros are still making handsome returns from bonds

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The continued volatility in bond markets has many investors scrambling for better fixed-income solutions as calls for rate hikes persist and the inflation battle wages on.

The rise in interest rates has produced shocking losses for every trader and investor who has had long exposure to bonds this year. Even those who have shortened the duration of bonds in their portfolio, by focusing on shorter-term issues that are less sensitive to rising yields, have still wound up with large losses.

Yet, some professional traders who have gone beyond simply long-only positions in bonds have actually done quite well. Key to knowing how that’s done is understanding that a bond market is made up of two parts: an underlying interest rate and a credit spread portion.

In the corporate bond market, the underlying interest rate is actually a federal government bond. They are considered risk-free.

Added to that underlying interest rate is, essentially, an extra amount of yield an investor receives by taking on the additional risk of buying a corporate bond. That’s the credit spread portion, and it reflects the quality of the company doing the borrowing and their risk of default. These two elements together are the so-called coupon, or total borrowing cost, on the corporate bond.

The credit element is reflected in the price of the bond. Some experienced fund managers have the tools to efficiently separate the credit element by hedging or eliminating the interest-rate element, producing exposure only to the credit spread.

Investment-grade credit spreads have increased in the past few months and likely have more pessimism built in than necessary. Indeed, with continued strong corporate earnings and record low unemployment, credit spreads may be a compelling investment opportunity.

World’s biggest bond markets back in vogue as recession fears mount

In fact, investment-grade credit spreads are close to their widest – and thereby cheapest – levels in more than 20 years, other than the exceptional periods of the global financial crisis and the onset of the pandemic. These historically wide spreads, arguably too wide for our current environment, generate sufficient continuing return, referred to as "running yield," to insulate the portfolio against potential credit-spread widening. The portfolio running yield is the annual income generated by a bond divided by the market price of the security. Additionally, because bond prices and yields move inversely, these historically wide credit spreads offer the opportunity for meaningful capital gains as spreads narrow.

One should expect an active manager to outperform an index or a rules-based exchange-traded fund in the current volatile environment. Bond portfolio managers can tap credit research and have access to primary and secondary bonds at competitive prices, plus have the ability to properly diversify a portfolio and use the tools to hedge efficiently. Assessment of credit quality is quite different from evaluating equities, which could be subject to discounted cash-flow valuations, price-to-earnings multiple shrinkage or lower future growth expectations.

Managers can position for relative outperformance of one corporate credit over another, or potentially Canadian corporate bonds versus U.S. or global corporates owing to their relative attractiveness. They have access to the new issue bond market where new issue spread concessions can pay a premium to existing bonds. And importantly, a credit manager has established access to market liquidity.

Past returns illustrate the benefits of having active management in corporate fixed income. According to Craig Harrison, president of Global Manager Research, a portfolio measurement and governance provider for Canadian institutional investors, active credit-focused funds have consistently outperformed the bond index returns. Examining the median return of GMR's subset of credit funds, as of July 31, the group outperformed the fixed-income index-tracking iShares Core Canadian Universe Bond Index ETF (XBB) by 5.7 percentage points, year-to-date, net of fees; and by 3.62 percentage points on a seven-year annualized basis, with similar volatility during the period.

Traditional approaches to fixed income may continue to disappoint through this continuing interest-rate rising cycle. Rates are not yet back up to historical norms and central bankers have been very clear about their intent to continue raising rates. An investment in a credit fund without exposure to rates could be an effective part of a current portfolio. Given current spreads and our expectations for the economy, we foresee the potential for credit funds returning 10 per cent annually. Granted, it's difficult for a do-it-yourself investor to implement this investment on their own, but retail and institutional investors won't have to look too far to find a suitable fund that delivers this credit strategy.

Kevin Foley, a former managing director, head of credit trading and bond syndication over two decades at a major Canadian bank, is currently a managing director at YTM Capital, where he focuses on institutional investing.