

## Maybe don't think of fixed income as fixed

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The name has always been a little misleading. Fixed income. It sounds like a declaration - steady, pre-determined, boring in the best possible way. You lend your money, you collect your coupon, you get your principal back. What could go wrong?

Quite a lot, as it turns out. And the gap between what investors think bonds do and what bonds actually do, especially in a rising rate environment, is one of the most expensive misconceptions in personal finance. The promise is real. The condition attached to it is not.

Here is what is actually true about a bond: if you buy it at par, hold it to maturity, and collect every coupon payment along the way, you will earn exactly the yield you were promised. A 3-year bond yielding 3 per cent will return 3 per cent per year. That part is indeed fixed.

What is not fixed is what happens in between. Suppose you buy that 3-year bond at par - \$1,000, yielding 3 per cent. One year in, rates have risen 100 basis points and you need to sell. You have collected your two semi-annual coupons - \$30 in income. But the bond's price has fallen, because new 3-year bonds in the market now yield 4 per cent, and yours only pays 3 per cent. Therefore, its current value - the price needed to attract a buyer - will need to be at a discounted price from par.

That scenario generates a sale price of approximately \$982. Your \$30 in coupon income is mostly consumed by an \$18 capital loss. Your total return for the year is roughly 1.2 per cent while you were promised 3 per cent. You earned less than half of it - not because anything went wrong with it, not because the issuer defaulted, but simply because rates moved.

That is the short, 3-year bond math, while the result gets considerably worse for longer bonds. And importantly, that doesn't only happen when you decide to sell. The 1 per cent rise in rates is immediately reflected in the current value of your portfolio. Some don't register that fact.

In 2022, the iShares 20+ Year U.S. Treasury Bond ETF - a fund holding nothing but bonds backed by the full faith and credit of the United States government - returned a shockingly negative 31.4 per cent.

For context, the S&P 500 fell roughly 18 per cent that year. A fund of government bonds, the instrument synonymous with safety and capital preservation, fell nearly twice as much as the stock market almost entirely due to changes in interest rates.

This was not a credit event. No one defaulted. The Federal Reserve raised rates aggressively and bond prices plummeted. Investors who thought they owned something boring found out they owned something with equity-like downside and only bond-like upside.

Closer to home, the iShares Core Canadian Universe Bond ETF - XBB-T, the actionable Canadian fixed income benchmark - lost nearly 12 per cent in 2022. It is negative again year to date in 2026. In the five years spanning 2021-2025, a period during which investors were presumably collecting steady, safe income, the rates-heavy index massively underperformed needs and expectations. Rates went up, prices went down, and the “fixed” label did little to soften the blow. □

### **Why the misconception persists**

The “fixed income” label is doing work it was never designed to do. Most investors’ intuitive model of a bond - lend money, collect interest, get it back - is accurate only in one scenario: holding the bond to maturity, experiencing the mark to market prices along the way, not needing the funds for expenses or better investment opportunities before the maturity date.

Some financial advisers have not always been eager to complicate the narrative. Telling a client their bond allocation is “safe” is a simpler conversation than explaining rate risk and its consequences, and a rates-heavy portfolio became the default. So the nuance gets swallowed, and investors arrive at 2022 - or 2026 - genuinely confused about why their safe money is going the wrong direction. Again.

XBB has returned less than 2 per cent annually on average over the last 10 years - and that’s total returns.

It is also worth noting that a passive fixed income index is weighted toward government bonds and longer maturities by construction - which means it is weighted toward rate risk, whether that is the right exposure at any given moment or not. Passive works against the investor here in a way it does not always in equities. The fixed income landscape rewards active judgment - knowing which exposures to own, in what weight, and when to shift between them.

### **What the other kind of investor knows**

Here is something worth knowing: the fixed income allocation in a sophisticated institutional portfolio rarely looks like the one a retail investor ends up with. Theirs is not simply a pile of government bonds waiting for rates to cooperate. And it is not static. Exposures shift as conditions shift - more rate sensitivity when the setup warrants it, less when it doesn’t, and a wider menu of yield sources at all times.

They understand and position for the distinction between yield that comes from interest rate exposure and yield that comes from credit spread premium. They are not the same thing and they do not behave the same way.

Investment grade corporate bonds are a clear example. A high-quality corporate bond yields more than a government bond of the same maturity because the market charges a premium for lending to a company rather than a government. That spread is a legitimate and persistent source of return - one that does not require a bet on rate direction. It too is not fixed, and it moves daily, albeit with a fraction of the volatility of government bond yields.

Managing credit spreads actively, across sectors and issuers, is where a particular fixed income skillset thrives. Worth knowing: strip the interest rate risk out of a short-term Canadian corporate bond and the credit spread premium that remains is a surprisingly quiet and resilient source of return.

Short-term mortgage portfolios occupy similar territory. A well-constructed portfolio of select, short-duration mortgages generates yield from credit quality and structure. The collateral is secured and underwritten to be sufficient when realized upon, and the return is largely independent of the Bank of Canada's overnight rate decisions. It is worth noting that real estate and mortgage investing are two very different exposures.

Beyond those two, a genuinely diversified income-oriented portfolio might carry measured positions in real assets, select high yield, private debt, or even a market neutral strategy - each chosen for what it actually contributes, not for what category it sits in.

The point is not that retail investors need to fully replicate an institutional portfolio. The point is that sophisticated investors treat interest rate exposure as one deliberate ingredient among many - a portion to size with intention, and to resize as conditions evolve.

Too many retail fixed income allocations default to rate risk, often unknowingly, and stay invested regardless of what rates are doing.

There may be times when interest rate exposure works well in a fixed income portfolio. It worked like magic at the end of the last century into the beginning of this one. But is that time now - with yields that are not particularly compelling and the persistent risk of rising rates? The active fixed income investor asks that question continuously, while the passive one can't, or maybe didn't know to.

### **The question worth asking**

The conditions that made 2022 so damaging have not been resolved. Rates are higher than their emergency levels yet still don't produce effective return. Inflation risk has not disappeared, and the benchmark Canadian bond index is already in negative territory for the year. None of that means disaster is imminent. It means the risk is real, visible, and not adequately understood by too many people relying upon it.

It also asks for better solutions.

Fixed income is not inherently or meant to be dangerous. But it is not inherently safe either. The right question - the one too many well-intentioned investors have never been asked to consider - is: where, exactly, is my yield coming from? And what really happens to it when rates move?

If you don't know the answer, you probably own more rate risk than you think.

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