THE GLOBE AND MAIL

This is how credit spreads can make you more money in the bond market

KEVIN FOLEY
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You knew that most bonds are a combination of an interest rate and a credit spread, right? That the credit spread for a government bond - the amount of yield added to compensate you for its willingness and ability to pay - is zero. And you knew that when bond yields rise, bond prices fall, and that those yields and prices change many times per day, right?

If you knew all that, then you must know that the interest rate portion of a bond and the credit spread of a bond change at different times, for very different reasons, by meaningfully different amounts. You may not realize however, that interest rate movements dominate your fixed income exposure. That when you buy the index or a fund that largely mimics it, including most labelled as a major Canadian bank bond fund, you are nearly entirely reliant on the current yield and future path of interest rates. Yes, the very same funds that many advisers and every friendly individual in a bank branch continue to recommend.

So what?

The so what is that the iShares Core Canadian Universe Bond Index ETF, widely considered the investible benchmark, has lost about 1 per cent this year, earned essentially nothing over five years, and a little more than 1 per cent over the last ten years. That may be surprising for a bond index and it's certainly disappointing, but the silver lining you might notice is that over each of those periods the ongoing return from credit spreads was almost always a positive return driver. The dominant effect of interest rates overwhelmed any of the credit spread benefit in the index's total return.

This insight is crucial right now because investment headlines are dominated by warnings about rising rates which cause bond prices to fall and hurt bond fund returns. Further, the current yields of Canadian government bonds aren't overly compelling. It's a good time to reconsider what you're expecting from your fixed income allocation, and where those returns might come from.

One source to consider, which you likely already have some exposure to, is the aforementioned investment grade credit spreads in your portfolio. Credit spreads are a distinct return driver that diversifies where your fixed income return is derived from. It's unlikely that anybody truly intended to hold interest rate risk as the single performance driver for about 40 per cent of the total portfolio (assuming a 60/40 portfolio split between equities and bonds). But it happened, broadly, encouraged by historically robust bond returns. Distinct credit exposure can help fix that.

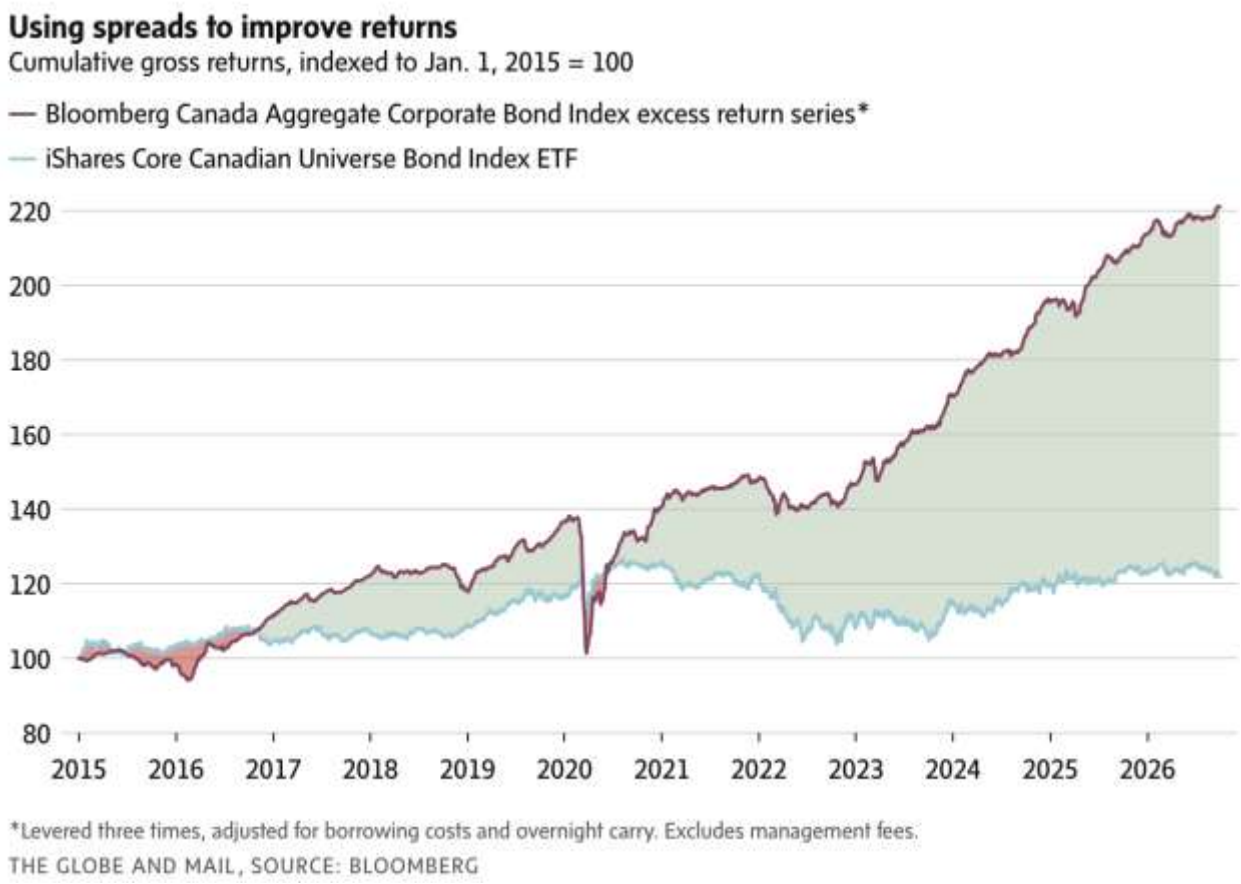
Importantly, the credit spread portion has historically been much less volatile than the bond yield. While spreads can widen sharply during periods of market stress, isolating the credit spread and removing the much greater volatility of interest rates can provide a more stable, dependable source of fixed income returns. Doing so efficiently generally requires a specialized investment fund manager.

As mentioned, interest rates and credit spreads move differently. Interest rates are largely driven by the economy: inflation, growth expectations, government borrowing and central bank policies. Corporate credit spreads respond more to the financial health of individual companies, their industries, and the compensation investors demand for lending to them. Owning the right amount of each immediately diversifies and improves almost any portfolio.

A return driver that produces the same or higher return with lower volatility is likely the better investment. The funds in Canada that have generated returns specifically from investment grade credit spreads have well outperformed the bond index and most bond funds over the past five, 10, and 15-year periods, usually with lower volatility. Their inclusion has likely increased returns, lowered risk, and almost certainly diversified most fixed income portfolios.

It is true that investment grade credit spreads tend to be muted most of the time yet can rise quickly. The March 2020 Covid-era shock is a good example of credit spreads widening sharply, followed by their rapid repair. Even accounting for that episode, and the fact that we can't find an example of an investment grade issuer defaulting in Canada, credit spreads have proven a more dependable and less volatile exposure than interest rates.

To demonstrate, the red line in the graph below shows the gross returns of Canadian investment grade corporate bond credit spreads, using the index's excess returns levered three times. Many specialized, prospectus credit funds employ leverage with high-quality, low-volatility credit exposure to generate effective fixed income returns.



The result is telling. The red credit spread exposure substantially outperforms the blue conventional bond index, with a lower standard deviation, meaning less volatility, and higher risk-adjusted returns. This is the credit spread versus interest rate return driver debate, framed. Most portfolios would benefit from an intentional mix of the two, rather than allowing interest rates to dominate the entire fixed income allocation.

Most investors spend ample time deciding how much of their portfolio belongs in fixed income, yet remarkably little deciding what risks they want that fixed income to take. It's the industry's fault to some extent. But now you know to ask if you have the right fixed income return drivers, or if you're simply betting it all on rates.

Kevin Foley is Managing Director, Institutional Accounts at YTM Capital, a Canadian asset manager specializing in credit and mortgage funds. He spent two decades trading and managing fixed income at a major Canadian bank and serves on several Canadian foundation boards and investment committees.
Kevin.Foley@YTMCapital.com