

# The bond-fund model built for a falling-rate world hasn't aged well

KEVIN FOLEY  
SPECIAL TO THE GLOBE AND MAIL  
FEBRUARY 17, 2025

The iShares Core Canadian Universe Bond Index ETF XBB has a simple mandate: To replicate the performance of the FTSE Canada Universe Bond Index, net of expenses.

It is a large, observable, widely held fund that has done exactly what it was designed to do, making it useful as a benchmark.

Today, XBB yields roughly 3.4 per cent. Its annualized total returns over one, three, five and 10 years are 1.9, 3.6, -0.1 and 1.8 per cent, respectively. In 2022, it lost nearly 12 per cent.

XBB carries a low-risk label, largely because most of its holdings are government bonds. Yet, its volatility has been meaningfully higher than what many investors associate with “low risk,” and its risk-adjusted return over the past decade has been poor.

It has not fully recovered from its 2022 drawdown, and its decade-long returns have barely kept pace with inflation.

XBB is not broken. It has faithfully replicated the bond index, and that is precisely the issue.

The majority of the billions invested in Canadian bond funds sit in products designed to hug the same index, with some hoping to beat it by a narrow margin. They share the same structural exposure: Heavy sensitivity to interest rates. When yields rise, these funds fall – it's a directional bet. When yields stagnate at today's modest levels, returns remain modest.

This isn't a product flaw. It's what happens when index replication becomes the strategy, even as more deliberate ways to build fixed income have emerged. And yet, it is the model most Canadians still rely on for a third of their portfolio (or more) because it is endorsed and marketed as safe, standard and sufficient.

## What fixed income is supposed to do

Fixed income is not meant to be a thrill ride. It's the portfolio seatbelt.

For families, foundations and pension plans alike, 30 to 45 per cent in fixed income is common. It exists to deliver stability, dependable income, capital preservation and ballast during equity sell-offs.

If your fixed income falls double digits during equity drawdowns, it isn't ballast. At yields between 2.5 and 3.9 per cent, bonds have limited capacity to rally when you need them most.

That doesn't mean bonds are obsolete. It means understanding what kind of fixed-income exposure you want, and acknowledging that the bond-fund model built for a falling-rate world hasn't aged well.

## Start with an audit

If you manage your own portfolio, review your fixed income allocation with fresh eyes. Examine its average duration, its exposure to government bonds, its current yield and how it behaved when rates rose.

Then ask what is truly driving the return.

A fund with seven or eight years of duration will see most of its price movement dictated by long-term yields, meaning a 1-per-cent rise in rates can translate into a roughly 8-per-cent decline. That is not diversified fixed income. It is a directional macro exposure. When a large majority of a "safe" allocation rises and falls with interest rates, concentration risk is present – regardless of how it's labelled.

Given the results, it is reasonable to reconsider why this structure remains the default for so many portfolios.

## How institutions think differently

The largest, most sophisticated pools of capital do not treat fixed income as a single line item. They separate risks deliberately.

They distinguish between:

- **Duration:** Interest-rate exposure, sized deliberately
- **Credit spreads:** Compensation for lending to companies
- **Secured lending:** Uncorrelated, collateral-backed income
- **Private credit and real assets:** Differentiated return streams once limited to institutions

These institutions do not automatically accept heavy interest-rate exposure in order to earn income. They deliberately choose how much rate risk to own, if any, rather than by default.

Over the past decade, funds set up to buy corporate bonds and hedge out the interest rate portion of the bond – thereby isolating the credit spread portion – have materially improved returns.

The same principle applies to secured lending. Mortgage strategies grounded in disciplined underwriting and tangible collateral have delivered dependable income with low historical loss experience, often with quarterly liquidity that better reflects the underlying assets.

None of this is exotic. It is intentional.

## A better blueprint

Anything representing one-third of your portfolio deserves structure. Think about it in three functional buckets:

1. Stability and liquidity: Shorter-duration, high-quality exposure that reduces sensitivity to large rate moves and provides accessible capital
2. Income generation: Credit strategies and secured lending that earn compensation for measured lending risk – not simply interest-rate exposure
3. Enhancers: Private credit or real assets, adding diversification and reducing correlation, increasingly available through alternative mutual funds and managed mandates

Many of these strategies now exist in accessible formats through advisers, alternative mutual funds and managed mandates. The institutional mindset is no longer reserved for institutions.

Diversification within fixed income matters as much as diversification within equities. Cost matters, too. But if a low-fee product delivers concentrated rate exposure, the savings are beside the point (XBB is a good example).

## The questions that matter

Before adding or replacing anything, ask yourself:

- What is the average duration of my fixed income? You can find this in the fund facts for an ETF or mutual fund.
- How dependent is my return on interest rates?
- How did this allocation behave over ten years? In 2022?
- Does it look like XBB? Should it, going forward?

The bond index remains what it has always been: A government-heavy, rate-dominated exposure. It is doing exactly what it was designed to do.

The question is whether that design is sufficient for a third of your portfolio.

*Kevin Foley is managing director, institutional accounts, at Canadian asset manager YTM Capital, who specialize 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](mailto:Kevin.Foley@YTMCapital.com).*