THE GLOBE AND MAIL

‘Fixed income’ has become a catch-all term. It shouldn’t be

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If a fund has fixed income in its title, or a synonym such as debt or yield, does that alone make it suitable for you?

Nope.

You’ll pass on a salad because it has walnuts or cilantro. Or perhaps because of the dressing. You may even demand to know what’s in it. Yet, many investors will buy something labelled “fixed income” without asking a single question.

Even if you’re not an expert investor, you can easily check. Look at the menu or ask the waiter; check the prospectus or the fund manager’s website. Ask your adviser. It’s not hidden any more. It stopped being somebody else’s fault a while ago.

Still, a surprising number of fixed-income investors unknowingly own equities, preferred shares and convertible bonds; bank loans, foreign currencies and emerging market debt; private credit, factored receivables, high yield and highly structured or securitized assets – sometimes even real estate investment trusts.

None of those are inherently bad investments. Some are very good ones. But if you didn't mean to buy them, and they don't solve your fixed income needs, then that's a problem.

It suggests the decision wasn't all that thoughtful – perhaps less thoughtful than your lunch order.

Part of the issue is labelling. "Fixed income" has become a catch-all. Some platforms group it that way. Databases reinforce it. Advisers often don't push back on it. The result is a category that often tells you very little about what you actually own.

Interest-rate risk within fixed income portfolios is another exposure that tends to get a free pass. For decades, the performance of rates carried fixed income portfolios. High and falling rates delivered consistent returns, and the default to rates as fixed income worked.

That hasn't been the case for a while.

Despite that, a large share of fixed income portfolios are still dominated by interest rate exposure – by default rather than design. The Canadian bond index and the funds that track it have demonstrated how unfortunate that has been over more than the last decade.

Rates still have a role. They just shouldn't be the only, or even the dominant, driver. Institutional portfolios figured that out years ago. Most individual portfolios haven't.

Which brings us back to what you're actually trying to accomplish.

Fixed income doesn't exist in isolation. It sits inside a total portfolio.

If your equity portfolio is aggressive, your fixed income should probably be protective. If your equities are stable and liquid, you may have some room to take risk elsewhere.

Many portfolios don't reflect that. They end up layering risk on top of risk, often unintentionally, simply because fixed income was in the name.

High yield, private debt, emerging market bonds – they all carry real risk. Maybe less than equities, but certainly more than core fixed income solutions, and they draw from the same total risk budget.

A well-constructed fixed income allocation can actually enable more risk-taking in equities. That's the point. Diversification, income, lower correlation and downside protection are supposed to support the portfolio, not add to the same drivers and increase total portfolio risk.

If you choose to include higher-risk exposures within the fixed income bucket, fine. Just know that they're there, and how they're likely to behave. Choose them on purpose.

Where do you go from here?

Most fixed-income investors start by choosing the amount and duration of their interest rate exposure and add investment grade corporate credit. That's familiar, and it's easy to access.

Some will choose funds that remove the interest rate exposure to isolate the credit spread premium in corporate bonds, and include high-quality asset-backed securities. They'll often select a mortgage strategy from a manager with a strong track record and suitable liquidity parameters.

From there, some stop. Others layer in high yield, private debt, bank loans or more specialized strategies. Institutions often include real estate and infrastructure equity within their fixed income allocation as well.

There isn't a single right answer.

But better portfolios tend to reflect a set of deliberate choices about what risks are being taken and why. Not just what happened to be included under a broad label, and not just interest rate risk by default.

You'll notice that equities, preferred shares, convertible bonds and warrants didn't make the allocation process above. That's not because they're bad investments. It's because they aren't fixed income.

If you want them, include them – maybe in a different part of the portfolio. Either way, account for them properly within your total portfolio risk.

The right combination of rates, credit, mortgages and select other exposures has worked well for many investors. That's not the issue.

The issue is assuming that anything that mentions fixed income will behave the way you need that part of the portfolio to.

Caveat emptor.

Because in an environment such as this one, it's easy for the fixed income portion of a portfolio to lapse or drift – to become something you wouldn't have chosen if you'd checked the ingredients.

And when the market tone changes, that's when you'll know what was actually in your salad.

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