Why some advisors are turning to alternatives in tricky bond environment

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What looked like a straightforward market for bonds with interest rates coming down may be more complicated.

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Bonds are back, or so the theory went.

As central banks embark on what's perceived as an interest-rate cutting cycle, bond values should be experiencing a significant lift, powering client portfolios.

Yet, 2024, hailed at the outset by some as "the year of the bond," doesn't feel that way as bond yields have remained much the same as they were in January, even after the U.S. Federal Reserve Board's "mega-cut" in September, says Imran Dhanani, principal and head of retail distribution at Toronto-based RP Investment Advisors LP, which manages about $13-billion in fixed income assets.

For example, the S&P U.S. Bond Index is only up about 3 per cent year to date.

"In today's world, where it's a balancing act between inflation and the Fed cutting, it's not so straightforward anymore," he says of the direction of interest rates and yields.

Mr. Dhanani points to confusing signals from the U.S. 10-year Treasury yield, which is higher today than it was at the start of the year.

"At the same time we've seen a dis-inversion of the [yield] curve," he adds, noting it had been inverted at this time last year.

Today, the curve is flat – neither a good nor bad sign, Mr. Dhanani says, although it illustrates investor uncertainty.

Many advisors feel equally unsure about inflation and interest rates. As such, some are allocating capital to active managers in the alternative credit space.

"What if inflation is stickier than thought?" says Diana Orlic, portfolio manager, wealth advisor and investment advisor with The Orlic Harding Cooke Wealth Management Group at Richardson Wealth Ltd. in Burlington, Ont. "What if it starts to climb? What if they can't lower rates?"

These looming questions make it difficult to determine where opportunity lies.

"I need a[n asset] manager that can move around to take advantage of whatever opportunities come," she notes, and "unconstrained" alternative credit funds provide that mobility.

Able to short-sell and use leverage tactically, alternative asset managers are often better positioned to generate consistent returns amid volatility, Ms. Orlic says.

Still, about 20 per cent of her clients' fixed income allocation is held in guaranteed investment certificates (GICs) or high-interest savings to cover expenses for the next two to three years. Another 30 per cent of fixed income is invested in low-fee index exchange-traded funds (ETFs) while the remaining 50 per cent is allocated to alternative funds, such as CI Alternative Diversified Opportunities Fund, she says.

Alts provide a better chance that fixed income squeezes out positive returns regardless of the direction of interest rates and inflation, Ms. Orlic explains – hopefully avoiding an outcome like in 2022, when traditional bond positions were crushed.

"It's hard to explain to clients when the part of their portfolio [that's] supposedly low risk is down dramatically," she says.

Another challenge for advisors is that a 3.5-per-cent yield on low-risk Government of Canada bonds can be a tough sell when GICs pay a similar return.

Many investors may not "feel all that excited about that yield" given the perceived risks, says Kevin Foley, managing director of institutional accounts at YTM Capital Asset Management Ltd. in Toronto.

But alternative credit strategies may resonate, potentially offering higher returns that aren't entirely predicated on falling interest rates, he adds.

"Most [alternative] portfolios are trying to find a way to get a fixed income return that they hope will be in the 5- to 8-per-cent range," he says.

Alternative strategies can involve, for example, low-risk leverage while exploiting spreads between investment-grade corporate bonds and government issues, he says. Current U.S. bond yields, which moved higher rather than downward after the Fed's cut, suggest advisors may require these more creative strategies.

"The market appears to be saying bond yields don't deserve to be any lower," he says. "If that's the case, traditional bond funds will have a hard time performing."

No matter the approach, the current market flux demands advisors spend more time with clients explaining market dynamics, says Andrew Pyle, senior investment advisor and senior portfolio manager with Pyle Wealth Advisory team at CIBC Wood Gundy in Peterborough, Ont.

"Even then, many clients get this glazed look," he says.

That said, the slap to fixed income portfolios in 2022 got their attention.

“What happened in 2022 hadn’t happened in more than 40 years,” Mr. Pyle says, noting most investors had no context for the impact of fast-rising interest rates.

He tilts client bond assets to alternative strategies as the “low-hanging fruits” from falling rates become “not as easy to grab.”

Bond index ETFs remain a staple, “but then we will layer managed money around that.”

Yet, investing in alternatives doesn’t necessarily mean adding complexity. Clients still must be able to grasp the reasoning, he says, and many recognize that alternative strategies give them protection if inflation comes back.

The current uncertainty, however, doesn’t make the task of explaining bond strategies easy. Even among experts, a diversity of views exists, Mr. Dhanani says.

Some managers are focused on exploiting interest rate spreads to generate returns because they don’t see falling rates driving returns. Others believe falling rates and yields can largely power returns, he says.

His team is more bullish on Canadian bonds, for example, because they think the Bank of Canada will have to cut rates faster than the Fed.

There’s also “a huge amount of what we call ‘relative value arbitrage’” available to fixed income managers, Mr. Dhanani says.

He says those strategies might be as straightforward as investing in a Canadian bank corporate bond with a higher yield in U.S. dollars versus its Canadian-dollar version.

A lot of the value generated for investors can be found in that “relative value space” between similar bonds, Mr. Dhanani says, which advisors may not be able to see due to the opaque nature of bond trading.

On that point, Ms. Orlic – who is much more active with the equity side of client portfolios – agrees.

“As an advisor, you just can’t be an expert on everything.”