Is Do-It-Yourself Bond Investing Worth It?

4 Key Themes Investors Should Consider When Getting Back into Bonds

As all-in yields across bond markets increase, more investors are contemplating buying their own individual bonds. We believe there are some important factors to consider when deciding between DIY investing and utilizing a bond portfolio managed by a qualified investment manager.

The Importance of Diversification

Default Risk: Typically, the greatest risk within a bond portfolio is default risk, which is the risk that a borrower will be unable to make interest payments or repay principal upon maturity of the bond. These risks might be minimal in government, municipal, and even many investments grade bonds, but anything can happen.

We believe that diversifying exposure by issuer (company), sector (industry), geography, and credit rating results in less risk related to a single bad event or economy. Even a worsening outlook could have a negative mark-to-market impact on bond positions, creating price volatility in a portfolio where the more concentrated it is, the more volatility expected.

Global Diversification: A domestic portfolio will be heavily correlated to the health of our concentrated Canadian economy, which tends to be overexposed to energy and financial issuers. We believe that in Canada, a significant drop in corporate bond prices in conjunction with a recession, could see Canadian bonds trade down along with home prices and job security – which is a scenario that we don't think anyone wants to be in.

By going global, investors can improve diversification benefits and gain better access to sectors that are limited domestically, like information technology and healthcare. In other words, we believe that in order to provide the protection expected from fixed income in bad times, investors should consider actively diversifying away from home bias – just as one would in an equity portfolio.

At RPIA, our strategies focus on global bond markets, specifically developed nations, providing diversification and typically a lower correlation to Canadian assets. Our investment team follows a rigorous process aimed at identifying top-down themes globally. Then, through fundamental credit research and analysis, our team determines their most compelling issuer(s) and uses proprietary technology and expertise to select what they deem as the most optimal security within the issuer's capital structure. Finally, we size the investment based on criteria like conviction levels, liquidity considerations, and existing portfolio exposures. This ongoing process enables us to build diversified portfolios and helps us capture opportunities in a risk-disciplined way through different market environments.

The Diversification Challenge

Limited Capital: Creating diversification when using a direct purchasing strategy can be difficult. Bonds are predominately traded "over the counter" rather than on a centralized exchange, thus creating opaque pricing and varying cost structures for different market participants. Individuals are limited by their personal assets and generally do not have access to institutional relationships to reduce transaction costs as professional bond managers do. This can lead to overpaying and put limitations on the choice of bonds that can be purchased. With limited capital and a lack of institutional relationships, it can be challenging and costly to build a well-diversified bond portfolio.

Limited Access: Generally speaking, institutional investors monopolize bonds market inventories, leaving retail trading desks and individual investors with limited investment opportunities and often on less attractive terms. Yields can deteriorate quickly when investors attempt to directly access a small amount of an illiquid bond at a difficult bid or ask price. Direct investors are tested further if faced with a market where bond prices have fallen. Given such sparse inventory levels, it could be near impossible to add to a position, making it challenging to execute a thoughtful trading strategy.

RPIA manages over $6 billion in assets across multiple investment strategies. Our size, experience, and capability allow us access to capital flows, and we actively trade our positions to optimize our portfolio strategies for the benefit of our investors. We also strive to strategically overlay protective trades into our portfolios with the aim of further insulating investors from market drawdowns.

Portfolio Repositioning and the Impact of Taxes

Holding to Maturity: In the current market environment, where interest rates are on the rise, our view is that many investors purchasing bonds directly will do so with the intention to hold the bond to maturity. Broadly speaking, this is because as interest rates rise, bond prices inversely fall. Liquating a position ahead of its maturity date would likely result in a capital loss within a bond portfolio.

There may be an inflection point, of course, where taking the loss to lock in a higher yield could be the right strategy but selling individual bonds can be a trickier pursuit than buying them – and there is a cost associated with this transaction also. We believe that if purchasing a bond directly, most individual investors should consider the notion that they are locked in.

Potential Tax Implications: Generally speaking, with a buy and hold approach, investors are likely maximizing taxes owed on their positions due to the higher taxation of interest income versus capital gains. In contrast, investing in an investment fund structure can be more tax efficient if the manager can provide more return from capital gain and less from interest payments.

A benefit of investing through RPIA is that we can provide both daily and monthly liquidity, mandate dependent. Our funds are priced through a third-party administrator, based on daily market levels. Investors can enter and exit our funds on the first applicable valuation and settlement dates.

Our active management style allows us to potentially increase the capital gains portion of overall portfolio returns. Given the common differences in taxation of interest income versus capital gains this can help create improved net of tax outcomes for investors compared to a buy and hold approach that is typically characterized by higher levels of interest income.

Time Needed for Portfolio Maintenance

Difficulty Re-Investing Clipped Coupons: Typically, bonds pay out interest semi-annually. Some investors take that income right away, and others redeploy it into new opportunities. Either way, there is a certain level of maintenance required when investing in fixed income markets. As discussed above, this could be a challenging undertaking given the capital and access limitations of individual investors.

Our investment team is constantly redeploying capital and actively trading our portfolios aimed at positioning them optimally for the current market environment. To put this into context, RP Debt Opportunities, a strategy which typically holds over 200 debt issuers and over 300 underlying securities, had a portfolio turnover of approximately 16 times on a 12-month rolling basis. Turnover tends to be a rotation between different areas of an issuer's capital spectrum – meaning although the company names we are invested in may remain consistent, the underlying securities of the company we are invested in, changes frequently.

Although the independence of DIY investing can seem appealing, we believe that investors should reflect on these key themes and potential challenges that exist with achieving diversification, managing, and maintaining bond portfolios costs, and the potential impact of taxes. A qualified investment manager that specializes in bond portfolios can help investors navigate this established asset class in a way that can help achieve investor objectives across market environments.

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