THE GLOBE AND MAIL

Bonds simply aren't working anymore. It's time for a rethink

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Remember when your parents did stuff for your own good? Santa, the tooth fairy and the Easter bunny for example. The markets, people writing investment theory, and the advisers have done largely the same thing. They told you that the interest rate risk in bonds is roughly "the other half" of a well-constructed portfolio.

It isn't.

Interest rate exposure serves a purpose, sure - as did those fun and convenient childhood myths. But you're an adult now, and it's time to set the record straight.

Interest rate exposure alone is not fixed income. An effective portfolio still allocates 30-50 per cent to fixed income - way too much to have riding on any single risk factor.

The purpose of fixed income isn't simply to own bonds. It's to provide dependable income, preserve capital, and behave differently than equities. Interest rate exposure is one tool - not the whole toolbox.

The chart below may explain why they Santa'd you with bonds. There was a time when the safety and return from government bonds was plenty to satisfy any fixed income bucket. Rates were high and falling - and falling rates caused bond prices to rise - for decades. In hindsight, bonds were a portfolio gift. But they haven't been that panacea during this century.

Government of Canada 10-year bond yield

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In the past five- and ten-year periods, the XBB Canadian Universe Bond Index ETF has produced, on average, total returns of 0.8% and 1.73%, respectively. When you don't even cover inflation, you lose purchasing power. Forget about any growth.

The industry has known for a long time that interest rates are not a complete fixed income investment. Yet investors, advisers, and consultants have been slow to adopt new and better solutions. In fact, most investments not driven by interest rate exposure are dumped into a bin called 'alternatives' - largely because the system hasn't developed an effective way to refer to, analyze, and include them. Ask the large Canadian wealth management firms. Many continue to steer investors toward interest rate-dominated bond funds while limiting access to other fixed income solutions that have delivered attractive returns over long enough periods to matter, with ample accessibility and transparency.

They propose that they do it to protect you - perhaps like the tooth fairy. One might argue they do it because they haven't found a better way to model and monitor newer, better solutions, or perhaps because they have built massive businesses around interest-rate dependent fixed income funds.

Before we look at some of the important asset classes and strategies to round out an effective fixed income portfolio in 2026, let's dig a little further into the Canadian bond index. It functions as the benchmark that the vast majority of fixed income funds compare to, and often mimic, creating inertia for interest rates exposure being the simple default choice.

The return of the Canadian Universe Bond Index can be decomposed into three components: income (the aggregate coupon collected across its approximately 1,900 bond holdings), price return (the gain or loss purely from interest rate movements), and a residual capturing everything else - primarily credit spread movements on its corporate and provincial bond allocation.

Over the 2002–2025 period, income from the semi-annual coupon payments provided a steady and predictable 2.9 per cent return per year on average. It was the interest rate-sensitive price component that really determined whether any given year was good or bad: swinging from +9.75 per cent in 2008 (when yields fell sharply) to -14.1 per cent in 2022 (when yields spiked). Statistically, this bond price or interest rate movement explains more than 71 per cent of the year-to-year variation in total bond index returns.

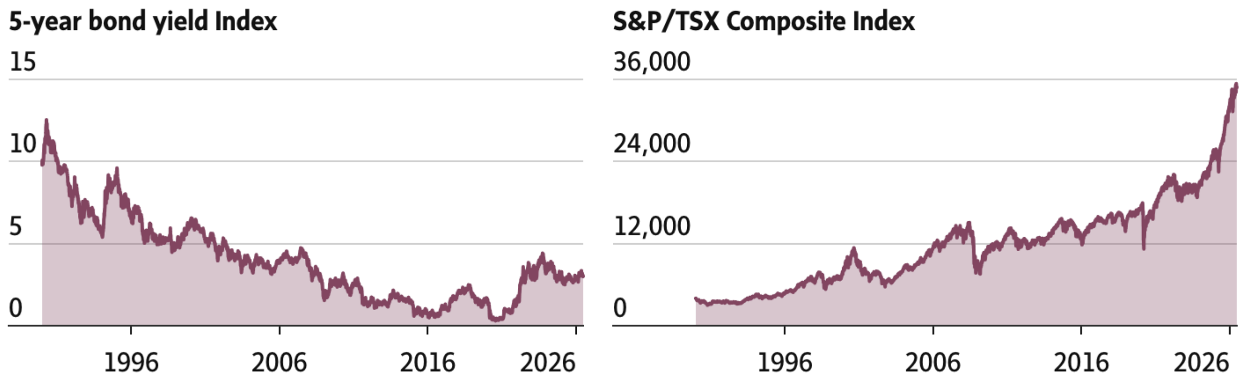
The residual - everything that is neither income nor rate-driven price return, including provincial and corporate credit spread movements, yield curve shape changes, and all other factors - was negligible - averaging just 0.5 per cent per year over the full period.

That return breakdown was derived from XBB monthly total return data, and monthly benchmark bond yields from the Bank of Canada. What it plainly shows is that interest rates don't merely influence the Canadian bond index - they are the Canadian bond market. Unsurprisingly, the Canadian Government Bond ETF XGB - which holds only federal and provincial bonds - moves in lockstep with XBB, with an R-squared of 99 per cent across 233 monthly observations.

The distinction between fixed income and interest rate risk has largely been lost. 0.80 per cent and 1.73 per cent annually over the past five and ten years means we can't ignore it any longer.

The good intention in suggesting bonds for fixed income was partly for the income, but arguably more for the investment's ability to act differently than equities when they fall. A quick scan of the graph below does not give you comfort that bonds hold their value or rise when stocks fall. It shows the level of the S&P/TSX Composite Index on the left and the yield of the Canada five-year bond on the right.

Government of Canada 5-year bond yield vs. S&P/TSX Composite Index



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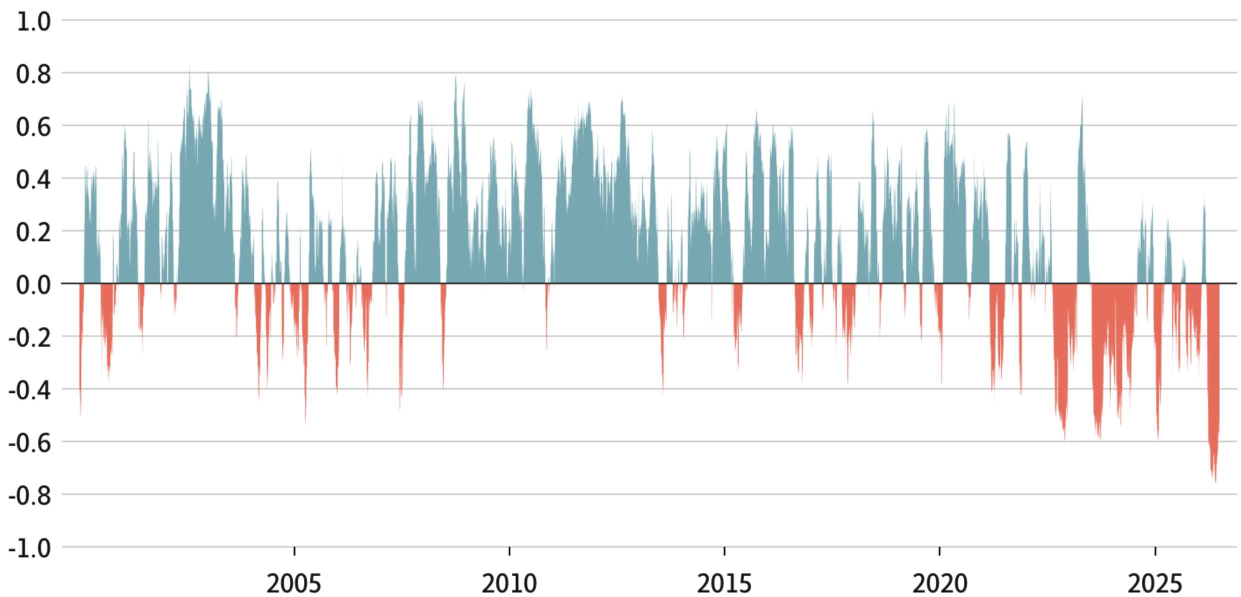
Correlation between daily log returns of TSX index and daily first differenced 5-year government of Canada bond index

30-day rolling correlation



THE GLOBE AND MAIL, SOURCE: BLOOMBERG

The second panel shows the rolling 30-day relationship between bond yields and stocks; each derived from daily observations of TSX returns and GoC five-year yield changes since 2000. Notably, the red parts, below the line, highlight the times when stock and bond prices moved in the same direction. Those are the times when bonds were not an effective diversifier or ballast for stocks, which occurs often, and has dominated the last several years.

Bonds, driven by interest rates, currently aren't paying much, and they aren't effectively offsetting stocks when they slide. That indicates that we need better fixed income solutions - ones that actually diversify and pay an effective return, perhaps like those gift-bearing mythical characters were designed to provide.

With this data it's reasonable to conclude that the negative correlation between stocks and bonds - the very foundation behind well-diversified portfolios - has become the exception, not the rule. Investors are being paid little or nothing for a service they have paid dearly for. The hedge against equity drawdowns, paid for by accepting paltry returns from fixed income funds dominated by interest rate exposure, hasn't been worth it.

The good news is that better fixed income solutions exist, have track records, and are more accessible than ever.

For most investors, the starting point is straightforward: floating rate loan funds, proven mortgage funds, and liquid investment grade credit funds without interest rate risk. For some, a well-selected high yield fund. Each earning its return from quality lending, not changes in rates.

For high net worth and institutional investors with greater capacity and access, that core list extends further: carefully selected private credit, real estate and infrastructure equity, emerging market debt, macro hedge funds, collateralized loan obligations, factoring funds, and insurance-linked securities.

Every investor's mix will be different. But the common thread is the same - dependable income that doesn't simply rely on where interest rates go.

For the industry, we're overdue to reconsider the narrative around fixed income. Portfolio construction hasn't kept up with reality. It's time to relegate interest rate risk to its much smaller yet still important role, and to build the data, analysis, and modelling needed for the better fixed income solutions to be broadly adopted. From the portfolios recommended in bank branches to the professional consultants, the knowledge, tools, and the products exist. The only thing missing is the will.

Interest rates should not dominate 30-50 per cent of your portfolio. Done right, fixed income can deliver on its income plus portfolio ballast mandate. It's high time that tooth fairy started leaving enough under the pillow to cover inflation.

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