THE GLOBE AND MAIL

This is how the pros actually go about making money from bonds

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SPECIAL TO THE GLOBE AND MAIL
JULY 24, 2026

The total return of Canada's broad bond index, including the interest income it pays, is still below its August 2020 peak. Seventy-one months later, investors who owned it then - or the funds that replicate it - are still underwater.

That's remarkable. But it doesn't prove that bonds no longer belong in portfolios. It confirms that expecting interest-rate duration to do all the work - one single risk factor - was always a mistake.

Once upon a time, last century, interest rates were very high and falling, causing bond prices to rise. They were a gift to any portfolio, and likely the reason the index and most bond funds still cling to them now. Too many investors have been thoroughly disappointed by those bond fund returns, by simply owning a few bonds, or surrendering to low-rate GICs. The experience has likely caused their fixed income allocation to wane from the 40 per cent guideline.

Exposure to interest rates, called duration risk, is still part of fixed income investing, even if the forecast return was recently upgraded to meh. Credit exposure is the other major factor in bond investing. Unlike duration, it isn't a bet on where rates go next, it's less volatile, and it certainly isn't underwater since 2020.

Perhaps it's time for fixed income investors to learn more about it.

What better way to explore credit investing than put you in the portfolio manager chair for the day? Actively managing credit spreads, protecting capital and positioning for opportunity - all day, every day.

So, imagine this:

Your monitor flickers once as it wakes.

A message about a pending new issue pushes everything else aside. You've earned those early calls. You screen for a list of the company's outstanding bonds, then pull the same for comparable credits. You note that it's the smallest borrower in the sector and remember how illiquid it was when you last sold it. That'll have to be baked into the new bond's credit spread.

You focus on the credit spreads of corporate bonds rated from AAA to BBB, issued by blue-chip companies. The bond's coupon, or annual fee, is the sum of the underlying interest rate and a credit spread - the additional compensation investors demand for the credit quality of the company borrowing the money.

As an active credit portfolio manager, you aren't preoccupied with trying to predict where interest rates are going. You determine if the credit spread is adequate compensation, and then you isolate that credit spread from the rate risk. If it's compelling, you integrate it into your portfolio of credit spreads, and you quickly see that a credit spread isn't set once and left alone - it's fought for, all day, every day.

Fortunately, you built the proprietary systems to do a bunch of that work in a click or two. Another button initiates a scrape of global market data: spread between A-rated and BBB's, equity indices, macro news, changes in the term structure of rates.

Once you've logged an early interest for the new issue, you get back to the daily grind. You scan the output of investment grade bonds that are currently two standard deviations cheap and the model-implied-value column beside it. Nine today, only two worth investigating. The first one's particularly appealing - it shows a U.S. dollar bond for a serial Canadian issuer at almost double the domestic credit spread.

Next, time for coffee while you survey the announced and rumoured new issue roadshows, prioritizing today's credit research. One of the lesser-known borrowers in the most compelling sector sticks out. Likely an upgrade candidate too. That one first. Which tweaks your process for what you'd sell to buy it, remembering that individual security liquidity is crucial in this up and down environment. The best issuer in the worst sector also earns a flag, but for later.

Now the curve. Since you focus on credit spreads all day it's easy to fall in love with an issuer or one of their bonds, but the holy grail is: great credit, compelling spread, on the right part of the curve. That one-year bond will roll down very nicely in the carry book, while that just less than seven year will probably earn five-year benchmark status soon.

Turns out that today's issuer is borrowing sub-debt, not senior, so your process restarts, but your early work wasn't wasted. You recognize that subordinate and less-liquid probably won't be the right play right here, right now. So, you decide to wait for pricing whispers, including the new issue concession that has to be ten or fifteen basis points, before doing more work. You note the investor-friendly call structure, which, with the recent M&A in that space, has your Spidey-sense mosaic theory tingling about the merits of a smaller position, but not for the carry book.

Now, what would each of those potential additions do to the total portfolio metrics? Thank God for computers. The output confirms a higher running yield, with lower total portfolio risk, and only marginally less liquid. Passes test number one anyway.

Time flies. Before lunch with that CFO you want to finish analyzing the index rebalancing effect, drill down on how much more the insurance company demand will support long utility spreads, revisit your CDX hedge, determine if borrowing cash might be the cheapest leverage available now, and re-review the asset backed security presentation with the worst-case scenario projections. It might be right in the portfolio's sweet spot.

You've had a productive half day. Final deal pricing was generous, but not enough for the subordination and illiquidity, so you passed. The bonds you don't buy are often the best decisions of all. This afternoon you'll update the historical risk and return chart of credit funds versus the index and several popular bond funds. You love how that graph always gets the audience leaning in.

A far more deliberate process than simply replicating a bond index.

Which leaves you wondering what the fixed income index has been doing underwater since late 2020. It makes you question the too-common default to interest rate risk as the be-all for fixed income.

The real job is protecting capital and positioning for opportunity. All day, every day.

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