

Empire Life fixed income segregated funds can help address the low interest rates and high market volatility of today

Fixed income has traditionally played a critical role in diversified portfolios. The benefits of fixed income include generating steady income while preserving capital and providing a hedge against equity risk. These benefits are particularly evident during periods of market weakness, as witnessed recently in the selloff triggered by the COVID-19 pandemic.

The COVID-19 shock altered the course of the global economy and caused extreme volatility in financial markets that we have not seen since the 2008 financial crisis. Policymakers around the world had to step in quickly to fight the global economic shutdown with unprecedented fiscal and monetary policies. In an era of low interest rates, how should investors be thinking about their fixed income allocations in a world of uncertainty and record-low yields?

Government bonds are still a critical hedge against equity risk

Over the past 25 years, the correlation between stocks and government bonds has been negative. A negative correlation implies that government bonds would appreciate when equity markets fell and vice versa. During periods of extreme market volatility and declining equity values like we experienced earlier this year, government bonds within a balanced portfolio can appreciate in value and thus help to mitigate the overall losses in your portfolio listed elsewhere.

Asset class correlation over 25 years

	US 5-Yr Treasury	US 10-Yr Treasury	Gold	U.S. Equity	U.S. Small Cap Equity	U.S. IG Bonds	U.S. Corp HY Bonds	Canadian Equity
US 10-Yr Treasury	0.94							
Gold	0.27	0.26						
U.S. Equity	-0.28	-0.26	0.05					
U.S. Small Equity	-0.34	-0.33	0.06	0.83				
U.S. IG Bonds	0.85	0.89	0.32	-0.02	-0.09			
U.S. Corp HY Bonds	-0.21	-0.18	0.15	0.64	0.65	0.19		
Canadian Equity	-0.25	-0.21	0.20	0.79	0.77	0.03	0.63	
Canadian Bonds	0.67	0.73	0.20	0.05	0.01	0.80	0.15	0.15

U.S. 5-Yr Treasury: S&P U.S. Treasury Bond Current 5-Yr TR Index in USD; U.S. 10-Yr Treasury: S&P U.S. Treasury Bond Current 10-Yr TR Index in USD; U.S. Equity: S&P 500 TR Index in USD; U.S. Corp HY Bonds: Bloomberg Barclays US Corp HY Bond Index in USD; U.S. IG Bonds: Bloomberg Barclays U.S. Agg Bond Index in USD; Canadian Bonds: FTSE Canada Universe Index in CAD; Canadian Equity: S&P/TSX Composite Index in CAD

Source: Bloomberg as of Oct. 30, 2020



The Empire Life Bond GIF focuses on government bonds and investment-grade corporate bonds, making it one way to provide risk reduction and portfolio protection when the economy is in a bad state.

The need for income and capital preservation in an era of diminishing yields and rising interest rate risk

It is called “fixed income” for a reason. Bonds usually offer an explicit and predictable income stream in the form of coupons. Historically, coupon payments have provided steady and predictable income to meet investors’ needs for liquidity and to maintain purchasing power. When central banks around the world lowered short-term rates to close to zero in response to the pandemic, the income component of the return on a government bond portfolio has declined to less than 1%. This has exacerbated the challenge for many investors but especially retirees, who may rely on investment income to maintain their lifestyle without having to drawdown their capital.

As yields/coupons have fallen over the past three decades, bonds have become increasingly susceptible to interest rate risk. The average duration has been extending, making bond markets, particularly the government bond sector, more sensitive to future moves in the interest rates and inflation. The world economy now faces a long road to recovery. The need to keep interest rates low for an extended period is the consensus among central banks. But the unprecedented infusion of cash into the financial system has renewed the concerns that inflation could surge.

Prudent investors need a way to address the challenges of record-low government bond yields and increased interest rate risk. A high-quality, short-term, high-yield strategy is one potential solution. This type of strategy not only provides incremental yield above government bonds (also known as the “credit spread”) but also serves as a cushion to counter the effect of rising rates. The dominant risk in high yield is credit risk, but this can be mitigated by rigorous credit research focused on high-quality (BB-rated) companies with solid business operations, significant liquidity, excellent cash flow fundamentals, modest leverage and favourable debt maturity profiles. Short-duration high-yield bonds issued by such companies are an attractive means to maintain yield, while limiting overall interest rate exposure.



Empire Life Short-Term High Income GIF, which implements such an investment strategy, offers the potential to enhance portfolio returns and reduce volatility in an era of record-low yields and increasing interest rate risk.

Building resilient and balanced fixed income portfolios

Facing the COVID-19 pandemic, policymakers made drastic interventions that have stabilized the financial markets. At the end of July, stocks, bonds and some commodities all posted one of the strongest four-month increases on record, reflecting the breadth of the market recovery. However, the economic reality is that the eurozone and the U.S. lost about one-tenth of their economic output in the second quarter¹. Canadian gross domestic gross product likely fell 12% in the three months to June², due to the COVID-19 shutdowns. The extent and breadth of the damage caused by these sharp declines in economic activity and massive job losses may cast a long shadow over any post-pandemic recovery. And the pace of the recent market rebound stands in marked contrast to the murky economic and political backdrop, leading to worries that asset prices may be disconnected from fundamentals.

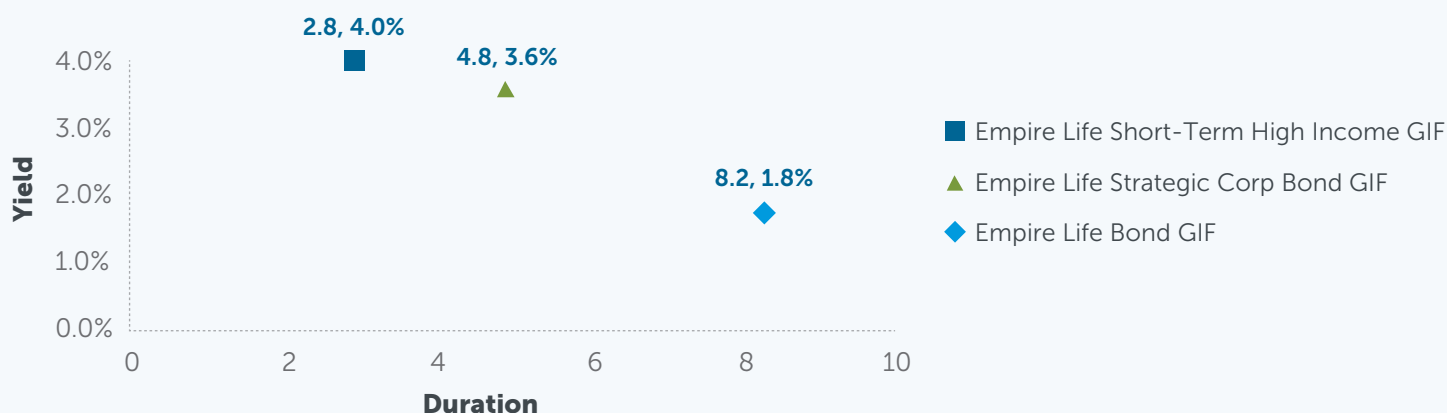
It is impossible to predict the direction of markets or interest rates. It is more important than ever, therefore, for prudent investors to build a resilient, diversified and balanced fixed-income portfolio that is both dynamic and active in terms of country, sector, credit spectrum and individual security selection.



Empire Life Strategic Corp Bond GIF represents one way to obtain this kind of appealing risk/return profile. The fund makes a strong case for a diversified bond portfolio, with the flexibility to invest as well in investment-grade corporate bonds, high-yield and convertible bonds, and preferred shares.

To help make the decision on the right fund for your fixed income portfolio, you can see how the funds are positioned in Yield and Duration, and their fund characteristics

Empire Life Fixed Income Funds interest rate risk and yield profile*



Empire Life Fixed Income Funds features*

	Empire Life Bond GIF	Empire Life Strategic Corp Bond GIF	Empire Life Short-Term High Income GIF
Objective	<ul style="list-style-type: none"> Income Capital preservation 	<ul style="list-style-type: none"> Higher income Capital preservation 	<ul style="list-style-type: none"> Higher income Capital preservation
Benefits	<ul style="list-style-type: none"> Very limited credit risk 	<ul style="list-style-type: none"> Low credit risk 2x the yield of government bonds Less than half of the rate risk of government bonds Geographic diversification 	<ul style="list-style-type: none"> Low volatility as a result of low rate risk and moderate credit 2x the yield of government bonds One-quarter of the rate risk of government bonds Geographic diversification
Category	Cdn Fixed Income	Gbl Corp Fixed Income	High Yield
Asset Class Mix			
Cash	2%	3%	3%
Governments	52%	2%	
Investment Grade Corp Bond	39%	56%	19%
High Yield Corp Bond	3%	25%	63%
Converts & Preferred	4%	14%	15%
Average Rating	AA	BBB	BB
Yield	1.8%	3.6%	4.0%
Duration	8.2	4.8	2.8
Other features	<ul style="list-style-type: none"> Gain exposure to broad Cdn investment grade bonds universe with highest interest rate risk and lowest credit risks among Empire Life fixed income products 	<ul style="list-style-type: none"> Actively managed across various asset classes including govt, investment grade, and high yield bonds, preferreds and convertible with minimum 60% investment grade Offers income with opportunity for capital gains with excess yield over government bonds 	<ul style="list-style-type: none"> Actively managed across various asset classes including govt, investment grade, and high yield bonds, preferreds and convertible Offers income with opportunity for capital gains with excess yield over government bonds

*As of Oct.31, 2020

¹ U.S. Bureau of Economic Analysis July 2020 https://www.bea.gov/sites/default/files/2020-07/gdp2q20_adv.pdf
Eurostat July 2020 <https://ec.europa.eu/eurostat/documents/2995521/11156775/2-31072020-BP-EN.pdf/cbe7522c-ebfa-ef08-be60-b1c9d1bd385b#:~:text=In%20the%20second%20quarter%202020,statistical%20office%20of%20the%20European>

² Reuters July 2020 [https://www.reuters.com/article/us-canada-economy-gdp/canada-second-quarter-gdp-likely-to-fall-record-12-on-covid-19-shutdowns-idUSKCN24W1Z3#:~:text=11%20days%20ago-,Canada%20second%2Dquarter%20GDP%20likely%20to%20fall,12%25%20on%20COVID%2D19%20shutdowns&text=OTTAWA%20\(Reuters\)%20%2D%20Canada's%20GDP,19%20containment%20measures%20were%20loosened](https://www.reuters.com/article/us-canada-economy-gdp/canada-second-quarter-gdp-likely-to-fall-record-12-on-covid-19-shutdowns-idUSKCN24W1Z3#:~:text=11%20days%20ago-,Canada%20second%2Dquarter%20GDP%20likely%20to%20fall,12%25%20on%20COVID%2D19%20shutdowns&text=OTTAWA%20(Reuters)%20%2D%20Canada's%20GDP,19%20containment%20measures%20were%20loosened).

A description of the key features of the individual variable insurance contract is contained in the Information Folder for the product being considered. **Any amount that is allocated to a Segregated Fund is invested at the risk of the contract owner and may increase or decrease in value.** Valid until Feb. 28, 2021.



To find out more about how the Empire Life Fixed Income Funds can fit into your portfolio, contact your advisor or visit empire.ca

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