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Is it wise to jump on the bond bandwagon?

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Long-term, high-quality corporate bonds in developed markets could flourish if economic weakness persists

Even veteran investing pros are amazed at the way money flooded into bonds as stock markets sank.

"I've looked at the bond market charts over the last week or so and I can't believe bonds moved like that," said Wilf Hahn, chairman and chief investment officer at Hahn Investment Stewards. "It's absolutely remarkable."

Nothing is more predictable than a rush into bonds at a time when stocks are falling hard, even if the current move is especially dramatic. But aren't investors supposed to buy low? Aren't stocks the place to put new money right now, not the high-flying bond market?

Generally speaking, yes. Bond yields are so low right now that individual investors buying five-year Government of Canada bonds late this week would have been lucky to get yields of 1.5 per cent. Five years from now, it's very likely the stock market will have made you a fair bit more than that.

But in the near term, there are money managers who believe that persistent economic weakness will make bonds a good place to be. Their view on bonds is a nuanced one that emphasizes long-term bonds over short-term bonds, high-quality corporate bonds over riskier high-yield bonds, and strong developed countries like Canada over emerging markets.

Robert Sneddon, president and portfolio manager at CastleMoore Inc., said clients of his firm have for a while had between 40 and 70 per cent of their portfolios in bonds. Most of the holdings are in long-term bonds, which in this case means they mature in between seven and 20 years.

Can you still make a buck on bonds, even after the big price increases of late? "We believe so, yes," Mr. Sneddon said.

Earlier this year, the common view was that rising inflation and economic growth would fuel an upward move in interest rates, which in turn would be bad for bonds. Now, as it becomes apparent that the global economy is struggling, the outlook is for rates to remain low much longer than previously thought. Great news for Canada's bondholders? Yes and no.

If you hold a diversified portfolio of bonds or bond funds, it's unlikely you'll see any big price increases or declines over the next year or so. Yields are low, but at least you won't lose money.

The best opportunities to make money in bonds could be in long-term bonds. Mr. Sneddon thinks they could still rise in price, and Mr. Hahn does as well. But mind the risks. When the economy finally hits its stride, long bonds will fall much harder than short-term bonds.

That's why Mr. Sneddon is keeping a close eye on economic developments for signs it's time to move out of long bonds. Three U.S. economic indicators he's looking at are wage increases, housing prices and the savings rate. Rising wages and house prices would be bullish, as would a falling savings rate (cautious U.S. consumers have curtailed spending and dramatically increased their savings in recent years).

"Will there be a time to sell bonds? Yes," Mr. Sneddon said. "That's the other side of this. I wouldn't be buying bonds to hold them to maturity."

Short-term bonds are more conservative, but they offer much less potential for gains in the next year or so. "They're a placeholder," Mr. Sneddon said. "You're getting a little more than if you sat in cash."

The low yields on virtually all government and quality corporate bonds have in the past couple of years driven some investors to buy high-yield bonds, issued by companies without top credit ratings, as well as emerging market bonds. These bonds offer markedly higher yields, and risk.

Oddly, given the uncertainty in global markets today, there are arguments being made that high-yield and emerging market bonds are attractive right now. The rationale is that it's governments, notably those in the developed world, that pose the big default risk right now. High-yield corporate bonds and emerging market bonds allow you to sidestep this risk, the theory goes.

Mr. Hahn, who in the past was head of the global investment group at Royal Bank of Canada, said it's becoming an increasingly accepted view that emerging economies have a financial and demographic base that compares well with the developed world.

Long-term, Mr. Hahn likes the idea of owning bonds from strong emerging economies. But he's not much interested in these bonds just now because of global economic uncertainties. "We have no way of telling where all these problems are going to ricochet to. For the time being, I wouldn't want to bite on any high-risk bonds."

The argument against high-yield corporate bonds is simply that tough times for the economy will make it tougher for companies with weak financials to pay what they owe. "Corporate profits will be under pressure over the next year," Mr. Hahn said. "I'd rather stay in quality corporate bonds."

Recent returns from exchange-traded funds focusing on high-yield bonds remind us that these bonds behave more like stocks than bonds in volatile times. For the year through Aug. 11, the worst performing bond ETFs listed on the Toronto Stock Exchange are in the high-yield category.

The best performers year-to-date are the BMO Long Federal Bond Index ETF ZFL-T and the iShares DEX Long Term Bond ETF XLB-T. A close look at these two ETFs tells you something about the mood of the markets right now.

The BMO fund holds only bonds issued by the federal government and its agencies, while the iShares fund holds some quality corporate bonds as well. The BMO fund's yield is lower than the iShares fund, but its share price has outperformed lately because investors favour the security of Canadian government bonds.

While the appeal of buying bonds right now is debatable, the benefit of permanently keeping part of your portfolio in bonds is not. Earlier this year, with both the stock markets and inflation on the rise, bonds looked like dead weight. Today, they're like portfolio flotation devices.

"For diversified investors with balanced portfolios, good gosh, bonds have been a nice offset to the equity market downturn," Mr. Hahn said.

One way to tell what's been working and what hasn't in bonds is to look at returns from the various types of exchange-traded funds that hold bonds. Here are recent results:

				% Chg to Aug. 11		
Fund	Ticker	$ Price	% Yield	Week	Month	YTD
Diversified Bond ETFs						
BMO Aggregate Bond Index	ZAG-T	15.66	3.8	0.6	2.6	3.2
Claymore Advantaged Canadian Bond	CAB-T	20.80	3.2	0.6	2.4	2.9
iShares DEX Universe Bond Index	XBB-T	30.87	3.7	-0.1	1.9	3.3
Long Term Bond ETFs						
BMO Long Federal Bond Index	ZFL-T	16.60	3.8	1.3	6.8	7.2
iShares DEX Long Term Bond ETF	XLB-T	21.82	4.0	-0.3	3.1	5.6
PowerShares Ultra DLUX LT Government Bond	PGL-T	21.10	4.1	0.8	4.2	n/a
Short Term Bond ETFs						
BMO Short Term Federal Bond	ZFS-T	15.20	2.8	0.5	1.7	1.7
Claymore 1-5 Year Government Bond	CLF-T	20.47	4.4	0.4	1.5	1.7
iShares DEX Short Term Bond	XSB-T	29.38	3.1	0.3	1.2	1.6
Corporate Bond ETFs						
BMO Short Term Corporate Bond	ZCS-T	15.13	4.0	-0.2	0.6	0.9
BMO Mid Corporate Bond	ZCM-T	15.77	4.8	0.8	2.3	3.7
BMO Long Corporate Bond	ZLC-T	16.62	5.1	-0.1	2.7	3.7
Claymore 1-5 Year Laddered Corp Bond	CBO-T	20.67	4.6	0.4	1.2	1.2
HAP Corporate Bond	HAB-T	10.52	4.0	-0.2	1.8	3.3
iShares DEX All Corporate Bond	XCB-T	21.11	4.4	0.3	1.5	2.5
PowerShares 1-5 Year Laddered Inv. Grade Corp.	PSB-T	20.63	4.4	1.7	1.9	n/a
High Yield Bond ETFs						
BMO High Yield Corp Bond US Hedge to CAD	ZHY-T	14.86	8.4	-1.7	-5.5	-5.3
Claymore Adv. Short Duration High	CSD-T	19.52	5.1	-1.6	-3.1	n/a
Claymore Adv. High Yield Bond	CHB-T	19.53	7.9	-5.0	-6.8	-5.3
iShares U.S. High Yield Bond	XHY-T	19.78	7.7	-1.5	-5.4	-4.4
PowerShares Fund. High Yield Corp. Bond	PFH-T	19.27	6.6	-4.8	-4.3	n/a
Real Return Bond ETFs						
BMO Real Return Bond Index	ZRR-T	17.38	2.2	0.9	4.1	10.3
iShares DEX Real Return Bond	XRB-T	24.11	1.9	0.0	3.1	8.5

Source: Globeinvestor.com

A note about yields: These numbers reflect the yields that investors would get based on the share prices shown here and the most recent distributions of interest income. Actual yields, reflecting changes in bond ETF holdings over time, will be lower. For a good indication of what to expect, look for a bond ETF's average yield to maturity (available on ETF company websites) and subtract the management expense ratio.