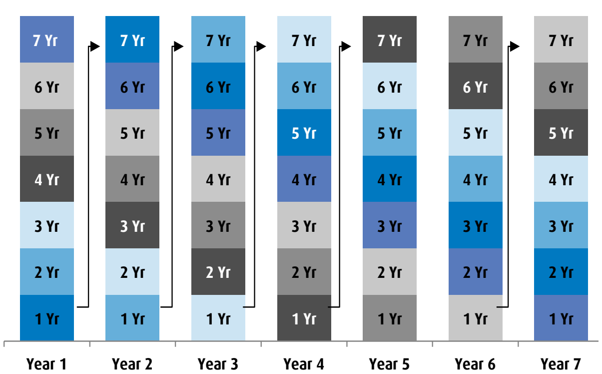
Take the Guesswork Out of Interest Rates With a Laddered Bond Strategy

Fixed income investors currently face a complex investment environment; one that includes unconventional monetary policies and higher volatility. While rising interest rates will continue to be a risk, trying to time this risk has proven difficult. By employing a laddered bond strategy, investors can help balance the risk between rising interest rates (interest rate risk) and falling interest rates (reinvestment risk) within their investment portfolio.

A laddered bond portfolio (also referred to as a bond ladder) is a fixed income investment strategy that constructs a portfolio by investing an equal amount of money in bonds with multiple maturity dates, spread evenly throughout the ladder-horizon. For example, investing $100,000 in a 10-year bond ladder could be implemented by investing $10,000 in bonds maturing each year throughout a 10-year period, or investing $5,000 in bonds maturing every six months over 10 years. As each bond matures, the proceeds are used to reinvest in the next tranche.

Figure 1 provides an example of a seven-year bond ladder and illustrates how each year the maturing bond proceeds are used to purchase a bond in the longest-term sector in the bond ladder; in this example a bond maturing in seven years.

Figure 1: Seven Year Bond Ladder



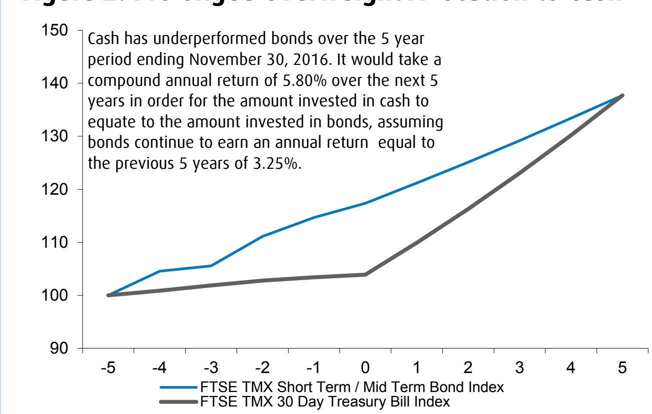
Source: BMO Nesbitt Burns

Benefits of a bond ladder

Among the benefits to implementing a laddered bond strategy, are the following:

- **A simple fixed income investment strategy**. Bond laddering is a simple buy and hold investment strategy that eliminates the "guesswork" involved with forecasting interest rates by investing in bonds with different terms to maturity.
- **Disciplined approach to staying invested**. The BMO Nesbitt Burns Portfolio Advisory Team believes that in today's investment environment, cash and cash equivalent securities remain expensive. Staying in cash for a prolonged period can have a significant impact on a portfolio's long-term performance. Based on historical data, staying in cash too long – and leaving return potential on the table – may cause investors to require equity-like returns in the future in order to catch up to benchmark portfolios. **(Figure 2)** A laddered bond strategy will keep investors exposed to fixed income markets at all times.

Figure 2: Prolonged Overweight Allocation to Cash



Source: BMO Nesbitt Burns, FTSE TMX

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Considerations for a bond ladder

Before implementing a bond ladder, investors should consider the following:

- A bond ladder typically does not provide as much diversification as other managed strategies. This is particularly important when a bond ladder is created using corporate bonds. A typical corporate bond mutual fund or Exchange-traded Fund holds hundreds of individual bonds spread across many sectors and issuers; whereas bond ladders are generally constructed using a limited number of bonds. However, investors can improve diversification by allocating a portion of their portfolio to a diversified fixed income investment vehicle.
- As a passive strategy, a bond ladder continually reinvests in the longest-term sector in the ladder, ignoring the shape of the yield curve and the opportunities it presents. Also, a bond ladder will not adjust its sector or issuer allocations given different credit opportunities and risks that may be present. However, it is important to note that a large part of long-term returns in fixed income markets are related to the general level of interest rates.
- Bond ladders typically utilize a buy and hold strategy that will not look to harvest capital gains or losses. However, if appropriate substitutions exist, tax management strategies may be employed.

Recommendations for creating a bond ladder

Bond ladders can be created in numerous ways, utilizing different investment horizons, fixed income sectors and issuers, including:

1. **Using high-quality bonds**. Since bond laddering is designed to be a simple, non-active investment strategy, high-quality bonds should be used. If higher returns are desired by taking on additional credit risk, an active management strategy should be employed. The investment universes should be limited to federal, provincial and high-quality corporate bonds.
2. **Using a ladder-horizon that matches your risk and return objectives**. A laddered bond portfolio's ladder-horizon will affect a portfolio's interest rate sensitivity. Although bonds are held to maturity, a 10-year bond ladder would be expected to have greater volatility than a five-year ladder, for example. While investment horizons are investor-specific, the Portfolio Advisory Team believes a bond ladder between five and 10 years in duration may be prudent, because on balance, the mid-term segment of the fixed income market provides some of the better investment opportunities.
3. **Increasing the number of holdings per term for shorter-term bond ladders**. Shorter-term bond ladders that consist of one investment per year, for example, may not be adequately diversified from a sector and issuer perspective. Therefore, increasing the number of bonds per term can help improve diversification.

Seek professional advice

A laddered bond strategy can be implemented to assist investors in balancing interest rate and reinvestment risk within their investment portfolios.

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Please contact your BMO financial professional to discuss whether a laddered bond strategy is suitable for your situation.

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