

Why Short Term Bond Funds Are Not Money Market Fund Proxies

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In the past few Mutual Funds Monthly pieces we've published we noted that Canadian investors are finally beginning to let go of their obsession with money market funds. From April to the end of June, \$4.1 billion was moved out of such products, and given the paltry yields that are offered, it's about time. Assets are being switched into other fund categories – mostly conservative categories at that and a good chunk has made its way into short term bond funds (equity funds, despite the run in the market, have only seen net outflows since the market's March lows).

Table 1: 2009 YTD Net Sales and Assets for Short Term Bond Funds

Period	Net Sales (millions)	Assets (millions)
January	\$147	\$7,921
February	\$400	\$8,367
March	\$527	\$8,975
April	\$402	\$9,133
May	\$610	\$10,007
June	\$360	\$10,394
Total	\$ 2,445	

Source: IFIC

Net new sales for the short term bond category since the start of the year stand at \$2.4 billion. Most of that has come in over the past three months and our fear is that short term bond funds are being used as higher-yielding proxies for money market funds. The fact of that matter is that short term bond funds do offer slightly more attractive yields than money market funds (many of which yield nothing at all at this point) but that's because they have a different risk profile than money market funds. These instruments can go down in value. Understanding what the risks of short term bond funds are is crucial before any decision to blow out a portfolio's money market fund holdings and shifting the proceeds into short term bond funds is made.

Investors who need absolute capital preservation and ample liquidity should stick with money market funds or CDIC-insured savings accounts. Short term bond funds are not a good proxy for money market funds in our opinion.

Nuts and Bolts

Before examining the different risks of money market funds and short term bond funds, it makes sense to first examine the composition of each type of product.

Short term bond funds typically hold investment grade government or corporate debt issues with maturities anywhere from one to five years and the CIFSC requires any product that is classified as a short term bond fund be have an average duration of 3.5 years or less. Bonds issued by government agencies, such as the Canada Housing Trust, which issues Canada Mortgage Bonds, are also commonly found in short term bond portfolios. The securities in short term bond funds generally pay an annual or semi annual-coupon and may trade above or below par, depending on market conditions.

To contrast, money market funds consist of cash, cash equivalents or other short term instruments, such as commercial paper or BAs, with terms to maturity of 365 days or less. The instruments in money market funds do not pay a yield. Most often they are issued at a discount to par and they mature at par. Money market funds are viewed as being the “safest” mutual funds available and this is so because their NAVs do not fluctuate. Rather, any return is paid out in the form of a distribution. Any paper held by a money market fund is issued by the Canadian government, its agencies or highly rated corporations such as the Canadian banks. There is an implicit guarantee that losses will not occur, however, an explicit guarantee does not exist as these funds are not protected by the CDIC. We believe investors needn't be fearful of a loss in their money market funds, but for those with serious concerns (as unwarranted as they may be) about the integrity of such products, there are numerous CDIC-protected high interest savings accounts available.

The label “high interest” that is attached to some of the savings accounts that are offered by the banks and other institutions is a bit of a misnomer, however, because you'd be hard pressed to find many that pay more than 1%. Things get even bleaker when you consider that the average yield on the money market funds covered in our most recent Cash Monitor report was 0.24%. It's of little wonder investors are looking for alternatives.

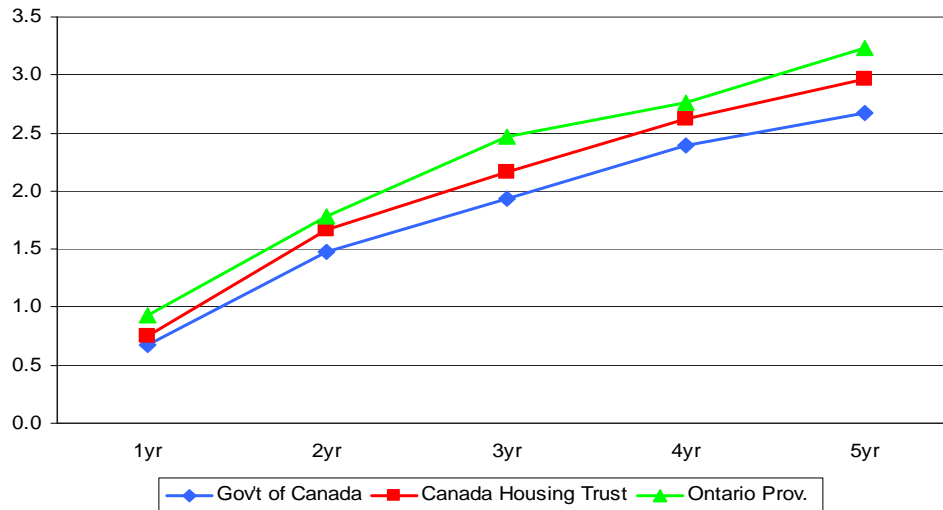
The Skinny on Short Term Bond Funds

The gross yield on the index is a shade under 2.4% at this time. The median fund in the category has an MER of 1.31% according to Morningstar, so everything being equal, the ballpark one-year return an investor should expect from these funds after fees should be in-and-around 1% to 1.2%. That's not mindblowingly superior to what you can get from some money market funds or high interest savings accounts. If the yields being offered by securities with maturities of one to five years were higher, a more compelling investment case could be made. However, higher rates for these instruments could mean losses for investors who already hold them. Interest rate risk is something that investors in these funds must be aware of. It is possible to lose money in short term bond funds.

Time to go back to fixed income 101. Bond prices fall when interest rates go up, and vice versa. Duration is a measure of a bond's sensitivity to interest rate fluctuations. The DEX Short Term Bond Index had a duration of 2.91 years to the end of July, meaning that if there was a 100 basis point upward shift in the yield curve, the value index would fall in value by 2.91%. Most short term bond funds will have a duration that is somewhat close to the index (recall that to be classified as a short term bond fund, duration must be 3.5 years or lower), so a rapid upward spike in rates would mean NAVs would fall. That's something that is not seen in money market funds and we are not entirely sure it is something investors in short term bond funds are prepared for regardless of how limited those potential losses might be.

By the same token, a downward shift in the yield curve would increase bond prices, and because rates at the short end of the yield curve have fallen so rapidly over the past year, most short term bond funds sport rather impressive returns (5%+ over the past year in many cases). That said, we do not believe there is much room for investors to get a lot more juice from lower interest rates given what the yield curve looks like today. We are not suggesting that yields are ready to pop higher, simply that one tailwind that's been an aid to these instruments may not be so helpful moving forward.

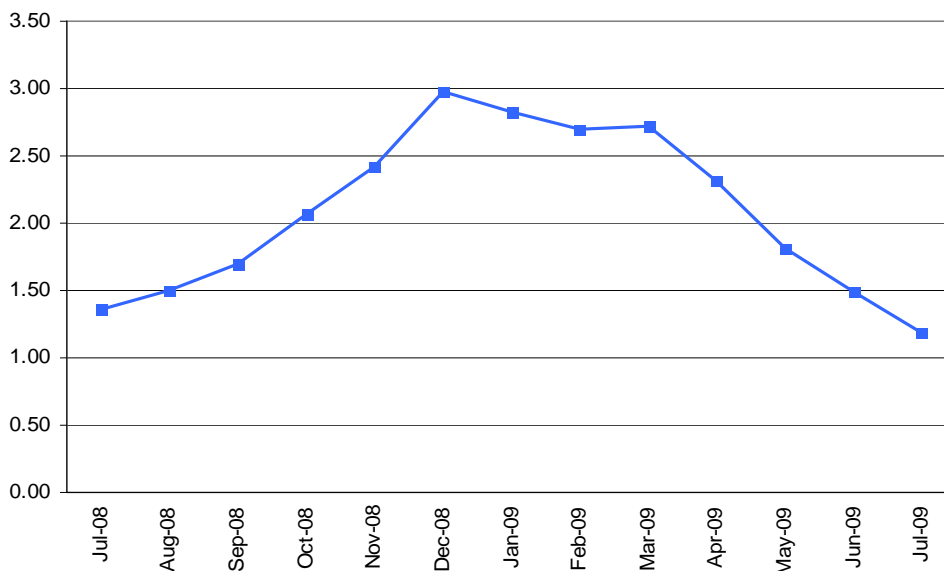
Chart I: Aug. 6 Yield Curve for Selected Bond Issues



Source: Bloomberg

Another tailwind that may be much weaker moving forward will be the push the category has experienced as a result of narrowing corporate bond spreads since the start of the year. While spreads are still well above their historical averages, in many cases, they are a couple of hundred basis points lower than where they were a few months ago and the spread narrowing process has boosted returns. The “low hanging fruit” has been picked, so to speak, and our guess is that unless the economy veers onto the road to depression, it will be challenging for short term bond funds to post returns over the next twelve months that look anything close to the returns they experienced over the past twelve months.

Chart II: Short Term Corporate Bond Spreads (%)



Source: PC Bond

What Sort of Losses Have Been Witnessed in the Past?

Fidelity Canadian Short Term Bond fund has been around for close to 15 years and we believe its historical performance is a decent proxy for the category. Table II highlights the frequency of positive and negative returns for the fund over various rolling time periods. Losses were experienced over periods of one month 26% of the time. Negative returns were also posted during 16% of the fund's rolling three-month return periods. From time to time investors would have experienced losses over periods of six months as well as one year. And while the magnitude of the losses weren't severe, the fact that there have been losses at all is hopefully an eye opener for many.

We should note that Fidelity Canadian Short Term Bond fund did not experience any losses over rolling periods two, three, five or ten years.

Table II: Rolling Returns Since Inception, Fidelity Canadian Short Term Bond Fund

	1 month	3 month	6 month	1 year
Number of Periods	172	170	167	161
Negative Periods	45	27	10	2
Best Period	2.8%	6.2%	9.3%	15.3%
Worst Period	-1.5%	-1.7%	-0.9%	-0.1%
Average Period	0.4%	1.3%	2.6%	5.0%

*Inception: Jan. 30, 1995

Source: Fidelity Investments

The Bottom Line

Investors have begun flocking to short term bond funds in an effort to pick up yields that are juicier than what's available from money market funds. The problem is that short term bond funds can go down in value, and factors such as narrower corporate bond spreads and already low interest rates mean it will be tough for these products to post returns that look anything like what we've seen from them over the past 12 months. We believe the upside for these funds is limited at this point while a higher interest rate environment could lead to negative returns – something that would no doubt come as a surprise to some of those who have piled into the category recently.

Even if we were to remain in a relatively benign economic environment, where spreads and yields stayed fairly constant, we wouldn't expect the after-fee returns investors get from short term bond funds over the next year to be dramatically higher than what they could get from some of the higher-yielding money market funds or high interest savings accounts that are available.

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