

Optimize your bond fund return by blending it with precious metals fund

CEMIL OTAR

The price of bonds and precious metals are inversely correlated, i.e. they move in opposite directions. You can take advantage of this to improve your returns in your bond portfolio.

When investors expect higher inflation ahead, they do two things: they ask for higher interest on the money they lend, and they increase their precious metal holdings as a hedge against inflation. This results in lower bond prices and higher precious metal prices.

Since the bond price and the price of gold generally work in opposite directions, you can take advantage of this inverse relationship. There are two areas where this can be useful:

- to maximize your returns without incurring a risk higher than that of the pure bond fund,
- to reduce the volatility of your portfolio if you are bullish on gold, but do not want the high volatility of the precious metals fund.

My interest was to find a practical way of applying this information to our Canadian portfolios. I looked at a multitude of bond/gold ratios using a five year monthly standard deviation as a measure of volatility (and risk) and analyzed the risk and the return for each combination. I studied two bond fund / precious metals fund pairs which had a history of over five years.

The first set was the Dynamic Income Fund (a bond fund) and the Dynamic Precious Metals Fund. This income fund is one of the least volatile bond funds in Canada. The precious metals fund also has a lower volatility when compared to other similar funds.

My study showed that for each \$90 invested in Dynamic Income Fund, if \$10 were invested in the Dynamic Precious Metals Fund, then this portfolio would have the same risk as holding the income fund alone, but the annual return would increase from 11% to 12.2% over the five year period ending June 1996. A ten-year study period gave almost identical results for this pair.

The second pair of funds I looked at was the very popular no-load Altamira Income Fund and Royal Precious Metals Fund. Both of these funds have a higher volatility than the first pair studied. As expected, higher volatility required a higher proportion of precious metals in the portfolio.

My study showed that for each \$83 invested in Altamira Income Fund, if \$17 were invested in Royal Precious Metals Fund, then this portfolio would have the same risk as holding the income fund alone, but the annual return would increase from 12.3% to 14.8% over the same time period, a very respectable improvement.

It is also interesting to note that if you invested in Dynamic Income Fund and wanted to expose your portfolio to the same volatility as the Altamira Income Fund, you could do so by investing about \$30 in Dynamic Precious Metals Fund for each \$70 invested in Dynamic Income Fund. You would get about 14.6% annual return over the same time period.

This bond/gold asset allocation optimization is fund-specific. Each fund pair should be individually studied and optimized. For most cases, the value of the precious metals fund is between ten and twenty percent of the total bond portfolio. Every few years, the optimization should be revisited and the portfolio rebalanced.

Investors generally regard the bond funds as the necessary, boring and the low-return portion of their portfolio. It does not have to be so. By hedging properly, it can be transformed into an exciting and rewarding part of your portfolio, while keeping the same degree of risk.

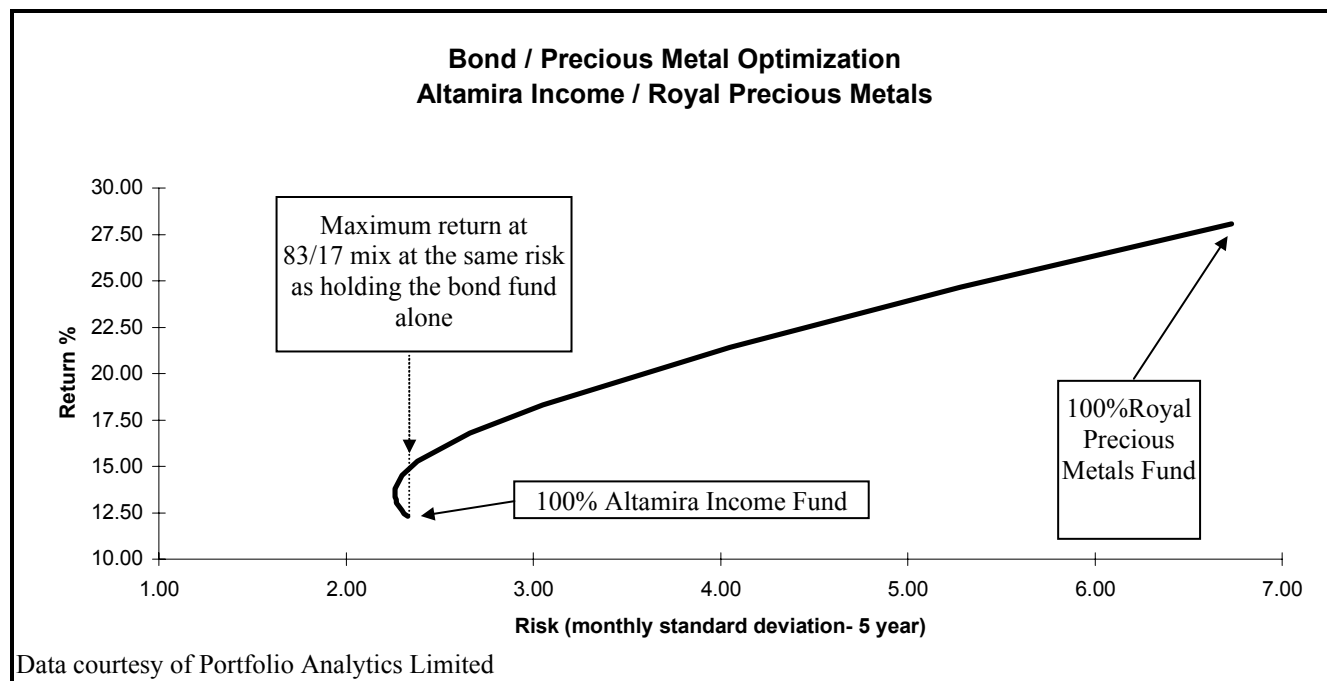
Hedging bond funds in this manner does not reflect your sentiment about the price of gold. If you are bullish in gold, then you need to add more precious metals funds to your portfolio.

Lastly, if you are bullish on the bullion you may also use this system to reduce your risk.

Combining Dynamic Precious Metals Fund with Dynamic Income Fund in a 60/40 ratio, or combining Royal Precious Metals Fund with the Altamira Income Fund in a 40/60 ratio, brought the volatility of the portfolio down to the same volatility of the TSE 300 index, and returned annually an enviable 15.7% and 21.4%, respectively

during the same time period. Of course, one must never lose sight of the rule: “past performance does not necessarily indicate future performance”.

Cemil Otar, P.Eng., is an independent financial advisor with W. H. Stuart Associates in Thornhill, Ontario. Phone (905) 889-7170, Fax (905) 889-7126



Optimum bond/precious metals blend ratios of few selected funds:

Fund Name and 5-year return ¹	Optimum Blend Ratio and 5-year Return	
	Dynamic Precious Metals Fund 21.8%	Royal Precious Metals Fund 28.1%
Altamira Income 12.3%	76/24 14.7%	83/17 14.8%
Dynamic Income 11.0%	90/10 12.2%	91/9 12.5%
P & H Bond 11.5%	85/15 13.2%	89/11 13.3%
Industrial Bond 9.7%	74/26 12.9%	85/15 12.6%
AGF Canadian Bond A 11.3%	81/19 13.7%	87/13 13.5%
Investors Government Bond 9.7%	87/13 11.5%	92/8 11.2%
MD Bond 10.8%	85/15 12.2%	94/6 11.8%

¹ All returns are based on June 30, 1996