

## **SignPost: Primer on Inflation-linked Real Return Bonds (RRBs)**

**RRBs** are federally- or provincially-backed bonds which pay a rate of return that is adjusted for inflation.

Unlike regular (nominal) bonds, this inflation adjustment feature assures that your purchasing power is maintained, regardless of the future rate of inflation. RRBs pay interest semi-annually, based on an inflation-adjusted principal. At maturity they repay the principal in inflation-adjusted dollars.

The academic literature on these types of bonds comes down strongly on the side of including them in the fixed income section of your portfolio.

### **Key benefits of RRBs are:**

- they eliminate the risk of inflation, unlike nominal bonds
- they are priced for a pre-determined real return, e.g. 2.5% above inflation
- they have less price volatility than nominal bonds with a similar term
- they have a low correlation with other asset classes

We think investors are well-served holding RRBs any time, but recently we have been selectively adding positions, for the following reasons:

- 1) Real yields have risen to levels in line with historical averages, about 2% to 2.5% above inflation. For the past number of years, real yields have been lower than normal levels.
- 2) There is growing concern about future inflation. In the short term, inflation is certainly not a problem, however, historically low interest rates and massive fiscal stimulus by governments worldwide may lead to future inflation. We believe that hedging some of this risk is prudent.

On the face of it, the technical mechanics of RRBs may appear difficult to understand because of ongoing inflation adjustments and actual pricing in the marketplace. If you are interested in more detailed information, *Real Return Bonds for Canadian Dummies* is an excellent website, containing a lot of detailed information. See the link below:

<http://www.bylo.org/rrbs.html>