Not Just Vanilla

By *Danielle Arbuckle*

Today, fixed income comes in many flavours, including global bonds, corporate debt and structured products

While pension plan sponsors continue to use their fixed income (FI) assets primarily to meet liabilities, there's been an unmistakable shift over the past few years in the types of FI holdings found in Canadian plans. Many are moving away from the "vanilla" government bonds that have typically made up the majority of FI portfolios and are starting to look at other options.

Yet the other "flavours" of FI investments under review are those that are traditionally seen as higher risk. So why the big change? Many plan sponsors are realizing that those vanilla bonds simply won't offer the yields or the liquidity they need to meet future liabilities.

"First and foremost, FI is a hedge against liabilities," says Marlene Puffer, managing editor, global FI strategy, with BCA Research. But, she adds, "most plans still have an emphasis on FI portfolios with short-maturity interest rate exposures, and that doesn't match long-term liabilities very well."

Denis Senécal, State Street Global Advisors' head of FI and cash, pins this issue squarely on the recent economic downturn. "Before 2008, pension plans saw FI as one asset class but have since realized there's a good amount of risk in FI portfolios and it's time to start looking around. In reality, only 10% of plans' FI portfolios are liquid—which has caused major problems—so now pension plans are looking at things differently. Although some larger funds have been asking questions [about their FI investments] for a while, small to mid-size funds are just starting to ask questions because of pressure from the downturn of 2008."

The Alpha Bet

With the realization that current FI portfolios may not be effective in meeting liabilities, many plans are adding an alpha component to the mix. "Traditionally in Canada, FI hasn't been used as a source of alpha so much," says Doug MacDonald, president of Aviva Investors Canada Inc. "Pension plans have invested in basic universe bond mandates, with lower allocations to corporate bonds and no global bonds. They've traditionally used equities and other higher-volatility asset classes for their alpha. Now that's changing a bit."

Adds Carlo DiLalla, a principal and lead Canadian FI researcher with Mercer, "It's true that, traditionally, FI beta has made up a higher proportion of total returns in most pension plans' FI portfolios, but FI alpha is becoming more important in the current environment." In particular, plans are looking to add global bonds, corporate bonds, FI derivatives and structured products (portfolios of various securities and derivatives, such as swaps and forward contracts, which can be customized based on risk tolerance).

These non-traditional investments bring diversification, better liquidity and higher yields—the FI alpha that many plans are now looking for—yet they also bring higher volatility. Do the benefits outweigh the risks? Many investment managers believe so.

"Should pension plans be looking at global bonds?" asks Senécal. "I think so. Markets elsewhere are more liquid and broader. There's better liquidity, different products—such as derivatives—and better diversity. [A global FI component] reduces risk because plans have access to different sectors, and they can get in and out of investments more quickly."

"Most Canadian pension plans have invested exclusively in Canadian and high-grade FI," says MacDonald. "We would recommend that *not* be the case—that there be some allocation outside of Canada. This gets you better diversification, which should lead to higher risk-adjusted rates of return."

The Canadian bond market is highly concentrated in government bonds. And even when pension plan sponsors look to Canadian corporate bonds, they'll find their options heavily weighted toward a few sectors, particularly financials. That isn't true of other marketplaces.

"Look at the global investment-grade bond market," adds MacDonald. "Canada is only 3% of that marketplace. For Canadian pension plans to have 100% of their holdings in Canada when it's 3% of the market…that seems like a pretty big bet."

Dave Makarchuk, a partner with Mercer who leads the investment consulting business for Western Canada, says there are opportunities in the global FI market offering more alpha, and investors have access to different yield

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curves (the relationship between yields and maturity dates at a specific point in time). "In the U.S., spreads on corporate bonds are about 40 basis points higher than spreads on Canadian corporate bonds," says Makarchuk. Puffer agrees. "Most Canadian pension plans focus their FI portfolio on the Canadian market because it's against a Canadian pension liability. But liquidity is better outside of Canada," she says, adding that there are many opportunities right now in the U.S. and in the U.K.

"There are good opportunities in Canadian investment-grade and high-yield bonds, but there isn't much diversification," Puffer continues. "The investment-grade market is heavily weighted to financials. You need to look outside of Canada for diversification. Yields in many countries are higher than in Canada, and risks can be managed."

MacDonald summarizes the two main reasons behind the shift to using non-traditional FI to meet liabilities. "For one thing, pension plans need to reduce interest rate sensitivity. The most sensitive vehicles are government bonds. High-yield and emerging debt are far less sensitive. Second, plans need additional alpha."

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Still, change isn't happening quickly. "Global FI has to compete with a lot of other investment structures, so it's taking the industry a long time to get there. It has a lot to do with how pension plans allocate their risk and governance budgets," says Makarchuk. "It's really about diversifi-cation, though. Global and corporate debt make sense if they are complementary to your overall investment strategy."

Senécal adds, "There's more discussion, but pension plans may not be changing their investments too quickly. The high-yield market in Canada is small, and the trend to emerging market debts isn't big yet."

Nonetheless, MacDonald says, "because it's such a large portion of most institutional portfolios, plan sponsors are looking at FI as more than just the stable non-alpha source—especially larger and mid-size plans. One thing that some market participants fail to observe is that FI risk encompasses more than just credit risk. Just by being in a high-grade Canadian bond portfolio, pension plans may think they're in a low-risk option. However, there's still interest rate risk. Plans should start to look at risk more holistically."

Considering the Risks

The major risk of investing in global FI is currency risk, but MacDonald adds that there are others to consider, such as the credit risk of the country you're investing in and the basis risk that could exist if that country's yield curve doesn't move in tandem with Canada's. However, Terry Kirby, vice-president, business development, with Franklin Templeton Institutional, says pension plan sponsors are using a few different strategies to manage risks. "Plans aren't looking at FI to add risk," says Kirby. "What we see more often is a 'core/satellite' approach, where the core investments are 75% to 80% of the FI portfolio and outside of that is the satellite portion, or the higher-risk portion. That's where we'll see interest in global FI, but it will likely never be a significantly large allocation. It might represent 10% to 15% of the bond portfolio or 4% to 5% of the overall portfolio."

It's a good strategy, he says. "At first blush, global FI sounds risky, but in reality, it's not as scary as it looks. There are about 100 countries that have stable partially or fully functioning capital

A NEW TWIST ON FIXED INCOME

What's the next big trend in fixed income (FI) investing? "The big issue for bonds right now," says Dave Makarchuk, a partner with Mercer who leads the investment consulting business for Western Canada, "is that many plan sponsors believe rates will rise soon, so they're tending to put off investing more in longer-duration bonds. However, there are some new products that let managers take a lot more discretion on duration."

Called tactical or absolute return bond funds, these funds tactically adjust their duration as interest rates rise and fall. "These funds provide an opportunity to make money when rates rise," adds Makarchuk. "They allow investors to capitalize on a rising interest rate environment." Although there aren't many options in Canada yet, he believes these products will interest plan sponsors that feel that significant value can be added by making the right interest rate call (e.g., shortening durations when interest rates are expected to rise).

Denis Senécal, head of FI and cash with State Street Global Advisors, notes two other recent FI trends that he believes will grow over the next few years. "In the Canadian market, investors are starting to look at structured public-private deals that are part of the index now. It's a small part of the index right now, but we'll see more. People are very interested in these investments. Another trend is the Tier 1 capital being issued by banks—the contingent convertible notes or CoCos—based on Basel III [a framework of banking standards to improve regulation, supervision and risk management in that sector]. A few pension plans have been interested, and we're finding ourselves explaining that these aren't provincial bonds, and we're explaining the risks."

Marlene Puffer, managing editor, global FI strategy, with BCA Research, says plan sponsors should also invest the time and effort to understand FI derivatives. "[Derivatives] can be a good strategy if all of the risks are recognized and well managed, but there are pitfalls if you don't do your homework. As a pension committee, you need to ask all the right questions."

markets at the moment. Global FI offers significant diversification, particularly if you're looking at high yield or sectors in which Canada doesn't have sufficient depth. It is also prudent to look at where growth will come from over the next 20 years, such as emerging markets. [These investments] won't have the same returns as equities, but in countries such as Australia, Israel and South Korea, we've recently seen yields in the range of 5% to 6%. Additionally, pension plans can take advantage of strong currencies in these countries."

The Case for Corporate Debt

Within Canada, pension plans are diversifying by adding more corporate debt to their FI portfolios. "To give some historical context," says DiLalla, "corporates have typically made up about 10% of FI portfolios. Now it's about 26% to 27%. So risk-taking in FI has increased relative to its past, but it's still low compared to the rest of the portfolio."

This increased allocation to corporate bonds is another by-product of the 2008 economic downturn. "Particularly when yields are low, the spread on corporate bonds generates higher returns," says Puffer. "[Adding corporate bonds] has worked for a lot of plans, especially those that took advantage of the blowout in credit spreads. The largest plans took advantage of that and earned good returns, especially the ones that invested in the high-yield sector. Spreads are tighter now, but the corporate sector is healthy, and there's still room for spreads to come in further."

MacDonald sees two big advantages to investing in corporate debt. "One, the risk in corporate bonds is idiosyncratic [specific to the company issuing the debt] and can be analyzed more easily. With government bonds, you have to make a call on the economy. Two, corporate bonds are less interest rate-sensitive, which matters in a rising interest rate environment." MacDonald believes that investment-grade corporate bonds are at fair value right now and that high-yield bonds are at slightly better than fair value, with room to tighten.

There's always a higher probability of default in corporate bonds than in government bonds, but Puffer doesn't think this should be much of an issue if a portfolio is carefully managed. "*Anything* other than government bonds has risk," she notes. Kirby agrees. "There is more risk in corporate bonds, especially below-grade credit ratings. It's just a question of having the right team in place and doing your due diligence. If you're looking at global corporate bonds, make sure the team has knowledge of local markets. In Canada, we tend to rely a little more on the dealer market, but on the global side, it's different. You can't rely on third-party sellers. Rigorous independent due diligence is critical to success."

FI in Action

Pal Benefits, a pension and benefits consulting firm, offers its employees a DC plan in which members choose the funds they invest in. Among the FI options are a money market fund, an index bond fund (tied to the DEX Universe Bond Index), an actively managed bond fund, a more aggressive bond fund (which, at one point, was 75% corporate debt) and a pooled mortgage fund.

What's interesting, says Mark Dowdell, vice-president and chief operating officer of Pal Benefits, is that the plan's membership uses each of these options. Still, "on the DC side, alpha isn't a conversation we typically have," he adds. "Because our asset managers have been outperforming the index, we haven't been seeking structured products, corporate debt, high-yield debt, etc."

However, some pension plans are making the shift to alpha. "Active FI portfolio management increasingly demands an understanding of the key global macroeconomic drivers and themes shaping financial markets," explains Kirby Connor, managing director, FI and currency, with OMERS Capital Markets (OCM). "At OCM, the FI team looks beyond the bond market, using information from foreign exchange, equity and commodities market analysis in developing portfolio strategy. Alpha is generated through active management of portfolio duration, yield curve exposure and sector allocation. International markets are accessed on an opportunistic basis, taking advantage of relative value across markets. A dedicated credit team provides the in-house expertise necessary to analyze non-traditional products and identify international credit opportunities."

The move to additional alpha may be happening slowly, but many investment managers believe it's just a matter of time. "It will happen," says Kirby, "just as it did on the equities side."

Danielle Arbuckle is a freelance writer based in Dundas, Ont.
danielle@daniellearbuckle.com