Pension Funds Wrestle With Globalization

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In the quest to match their liabilities and deal with funding issues, Canadian pension funds are entering uncharted waters – global bonds and fixed income products.

In this, Benefits and Pensions Monitor's first ever Report and Directory of Fixed Income Managers, we invited leading Canadian bond and fixed income managers to share some insights on what is currently happening and why.

Managers who participated are Gia Steffensen, executive vice-president and chief investment officer, Legg Mason Canada; Harold Scheer, chief investment officer, Baker Gilmore and Associates; Joe DiMassimo, senior vice-president, sales and service, Addenda Capital; and Steve Sevsek, fixed income capabilities manager, UBS Global Asset Management

As well, the report features our first Directory of Fixed Income Managers which starts on page 37.

Gia Steffensen

Executive Vice-president & Chief Investment Officer Legg Mason Canada

The globalization of credit markets is a really big deal and it's happened very quickly. This impacts Canadian bonds, but also has ramifications in terms of how we look at global fixed income alternatives.

In terms of the impact on credit markets around the world, the global flow of funds is now so open that it's changing some of the historical linkages that most professionals have relied on.

If we look at the U.S. market and rolled back the clock and told the profession with certainty that the U.S. is going to be running unprecedented current account and budget deficits with a domestic savings rate of effectively zero, that inflation would be accelerating, oil prices would be north of $60 a barrel, and the Fed would engage in 14 consecutive interest rate hikes, you would have a near zero probability that anybody would have forecast that bond yields would decline over that time frame. In retrospect, global financial flows have meant a scenario that historically would have resulted in a very weak bond market, but that has proven to be very benign.

Why this has occurred is a matter of opinion and everybody will have a different opinion.

A couple of factors, however, go back to economics 101 and supply and demand. Historically, budgets deficits of the order of magnitude seen in the U.S. would require significantly higher real yields to attract investors. This time around, the required capital has largely been supplied by foreign central banks. The Bank of Japan, in particular, has been a steady buyer of U.S. treasuries as a way to dampen the appreciation of the yen. This has also turned history upside down. Typically, as a currency weakens, that country's yields rise to stem the flow. Over the past couple of years, the opposite is true as weakness in the U.S. dollar triggered Japanese buying that actually forced yields down.

Pension funds are another factor. They are big net buyers of bonds, especially long maturity issues, in response to erosion in their funding status and reduced risk tolerance. While weak equity markets in the 2000 to 2002 period contributed to rising deficits, the bigger culprit is the dramatic decline in long-term interest rates which increased pension liabilities. To reduce their funding volatility, sponsors increased their exposure to bonds and increased the duration of their bond portfolios to better match the duration of their liabilities. This trend has driven long yields below those of intermediate maturities.

Harold Scheer

CIO Baker Gilmore and Associates

The very big issue for pension plan sponsors these days has been the low level of long-term interest rates, particularly with the focus on marking-to-market plan liabilities. It seems that sponsors are looking at year-end long bond values with such precision nowadays. However, this precision seems overdone, especially since liabilities have such long-term duration, which makes them very volatile. Putting so much weight on where long government of Canada bond yields were at year-end when pricing up a plan's liabilities, risks losing sight of the forest for the trees.

By focusing on matching the duration of liabilities taken at a single point in time, plans are reducing their investment opportunities. There are not a lot of assets available that match duration of liabilities and provide a good return profile. To match duration, plans are just looking at conventional bonds and strip bonds that have a duration of 15 to 20 years. However, with pension plans chasing these relatively few securities that supposedly match their liabilities and buying more of these assets that are in short supply, prices are being driven higher and yields lower. Since these yields are then being used to discount liabilities, the mismatch between assets and liabilities is further increased. It's a vicious circle.

We have been looking at what happened in the UK, where regulators forced pension plans to more closely match their assets and liabilities. This created an excess demand for long-maturity fixed income products. Last year, the British government issued 50-year linkers that are similar to Canadian real rate of return bonds. In January, forced buying by pension plans drove the yield of these securities through half a per cent. Investors were locking in a 50-year investment for a real return below half a per cent a year!

In this environment, one type of mandate that plan sponsors have become increasingly interested in is a long maturity mandate. This mandate is typically benchmarked against the Scotia Long Term Bond Index. Given our view that long rates are currently very expensive, one of the strategies that we think is really attractive for these mandates right now is owning retractable bonds. These are long-maturity bonds with a feature that allows the holder to put them to the issuer, effectively

Fixed Income Terms

Core Plus
Strategy where managers take small bets relative to the benchmark index, typically the universe index.
Corporates
Bonds issued by companies, not governments.
Emerging Market Debt
Bonds issued by countries classified by MSCI as emerging markets (not part of the 23 countries that are considered developed).
Duration
The duration of a bond represents the average value of payments (coupons and principal) at maturity, weighted by their present (discounted) value. Where a bond has no coupons, its duration is equal to its maturity; in all other cases, it is shorter. The higher the coupon rate and the more frequent the coupon payments, the shorter the duration. Duration measures how sensitive bond prices are to changes in interest rates. The longer the duration, the more it amplifies the impact of interest rate movements on the price of a bond.
Immunization
A technique used to protect a portfolio against potential unfavourable variations in the value of its assets. For instance, the duration of assets is often matched with that of liabilities to protect against changes in interest rates.
Long-term Bond
Bond with a maturity of more than 10 years.
Mid-term Bond
Bond with a maturity of between five and 10 years.
Real Return Bond
Bond whose par value or coupon rate is indexed to an inflation index increased by a given rate.
Retractable
Feature of a fixed-income security (bond or preferred share) by which a holder can demand redemption prior to maturity, at a date and under conditions that have been predetermined.
Short Term Bond
Bond with a maturity of between one and five years.
Universe Index
Broad market index that is diversified by sector (Government of Canadas, Provincials, Municipals, Corporates, Real Return Bonds) and maturity (Short-, Mid-, Long-term).
Yield Curve
Curve representing the relationship between the maturity and yield to maturity of similar bonds that differ only in terms of maturity. It is a graphic representation of the term structure of interest rates. ■

shortening the bond's duration, and, therefore, reducing risk as interest rates rise.

Rates may be forced higher by several factors including an increase in inflation, a shift into equities and out of bonds, or a move by Asian central banks to adopt more flexible exchange rates that would lead them to reduce bond holdings. If any of these events were to occur, forcing rates significantly higher, the holders of the retractable securities have the option to put the long-maturity bond back to the issuer, subject to the strike price of the option. As rates rise and the probability increases that the long-maturity bond will be put, the duration of the bond declines from that of a long-maturity bond to that of a short-maturity bond, providing the portfolio with a significant amount of capital preservation insurance.

Joe DiMassimo

Senior Vice-president, Sales and Service
Addenda Capital

One thing that is happening quite a bit is more and more people are getting away from purely managing bonds on a passive basis. The index has changed dramatically if you look at it over the last 10 years. You look at the SCMU, and the proportion of Canada bonds has come down dramatically because Canadian finances have picked up.

There are a lot less government bonds and the winners of that are corporate bonds. But what that says, in looking at the index in the last 10 years, is that you're taking more corporate bond risk and credit risk and there are some sponsors who are not as comfortable doing that. They want to control that risk.

It's the same thing for duration. Duration in the last 10 years has gone from 5.1 to 6.5 years today. If you hire an indexer, you may be taking more duration risk then you might want. The index has changed a lot and that's why I think more pension funds are looking at active, rather than passive, management.

Another thing we're seeing with the elimination of the FPR is more plan sponsors looking at the international side as a tactical investment. They're looking at yield any way they can get it and international bonds may be a nice tactical way of doing it.

However, they're being very careful with the currency because in the good old days, when the currency was at 62 cents U.S., nobody worried about the currency. But they got hurt big time when the currency rapidly shot up to 85 cents.

Now, everybody who is looking at international products is giving managers some leeway, not a lot, on the currency.

Another issue is supply.

Given that the finances in Canada are that much better, there isn't as great a supply of government bonds as there used to be. Thank goodness the provinces have made up for some of that because the provinces are still struggling to make ends meet, not like the Canadian government.

What Canada has done is bought up off-the-run type of bonds and increased the benchmark 30-year bond, the 10-year bond, the five-year bond, and the two-year bond. So it's taken the other bonds and made those a little more available. It's helped us in that manner.

But, in the last 10 years, from 1995 to 2005, Canadian government bonds in the index have decreased 19 to 20 per cent. So that's absolutely an issue.

Steve Sevsek

Fixed Income Capabilities Manager
UBS Global Asset Management

The elimination of foreign content rule last year means that, for the first time, clients, consultants, and investment managers need to change the way they think about fixed income going forward.

New products need to be geared toward delivering the 'global opportunity set' in a manner that addresses Alpha, Diversification, and Total Volatility in a manner clients are familiar and comfortable with.

It is why we believe that there is a fundamental shift occurring within the fixed income markets globally. Core mandates are likely to evolve into Core Plus mandates as clients search for alternatives.

The second is the notion of Absolute Return products which have been slow to develop within Canada. This is an area we think will experience tremendous growth in the years to come.

What is exciting about these strategies is that they address the concern we hear from many of our clients and prospects – where can I get more alpha within a traditional bond mandate?

Institutional investors are looking for alternatives for a number of reasons.

The Canadian opportunity set is relatively constrained. For example, 73 per cent of the Scotia McLeod Universe index is represented by sovereign debt.

When you look at historic returns, the medium manager in Canada has delivered index-like returns. What this implies is that any alpha generated from a universe type portfolio is likely to come from the duration decision.

There are also concentration issues within credit. We have approximately 35 issuers in Canada issuing most of the bonds.

The elimination of barriers restricting investment in alternative solutions changes this. Maple Bonds, for example, have exploded into the Canadian marketplace, indicating the market is receptive to new and diversified issuers.

However, this does not address the fundamental question of how to achieve greater sources of alpha. ■