GETTING THE MOST OUT OF BONDS

With no FPR, it's time to go global with fixed income.

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With removal of the foreign content restriction, Canadian fixed income investors can use this flexibility to invest in global bonds. Research shows that a near-permanent, but dynamic use of global bonds is an optimal way to increase a plan's returns and reduce risk. The most appropriate way to introduce global bonds to a Canadian portfolio is to consider the risk that global bonds introduce versus a plan's liabilities.

Getting started

As a first step, one can assume that the Scotia Universe index or the Scotia Long Index are low-risk portfolios where risk is defined as matching a plan's liabilities. In addition, both have similar exposure to Canadian interest rates and the Canadian dollar. In this context, the introduction of hedged global bonds, represented by the Citigroup World Government Bond Index (WGBI) for purposes of this example, brings tracking error to a plan. In hedged terms, the WGBI has about 350 basis points (bps) of tracking error versus the Scotia universe, while unhedged global bonds introduce more than 550 bps. This presents an argument for avoiding large currency exposures within Canadian bond portfolios.

Ideally, one would avoid large exposures to foreign interest rates and foreign currencies while exposing the portfolio to diversified yield-enhancing sectors such as credit and emerging markets. Using readily available derivatives such as futures and swaps to hedge unwanted risks, there are numerous ways to capture excess yield and maintain portfolio exposure to the risks appropriate for managing against domestic pension liabilities.

How it works

To illustrate this approach, we constructed a portfolio utilizing our non-Canadian sector forecasting models over the period January 1992 to December 2005 in order to determine the optimal mix and usage of foreign content. Investment allocations were made based on quantitative sector and yield-curve models and overall portfolio duration was maintained so that it was exactly equal to the Scotia Universe. No currency exposure or leverage was employed. The resulting optimized portfolio averaged 29.5% in foreign content (ranging from 14% to 53%) and outperformed the Scotia Universe by 110 bps, with 101 bps of annualized tracking error. The foreign content allocation varied over the period as the opportunity set outside of Canada changed. When opportunities were high compared to Canadian bonds, a maximum allocation to foreign content was made. Conversely, when opportunities were scarce (as in 2005), a smaller allocation was made outside of Canada.

The global credit markets are one of the most promising areas for Canadian fixed income plans to add return and diversify risk. By looking globally, a plan can enhance yield, diversify across sectors and regions, reduce unwanted idiosyncratic risk, and choose between more return opportunities across currencies and capital structures.

Research is key

With so many more bonds to choose from, a skilled manager is far more likely to find value-adding opportunities. However, because the downside to global investing can be quite dramatic, extensive credit research and broad global resources are required to identify and evaluate the broad spectrum of global alpha-generating opportunities. Managing to a Canadian benchmark (market- or liability-based) while utilizing a global perspective requires expertise in both domestic and global bond markets. It also requires knowledge and familiarity with hedging interest rate and currency exposures as well as a broad research platform for analyzing opportunities. Global bonds should be used opportunistically and, when done correctly, globalizing your fixed income can provide a valuable source of diversification and return enhancement. ■