



GLOBALIZING CANADIAN BOND PORTFOLIOS

Don't neglect the fixed income side of investing when going international.

When it comes to bonds, global is better. A global approach can increase returns, reduce risk, and is very effective when managing against liabilities.

Most institutional investors seek to generate sufficient returns to pay for certain promised future payments, or liabilities. While strongly positive returns are welcome and negative returns are preferably avoided, the real goal is to generate sufficient returns to meet future liabilities without taking the risk that assets decrease while liabilities increase.

In this context, surplus volatility—the volatility of the difference between assets and liabilities—is a more important risk metric than absolute volatility. Because many liabilities have bond-like characteristics, their value tends to track more closely with bonds than with equities. As a result, bonds are the asset of choice for liability-matching.

Many investors assume that because their liabilities are denominated in Canadian dollars and are sensitive to changes in Canadian interest rates, their investment universe for liability-matching is limited to Canadian securities. Our research shows that going global is a far better choice.

A global approach reduces risk through increased diversification. Diversification is particularly important in the realm of corporate-bond investing, where the risk of default or deterioration in quality can be mitigated by increasing the number of issuers held. When it comes to investment-grade credits, our research shows that a portfolio of 50 to 100 issuers is optimal. Unfortunately, with only about 150 corporate issuers in Canada, such diversification is virtually impossible. By looking globally, a manager increases the opportunity set of liquid issuers by roughly 20 times.

In addition, with so many more bonds to choose from, a skilled manager is far more likely to find opportunities to add value. We tested how well a manager with perfect foresight could do if restricted to picking the 50 best Canadian corporate bonds. We

then compared the results to a similarly perfect manager operating within a global universe. The global manager was able to add 1,400 basis points more than the domestic manager, even with all foreign interest rates and currency risks fully hedged.

We believe a global perspective is particularly critical in today's low interest rate environment, when alpha-generating strategies are important to meeting funding goals. Additionally, a global view allows a bond manager to invest in higher-returning asset classes such as high yield and emerging markets.

Surplus volatility is reduced by matching the interest-

"BONDS ARE THE ASSET OF CHOICE FOR LIABILITY-MATCHING."

rate sensitivity, or duration, of the portfolio to the effective duration of the liabilities. Therefore, when applying a global approach to a liability-based framework, portfolio managers must target the portfolio's overall exposure to Canadian interest rates. They can do this by hedging foreign interest rates and currency risks and replacing them with exposure to Canadian interest rates, typically through the use of swaps or futures. Although high-yield and emerging market debt entail additional risks, limiting investments in these asset classes to less than 20% of the portfolio can keep overall risk within a comfortable range. The net result is a portfolio better matched to liabilities, with greater diversification and higher potential returns.

Using a global approach against a Canadian benchmark requires expertise in domestic and global bond markets and the ability to hedge interest rate and currency exposures. And because many investors are subject to foreign content restrictions, knowledge of these regulations is also important. We have found that the use of pooled funds and similar structures can mitigate or even eliminate foreign content issues. ■

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