FIXED INCOME: THE NEW "NEW THING"

The removal of foreign content limits will benefit bonds.

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Fixed income markets have changed and evolved significantly over the last several years. As a result, the investment opportunity set has also been transformed in ways that most investors may not yet be fully aware of. For example, in Canada some of the main fixed income themes are as follows:

- Bond yields are currently at 40-year lows, with inflation remaining subdued and well within the Bank of Canada's desired bands;
- Credit spreads have narrowed—moreover, provincial and corporate sector spreads have become less volatile and trade in lower ranges,
- The corporate bond sector has grown in size and breadth—corporate bonds now represent over 26% of the market with 124 issuers up from only 10.2% and 82 issuers in 1995;
- Lower volatility and trending rates and spreads have narrowed the dispersion among market sectors, quality ratings, and individual security returns;
- The Foreign Property Rule (FPR), which has governed pension investing for decades, will likely be abolished in the near future, although the exact timing is now in question, and;
- Investors are increasingly focused on investing assets to best meet funding obligations rather then to outperform a market benchmark or a group of peers—this trend toward liability-driven investing has its own implications on the future evolution of the fixed income product set in Canada.

Reduced volatility in bond yields and lower cross-sectional dispersion mean that the active manager's opportunity to take active or non-systematic risks has been dramatically curtailed. Not surprisingly, we find that on average core active managers in Canada have reduced their active risk by 40% over the last three years. What all of this implies is that unless these managers can significantly increase their skill, traditional means of adding value are likely to produce lower value-added in the future.

However, the removal of the FPR will increase available options and opportunities for fixed income investors, as non-Canadian fixed income securities start finding homes in Canadian portfolios. Furthermore, continuing growth and improved liquidity in derivatives such as credit default swaps have increased the type, precision and frequency of expressible credit views. In addition, trading systems such as Market Axxess in the U.S. and others in Canada and Europe have improved data availability and quality, and enabled systematic research-driven investment processes in the fixed income world.

A NEW PARADIGM

In this new world, opportunities will exist to generate consistent alpha through a research-driven strategy. Investors will also have the opportunity to create more robust active fixed income strategies and will be better able to separate beta and alpha. However, more systematic portfolio management approaches will be required, including ones where forecasting and controlling risk and minimizing transactions costs will become explicit goals alongside increasing return. Human insights and expertise will need to develop further and will remain at a premium, and use of technology will increase in order to analyse and assess an expanding list of securities and markets.

Key product attributes will likely include portfolios that are well diversified across securities and alpha drivers, and which use a higher proportion of derivatives than is currently the case. The market will evolve from one where there are index fund managers and traditional long-only active managers to one where managers offer solutions that are either closely correlated to liabilities or have highly customized long-only or long-short high-quality alphas associated with them. However, to be fully successful in this realm managers will need to develop new skills and infrastructure to deal with the new realities of the Canadian and global fixed income markets. ■