Bonds without borders:

A SPECIAL CANADIAN INVESTMENT REVIEW ROUNDTABLE

What should pension plan sponsors know about international fixed income in a post-FPR world?

BY JAMES LEWIS

In an anonymous survey of 30 plan sponsors attending April's Global Investment Conference (see page G1), nearly half said they would consider a move into foreign fixed income if the Foreign Property Rule was abolished as proposed in the 2005 federal budget. Surprising, considering that few funds in the Canadian Pension Fund directory have any meaningful allocation to this asset class. We asked five fixed income managers and one consultant to discuss the potential choices—and caveats—Canadian pension funds should be aware of when investing in international debt.

CIR: *What's the best way to approach an international fixed income allocation?*

Rajiv Silgardo, CEO and CIO, Barclays Global Investors Canada: Today, investors are more focused on their liability stream: how do we build a portfolio today to match the expected growth in liabilities? That starts with a better understanding of liabilities, setting up a process for monitoring them more closely, and then building a more robust beta portfolio to match them. However, beta alone will not do it today, because the expectations of future return from the capital markets are reasonably low, and typical liability growth is in the range of 7% to 8% per annum. That's where alpha comes in: non-Canadian fixed income will likely provide additional opportunities to obtain alpha.

Zainul Ali, senior member of the asset consulting team, Towers Perrin: In a post-FPR world, it is incumbent upon institutional investors to look at foreign bonds, but more so with a focus on investment-grade corporate bonds, high-yield securities, and asset-backed securities. Sovereign debt can actually introduce some mismatch risk into a pension plan.

In a non-inflationary benefit plan, nominal bonds provide some matching: we're talking about a Government of Canada, 10-year-plus bond, because that's the yield that's used to measure liabilities. Anything other than that introduces mismatch risk into the portfolio. For an inflation-sensitive plan that's indexed, the risk-minimizing portfolio is a real-return bond, which doesn't give you the risk-matching characteristics, but does give you some diversification benefits in an asset space only.

Pat Palmieri, head of fixed income, UBS Securities Canada: The first step for anybody wanting to enter this market is to look at sovereigns first: if you go with corporates, you have to have the staff.

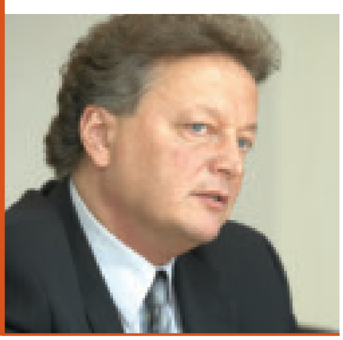
We've done a study using sovereigns from a Canadian perspective using historical data: on an unhedged basis,

"The FPR...kept certain sectors in Canada chronically expensive."

—Margaret Isberg

we found the optimal percentage exposure to global bonds for pension funds was about 15% to 20%. What's interesting is not so much the yield enhancement, because really whether you use hedged or unhedged, it's the same; where there is improvement is with the risk-adjusted return, which is basically the Sharpe ratio. Assuming you have 20% unhedged foreign bonds in your portfolio, your Sharpe ratio increases by about 2%. If you add 3% worth of high-yield bonds, that jumps to about 6%. On a hedged basis the correlation is a lot stronger: if you maximize your portfolio at 30%, your Sharpe ratio goes up by 8%.

Terry Carr, vice-president and senior portfolio manager for North American fixed income, MFC Global Investment Management: Corporates outperformed Canadas over the last 15 years by 90 basis points per annum, so it's a huge give-up to have 60% to 65% of pension fund fixed income assets in Canadian federal and provincial government securities, yet that's a typical mix for a pension plan.



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I think the market segmentation between high-yield and investment grade is clearly breaking down—we should be looking at this as a continuous credit spectrum, from the highest quality to the lowest. And, an active management style moving up and down the credit quality spectrum through economic cycles has the potential to add the most value, particularly if you're not in a captive market and you can look abroad.

Margaret Isberg, president, PIMCO Canada: I agree with most of the remarks regarding fixed income opportunities outside of Canada: there are some structural reasons, one being the Foreign Property Rule, that have kept certain sectors in Canada chronically expensive. There's no question that you get a diversification advantage from global bonds, but in our view there's no reason to expect they'll significantly outperform Canadian bonds over the long term. So, I share the concern that investors will be introducing a mismatch versus their liabilities; however, there's certainly a place in a Canadian portfolio for exposure to global bonds—you can access and exploit foreign markets without taking permanent exposure to them, either by taking tactical long exposure or with spread trades.

PP: Margaret, I agree. We just did a white paper on global asset allocation [which] started off with a historical analysis; however, we then modified the expected risk-return characteristics to incorporate our current views. The end result was kind of surprising: total exposure to bonds decreased, even though the weighting to foreign bonds increased to about 4%. Most of the allocation actually went into other active classes, particularly the non-traditional classes such as real estate, private equity, hedge funds and so forth. According to this white paper, the optimal exposure is 48%, I believe, in non-Canadian assets, but 50% of the currency exposure is hedged.

RS: [Surveys show] Canadian pension plans have a total of 0.3% invested in non-Canadian fixed income assets—it's a huge asset class that's been completely shut off from the Canadian pension community. I can see why they want to jump in with both feet, and I think some of that will happen, but I also have to agree with the notion that it's going to happen first from a diversification perspective. The next step will be active management and absolute returns as investors get more comfortable with the available securities, managers, and investment strategies that are out there.

Paul Fahey, managing partner, Aurion Capital Management: If you're going to have fixed income in your asset mix, obviously you want to have foreign bonds: Canada represents less than 2% of the overall global market, so you'd be stupid not to consider it. We've run some simulations ourselves which basically came to the same conclusion with regard to reduction of risk being the primary benefit,

I think we've been looking at convergence over the years in all markets: countries [and central banks] have become smarter at managing their economies and inflation, but there's this long-term secular decline in interest rates. I think higher-yielding foreign bonds make a lot of sense in that context especially.

ZA: I think again we need to step back and define what we mean by risk: you have to ask "Do I have enough assets to pay my liabilities?" The primary reason for having bonds in a non-indexed plan is for their risk-matching capabilities. If I can get some alpha, that's nice, but I can [probably] get more alpha in equities.

For an indexed plan, however, nominal bonds have little to with liability matching: you're investing in bonds primarily for some diversification, because you want to reduce or mitigate your short-term variability of income. As I said before, the risk-minimizing portfolio for an indexed plan is a real-return bond: if you don't invest in a real-return bond, you introduce risk.

MI: On the subject of real-return bonds, the Canadian market is typically expensive and limited in terms of issues—there are only four of them. You see relatively high correlation among inflation rates in developed countries over time, so we think a global portfolio of inflation-linked bonds is a good proxy for Canadian real-return bonds. Adding global ILBs dramatically increases your opportunity set, though you should be careful to currency hedge.

TC: Most high-yield bonds are callable instruments, and the universe—when it ages a bit—is more of a six- or seven-year kind of universe. So, you have some challenges [against] your fixed income benchmark in Canada, but you really should compare it to the five-year Canada part of the curve.

Also, there are big differences in risk and return between the highest quality double-B, mid-quality single-B, and the weakest and riskiest securities, triple-Cs. When you analyze the Sharpe ratios you find out that double-Bs are kind of a sweet spot: the incremental pick-up by moving into higher-quality high-yield is very significant, while the incremental default risk isn't all that great, and many pension plans and conservative trust accounts have a general prohibition on dipping below the triple-B layer.

CIR: *Realistically, how much alpha or upside can be derived from active currency management in a bond portfolio?*

TC: Adding value in currency is one of the toughest things to do. The consensus at times is quite correct; at other times, it's dead wrong. We have multiple currency risks, but we prefer to fully hedge our portfolios and essentially eliminate them. I could definitely see that 50% hedged-unhedged hypothesis worthy of further study, but to suggest to clients that you have a superior call on currencies is risky.

RS: I'll take the other side of that. There's a lot of empirical evidence and theoretical work that shows active managers should expect to outperform the currency market. The argument is that currency markets are not as much of a fair game as equity or bond markets, since many of the participants are not motivated by profit.

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So, if you have an understanding of what drives currency, you should expect to get into this game and make money. But, the way we do it is by using as much breadth as possible. We don't just look at Canada and the U.S.: if you have the skill, you should invest in a range of currencies and target a level of [acceptable] risk.

MI: Going back to what Zainul said about mismatches, currency could be the mother of all mismatches, because pension plans have to pay their benefits in Canadian dollars. Moreover, PIMCO is in Terry's camp: currency markets are a very difficult asset to predict.

"I can see why [Canadian pension plans] want to jump in with both feet."
—Rajiv Silgardo

RS: I think we're mixing up two things here: your liabilities are in Canadian dollars, so if you want Canadian dollar exposure you hedge. What I'm talking about on the active currency side is pure portable alpha.

TC: One statement I would make is that one shouldn't assume fixed income managers necessarily have the best call on currency. There is the possibility of having alpha return as an overlay on a fixed income group that focuses either on localized markets or regions, but it is a challenge to coordinate both disciplines effectively and get the desired results.

CIR: *What does the widening gap between U.S. and Canadian short-term rates mean, and is there a knock-on effect from GM's and Ford's downgrades?*

TC: [The downgrades] had a tremendous effect on corporate credit markets, particularly high-yield: they're estimated by some to be about 10% or 15% [of the total high-yield market], and their potential impact on high-yield indices is large. Merrill Lynch and others [plan to] create two sets of indices: one will be the regular version, which might fully incorporate Ford and GM at their market weights, and the other will be capped, where we'll see only 2% to 3% per issuer.

There's also a difficult challenge for the investment-grade community: what if it violates your policy to hold these now-non-investment grade securities? I think there's going to have to be some pragmatism on the part of investment committees. These two firms' securities in the 10-to-30-year area are trading not as double-B or strong double-B credits, which is what they're about to be rated, but as weak B-minuses or triple-C securities. Serious credit analysis might lead one to the conclusion that they're not all that weak, and the rating agencies are tracking appropriately at this time by moving them to the double-B category. So, they're extremely cheap double-Bs.

CIR: *What about Europe? Are there opportunities for value with the 10 new EU entrants?*

PP: The convergence play would have already occurred, but there are opportunities if you play the yield curve spread. Based on our estimate of fair value, we don't see any value in any of the bond markets.

MI: We do see opportunity in Europe because structural inefficiencies, in our view, are going to continue to weigh on growth and inflation, which is good for bonds. That strategy is relative to the U.S., where you've got a big budget deficit and a consumer that wants to keep spending.

RS: From our point of view, there is an opportunity in that the French are going to vote on the EU constitution, and whether or not to adopt it [Note: France rejected the EU constitution on May 30, shortly after this roundtable]. There is a little bit of event risk, if you will, associated with that vote.

CIR: *Does anyone find Japan an attractive proposition at present?*

PF: If there's going to be some seismic event that will change things around, I haven't identified it. They've been experiencing some heavy deflation for the last number of years—they've been printing money like crazy and they still can't get it started.

PP: Our viewpoint is different: we believe there is some GDP growth there, and actually they'll have GDP growth in the second half [of 2005] approaching 2%, according to our colleagues in Japan, which puts their 10-year JGBs about 50 basis points or so below fair value.

MI: The current carry in JGBs is positive relative to the U.S., but investors in that trade are obviously vulnerable to stronger growth and higher inflation which could lead to rising interest rates in Japan. That said, interest rates have been low for a decade, but it's hard to fathom they could go much lower.

PF: I think one of the real opportunities in international bonds is the opportunity to trade with people who are trading for different reasons than you are. At the international level, they're clearly in it for currency reasons. I see bonds on a regular basis that are sold into the Japanese retail market: these aren't people who know anything about the deal, but they know where they are in Japan, which is desperately low. So, they're looking for a different currency, and any kind of pick-up. I find myself buying bonds designed for the Japanese retail system that no one here even recognizes—there's no liquidity, but wonderful yield. So, if you're patient and do a bit of homework, you can find value and opportunities. ∎

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