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FINDING THE RIGHT MATCH

Global bond markets offer duration-matching and alpha-generating solutions.

Today's global fixed income markets—including extensive and highly liquid fixed income derivatives—offer plan sponsors compelling solutions to match their portfolios' duration to that of their liabilities, and achieve higher rates of return without markedly increasing portfolio risk. The concept of extending duration for liability purposes has been receiving a lot of attention from plan sponsors worldwide. To keep up with this trend, some asset managers have developed liability-driven investing (LDI) teams along with a suite of products. However, matching duration is something that can easily be performed by many market participants by using instruments that have a high degree of liquidity and are not expensive to fund. Instead, an institutional investor's focus should be on finding managers that can add alpha.

CHANGING LANDSCAPE

While the investment landscape for global bonds has evolved significantly over the past 20 years, the asset class remains a rich source of alpha for sophisticated investors. Early on, global bond managers generated returns by taking advantage of wide yield spreads among countries and corresponding variances in currency values. Today, yields and spreads are lower and volatility is also down. In addition, with the spread of the Euro, there are fewer variances in currency values, particularly among developed markets. At the same time, issuance in fixed income markets has migrated from government-backed securities to bonds issued by corporations or securitized by mortgage payments or other cash flows. As a result, the market has become much broader in terms of investable, liquid sectors. It is now also deeper in terms of sub-sectors and securities. Sector and security selection offers investors myriad opportunities to generate incremental excess return.

While the global fixed income marketplace presents many opportunities for additional sources of return (alpha), it is crucial that this incremental return not come at the expense of a substantial increase in risk to the plan's desired benchmark return (beta). One way to manage risk would be to artificially replicate beta exposure using derivatives. If the plan has a policy benchmark for fixed income, it is possible to synthetically achieve index exposure without significant capital allocation.

REPLICATING RETURNS

For example, for Canadian institutional investors there is a way to replicate the returns of two commonly used indices, the Scotia Capital Universe Bond Index and the Scotia Capital Long Term Bond Index using a combination of two Canadian interest rate swaps and the 10-year Canadian interest rate future. Each month, the weights assigned to each of the swaps and the future can be rebalanced to closely match the duration of each of the respective indices. In each case, it is possible to create a synthetic portfolio of only three instruments, which exhibit very similar return and risk

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characteristics to each respective index.

If a plan is able to achieve its fixed income policy exposure (beta) through this synthetic approach, which requires very little capital, it frees up capital to take advantage of uncorrelated, idiosyncratic opportunities with high alpha potential without a substantial increase in risk. In this manner, it is possible for a plan to achieve a better risk/reward balance. ■