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FIXED INCOME JOINS THE PARTY

Move over equity. It's time for fixed income to get in on the fun.

In investment circles, equities are usually the life of the party while fixed income can be a bit of a wallflower. But guess what? Investment opportunities in the Canadian fixed income market are expanding, providing investors with several more ways to improve risk-adjusted returns.

Three important developments have occurred at roughly the same time: first, the Canadian securitized sectors have expanded; second, so-called maple bonds from non-Canadian issuers have flourished; and third, the removal of foreign content restrictions has encouraged more global holdings in fixed income portfolios. It's all good news, but it will also challenge investors to upgrade their research capabilities and establish broader risk management frameworks.

PLAIN VANILLA

Canada used to have a plain vanilla fixed income market compared to the U.S., but we're now converging on their model. Where we traditionally had lots of government-issued investment grade, they had a much larger corporate segment as well as a growing securitized sector of asset-backed securities (ABS) and commercial mortgage-backed securities (CMBS). Now the Canadian market is moving strongly in that direction.

Why? One of the key drivers is a decrease in federal government issues. Unique among G7 countries, Canada has been running national budget surpluses for several years in a row. This eases the dominance of the federal government in our fixed income market, and focuses more investor attention on corporate issues. Although Canada's corporate bond market has indeed grown much larger, credit spreads remain tight in the current economy.

This leaves room for yet another opportunity—securitized assets and mortgages that presently offer greater choice, and better diversification. In fact, the securitized sector in Canada grew sevenfold in seven years: from about $18 billion in April 1997 to approximately $125 billion at the end of 2005.

Another change from the federal government has also shaped the way investors look at fixed income. The elimination of the foreign property rule in 2005 has widened investor perspectives to include more segments of the U.S. market, and offshore debt including emerging market debt. Since Canada only represents about 2.3% of the global bond market, pension plans can now risk a little more for better returns on their bond portfolios, offset by the increased diversification benefit from broader holdings.

CURRENCY EXPOSURE

However, the good things that come from unrestricted foreign investment must be balanced with an increase in foreign currency exposure. Investors who substantially increase their foreign holdings will have to decide whether or not they want to hedge foreign exchange risk.

The opposite applies to maple bonds, however, where the foreign issuers come to us. Foreign companies issue maple bonds in Canada, denominated in Canadian dollars. They have grown in popularity because investors benefit from the diversification and higher yields, while foreign issuers benefit from different and often cheaper sources of funding than they would find at home.

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So move over equity markets. The Canadian fixed-income market is suddenly showing some vitality and excitement. To make the most of these opportunities, managers need to sharpen their skills in such key areas as research, risk management and portfolio management. ■