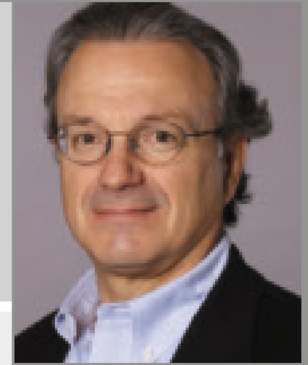
# GREENER GRASS IN FOREIGN PASTURES?



*Liabilities need credit diversification without the yield curve risk.*

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The elimination of the foreign content limit effectively changed the investment landscape for Canadian plan sponsors. No longer are they required to use equity derivatives in order to push their foreign exposure beyond the 30% limit. Instead, cash market instruments will either passively or actively replace those derivatives. However, the less obvious decision they must face is what to do with their domestic bonds which, in most mandates, represent the single largest asset class. Suddenly, plan sponsors must choose between domestic bonds and foreign bonds. Overall, the arguments for foreign bonds have been:

- Enhanced returns versus domestic fixed income;
- Lower overall portfolio risk due to the diversification of return; and
- Additional currency diversification.

To see whether or not these arguments hold water, we tested the transition into foreign bonds with simulations of alternative asset mixes that compare both return streams and changes in surplus in the asset/liability space. When the data demonstrated that the addition of foreign bonds was suboptimal in the surplus space, our initial hypothesis was confirmed. At the same time, however, our analysis also showed that adding global bond and currency alpha is highly effective for pension plans due to the uncorrelated sources of return.

The task of substitution looks particularly difficult when looking at the return streams of the unhedged World Government Bond Index (WGBI) versus the domestic bond indexes from 1987 to the present. Over that period, the WGBI returned 8.67% versus 9.33% for the Scotia Capital (SC) Universe and 10.90% for the SC Long. But the volatility of the WGBI was less than the domestic indexes, which resulted in a higher information ratio.

While still in the asset space, we substituted 20% from the traditional 40% domestic bond mix and moved it into foreign bonds. The result was about 40 basis points less yield in the overall portfolio with the same information ratio.

In our opinion, the real test was how these portfolios performed against an actual Canadian pension liability stream. Clearly, the addition of the global bonds would underperform the domestic-only bond portfolio by about 40 basis points per year, resulting in a deterioration of the surplus. However, the volatility of the change in surplus was higher with the foreign bonds (11.6% versus 12.1%). Intuitively this made perfect sense since Canadian pension liabilities are discounted by the Canadian yield curve. Thus, importing foreign yield curves will only increase volatility against the liabilities and should be compensated for by higher returns in order to justify their addition to the asset mix. But it is also clear to us that plan sponsors need credit diversification in their domestic bond portfolios. The credit diversification dilemma can be achieved by the use of credit derivatives or U.S. high yield.

## DOES ALL THIS MEAN WE SHOULD ABANDON GLOBAL BONDS AND CURRENCY ALTOGETHER?

Does all this mean we should abandon global bonds and currency altogether? The answer is quite simply no. Instead, we ought to consider proven portable alpha strategies that take advantage of inefficiencies in these capital markets in order to port the alpha onto other strategies, obtaining a higher yield at a lower level of volatility as a result of the diversification benefits. For example, an alpha strategy could combine a large amount of active fixed income (say, 95%) with a 5% allocation towards a long/short global bond process and a long/short currency process. In our experience, the result has been an additional 125 basis points in yield at a lower level of volatility than the market. ■