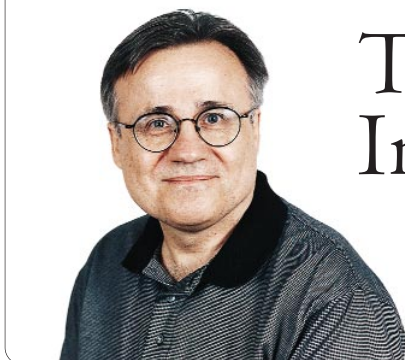


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The Future of Fixed Income Management

Historically low interest rates call for a new, and more active, approach to managing fixed income risk.

A number of structural changes are

transforming the Canadian fixed income market. The biggest change is the shift in relative market weight from government to corporate bonds. It is altering the risk, return and liquidity characteristics available to passive bond investors, as well as the strategies to add value from active bond management. This is expected to boost the anticipated return of the bond portfolio given an increase in credit risk and decrease in potential diversification resulting from higher expected correlations between lower-grade bonds and equities for same issuers.

The return correlations are above 0.9 for five of the nine pairings of the Scotia Capital (SC) universe fixed income series. They are highest for Corp BBB and the TSE300 Composite Index (0.440) over the 15-year period from 1987 to 2001. These changes make it more difficult for Canadian fixed income portfolio managers and investors to fully diversify their portfolios, decrease liquidity and increase the associated trade costs of bond investing. At the same time, this shift also increases the need for effective credit analysis.

In this environment it is important that securities regulators implement changes to restore investor confidence in the veracity of corporate accounting by eliminating corporate malfeasance. Credit risk premiums will increase in the absence of such changes, and bond raters are likely to exhibit rating overreaction due to a lowered tolerance to possible downward credit risk jumps for lower-rated borrowers.

Previously, when government bonds dominated the fixed income market, investors and plan sponsors embraced the case for indexing or passively managing at least the core portion of a fixed income portfolio. Gains from active management were not easily obtained

from assets with low levels of credit risk, especially from those that were both widely held and recognized by investors, and traded in sufficient volume to ensure reasonably low trade costs and high liquidity.

That period of low credit risk coincided with high and volatile interest rates. Active Canadian institutional bond investors essentially used rate or rate-curve anticipation strategies to add net value. Between 1987 and 2001, all nine SC indexes outperformed the TSE 300 Composite Index mean annual return of 9 per cent. However, when the level and volatility of interest rates are low as they are today, these active strategies offer much poorer prospects of adding value compared to yield or yield-spread anticipation strategies that are based on effective credit analysis.

The importance of tracking credit rating transition patterns and conducting effective credit risk analysis for both passive and active fixed income portfolio management is higher for yield spread strategies. Historical evidence suggests that the likelihood of a credit quality rating movement is correlated across issuers and increases for the same issue with an increasing tracking horizon.

Recent Canadian estimates are 13 per cent and 53 per cent for a corporate bond currently rated as AAA after one and five years, respectively. An assessment of the risk-mitigation protection offered by covenants (which requires a thorough understanding of the wording of debt covenants) is another important component of credit analysis.

Future fixed income portfolio management will require greater risk management and control, as well as varying degrees of active management as investors strive to deal with the greater credit risk of the average fixed income security investment. Institutional investors and sponsors will need to shift towards a more focused credit management strategy to achieve their required returns in an environment of historically low interest rates. ■