The Death of Canadian Fixed Income Management as We Know It

BY HARRY S. MARMER, CFA®

Introduction

The subtitle of this article could be, "How to lose Canadian fixed income portfolio managers as friends." Do I perhaps need to take a Dale Carnegie course? While we will leave that question unanswered, it is a fact that the shift toward liability-driven investing and the elimination of the parental Foreign Property Rule permanently are changing the face of Canadian fixed income management. Bond management never will be boring again.

Liability-Driven Investing

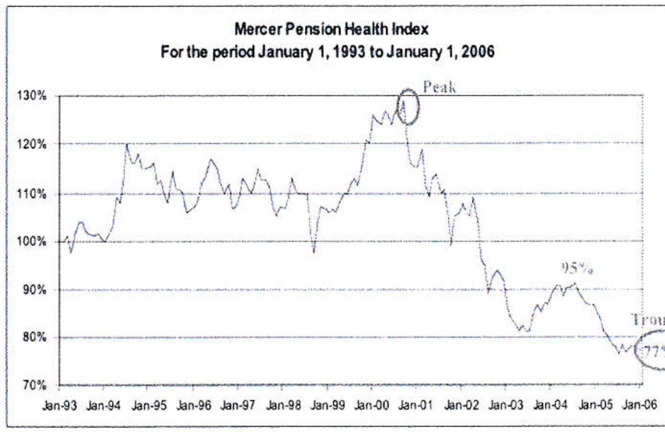
Liability-driven investing (LDI) currently is all the rage in the pension industry, but it also is most likely an enduring rage. LDI refers to structuring your asset mix to better match liabilities. In its most logical form, it is a restructuring of your fixed income portfolio to increase correlation with your plan's liabilities. Two key factors pave the way for LDI:

1. Weak pension fund health
2. Lackluster Canadian fixed income results

Weak Pension Fund Health

It is no secret that pension fund health in Canada is soft. The easiest way to understand this issue is to look at the ratio of pension plan assets to liabilities. Figure 1, which displays the Mercer Pension Health Index since 1993, is an illustration of this ratio.[1] This index monitors the directional impact of capital markets on the financial position of Canadian pension plans. More specifically, it represents the ratio of assets to liabilities for a model pension plan—the higher the ratio, the healthier the plan.

FIGURE 1 Pension Plan Health is Soft



Data Source: Mercer Investment Consulting Pooled Fund Survey

The Mercer Pension Health Index peaked around September 2000. Equity markets were entering a globally synchronized bear market that bottomed around September 2002. Bond markets, on the other hand, were continuing their bull market with long-term interest rates dropping over the period by more than 225 basis points from 6.65 percent to 4.49 percent. This environment created a "perfect storm" for pension plans with mismatched assets and liabilities.

The typical pension plan asset mix is 60-percent equities and 40-percent midterm bonds. Solvency liabilities, however, are priced from long-term Government of Canada bonds. With both equity markets and fixed income yields falling, pension plan asset values dropped at a time when liabilities were on the rise. Fixed income assets in the typical plan tend to be of shorter term than liabilities, further exacerbating the gap; so even though interest rates were in decline, bond assets failed to rise as quickly as liabilities. This may help answer the question, "Why does my actuary tell me bad news when my bond manager tells me good news?"

Investment consultants Watson Wyatt found similar results when they examined pension funds in other countries. Pension balance-sheet health generally has been weak in developed markets where plans have significant equity exposure and generally have not managed their fixed income from a liability-driven perspective.

Canadian Fixed Income Results

The other factor significantly affecting the Canadian fixed income environment has been active bond man-

>> "FIXED INCOME MANAGEMENT" CONTINUED

agement's lackluster performance in Canada over the past decade. Figure 2 reveals the Mercer Median Canadian Fixed Income Manager (MMCFIM) value-added results relative to the Scotia Capital Universe Total Return Index (SCU TRI) since 1986 for the following calendar-end value periods: yearly, four-year annualized basis, and annualized since inception. If you had no skill at picking managers and ended up with the MMCFIM every year since inception, your annualized value added would have been 0 percent before fees.

Although it depicts a somewhat naïve simulation, figure 3 looks at the Mercer universe data from a spread perspective before fees. Specifically, this chart compares the differential in performance between the Mercer first-quartile fixed income manager and the median manager with the Mercer third-quartile manager and median manager. Over the past 20 years, the spread or differential in performance between the Mercer median manager and both first- and third-quartile managers clearly has narrowed.

Examining this issue a little closer, figure 4 reveals that the Canadian fixed income market indeed has had two different fixed income management regimes. During the first regime, 1986–1997, the average spread between the first quartile and

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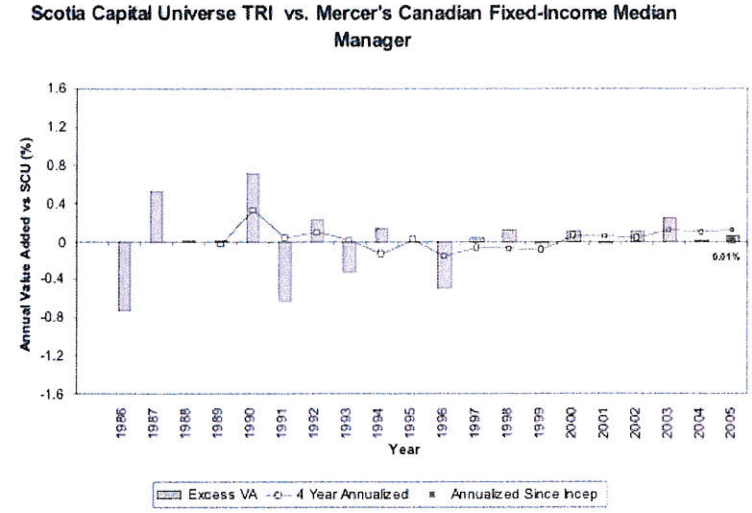
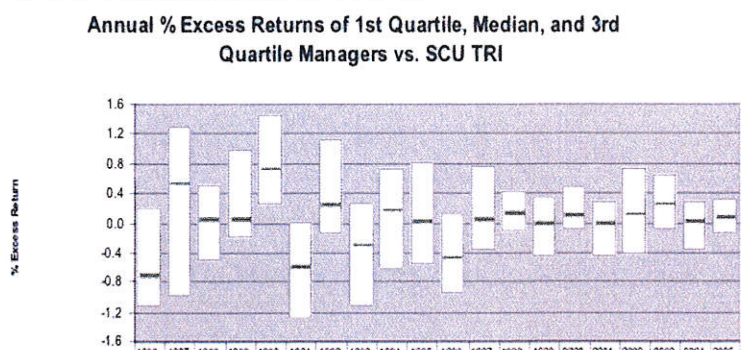
FIGURE 2 Lackluster Active Manager Results



Data source: Mercer Investment Consulting Pooled Fund

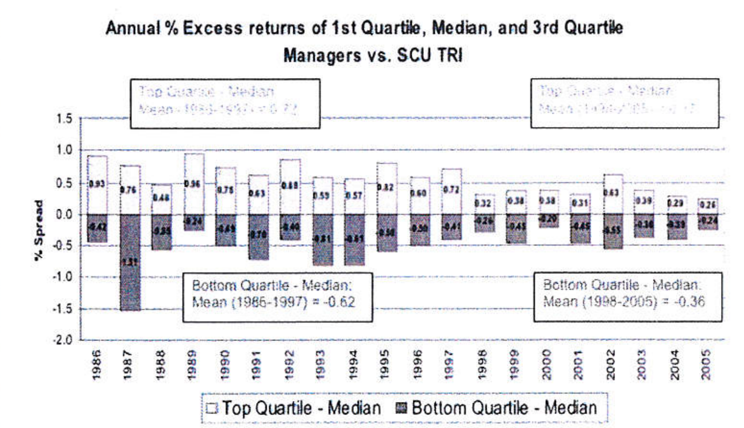
FIGURE 3 Performance Spreads Have Narrowed



	1986	1987	1988	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005
1st Quartile - SCU	0.2	1.3	0.5	1.0	1.5	0.0	1.1	0.3	0.7	0.8	0.1	0.8	0.4	0.4	0.5	0.3	0.7	0.6	0.3	0.3
Median - SCU	-0.7	0.5	0.0	0.0	0.7	-0.6	0.2	-0.3	0.2	0.0	-0.5	0.0	0.1	0.0	0.1	0.0	0.1	0.2	0.0	0.1
3rd Quartile - SCU	-1.1	-1.0	-0.5	-0.2	0.2	-1.3	-0.2	-1.1	-0.7	-0.6	-1.0	-0.4	-0.1	-0.5	-0.1	-0.5	-0.4	-0.1	-0.4	-0.2

Data source: Mercer Investment Consulting Pooled Fund Survey

FIGURE 4 Tough to Sell Active Canadian Fixed Income



Data source: Mercer Investment Consulting Pooled Fund Survey

TABLE 1 Global Fixed Income Roadmaps

	STRATEGY	BENCHMARK	IMPLEMENTATION
1	Canadian Fixed Income & Non Domestic	Canadian	Current Manager
2	"Core Plus"	Canadian	Current or New Manager
3	Global Aggregate	LB Global Aggregate	New Manager
4	Portable Alpha	Any	New Manager

TABLE 2 Global Fixed Income Opportunities Galore

STRATEGY	BENCHMARK	APPROX. DURATION (YRS)	ESTIMATED 1ST QUARTILE ALPHA
Global Aggregate	LB Global Aggregate	4.8	100-150 bps
Global Credit	LB Global Credit	5.0	75-125 bps
Global Sovereign	Citigroup WGBI	5.8	75-125 bps
Global Inflation Linked	Barclays Global Inflation Linked	9.0	75-100 bps
European Aggregate	LB European Aggregate	5.1	75-100 bps
Emerging Markets	JP Morgan EMBI Global Diversified	3.0	LIBOR + 500 bps
U.S. Low/ Intermediate Duration	ML 1-3 G/C, LB Intermediate G/C	1.5	75-100 bps
U.S. Core	LB US Aggregate	4.3	75-100 bps
U.S. Core Plus	LB US Aggregate	4.3	100-125 bps

TABLE 3 High Opportunity Space—Fixed Income Market Comparisons

	LB GLOBAL AGGREGATE	SCOTIA CAPITAL UNIVERSE
Market Cap (Cdn Bn)	24,935.79	605.59
# Securities	10,232	972
# Corp Issues	4,970	576
# Countries	57	1
# Currencies	24	1

TABLE 4 Diversification Benefits of Global Fixed Income Low Correlation to Other Assets

	SCU	S&P/TSX	S&P 500	MSCI EAFE	MSCI WORLD
Scotia Capital Universe	1.00	0.18	0.12	0.09	0.11
Citigroup WGBI	0.24	-0.24	0.00	0.30	0.19
Citigroup WGBI Hedged	0.23	-0.28	0.12	0.10	0.11

Mercer median and the third quartile and Mercer median was 72 and –62 basis points, respectively.

During 1998–2005, the average spread between the first quartile and Mercer median and the third quartile and Mercer median was 37 and –36 basis points, respectively. These results are, of course, before subtraction of explicit investment management fees and implicit monitoring costs. Clearly, active Canadian fixed income management over the past five years has been a tough sell.

The Playing Field Has Changed

Weak pension fund health, in combination with lackluster results from active management of Canadian fixed income, has led sophisticated pension fund sponsors to convert from active fixed income investing with a universe duration benchmark to an indexed long-duration approach. After all, why bother with active midterm bond management if the odds of winning net of fees are low and it does not match well with liabilities?

One other factor dramatically will change the landscape of the Canadian fixed income market: the elimination of the Foreign Property Rule. Canadian fixed income markets comprise only about 4 percent of world fixed income markets. Now Canadian fixed income managers can play for opportunities anywhere in the world.

Table 1 reveals that Canadian institutional investors can choose from a number of implementation pathways in their attempts to take advantage of this new environment.

The case for global fixed income investing is unprecedented from both an alpha enhancement and a beta reduction perspective.

Table 2 is a partial listing of the smorgasbord of global fixed income opportunities available to investors as well as an alpha estimate for first-quartile performance. An analysis of Mercer's global fixed income database suggests that the alpha potential for global fixed income management is real.

There are fundamental reasons for this alpha potential. The global fixed income arena has a deep and broad opportunity space offering diverse choices (see tables 3 and 5, and figure 5). These factors also provide global fixed income investors with diversification benefits relative to Canadian asset classes (table 4).

Where Are We Going?

The seeds have been planted for the institutional investing world to significantly change in the future. This especially is true for institutional fixed income portfolios. Institutional investors can go down a number of different roads in this new environment (see table 1). My forecast is that performance spreads in the Canadian fixed income manager universe again will widen as more managers add foreign bonds to their portfolios. The movement into LDI will lead sophisticated sponsors to utilize portable alpha strategies to harvest the alpha potential in global fixed income.

Other institutional investors will invest directly in global fixed income strategies to obtain that market exposure, either as a means of reducing some of their systematic risk exposure to the Canadian market or as a strategic call on relative valuation. By extension, Canadian fixed income portfolio managers will have to keep pace with where their clients are leading them.

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FIGURE 5 Diverse Choices

Lehman Global Aggregate Index

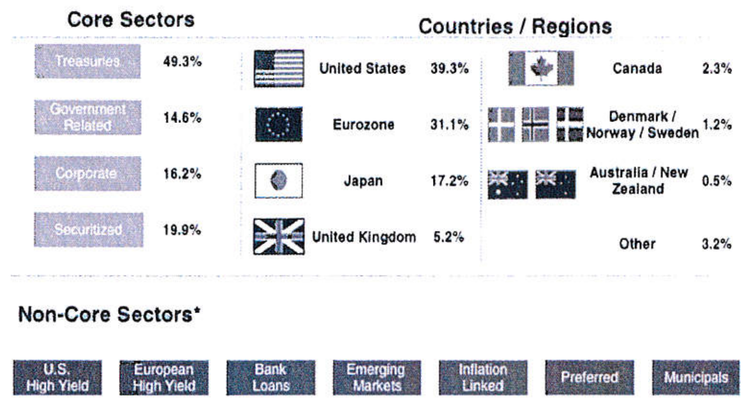

TABLE 5 Broad Market Exposures

COUNTRY	LEHMAN GLOBAL AGGREGATE	SCOTIA CAPITAL UNIVERSE
United States	36.14	0
Japan	17.18	0
Germany	10.06	0
France	6.12	0
Italy	4.96	0
United Kingdom	4.93	0
Spain	2.97	0
Canada	2.70	100
Netherlands	1.97	0
Supranational	1.44	0
S.Korea	1.40	0
Belgium	1.25	0
Greece	0.99	0
Austria	0.96	0
Sweden	0.82	0
Australia	0.56	0
Denmark	0.55	0
Mexico	0.53	0
Portugal	0.47	0
Taiwan	0.46	0

Endnotes

1. The Mercer Pension Health Index monitors the directional impact of the capital markets on the financial position of Canadian pension plans, not just pension funds. The index represents the ratio of assets to liabilities for a model pension plan—the higher the ratio, the healthier the plan. The ratio has been arbitrarily set to 100 percent at the beginning of the period. The assets of the model plan are assumed to be invested in a passive balanced portfolio, while the liabilities are determined using the assumptions required for solvency valuations, which are based on the yield on long-term Government of Canada bonds. The starting point and the magnitude of the changes for any pension plan will depend on a range of factors: asset mix, the impact of active management, plan demographics, and plan design. Assets: Passive balanced portfolio, which consists of 42.5 percent SC Universe Bond Index, 25 percent S&P/TSX Composite Index, 15 percent S&P 500 Index, 15 percent MSCI EAFE Index and 2.5 percent SC 91-Day T-Bill Index. Liabilities: 50 percent active members; 50 percent retired members; non-indexed pensions; Canadian Institute of Actuaries transfer values without the two-month lag. The Index assumes contributions equal to current service cost and no plan improvements. Results will vary by pension plan.