CORPORATE CREDIT COUNTS

Plan sponsors are increasingly entering credit product and derivative markets and using new products directly to diversify credit exposure. A clear understanding of this new field is a necessity.

By Marlene Puffer

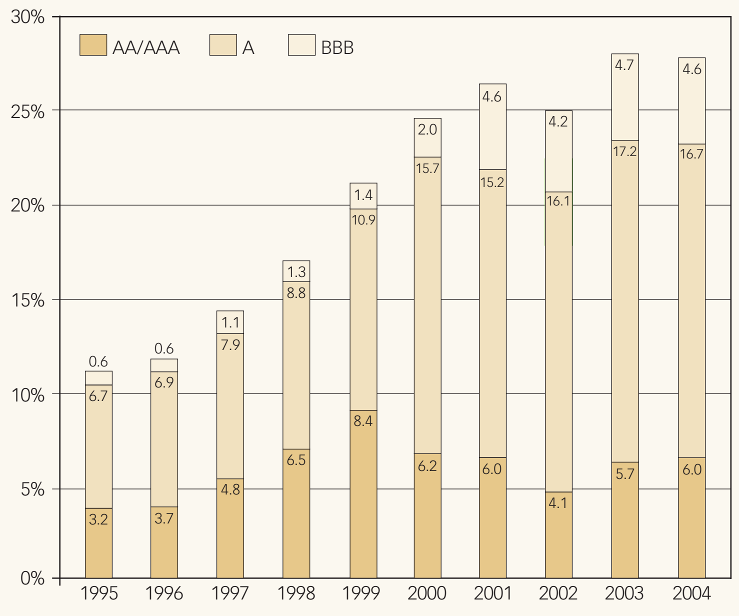
The average Canadian pension fund has over 50% of its assets in fixed income investments, usually concentrated in the domestic market, reserving the restricted global exposure for equities. The credit risk of these fixed income assets has changed dramatically as corporate bonds have grown from 10% of the Canadian bond market in 1995 to nearly 30% today. Clearly, corporate credit, which can be as much as 30% of a fund, merits the close attention of plan sponsors.

Not only has the weight and nature of corporate credit increased in benchmarks and portfolios, but the ongoing development of new credit product and derivative markets means that money managers and plan sponsors have many new tools at their fingertips to invest in credit and to manage credit risk. Some sponsors are already entering into some of these markets and using new products directly to diversify credit exposure. Now, more than ever, plan sponsors need a clear understanding of credit markets.

Credit markets have changed a lot in 15 years. As government deficits and borrowing diminished in the 1990s, corporate borrowers began to forgo the U.S. market in favour of the domestic market. A decade ago, the Canadian bond market was dominated by A and AA-rated issuers. The market expanded into BBB-rated territory as investors loosened credit constraints and improved credit analysis. Bonds rated BBB have increased from under 1% of the overall bond market in 1995 to the current level of nearly 5%, and even these issuers no longer automatically turn to the U.S. market (see “Triple Bs on uptrend”chart).

Triple Bs on uptrend

Corporate issues as a percentage of the Scotia Universe Index.



Source: *Scotia Capital Markets*

By the late 1990s, development of new types of corporate and quasi-government issuers, primarily for infrastructure projects, occurred. Issuers such as airports, hospitals, and highways currently have over $18 billion in bonds outstanding, which amounts to 3.6% of the Scotia Capital Universe Index. Universities, school boards and other quasi-provincial agencies add another $15 billion, or 2.8% of the index, with most classified in the provincial sector despite the absence of provincial guarantees. All of these securities require specialized analysis of their structures and credit risks since all issues are not created equal in this growing sector.

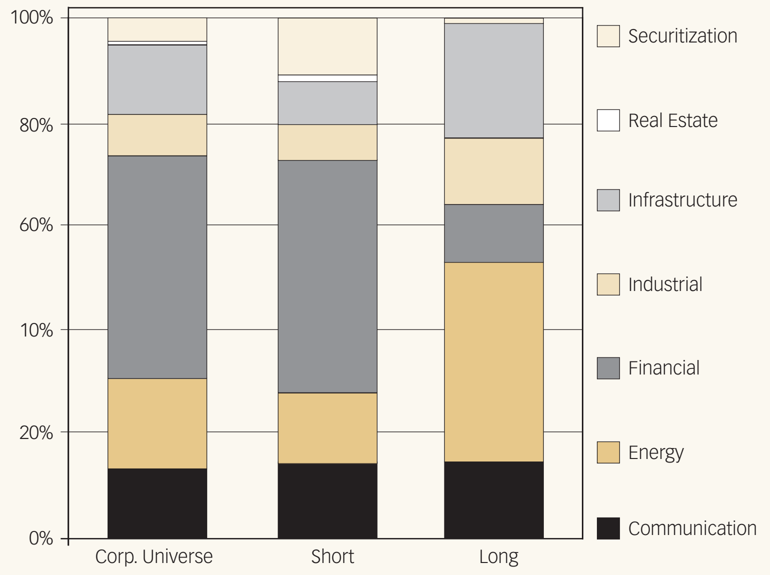
As of mid-August, the $20 billion issued in the corporate sector this year has been dominated by the major banks that issued 36% of new bonds, up from 22% in 2003. BBB-rated bonds have been 18% of issuance this year (compared to 10% in 2003), contributing to the increasing importance of this sector.

SHORT VS. LONG-TERM CREDIT

For fixed income mandates that specialize by maturity, it is important to understand that the short end (one to five years to maturity) currently has 30% corporate bonds, while the long end (10 years and longer) has only 22%. Over half of short corporates are financials (13%) and AAA-rated asset-backed securities (4.5%). In contrast, the long end is dominated by the energy sector at 8.4%, and nearly 6% in infrastructure, with only 2.4% in financials and no asset-backed securities (see "Beware sector breakdowns" chart).

Beware sector breakdowns

Financial issues dominate the short end of maturities; energy influences the long end.



Source: *Scotia Capital Markets*

By rating, the short end has 9.3% in corporates rated AA or better, while the long end has only 0.8%. Bonds rated in the BBB category are also more heavily concentrated in the short end (6%) than the long end (3.5%). This is because most BBB issuance is concentrated in five-year maturities where investor demand is strongest for lower quality bonds. The long BBB-rated securities were not generally issued as BBBs. Rather, they were downgraded due primarily to the deregulation of the energy sector, combined with Standard and Poor's ratings harmonization upon taking over the Canadian Bond Rating Service in 2000.

ADDING VALUE

Corporate bonds have higher yield than government securities, so they have the potential to add significant value if risk is managed carefully. Lower credit quality translates into higher yield and higher returns provided spreads are stable or improve, but comes at the expense of increased default risk and greater volatility due to spread movement.

The past decade has seen tremendous volatility in the value of credit. The relative value of corporate bonds can be measured by the difference in yield for a corporate bond compared to the yield on a Government of Canada bond of similar maturity. The chart on page 55 shows this spread (see "Triple Bs Tight as a Drum") broken down by rating for mid-term bonds (five to 10-year maturity). When the spread widens, investors demand greater compensation for riskier credit. The chart clearly shows the dramatically higher volatility in BBB spreads compared to higher quality credit. Mid-term BBB-rated spreads have ranged from 80 to 290 basis points over the past decade, while A-rated spreads have ranged from 10 to 90 basis points.

Credit spreads in aggregate tend to be driven by specific events, economic growth, interest rate levels, corporate profitability, equity market performance and volatility, and swap spreads (spreads that reflect the cost of converting fixed rate to floating rate debt). Current spreads are near all-time tight levels, particularly for lower quality credit, as investors have been on the search for yield in a low interest-rate environment, and corporations have improved their balance sheets. Spreads have widened slightly this year as the U.S. Federal Reserve Board has started raising rates.

Pension plans that excluded BBB bonds have missed out on the best performance in the Canadian bond market. Over the two years ending July 2004, the Scotia Capital Markets BBB index returned 20.9% compared to the A-rated index at 12.8%. Over two years, BBB spreads tightened 165 basis points relative to higher quality credit, offering capital gains in addition to the higher running yield. However, with BBBs currently yielding an average of just 25 basis points over As, investors are not getting much compensation for the added risk of underperformance that would occur if spreads widen.

Below-investment grade spreads are also at tight levels. This market is limited in Canada, and generally requires a foray into structured products, or into the U.S., which entails added currency risk and competes directly with equities for the global asset allocation.

NEW CREDIT PRODUCTS AND MARKETS

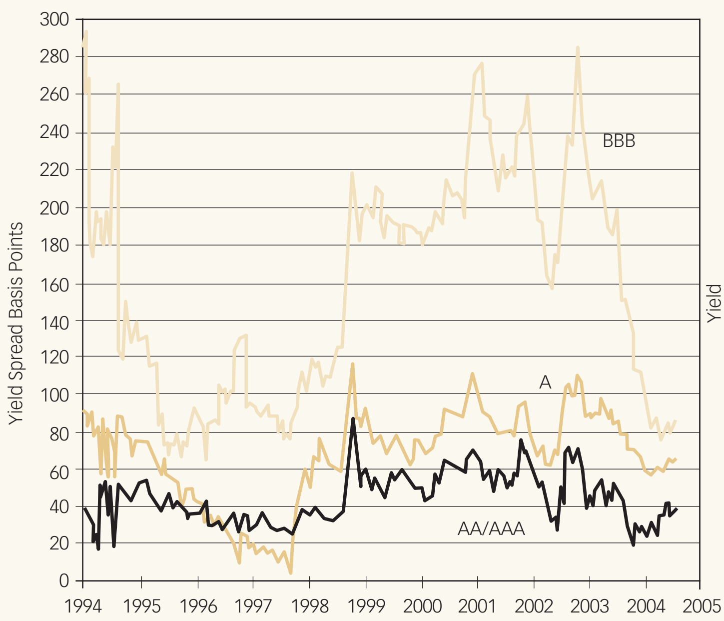
The alphabet soup of credit products seems to get spicier every day, with asset-backed securities, commercial mortgage-backed securities, credit default swaps (CDS), collateralized debt obligations, collateralized loan obligations, credit linked notes and asset swaps entering the market. One of the most important developments in credit markets is the emergence of the CDS market. Credit default swaps allow counter-parties to trade the loss due to default by a specific issuer, and the market has evolved into trading the risk of loss on portfolios. This is a global market that provides access to some Canadian-based credits along with a wide array of international issuers whose valuation in the CDS market can now more directly influence the value of related Canadian issuers.

International banks continue to be the most active parties using this market to manage the credit risk of their loan books. The emergence of the CDS market has changed the face of the bond market as liquidity has been significantly enhanced, and managers must also be aware of the influence of a whole new dimension of demand and supply of credit in addition to traditional sources. Investment dealers, hedge funds and bond portfolio managers have a new way to manage the credit exposure of bond portfolios.

These players can also add value by taking advantage of temporary differences in the way a specific credit is valued in the global CDS market versus the domestic bond market. Importantly, the CDS market can allow portfolio managers to hedge the credit risk of a bond portfolio without selling the underlying securities, which can be a useful tactic when a manager is pessimistic about particular credits over a relatively short horizon. Often, purchasing relatively illiquid bonds can be a challenge, but expressing a view in the more liquid CDS market can add value and increase diversification. Direct use of this market by Canadian players is still relatively small, but growing, and its influence cannot be ignored by domestic managers.

Triple Bs tight as a drum

Comparison of mid-term corporate yield spreads vs. Government of Canada bonds.



Source: *Scotia Capital Markets*

IMPLICATIONS FOR PENSION PLANS

Particularly for long-term mandates, benchmarking a bond portfolio against a broad market index can severely limit diversification and added value through credit. An innovative way to oversee a pension fund portfolio is to manage the bulk of liabilities with a long-term government-only bond fund, and to complement this with specialized exposure to corporate credit and other asset classes to enhance returns. This allows greater flexibility to access higher yielding assets, and to tailor credit risk to individual tolerance. The credit component of this approach can be as straightforward as a portfolio of investment-grade Canadian bonds, or can include high-yield bonds or exposure to domestic and global credit of any quality through derivatives and structured products.

At current spreads, now is not the ideal time for a first venture into the world of lower quality credit, but plan sponsors who were left behind the past two years should look at changing mandates now to allow BBB or higher yield bonds in time for the next market opportunity. Allowing managers to use the CDS market to manage credit is a forward-looking approach worth considering. Clearly, selecting managers with credit expertise is key. **BC**

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