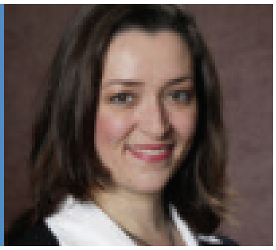
Bonding with your manager

Plan sponsors need to be aware of the rules governing fixed income benchmarks.

By Joel Kranc

MARLENE PUFFER

Managing director at Twist Financial Corporation in Toronto.



BC: *Is the selection of a bond benchmark more of a focus now than in the past few years among plan sponsors?*
MP: Many funds are now looking more closely at the term of their benchmark to more accurately reflect their liabilities, and performance measurement and governance concerns are starting to highlight the importance of benchmark selection. Pension funds are also taking a closer look at fixed income portfolios and benchmarks in light of the change in the Foreign Property Rule.

BC: *Why are fixed income benchmarks important?*
MP: One reason is that the investment universe is shifting in Canada. This impacts whether returns on new types of bonds are categorized as alpha, i.e. value added, or are categorized as beta—essentially the benchmark return. Around $12 billion in foreign bonds has been issued in Canada since the Foreign Property Rule was lifted. Those assets have been eaten up by Canadian money managers and pension funds because they present the opportunity for diversification of corporate credit. But they don't necessarily offer the best possible value relative to buying foreign bonds in other markets and hedging back the currency risk.

BC: *What makes a good bond index?*
MP: Objectivity and transparency. The system of how a [bond] index is created should be clearly laid out; it should not be biased in any way by the self-interest of the index provider. It should be an accurate representation of the investable universe that you are trying to capture.

BC: *What about sub-sectors of the index?*
MP: Whether the bond is in the index or not, that's layer one. Layer two is where it belongs in terms of sub-sectors. This is important because some portfolios are managed against a sub-index such as governments or corporates. For example, in the last five years or so, there's been huge issuance of infrastructure bonds, which are issued by quasi-government entities, trusts, or non-share corporations.

BC: *Are these classified as government or corporate bonds?*
MP: Non-share corporations such as Greater Toronto Airport Authority and Toronto Hydro are corporates. Other bonds like school boards, hospitals, and universities get trickier. Most or all the revenue comes from the province. There's no guarantee by the province on the debt, but their high quality rating depends on the support of the province. These bonds can be classified differently by different index providers.

BC: *Should plans sponsors seek managers elsewhere?*
MP: I think Canadian institutional investors should absolutely be broadening their universe of managers on a global scale because diversification and more value-added in fixed income is achievable. There's incredible corporate concentration in Canada. There are only so many tools that managers who are restricted to the Canadian bond market can use to add value. Benchmark selection and currency risk management are key considerations when going global.

BC: *What are other index related issues?*
MP: A big one is pricing. Unlike the equity market, where you have a stock exchange, there is no official closing price for bonds. And the reality is that many of the bonds are not very liquid, so there's not a lot of agreement about what the pricing should be. This makes portfolio valuation and performance attribution challenging. Consistent high quality pricing of a portfolio and comparison index helps pension funds identify manager skill.

Joel Kranc is news editor of BENEFITS CANADA.
Joel.kranc@bencan-cir.rogers.com.