The world over

Limiting your investments to the domestic market can be restrictive, at a time when global bonds offer added value.

By Marlene Puffer

Pension funds have a dilemma on their hands: risk management is at the top of the agenda, but plans in deficit positions need investments to do more than match liabilities. Low yields and the threat of rising rates make this more challenging than ever.

The good news is that following the removal of the Foreign Property Rule in 2005, Canadians can now freely access global fixed income markets for added performance while controlling currency and interest rate risks. Global bonds should be assessed in the context of managing domestic liabilities, so a global bond benchmark may not be appropriate. While there are inherent risks, global bonds offer a number of benefits not available in the domestic market.

VALUE OPPORTUNITIES

Value added in bonds comes from duration, curve positioning, sector allocation, and security selection. Global bond markets give managers more tools and opportunities, and currency risk can be easily hedged, with the cost incorporated into assessing the relative value of foreign bonds.

1. Duration. Global government bond markets permit many views on relative interest rate movements, rather than just one view on Canadian rates. Major foreign markets are more liquid, and interest rate derivatives such as swaps and futures add additional relative value opportunities.

Many Canadian managers hesitate to risk underperformance by putting all their "interest rate view" eggs in one basket. For fear of being wrong, a typical manager may outperform the benchmark by a paltry 15 basis points or less even if interest rates move 50 basis points. Low and stable interest rates can also exacerbate the problem.

2. Curve. Interest rate risk can be further diversified globally be taking positions in different maturity bonds. Many combinations of relative interest rate movements at different maturity points along the yield curve are possible, and simple strategies can pay off in a variety of scenarios.

Canadian domestic managers don't take enough risk for curve bets to pay off significantly since the risk can't be diversified at home.

3. Sector allocation. Global markets open the door to many sectors with low correlations with Canadian bonds and better liquidity. However, the Canadian bond market consists mainly of government bonds and investment grade corporate bonds, with a smattering of other products. Spreads are generally low and highly correlated. Liquidity can be a concern because corporate bonds are often bought and held rather than actively traded.

4. Security selection. Global markets offer thousands of securities in many sectors, but in some sectors a large team may be required to skillfully analyze risk vs. reward.

Canadian market efficiency has improved, limiting profitable security selection in government markets. Corporate bonds offer some opportunities to add value, but offer limited diversification. For example, nearly 50% of corporate bonds in Canada are financials. "Maple" bonds (see page 39) improve diversification, but are concentrated in the financial sector.

FIXED INCOME OPTIONS

Canadian investors should consider a variety of foreign bonds while being mindful of new risks. Modest strategic allocations to seemingly risky sectors can add value while maintaining or even lowering overall portfolio risk if managed well. Currency risk, for one, can be managed with the use of simple derivatives such as forward contracts by bond managers or using an overlay strategy (i.e. management of currency risk for the overall fund by a separate manager). Knowing which risks to take, and which to avoid, is the key.

MAPLE BONDS

These are bonds issued by foreign countries or corporations in Canadian dollars, in the Canadian market. Maple bonds make up nearly half of the domestic corporate issuance this year as many pension funds consider these Canadian content. Sponsors should watch for legal structure, illiquidity and extra custodial fees.

The U.S. and European corporate markets offer diversification and liquidity, but trading volume is now greater in credit default swaps (see below). Depth of expertise is especially important in high yield due to greater risk of default. Collateralized debt obligations (CDOs) are another way to invest in portfolios of high yield bonds.

MORTGAGE-BACKED SECURITIES

These are pools of residential mortgages whose payments are securitized and "passed through" to bond investors. Mortgage-backed securities (MBS) are AAA rated and offer a different sort of interest rate risk than is available in any other type of bond. The option that homeowners have to prepay their mortgages creates uncertainty in the actual term to maturity of a mortgage, and therefore creates uncertainty about the interest rate sensitivity (duration) of an MBS pool. Changes in interest rates, rather than their level, affect prepayment rates, and therefore affect MBS values. This market is very liquid and is bigger than the market for U.S. Treasury Bonds.

CREDIT DEFAULT SWAPS

Credit default swaps are like an insurance policy on bond or loan defaults. The buyer of default protection pays a periodic premium, and receives a specified dollar amount in the event of default of a reference bond or loan. The seller of protection gets the premium and receives the recovery value of the defaulted asset. The buyer benefits if credit markets deteriorate and spreads widen. Credit default swaps are also packaged in baskets and indices that simplify trading in diversified portfolios. They are liquid, entail no interest rate risk, and have minimal currency risk.

STRUCTURED FINANCE

This market has evolved from asset-backed securities, which are pools of assets like credit card receivables; commercial mortgage backed securities; to collateralized debt obligations, which are trusts filled with loans or bonds that may be below investment grade, divided into pieces with varying protection; and equity. There is currently a huge market for structured finance in Europe and the U.S.

Fixed Income Basics

Price/yield relationship – As yields, or interest rates, rise, the price of a bond falls.

Yield curve – The relationship between Government of Canada bond yields and maturity. The yield curve is usually upward sloping ("steep"), i.e. rates are generally higher for longer term bonds.

Duration – The measure of sensitivity of a bond's price to changes in yield. If a bond has a duration of six years, when rates rise by 1%, the bond's price will fall by 6%. Duration is also a weighted average time until cash flows are received. Duration measures sensitivity to parallel yield curve movements. Longer-term and lower coupon bonds have longer duration.

Bullet/barbell – The positioning of a portfolio along the yield curve compared to the benchmark. A "bulleted" portfolio is overweight the "belly" (mid-term maturities) vs. the benchmark, and underweight the "wings" (short and long maturities), and usually outperforms if the curve gets steeper. A "barbelled" is concentrated in mid-term maturities, and usually outperforms if the curve gets flatter (short rates rise more than long rates).

Credit spread – The difference between the yield on a non-government bond and a treasury bond with similar term to maturity or duration.

Sector allocation – Over or under weighting specific sectors (e.g. provincials, corporates) vs. the benchmark.

STEPPING INTO THE FOREIGN BOND MARKETS

Many medium-sized pension plans are already approving guidelines for pooled funds that allow foreign assets and related derivatives. The potential added value is significant, and diversification can be dramatically improved through an array of foreign strategies and products.

The easiest step into foreign credit is through "Maple" bonds, but having the expertise to understand the foreign issuers is important. The alternative step directly into foreign credit markets can offer the same risk profile as Maple bonds with better diversification, but also requires a derivatives policy to manage currency risk.

Interest rate risk can be diversified through foreign government or other bonds, or even global macro hedge funds. A derivatives policy is also required, along with careful consideration of investment guidelines and benchmark selection.

The critical step is selecting managers who have the skill, expertise, experience, analytics and risk management systems to effectively add value while controlling risk vs. domestic benchmarks or liabilities. Many domestic managers can do well with some foreign credits and foreign government bonds and derivatives, but you might want to call in global or niche players for products like high yield, emerging markets, or CDOs, either as specialized products, or as part of a "core-plus" approach through a single manager. **BC**

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