MARLENE PUFFER
*Managing director, Twist Financial Corp.*

# CALLING ALL LONG BONDS

*Fixed income comes to the rescue in risk management.*

Canadian pension plans are not the only ones considering extending the duration of their fixed income portfolios so they can improve the hedge against long-term liabilities. However, are there any inflation-linked and long-term nominal bonds out there to satisfy this demand? From a global aggregate perspective, the answer is not really, which is why long yields are low in every major market, offering poor risk/reward tradeoff in absolute terms. Here in Canada, the availability of Canadian inflation-linked and long-term nominal bonds is also limited and the cost is high. The good news is that for most Canadian pension plans, the global markets still offer added value and risk management opportunities relative to the domestic market.

Canadian inflation-linked bonds (ILBs, called real return bonds, RRBs, in Canada) represent only 3.4% of the global ILB market. There are only four federal issues, all in the long end. The U.S. and U.K. have inflation-linked bonds with many maturities, and represent 63% of the global market. France now represents 16% of the market, and Italy over 8%, with a handful of other new issuers.

The question is, do these foreign markets provide a good hedge for Canadian inflation? Over the long term, Canadian and foreign inflation are highly correlated (around 75% across all major markets), so long-term foreign ILBs provide a decent hedge for Canadian plans. Over shorter periods, this correlation can be much lower, so plans must be able to withstand some volatility in their inflation hedge. The good news is that the variability of correlations can add value through actively managing a portfolio of global ILBs versus a Canadian ILB benchmark. The growing inflation derivatives market offers additional opportunities to add value.

## THE LONG END

The long end of the Canadian nominal bond market is dominated by nearly 40% provincial issuers, with corporates only 21% of the long S&P/TSX Canadian Bond Index, compared to 28% of the Composite Index. The long end is dominated by a handful of very large corporate issuers, and offers poor diversification. Long corporate bonds are particularly illiquid. Consider a long government-only mandate to hedge liabilities and focus on global credit opportunities for diversification. This can be achieved through specialist actively managed global corporate mandates. Alternatives include derivatives, a "core-plus" strategy versus a Canadian benchmark, which inclues foreign corporate bonds, "alpha transport" strategies that hedge out foreign benchmark risk and gain exposure to long Canadian bonds through swaps.

Long bond mandates may not be long enough to match many plans' liabilities. The S&P/TSX Canadian long bond index duration is only about 12 years, and the duration of 30-year bonds is only about 15 years. To go longer, strips are required. The supply of strips is only constrained by the amount outstanding of the underlying bonds, but the price of a long residual is driven by complex dynamics of the shape of the curve and demand for strips of varying maturities. Only a handful of strip securities outstanding trade regularly with liquidity. Management skill is important in the very long end where convexity, curve risk, and trading play important roles in risk management.

Benchmark selection is another concern for very long mandates. The ideal would be to compare portfolio performance directly to liabilities, but this is not feasible for many plans. The next best thing is to build a custom index that is replicable, consists of liquid assets, and reflects the liability structure closely. Market value-weighted indices of long bonds and strips don't fit this bill.

Adding inflation-linked bonds or going longer-term now might seem hard to do, but it may be necessary for prudent risk management. The limitations of the domestic markets make a strong case for going global in both inflation-linked and nominal bond markets, and for considering credit exposure separately as an opportunity to add alpha. ■