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# Fixed income forum

Hear from six industry experts on building allocations in a low-yield environment.

by KAREN WITHAM



**C**urrents recently hosted a round-table discussion on fixed income investing in Canada. Here, we've captured highlights from this interactive conversation, which covered topics including dynamic de-risking, Core Plus mandates and trends to consider as investors look toward the future while grappling with today's challenges.

Participants from the Canadian consultant community included Brad Bondy, Aon Hewitt; Carlo DiLalla, Mercer Investments; and Michèle Laframboise, Normandin Beaudry. BlackRock® participants included Julie Ducharme, Canada Institutional team, Global Client Group; Paul Purcell, Canada Institutional team, Global Client Group; and Aubrey Basdeo, Head of Canadian Fixed Income, Portfolio Management Group.

**Julie Ducharme: What are you hearing from pension clients about their fixed income allocations and what changes do you think they're contemplating making in 2012?**

**Brad Bondy:** One of the primary themes has been de-risking. I think a lot of the interest stems from the volatility we've seen in equity markets. Our view is that what we've seen over the last 10 years is not likely to continue over the long term, but we certainly understand clients' desire to reduce risk. We see de-risking in two phases. The first step is to remove unrewarded risk by moving the current bond allocation from universe bonds to long bonds. The next step is to determine if a higher allocation to bonds is appropriate and, if so, create a path for getting there.

**Carlo DiLalla:** I would agree. Clients, more than ever, realize how important fixed income is in terms of its risk

management purpose, including its liability-matching abilities. I don't believe that will change going forward, despite the current environment.

**Michèle Laframboise:** It really depends on what the initial allocation to fixed income is. Clients who already have an exposure of 45% or higher to fixed income are relatively happy and thinking about fine-tuning their liability duration matching or optimizing their bond portfolio. This can be done by redefining their benchmark or by diversifying into nontraditional fixed income categories. Clients with a lower exposure to fixed income are definitely talking about increasing their allocation when the time is appropriate.

**Ducharme: Where do you think we are in the trend from a universe bond strategy to a long bond strategy?**

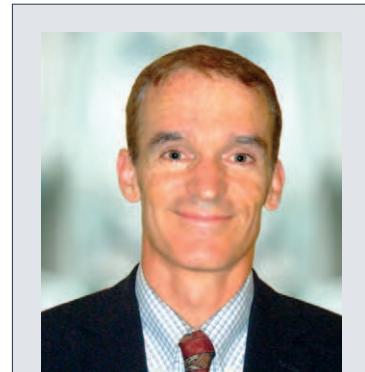
**Aubrey Basdeo:** Coupled with the shift to de-risking, as clients move up their fixed income allocation, they're also trying to tie their liabilities with their assets in terms of the duration match. We're seeing a shift into longer-duration assets from the universe portion of the index.

**Bondy:** For those who will actually move, I'd say we're probably more than halfway through. But there will be some that just won't move until the environment is more conducive.

**DiLalla:** Most defined benefit plans have already gone long. Generally the ones who haven't are those that use a balanced fund approach, as opposed to dedicated mandates in each asset class. And most of the balanced funds don't offer a long option. So that may explain why some of those clients haven't yet made the move.



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**Michèle Laframboise** is a principal at Normandin Beaudry. Contact her at [mframboise@normandin-beaudry.ca](mailto:mframboise@normandin-beaudry.ca).

**Laframboise:** If you take a look at bigger plans and their fixed income exposure and duration, it is surprising how many are still at the DEX Universe duration with a low exposure relative to equities. Yield levels are certainly an explanation. However, the fact that many of these plans are maturing and doing nothing means that the amount of interest rate risk they take is increasing every year. I expect that demand for long-term bonds will remain very high and we have yet to see another wave of duration extensions when yield levels rise from the current low levels.

**Ducharme: What are you recommending to clients?**

**Laframboise:** You cannot look at the fixed income allocation without looking at liabilities and risk tolerance, and in every case it's different. We believe that in many cases it is appropriate to segregate the investment policy of active participants from that of pensioners. Active participants in a plan can bear some market risk, while pensioners should bear less. Having a strategy for the next five to ten years is crucial, because for most plans doing nothing to your policy today means that as the maturity of the plan evolves the risk increases.

So by having two investment policies and isolating the pensioners' portfolio, the global allocation to fixed income will increase and follow that of the pensioners' weight to total liabilities automatically. As assets migrate from the active participants' to the pensioners' portfolio, gradual derisking of the plan follows without having to change your investment policy every year. We work closely with committees to draw

a strategic plan and encourage them to think of their investment policy with a 10-year horizon.

**Bondy:** I advise clients to concentrate on taking risks where they are best rewarded. We also try to focus clients on the long term; most of them are in long bonds already. For those who aren't, a common question is, "How much more downside risk is there of not being matched?" We do think that investors should look at Core Plus bonds as a possible way to add some returns without taking excessive risk. We also see low-volatility equities as an effective way to reduce risk. They don't match the liabilities the way long bonds do, but they take risk off the table in another way that may not reduce returns as much.

**Basdeo: What are the highlights of a Core Plus mandate relative to the traditional active mandates?**

**Bondy:** Core Plus is probably the easiest way for clients to get access to additional sources of value added and market exposure and to obtain better diversification and higher expected returns without taking too much risk. Just combining exposures to different markets, even without an active component, has some value. If investors are invested only in Canadian bonds or Canadian corporate bonds, they're not necessarily achieving the kind of diversification that would be available elsewhere. Particularly, long bonds in Canada are limited in the number of issuers, so it can lead to a fairly concentrated portfolio in terms of the exposures to individual corporate issuers.



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**DiLalla:** We, too, are recommending Core Plus to clients given the current low rate environment. Again, the broader opportunity set is a key selling point for Canadian investors. Many of our clients have already extended duration; however, I've learned that many don't realize a Core Plus strategy can be managed against a long benchmark. A long bond mandate relative to a universe mandate further narrows an already thin market. Given the de-risking objective many plans have, broadening the opportunity set while seeking to ensure that your liabilities continue to be closely matched is possible using a Core Plus strategy against a long benchmark.

Also, investors looking to expand outside of Canada should ensure that the manager they hire has the appropriate resources to cover the different alpha sources available,

that the allocations are managed opportunistically, and most importantly, that they're getting the full alpha diversity set.

**Laframboise:** For plans of a good size, and that can handle more than two fixed income managers, it makes a lot of sense to have 25–30% of bonds with a manager looking outside of Canada. By this I mean global credits—investment grade, high yield, emerging debt—not just global governments. You have to get extra current yield that is paying you for the risk taken, and the small and expensive Canadian corporate market is not giving you the best reward. However, one has to expect more important active risk if comparing returns to a traditional DEX Index.

**DiLalla:** Some Canadian managers seeking to expand into US or global markets typically have expertise in



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## TRACKING ERROR TESTIMONIAL

“When we look at our A-rated strategies and what the average historical tracking error has been, Canadian fixed income has had a historical tracking record of 0.6. Whereas, the equivalent tracking error has been 1.4 in Europe, 1.9 in the UK, 3.0 in the US, 3.5 in emerging market debt, 3.5 in global fixed income and 4.8 in high yield. Most likely the relatively narrow opportunity set in Canada partially explains this tracking error difference and argues that opportunities do exist outside of the Canadian market.”

—Carlo DiLalla, Principal, Mercer Investments



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maybe one single alpha source beyond the Canadian market and therefore, their Core Plus will focus on that alpha source. It's not a pure Core Plus offering. It's more of a Core with an additional yield enhancement.

**Paul Purcell: There has been a growing amount of talk about dynamic de-risking. Are plans on a glide path now? What triggers make the most sense?**

**Laframboise:** The type of dynamic de-risking should depend on the urgency to reduce risk. If something has to be done, then there should be a plan related to yield levels combined with calendar date triggers and independent from the funding level. Combining date triggers and yield levels ensures that something gets done even if yields do not rise, but mitigates the impact of the move throughout a period of, say, two to four years. After the plan has reached its initial duration and weight target, further steps to increase the fixed income allocation can be taken related to the funding ratio.

**Bondy:** We are seeing a lot of clients dynamically de-risking. I think plan sponsors recognize a move to a more defensive mix would be very expensive and to do it all at once would be very unpalatable. In some cases it's triggered by interest rates, but we generally recommend using funded ratio. We have created a tool that tracks the funded ratio of the plan on a quarterly basis. We can also do projections over the next five years based on where the plan is now. These are important issues. If you're going to be doing dynamic de-risking, you need to be on top of where you are and where you want to get to.

**Purcell:** In my experience, if you're doing a projection or proxy for funded ratio you can nail it pretty close.

**Ducharme:** The advantage is that you get to increase the frequency of your funded status assessment and make dynamic moves more efficiently, even with less-than-perfect information, than if you were to wait for a semi-annual exercise that may be much more rigorous.

**Bondy:** I agree that with a proxy you can be very close. An even more accurate approach, incorporating projected plan cash flows, can be set up in a cost-effective manner. It isn't as difficult as running a new valuation each time. Here's the important distinction: if all you need to know is your current funded status each quarter, it's very easy to estimate that inexpensively using a liability proxy. It becomes a little more expensive if you want to be able to project your funded ratio or contributions into the future. It's probably going to take a while before we see significant rises in interest rates, and I think people are realizing that and seeing that some action is needed.

**DiLalla:** We are working with clients who want to pre-set specific interest rate targets as triggers for making asset mix changes. We also have a dynamic de-risking solution that uses pre-determined funded status triggers for reducing equity exposure in a disciplined risk management framework, taking off risk when the market provides opportunities to bank market gains. This means clients can de-risk gradually in an opportunistic way so as to improve the possibility of reaching a fully funded status.

**Purcell: What are you seeing from plan sponsors looking for capital efficient or leveraged exposure to fixed income?**

**DiLalla:** We are seeing quite a bit on the manager side in terms of launching these leveraged fixed income strategies. But I wouldn't say that a mainstream application of its use has yet occurred. I think it's geared more towards clients that are serious about their de-risking strategy at this point. I don't know if they are for everyone, but obviously they serve a good purpose, especially for those that need a better total portfolio de-risking strategy.

**Bondy:** I would say the take-up hasn't been that big on leverage strategies. And I'm thinking specifically about duration. People are finding the move to long bonds a bit of a struggle already. It's also the whole concept of leveraging. People are aware of what can go wrong when you introduce leverage and I think that's another issue that may hold back some interest.

**Laframboise:** We've done a lot of analysis of these strategies in the last three years. It doesn't make sense for everyone. We think the initial steps in de-risking using physical bonds have

to be done first, before adding leverage to the portfolio structure. It can be a very good strategy, but some have put it in place too fast without understanding the implications of different curve scenarios. It is sometimes seen as a magical solution, but leverage costs something and rates will not be low forever. Another way to use leverage efficiently is to increase the allocation to bonds and overlay a synthetic equity strategy. Are these strategies capital efficient? Is borrowing to invest or purchase a hedge capital efficient? Sometimes, not always.

### BACK TO BASICS

Our experts have reiterated commonly held wisdom such as taking a long-term view, proceeding with caution and doing the detailed analysis needed to make sound, strategic decisions.

Institutional investors in Canada need to continually refine their focus on diversification, funded status, risk and de-risking. In a complex and rapidly changing environment, the right partners can help investors make the most of their fixed income allocation in order to meet their investment goals now and in the future. ♦

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