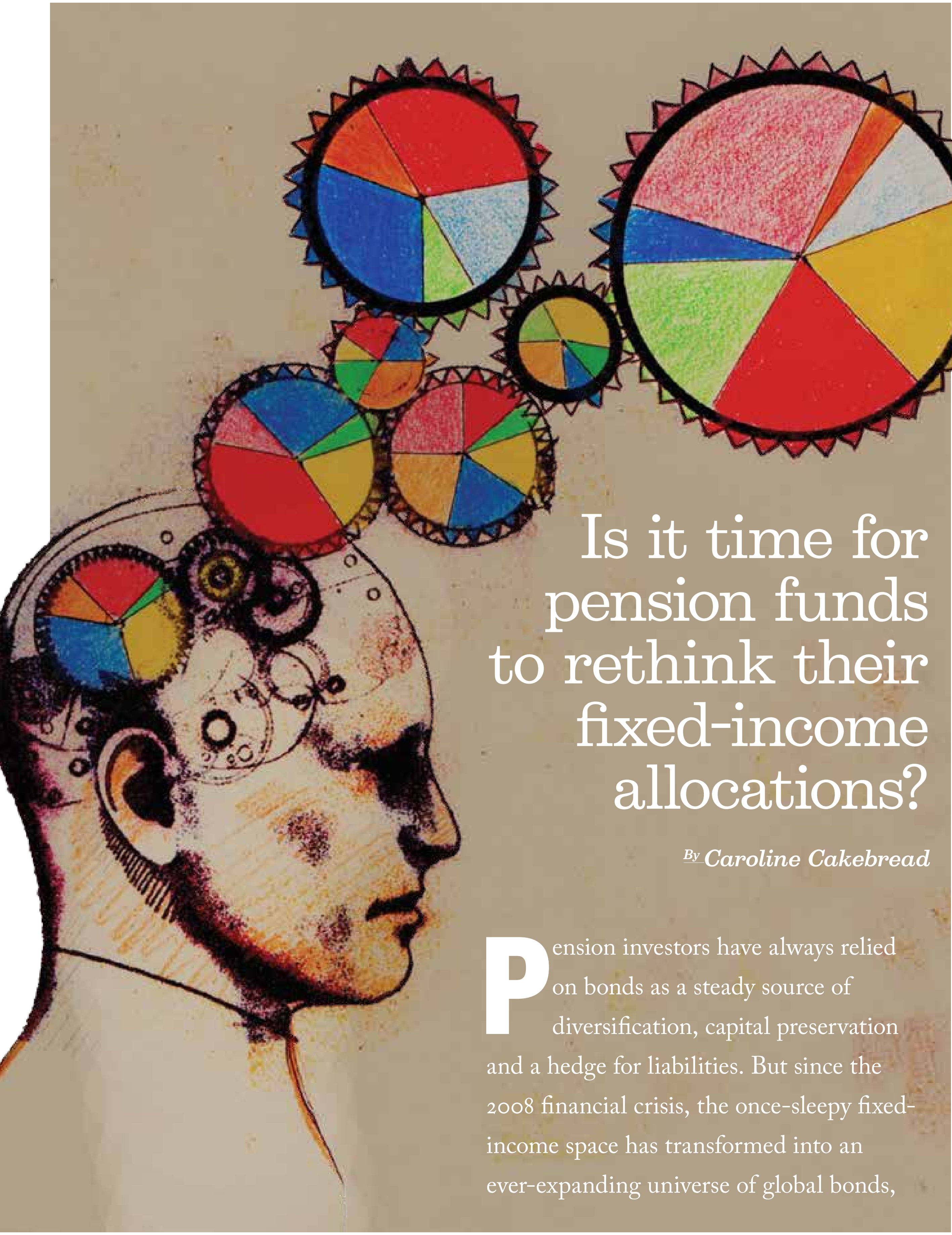

GARY WATERS/GETTY IMAGES

Is it time for pension funds to rethink their fixed-income allocations?

By Caroline Cakebread

Pension investors have always relied on bonds as a steady source of diversification, capital preservation and a hedge for liabilities. But since the 2008 financial crisis, the once-sleepy fixed-income space has transformed into an ever-expanding universe of global bonds,

Colin Sinclare
Managing Director
Institutional Sales
Western Canada

Q: What considerations do plan sponsors need to take into account when assessing fixed income opportunities outside of Canada?

Tapping fixed income opportunities outside of Canada merits careful consideration, and plan sponsors need to balance the desire for higher returns with a risk profile that remains consistent with their domestic liabilities. In our opinion, a carefully built Canadian core plus strategy can meet those needs.

We believe Canadian investors should view a core plus portfolio holistically to ensure that risk characteristics are aligned with their objectives. Many core plus mandates are managed in silos or in sleeves, with potentially different management teams having responsibility for each part of the portfolio. This fund-of-funds approach can expose investors to unintended risks inherent in each of the underlying fund's benchmarks.

Q: What are the advantages of an integrated core plus portfolio in terms of adding value and managing risk?

This approach can better leverage sector and issuer selection — which we believe are more stable and durable than duration and FX positioning — as alpha sources. Risk pricing across fixed income spread markets (*i.e.* high yield and high-grade corporates, emerging market debt and structured products) is less efficient than risk pricing in government and FX markets. This creates more opportunity to create value by leveraging a globally integrated credit research platform. In our view, a global perspective can provide a fully developed relative value framework to better understand when risks are not appropriately priced and investors should seek more attractive alternatives.

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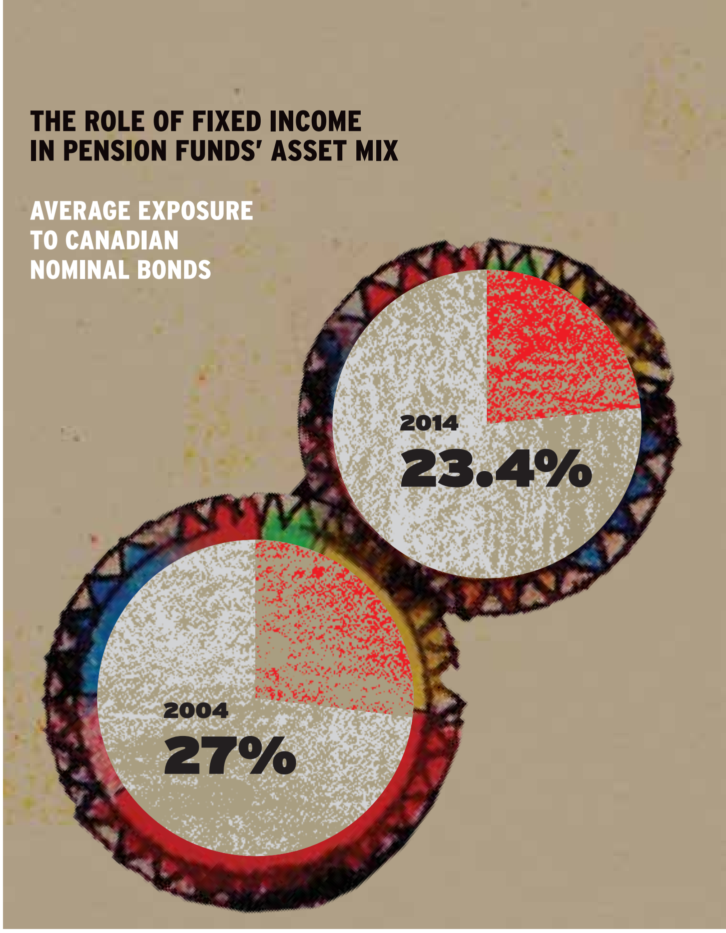


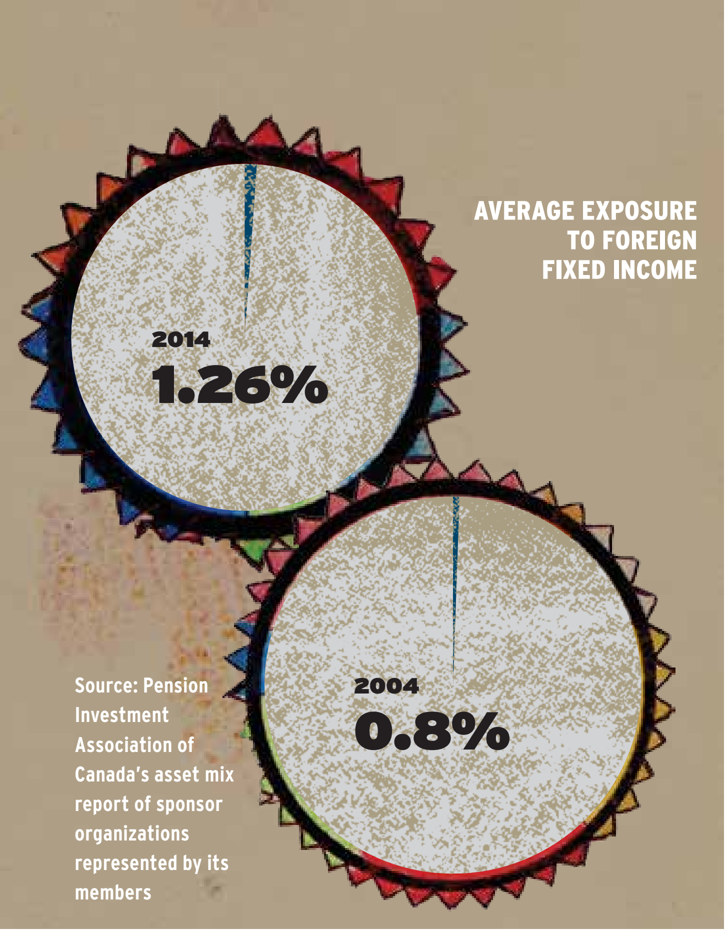
credit and other new products meant to satisfy a growing appetite for yield. As interest rates test new lows and liquidity challenges mount, plan sponsors face tough choices around their bond allocations. And while many continue to stick with the status quo, there are a growing number of plan sponsors making major changes in response to the new realities of the fixed-income landscape.

Long-term issues

The challenges in the bond market aren't going to disappear any time soon. As Alan Cauberghs, senior investment director for fixed income at Schroders in London, England, explains it: "Long-term debt dynamics in both the private and public sector will continue to drag on growth for years to come."

Right now, developed economies are "in a situation with high levels of debt to support based on low and lower growth," he adds. As interest rates test new lows — and in some cases fall below zero per cent — Cauberghs notes it's becoming harder for plan sponsors that have to discount their liabilities at realistic rates.

Another major issue in the bond market today is supply constraints. "Over the last 12 months, it's become difficult to impossible to trade all but the most liquid treasuries or government bonds," says Cauberghs. That's because investment banks have pulled out of their role as market makers in the wake of the Dodd-Frank Wall Street Reform and Consumer Protection Act, something that's a big problem for plan sponsors that rely on large bond allocations for liquidity.



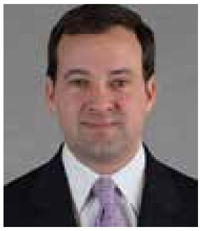
Bonds at home

In Canada, the fixed-income space has also changed dramatically over a relatively short period. Rob Pemberton, head of fixed income at TD Asset Management in Toronto, notes the Canadian bond market has more than doubled in size in the last few years. At the same time, the growing corporate bond space has become more concentrated in triple-B bonds, which is a challenge for plan sponsors that rely on double-A credit for the discount curve, he adds.

Plan sponsors with long time horizons also face another hurdle around the high costs of ultra-long bond exposure, says Pemberton. While there's a growing supply of such bonds coming from the government of Canada, the provinces and even corporations, they're expensive, especially with rates at current low levels, he notes.

Despite the changes in the fixed-income space, allocations to bonds appear relatively stable, according to the most recent data from the Pension Investment Association of Canada's asset mix report. Between 2004 and 2014, the average exposure to Canadian nominal bonds inched down to 23.4 per cent from 27 per cent a decade earlier. Average exposure to foreign fixed income also remained low at 1.26 per cent in 2014 versus 0.8 per cent in 2004.

"When plan sponsors stick to the traditional model of 60-40 equities and fixed-income securities, it frankly beats me how they can justify the rationale," says Zev Frishman, chief investment officer at Morneau Shepell Asset and Risk Management Ltd. in Toronto. "Most pension funds have return targets they need to meet in order to meet their long-term going-concern liabilities."



Scott DiMaggio, CFA
AB, Director—Global Fixed Income and Canada Fixed Income

Q: WHY CONSIDER A BOND PORTFOLIO THAT INVESTS GLOBALLY?

Canadian pension funds have historically invested close to home, but with more than 16,000 issues in the Barclays Global Aggregate Index, fund managers are able to cast a wider net in a global fixed-income strategy.

The case for going global is multi-faceted: diversifying interest-rate and economic risk is important when business cycles, national growth rates, monetary policies and yield curves around the world are moving in different directions. But not just any global bond portfolio fits the bill.

Q: WHY AB'S CANADA CORE-PLUS?

For 17 years, AB's Canada Core-Plus Fixed Income Portfolio has taken a global approach that combines Canadian bonds with up to 50% exposure to non-Canadian securities. It's a research-driven portfolio construction that's designed to increase return opportunities in low-yielding environments through a globally diverse mix of issuers, reduce risk with more diversification and improve portfolio liquidity. These opportunities can range from investment-grade government and corporate securities to modest amounts of high-yield and emerging-market debt. And our foreign currency exposure is largely hedged back to Canadian dollars, which helps reduce volatility.

As economic and market conditions evolve, so do opportunities and risks. A global investment strategy that's actively managed is able to evolve with them. By investing globally, Canadian investors may be better positioned to cushion downside risk while capturing nearly all the upside potential of a domestic bond portfolio. We think that can make plans better-suited to meet retiree-benefit obligations.

The views expressed herein do not constitute research, investment advice or trade recommendations and do not necessarily represent the views of all AB portfolio-management teams.

Alex Johnson, *Head of Absolute Return Multi-Sector Fixed Income* & **Robert Brauns,** *CFA, Portfolio Manager, Absolute Return Fixed Income, FFTW, a subsidiary of BNP Paribas Investment Partners*

Q: How do Absolute Return strategies aim to deliver what they promise?

We define absolute return as a style of investing that can be used to deliver fixed income returns uncorrelated with market direction. Having this unconstrained approach offers the flexibility to build portfolios from all available fixed-income instruments, thereby maximizing diversification.

Our absolute-return approach targets global interest rates, foreign exchange, global credit, structured securities, emerging markets debt, etc. It contains virtually all of these themes at all times in a balanced way where no one theme dominates.

In our view, investors cannot insulate themselves from interest-rate risk completely. But what is completely avoidable is having their returns buffeted by changes in interest rates because the portfolio matches a given benchmark. Absolute-return fixed-income means pursuing a diversified set of opportunities in which investors can be long or short based on their conviction to help mitigate interest-rate risk.

Q: How does absolute return fit into a client's objectives?

The first and arguably most obvious application for investors is that freeing a portfolio return from an underlying beta is particularly appropriate if the investor is concerned that the market return will be anaemic or negative. While beta is usually positive, it may not always be. The Barclays US Aggregate Unhedged Index delivered negative total returns in 1994, 1999, and 2013. Indeed, periods such as the 1970s and the Volcker interest rate hikes of the early 1980s remind us that bond market underperformance can be structural and not merely a correction in a trend. With interest rates so low in much of the world, it is reasonable to ask whether a rising rate environment is imminent. Absolute return aims to deliver returns uncorrelated to this beta, giving investors the choice of whether they wish to be tied to this or not.

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Nowadays, most pension plans require real returns in the range of four to 5.5 per cent, he says. As a result, a plan sponsor with heavy exposure to more traditional long-term domestic bonds would have to set what Frishman calls "heroic" return targets from other asset classes like alternatives and equities to make it happen, he adds. "If you have a 30 per cent or 40 per cent allocation in an asset class yielding far below your return requirements, how will you meet your overall return target? Currently, real yields for Canadian government bonds are negative all the way to maturities of 10 to 11 years. Very long-term government of Canada real-return bonds yield about 40 [basis points]."

Rethinking the role of bonds

How should pension investors be responding to the changes? A first step is to think about the role, starting with liquidity needs, that bonds play in a pension portfolio. Pemberton sees more plan sponsors dividing their liquidity requirements into two buckets: one focused on near-term liquidity required to meet their ongoing obligations and another on longer-term needs over time. "In this longer-term bucket, plan sponsors are looking at private debt to enhance yield," he says.

While it's important to rethink the role fixed income plays in a pension portfolio, plan sponsors still have to find the bonds to do the job. "There is no free lunch when it comes to bonds, or any other asset class, for that matter," says Frishman, noting there are fixed-income securities that can add higher-than-expected returns and lower volatility.

There's a tradeoff, however. "Some securities might come with less liquidity," he says. For example, many commercial mortgages have good credit quality and can offer as much as 200 basis points or more above bond rates but are not actively tradable.

"If you can afford to have somewhat less liquidity and go down a little on the credit scale, there are opportunities to help meet ongoing requirements," says Frishman.

Some pension investors are already there. Jacques Marleau, deputy treasurer with the City of Montreal, says his plan began reducing exposure to bonds years ago, substituting other assets like infrastructure, global bonds, private debt and real estate. "A few years ago, due to the low interest rate environment, we reviewed our portfolio to introduce a core/satellite structure," he says.

"We now have a low-volatility component to give us liquidity and steady cash flow, enhanced by a global credit exposure."

For its part, the Healthcare of Ontario Pension Plan has a significant fixed-income exposure as part of its liability-driven investment strategy. While much of its bond holdings are meant to hedge the plan's liabilities, senior vice-president and chief investment officer David Long notes the plan also takes an active approach to fixed income, including global bonds.

"We trade a number of international markets on an active basis," he says, noting global bonds make a good deal of sense because they allow investors to take advantage of interest rates in various countries.

Josée Mondoux, director of investments for the Canadian Medical Protective Association, doesn't have the same constraints as a pension plan, but her fund is actively working to enhance its fixed-income exposure without increasing correlations to public equity markets. It's the same challenge that all plan sponsors face and one her organization has been working on since 2015.

"Our target return is 5.5 per cent," she says. "How do you achieve that given the current level of developed market bonds?" To maintain its risk and return targets, her organization revised its asset mix in 2012 to add exposure to emerging markets fixed income.

Today, it's looking at tactical and strategic positioning for its fixed-income portfolio, examining core-plus exposure to credit, including corporate bonds, high yield and collateralized loan obligations, or using a derivatives overlay strategy to maintain duration and yet reach for a higher value-added target, says Mondoux.

There's some risk, however. "If we add too much credit and move too far from a core bond portfolio, you can tip into equity-like risk," she says. "We don't want to lose the correlation benefits of fixed income."

High-yield conundrum

At a time when added returns are important, high-yield bonds are one area of fixed income that more and more plan sponsors now use. Cauberghs, however, sounds a note of caution around deteriorating fundamentals, looser covenants and heavy exposure to the U.S. and Canadian energy markets.

Long, however, notes that while yield spreads have been widening, there has been a rally recently that has benefited investors. "There is still some risk premium in high yield that might be worth accessing. It doesn't feel tremendously overpriced given the return," he says.

The big question facing investors today is what to do about rising interest rates. For plan sponsors with a heavy exposure to long-duration bonds, it's definitely important to understand and deal with that prospect. But it's a risk they have time to deal with, says Pemberton.

"This will be the loosest tightening cycle in the history of the U.S. Federal Reserve," he says. Still, plan sponsors should be educating themselves and their boards about the overall impact of rising rates over time. Being disciplined about developing a plan glide path will focus both sponsors and boards on the outcome, says Pemberton.

At the same time, there's a silver lining. "As interest rates rise, a plan's funded status can improve dramatically," he says. "You need to think about the whole plan." BC

Caroline Cakebread is a Toronto-based freelance writer.

Aubrey Basdeo
Head of Canadian Fixed Income, BlackRock

Q. As you look at the fixed income landscape going forward, what is your biggest concern?

A. In a phrase, suppressed yields. We are living in a low-growth world, and not just in Canada. Other economies are experiencing even more lacklustre growth, which is pushing their central banks to lower rates, which makes Canada and the U.S. even more attractive to global inflows, which suppresses yields here. You can see how it all follows. Over 25% of the bonds, or approximately $7 trillion USD, in the J.P. Morgan Global Government Bond Index are now offering negative yields, and it's not clear that even this highly exceptional monetary policy is achieving what it aims to do. As a result, we don't expect the low-growth/low-yield era to come to a close anytime soon.

Q. How should institutional investors respond to these pressures?

A. Investors should consider expanding their horizons. Granted, there's room to be constructive on sovereign bonds, as Canada and the U.S. will continue to look attractive compared to Europe or Japan, for example, where rates are in the red. As well, the high-yield market, though spreads have tightened recently, still offer attractive returns. But on the whole, we believe investors should look beyond traditional borders, both in geography and asset classes. International fixed income opportunities – for instance, in emerging markets – are likely to present themselves in this environment. Meanwhile, investors may find attractive and stable yields in alternative investments, like global real estate, infrastructure and private debt. If there ever was a time to be creative in fixed income, this is it.

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