T. Rowe Price®

Global Fixed Income Report

Canadian Defined Benefit Market
2019

For Accredited Investors Only. Not For Further Distribution.

Table of contents

Introduction 3
A look at the late-cycle environment 4
Asset allocation: current state of play 5
Digging into fixed income 5
  Looking back at the changes to fixed income (or lack thereof) 5
  Fixed income risk and reward 6
  Breaking down foreign fixed income 9
    What's next for Canadian plans? 11
    A closer look into emerging markets 12
Conclusion 12
Fixed income in action 13
  City of Montreal pension plans 13
  Halifax Port ILA/HEA pension plan 13
  Bruce Power pension plan 14

This research was conducted by the Canadian Institutional Investment Network/
TC Media and commissioned by T.Rowe Price.

COVER: 123RF STOCK PHOTO

T. Rowe Price®

Global Fixed Income Report

Canadian Defined Benefit Market
2019

Introduction

AFTER A DECADE of post–financial crisis monetary policy easing, fixed income markets are confronting many disruptive forces: interest rate and inflation uncertainty, geopolitical noise and a rise in overall risk and volatility.

As plan sponsors confront the late stages of the economic cycle, how have they positioned their fixed income portfolios for the future? Have portfolios and allocations changed to account for these factors, or is inertia holding firm, with plan sponsors either comforted by perceived safety or unclear as to which direction to turn? Is global diversification into emerging and other markets prudent or does a stay-the-course strategy win out? What are pension plan sponsors thinking about the future?

This survey looks at the intermediate plans of large Canadian defined benefit plan sponsors (with at least $500 million in pension plan assets) and their respective fixed income allocations.

Among the highlights, the biggest challenge defined benefit plans face is funded status volatility (38%). And 41% of plan sponsors said reducing equities and increasing fixed income is an effective strategy to protect their entire portfolio from volatility. Despite this acknowledgment of the importance of fixed income, defined benefit plan sponsors have not made drastic changes to their fixed income allocations.

There also appears to be bifurcation when it comes to how Canadian plans think about foreign fixed income versus how they act, the survey results show. Despite incorporating foreign equity into allocations, Canadians still report a home bias when it comes to fixed income investing, with only 4% of assets allocated to foreign fixed income. This is substantively lower than plans' foreign equity allocation.

This comes despite an acknowledgement of the potential benefits of going global. For example, looking forward, 28% of plans reported emerging market bonds as one of the top two fixed income categories that offer the best risk-return opportunities, and 25% reported global unconstrained bonds. Canadian bonds, on the other hand, accounted for only 9% of plans' combined top two choices, while Canadian core plus bonds ranked slightly better, with 16% reporting this in their total top two choices.

This acknowledgment about the risk-return opportunities of leaving Canadian borders has not led to action. Over the past three years, the majority of plans (59%) note they've seen no

Methodology: This survey includes respondents from 32 defined benefit plans. The majority of respondents (84%) had $1 billion or more assets under management in their pension plans. The minimum size plan had at least $500 million in assets under management. The mean funded status of the plans that responded was 98.7% as of September 30, 2018.

The research was fielded between December 21, 2018 and February 28, 2019. Thirty per cent of plans were from Ontario, 25% were from Western Canada, 22% were from Quebec, 19% were from Atlantic Canada and 6% didn't disclose. Most respondents who disclosed the information have been in the industry for over 11 years, with 47% indicating they have been working for 21 years or more.

Results may add up to greater than 100% when respondents were allowed to select more than one response, or when a single choice added up to more than 100% due to rounding.

change to their overall foreign fixed income allocation, whereas 28% have increased their overall fixed income allocation. As well, only 25% of plans are invested in emerging markets fixed income.

A look at the late-cycle environment

An extended investment cycle, persistently low interest rates relative to long-term historic norms and market volatility make for a difficult environment for plan sponsors.

Plan sponsors reported that the single biggest challenge facing their defined benefit plan is funding status volatility (38%), closely followed by meeting rate-of-return assumptions (31%), with solvency level requirements trailing behind at third (16%). These results are not particularly surprising, given the current market environment.

Watching how legislative developments across Canada influence investment choices will prove interesting, with recent solvency changes in Quebec and Ontario and the implementation of a requirement to fund a provision for adverse deviation, often called a funding cushion, in Ontario.

When it comes to addressing volatility, a plurality of plan sponsors (41%) said reducing equities and increasing fixed income are effective strategies to protect their entire portfolio from volatility. As well, 28% said using longer-duration fixed income is also an effective strategy (See Figure 1).

When asked, two-thirds (66%) concurred with the statement: “We have increased our focus on long duration.” The move to long duration may be explained by improved funded status, with plans wanting to protect funded status from future erosion.

In your opinion, which of the following strategies would be effective to help **protect your entire portfolio** from **volatility**?

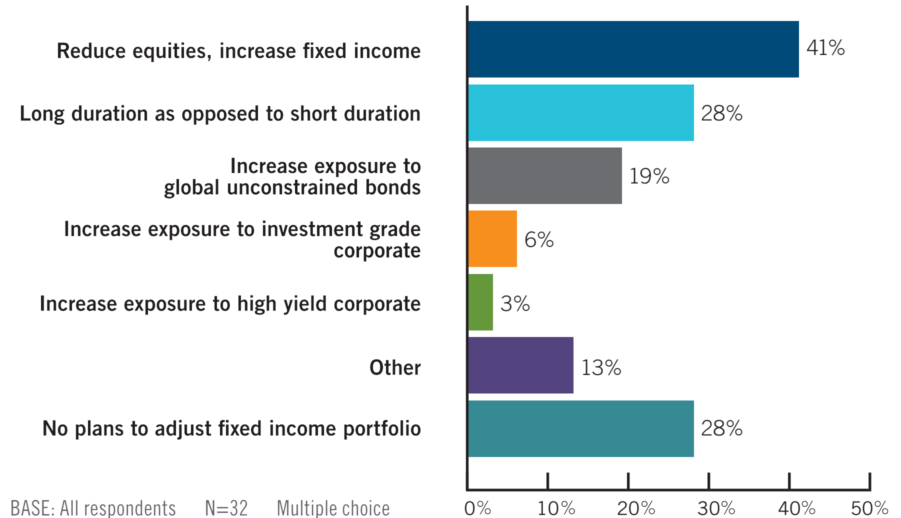


FIGURE 1

> An extended investment cycle, persistently low interest rates relative to long-term historic norms and market volatility make for a difficult environment for plan sponsors.

123RF STOCK PHOTO

Asset allocation: current state of play

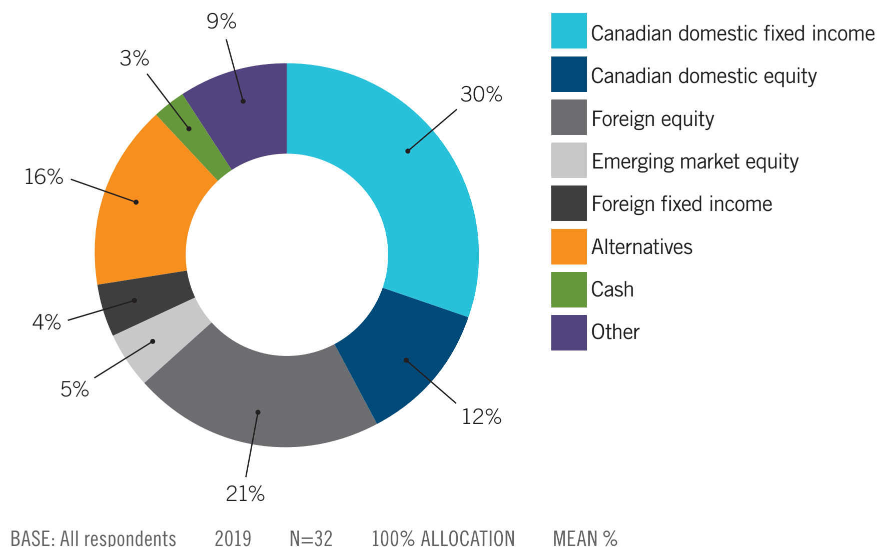
When breaking down the average asset allocation of the plans surveyed, 34% of assets are allocated to fixed income, with 88% of that invested in Canada. Of the plans surveyed, an average of 38% is allocated to equities, with foreign equity at 21% and Canadian equity at 12%. Aside from fixed income and equities, plans have an average of 16% allocated to alternatives and 3% to cash (See Figure 2).

Interestingly, over the past 20 years, U.S. and Canadian pension plans have had almost identical allocations to their own domestic fixed income, according to 2017 research by Willis Towers Watson. However, the U.S. bond market has a lot more diversity than what Canada provides, and therefore the home country bias may be justified in the U.S. That being said, over the past five years U.S. investors have begun increasing their global bond allocations.

When it comes to risk, 66% of plans have reported becoming more risk aware in their asset allocation. Of these, 71% report they are doing so by de-risking their portfolios, 19% are moving to risk factor allocations and 14% are annuitizing their portfolios.

This move to de-risking is not surprising, as many corporate pension plans in Canada have been looking to take risk off their balance sheets and increase focus on their core business. In fact, 2018 was a record year in Canada for institutional annuity purchases, which reached $4.6 billion according to data from LIMRA Secure Retirement Institute.

In your DB pension, what is your current asset allocation in the following asset classes? (To the best of your recollection)



BASE: All respondents 2019 N=32 100% ALLOCATION MEAN %

FIGURE 2

Digging into fixed income

Looking back at changes to fixed income (or lack thereof)

When asked what significant changes were made to their fixed income portfolios in the past three years, 38% of large DB plan sponsors reported not making any changes.

Approximately 3 in 10 (28%) respondents indicated they reduced equities and increased fixed income, while 31% reported increasing the duration of their fixed income.

This is aligned with the idea that plans are looking to de-risk their portfolios, and those with strong funding positions may want to lock in their gains by moving to longer-duration bonds.

As well, 19% reported increasing investment-grade corporate fixed income, while 13% said they have moved domestic assets to foreign fixed income.

Fixed income risks and reward

The majority of plan sponsors (58%) agreed with the statement that fixed income investments will play a more important role in the near future than in the past five years. And, as seen earlier, the plans reported that an average of 30% of their portfolios are allocated to Canadian domestic fixed income and 4% to foreign fixed income.

From a capital market perspective, plan sponsors indicate that the top risks facing their fixed income portfolio are duration risk (34%), followed by geopolitical risk (19%) and inflation risk (13%) (See Figure 3).

The significant focus on duration may relate to plan liability exposure and the uncertain interest rate environment, which can have a big effect on bond portfolios. It also likely relates to plans' liability exposure as plans manage the interplay between assets and liabilities.

While geopolitical risk was top of mind, this may be more of a knee-jerk reaction than an actual factor influencing fixed income; because geopolitics is consistently in the news, it could result in a perception that it is a top risk. However, in reality, it may be that all the noise around geopolitics heightens a sense of perceived risk. Geopolitical risk may also be ranked high because there is not a lot of clarity on the outcomes or how plan sponsors could address these risks, even if they desired to make an adjustment.

When looking at the combined results of the top two risks, duration risk still leads at 47%, followed by credit risk at 44%. Interestingly, credit risk ranked as the number-one risk for only 9% of respondents.

Credit generally has done well and has been supported by sound fundamentals, which may explain its popularity with respondents. For instance, according to J.P. Morgan 2018 fourth quarter data, interest coverage ratio data for investment grade and high-yield issuers were approximately 10 times and 5 times, respectively. This indicates that issuers' debt-funding capacity remains resilient. This may mean credit is not top of mind as a risk, but it is on plan sponsors' radars because credit risk always bears monitoring.

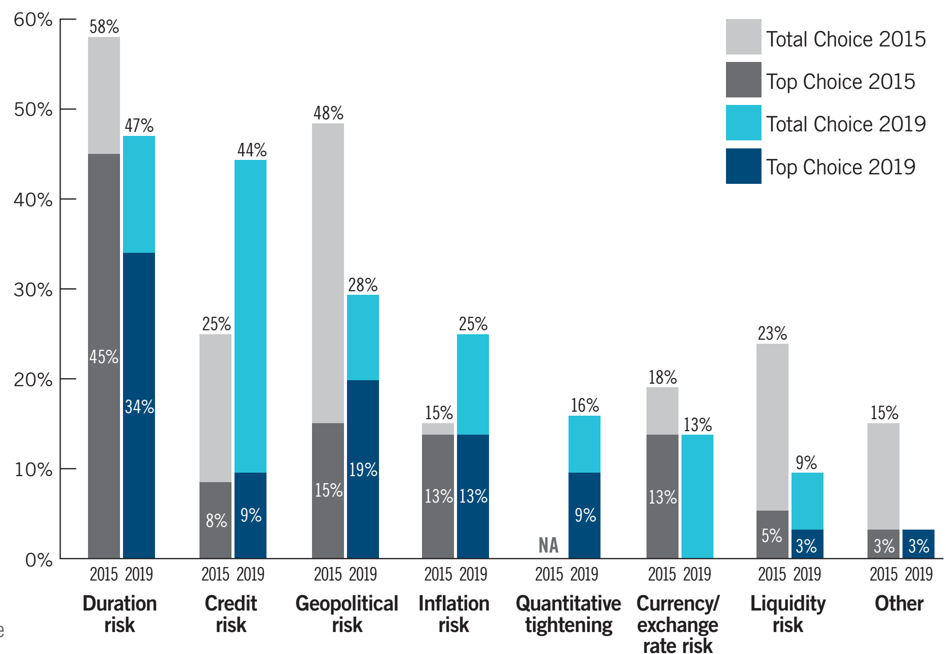
Looking forward, plans report the top two combined fixed income categories that offer the best risk-return opportunities are investment-grade corporate bonds (31%), followed by emerging market bonds (28%), global unconstrained bonds (25%), high-yield corporate bonds (25%) and long-duration bonds (22%) (See Figure 4).

While high yield ranked near the top of respondents' combined choice, it was chosen by just 3% as their number one choice. This indicates the importance of the asset class, although plan allocations may attempt to be more tactical even though the data indicates that perhaps a more permanent high-yield allocation is warranted.

The choice of investment grade as the best risk-return opportunity may be explained by plans' desire to dial down risk. However, it seems surprising that high yield did not rank higher since the yield currently offered, at approximately 7%, is quite compelling compared to government-related securities. One potential explanation is that the high-yield companies are more leveraged and therefore potentially exposed to

FIGURE 3

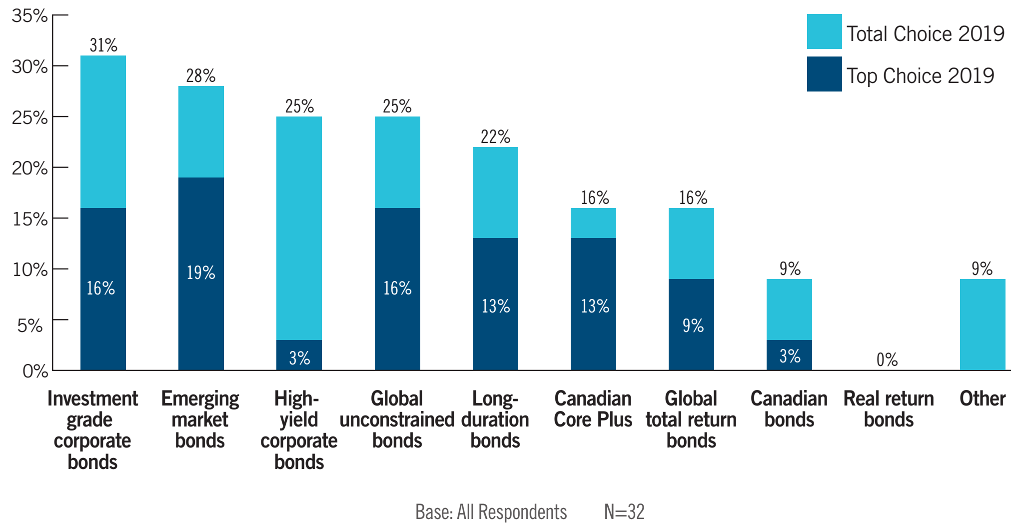
From a **capital market perspective,** which of the following are the **top two risks** facing your fixed income allocation?



NOTE: In a Top 2 ranked question, we asked respondents for up to 2 responses in order of importance. Top Choice is the proportion who ranked a category as Number 1. Total Choice is the combined proportion who ranked the category as 1 or 2 (i.e. Ranked 1 + Ranked 2).

FIGURE 4

Thinking about the next three years, what do you consider as the top two fixed income categories that offer the best risk-return opportunities?



downdrafts in fundamentals, so plans could be cautious on the risk side.

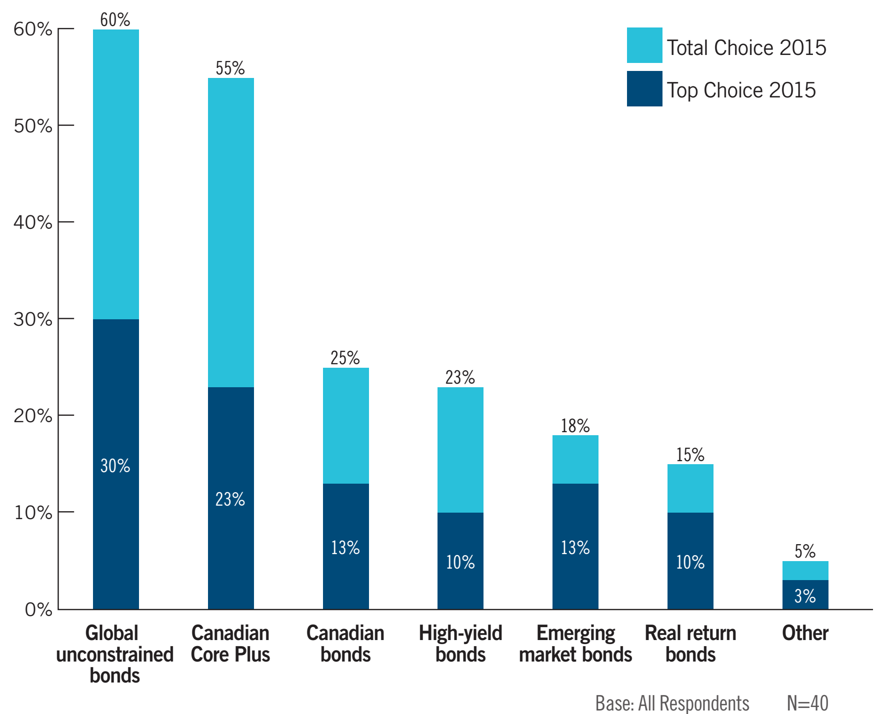
Canadian fixed income ranked lower among respondents, with 16% including core plus in their top two choices (including 13% who listed it as their number one option). As well, Canadian bonds were chosen by only 9% as one of their total top two selections, and just 3% as their number one option.

Not surprisingly, Canadian bonds are ranked low in terms of offering the best risk-return opportunities. This further hits home that while plans' expectations for Canadian bonds are low, there seems to be a disconnect with their actions, as this is where they are predominantly invested in the fixed income space.

In a 2015 T. Rowe Price research report on Canadian defined benefit fixed income allocations, plans were asked which two fixed income categories offered the best return opportunities over the next 12 months. Of the respondents, 25% selected Canadian bonds in their top two choices, with 13% selecting it as their number one option. Further, 55% ranked Canadian core plus bonds in their top two choices, including 23% ranking it their number one choice (See Figure 5).

FIGURE 5

How does this compare to 2015? We asked: Thinking about your near-term outlook **over the next 12 months**, what do you consider the **top two fixed income categories that offer** the best **return** opportunities?



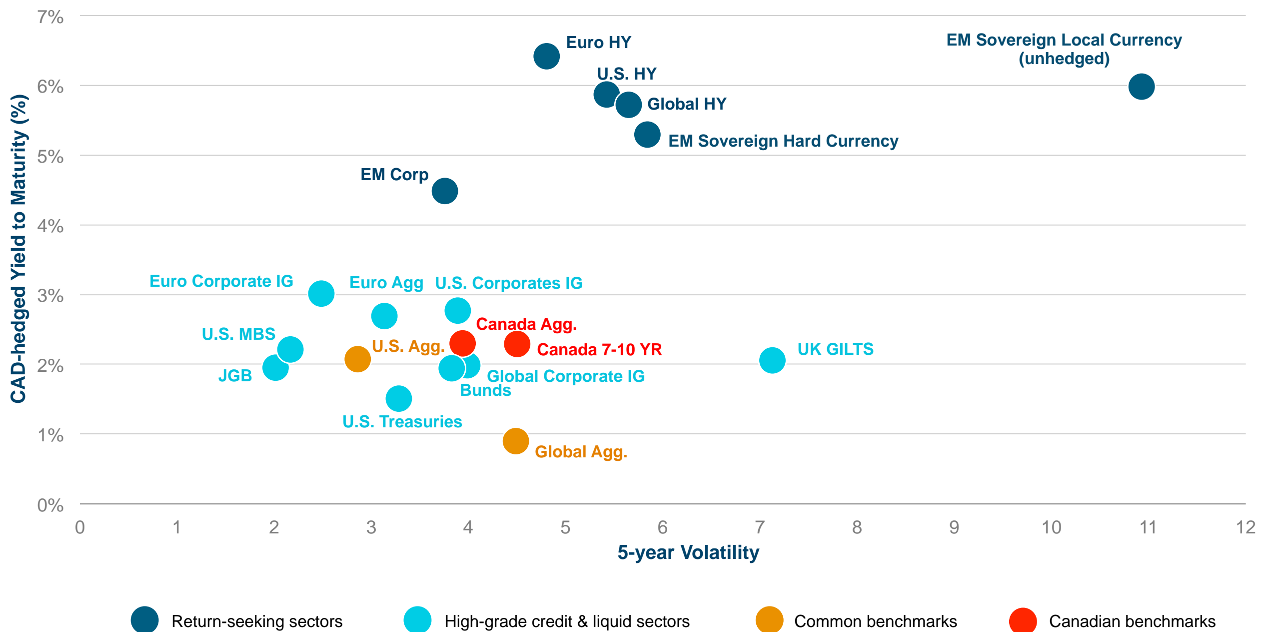
Cast a wider net for fixed income sector opportunities

It may be time for plan sponsors to shift how they think about high yield, viewing it as a de-risking tool rather than one that adds risk. Over the past 10 years, the J.P. Morgan Global High Yield Index has delivered annualized equity-like returns of 11.4%, compared to the S&P 500 return of 13.1% and the AC World Index return of 10.1%, with approximately half the volatility of equities. This leads high yield to deliver a higher Sharpe ratio of 1.5 versus the S&P 500 of 0.9 and MSCI World of 0.7. For plans looking for ways to maintain return potential while reducing risk, high yield may be a good replacement for a straight equity-like position and be a risk-reducer from a portfolio perspective.

As evident from the following chart, the higher yield bonds (y axis) capture the additional yield and return opportunity, without significant increases to volatility. The high-yield opportunities also provide additional diversification benefits to a portfolio.

DIVERSIFICATION OF BOND OPPORTUNITIES

As of 29 March 2019



Past performance is not a reliable indicator of future performance.

Volatility is standard deviation of monthly returns over the 5-year period. Sources: Bloomberg Barclays, J.P. Morgan Chase & Co., and T. Rowe Price. All indices used are Bloomberg Barclays except for the Emerging Markets indices and Canadian HY Index. Source for EM Indices: EM Sovereign Hard Currency: J.P. Morgan Emerging Market Global Diversified Bond Index; EM Corporates: J.P. Morgan CEMBI Broad Diversified; EM Sovereign Local Currency: J.P. Morgan GBI EM GD Index. Source for Canada HY: S&P; S&P Canada High Yield Corporate Bond Index. Yields are hedged using 3 month forward implied yields. EM Local yield is unhedged.

Source for Bloomberg Barclays index data: Bloomberg Index Services Ltd. Copyright© 2019, Bloomberg Index Services Ltd. Used with permission.

Breaking down foreign fixed income

When asked how they separate their foreign fixed income portfolio, Canadian defined benefit plans with these types of investments said they use the following top "buckets": global unconstrained bond portfolios (31%), emerging market bond portfolios (25%), investment-grade corporate bonds (13%) and opportunistic/private credit portfolios (13%). One-quarter (25%) indicated they do not have separate buckets for their foreign fixed income allocations (See Figure 6).

Global unconstrained bond portfolios are popular because they are more flexible; they can be of short or long duration, contain credit and have more securitized assets. However, it's important to recognize that unconstrained strategies can vary significantly in terms of portfolio construction and parameters.

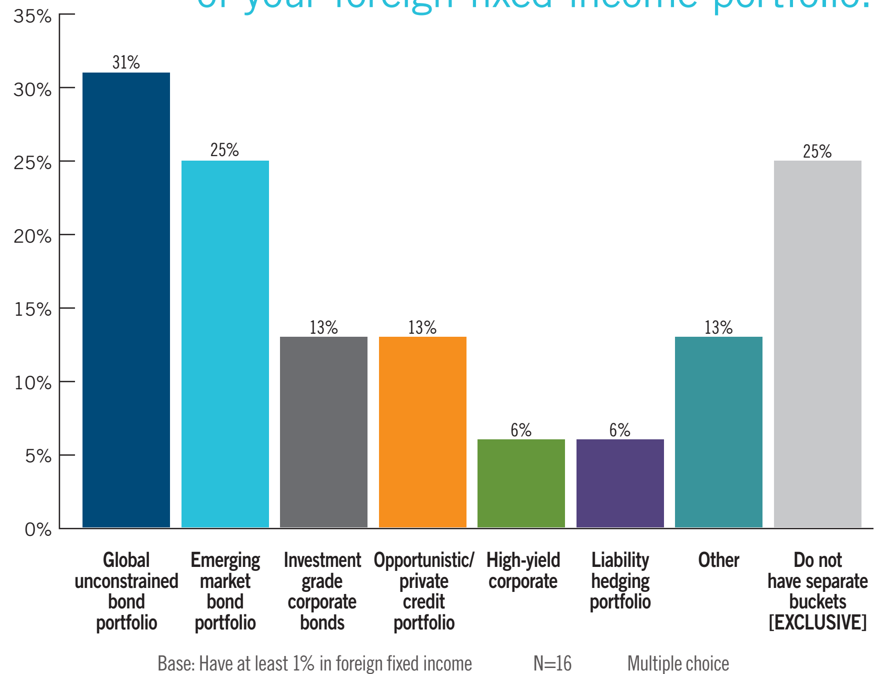
Over the past three years, 59% of plans note they have had no change to their overall foreign fixed income allocation, whereas 28% have increased their overall allocation to foreign fixed income. This movement to global fixed income is an appropriate and prudent re-allocation and consistent with what we think will take place in the coming years.

When asked what drives changes to foreign fixed income allocations, most respondents cited seeking higher returns as the top choice (34%), followed by de-risking (16%) and increasing diversification (13%).

When looking at the combined top three selections for what drives changes to foreign fixed income asset allocation, the top choice remains seeking higher returns (50%), followed by increasing diversification (44%) and de-risking (41%). Capturing tactical opportunities also ranked high (22%) (See Figure 7).

FIGURE 6

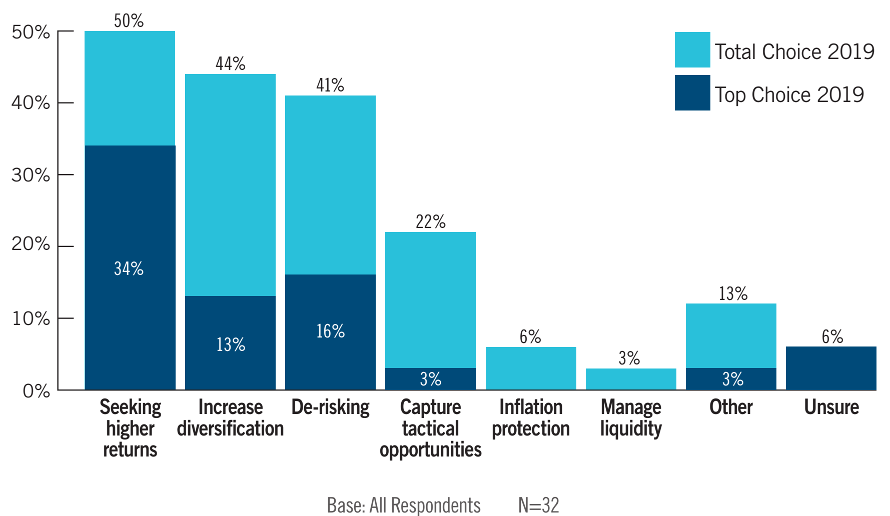
What are the primary buckets of your foreign fixed income portfolio?



Base: Have at least 1% in foreign fixed income N=16 Multiple choice

FIGURE 7

What are the primary factors driving these foreign fixed income asset allocation changes?



Base: All Respondents N=32

NOTE: This is a Top 3 ranked question. In a Top 3 ranked question, we asked respondents for up to 3 responses in order of importance. Top Choice is the proportion who ranked a category as Number 1. Total Choice is the combined proportion who ranked the category as 1, 2 or 3 (i.e. Ranked 1 + Ranked 2 + Ranked 3).

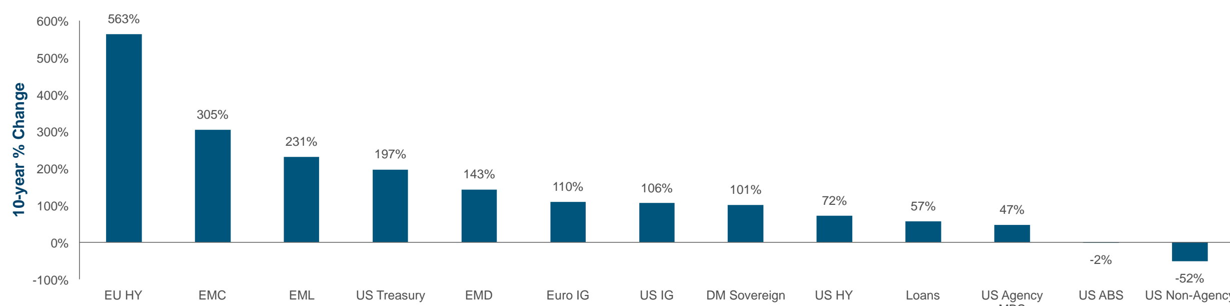
Global fixed income: broad and growing opportunity set

The ability to invest across geographies and throughout the capital structure can produce more diversified risk-managed portfolios.

For plans that have not recognized these benefits and have not made the foray into foreign fixed income, it may be important to realize that foreign fixed income is not as complex as it may seem and there has been tremendous growth in the foreign fixed income opportunity set.

GROWTH IN FIXED INCOME MARKETS

As of 31 December 2018



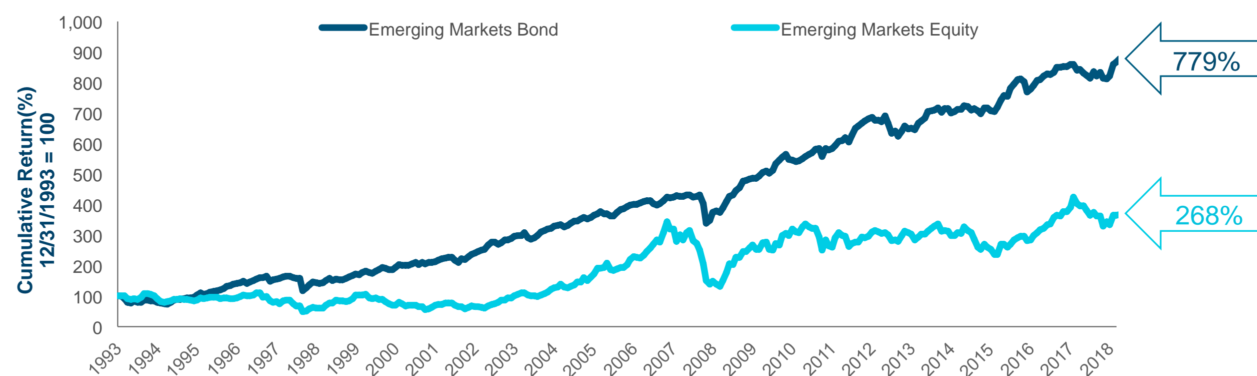
(In CAD Trillions)

	EU HY	EMC	EML	US Treasury	EMD	Euro IG	US IG	DM Sovereign	US HY	Loans	US Agency MBS	US ABS	US Non-Agency (CMBS & RMBS)
12/31/2008	0.12	0.74	1.23	7.16	0.62	1.23	4.57	20.99	1.11	1.06	7.78	2.22	3.95
12/31/2018	0.82	3.00	4.09	21.28	1.50	2.59	9.41	42.14	1.91	1.66	11.46	2.18	1.91

LONG-TERM CUMULATIVE RETURNS IN EMERGING MARKETS

As of 31 March 2019

As seen below, allocations to emerging markets bonds have demonstrated higher, more consistent returns over time than emerging markets equities.



Past performance is not a reliable indicator of future performance.

Sources: J. P. Morgan, T. Rowe Price, SIFMA, Credit Suisse. US Treasury, US ABS, US Non-Agency (CMBS & RMBS) and US Agency MBS are from SIFMA (www.sifma.org/resources/research). EMC, EMD, and US IG are from J.P. Morgan. EML is a T. Rowe Price internal estimate of the actual investable EM Local universe. Developed Sovereigns is the BBgBarc Global Treasury and Government Related Index. Euro IG is the BBgBarc Euro Aggregate: Credit Index. US HY, EU HY, and Loans are from Credit Suisse.

Values were converted to CAD using historical spot rates (1.2345 as of December 31, 2008 and 1.3638 as of December 31, 2018). Bloomberg Barclays index data: Bloomberg Index Services LTD. Copyright 2019, Bloomberg Index Services Ltd. Used with permission.

Source: JP Morgan, MSCI. Data analysis by T. Rowe Price. EM Bond is based on the JP Morgan EMBI Global Diversified Index. EM Equity is based on the MSCI Emerging Markets Index.

What's next for Canadian plans?

Thinking longer term, respondents were asked what their expected asset allocation changes are for certain foreign fixed income categories over the next one to three years.

55% of respondents who reported the category is applicable to their situation indicated they expect some increase to their opportunistic and private credit (including 10% who expect a significant increase of at least 5%), while 45% said they expect no change.

Looking at other categories, 38% expect increases to their long duration, with 52% indicating no change and 9% expecting to decrease this. When it comes to short duration, most plan sponsors invested in this asset class are not planning changes (86%), with 10% anticipating decreases and 5% reporting expected increases.

Regarding investment-grade corporate bonds, 37% indicated an expected increase in investments, while 45% anticipate no change. Only 4% expect a decrease.

A majority reported not expecting changes to their investments in global unconstrained bond portfolios (71%), emerging market bonds (71%), high-yield corporate (76%), liability-hedging portfolio (70%) or short-term durations (86%).

Looking forward, most plans (63%) disagreed with the statement that they will move some domestic assets to foreign fixed income in the next one to three years, compared to approximately one-third who agreed (34%).

So why are some Canadian plans still not diversifying globally?

According to respondents who are currently not invested in foreign fixed income, the top challenges facing plan sponsors with implementation of such strategies in their portfolios are the return is not worth the effort (19%) and a lack of knowledge and experience (19%), trailed closely by currency hedging policy (16%).

While the top choice is split, when looking at respondents' top three combined responses, currency-hedging policy leads the way (38%), followed by return not being worth the effort (34%), investment policy statement (31%), lack of knowledge and experience (31%), and expense (31%) (See Figure 8).

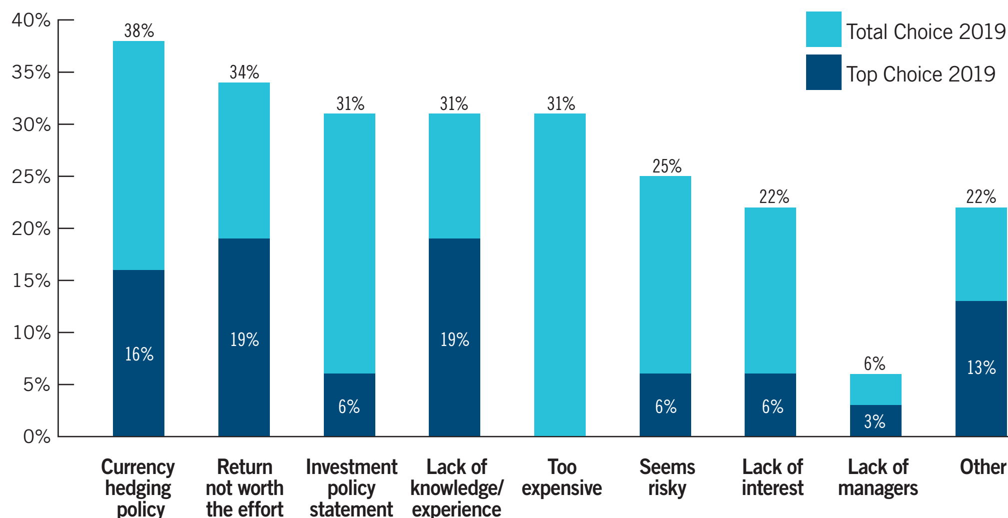
For plans that don't use currency hedging, it isn't as complex or costly as they may think, and the benefits are real. Foreign bonds often appear to yield less than Canadian bonds at first blush, but often can yield more when hedging is utilized.

Of note, while investment policy statement was 31% of respondents' total top three challenges, it was selected by just 6% as their number one challenge. Further, while being too expensive was also cited by 31% of plans as one of their top three challenges in implementing foreign fixed income in their portfolio, no respondent cited it as their number one challenge.

These rationales listed by Canadian plans can all be addressed through increased education about the benefits of foreign fixed income, which may mean that more asset managers need to proactively fill the gap and pass on information to plans to help address these hesitations (See Page 10).

FIGURE 8

In your opinion, what is the biggest challenge with implementing foreign fixed income in your portfolio?



Base: All Respondents N=32

A closer look into emerging markets

Most plan sponsors who took the survey (66%) don't have fixed income holdings in emerging markets, while just 25% reported they do.

Compared to 3% of plans reporting they were considering fixed income holdings in emerging markets, when asked directly, 31% said they are likely to invest in emerging markets over the next three to five years, while 51% said not likely, and 19% were not sure or didn't answer. Of those who said they are likely to invest in these markets, the intensity is high at 22% being very likely (See Figure 9).

Of note, 88% of respondents that said they are likely to invest in emerging markets over the next three years are already invested there, compared to 15% that are not currently invested in these areas.

Paradoxically, as mentioned previously, plans indicted that looking forward, the top two fixed income categories that offer the best risk-return opportunities are investment grade corporate bonds (31%) followed by emerging market bonds (28%). One-third (33%) of those who list emerging market bonds as one of their top two best risk-return opportunities is not currently invested there.

Further evidence of the potential benefits of emerging markets can be seen in the 'Cast a wider net' chart (See Page 8), where over the past 5 years (as of 29 March 2019), emerging market investments have provided a much higher yield than more traditional strategies while also carrying an overall investment grade rating. For example, the 2.6% yield of the Canadian Aggregate pales in comparison to the 4.5-6% yields from emerging market opportunities. For underfunded plan sponsors, this may be a way to meet plan assumptions with minimal to moderate increases in risks levels, depending on the strategy chosen.

In the next three to five years, do you anticipate investing in emerging markets?

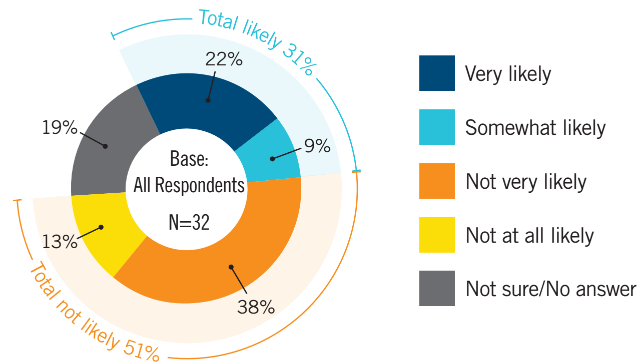


FIGURE 9

> For underfunded plan sponsors, this may be a way to meet plan assumptions with minimal to moderate increases in risks levels, depending on the strategy chosen.

Conclusion

While in the past few years, plans don't seem to be making drastic changes in the fixed income space, there is an acknowledgement of the importance of fixed income as a tool to combat plan challenges like volatility. Pension executives will need to be more nimble and adaptive moving forward, untethering from traditional allocation bias when it comes to Canadian fixed income.

In addition, Canadian DB Funds are beginning their transition to global fixed income sectors as they understand the diversification benefits of these global sectors. But it's still early days.

Adding a foreign component to plans' fixed income portfolio can be both a diversifier and a yield enhancer – an opportunity set that Canadian plans may be missing.

So what can help Canadian plans get more comfortable with the foreign fixed income space? Education. It's time for investment managers and industry players to step up to increase information about how foreign fixed income can benefit Canadian plans. Building this comfort level may help make Canadian plans more open to looking beyond domestic markets in their bond portfolios.

Fixed income in action

Using fixed income for stability and cash flow in the City of Montreal

The City of Montreal has six pension funds, with assets under management of around $8.5 billion. The main role fixed income plays is providing stability to the assets, says Jacques Marleau, deputy treasurer with the city.

Fixed income is also key to providing a steady cash stream because the plan is very mature and must pay large benefits to pensioners, he adds.

The plan's target asset mix is around 53% equities, 31% fixed income and 16% alternatives. "The main objective with respect to that component of the portfolio is stability, a good cash flow, less risk I would say than some other assets," Marleau says.

The City of Montreal is currently reviewing its asset mix and expects to maintain its fixed income allocation, but also increase alternatives. "We want some stability [in] the pension plan assets, but we don't have the feeling that with the traditional bond market we will have enough returns, so we increased the alternative component," he adds.

When it comes to fixed income, the plan is exposed to credit around the globe. It also uses both active and passive strategies. "Most of our government exposure is more passive and our corporate exposure in Canada is active," says Errico Cocchi, head of pension investments and debt financing at the City of Montreal. "And then, [let's] call it the satellite part, that's where we have different global mandates, so unconstrained, credit, we have some private debt, we have bank loans, we have mortgages."

The City of Montreal plan also uses fixed income for diversification. "The Canadian market, especially on the credit side, is quite narrow," says Cocchi. "I mean it's very limited with diversification, so we have banks, we have some pipelines and there's not a lot of diversity in the fixed income landscape on the corporate side. So obviously you want to look elsewhere for diversification."

As well, the plan acknowledges that entering emerging markets makes sense. "Besides the U.S., I'm not sure where else you would go because the rates are low everywhere else in the world except emerging markets," Cocchi says. "So U.S. emerging markets would probably make sense if you have the right managers and you're comfortable with the risk."

Many plans in the survey cited lack of expertise as a barrier to going global, but for the City of Montreal, this isn't an issue, as it uses external managers instead of managing this in house, Marleau says. "We have a strong process to find good managers, so for us, it was not a big issue."

The City of Montreal plan has always been risk-aware, says Cocchi. "I don't think we're more or less, we're really just looking at it in a different way. . . I think right now since we're pretty much at the end of a cycle, it's important to be nimble, to be dynamic and really know what our portfolio is exposed to on the risk side."

Going forward, Cocchi says private debt might offer the best risk-return opportunity because government bonds are expensive and credits are tight. "Pretty much everything is expensive right now, so [in] the private debt space, at least you get a little bit of pickup on the yield, but it's a tough environment in fixed income, so you have to be a bit more tactical right now and not really be a buy-and-hold manager within the fixed income market."

Avoiding white water turbulence with the Halifax Port ILA/HEA pension plan

For the Halifax Port ILA/HEA pension plan, fixed income plays a role for providing diversification, says Blair Richards, chief executive officer of the plan, which currently has around $57 million in assets under management.

However, he notes the weighting to fixed income has been reduced because of expected returns. "We don't need it for liquidity, we don't need it for return," he says. "We actually employ it because of its qualities with respect to the liabilities, but the reduced allocation has everything to do with the fact that expected return around our duration is less than our break-even requirements."

The fixed income reductions have been slow over the past 10 years, Richards notes, and it now sits at 38% of its asset allocation.

When the plan shifted out of fixed income, the funds were reallocated to alternatives, he adds. "Although we weren't happy with expected return, we weren't willing to take on the risk of equities because we just didn't need it in that DB portfolio."

Richards also made the move from passive to active fixed income management and keeps the plan's allocations mostly domestic, he says. "We calculate the duration of our liabilities quarterly, and we artificially mix mid- to long-term bonds to match that duration. So the fixed income portion still moves in a correlated manner with the duration of our liabilities."

When the foreign property rule was eliminated, Richards says the plan wanted to find higher returns than the index; unconstrained fixed income was appealing, and they were willing to swap market risk for manager risk. "In other words, we gave our money to people who could go anywhere and do anything within the fixed income space and rely on their skill to extract a higher return out

of the same fixed income space than you would get from a simple index product."

However, most of the plan's fixed income is still Canadian. "Even though there's a lot of opportunity, we gave some serious time to examining what was out there, so [with] high yield, emerging markets, we liked the returns [but] we didn't like the volatility. We concluded that we simply didn't need to take on that risk, that what we were doing could be accomplished with money that's close to home."

Staying close to home also eliminated other variables from the equation, like currency and geopolitical considerations and volatility of returns. "I run a pension plan, I like the smooth upward track. And so, I'm trying to avoid categories that are going to potentially create that," Richards says. "I'd love to have the higher returns too, but I'm not willing to trade off what could be the downside for that upside because quite frankly I don't need it."

Richards also notes that high yield isn't appealing because of the volatility. "Yes, we know there are places we could make more money. But as you know, there are two sides to that coin. You're going to take on more expected return, you're going to take on more risk. And we simply haven't been willing to take on more risk, or at least not much more."

"Yes, we know there are places we could make more money. But as you know, there are two sides to that coin. You're going to take on more expected return, you're going to take on more risk. And we simply haven't been willing to take on more risk, or at least not much more."

– Blair Richards, Halifax Port ILA/HEA pension plan

Keeping its eye on the liabilities at the Bruce Power pension plan

The Bruce Power pension plan, which has about $4.5 billion in assets, uses fixed income as an anchor for the pension liabilities, says Simon Fréchet, chief investment officer at the plan.

With a 40% allocation to fixed income, about 30% of that is allocated to long bonds and 10% is allocated to real return bonds.

"We're all passive too, so we don't use any active investments on the fixed income side," he says, noting the return-seeking assets are separate.

The plan's approach to fixed income has remained stable over the past few years, with the only change being allocating some funds to real return bonds several years ago. "It was more to do with our liabilities because we're a fully indexed plan and we saw that there were benefits to holding some real return bonds for the inflation protection if you will," he notes.

Fréchet notes that duration risk is important to consider because if interest rates rise, bonds with long duration will go down, which will impact the bond portfolio and real return funds. "But I'm less fussed about that because ultimately our liabilities will go down by a greater extent."

From a fixed income perspective, the Bruce Power plan also is invested fully in Canada, which Fréchet credits to the need to match the liabilities on a solvency basis. "As long as solvency valuations exist, it makes more sense to hold Canadian bonds . . . the interest rate that's used to discount solvency liabilities is, I guess to a certain degree, pegged to Canadian instruments."

He also notes that over the long term, the plan sponsor didn't see the benefit of exposing the plan to another country's rate cycle, currency risk and political risk. "There's a plethora of additional things that we would have to consider, which we don't think would be beneficial [at this point]."

At Bruce Power, they've always been risk-aware, Fréchet says. "We conduct asset-liability studies very diligently every three years, and part of that exercise is to understand the difference between return seeking and non-return seeking assets and what that means [to the plan]. But ultimately, our asset-allocation decisions are driven by our corporate objectives. We look closely at the pension plan's impact on the business, so that's really what drives our allocation."

Fréchet notes the plan is shifting to real assets, particularly a combination of real estate and infrastructure. "We're actually taking the allocation 50% out of bonds and the other half out of equities," he says, highlighting that there's probably more downside risk to bonds in the short- to mid-term and that the plan wants to benefit from the de-risking exercise on the equity side.

123RF STOCK PHOTO

IMPORTANT INFORMATION

This material is being furnished for general informational purposes only. The material does not constitute or undertake to give advice of any nature, including fiduciary investment advice, and prospective investors are recommended to seek independent legal, financial and tax advice before making any investment decision. T. Rowe Price group of companies including T. Rowe Price Associates, Inc. and/or its affiliates receive revenue from T. Rowe Price investment products and services. **Past performance is not a reliable indicator of future performance.** The value of an investment and any income from it can go down as well as up. Investors may get back less that the amount invested.

The material does not constitute a distribution, an offer, an invitation, a personal or general recommendation or solicitation to sell or buy any securities in any jurisdiction or to conduct any particular investment activity. The material has not been reviewed by any regulatory authority in any jurisdiction.

Information and opinions presented have been obtained or derived from sources believed to be reliable and current; however, we cannot guarantee the sources' accuracy or completeness. There is no guarantee that any forecasts made will come to pass. The research was fielded between December 21, 2018 and February 28, 2019, data is therefore accurate as at that date. The views contained herein are as of the date of this presentation and are subject to change without notice; these views may differ from those of other T. Rowe Price group companies and/or associates. Under no circumstances should the material, in whole or in part be copied or redistributed without consent from T. Rowe Price.

The material is not intended for use by persons in jurisdictions which prohibit or restrict the distribution of the material and in certain countries the material is provided upon specific request. It is not intended for distribution to retail investors in any jurisdiction.

Issued in Canada by T. Rowe Price (Canada), Inc. T. Rowe Price (Canada), Inc.'s investment management services are only available to Accredited Investors as defined under National Instrument 45-106. T. Rowe Price (Canada), Inc. enters into written delegation agreements with affiliates to provide investment management services.

© 2019 T. Rowe Price. All rights reserved. T. ROWE PRICE, INVEST WITH CONFIDENCE, and the Bighorn Sheep design are, collectively and/or apart, trademarks of T. Rowe Price Group, Inc. 201904-815832

ADDITIONAL DISCLOSURES

Bloomberg Index Services Limited. BLOOMBERG® is a trademark and service mark of Bloomberg Finance L.P. and its affiliates (collectively "Bloomberg"). BARCLAYS® is a trademark and service mark of Barclays Bank Plc (collectively with its affiliates, "Barclays"), used under license. Bloomberg or Bloomberg's licensors, including Barclays, own all proprietary rights in the Bloomberg Barclays Indices. Neither Bloomberg nor Barclays approves or endorses this material, or guarantees the accuracy or completeness of any information herein, or makes any warranty, express or implied, as to the results to be obtained therefrom and, to the maximum extent allowed by law, neither shall have any liability or responsibility for injury or damages arising in connection therewith.

Information has been obtained from sources believed to be reliable but J.P. Morgan does not warrant its completeness or accuracy. The index is used with permission. The Index may not be copied, used, or distributed without J.P. Morgan's prior written approval. Copyright © 2019, J.P. Morgan Chase & Co. All rights reserved.

The "S&P Canada High Yield Corporate Bond Index" is a product of S&P Dow Jones Indices LLC, a division of S&P Global, or its affiliates ("SPDJI"), and has been licensed for use by T. Rowe Price. Standard & Poor's® and S&P® are registered trademarks of Standard & Poor's Financial Services LLC, a division of S&P Global ("S&P"); Dow Jones® is a registered trademark of Dow Jones Trademark Holdings LLC ("Dow Jones"). T. Rowe Price's products are not sponsored, endorsed, sold or promoted by SPDJI, Dow Jones, S&P, or their respective affiliates, and none of such parties make any representation regarding the advisability of investing in such products nor do they have any liability for any errors, omissions, or interruptions of the "S&P Canada High Yield Corporate Bond Index."

T.RowePrice®