Fixed Income REDEFINED

Plan sponsors must rethink the role of their bonds, but it's a hard, slow road.



> Plan sponsors can no longer sit back and ignore the 40% of their portfolio that is dedicated to fixed income assets. That was the view of participants at our fixed income roundtable, which featured representatives from the money management and plan sponsor side of the pension industry sharing their views on this rapidly changing asset class. Plan sponsors today have to rethink their fixed income allocations in the face of historically low interest rates and volatile equity markets. They want their bonds to work harder and add value while continuing to provide a sound foundation for the pension fund as a whole—kind of like stepping on the gas and the brake at the same time, according to one participant. Call it a sea change in the fixed income landscape that has plan sponsors asking their fixed income managers to do two things at once. But for pension funds to fully embrace the host of new opportunities in the evolving fixed income space, it's going to take baby steps and a lot of board education. Yes, change is on the way—but it's going to take some time.

Ten or fifteen years ago, the fixed income side of the Canadian pension business was a pretty sleepy affair. You had long-term Canadian government bonds and that was pretty much it. How has that changed?

Jean Charbonneau: Two major changes have occurred in the fixed income space in the last five to ten years. The first is the surge of emerging markets, which will continue to be a tremendous source of growth over the next few years. Emerging markets have brought more breadth to the fixed income space. The second big change is the growth of the high yield bond market and the subsequent removal of the "junk bond" label. This is now an asset category that must be looked at seriously by plan sponsors.

Todd Parsons: Derivative products have added a new dimension of risk and reward to the fixed income space. Managers need to understand these new tools and the options they provide in order to better manage risk for clients as they provide further options to tailor a portfolio to client's objectives and risk tolerances. For



example, they can be used to gain a more desirable duration for portfolios along the yield curve. There are also far more credit products available.

Michael Taylor: Debt issuance patterns have changed fixed income markets. For example, we've seen significant growth in issuance from emerging markets, especially emerging markets' corporate debt. More recently, developed market government bond issuance has risen sharply as fiscal deficits have ballooned in response to the global economic slowdown.

David Stonehouse: That being said, circumstances have changed dramatically since the financial crisis. All net issuance has come from the sovereign side of the fixed income space, and asset classes that ballooned pre-2008 have contracted markedly. We have also seen further lowering of yields from already low positions early in the decade, and this has presented additional challenges for plan sponsors.

Gary Stewart: The volatility over the past few years has underlined the importance of employing a multi-dimensional approach to managing fixed income. You can't just be a duration shop or a credit shop anymore. Managers need to look at multiple strategies to better control risk and add value for clients. They need to be able to change the composition of their portfolio based on changing market conditions. Managers must branch out into other strategies, using all of the tools in the tool box to protect client capital and add value.

> How are plan sponsors benefiting from changes in the fixed income landscape?

Denise Kehler: Today's small- to medium-size plan sponsors are looking at fixed income and assessing what's out there. The industry is really

driving the change and we are late to the game, in my opinion. Right now we are talking to managers and looking at what they have. We know what our problems are but we're looking to these experts for solutions.

Alan Matijas: I think Canadian plan sponsors are more predisposed to embrace the new opportunities that fixed income has to offer. U.S. plan sponsors have been a little further ahead to date, but Canadian plans have been increasingly engaged.

> What are the major risks in the fixed income space today?

Michael: We need to talk about the risks to the U.S. and European economies, and the fact that low nominal growth and low interest rates seem poised to linger for a long time. Low interest rates make it very hard for pension funds to meet their actuarial objectives. That is a risk that should never be discounted, because if equity returns don't rebound to doubledigit levels, it's going to be hard to meet those objectives going forward, especially if we see further deleveraging. Deleveraging is going to dampen economic growth and keep returns low. It will only increase the importance of income in a pension portfolio. This may lead to a reversal of the traditional roles of fixed income and equity as income becomes more central to pension fund returns and capital gains continue to wane.

Jean: The most significant risk we face is the deleveraging of consumers—this will linger for many years. At the same time, we have these massive austerity packages in virtually all developed countries. Austerity and economic growth don't go together. As developed countries follow the same monetary policy of intervention and austerity, this has created

high correlations between developed market economies. All this will create major headwinds for fixed income in the years ahead.

Todd: We have been in a long period of low interest rates and that may continue. The challenge is to manage the risk and reward in this environment and use all of the tools at your disposal to maximum advantage to reach client goals.

Gary: From the client's perspective it's all about what they're going to do with the plan in response. There's not a lot we can do about things like interest rates, but we can help plan sponsors get their market view right in terms of what's happening in Europe. This low interest rate environment may be around longer than people think and they're going to have to look at other ways to add value. Corporate bonds are a good opportunity and they are positioned to do quite well. That's our outlook.

It sounds like a depressing scenario, at least for the developed world! Given a future of low interest rates and low economic growth, what are the opportunities in fixed income for plan sponsors?

Denise: From a plan sponsor perspective, we have to make our fixed income work harder for us. If people in the industry can show us better ways to make this happen, that's great. Plan sponsors can no longer sit back and ignore this 30% to 40% chunk of our assets. Frankly, most of us have been doing this for years. We no longer have the luxury of just letting it sit there and turn over the way we have in the past. If the marketplace is shifting and there are different opportunities, we need to look at them.



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— Denise Kehler,
Public Employees Benefits Agency

> Denise, what does working harder look like to you?

Denise: It means getting better returns. Point blank. As plan sponsors we need to be braver. Yes, we need to think outside Canada. We have always just focused on Canada for fixed income. We have to be able to go to our boards and tell them about these global opportunities.

Educating your boards about this must be challenging. What's the best way to get that message across?

Denise: It's a challenge. I work with a lay board, and from their perspective, making big changes to our fixed income portfolio can be kind of scary. We have to start at the ground level and review what we're trying to accomplish and what the environment has done to our fixed income. How does this put our pension plan at risk? That means basically starting with asking "What is fixed income?" because a lot of people don't know. The education is really basic and much needed right now.

When we start bringing derivatives strategies to them, it adds a whole

other level of complication. But it's worth it and we need to do it. So far, it's working. Our board is responding positively and they want to embrace the other opportunities out there. From our perspective, we can move slowly but we have to move forward.

Alan: Denise makes a really important point. But changing a plan's approach to fixed income also brings up questions about risk management. One way to make fixed income work harder is through a core plus approach utilizing domestic portfolios that invest tactically in global opportunities to add value. However, you have to be mindful of how your fixed income strategy is doing this. Are you just allocating to spread beta-like emerging market debt, for example? If so, then what you introduce is actually an alpha source that is correlated to your equity performance. When you are thinking about core plus structures you need to make sure you go beyond just spread opportunities, given their correlation to equities. You need to keep an eye on the risk you are introducing into your bond portfolio and make sure your fixed income allocation isn't excessively correlated to equity markets.

Gary: In Canada, you have a lot of index-oriented managers who are reluctant to stray very far from benchmark weights. It's a leap for some in our industry, but in today's environment we need to incorporate an expanded view in the management of fixed income

David: Achieving that expanded view is also a challenge for plan sponsors—they have to think in terms of risk, first and foremost. So it's hard to veer away from traditional paths of thinking and embrace new opportunities. But if they stay put, they run a huge risk—a 2% government bond is very risky right now. That 2% is not going to get you the 7% you've targeted. It is surprising to me that plan sponsors have been able to embrace 65% allocations to equities with impunity over the years and yet not be comfortable investing in high yield bonds, which have experienced a little over half the volatility.

> So plan sponsors should change how they invest in fixed income. But doesn't that present some big challenges on the investment policy front?

Denise: It struck me as I was flipping through our investment policy that we are expecting considerably more in value add from our new fixed income managers than we are from equity managers. Given the categories in our investment policy, that doesn't make sense. We have this growth portfolio and our liability matching—and we have fixed income in there. It doesn't make sense because we're looking for growth out of it now.

There is a big shift underway in how we're defining our investments. It's a challenge for us to make sure that both sides of our table—the pension managers and our boards—really understand that we are now asking

"It's critical that plan sponsors understand the risks embedded in their portfolios and make sure they get paid for the risks they take."

— Gary Stewart, Lincluden Investment Management Ltd.



fixed income to do something else. When I first started in this business, fixed income was a neutral place; it was the bedrock and the foundation you built everything else on. For us, that's not the case anymore, and we need to make sure we're not just leaving the labels as they were.

We need our board to understand how we're using fixed income and where, to take risk off or on. It's not all generic anymore. They understand this is the case with equities, but not with fixed income. We are working on getting there, but it's a challenge.

Michael: It's essential to properly define the objective of your plan's fixed income allocation. Is it to provide something of an anchor to windward for your equity allocation when equities are selling off? In that case, you need more duration and more government bonds. Is it for returns? Then you probably need more credit. Plan sponsors must have a clear understanding of what they are trying to achieve with fixed income, and then allocate accordingly.

Gary: It's critical that plan sponsors understand the risks embedded in their portfolios and make sure they

get paid for the risks they take. In order to do that you need to work with clients and quantify what those risks are. It's one thing to take on more risk in fixed income, but you have to have a disciplined and prudent risk management framework in place.

Jean: I find it mind-boggling that given how risk management has evolved in recent years in Canada, many pension plans are still taking most of their active risk out of their asset allocation equity portion. Off-



benchmark bets are taken in emerging market equities and EAFE mandates, for instance. Then there is the 40% fixed income portion, where the buy and hold coupon stuff is managed conservatively with often little active risk. Overall the active risk is not well spread out among assets.

> We know plan sponsors need to make their fixed income work harder. But what types of bonds can help them get there?

David: For most bond managers, I think investment grade corporate bonds have been the easiest way to make a fixed income portfolio work harder. They're low risk from a default perspective and they tend to give managers the opportunity to deliver more reliable alpha than some of the other tools in fixed income, such as duration. However, we believe there are other interesting vehicles for fixed income investors that have not been as widely embraced. High yield is another good opportunity, especially compared to equities. Over the last 25 years, equity volatility has been nearly double that of the high yield market, and yet returns have been similar. So high yield brings a big benefit on a risk-adjusted basis.

Todd: I agree there is great benefit for clients in corporate bonds. Right now the spread being offered over government bonds in Canada and the U.S. is high and in some cases double the yield [of the underlying government bond]. Corporate bonds also offer protection when interest rates eventually rise. The spread compression in corporate debt can help mitigate any risks on the duration front at that point. We're now positive about corporate bonds, more so this year than last year.

Gary: You can't just look at corporate bonds generically, making an over- or

underweight decision. You need to do in-depth credit analysis because one of the best ways to protect client capital is to avoid the disasters. This was very evident by the wide dispersion of bond manager returns during the credit crisis.

Jean: There are opportunities in corporate credit as long as you go outside of Canada. In Canada the market has become highly concentrated in just a few sectors. But in the U.S., for example, corporate bonds offer access to all sectors of the economy. So, while I agree that there is value, I think plan sponsors have to look beyond Canada.

Denise: Three or four years ago we decided to look at high yield bonds to see what the opportunities were. In the end, we decided not to go there, and we currently don't have high yield bonds. In our case, it's been a bit too difficult to work through the education process with the board. We have struggled with it but we've also taken baby steps. We are moving slowly, even in the corporate space. As the board gets more comfortable with these asset classes, we will bring them forward again.

We're talking about an evolution in how we as plan sponsors look at fixed income. We need to roll this out in a sustainable way so we don't have a backlash where the board feels we offered the moon and then didn't deliver.

David: High yield bonds have different risk return characteristics than other fixed income instruments.

They're more correlated with equities and they offer low correlation with government bonds—a major benefit. It means that in a non-recessionary environment, they can provide better insulation against rising interest rates than government bonds, which is one way we've been employing them in our core plus product.

In Canada, however, one key challenge is that the high yield universe is still small. So if you're interested in the space you need to look abroad, particularly in the U.S., where the market is in excess of a trillion dollars and well diversified. We also like the way high yield looks versus equities—you have generated comparable returns over the past 25 years with much lower volatility. High yield has also done well during bull markets, which surprises many investors, who tend to underweight bonds during good times.



"I agree that high yield bonds push the boundaries of how traditional investors look at fixed income."

— Alan Matijas, Wellington Management Company, LLF



Alan: I agree that high yield bonds push the boundaries of how traditional investors look at fixed income. If we think of it as an equity substitute or part of a plan's return-seeking bucket, traditionally dominated by equities, then you can consider high yield in a broader context as opposed to just parsing it off from a traditional fixed income mandate. I think this conversation is happening today.

Tredit ratings are a big part of the fixed income landscape. But should plan sponsors be relying on them? Especially after what we learned during the assetbacked commercial paper crisis (ABCP)?

Jean: This reliance on rating agencies to guide investment policy really bothers me. I think plan sponsors should be questioning their dependence on ratings especially today when there are hardly any AAA rated companies in the corporate landscape. The average rating is BB+. In this context, looking at high yield as an asset class that can deliver riskadjusted returns makes a lot of sense in an asset allocation framework,

especially in terms of correlations with other asset classes. It's less volatile and offers better returns. Ratings should be secondary.

Gary: We don't put a lot of weight on credit ratings as leading indicators of credit quality. This was the case with the recent ABCP problems, for example, when the majority of investors relied solely on the AAA credit rating from DBRS. We have a simple concept: if we don't understand something we don't buy it. You need to do the in-depth research yourself rather than relying solely on the rating agencies.

Denise: I understand intellectually and practically what you are saying about credit ratings. But for us, we need to put something in our policy. What else is there but credit ratings? There have to be at least some minimum standards we can use and adhere to. We know coming out of the ABCP crisis that doing your own research is important. But as plan sponsors, we do not have an alternative.

We've talked about getting out of Canada for bonds. Where should plan sponsors be looking? Emerging markets?

Denise: When it comes to educating our board, emerging markets are challenging enough for us on the equities side. To go there on the fixed income side is even harder. Right now, we're willing to give our managers some discretion to go that route if they can find something, but we just can't do it. Maybe you have to be a bigger plan sponsor or braver, or maybe you have to have fixed income expertise in house. But for us, emerging markets fixed income isn't there yet. For us, we try to set three-to-five-year plans. We make our investment plans and then implement in those shorter-term cycles. Maybe emerging market fixed income will be on the schedule in the next five-year cycle. But right now it's not in our comfort zone. That's our reality right now.

David: Emerging market fixed income is a good way to enhance returns, but liquidity is lower than for developed markets. When people look at metrics such as growth rates and fiscal strength, it's easy to see emerging market sovereigns are in a much better position than developed market sovereigns.

The challenge, however, is that investors perceive more structural and political risks. Over time, as emerging economies continue to develop and this asset class becomes more accepted, they can be an increasingly attractive alternative to developed markets given their higher yields and generally stronger balance sheets.

Let's move on to the L-word—liability-driven investing (LDI). What impact has LDI and asset liability matching had on the fixed income space?

Denise: We have found religion and are lengthening the duration of our fixed income to match our liabilities. Right now it feels as if we are stepping on the gas and the brake at the same time on the fixed income side. We're using fixed income to take interest rate risk exposure off the table through overlays and derivative exposure.

On the other hand, we're using it to add value. Why are we trying to do both? Because we keep coming back and asking "Is derisking the right strategic decision? Is this the right time?" We can't predict where rates are going—they could go lower. But we still think it's a good time to take the risk off the table.

"Emerging market fixed income is a good way to enhance returns, but liquidity is lower than for developed markets."

— David Stonehouse, Acuity Investment Management Inc.



Denise has posed the million dollar question: Is now a good time for Canadian plan sponsors to be lengthening duration and derisking?

Gary: LDI strategies are not a "one size fits all" approach. The financial risk tolerance of the sponsor will dictate the appropriate time frame to implement the strategy. Gaining an in-depth understanding of the client's pension liability and business situation is always the first step in determining how and when to implement this type of strategy.

Todd: In the meantime you need to be focused on the yield in your portfolio. You need to target a return that is higher than the discount rate you're using to value your liabilities. Plan sponsors need to get all the extra yield they can from their fixed income. We like corporates right now, especially at the spreads they offer. We expect this low rate environment to continue for some time, so you need to be looking at incremental yield you can generate to help out the plan.

Jean: Over the next five to ten years, structural and demographic changes

will affect how pension funds are being managed—it's unavoidable. Strong secular trends will mean we have to re-assess how we look at fixed income. Emerging markets, for example, are still in their infancy stage, and I am not expecting pension funds in Canada to have a permanent allocation to them in their asset mix. But at the same time it's important to look at what emerging market equities have provided to DB plans in Canada and the U.S. over the last decade. I think emerging market bonds will also become an integral part of DB asset allocation in the years ahead.

David: Plan sponsors can't afford to ignore the discount rate and liability side of their plans for fear of being underfunded. Today, we've focused on using unconventional tools rather than conventional ones. We see opportunities in convertible debentures, for example. Going with a core plus strategy that integrates things like convertible debentures makes a lot of sense in our minds. You're still adhering to a fixed income mandate, but you're better able to match duration and prepare for when interest rates eventually rise.

Alan: I think many plan sponsors are struggling with this decision. For every plan sponsor that has decided to embrace LDI, there are two or more sitting on the sidelines waiting for a more attractive entry point. I think the number of plan sponsors who are waiting to implement will have implications for yields on the long end. There is pent-up demand on the sidelines waiting for the right market conditions.

Michael: We have done research in the U.S. to quantify the pent-up demand for long-duration securities resulting from liability-matching by U.S. corporate pension plans. We found it outstrips Treasury supply over the next decade.

> Any closing advice to plan sponsors who are seeking to make their fixed income work harder?

Alan: It goes back to defining objectives and looking at where fixed income fits in relation to different parts of your portfolio. What are you trying to do? It starts with objectives.

Jean: Down the road fixed income will no longer be seen as a single block. It will be more like equities, which have been divided between U.S., emerging market, and so on. These are now permanent asset classes within equity portfolios.

Denise: If I was a manager on your side of the table, I would be excited. The world is at your feet because you have all the tools plan sponsors need. The challenge is getting people like me to tell us what you have to offer. There are new ideas for us to manage our pension funds and we have huge challenges coming. You have ways to help us deal with them. We haven't found solutions in alternatives or equities. Fixed income is one area we can use.

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