

**ANNUAL REPORT
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**FIXED INCOME
MANAGERS**

Fixed Income: Challenging Times, Heightened Expectations

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Waiting for long bonds to rise is a risky approach to de-risking Defined Benefit pension plans, says Greg Hyatt, general manager, pension plan management, at Canadian Pacific.

In a presentation at the Conference Board of Canada's '2011 Summit on the Future of Pensions: Rebuilding Pensions, Rethinking Retirement,' he said sponsors today are paying for the fatal mistake "we all made, and actuaries have to take responsibility for this as well," when designing plans 30 years ago. They were designed on the premise that the assets would be put in balanced funds; equities would outperform bonds by three per cent; and the discount rate would be 7½ with a four per cent rate of return on bonds. The belief was this would continue indefinitely.

Unfortunately, that premise was reached just as a 27-year bull bond market was starting, says Leo J. de

cent plan to increase their fixed income allocation over the next three years.

However, many of these private sector plans are waiting for long bond yields to rise before taking any action.

Many may never get to make the switch to de-risk their plans because, as de Bever says, "going into long bonds was an excellent idea 15 years ago, but it is a bad idea today. If you switch into long bonds today, you are locking into a low return for next 15 years."

So what are plan sponsors to do? *Benefits and Pensions Monitor* turned to some of Canada's leading fixed income portfolio managers for their thoughts.

Stuart Graham, president, & Jafer Naqvi, senior associate, PIMCO Canada

In the past, there was very little difference between fixed income managers and investors often



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Bever, chief executive officer and chief investment officer, Alberta Investment Management Corporation. He told the same gathering that most people in asset management today have only worked in a bull bond market. However, there are only two periods in history where bonds have had a significant return – after World War I and the period that has just ended. During the latter, he notes, it was easy to make money with bonds returning CPI+8. "I expect we're coming into a period where bonds have minimal impact like the period from 1930 to 1980."

And this could pose serious problems for private sector pension plans. Many are waiting for an opportunity to move into fixed income to de-risk, says David Service, director of Towers Watson investment services. Its Canadian pension survey shows many of these plan sponsors plan to move money from equities to fixed income over the next 12 to 36 months.

The shift is pronounced among sponsors of plans with assets of more than \$500 million. Here, 63 per

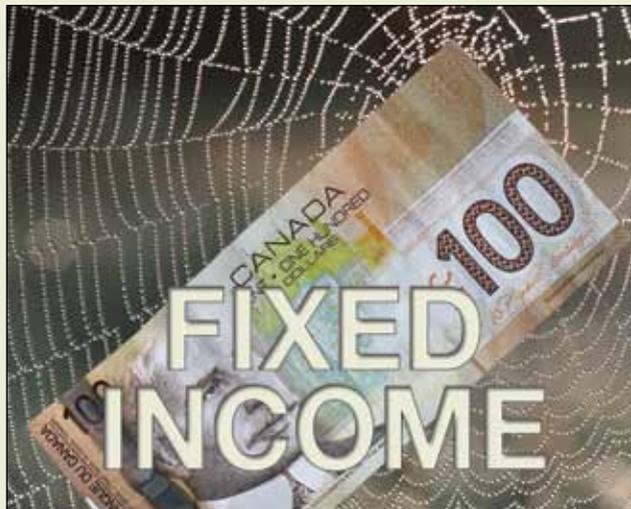
cent paid active fees for passive results. High coupons and falling yields generated fixed income returns at or above pension fund return objectives, making low alpha an acceptable reality.

With bond yields currently at approximately 3.4 per cent, the simple math shows that pension funds are now going to face a difficult hurdle with meeting actuarial required returns in the five to seven per cent range.

Pension funds have to balance this low yield reality with a need to match liability relative risk. This means that domestic fixed income, the asset class that best matches liabilities, has a growing impact on total plan returns. As a result, alpha from bond portfolios matters more than ever.

The good news is that there are now options available that can add fixed income alpha while still controlling risk.

Canadian pension plans have the ability to access strategies that can deliver materially higher returns through a wider opportunity set. If a manager can add one per cent to 1.5 per cent above their fixed



income policy benchmark, this will go a long way to achieving required investment returns for the total plan.

Using a wider opportunity set means taking multiple positions in off-benchmark opportunities such as emerging markets, high-yield debt, or non-Canadian investment grade credit. One important note for clients is to select a manager that has the scale and resources to evaluate the full spectrum of off-benchmark opportunities.

This wider opportunity set becomes even more critical as clients move to long duration mandates. Our view is that historical approaches to domestic fixed income struggled to add value because asset managers had to work with a narrow universe of domestic credit and duration. In long bond mandates, this opportunity set is even narrower. Successful asset managers can overcome this limitation through active decisions outside of the benchmark.

A great example of the problem with a narrow opportunity set is Canadian credit. Investors are sometimes surprised to hear that Canadian corporate bonds are among the most expensive in the world. Most pension plans would agree it doesn't make sense to have all your equity exposure in one country, especially if it is the most expensive stock market in the world. We simply extend this logic to fixed income portfolios and take exposure wherever the most value can be found.

So is this a recommendation for global fixed income? Well, yes and no. We spoke earlier of the need to manage against Canadian liabilities, often reflected by Canadian fixed income benchmarks. Purely global fixed income mandates can bring in material interest rate and currency risk that does not necessarily meet the objectives of a domestic plan.

By employing a total return approach against Canadian benchmarks, whereby foreign exposures are hedged back to Canadian interest rates and currency, pension funds can delegate tactical foreign decisions to an experienced fixed income manager with the capability of evaluating when and how much off-benchmark exposure should be taken.

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The last several years have been a volatile period

for capital markets globally. The bursting of the mortgage-fueled credit bubble and the resulting recession have cast a long shadow over the global economy, weighing on economic activity and keeping unemployment rates high.

In this environment, pension plan sponsors are increasingly focused on reducing risk by seeking fixed income benchmarks that better match their liabilities. Plans also want active fixed income managers to add value relative to their benchmark while protecting against the risk of negative returns resulting from a move to sharply higher yields.

Uncertainty regarding the timing and type of measures used by policymakers to unwind aggressive monetary stimulus and address ballooning deficits is expected to keep both economic and market volatility at elevated levels. Inflationary pressures are likely to continue building despite recent efforts by some developing market central banks to tighten monetary policy and dampen activity.

The recent acceleration of the U.S. economy should continue, providing a boost to Canadian exports. However, rising oil prices stemming from unrest in the Middle East and potential supply chain disruption arising from the destruction in Japan have increased uncertainty around this view. Nonetheless, we expect the Bank of Canada to begin raising interest rates in the second half of the year in response to stronger than expected growth and inflation.

The current and ensuing period of heightened volatility should provide opportunity for active fixed income managers to outperform client benchmarks while providing the desired downside risk protection.

Active duration and term structure strategies, effective when yield curves deviate significantly from levels suggested by underlying fundamentals, are currently attractive. Given low yields and expectations that the Bank of Canada will push overnight rates higher, we have positioned client portfolios with shorter than benchmark duration and yield curve flattening exposures.

To protect against negative portfolio returns, we have allocated to 'tail risk' strategies that shield portfolio values from sharp increases in bond yields. Finally, we continue to maintain selective overweight exposures to high quality credits where downgrade and default risks are very low and spread levels offer attractive liquidity premiums.

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From a short term, tactical point of view, we believe that Canadian bond returns will lag those of other asset classes. With economic growth accelerating and inflationary pressures rising, higher short-term interest rates are likely in 2011. We concur with the Bank of Canada's view that its one per cent overnight target rate is extremely low and likely causing undesirable distortions in the Canadian economy.

As a result, we believe that the bank will raise rates 75 to 100 basis points over the balance of the year. That will put upward pressure on bond yields and bond prices will likely fall. Achieving positive bond fund returns will be possible this year, but it will require considerable skill and expertise in both portfolio construction and risk management. Index funds and 'closet index' managers will likely show negative returns for 2011.

On a fundamental basis, though, we believe that bonds should form the core of any pension fund because of their lower volatility and better matching with liabilities. Equities, while offering the possibility of large gains, are best used on a tactical basis because of their volatility and dependence on the economic cycle. Canadian corporate profits represent a fairly steady four per cent of GDP. So, barring an expansion in P/E multiples, equity prices over the long term are likely to grow at the same rate as the economy. On a nominal basis, Canadian GDP has the potential to grow at a four per cent pace, comprised of two per cent real growth and two per cent inflation. Adding that growth to the dividend yield of Canadian stocks, it appears that the long-term potential for Canadian equities is six per cent to 6.5 per cent. Compared to the 5.5 per cent yield currently available on long-term corporate bonds, the incremental return potential of stocks is not as large as many trustees assume.

To sum up, we are recommending that clients continue to hold their core positions in bonds, but tactically emphasize equities to benefit from rebounding profits as the economic recovery continues. Once the growth in profits slows to its long-term trend, we will look to increase the bond exposure again.

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Pension funds have always held a good chunk of their assets in fixed income; it has been part of their traditional asset mix as bonds are considered to have a less volatile return profile and are an almost sure bet not to lose capital in uncertain time.

Of course, we know one can lose money with bonds, in terms of market value when interest rates go up, but also when the securities in the fixed income portfolio have a risk profile far different than the traditional government bonds usually held for capital preservation. The last crisis showed how much financial engineering can produce so-called fixed income securities with embedded risks that were not always well understood.

After such a difficult cycle, and with the rate structure so low, bonds have now moved

from the traditional asset mix decision set of tools to the forefront of asset-liability matching. Liability driven investment (LDI) strategies are now widely implemented. Bonds are a natural match for liability cash flows and the return of the fixed income portfolio gets second rank after its ability to match the liability changing present value.

As for the traditional fixed income portfolio, finding higher returns is not easy these days. International markets are increasingly correlated and the yield pick-up from investing in foreign bonds is not always that great. Clearly, in the sovereign bond world, the real game is to increase risk and go for those juicy spreads offered by emerging countries or take a contrarian view and bet on those troubled issuers like Greece, Spain, Portugal, and so on. The currency risk can be hedged.

And then there is the usual way of overweighting corporate and provincial bonds at a much higher rate. Investment grade

credit bonds still offer hefty spreads despite their fantastic run of the last 24 months. High yield credits are also available, but that market is mainly U.S. and global.

So, opportunities exist, but clearly expectations of high returns are not in order. The investor basically has two choices – buy the yield and hold to maturity or have a portfolio tilted according to the desired risk profile and have it managed actively. Indeed, in the current environment, active management can provide value in rate expectations and sector and security selection. We should all remember that as yields declined, the sensibility of a small change in interest rates is far greater than before.

As for credit and security selection,

no one wants to go through another credit crisis again. Active management, with little constraint, is still a good path toward higher returns.

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