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Investment: Riding The Fixed Income Trends

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INVESTMENT

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"Trends, like horses, are easier to ride in the direction they are going"

– John Naisbitt, author of 'Megatrends'

In a horse race, each horse is handicapped by the specified weight it must carry to equalize the odds of all competitors. After the recent strong performance by fixed income investments, the weight of the low interest rate 'handicap' appears to be taking its toll on returns in 2013. While equity markets are 'racing' ahead, defined benefit plans still have ground to make up to regain their strong financial shape of years past. Despite recent market setbacks, there are four key trends that will help fixed income get back in the 'race.'

▸ Trend 1 – Keeping it in the family

Given today's low interest rate environment, higher yielding fixed income investments have seen increased interest from investors. Domestic and foreign high yield bonds, emerging market debt, and, in some cases, private debt have emerged the winners in this highly competitive fixed income 'race.' Brian Eby, head of fixed income at Connor, Clark & Lunn Investment Management Ltd., says "With the exception of private debt, higher yielding assets generally imply lower liability matching characteristics. As a result, some DB plans have introduced higher yielding fixed income allocations as an opportunistic investment, while for others the allocation is more for strategic diversification."

▸ Trend 2 – Meaningful alpha contribution

In low interest rate environments, the contribution to total return from active investment management (added value or alpha) is more pronounced. As a result, there has been an increase in plan sponsors moving a portion of their fixed income assets to active management from passive approaches, particularly in light of concerns over declining fixed income returns.

In the search for alpha, some plan sponsors are considering overlay strategies. For example, by combining synthetic exposure to fixed income with absolute return focused overlay strategies, higher added value targets may be achievable when compared to traditional active fixed income mandates.

▸ Trend 3 – Beneficiary of de-risking

The good news story for plan sponsors in 2013 is that healthy capital market returns have led to improved funding levels for many DB plans. How plan sponsors react to this improvement will have critical implications for future cash flows to and from various asset classes. Despite relatively low interest rates, it may be unwise to 'bet' against fixed income as plan sponsors' desire to de-risk portfolios could lead to significant inflows to bonds. In fact DB plans with dynamic de-risking programs, where pre-determined triggers signal asset mix moves to a higher liability matching allocation, may well have started shifting assets to fixed income already.

For larger plans with multiple investment managers, recent shifting activity may have uncovered complex implementation challenges that were not previously anticipated. Darren Ducharme, CEO of Baker Gilmore & Associates, believes that these challenges may lead to the introduction of a duration gap manager specialist role. He says "a duration gap manager takes responsibility for implementing the desired total portfolio duration target over time. Plan sponsors benefit as the implementation complexity is reduced and the impact on individual investment manager mandates is lowered."

▸ Trend 4 –More precise matching

Historically, pension plans have had a low allocation to fixed income assets. As a result, the largest source of risk for a DB plan came from its return-seeking equities, which reduced the need to be overly precise in matching the plan's fixed income portfolio and the liability risk factors.

However, with plans now gravitating towards higher fixed income allocations, the need for greater precision in fixed income liability matching is becoming more appropriate. Ducharme notes "While a cash flow matched approach is best for explicitly matching liability cash flows, it is likely the most costly approach, since it requires purchasing expensive securities, such as long-dated strip bonds."

Ducharme and Eby believe most plan sponsors will benefit from adopting either an immunized approach focused on matching risk factors or a horizon matching approach combining elements of both the cash flow matched and immunized methods. "The immunized and horizon matching approaches allow for active management on what will likely become the largest component of DB plan portfolios, so the added value from fixed income will become more significant in terms of total dollars," says Eby.

The Dark Horse

We are not quite in the final stretch of the race, but don't overlook the 'dark horse' of fixed income to be the ultimate winner of future inflows from asset mix shifts as plan sponsors look to reduce risk following improved funding levels for many DB plans. BPM

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