A Canadian Approach to LDI

By: Michael Augustine, FCIA, FSA, CFA, Vice President & Director
Rachna de Koning, FCIA, FSA, Vice President & Director
June 2015

Canadians are used to stick handling through some tough challenges; perhaps most notably our frigid winter weather. Canadian liability driven (LDI) investors are no different. They also have to face off against some tough opponents — in particular, Canada’s limited fixed income marketplace. Canadians’ adaptability has always been a key to overcoming obstacles, and LDI investors can benefit from the same trait.

**Bond Market Characteristics**

Home ice for Canadian bond investors is small — the entire investment grade universe in Canada represents only approximately 2% of bonds issued worldwide. In spite of the market’s small size, demand for Canadian bonds is strong, supported by a large pool of domestic investors (institutional and retail) plus growing interest from foreign investors who are attracted to Canada’s strong credit rating. This limited market size coupled with robust demand can create supply/demand imbalances that affect bond prices and corresponding yields — particularly in the long-duration space favoured by LDI investors.

**Federal Government Bonds**

Federal government borrowing requirements are declining as the Canadian deficit falls. This means that the federal government is likely to issue less debt over the medium term, which will further shrink the already limited supply.

In addition, Canada has a relatively short sovereign debt maturity schedule. The government has begun to extend the average term of its debt, recently issuing its first 50-year bond. However, Canada still has the second-shortest sovereign debt maturity schedule among G-7 countries, which can make it difficult for plan sponsors to access the long-duration bonds they need. In larger bond markets, synthetic instruments are readily available and can fill gaps left by any long-duration voids. But in Canada, these instruments are either non-existent (such as a 30-year Government of Canada futures contract) or thinly traded (such as the 30-year interest rate swap).

**Provincial Government Bonds**

Provinces have been extending the terms of their debt maturity profiles, which has allowed them to lock in lower funding costs and helped satisfy some of the institutional de-risking demand. In addition, the provincial strip bond market offers investors customized instruments that can meet their interest rate risk management objectives. It’s important to note, though, that some of the customized provincial instruments have limited liquidity and can trade on scarcity value rather than fundamentals.

**Corporate Bonds**

Corporate bond issuance has been robust over the last several years, however, the supply of long corporate bonds for LDI investors is still lacking. Because of the long-term nature of their obligations, LDI investors seeking to hedge their liabilities often favour high quality bonds. Unfortunately, there is a dearth of long-term AA-rated corporate bonds; most of the supply is present in A-rated and BBB-rated bonds.

---

1As at December 31, 2014
Adapt by Widening the Investment Universe

Fortunately, LDI investors who are willing to be flexible can help address these challenges by exploring the full roster of fixed income offerings. They can benefit from including some of the following alternatives to their portfolios.

A-rated and BBB-rated bonds

LDI investors focused on their accounting basis liability tend to prefer AA-rated corporate bonds because of assumptions made in the construction of the accounting liability discount curve, and some LDI investors focused on their solvency basis liability tend to prefer provincial bonds. However, given the limited number of issuers of long-term AA and provincial bonds, it’s important to consider other parts of the fixed income market when building a liability hedging portfolio.

While some plan sponsors are inclined to leave lower-rated corporate bonds on the bench, they can be a valuable part of a fixed income line up. TD Asset Management Inc. (TDAM) research indicates that other sectors of the bond market can be considered high-correlation substitutes for AA-rated corporate or provincial bonds. For example, accounting-based liability returns are highly correlated with long A-rated and long BBB-rated corporate bonds. Not only can these bonds provide a good quality hedge, but the credit compensation found in the expanded opportunity set can, in many cases, lower expected hedging costs.

Synthetic strategies

Derivatives overlay strategies can be useful when constructing a good quality hedging portfolio, particularly if the plan sponsors also hold return-seeking assets such as equities. However, as we noted above, liquidity in Canada is limited to ten years in some commonly used instruments like interest rate swaps. Instead, bond overlay strategies that use bond forwards or repurchase agreements can be a much more pragmatic way for a plan sponsor to cost-effectively enhance their liability hedging portfolio. Synthetic bond overlays can significantly increase the duration match to mark-to-market measures like solvency or accounting. They can also provide a good source of additional income via coupon payments on the referenced bond, net of the financing cost (often referred to as the “positive carry”).

Active management

Working closely with an asset manager that’s focused on risk mitigation relative to liabilities rather than traditional measures of performance can help plan sponsors to navigate the increasingly complex and uncertain future of plan risks. Giving that manager additional freedom to take advantage of market opportunities as they arise can also be beneficial. A manager who is less constrained can strive to add value through a number of active management tools, including credit research and security selection, yield and credit curve analysis, and portfolio construction.

An experienced manager with a diverse suite of cost-effective solutions can make a significant difference to LDI outcomes. If investors can achieve a better return, adjusted for whatever risk is inherent in their particular obligations, then they should expect to achieve a much more satisfactory and stable investment outcome. This will help increase the likelihood that they’ll be able to meet their obligations over time.

At TDAM, we believe that LDI is a framework for making investment decisions. An integral part of designing this framework is understanding the entire opportunity set available. This is particularly important in Canada, where the fixed income landscape can be challenging. Instead of relying solely on star players like government and AA bonds, plan sponsors who are flexible and recognize the bench strength of all investment options available are more likely to create a successful LDI portfolio.

This article first appeared in the French publication, Avantages, in November 2014.