

Maple bonds sweeten currency spreads

Canadian pension funds gain southern exposure — without the sunburn.

BY JOHN BRAIVE, AMANDA MCPHERSON AND BRIAN LANCASTER

Maple bonds, which are U.S. and other foreign bonds denominated in Canadian dollars, allow Canadian investors to buy non-Canadian bonds without having to deal with currency risk. But plan sponsors must understand the nature of maple bonds before deciding to invest in them.

According to analysis undertaken by CIBC Global Asset Management, issuance of maple bonds has grown rapidly in the last few years, from \$11 billion in 2005 to almost \$26 billion in 2006. In the first nine months of 2007, maple issuance has already reached \$27 billion. Between January 2005 and September 2007, there have been close to 80 different maple issuers, with the largest volume originating from the United States.



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financial institutions have issued 87% of the maple bonds, and this is a sector that already dominates the domestic bond market.

Many foreign bond issuers are attracted to Canada today, but continued maple issuance is not a sure thing. Maple issuers are not looking for Canadian dollars; they just want to borrow money cheaply and then immediately convert the Canadian dollars back to their own currency. Maple issuers measure the attractiveness of the Canadian market using two key factors — Canada and BA-Libor swap spreads. The greater these spreads are, the greater the attractiveness of Canada to foreign bond issuers.

Because maple bonds are issued as private placements in Canada, they can be issued quickly and inexpensively. However, many institutional investors shy away from private



rate bonds. Even though more Canadian investment dealers are participating in maple offerings and market making, the breadth and depth of the maple market is still somewhat limited. This lack of broad-based dealer participation, the opportunistic nature of maple issuers and the private-placement structure of maple bonds lead investors to demand a liquidity risk premium. In addition, the bond market adds in a premium to address country risk, political risk and enforceability issues.

These premiums often result in maple bonds yielding slightly more than comparable Canadian corporate bonds.

CONDUCTING A CREDIT REVIEW OF MAPLES

As a result of the liquidity concerns revolving around maples, CIBC

A prudent exposure limit for maples should be between 10%-15% of a fixed-income portfolio, with a maximum exposure to a single issuer of 2%-3%.

While maple bonds offer the benefit of international diversification in Canadian dollars, they do not offer industry diversification. Between January 2005 and September 2007,

placements due to their lack of liquidity.

Maples are generally more liquid than traditional private placements but not as liquid as Canadian corpo-

Prerequisites to a maple credit review

- * A minimum of two dealers in the offering syndicate.
- * A minimum of two public ratings from the four major rating agencies.
- * A minimum rating from these agencies.
- * A minimum issue size.
- * Current financial statements.

SOURCE: CIBC Global Asset Management

continue to be a viable option for pension funds seeking southern exposure. —I²

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Global Asset Management has developed several criteria as precursors to any credit review of a maple issuer.

While these are not overly stringent requirements, our analysis of 47 maple bond issues in 2006 revealed that 23 of them did not meet all these criteria.

Even where maple issues meet all prerequisites, we recommend investors perform further credit analysis beyond the issuer's credit rating, because not all AAA-rated issuers are created equal. Many maple bond issuers have unique ownership considerations, structures or guarantees. For example, Kommunalbanken AG is an AAA-rated financial agency that is 80%-owned by the government of Norway but only benefits from an implied government guarantee.

THE BOTTOM LINE FOR PLAN SPONSORS

Plan sponsors need to be mindful of the potential pitfalls of maple bonds, but the international and

security diversification that these bonds provide makes them worthy of consideration as eligible fixed-income investments.

Permitting maples in the pension fund's investment policy statement will provide the manager with some flexibility in using these securities to add value and diversification to a portfolio.

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between 10%-15% of a fixed-income portfolio, with a maximum exposure to a single issuer of 2%-3%.

Nevertheless, it is important to remember that maples are not part of the Scotia Capital Universe Bond Index, around which many plans are benchmarked.

With tens of billions of dollars of maple bonds in the market, this form of investment has been one of the big fixed-income stories of the last two years. And if swap spreads stay wide enough, maples may con-



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THE CREDIT REVIEW

An evaluation of the issuer's industry is a major determinant of future prospects. Even the most successful companies' prospects may be compromised if they operate in industries that are declining, highly competitive or characterized by variable returns.

Quality of management is also important — a company is only as strong as the leadership skills of its management team.

Investors should also look at a maple issuer's financial statements. On the balance sheet, the key factor is the amount of leverage and whether or not it is appropriate for that industry. On the income statement, companies must meet minimum industry levels for earnings power, interest coverage and cash flows.

The credit analysis of a maple issuer should be even more stringent than normal because of the need to consider political and country risk.

A review of the covenants contained within the legal documents is recommended. The current trend is toward fewer covenants and minimal-to-no security, conditions that warrant a thorough security selection process.

SOURCE: CIBC Global Asset Management