

Moving BENCHMARKS

A reduction in Canada's government bond issues is having a profound impact on bond portfolios. It's time to re-examine the benchmarks.

By John Braive and Jacques Prevost

The measurement of performance and risk relies heavily on investment benchmarks. In fact, these benchmarks are essential to developing a thorough understanding of the risks that investment managers take when they are fulfilling plan sponsors' investment policy objectives.

Managers spend a considerable amount of time and effort analyzing a portfolio's performance and risk profile relative to a stated benchmark. Unfortunately, far too little effort is spent analyzing the inevitable changes to the actual benchmarks. That is a reason for concern considering these changes have significant implications for portfolios and investment policy statements.

WEIGHING IN

The need to reassess benchmarks was illustrated last year when, for the first time since its inception nearly 20 years ago, the corporate bond weight of the Scotia Capital Universe Bond Index rose above 20%. Just five years ago, the corporate weighting in the index was almost half this rate, at 10.5% (see "Scotia Capital Universe Bond Index," page 68).

When setting the Scotia Capital Universe Bond Index (SCUBI) as the benchmark, many policy statements assume the benchmark is more or less static. But clearly, the index has changed markedly in the past several years.

It's safe to assume there is more change ahead. An analy-

sis of domestic debt issuance trends provides a projected index make-up. It is not unreasonable to predict that the corporate component of the Scotia Capital Universe Bond Index will exceed 26% by the end of next year.

That degree of change would effect all bond mandates using the index as a benchmark. It would also raise a number of important questions, notably: What does this mean to plan sponsors? Are investment managers prepared? And, how will the change impact individual portfolio risk profiles and future performance?

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DOMESTIC DEBT

An understanding of the nature of the current Canadian economy is essential to grasp these issues. Today, we are experiencing near-full employment, strong economic growth and solid productivity numbers—all in a low-inflation environment.

Canada's federal and provincial governments have benefited greatly from the prolonged economic expansion. In addition, a new commitment

to fiscal austerity by provincial and federal governments combined with the strong economic environment is resulting in the disappearance of many government budgetary deficits.

That trend has had a remarkable effect on investment patterns, including those of pension asset managers. Capital that has, in past years, been invested in government-issued bonds is now moving into corporate issues.



Projected financing activity (millions)

| DESCRIPTION | CANADA | | PROVINCIAL | | CORPORATES | |
|-------------------------------------|---------------|---------------|--------------|--------------|---------------|---------------|
| | 2000 | 2001 | 2000 | 2001 | 2000 | 2001 |
| Bond Debt Maturing | 44,200 | 49,500 | 19,500 | 18,500 | n/a | n/a |
| Roll-Outs of SCUBI (under one year) | -45,800 | -30,500 | -5,700 | -7,700 | -7,800 | -11,800 |
| Budget Surplus | -4,000 | -4,000 | -1,500 | -3,500 | n/a | n/a |
| External/Other Financing | -2,200 | -2,200 | -6,000 | -5,500 | n/a | n/a |
| Net New Financing/Issues | 38,000 | 43,300 | 12,000 | 9,500 | 30,000 | 30,000 |
| NET AMOUNT TO SCUBI | -7,800 | 12,800 | 6,300 | 1,800 | 22,200 | 18,200 |

The movement is significant. Canada's provincial and federal governments have generated budgetary surpluses of \$4.4 billion in the last three years. Compare this figure to the 1991-to-1997 period, when total government deficits drained \$337 billion out of the capital markets, and the breadth of change is apparent.

The unyielding competition for capital that began in the early '90s raised borrowing costs and stifled economic growth. Domestic debt markets are still reverberating a decade later, and as much of that debt matures, it is either being refinanced or paid down.

WHAT LIES AHEAD

The federal finance department is projecting conservative

surpluses of \$4 billion for the next three years. These numbers are based on a gross domestic product (GDP) growth rate of 2.7%, and an average 10-year bond yield of 5.7%.

Government spending is projected to grow by \$16.8 billion over the same period. As a percentage of GDP though, that figure represents a drop from 12.4% to 11.6%.

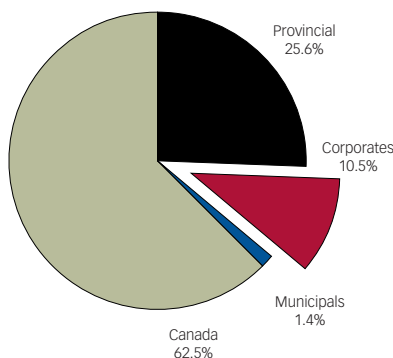
There's always the risk that Ottawa will succumb to political pressure and increase spending. That has been taken into consideration, though, with conservative assumptions built into the forecast which allow for some unplanned spending.

Based on the federal government's new budget, it's

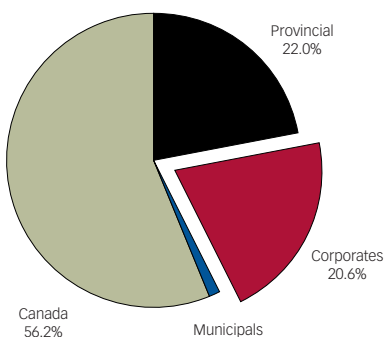
Scotia Capital Universe Bond Index

The corporate weighting in the Scotia Capital Universe Bond Index nearly doubled between 1994 and 1999. The index is projected to increase another 6.1% by Dec. 31, 2001.

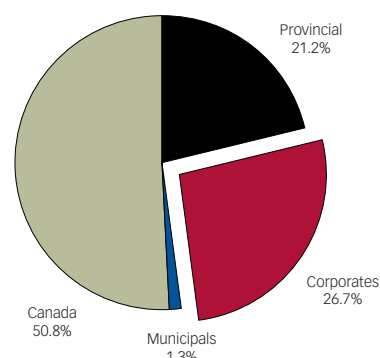
Dec. 31, 1994



Dec. 31, 1999

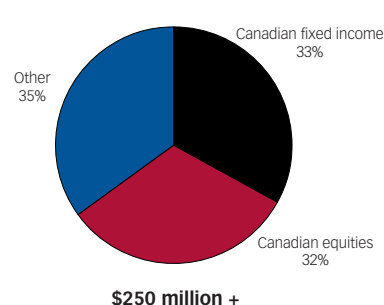
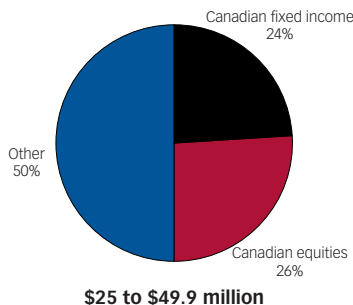
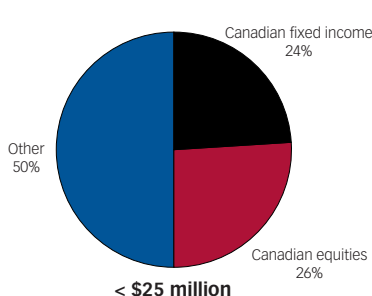


Projected - Dec. 31, 2001



Fixed income in 1999

The average Canadian pension asset portfolio featured at least 24% fixed income in 1999.



SOURCE: Canadian Pension Fund Investment Directory

reasonable to project a cumulative federal surplus of \$8 billion and provincial government surpluses of \$5 billion over the next two years.

New bond issues from the corporate debt market are estimated at \$30 billion this year and \$30 billion in 2001. Those figures include new issues from the Ontario Power Generation Corp. and Hydro One, formerly Ontario Hydro. In contrast, total issuance was roughly \$27 billion in 1997, \$24 billion in 1999 and \$17.8 billion in the first six months of 2000.

Maximum exposure to corporates should be increased to 50% to allow for continued upward movement in the index weighting.

This year, a total of \$45.8 billion in government of Canada debt is projected to roll out of the Scotia Capital Universe Bond Index as it falls under one-year maturity (see "Projected financing activity," page 68). When that debt matures next year, the portion that has not been paid down will be refinanced as new debt, and re-enter the index. As a result, Canadian bonds are expected to increase and provincial bonds to decrease in the index next year.

THE RESULT

The combined effect of decreased government borrowing and increased corporate issuance will raise the corporate weighting of the Scotia Capital Universe Index to 26.7% by the end of 2001. This will alter the risk that portfolios assume. In fact, it may need to be addressed in the investment policy.

It's important to ensure policy guidelines are not suffering from an investment policy lag—one that reduces an effective investment management tool. For example, in 1994 corporate bonds comprised 10.5% of the index. Back then, investment managers could overweight corporate bonds in a portfolio when the investment policy statement allowed the corporate bond weighting to vary between 0% and 30%.

Times have changed though. Today, as the corporate weight increases in the index, managers that want to add value have less room for overweighting the sector. Maximum exposure to corporates should be increased to 50% to allow for continued upward movement in the index weighting. That additional weighting will require investment managers to have experienced in-house corporate credit analysts with the resources to operate in this expanded credit environment. **BC**

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