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BALANCING BETA AND ALPHA – UNDERSTANDING ENHANCED PASSIVE FIXED INCOME INVESTING

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Executive Summary

Given the constant dialogue around "Smart Beta" and active versus passive debate, revisiting our argument for enhanced passive strategies seems warranted. With apologies to Gene Fama, we have always believed that fixed income markets are somewhat inefficient – a feature that can be exploited with active management. After many spirited client debates over the benefits of active versus passive strategies, we find the best way to look at this issue is not in black and white, but in shades of grey. We have found that for those clients that believe markets are (near) perfectly efficient, an Enhanced Passive strategy provides an ideal balance between beta exposure to a desired market and the ability to exploit small, shorter-term inefficiencies to help offset costs.

In this paper, we discuss the unique aspects of passive investing in fixed income markets and make the case for enhanced passive as a viable allocation, even for investment committees that choose a passive approach for their Canadian fixed income allocations.

The Need for an Active Approach to Passive Investing

When selecting passive fixed income managers, we argue that plans should consider whether the managers have access to an active fixed income team. We believe this is an important, although counterintuitive, point that is worth exploring.

Passive investing in fixed income assets, unlike equities, dictates that "full replication" is not a viable approach because of the specific nature of the bond market. The fixed income market continues to be mostly a dealer-driven, over-the-counter marketplace, despite an increase in electronic trading. As such, the way in which managers trade fixed income securities is quite different from the operation of Canadian equity markets. Unlike equity markets, securities in the Canadian bond market are not always readily available for trading. Fixed income securities can be held "on the books" of market participants for long periods, sometimes until maturity. As a result, full replication becomes less practical and most firms employ a process known as "stratified sampling".

Stratified sampling involves breaking down the index into component "cells" based on characteristics such as sector and duration. Each cell contains securities with similar sector and duration features. The list of securities in each cell represents a menu of securities from which managers can select individual bonds. By choosing a certain number of securities from each cell, the manager's overall holdings will accurately reflect the benchmark without the need to buy all the constituent bonds in each cell. The following table illustrates a much-simplified version of a stratified sampling process. In practice, this process is refined by breaking cells down further by credit quality, yield, convexity and other metrics.

SIMPLIFIED ILLUSTRATION – STRATIFIED SAMPLING AND CELLULAR ANALYSIS

	Sector	
Duration	**Provincials**	**Corporate**
6 Years	Index Bond A Index Bond B Index Bond C Index Bond D	Index Bond E Index Bond F Index Bond G Index Bond H
7 Years	Index Bond I Index Bond J Index Bond K Index Bond L	Index Bond M Index Bond N Index Bond O Index Bond P

While the process of stratified sampling ensures that portfolio and benchmark characteristics are aligned, there are implicit security selection decisions embedded in this approach. Due to these selection decisions, we believe that a passive team should have access to the research of an active management group. This research helps the passive manager anticipate and manage the idiosyncratic risks of individual bonds – risks that are often overlooked from a passive point of view.

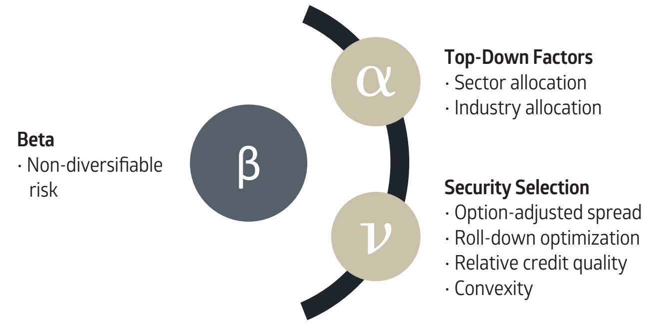
This point can be best illustrated by looking at corporate debt. Two corporate bonds might have similar characteristics in terms of duration, credit quality, etc. However, they may have very different underlying risks based on other factors such as industry, issuer size, covenants, barriers to entry within their industry and other considerations that are usually analyzed from a credit research perspective. Even if a plan's portfolio is passively managed, active decisions are being made by managers as they attempt to mitigate certain risks specific to individual issues. These decisions can be better informed when there is access to the views of an active management and credit research team. The importance of these decisions is magnified in today's low yield environment, with most issues having an asymmetric risk profile. Any deterioration in a bond price caused by the idiosyncratic risks of each bond, that was selected to replicate the index, cannot be easily recouped by passively clipping coupons.

Akin to active strategies, an investor should be certain that a passive manager has the resources of a deep credit research team. The team should be able to advise on the specific risks of various corporate issues selected for the stratified sampling process, beyond the basic characteristics of the bond. The resources of an active management team will also aid in making overall security selection decisions, beyond corporates.

Exploring Enhanced Passive Strategies

Some Canadian institutional investors are not prepared to implement an active fixed income strategy. However, they would benefit from some level of yield enhancement and risk management, especially in the face of ultra-low interest rate policies. As investment committees establish and evolve their belief systems – which tilt them towards either an active or passive approach – certain institutional investors may benefit from considering an additional, less common strategy available in the Canadian fixed income space: an enhanced passive strategy.

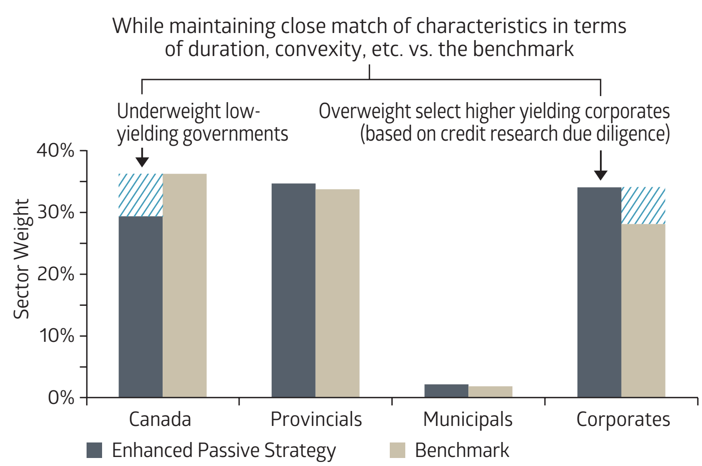
ENHANCED PASSIVE MAINTAINS BETA WHILE ALLOWING FOR ACTIVE TILTS



Defining Enhanced Passive

An enhanced passive fixed income portfolio combines most of the characteristics of a passive mandate, with a moderate tilt towards adding value over the benchmark, while keeping duration neutral. A typical strategy uses the stratified sampling approach to ensure that the primary objective of beta-replication is achieved. However, this strategy gives greater leeway to exploit factors that add value above the benchmark and limit downside risk. This includes moderate sector positioning based on firm outlooks and trades that capture additional convexity compared to other securities. It also includes relative value positioning that tilts exposures to securities that the manager believes to be cheap relative to peers and avoids those that appear rich. This broader allowance for active tilts means that investors can achieve stable beta exposure and potentially benefit from an ability to offset costs through "smart" selection and positioning.

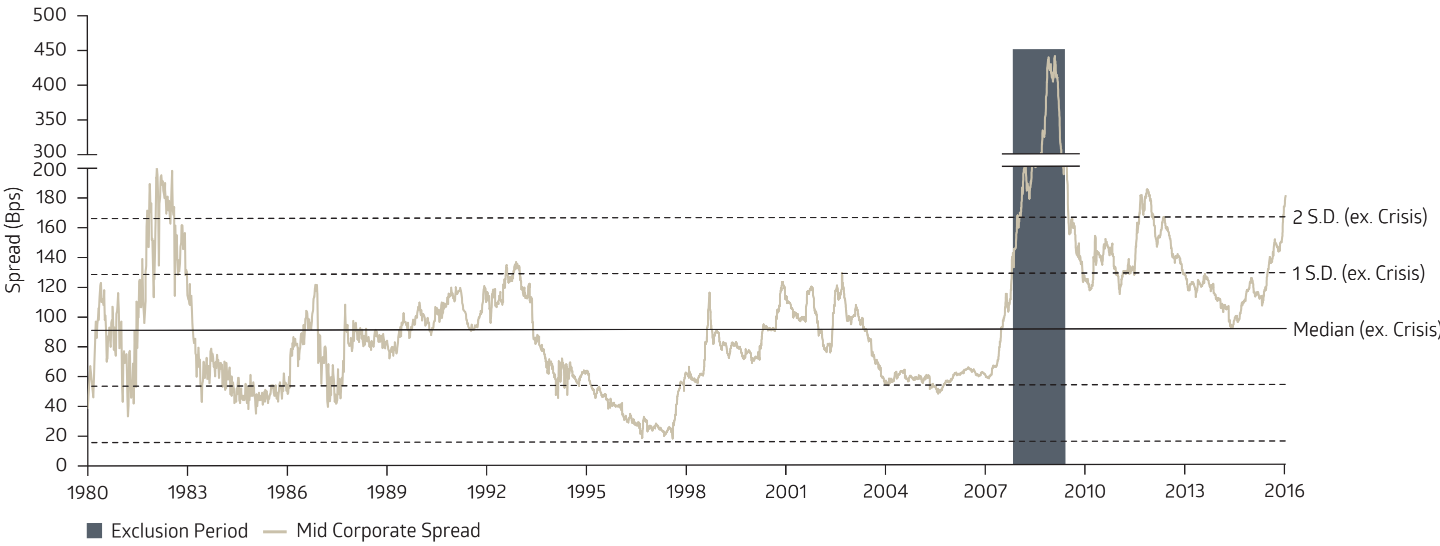
SECTOR POSITIONING EXAMPLE – OVERWEIGHT SELECT CORPORATES



For illustrative purposes only.

In today's market environment, possible alpha contributions might come from current credit spreads. As illustrated on the previous page, an enhanced passive strategy would have the flexibility to overweight corporate bonds in the current environment. In the following chart, we see that credit spreads are currently attractive, a market reality which can be captured in the enhanced passive approach.

CANADIAN INVESTMENT GRADE SPREADS



Standard deviation lines exclude crisis wides, defined as December 2007 through June 2009 (Canadian Recession). Source: CIBC Asset Management and FTSE TMX Debt Capital Markets

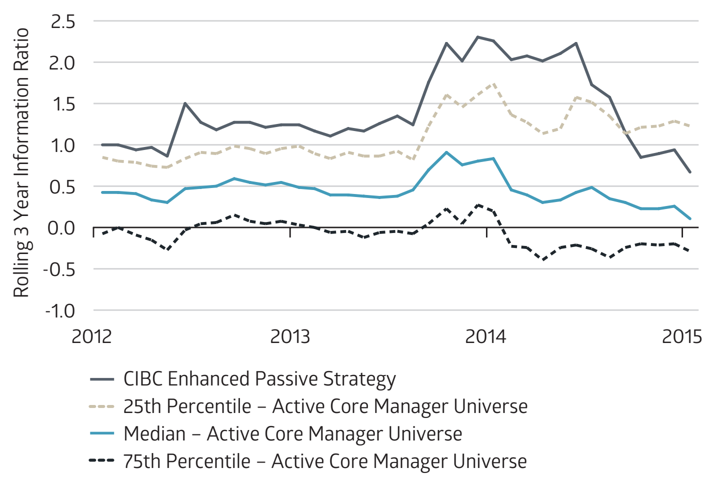
This sector positioning is also offset by the security selection decisions in credit which are underwritten by the credit research team who can direct the manager to corporates that do not pose undo risk on the portfolio through inferior bond covenants, debt structure risks and other issuer specific factors.

Because enhanced passive allows for greater active positioning, we believe passive managers with direct access to skilled, active fixed income teams can deliver a "smarter beta" to an investor. Portfolios are constructed based on the factors discussed above and go beyond simple market-cap weighting. In addition, the enhanced passive manager will address the potentially inefficient benchmark weighting and adjust to create either a higher-yielding or more defensive portfolio.

In today's post-crisis market environment, historically low yields have diminished the income opportunities for pension plans and other institutional investors. The possibility of a slightly higher yield in an enhanced passive portfolio helps offset the otherwise low income potential and fees charged. Similarly, with interest rates at historic lows, the moderate risk control afforded an enhanced passive manager helps to buffer the impact of possible future interest rate increases or slowly rising yields. All of these potential benefits are present in an enhanced passive strategy, while still maintaining the desired broad market exposure.

On a three-year rolling basis, enhanced passive mandates have performed well, resulting in relatively high information ratios. In fact, enhanced passive mandates can post risk-adjusted returns that compete against the fully active peer universe. This occurs despite the large difference in policy constraints and allowance for active positioning.

ENHANCED PASSIVE STRATEGY INFORMATION RATIOS



Active Core Manager Universe = eA Canadian Fixed Income Core Universe
Source: CIBC Asset Management, eVestment and FTSE TMX Debt Capital Markets

Conclusion

Fixed income asset management requires a different approach to manager selection when allocating passively. The Smart Beta movement in fixed income is partly an expression of a growing discomfort with investment exposures driven by the decisions of market-cap weighted benchmark methodologies and rating agencies. Enhanced passive can be a natural hedge against these forces and allows managers the breadth to apply moderate, active tilts while maintaining a duration neutral positioning against the benchmark. Enhanced passive fixed income management may provide just the right alternative for plans seeking passive fixed income exposure.

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