INVESTMENTS

Your Fixation On Benchmarks Could Be Leading You Down The Wrong Path

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Every committee is guilty. We all do it. Quarter-end rolls around and the pension performance report arrives. If you are typical, the first thing you do is look at the performance of the investment funds and fixed income is often at the top of the list. You notice the active Canadian fixed income manager produced a return of -1.0 per cent for the quarter and, at first blush, think, ‘Oh dear, we lost money!’ However, before that thought has truly settled in, you see the benchmark – in this case the FTSE TMX (Canada) Universe Bond Index – fell by 1.5 per cent during that period. The manager outperformed by 0.5 per cent in only three months and did so with less volatility than the index! You deem it a successful quarter for the manager and move on.

Exactly That

For the manager, this period was a success. They were given a mandate to outperform a certain starting point or benchmark and they delivered exactly that. However, for the pension plan, the information is incomplete. We do not know if this performance helped or hurt the plan. All we know is that the manager did better than the starting point. But was the starting point correct?

Pension committees certainly agree on one thing, the manager ought to beat the benchmark. The question that is often ignored or dismissed is, ‘what should the benchmark be?’ If you are investing in Canadian fixed income, the starting point is typically the FTSE TMX (Canada) Universe Index, which is comprised of Canadian government and investment grade corporate bond issues. Once the pension plan has chosen the index that will make up the investable universe for the mandate, it is likely that parameters relative to the benchmark will be outlined in the Statement of Investment Policies and Procedures within which the manager is permitted to invest. For example, the policy will identify allowable ranges around certain desirable portfolio characteristics such as a duration range that is within one year of the index duration.

Often, very little thought is given to where the index duration lies. Committees and boards ought to confirm that the index duration represents an appropriate level of interest rate risk for the plan. Complicating the matter is that the interest rate risk inherent in the index is not static. As the policy is usually written with a minimum and maximum band around the index, if the risk in the index changes, the plan’s investment risk will also change, despite a potential lack of appetite for more risk by the committee or board.

These changes can be significant. For instance, while the yield on the overall Canadian bond index fell from 6.3 per cent as of December 2000 to 2.8 per cent as of the end of 2013, the credit quality of the index fell, the duration was extended, and the average coupon plummeted. Specifically, the portion of the index represented by AAA rated securities fell from 56 per cent to 44 per cent. Intuitively, a decrease in credit quality would translate to a higher expected coupon. However, due to a decline in interest rates over the period, the average coupon actually fell from 7.2 per cent to four per cent over this time. Meanwhile during that 13-year period, the exposure or sensitivity of the index to interest rate changes climbed from 5.7 years to 6.7 years. (*Figure 1*)

The change can be fast, dramatic, and unannounced. Since closing out 2013 with a duration of 6.7 years, the index finished 2014 with a duration of 7.4 years. One month later, at the end of January, the index’s sensitivity to interest rate changes (as measured by duration) further increased to 7.7 years. That means

that over the last 13 months, the interest rate risk in the index rose an additional 15 per cent!

With the Bank of Canada cutting interest rates, the average yield fell from 2.2 per cent at the end of December 2014 to 1.6 per cent at the end of January. The lower yield exacerbates the potential issue for pension plans as a smaller buffer (via the coupon) now exists to absorb losses from interest rate changes before the fixed income investment will realize a negative return for the period.

More Risky

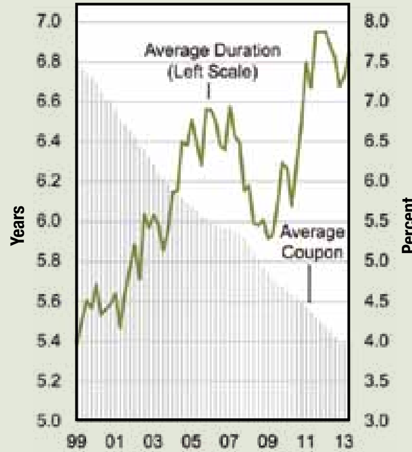
Overall, the FTSE TMX (Canada) Universe Bond Index has become significantly more risky since the turn of the millennium. Due to the benchmark relative approach utilized by many plan sponsors, money managers have been forced to decrease the quality of the fixed income portfolio and increase the interest rate risk, meaning that the absolute risk of your pension investments has also increased, albeit quietly.

If you think like I do, the ever dynamic nature of the benchmark relative investment approach can make you feel uncomfortable. Committees and boards ought to evaluate their comfort level with a mandate that has an evolving risk profile and consider utilizing an absolute approach as opposed to a benchmark relative approach when setting investment parameters. Your pension and investment consultant can work with your team to help you identify comfort levels and determine the best course of action given your plan's unique goals and objectives.

While this article has been framed around things to consider regarding a fixed income benchmark, committees and boards face similar challenges and questions when identifying appropriate benchmarks or starting points for equity investments, but that is for another article. BPM

Figure 1

Bond Market Duration Is Climbing While Coupon Declines*



* December 2000 through March 2014. Modified adjusted duration and average coupon of DEX Universe Index (Now FTSE TMX (Canada) Universe Index) measured quarterly.
Source: Barclays and AllianceBernstein

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