a fragile bond

In this golden period of high bond returns, bonds appear to be the ideal investment. But plan members—and pension plan fiduciaries—should be cautious.

By Gord Lewis

If you're looking at bonds as an investment opportunity, you may want to think again. That's especially true if you are a fiduciary of a defined contribution (DC) pension plan or group registered retirement savings plan and you now have more defined responsibilities thanks to the Joint Forum of Market Regulators' *Guidelines for Capital Accumulation Plans* (CAPs).

That's because bond investments are not easy to understand. According to a May 2004 survey by SEI Investments, *DC Pension Plan Members: Needs & Knowledge,* too many plan members don't really understand their retirement plan, let alone how the investments work. Bond funds are likely the most complicated investment option they may have.

Mention a bond fund to many plan members and the first image they get is that of a Canada Savings Bond with the expected guaranteed rate of return. But bond fund returns are far from guaranteed—just ask the investment managers that held the AT&T Canada bonds, valued at over $4.6 billion back in October 2002. Some managers lost over 1% of the value of their total bond portfolio because AT&T Canada defaulted on its debt.

The construction and operation of a bond fund is something that is not well understood by many CAP investors. How the portfolio is constructed based on durations, quality ratings, spreads between governments versus corporates etc., are all types of information that are rarely disseminated to the individual plan member.

Why? Possibly because communicating about a pension plan involves a lot of detail and this information may just confuse the matter. With the CAP guidelines in play, fiduciaries have a responsibility to at least try. It makes it even more challenging for those plans that offer multiple bond options; if plan members don't understand how a generic bond fund works, how will they determine which is most appropriate from a list of three or four?

STRONG PERFORMANCE

For the past 15 years, bonds have provided great returns with the index, averaging 9.4% per year over that period. For the period ending Dec. 31, 2005, the bond index has provided positive returns 14 of the 16 periods. In fact, bonds have outperformed Canadian equities in eight of those years.

Given the bond market's golden run, it is not surprising to hear plan members expect more of the same. But they don't understand where a big part of the solid performance came from—mainly interest rates. Over the past 10 years, yields for the Canadian Government 10-year bond have dropped from approximately 6.4% to 4.2%.

How much of an increase in interest rates do you need to make a material impact on the return of a bond portfolio? That depends on things like the duration of the portfolio; a 1% change in interest rates will have approximately twice the impact on a 25-year bond as it does on a 10-year bond.

Which way are interest rates going in the future? Only David Dodge, the Governor of the Bank of Canada, knows. The Bank recently increased the overnight rate by 25 basis points to 3.75%. As important as these rate changes are, the Bank of Canada controls the overnight lending rate to the chartered banks while the interest rates affecting bond funds are the longer-term rates (i.e. 10+ years), which are determined by the markets.

Bob Sanderson, vice-president and director at Lincluden Investment Management in Oakville, Ont. points out that interest rates are largely dependent on inflation. If inflation is rising, interest rates will tend to rise. Conversely, if inflation is falling, as has been the case in the past decade, interest rates tend to fall. This has resulted in interest rates hovering around 40-year lows.

If over the next couple of years interest rates increase, this will have a negative impact on bond returns, possibly surprising many CAP plan members. And CAP members are not the only ones at risk here. Certain foundations have over 90% of their assets in fixed income. Defined benefit pension committees should also observe the duration of their bond investments and how they relate to the duration of the plan's liabilities. If the duration of the two are matched, then movement in interest rates will proportionately have a similar impact on the liabilities as it does on the assets.

What's the solution? Education. Plan members need to understand the characteristics of their investments and what they should expect given different external scenarios. Plan sponsors, as fiduciaries, are expected to help plan members understand their investment options. And that includes warning them that one day the bond train might come to a screeching halt. **BC**

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