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The Case for a Strategic Allocation to Canadian Corporate Bonds

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In Brief

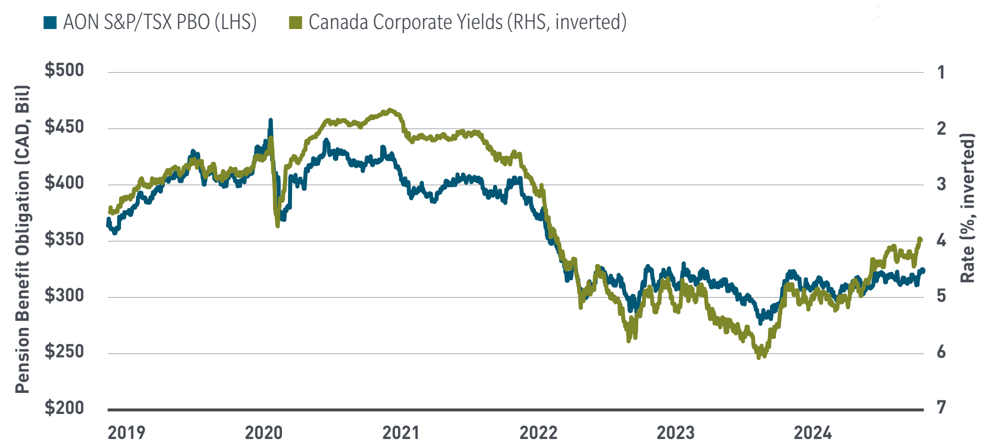
- With aggregate funded status ratios for Canadian DB plans increasing above 100% post COVID, now is the time for plan sponsors to consider derisking their plans and locking in historically high market yields.
- High correlation exists between Canadian corporate bonds and the liabilities that plan sponsors need to manage to.
- We offer three possible investment solutions to consider implementing, using Canadian Corporate bonds as a derisking instrument.

Funding statuses have improved substantially. Despite the wave of volatility experienced in markets since the onset of COVID, Canadian pension fund portfolios, in aggregate, have performed relatively well. Many of these plans, which have been overweight equities and alternatives as opposed to public fixed income,[1] have enjoyed strong market returns, with global equities, infrastructure and real estate returning 115.1%, 48.8% and 27.3%, respectively, since March 2020.[2] These strong returns have helped boost the aggregate funded status of these plans substantially; per Mercer they stand at 121.4% as of 30 September 2024 against an average of only 88.4% during the 2010–2020 decade.[3]

Time to shift to de-risking. With funded ratios now well above 100%, we believe it is prudent for these funds to consider a transition towards portfolio de-risking. De-risking would involve removing as much funded status volatility as possible from a plan, either through risk transfer agreements with a third party or through changes to the strategic asset allocation. We believe that plans could benefit from de-risking by rebalancing into fixed income, including increased exposure to Canadian corporate bonds.

We believe Canadian corporate bonds can be a great strategic asset class for liability-driven investors because of their natural synergies with liability accounting. In Canada, corporate pensions liabilities are discounted using a yield curve comprised of high-quality corporate bonds, typically AA corporate bonds. As seen in Exhibit 1, the calculation for the pension benefit obligation (the aggregate liability) inversely tracks the yield of Canadian corporate bonds.

Exhibit 1: Canadian Corporate Yields and Pension Benefit Obligations



Source: Bloomberg, AON Pension Risk Tracker. Daily data from 1 January 2019 to 11 December 2024. Aon tracks the aggregate pension benefit obligations for those companies which are publicly traded on the S&P TSX index. Yields displayed are yield-to-worst.

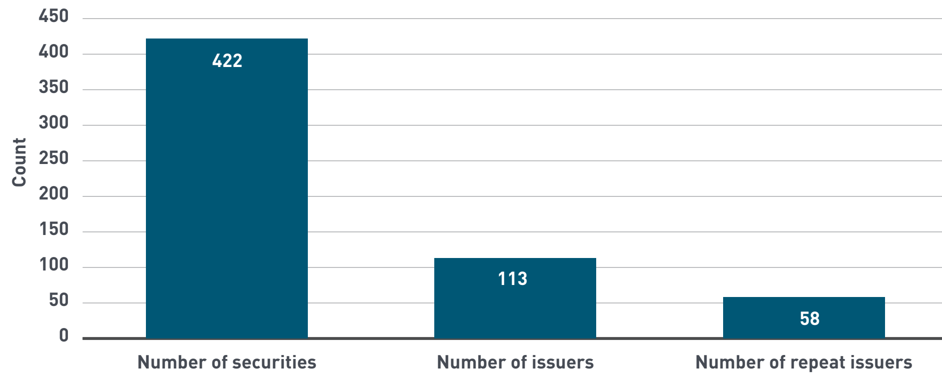
The high correlation between pension liabilities and bond yields allows for immunization, an asset allocation strategy that involves investing in assets that will closely track the growth of the liabilities. While this would appear straight forward in nature, in practice, tweaking an asset allocation to de-risk funded status volatility can be rather complex. To start thinking about implementation, we review the potential benefits and drawbacks of a handful of investment strategies: an allocation to long Canadian corporate bonds, an allocation to universe corporate bonds and a long Canadian corporate Core plus approach blending in some long US corporate bonds.

Allocation to Long Canadian Corporates

While corporate bonds already do relatively well at tracking pension liabilities, some plan sponsors with long-dated liability durations may want to consider an allocation to long Canadian corporate bonds. These corporate bonds are typically between 10 and 30 years in time to maturity, giving them a longer duration profile than standard universe corporate bonds and align closely with the duration of an average corporate pension liability of 14.2 years.[4] Given that the bonds are also reasonably high-quality Canadian corporates, they also have the advantage of naturally maintaining exposure to the yield curve their liability is discounted against, which helps to mitigate the interest rate risk. Immunization is an effective strategy for derisking when the plans' asset values move in unison with the liabilities. In this case, Canadian corporates and the liability yield curve are typically highly correlated given that the liability curve is derived from AA corporate bonds.

While long Canadian corporates can be an excellent choice as an immunization asset, there are a few things to consider when implementing the strategy. The long end of the Canadian corporate market is relatively narrow, which can cause concentration and illiquidity risks. Nearly 80% of the Canadian long corporate market is comprised of just a few sectors — utilities (34.7%), energy (22.2%) and industrials (21%) — while having very little exposure to sectors with secular tailwinds such as health care and technology. This gives rise to idiosyncratic risks within one sector dislocating the asset values from the liability, which would increase the amount of funded status volatility. Additionally, the market is narrow in terms of the number of companies that issue bonds on the long end of the curve. In the chart below, we see that, as of 30 November 2024, there are only 113 companies that have a bond in the long corporate index, and only 58 of those companies have more than one long-dated bond.

Exhibit 2: Long Canadian Corporate Security and Issuer Counts



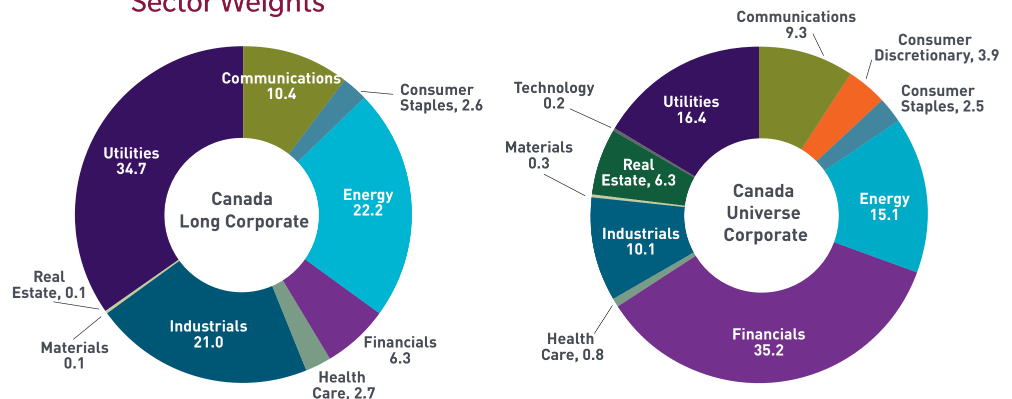
Source: FTSE, Bloomberg. Data as of 30 November 2024 for the FTSE Canada Long Term Corporate Bond Index.

This issuer concentration can greatly reduce liquidity in stressed market environments and potentially increase volatility. To combat the concentration concerns, we will review strategies that try to increase the amount of issuer and sector diversification.

Allocation to Canadian Universe Corporate Bonds

Another route to consider may be Canadian universe corporate bonds. Unlike the long corporate bond strategy, universe bonds comprise the entire maturity spectrum of the Canadian corporate bond market. This doubles the issuer count available to investors in the universe bond strategy to 230 versus 113 for the long strategy, and the number of issuers with multiple issues nearly triples to 153 versus 58. We can also see how the sector weights differ in Exhibit 3 below; the weights in utilities, industrials and energy, which comprised the vast majority of the long corporate index, have been reduced to just 41.5% while other sector weights such as financials and real estate have increased. Investors would have a much larger pool of assets to construct their portfolio from without the issue of high concentration. The average issue size in the universe corporate index also increases versus the long corporate index, jumping up by nearly 34% from $360 million for the long index versus $481 million for universe bonds, which enhances the liquidity profile of the universe strategy versus the long-end approach.

Exhibit 3: Canadian Universe Corporate vs. Canadian Long Corporate Sector Weights



Source: Bloomberg, FTSE. Data as of 30 November 2024. Canada Long Corporate = FTSE Canada Long Term Corporate Bond Index. Canada Universe Corporate = FTSE Canada All Corporate Bond Index. Sectors weights determined using the Bloomberg BICS classification.

While increased diversification can be a benefit for the universe corporate strategy, one of the headwinds it faces is duration mismatch. Today the index duration stands at around 5.9 years, which is much shorter than the long corporate index at 12.7 years.[5] For plans that have shorter liability duration profiles, this may still be an attractive option, but for others with longer duration profiles, it may introduce an allocation that would have sizeable difference in interest rate volatility compared to their liability. To try to reconcile both the concentration issues in the Canadian Corporate market as well as the duration profiles, we present a third investment solution which combines Long Canadian Corporate exposure with Long US Corporates.

A Long Canada and US Long Corporate Approach

With this approach, investors would typically continue to invest mainly in the Canadian long corporate market, with an allocation size between 70% to 80% of portfolio assets, combining it with a sleeve of US long corporates (for 20% to 30%). Compared with the universe bond strategy, this approach is designed to result in assets maintaining their long duration exposure as the US long corporate index has an overall duration 13.1, which is only 0.4 years different than Canada and much closer than the universe strategy. The diversification benefit from adding the US exposure is also reflected in both the sector allocations as well as the number of issuers that the combination of the two markets have to offer to investors. In the table below, we compare the US long corporate sector weights against Canada: We see that the US can help add exposure to new sectors such as health care and technology, while also helping manage the exposure to sectors like energy and infrastructure (such as utilities and industrials). Issuer count also increases as US exposure is added. The US long corporate market has nearly triple the number of issuers with long-dated paper at 695. The average issue size of these issuers is also $1.3 billion, which is about 260% larger than Canada, helping provide more room to source an allocation to these bonds and therefore increase liquidity.

Exhibit 4: US and Canada Long Corporate Statistics

	Canada Long Corporate	US Long Corporate
Select Sector Weights		
Utilities	34.7%	13.2%
Industrial	21%	8.8%
Energy	22.2%	9.6%
Health Care	2.7%	16.4%
Technology	0.0%	8.4%
Market Size		
Number of Issuers	113	695
Repeat Issuers	58	474
Average Issue Size (CAD, Mil)	$359.9	$1,307.1

Source: Bloomberg, FTSE. Data as of 30 November 2024. Canada Long Corporate = FTSE Canada Long Term Corporate Bond Index. U Long Corporate = Bloomberg Long US Corporate Bond Index. Sectors weights determined using the Bloomberg BICS classification. Issue size is measured in Canadian dollars.

While the additional diversification benefits and maintenance of a long duration profile may be clear, the potential for the two markets to diverge can create challenges for liability management. Typically, the US and Canadian markets are highly correlated, as their proximity has created a robust trade relationship with deep financial interconnectedness that causes the two economies to grow in lockstep. However, differences in macro-economic policies and market environments can cause the two asset classes to deviate at times. When these divergences occur, it will impact the portfolio's ability to properly hedge any shifts in the liability and results in increasing funded status volatility. To help combat this, fund managers can utilize futures and other derivative instruments to hedge both the US currency and yield curve exposure back to Canada. There typically has been a modest give-up in yield from the portfolio to enter these contracts, but from an LDI perspective, the ability to convert and maintain exposure to only Canadian currency and curve movements is an attractive feature. Plans that are overfunded may find this to be an attractive option for de-risking as maximizing yield may not be as an important objective as the need for duration matching.

Consideration for Implementing Canadian Corporate Strategies

As plans continue to review their options of derisking, we believe many plans would be well suited by considering gaining or increasing exposure to Canadian corporates through one of the solutions discussed. Active management may be another lever that funds have at their disposal within the corporate space that could assist them in managing to their liability. With risk management in mind, an active manager could work with an investor to help construct a portfolio of securities that seeks to match the liability duration. If return generation is a consideration, then certain strategies such as the Canada and US approach may also give an active manager the ability to go under or overweight regional allocations. In addition, having a larger pool of bonds to pick from at the security level can help broaden the active manager's ability to potentially generate alpha. Looking at current market conditions, today's yields remain significantly above their historical average and therefore represent a compelling entry point for many investors. However, it is important to stress that the Bank of Canada is now in rate-cutting mode. The Bank of Canada initiated a rate cutting cycle in the second half of 2024, with more cuts expected to be in the pipeline in 2025. With that in mind, if investors are looking to lock in elevated yields in an asset class that can offer the ability to potentially reduce funding volatility, the time to consider an allocation to fixed income is now, in our view.

Endnotes

[1] Pension Investment Association of Canada, 2023 asset mix report. Data reported as of 31 December 2023, asset allocations represent PIAC member organization medians.

[2] Bloomberg, MSCI, FTSE. Data from 31 March 2020 to 31 December 2024. Global equities = MSCI World Index. Infrastructure = MSCI World Infrastructure Index. Real Estate = FTSE EPRA Nareit Global REITS Index. Returns are cumulative and in CAD.

[3] Mercer Pension Health Pulse. Data as of 30 September 2024 from Canadian DB pension plans slightly improve as market gains offset interest rate declines. Solvency data based on 450 pension plans across Canada tracked by Mercer's pension database.

[4] Beath, A. D., Betermier, S., Flynn, C., & Spehner, Q. (2021). The Canadian Pension Fund Model: A Quantitative portrait. The Journal of Portfolio Management, 47(5), 159–177. https://doi.org/10.3905/jpm.2021.1.226

[5] FTSE, Bloomberg. Data as of 30 November 2024. Duration measure used is modified duration. Canada Long Corporate = FTSE Canada Long Term Corporate Bond Index. US Long Corporate = Bloomberg Long US Corporate Index.

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