Pension News

UBC Faculty Pension Plan
First Quarter 2009 Edition

Bonds and Their Performance in 2008

Bonds are an important component of the Faculty Pension Plan (FPP) – they make up 38% of the Balanced Fund and there is also a separate Bond Fund option. The Bond Fund earned less than the performance target in 2008. This article discusses bond investment in general and the 2008 underperformance in particular.

What are Bonds?

Bonds are loans to governments and corporations, primarily to finance capital expenditures and operations. The loans are normally for a specified, fixed term that ranges from a few months up to 40 years. During the term, the borrower (bond issuer) pays interest at a specified rate that may be fixed or may be variable by reference to an external index. At the end of the term, the loan is repaid.

The rate of interest paid on a bond depends on the creditworthiness of the lender. Bonds issued by the Government of Canada, secured by their taxing power, are the most secure and offer the lowest interest rate; bonds issued by provinces and corporations pay higher rates of interest that vary according to the creditworthiness of each province or corporation. Within the corporate bond sector, the bonds of businesses more exposed to economic downturns (for instance, commodities) normally pay more interest than those of businesses that are less exposed to economic downturns (such as utilities and telecommunication companies).

The Importance of Bonds

Bonds are a favoured investment by certain investors – especially retirees and institutional investors such as charities – because they provide a steady stream of income. Bonds are also an important component of pension funds such as the FPP Balanced Fund because they reduce the risk of capital loss in funds that also contain stocks. Most of the equity (stock) markets worldwide lost 30% or more in 2008; most bond markets gained 5% or more. Even though bond values can also be volatile when economic conditions change – as discussed below – investing in bonds in a balanced fund removes some of the fund's overall downside risk. Over the past 40 years, bonds have had only six negative years, providing a good offset to stocks to moderate the rate of return.

Bond Values

Although the features of a bond (interest payments, term to maturity) won't change once it has been issued, its selling price in the bond market will vary depending on prevailing economic conditions. Rising interest rates tend to decrease the value of existing bonds; declining interest rates tend to increase those values.

Not all bonds change in value by the same degree: because of their long term payment stream, longer term bonds tend to be more variable than short term bonds. Similarly, corporate bonds, because of their reliance on the ability of the issuing company to make interest payments and principal repayments, are more vulnerable to economic shocks than government bonds, which are supported by the broad taxing power of the government issuer. Corporate bonds tend to perform better than government bonds during periods of economic growth, and worse than government bonds during periods of economic weakness. The value of specific issues of corporate bonds depends on the financial soundness of the underlying business.

Active Bond Management

An investor can simply buy bonds, collect the interest and the principal re-payments, re-invest the cash proceeds in new bonds, and earn, in the current environment, income of 3% to 5% per year, depending on the type of bonds. This approach to bond investing is referred to as "buy-and-hold" or "passive" bond management.

An alternative approach to passive investing is "active" bond management, in which an investment manager is given the mandate to try to add value to a bond portfolio over a bond index benchmark by anticipating changes in interest rates or in the relative value of different bonds – not all bonds perform equally well (or equally poorly) during different economic conditions.

There are several strategies to add value to bonds:

- **Interest rate anticipation** is a strategy in which the bond manager assesses the broad direction of interest rates – falling interest rates are more favourable to longer term bonds than to shorter term bonds, and rising interest rates more favourable to shorter term bonds than longer term bonds – and positions the portfolio accordingly.
- **Sector selection** is a strategy in which the bond manager assesses the expected performance of different sectors of the bond market (federal, provincial, corporate), that may perform differently at different times. Bonds of riskier lenders tend to vary more substantially than government bonds; they will increase in value when economic conditions are good, and decrease in value when economic conditions are poor.
- **Yield curve management** is a strategy in which a bond manager might anticipate changes for bonds with different terms to maturity, even though the manager does not want to change the broad exposure of a bond fund to interest rates in general.
- **Security selection** is a strategy in which the bond manager conducts credit analysis, usually within the corporate sector, to identify bonds that are expected to perform particularly well (and to avoid bonds that are expected to perform particularly poorly).

The FPP Trustees have retained several bond managers that use some or all of these techniques, to create a fund that is broadly diversified by investment process.

The FPP Bond Fund and the Bond Component of the FPP Balanced Fund

The FPP Bond Fund is actively managed by the following managers using the following strategies:

Bond Manager	Target Allocation	Investment Strategy
State Street Global Advisors	43.4%	Enhanced Index
PIMCO Canada	26.0%	Core Plus
AllianceBernstein	17.4%	Core Plus
Barclays Global Investors	13.2%	Real Return Bonds

State Street Global Advisors uses an "enhanced" strategy, to create a fund that is similar to the underlying bond universe benchmark (the DEX Universe Bond Index), but with the mandate to take relatively small positions away from the index using all of the techniques described above to add incremental value. Their results will tend to be close to that of the index.

PIMCO Canada and AllianceBernstein use a "core plus" strategy" in which the "core" consists of a diversified portfolio of bonds that substantially match the DEX Universe Bond Index and the "plus" consists of bonds not part of that index, including global bonds, bonds denominated in foreign currency, high yield bonds, asset-backed securities and emerging market debt.

Barclays Global Investors (BGI) invests in real return bonds issued by the Government of Canada or the provinces. Unlike the more traditional bonds that provide a fixed amount of interest each year and re-pay the principal amount at the end of the term, real return bond interest payments and the principal repayment are adjusted for inflation.

The Performance of the Bond Fund in 2008

The broad bond index, as measured by the DEX Universe Bond index (the "benchmark") earned 6.4% in 2008. The FPP Bond fund earned 3.0%, certainly a disappointing year.

Although stocks received most of the media attention in 2008 as they crashed worldwide, bonds also had remarkable results. As the stock markets crumbled and as pessimism grew about the economy, investors "fled to quality." In Canada, Government of Canada bonds earned 11.5% in 2008; corporate bonds earned 0.2%, a difference of 11.3%, a historically very large number. In the U.S, the difference was even wider, with most corporate bonds losing value.

Within the FPP Bond Fund, State Street Global Advisors earned 7.0%, a good result consistent with their investment process.

The two core plus managers, PIMCO Canada and AllianceBernstein, had very poor years, with PIMCO earning only 0.63% and Alliance Bernstein losing 3.2%.

PIMCO's underperformance came from several sources, as they underestimated the impact of the global economic crisis. They held substantial positions in non-Canadian corporate bonds, which underperformed Canadian corporate bonds. They also held asset-backed securities which, although considered very secure even now, lost value as the demand for them fell as few purchasers were willing to buy them.

AllianceBernstein had similar problems to PIMCO. They had anticipated an earlier turnaround in the market, and held a large position in corporate bonds, in particular high-yield bonds, that are expected to have a high rate of return when the economy improves. They also invested in asset-backed and mortgage-backed securities, similar to PIMCO, that are considered secure, but have decreased in value because of a shortage of willing buyers. Some of their choices of foreign bonds, such as Russian bonds, performed poorly as well.

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The BGI real return bonds earned 0.5%, which was below the DEX Universe benchmark, but better than the DEX Real Return Bond Index. The BGI results won't normally match the benchmark as the BGI fund is invested solely in real return bonds, which are included in the portfolio to provide diversification and as an inflation hedge.

The trustees examine how the FPP funds perform relative to other pension funds. In 2008, the median bond fund, as reported by RBC-Dexia earned 4.9%, which was also below the index benchmark but higher than the FPP's 3.0% result. Most investment managers did not anticipate the extent to which corporate bonds would significantly underperform during the year.

Trustees Review

The trustees regularly review the performance of all the investment managers. The performance of the bond managers in 2008 was disappointing. The trustees have received explanations from the investment managers, that the portfolios were generally positioned for a recovering economy which has not yet occurred, and they will continue to monitor the investment managers' processes.

This article was prepared by Satanove & Flood Consulting Ltd. Comments should be sent to: fpp@hr.ubc.ca

Faculty Pension Plan Open House

The Faculty Pension Plan is having an Open House on Tuesday, June 9, 2009 from 2:00 pm to 4:00 pm in the Arbutus Room at the Ponderosa Centre, 2071 West Mall. Please join us and meet the trustees and staff of the FPP. At 2:30 pm, Joost Blom, Chair of the Faculty Pension Plan, and Mike Leslie, Executive Director of Investments, will do a short presentation on the performance and accomplishments in 2008 and outline the Plan's initiatives for 2009. Please confirm your attendance with Kathy Pang at 604-822-8100 or e-mail kathy.pang@ubc.ca

Voluntary Contributions

Did you know that voluntary contributions are allowed in the Faculty Pension Plan? Any member whose annual pensionable earnings are less than $155,000 may have eligible voluntary contribution room.

Take advantage of the calculator on the FPP website to calculate your voluntary contribution room.

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Market commentary

The first quarter of 2009 witnessed negative returns again for most stock markets, although the Canadian equity market suffered less than global equities and bond returns had a positive quarter. Negative economic news and increasing unemployment (7.7% rate) continued to affect the markets, although March produced very strong returns in most equity markets. The Bank of Canada cut their overnight lending rate from 1% to 0.5%, their lowest level ever in Canada.

The Canadian market was down 2.0% in the first quarter, despite a strong rebound in March when the Canadian stock index returned 7.8%. Only three of the ten market sectors (Materials, IT, and Health Care) had positive returns for the quarter. Industrials and Utilities were the weakest performing sectors for the quarter. Both gold and oil rose in price during the quarter and the Canadian dollar ended at $0.79 USD.

The U.S. stock market had another weak quarter (-9.3% in C$s) and by early March the S&P 500 had fallen to a 12-year low. A late quarter rally led to a 7.8% gain for the month of March driven largely by financial stocks. This has still led to a year-over-year decline of more than 24% for the S&P 500. International equities, as measured by the MSCI EAFE index, also remained weak, with a loss of 12.3% for the quarter. These stocks are now down almost 57% from their peak in local currency terms and are back to 2004 value levels.

The first quarter was positive for bonds with the DEX Universe Bond index up 1.5%, mainly driven by March's 1.8% return. Mid-term bonds were the strongest segment (+2.6%), while real return bonds also had a 4.7% return for the quarter. Corporate issues significantly outperformed government bonds for the quarter as credit spreads narrowed in a reversal of the previous flight to quality.

Performance of Funds for periods ending March 31, 2009

	3 Months	1 year	3 years	5 years	10 years
Balanced Fund - gross	-3.34%	-15.19%	-1.69%	3.02%	4.58%
Balanced Fund - net	-3.46%	-15.62%	-2.15%	2.56%	4.14%
Composite Index 1	-3.07%	-14.67%	-1.89%	2.67%	4.06%
Bond Fund - gross	1.94%	1.38%	4.18%	4.26%	5.55%
Bond Fund - net	1.86%	1.06%	3.92%	4.01%	5.29%
Composite Index 2	1.97%	4.29%	4.96%	4.93%	5.94%
Canadian Equity Fund - gross	-3.72%	-30.58%	-6.46%	3.79%	6.94%
Canadian Equity Fund - net	-3.83%	-30.88%	-6.85%	N/A	N/A
Composite Index 3	-1.88%	-31.94%	-7.36%	2.78%	5.23%
Foreign Equity Fund - gross	-9.97%	-29.85%	-12.40%	-4.63%	-2.14%
Foreign Equity Fund - net	-10.08%	-30.21%	-12.78%	N/A	N/A
Composite Index 4	-10.35%	-28.35%	-10.95%	-4.11%	-2.19%
Short Term Investment Fund - gross	0.25%	2.38%	3.67%	3.25%	3.86%
Short Term Investment Fund - net	0.20%	2.23%	3.51%	3.08%	3.61%
Composite Index 5	0.19%	1.85%	3.43%	3.06%	3.51%

Composite Index 1: *33% DEX Universe, 10% S&P/TSX Capped, 5% S&P/TSX,5% S&P/TSX 60 Capped, 15% S&P 500, 15% MSCI-EAFE, 2% DEX 91-Day TB, 10% IPDCPI, 5% DEX Real Return Bonds*
Composite Index 2: *86.8% DEX Universe, 13.2% DEX Real Return Bonds*
Composite Index 3: *25% S&P/TSX, 50% S&P/TSX Capped, 25% S&P/TSX 60 Capped*
Composite Index 4: *48% MSCI-EAFE, 48% S&P 500, 4% DEX 91-Day TB*

Composition of Funds as at March 31, 2009

Balanced Fund	**Market Value ($ Millions)**	**% of Fund**
Equities - Canada	166.9	19.2%
Equities - U.S.	125.4	14.4%
Equities - EAFE	105.2	12.1%
Absolute Return Hedge Fund	20.5	2.3%
Real Estate - Canada	95.1	10.9%
Fixed Income	306.0	35.1%
Real Return Bonds - Canada	48.2	5.5%
Cash & Short term	4.2	0.5%
Total Balanced Fund	871.5	100.0%
Bond Fund		
Fixed Income	34.2	86.4%
Real Return Bonds - Canada	5.4	13.6%
Total Balanced Fund	39.6	100.0%
CANADIAN EQUITY FUND	58.6	100.0%
FOREIGN EQUITY FUND		
Equities - U.S.	12.5	52.1%
Equities - EAFE	10.4	43.3%
Absolute Return Hedge Fund	1.1	4.6%
Total Foreign Equity Fund	24.0	100.0%
SHORT TERM INVESTMENT FUND	70.1	100.0%