Why record low bond yields still draw Canada's smart money

By Tim Kiladze
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As global bond yields plummet to record lows, many of Canada's largest and most sophisticated fixed-income investors have every intention to keep loading up on debt – despite its dismal returns.

Last week, the Canadian 10-year bond yield closed below 1 per cent for the first time ever. With inflation hovering at around 1.5 per cent, anyone holding this debt is likely to lose money in real terms.

Yet the Canadian pension funds and insurers that dominate the fixed-income market intend to keep buying both government and corporate bonds. Their justification: They are adapting to a new world order, one that has forced them to rethink traditional investing rules and benchmarks.

"Many institutions went from thinking of return on capital to return of capital," Sun Life chief investment officer Randy Brown said of the paradigm shift. "If I can just preserve my money … then that's something."

Historically, insurers and pension funds invested in fixed-income securities for their stable and predictable income streams. Bonds typically pay interest at regular intervals, and the principal amount on those with good credit ratings is all but guaranteed to get repaid at maturity. Such security helps these investors fund pension and life insurance liabilities decades down the road, while earning decent returns in the interim.

But with bond yields plunging, those returns are vanishing. Roughly $12-trillion (U.S.) worth of sovereign debt – that is, bonds issued by governments – now pays negative interest rates. In Switzerland, 50-year bond yields turned negative in July, meaning investors must pay the government a small sum to simply safeguard the funds for half a century.

The situation can be baffling. "I can't make sense of negative rates. That to me is completely idiotic. Why would you pay somebody else to hold your money?" said Jim Keohane, who runs the Healthcare of Ontario Pension Plan, which manages $64-billion (Canadian) in assets. "It's an irrational thought process."

However, the bond market keeps humming along. The dichotomy, insurers and pension funds explain, stems from a swath of new investing principles.

Over the past five years, major central banks – from the Federal Reserve to the European Central Bank to the Bank of Japan – have unleashed multiple rounds of quantitative easing. These programs involved massive amounts of bond buying to keep yields low, in the hope that people and companies will borrow more money to fund home renovations or capital expenditures on new factories. (Bond prices and yields move in opposite directions.)

At the same time, global growth has remained stubbornly low. Many countries are still dealing with the aftermath of the 2008-09 financial crisis, which led to high unemployment and minimal wage growth, and aging populations in the developed world are sapping demand. In April, the International Monetary Fund cut its estimate of global growth for 2016 to 3.2 per cent from 3.4 per cent.

Technological disruption also looms large. In a world where Netflix is a threat to telecom giants, Amazon is a threat to retailers and Silicon Valley is a threat to retail banking, any

return – perhaps even 1 per cent – suddenly seems encouraging, because it's still better than losing ground.

"Those three things make an environment that is new and uncharted territory," said John Addeo, Manulife Financial Corp.'s CIO for U.S. fixed income. In this world, a 1-per-cent yield doesn't seem so horrible to a conservative insurer.

Fundamental valuations help explain why. Bond yields factor in risk-free, or minimum, rates of return, inflation expectations and any necessary premiums, such as for illiquidity, explains Ed Cass, chief investment strategist for the Canada Pension Plan Investment Board, which oversees $279-billion in assets under management.

"If you expected zero growth forever, what would you expect a bond to yield?" he asked. By way of deduction, if inflation barely exists, economic growth is anemic and an investor is buying safe Canadian debt, a 1- or 2-per-cent yield can seem reasonable.

Many pension funds and insurers are forced to use such logic because they are bound by high-level asset allocation mandates; their boards require them to invest a large chunk of money in fixed-income investments. For insurers, that's partly because accounting rules require them to perfectly match long-term liabilities with long-term bonds – say, a 20-year life insurance contract with a 20-year bond. If they don't, they have to devote much more capital, or a loss cushion, to the portion of the contract that isn't hedged – which means that money can't be reinvested elsewhere in the business to fund growth.

But age-old investing biases also factor in, and the relativism game likely plays a bigger role than most people appreciate, argued HOOPP's Mr. Keohane. The same situation played out in the early 1980s, when Canadian bonds paid 19 per cent annually. Back then, he said he would tell people to load up on 30-year debt because it paid such an astronomically high yield. They often wouldn't for one simple reason: "Because [the yield] could go to 20 per cent," he said.

Today it's the opposite phenomenon. Investors might be willing to buy debt at negative 10 basis points (a basis point is 1/100th of a percentage point) simply because they worry that if they wait, the same bond could fall to negative 20 basis points. "It's equally ridiculous," he argued.

Despite all of the justifications, there seems to be one scenario even the most sophisticated buyers haven't fully factored in: the bubble threat. If everyone's betting using the same principles, what happens if the fundamentals change?

For fixed-income, the fundamental that arguably matters most is inflation. Right now everyone is ruling out a spike. "What we've seen is a concern of inflationary pressure dissipate entirely," Manulife's Mr. Addeo said.

Pausing for a moment, he admitted that could become a big problem. "The biggest risk investors are taking is [assuming] that environment remains in place," he said. If it changes, and inflation materializes, "the spring is loaded, and the only way for rates to go is up."