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LOW RATES, LOW OIL, LOW CANADIAN DOLLAR — WHAT'S AN INVESTOR TO DO?

MARSH & McLENNAN COMPANIES

The last 6 to 12 months in the markets have been full of surprises:

- Plunging oil prices.
- The Canadian dollar (as well as a number of other major currencies) declining significantly relative to the US dollar.
- The Swiss National Bank's decision to remove its currency peg to the euro, resulting in the biggest one-day move ever for a G10 currency.
- An unexpected Bank of Canada rate cut.
- Long-term interest rates that continue to grind lower and lower, in defiance of what many thought might finally be the beginning of a secular upswing in rates in 2013.

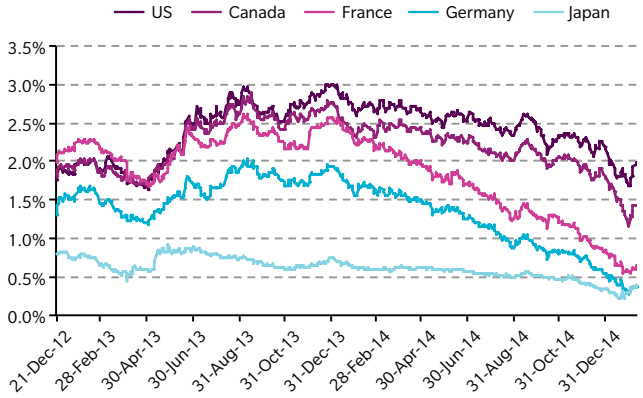
How should investors respond to these developments?

LOW INTEREST RATES

After falling 90 basis points in 2014, Canadian long-bond yields declined by a further 55 basis points in January 2015, and subsequently recovered by about 15 to 20 basis points over the first two weeks of February. January 30, 2015, marked the lowest level ever recorded for the yield on 10-year Canada bonds. The fact that yields are at or near record lows, however, doesn't mean they can't decline even further, and current bond yields in a number of countries around the globe illustrate that possibility.

Chart 1

10-Year Government Bond Yields



Source: Datastream (last data point is 11 Feb 2015)

Net of expected long-term inflation (of roughly 2%), Canadian investors who hold federal government bonds to maturity may be lucky to achieve real returns of 0%. Investors of provincial and high-quality corporate bonds may fare only marginally better. However, defined benefit (DB) plan sponsors may still find longer-term Canadian bonds attractive in terms of their ability to fund expected future pension cash flows and match the marked-to-market liability movements that arise from solvency rules and accounting requirements.

DB plan sponsors with material pension obligations, faced with unwelcome funding or accounting surprises, may find solace in matching long bonds — or annuities — against their pension obligations, despite the increasing cost of these solutions. There is clear evidence of a rapidly growing group annuity market in the UK, US, and Canada as DB plan sponsors look to offload their obligations (especially in respect of closed and maturing plans). The demand for longer-dated, risk-reducing matching bonds may well be contributing to sustained low and falling long-bond yields.

Longer-term investors, less subject to short-term volatility concerns, are recognizing the prospective low returns on traditional, medium-term and long-term Canadian bonds, and shifting more toward alternative investments. This trend may be seen among the investment policies of endowments, foundations, sovereign wealth funds, and open DB plans not subject to solvency funding rules (such as a number of public sector plans). Two investments themes are gaining prominence:

- **Bond investments that are less exposed to yield increases:** Greater exposure to corporate credit (including high-yield sourced on a global basis) and careful selection of emerging market debt (both government and corporate) could both be sources of higher yields. Private debt, which includes an illiquidity premium, may also offer the prospect of higher yields. Investors can access these mandates on either a stand-alone specialized basis, or through a broader "core-plus" fixed-income mandate. In general, investors should also consider broader global mandates — such as unconstrained bonds, absolute return bonds, and multi-asset credit mandates — which allow skilled managers a greater opportunity set, the ability to dynamically manage exposures to various bond sectors, and the scope to manage duration positioning within a broad range.

- **Greater allocation to, and diversity of, growth assets:** In the current environment, it may be sensible to reduce the allocation to traditional bonds (given diminished forward-looking return expectations) and instead aim to reduce risk by achieving greater diversification among growth assets. An increased but more diversified exposure to growth assets can enhance forward-looking return expectations while maintaining a similar overall risk posture. As an example, growth assets can be diversified beyond public equities into asset classes, such as conservatively invested core real assets (including domestic and global real estate and infrastructure) and low beta hedge funds.

  Although alternative investments continue to move into the mainstream, some institutional investors may still find a number of these alternatives too illiquid, complex, or expensive. But before dismissing these ideas, we suggest investors ensure they are fully aware of the current product availability and latest implementation options, which have made it easier to gain exposure to these asset classes. And for those investors who truly need greater liquidity, there are other options, such as diversified growth funds (a modern and much more dynamic and diverse incarnation of the traditional balanced fund) and various low volatility equity funds (including those better designed to deal with potentially rich valuations in some sectors and possible future increases in interest rates).

For DB investors sensitive to short-term fluctuations, are there ways to reduce the sensitivity to the short term and move toward a longer investment time horizon?

Two options to consider include the use of prior-year credit balances (for Ontario registered plans) and letters of credit for solvency special payments, in order to smooth out the impact of market movements on cash-funding requirements. In addition, for some sponsors with good credit ratings, borrowing to fund may be a good strategy to access capital at low rates, and hopefully earn higher returns in the fund. Finally, plan sponsors can add their voices to the growing numbers urging reforms to existing funding rules in order to reduce the significant volatility of the current solvency funding regime. Such reforms could include the introduction of more effective techniques that permit smoothing of changes in solvency contributions, or perhaps even scrapping the current solvency approach in favour of a revised going-concern funding approach, as proposed by The Association of Canadian Pension Management (ACPM).

LOW OIL PRICES

The 50%+ decline in oil prices has taken its toll on the market prices of many energy-related investments. This decline has negatively impacted public equity stock prices (particularly in Canada, given the large weighting of the energy sector), high-yield bond returns (since the energy sector is a significant component of the US high-yield bond market), and many energy-related private equity investments.

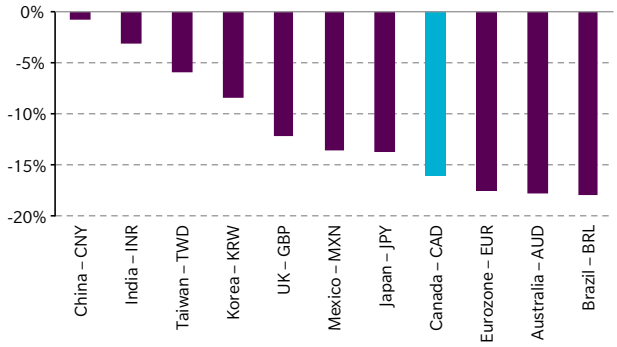
Although there have been "losers" adversely impacted by the recent slide in oil (such as the energy sector and energy-producing countries), there will also be "winners" (consumers, businesses such as airlines with significant energy input costs, and energy-importing countries). A globally diversified equity portfolio has fared reasonably well over this period of rapidly declining oil prices. For instance, over the last six months of 2014, the return on the MSCI World Index in local currency was +4.3%, versus the corresponding return on the S&P/TSX Index of -2.0%.

Investors in the concentrated Canadian equity market have now experienced the impact of a significant decline in oil prices to go along with their previous experiences of the bursting of the Nortel bubble and the fall in resource prices during 2011–2013. Although Canadian banks have been excellent long-term investments — and arguably, are relatively attractively priced today — the claims of an overvalued housing market in Canada should give investors pause to consider the implications of a disorderly housing correction and what that might mean for Canadian bank stocks. Again, the concentration of the Canadian equity market (that is, roughly 68% comprised of financials, energy, and materials) may create a divergence in performance versus global markets that are more diversified in nature. Investors who haven't yet acted to reduce home country bias (that is, to reduce the allocation to Canadian stocks versus foreign stocks) within their equity portfolios should reconsider their strategic positioning in this respect.

LOW CANADIAN DOLLAR

Along with lower oil prices, the Canadian dollar — relative to the US dollar — has also fallen. Although oil prices have no doubt had an impact, it's interesting to note that many currencies have declined notably versus the US dollar in recent periods. The story is as much or more about US-dollar strength than it has been of Canadian dollar weakness.

Chart 2
Exchange Rates vs. USD
30 June 2014 to 30 January 2015



Source: Pacific Exchange Rate Service

Investors with unhedged foreign investments, particularly unhedged US investments, have been buoyed by the appreciating US dollar. For example, for a Canadian investor, the unhedged return on the S&P 500 was 15.4% over the last six months of 2014 as compared to the hedged return of 6.5%. So should investors revise their currency hedging policies in light of recent events?

The future path of exchange rates, as is typical, is far from clear. On one hand, the strength of the US economy, monetary easing in Europe and Japan, and continued lower oil prices, argue for further US dollar strength. On the other hand, these factors may already be priced in, and a consensus view of a strong US dollar could reverse if events do not unfold as expected (for

example, if the US Federal Reserve System is slower to raise rates than expected, or if foreign central banks are less accommodative than expected). Regardless of one's personal view of likely near-term exchange rate movements, fiduciaries should take the opportunity to revisit their beliefs and policies with respect to foreign currency exposure and foreign currency management.

In summary, the recent significant market events should lead many investors to consider:

- More alpha-oriented bond strategies.
- A larger allocation to and greater diversification within their growth portfolio.
- Reviewing a number of their beliefs and strategic policies, such as home-country equity bias and currency hedging policy.

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