



# LOST OPPORTUNITIES – HOW THE ROLE OF BBBS IS CHANGING IN CANADIAN DEBT MARKETS

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## Executive Summary

- The recent downgrade of Enbridge to the BBB category highlights this rating category as a growing portion of the FTSE TMX Canada Universe Bond Index. BBBs now make up 10% of the index. We believe continued growth of this category will result from future downgrades and strong issuance.
- The impact on institutional investors could be lost opportunities. The BBB category has become more diverse, offering attractive opportunities in the Canadian credit universe. Excluding BBBs could result in reduced return and yield, with risk remaining static, at best.
- We argue that adding or increasing exposure to BBBs should be done selectively, with a quality bias, and backed by a strong credit research process. While our arguments focus on a Core approach, they are equally applicable to a longer duration strategy and the more lenient constraints typically associated with Core Plus mandates.

The downgrade of Enbridge Inc.<sup>1</sup> to the BBB category caused quite a stir. The event highlighted the ongoing debate between asset managers, consultants and institutional clients over the limitations of BBB rated exposure within Canadian fixed income portfolios benchmarked against the FTSE TMX Canada Universe Bond Index. Historically, some plans have excluded or placed a limit on BBB issuers to avoid lower quality credits within their portfolios. While this decision may have had a minimal impact on active management in prior decades, this limitation may be outdated and too restrictive for active managers today, as the index continues to tilt towards more BBB exposures.

We believe the changing dynamics in the Canadian debt market landscape warrant a review of constraints imposed by Investment Policy Statements around BBB exposures. Failure to do so could result in lost opportunities. Loosening BBB constraints affords managers with strong credit research the opportunity to improve risk-adjusted returns as well as portfolio diversification.

**In this paper, we examine the trend towards higher BBB weightings and what the BBB universe looks like compared to other rating buckets. We also illustrate the effect of excluding or limiting BBBs on portfolio performance and risk.**

## The Growing Trend: Rise of BBBs in the Index

In the period after the 2007-2009 financial crisis, the credit quality profile of Canadian debt markets underwent significant change as BBB rated bonds took a greater share of the overall universe. As Figure 1 illustrates, BBB issuers, as a percentage of the FTSE TMX Canada Universe Bond Index, have increased significantly since 2008.

**FIGURE 1 – BBBS AS A PERCENTAGE OF THE INDEX HAVE GROWN SIGNIFICANTLY SINCE 2008**



Source: FTSE TMX Debt Capital Markets

The rise in BBBs as a percentage of the Canadian universe is beginning to mirror that of global markets, which have already experienced the type of expansion we are now seeing in Canada. As of June 30, 2015, BBB rated bonds made up 16% of the Barclays Global Aggregate Bond Index and 13% of the Barclays U.S. Aggregate Bond Index. This represents a significant increase from ten years earlier, when BBBs represented only 5% of the Global Aggregate Index and 8% of the U.S. Aggregate Index. Canada may simply be catching up with its global peers in terms of a broader issuance base across the credit spectrum.

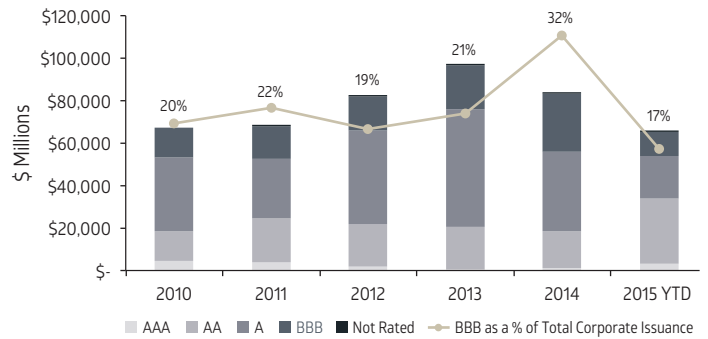
### CATALYSTS FOR BBB GROWTH

Domestically, two major catalysts are driving the FTSE TMX Canada Universe Bond Index's steady march towards increased BBB exposure:

- i. Issuance is being driven by issuers (new and old) that are employing higher leverage. The incremental borrowing cost is not significant in the current context of historically low interest rates. In addition, changing bank regulations are pushing some issuers that were formerly financed by banks to seek financing in public bond markets.
- ii. Rating downgrades, as illustrated by the downgrade of Enbridge in mid-June 2015, are leading to fundamental changes in the quality composition of the benchmark.

With continued low rates and attractive funding prospects, issuance has been a large contributor to BBB growth. From 2010 through 2013, BBB rated issuance was approximately 20% of total corporate issuance, increasing to over 30% last year (2014), as shown in Figure 2. As BBB issuance remains strong, the trend towards higher index exposure to this rating bucket could continue for the foreseeable future.

**FIGURE 2 – BBB ISSUANCE SAW A DRAMATIC RISE IN 2014**



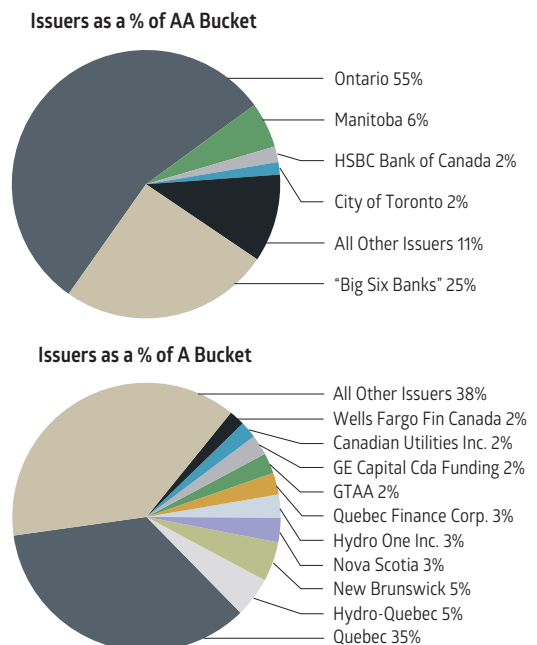
Source: CIBC Asset Management Inc., Bank of Montreal, Toronto Dominion Bank, Royal Bank of Canada, Scotia Bank, National Bank

### THE ENBRIDGE EXPERIENCE: RATING DOWNGRADE IMPACTS INDEX QUALITY

Ratings downgrades are another significant factor in the growth of BBBs. A single issuer downgrade can significantly shift the quality profile of an index. The most recent example is the downgrade of Enbridge, which represented 7% of the single-A bucket prior to S&P's action. We must also consider the possibility, although remote, of downgrades to dominant financial and provincial issuers whose impact on benchmark composition would be more severe than the Enbridge experience.

Given the dominance of some issuers within certain ratings buckets, it is important to evaluate how a change in a single issuer rating can impact the composition of a benchmark's rating profile, whether up or down the quality spectrum. Figure 3 shows the top ten issuers for both the AA and A categories, any of which could have a meaningful impact on the indices' quality profiles if ratings changes occurred.

**FIGURE 3 – DOMINANT ISSUERS IN A AND AA BUCKETS CONTRIBUTE TO A CONCENTRATED UNIVERSE**



Source: FTSE TMX Debt Capital Market. As at June 30, 2015.

As BBBs have increased as a percentage of benchmarks and exhibited greater differentiation within the category, Canadian asset managers have increased the resources dedicated to their credit analysis. This is a key input to ensuring that credit quality is not sacrificed to expand the investable universe. The average number of analysts associated with fixed income products at Canadian firms has doubled in the past 10 years, according to eVestment databases. This highlights the growing role that corporate bonds, across the spectrum, play in Canadian debt markets.

Continued issuance and possible downgrades both underscore the reality that BBBs could continue to play a dominant role in the fixed income universe. With the looming possibility of rapid change, we turn to the investment policies of plan sponsors to see how they have adapted to this reality.

## Unintended Consequences: A Forced Benchmark Neutral or Underweight Position

**BBB names are becoming an increasingly dominant component of the index. But have plan sponsors' investment policies kept up?**

Generally speaking, client constraints on BBB allocations were written years ago when the quality profile of the index was more tilted to the AA/A buckets. A recent survey by CIBC World Markets' Macro Strategy Group showed that, on average, institutional respondents had a policy constraint on BBB exposures that ranged between 0 – 20% of the total portfolio.<sup>2</sup> A survey of CIBC Asset Management's own institutional accounts showed an average maximum allocation to BBBs of 10.7%.

Based on these surveys, and assuming an average of 10% BBB allocation, we can begin to see how legacy policy statements may be placing unintended restrictions on managers who now operate in a new market environment. While a 10% maximum constraint was moderately flexible up to the 2010 period, with an average 5% room for overweights, the maximum allowable exposure for many investment policies is now at the benchmark weight. **In effect, the policy maximum on BBB exposure becomes a "forced" neutral or underweight positioning for fixed income managers. As BBBs continue to grow, the constraint's impact will only be magnified.**

Beyond what clients forgo by limiting or excluding this ratings category, we must also consider the effects on other parts of the universe. With multiple market participants holding the same BBB exposure limit or outright exclusion, managers may find themselves crowding into AA and A rated paper, pushing spreads lower until they become structurally overvalued.

**Investment policies that exclude BBBs outright face unique risks in the event that a major issuer is downgraded to the BBB bucket. Managers may become forced sellers, in size, to avoid breaching investment policy constraints.**

With these limitations in mind, if we are willing to expand the investment policy further into BBB territory, what is the portfolio gaining? What are the risks?

### NOT ALL CREDIT BUCKETS ARE CREATED EQUAL

There are portfolio benefits beyond "yield pick-up" when considering the addition or increase of allowable exposure to BBBs. Comparing the current composition of the BBB universe versus ten years ago illustrates how the space has been the benefactor of increased diversity among issuers. There is now substantial issue differentiation within the universe (Table 1) in terms of both industry profile and spread. With the growth described previously, **we see new opportunities to capture relative value and a larger universe within which managers can express both single name and industry positioning.**

**TABLE 1 – A GROWING BBB UNIVERSE WITH SUBSTANTIAL ISSUE DIFFERENTIATION**

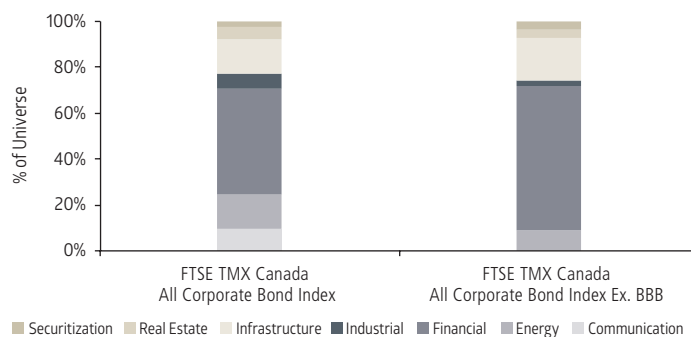
	2005	2015
Market Value ('000s)	\$23,389,833	\$140,544,204
# of Issues	128	398

Source: FTSE TMX Debt Capital Markets.

### BBBS OFFER DIVERSIFICATION ACROSS INDUSTRIES

Looking at Figure 4, we see that the exclusion of BBB names has a large impact on diversification potential. Excluding BBBs from the investment opportunity set causes financials' share of the index to surge by 17%, energy exposure to be nearly cut in half and communication to be excluded in its entirety from the equation.

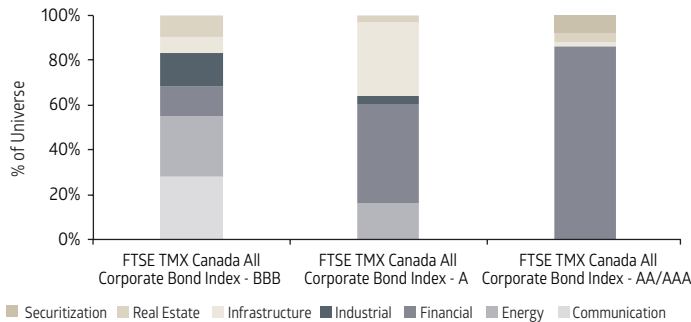
**FIGURE 4 – COMPARING DIVERSIFICATION WITH AND WITHOUT BBB NAMES**



Source: FTSE TMX Debt Capital Markets. As at June 30, 2015.

**The BBB space offers opportunities for managers to diversify holdings across industries. When forced into the spaces of AA and A corporates only, portfolios can fall victim to single industry dominance. Comparing the composition of the BBB universe to AA and A credits illustrates this point. Figure 5 illustrates the diversification benefit of A and BBB credits and their ability to reduce exposure to financials.**

**FIGURE 5 – COMPARING INDUSTRY DIVERSIFICATION ACROSS RATINGS BUCKETS**

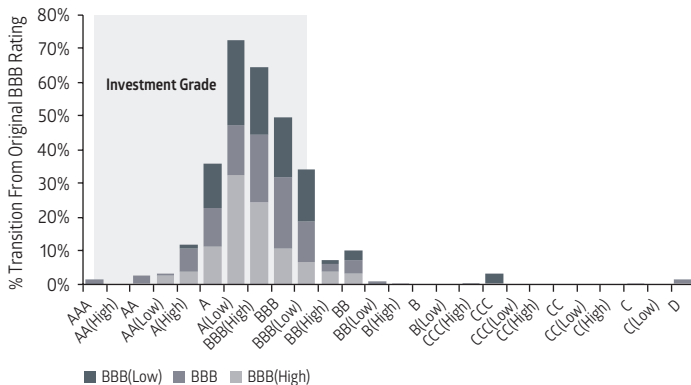


Source: FTSE TMX Debt Capital Markets. As at June 30, 2015.

**BBBS OFFER RELATIVE STABILITY**

The relative stability of BBB names and their ability to maintain their investment grade rating, or migrate up the credit quality spectrum, is worth noting. Figure 6 shows the distribution of rating transitions over a ten-year period ending December 2014<sup>3</sup>. Bonds with initial ratings of BBB (High, Mid and Low) may transition either up or down the credit spectrum. On average, 92% of issues initially rated BBB remained BBB or higher over the ten-year period, avoiding the type of credit deterioration which would lead clients to exclude these issuers from their portfolios.

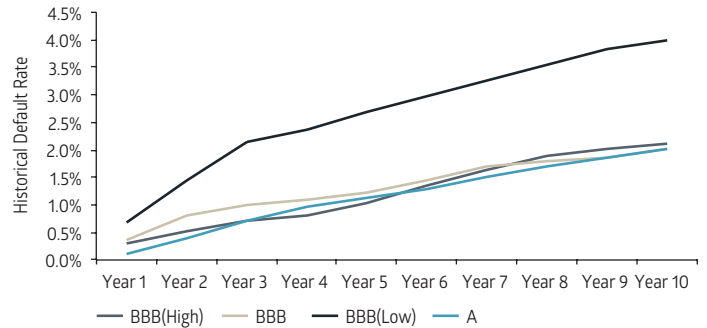
**FIGURE 6 – BBB TRANSITIONS UP AND DOWN THE QUALITY SPECTRUM (10-YEAR PERIOD ENDING DEC. 2014)**



Source: DBRS

Along with this relative rating stability, the BBB space also remains remote from default. Figure 7 illustrates default rates within the BBB space over the ten years ending 2014. BBB Lows maintained a remote default probability (below 4%) over the period, while BBB Mids and BBB Highs remained below 1.5%.

**FIGURE 7 – HISTORICAL DEFAULT RATES<sup>4</sup>**



Source: DBRS

Analysis by Moody's shows that between 2009 and 2013, BBB rated issuers (excluding financials) reduced debt-to-EBITDA ratios by approximately 7% while increasing EBITA-to-interest expense by approximately 22%. This means that, despite increased issuance, many of the old and new BBB issuers coming to market have been able to maintain coverage ratios without overly leveraging their balance sheets.

Our analysis shows that the BBB bucket cannot be painted with a broad brush, especially as the space continues to show greater differentiation among bonds with the same agency rating. The lower quality implied by the rating should not detract from the diversification benefits for portfolios.

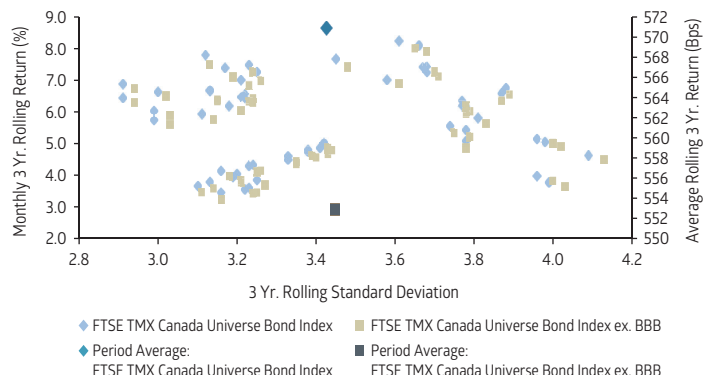
Next we discuss the impact on portfolio performance when choosing to exclude or limit BBB exposure.

**BBB IMPACT ON PORTFOLIO PERFORMANCE AND RISK**

Logically, an addition or increase of BBB exposure should result in greater returns for taking on greater credit risk within a portfolio. However, comparing the FTSE TMX Canada Universe Bond Index with and without BBB rated credits results in an unexpected risk-return profile.

Figure 8 illustrates three-year rolling returns vs. standard deviation over the last eight years. Excluding BBB names, on average, reduced total return (as expected) by 18 basis points (bps) and increased risk by an average of 2 bps.

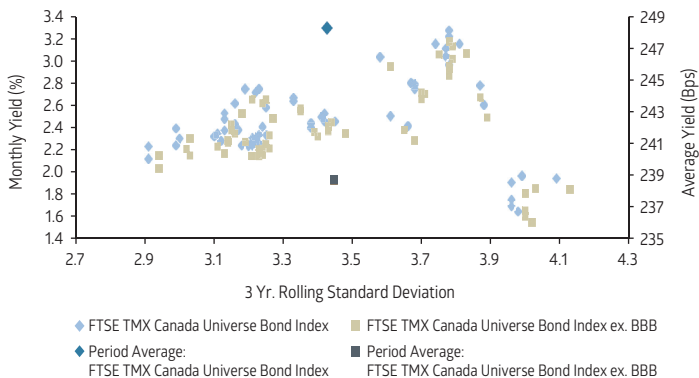
**FIGURE 8 – RETURN TO RISK WITH AND WITHOUT BBBS**



Source: FTSE TMX Debt Capital Markets, CIBC Asset Management Inc. calculations. Three year and one year rolling returns from August 2007 through June 2015.

When comparing average yield to risk, the exclusion of BBBs translates to an average 10 bps of yield loss and a gain of 2 bps of risk, as shown in Figure 9. On a rolling one-year basis, the exclusion of BBBs translates to an average return loss of 14 bps while adding an average 2 bps of additional risk.

**FIGURE 9 – YIELD TO RISK WITH AND WITHOUT BBBs**



Source: FTSE TMX Debt Capital Markets, CIBC Asset Management Inc. calculations. Three year rolling and month end periods from August 2007 through June 2015.

Adding BBB exposure seems to be a fair trade between return and risk. For an average 18 bps of additional return, or 10 bps of average yield pickup, we actually shed 2 bps of risk.

**DURATION EFFECT**

Part of this phenomenon is the result of higher yields and coupons among BBB names, which decreases duration, and thus price volatility, in the face of interest rate movements. This brings to light an interesting, perhaps unintended, consequence of excluding BBBs from the portfolio – a very moderate duration extension of 0.07 years (modified) which leads to incremental rate risk. As a result, the FTSE TMX Canada Universe Bond Index ex. BBB return exhibits higher volatility as compared to the entire universe.

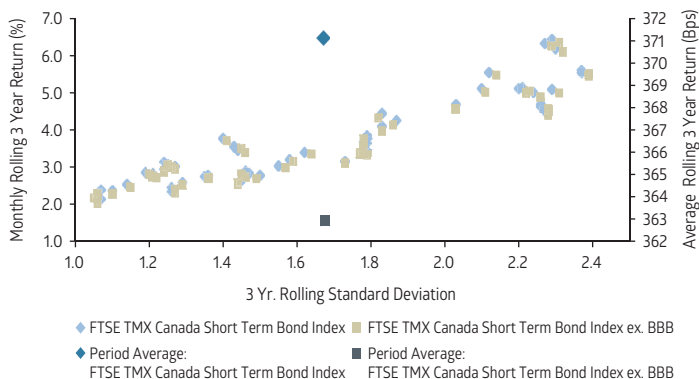
**TABLE 2 – KEY CHARACTERISTICS**

	FTSE TMX Canada Universe Bond Index Ex. BBB	Change	FTSE TMX Canada Universe Bond Index
Avg. Yield	1.84	↑	1.96
Modified Duration	7.51	↓	7.44

Source: FTSE TMX Debt Capital Markets, as of June 30, 2015.

To control for the duration effect, we also compared the FTSE TMX Canada Short Term Overall Bond Index against the FTSE TMX Canada Short Term Overall Bond Index Ex. BBB to narrow the duration differential between constituents. Figure 10 illustrates that the results maintain the same profile as the universe, with an average of 8 bps of outperformance with the inclusion of BBBs while volatility is reduced by 1bp, on average.

**FIGURE 10 – RETURN VS. RISK WITH AND WITHOUT BBBs – DURATION NEUTRAL PROXY**



Source: FTSE TMX Debt Capital Markets, CIBC Asset Management Inc. calculations. Three year rolling periods from August 2007 through June 2015.

Some critics might argue that the reduced liquidity in BBB names may artificially force down the standard deviation of returns on bonds that trade infrequently. However, the argument holds less relevance if we look at the one-year average trade volume broken down by rating. Table 3 shows corporate A rated bonds posted less daily average volume than their corporate BBB rated peers.

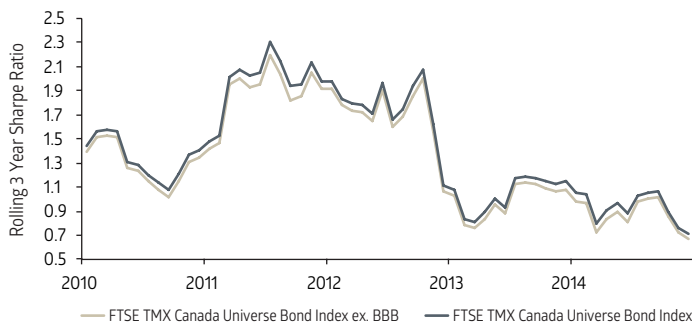
**TABLE 3 – AVERAGE CORPORATE DAILY TRADE VOLUME BY RATINGS CATEGORY**

	AA	A	BBB
	1,150,419	272,095	323,706

Covering one year period ending June 30, 2015. Source: FTSE TMX Debt Capital Markets.

The liquidity and duration differentials between differently rated bonds may marginally skew the numbers. However, it is reasonable to also suggest that the relative reduction in risk reflects the additional diversification benefits and reduced correlation between issues as we expand the universe of investable assets.

From a performance perspective, we can see again that the additional return captured by including BBBs far outweighs the incremental risk added to the portfolio. Figure 11 looks at the Sharpe ratios produced by the full index versus the exclusion of BBBs.<sup>5</sup> We find that in all three periods – annualized, calendar year or rolling three-year (shown on the next page) – including BBBs produces the same or excess Sharpe Ratios as compared to a universe that excludes them.

**FIGURE 11 – COMPARING PERFORMANCE AND RISK**

Source: FTSE TMX Debt Capital Markets, CIBC Asset Management Inc. calculations. Three year rolling periods from August 2007 through June 2015.

## Think “Selective and Tactical” When Loosening Constraints

When all is said and done, our argument for expanding the allowable ranges on BBB exposures is not to make the case that all portfolios should blindly hold more BBBs. Instead, looser constraints on BBB allocations allow active managers to tactically position around their benchmark.

We do not believe that managers should simply market weight or overweight BBB credit just to boost running yield. Rather, increasing the allowance for exposure to BBB names (across credit notches) means managers should be given the opportunity to add bonds that present attractive value opportunities. By increasing these exposures as spreads tighten, managers can capture excess yield without significant incremental risk and can underweight or exclude less attractive BBB issues.

Maintaining a 10% or lower ceiling on BBB exposures means that active managers are forced into a benchmark neutral or underweight positioning. This limits opportunities to generate alpha and execute investment positioning on single names and industries.

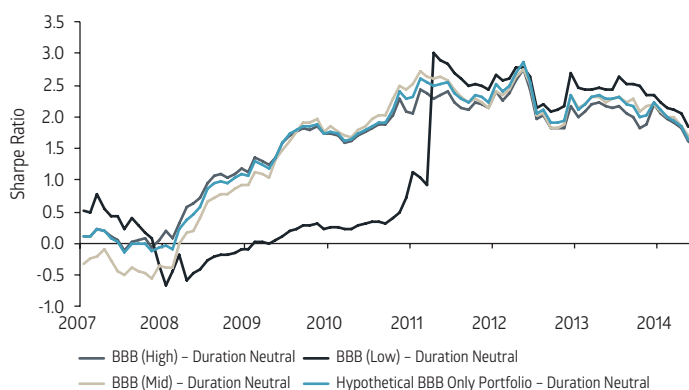
In our opinion, the best approach to BBB allocations is one that is supported by quality control. This comes from a rigorous credit analysis process, implemented by a dedicated credit research team conducting independent analysis. This process seeks to identify misrated bonds, both those bestowed with a higher rating than deserved, and those that offer better quality and issuer strength than their credit rating suggests.

Some examples of issuers that we believe exhibit a higher quality profile than implied by the rating from credit rating agencies include infrastructure names that were initially downgraded to BBB due to project delays but have yet to be re-rated as completion approaches. As well, we favour certain legacy bank issues that have migrated to BBB ratings based on credit rating agency methodologies that do not account for possible near-term maturities and redemptions by their issuers.

## IDENTIFYING “QUALITY-BIAS” BBBS

We have found over time that independent, thoroughly implemented credit research leads to BBB exposures that exhibit a “quality-bias.” Analysts are able to distinguish incremental credit quality within the sub-universe of BBB issuers. This should lead to BBB allocations that deliver risk-adjusted returns that surpass the BBB universe as a whole.

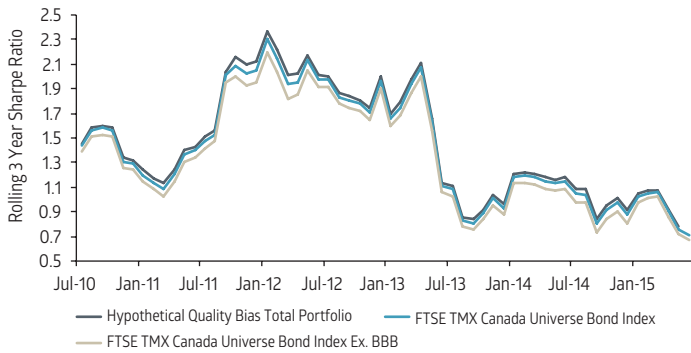
To illustrate this point, we constructed a hypothetical portfolio of BBB rated bonds on a duration neutral basis. To express a manager’s “quality-bias”, we overweighted those bonds rated BBB-High based on composite ratings from DBRS, Moody’s and S&P. Comparing this portfolio against the other BBB notched categories (all of which were also held duration neutral) we see that, on the basis of risk-adjusted returns, the Duration Neutral Hypothetical BBB Only Portfolio posts Sharpe ratios in-line with its component parts but with much less volatility. Yields and spreads also exhibit a much more stable profile as compared to the individual notched categories.

**FIGURE 12 – “QUALITY BIAS” BBB VS. BBB UNIVERSE COMPONENTS – SHARPE RATIOS**

Source: BofA Merrill Lynch, CIBC Asset Management Inc. calculations. Rolling three year Sharpe ratio from December 2007 through June 2015.

To take into account the entire fixed income universe, we again constructed a Hypothetical BBB Only Portfolio, this time including bonds across all duration buckets. We then applied the same overweight to BBB-Highs as a proxy for a manager’s quality bias. We paired this Hypothetical BBB Only Portfolio with the FTSE TMX Canada Universe Bond Index Ex. BBB to give us a proxy for a Core portfolio whose BBB allocation is managed with a quality-bias. If we apply the same historical BBB allocation as the index, on a rolling three-year basis the Hypothetical Quality Bias Total Portfolio posts equivalent Sharpe ratios to that of the FTSE TMX Canada Universe Bond Index while maintaining a BBB exposure that exhibits a higher quality tilt than the entire BBB universe. If we increase exposure to BBBs by 5% over the index to proxy a portfolio manager’s overweight positioning to that part of the credit spectrum (with a quality bias) we find that the portfolio posts an average of 10 bps in excess return while volatility remains equal to the benchmark.

**FIGURE 13 – CORE UNIVERSE WITH QUALITY BIAS – SHARPE RATIOS**



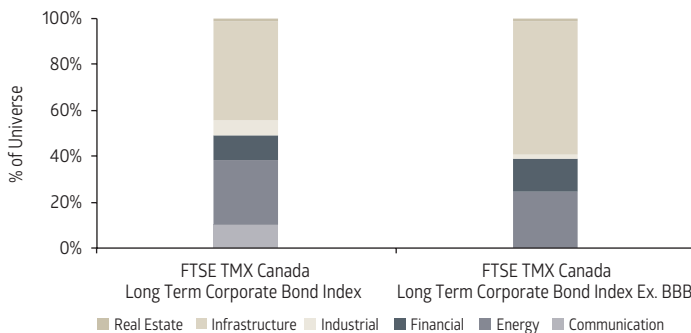
Source: BofA Merrill Lynch, FTSE TMX Debt Capital Markets, CIBC Asset Management Inc. calculations Rolling three year Sharpe ratio from December 2012 through June 2015.

This exercise shows that expanding the investable universe into BBBs can be worthwhile provided the manager thoughtfully implements appropriate exposures in the BBB category.

## Exploring Beyond the Core Universe

For defined benefit pension plan sponsors who are focused on long duration strategies, our previous findings are consistent when applied to the long end of the curve. In Figure 14 we compare the FTSE TMX Canada Long Term Corporate Bond Index against the same universe excluding BBBs. The exclusion of BBB issuers places a greater emphasis on infrastructure and financial issuers with a reduction of holdings in the industrial and communication sectors.

**FIGURE 14 – INDUSTRY PROFILES IN THE LONG END**



Source: FTSE TMX Debt Capital Markets. As at June 30, 2015.

Long Term Index characteristics before and after removing BBBs exhibit greater disparity as compared to the core universe. The exclusion of BBBs results in 0.14 years of duration extension with 24 bps of yield drag (Table 4).

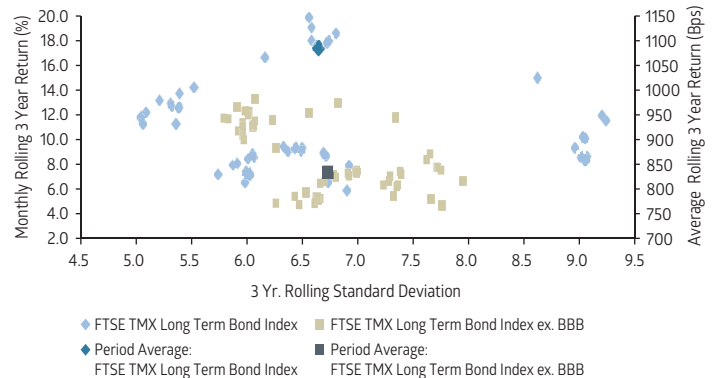
**TABLE 4 – KEY CHARACTERISTICS – LONG BONDS**

	FTSE TMX Canada Long Term Overall Bond Index Ex. BBB	Change	FTSE TMX Canada Long Term Overall Bond Index
Avg. Yield	3.84	↑	4.08
Modified Duration	13.16	↓	13.02

Source: FTSE TMX Debt Capital Markets. As at June 30, 2015.

The return-to-risk profile appears as an exaggerated version of the core universe illustrated earlier in this paper. The exclusion of BBBs results in an average loss of 251 bps in return with a risk increase of 8 bps.

**FIGURE 15 – RETURN TO RISK WITH AND WITHOUT BBBs ON THE LONG END**



Source: FTSE TMX Debt Capital Markets, CIBC Asset Management Inc. calculations. Rolling 3 year periods from December 2007 through June 2015

For plans interested in expanding their investment opportunity set, Core Plus mandates take the thesis of this paper to the next level. Core Plus mandates acknowledge that allocations below investment grade provide opportunities to capture additional return and yield on issues that may be misrated by the agencies. Much like our discussion on BBB rated issues in Canada, high yield issues have become a more diverse landscape than in years past, with inefficiencies and spread differentiation among issuers that allow for active management and relative value opportunities.

## Conclusion

Due to changing market dynamics, it is time to reconsider investment constraints when it comes to BBB exposures. Given additional flexibility around the BBB constraint, a fixed income manager with a strong credit research process has the opportunity to improve both risk-adjusted returns and portfolio diversification. The arguments apply not only to universe mandates but also to long duration strategies. Overall, we believe that legacy restrictions on the BBB universe create inefficient fixed income portfolios and lost opportunities for portfolio managers and their clients.

<sup>1</sup>Includes Enbridge Inc., Enbridge Pipelines Inc. and Enbridge Gas Distribution

<sup>2</sup>The Prospects for BBBs: A CIBC Investor Survey; CIBC Macro Strategy Research – July 7, 2015

<sup>3</sup>2014 DBRS Corporate Rating Transition and Default Study – March 2015

<sup>4</sup>Historical default rates based on DBRS global coverage. Canadian-only default rates would be lower.

<sup>5</sup>Sharpe Ratio is calculated as annualized return in excess of the risk-free rate per unit of volatility. It is calculated as (Annualized Return-Annualized Risk Free Rate)/(Standard Deviation). In this example and those following, the risk-free rate used was the CIBC WM 91-Day Treasury Bill Index.

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