After budget, pension plan investors should focus on buying 30-year bonds, says BMO exec

Consultant adds that government has a 'carrot and stick' approach to pension investing

By Josh Welsh
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Canada’s 2024 budget, which Finance Minister Chrystia Freeland unveiled Tuesday, has already elicited a range of reactions, especially for the tech industry leaders and young Canadians. For the pension plan space, however, there were virtually no surprises, says Earl Davis, head of fixed income and money markets at BMO. From an investor perspective, he says the main takeaway is the debt management strategy.

“I look at it from the perspective of two things: how much debt is Canada going to issue and where are they going to issue it? Are they going to issue more treasury bills or issue more long bonds?”

The reason for that perspective, he added, is the supply and demand dynamic. “Over time, they’ve said the percentage of the T-bills issued will be reduced, and we're looking to issue more sort of tenure area and slightly more 30-year.”

Davis thinks that's a good thing from a sustainability perspective. Investors might want longer term debt so they’re not rolling over as much and locking in the interest rate. He added one of the key things of a pension plan is buying more 30-year bonds because it immunizes the longevity risk of the life liabilities that pension plans have.

“More bonds being issued means two things: one is you have a better chance of buying them, and you also have a better chance of buying them at higher yields. Right now, it's pretty controlled. It's slightly more. It was 2 billion more on 30-year bonds and 13 billion on 10-year bonds. From a pension plan, you want to see more 30-year bond issuance because that's where you buy.”

Higher yields are also better for pension plans in Canada, as Davis says, because they do two things: the discount rate for liabilities increase, which means liabilities decrease with higher tenure bond rate levels. Plan sponsors could also invest to buy bonds at these levels, to lock in or immunize the liabilities, and lock in the surplus.

“These types of yields and higher are very good for pension plans,” Davis noted. “There’s still underweight fixed income and we’ll continue to look to buy. The thing they want to ensure is that there's enough bonds for them to buy out there. Reallocating some of the debt to longer term maturities is very important from a pension sponsor, pension plan perspective.”

Joe Nunes, co-founder and executive chairman of Actuarial Solutions Inc., compares the government of having the “carrot and the stick” when it comes to pension investing.

“The carrot approach is making Canada the kind of environment that businesses want to invest in and can prosper,” he says. “It’s not just making taxes reasonable. It's helping make sure we have an educated workforce; it's reducing red tape as much as possible. There's all sorts of things that governments collectively can do to make it attractive for businesses to be here in Canada.”

As for the stick approach, Nunes says the government mandating that a certain percentage of pension funds has to be invested in Canada, is the one that gets talked about more. However, he noted that's the least preferable approach.

“The problem with mandating investment in Canada, is, in theory, if they were good investments, the pension funds would be rushing to them in the first place. You might be dooming the pension funds to lower returns for less-than-ideal investments, if you mandate that they have to invest in Canada. Ultimately, I think that leads to either lower benefits or higher contributions, and higher contributions probably come out of wages.”

While he doesn’t think the stick approach is the right answer, he says it would be ideal if Former Bank of Canada Stephen Poloz’ working group on pension funds can focus not on a mandate for Canadian pension funds, but rather, provide strong advice to the government on how they can make investment in Canada more attractive.

“You can talk all you want about wanting people to invest in Canada, but you've got to create the right environment,” he added.

Davis noted that the confidence level for 2024 is high and for the government to maintain that confidence level, “the revenue streams and projections they have to be realized. That's an important quality for both the rating agencies, as well as the future bond yields for Canada.”