Shaken and stirred
How the OSFI wants to manipulate bond investors

A recent piece in the Financial Post stated that the federal bank regulator, the Office of the Superintendent of Financial Institutions (OSFI), wants bank-contingent capital in the bond index, and has a plan to achieve this objective.

Taking this step would be abusive to bond investors of all kinds, particularly retail investors who have — for the most part quite rightly — become enamoured of indexing their bond portfolios. But to understand the abuse, we must first understand the difference between a good and a bad index, and why including bank-contingent capital bonds, or “CoCos,” in the bond index will turn it into a bad index.

A GOOD INDEX HAS THREE PURPOSES:

• To act as performance standards for active managers.
• To serve as proxies for asset allocation purposes.
• To become purchasable and replicable vehicles for passive investment strategies.

The performance standard is paramount. Investment managers work in an industry in which their ability to do their jobs can to a large extent be measured objectively — the performance of a stock or bond portfolio can be measured precisely and compared with benchmarks.

The third element is, however, achieving increased emphasis, particularly among retail investors and their advisors — professional and otherwise. Something of a cult has formed around passive investment, otherwise. Something of a cult has formed around passive investment strategies.

The three purposes of an index can be achieved only through careful construction. Elements of an index should display a high degree of correlation within their segment and a lesser degree of correlation with other segments; the limiting factor in the degree of correlation is the desired broadness of the index.

The importance of correlation is emphasized by the second purpose of indices — providing a proxy for asset allocation purposes. A good index will have a predictable response to certain economic events. For example, long bonds will do poorly as inflation expectations rise (this old truism is one reason, perhaps, why Real Return Bonds are excluded from the DEX Universe Bond Index). Moreover, estimates of future sensitivity can be made by comparison to historical data, but only if the index chosen as a proxy has a reasonable level of homogeneity.

Thus, catastrophe bonds, for instance, are not included in the major indices. These bonds pay high interest, but are subject to losses after specified events, such as earthquakes and hurricanes. Catastrophe bonds are not necessarily reflect their relative weight in the marketplace. This will also have the effect of changing the index’s response to economic stimuli.

Finally, the index’s name is a misnomer. The term “hybrid” is used in the bond market to denote a particular kind of investment, generally issued by banks and other regulated financial institutions, that has characteristics reflecting both regular debt and equity. The unwary might assume from the name of the index that such hybrid bonds are the constituents of this index, which is not the case.

Try as I might, I am unable to discern a purpose for this index based on benchmarking or asset allocation. It appears to have been initiated solely to serve as a platform for an ostensibly passively indexed investment vehicle. In a piece that appeared in Financial Analysts Journal, John Bogle charged, “The bond (mutual fund) industry is vast and highly successful marketing business, an industry focused primarily on salesmanship.” Sadly, DEX Hybrid Bond Index serves as an excellent example of how this salesmanship is extending into index creation.

The TMX becomes defensive when its indices are criticized. My earlier criticism of DEX Hybrid Bond Index resulted in my receipt of a series of vituperative emails from a TMX official threatening a complaint to my professional association, and claiming my views were motivated by a greed regarding an unsuccessful sales presentation in 2006.

OSFI and hybrid bonds
As I’ve discussed in previous articles, the panic of 2007 has motivated commercial banks and regulators to seek ways of broadening credit sharing. Governmental purchase of equity in various hard-hit banks allowed the banks to avoid bankruptcy, thereby protecting holders of bank non-equity capital securities (such as preferred shares), Innovative Tier 1 Capital (“hybrid bonds”) and subordinated debt.

Thus, the OSFI has proposed that all future issuance of these instruments must contain a “Non-Viability Contingent Capital” clause, which will require the full and permanent conversion of these instruments into common shares of the issuer should the Superintendent decide that the issuer has ceased, or will soon cease, to be viable. There is no necessity for the Superintendent to justify views in any way, nor is there any path of appeal.

It is breathtaking to consider the amount of power granted thereby to a single bureaucracy. It shows the lengths to which governments are prepared to go to gain for themselves the powers ordinarily reserved for bankruptcy courts operating in the clear light of day. But that is more of a political question.

There is much to criticize in the plan. By making the trigger event non-viability, OSFI is preparing to deal with a crisis after the fact. If the conversion trigger occurs earlier in the life of a bank’s fortunes, there is a greater chance that such a crisis would be averted. This is the path taken by the Swiss, who have good reason to avoid crises rather than punish creditors afterwards.

Additionally, the draft proposal requires issuers to “provide a trust arrangement or other mechanism to hold shares issued upon the conversion for non-common capital providers that are not permitted to own common shares of the DTI due to legal prohibitions.” Some might consider this a clever way to circumvent the intent of legislators and non-legislated investment mandates. Others might choose a different adjective.

But the more immediate concern to fixed income investors is the question of the inclusion of these instruments in bond indices, which is all the more important in Canada since there is only one universal index in common use.

We were fortunate during the crisis not to have any of the major banks get into serious trouble, but this will not necessarily be the case during the next crisis. When this happens, speculation about OSFI’s intentions will add yet another layer...
of uncertainty to the analysis of hybrid bonds and result in their market values becoming uncertain related with their peers. This will be in addition to fears of having creditor rights arbitrarily changed to suit bureaucratic convenience, as happened in the UK Bradford & Bingley nationalization.

In Canada, we’ve already seen the effect of arbitrary regulatory change on hybrid bond returns: this class of issue dropped by 7.3% in the six months commencing August 2010. Drops for issues with long periods until their first par call were even more dramatic: a TD Capital Trust issue dropped 15.6% in the complete absence of changes in the overall economy, bond market, or credit quality that could justify such a move. Virtually all the change was due solely to fears that OSFI would change the rules of the game by refusing to allow these issues to be included in Tier 1 Capital and thereby enable use of the “Regulatory Event” clause in the issue terms, allowing an immediate call at par. This un-bond-like behaviour of bank regulatory capital should be of great concern to investors of all stripes, as these issues are currently included in the DEX Universe Bond Index and hence in most performance benchmarks and many ETFs. Indeed, these issues are often overweighted in popular ETFs, presumably because of their higher quoted yields.

With its refusal to grandfather extant regulatory issues when changing requirements for new issues, OSFI has cemented its reputation for operating with little regard for the capital markets. It should be clear that while bank hybrids and subordinated debt may well be good investments, they cannot and must not be regarded as bonds in the same category as senior debt. Their uncorrelated behaviour is likely to increase during a crisis, just when the safety of bonds — actual bonds, which at worst will default and give rise to a restructurization in a clearly defined process — is most desirable.

Investors and portfolio managers should therefore urge the TMX to remove these instruments from the main index — or, at the very least, incorporate them only as a distinct and easily removable group, as is currently the case with Maple bonds. Should this change not occur, the development and use of bond indices from other bond-indexing services ought to be encouraged. Investors in the UK have been successful in keeping some contingent capital out of major indices, despite similar pressure from UK regulators. This success should be replicated and reinforced in Canada.

BY MURRAY SELZBERG

Party pooper

Why investors should care about the consumer debt bubble

The U.S. economic recovery is well underway. So we can sit back and watch our investment portfolios grow steadily — right?

Not so fast. There’s still the pesky issue of a record-high consumer debt-to-income ratio blurring the otherwise sparkling visage of the equity market landscape, particularly in Canada. The issue is by no means trivial: the consumer debt bubble may have a negative and lasting impact on corporate profits — and investor returns — for years.

The truth is, North Americans have been living beyond their means for decades, but it looks like the party may be over. American consumer savings rates are up significantly, to more than 5% of net disposable income, after hitting virtually zero just before the recession started in August 2007. This means Americans are spending less and, for the first time in a generation, actually working to reduce their debt load, which doesn’t bode well for the corporate profit machine that relies on consumers.

Compounding the issue is the fact interest rates have nowhere to go but up, which provides even more incentive to consumers to focus on paying down debt.

Here in Canada we like to think we’ve been largely sheltered from the global economic storm. However, you only have to glance at recent statistics released by the Vanier Institute of the Family to see Canadian consumers are playing a game of Russian Roulette in terms of consumer finances. The average Canadian family is now carrying a debt load of $100,000, and their debt-to-income ratio stands at a record 150%. The Institute also says this ratio has been steadily climbing for the past 20 years. In 1990, average family debt stood at $56,800, with a debt-to-income ratio of 93%. The $100,000 figure represents a real increase of 78% over the past two decades.

The sad truth is Canadians’ debt-to-income ratio is now higher than Americans’ for the first time in a dozen years. In fact, Canada’s household debt hit a record of just over $1.5 trillion in December.

In the U.S., the Federal Reserve tracks the Household Debt Service Ratio or DSR, similar to our debt-to-income ratio. The fourth quarter of 2010 marked the seventh consecutive quarter the U.S. household DSR had fallen, returning to levels not seen since the end of the 1990s.

Americans are saving more of their money and, despite the almost desperate pleadings of the government to get people to spend money on more stuff, are taking tentative steps towards paying down their household debt.

The difference between Canadian and U.S. consumers is pronounced. However, Canadians are extremely vulnerable to any new economic shocks that may materialize, like runaway energy and food prices. And while we aren’t likely to suffer as long and hard as our neighbours to the south have, we may yet get steamrollered by our own economic hubris.

What’s the potential impact on investors’ portfolios? While the recovery in the U.S. is reflected in the recent performance of the equity markets, there are still enough trouble spots within the U.S. and global economies to warrant a go-safe approach.

North American equities, particularly those whose profits are driven by consumer demand, may well be close to being overbought. Of course, commodity prices keep rising, but there are danger signals on the horizon for many of these, too. Bonds still hold appeal, but even here the yield on many products may not adequately reflect the associated risks.

An investment approach guided by the sound principles of risk minimization and capital protection will always point investors in the right direction. It may not be sexy or hip, but for most people, neither is losing your shirt.

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