

What is Good for the Goose May Not Be Good for the Gander

BCE, the parent of Bell Canada and one of Canada's largest companies, is being auctioned off to a consortium of pension plans and private equity players. It will join a growing list of Canadian icons to be delisted from the public markets in a wave of mergers and takeovers.

This transformation of the Canadian business world is a result of decisions made not in Toronto or Montreal, but in places like Beijing and Riyadh. It's all part of a series of fundamental changes in global markets related to the stunning growth of sovereign wealth funds.

The most far-reaching consequence of sovereign wealth funds has been their impact on interest rates. We have seen four and a half years of strong global economic growth, soaring prices for energy and other commodities, and central banks that have been raising short-term interest rates for the last couple of years – yet long-term bond yields have been flat or falling.

One of the main reasons is that sovereign wealth funds are massive pools of money that need to be invested, and they have a huge appetite for government bonds. This has suppressed long-term yields, keeping the yield curve flat for more than two years and creating a ripple effect throughout the markets.

The fallout from these low yields include the explosion of structured credit vehicles, such as collateralized loan and debt obligations, much looser lending standards as market participants gave up protection in order to earn higher yields, and the fuelling of leveraged buyouts (LBOs), with huge implications for both equity and bond investors.

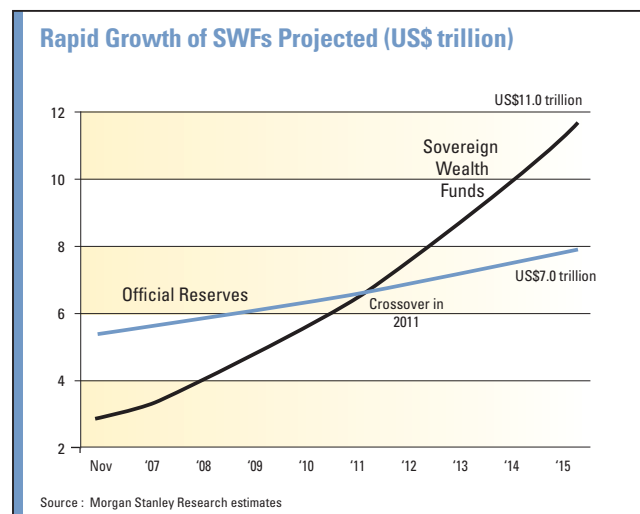


Chart 1: Morgan Stanley predicts that in five years, total assets of sovereign wealth funds will be approximately US\$12 trillion. Non-oil Asian exporters will become as important as the oil-producing countries with both groups holding approximately US\$6 trillion in assets.

What are SWFs?

Sovereign wealth funds, or SWFs, have been around for more than three decades, but in recent years their numbers and sheer size have grown tremendously. Morgan Stanley predicts that SWF assets could reach US\$12 trillion by 2015, and surpass the size of the world's total central bank reserves within five years (see Chart 1).

SWFs are pools of capital that are controlled by sovereign nations. They are government investment vehicles that are



funded by foreign exchange assets and managed separately from the government, or the central bank. They are distinct from pension plan investors, such as the Canada Pension Plan Investment Board. Countries with large SWFs include the oil-exporting countries of OPEC, Russia and Norway, as well as significant exporters of manufactured goods such as China and South Korea (see Chart 2).

Sovereign Wealth Funds estimated assets, March 2007

| Country | Fund | Assets US\$ billion | Inception year |
|---------------|--|------------------------|-------------------|
| UAE | ADIA | 875 | 1976 |
| Singapore | GIC | 330 | 1981 |
| Saudi Arabia | Various types of funds | 300 | n.a. |
| Norway | Government Pension Fund – Global | 300 | 1996 |
| China | Sate Foreign Exchange Invest. Corp. and Central Huei Lian Company * | 300 | 2007 |
| Singapore | Temasek Holdings | 100 | 1974 |
| Kuwait | Kuwait Investment Authority | 70 | 1953 |
| Australia | Australian Future Fund | 40 | 2004 |
| U.S. (Alaska) | Permanent Fund Corp. | 35 | 1976 |
| Russia | Stabilization Fund | 32 | 2003 |
| Brunei | Brunei Investment Agency | 30 | 1983 |
| South Korea | Korean Investment Corp. | 20 | 2006 |

* Not yet finalized
Source : Morgan Stanley Research estimates

Chart 2: China's Central Huei Lian Company is still in the process of being established, but it's estimated that it will be the single largest SWF by 2009, surpassing the Abu Dhabi Investment Authority (ADIA) of the United Arab Emirates, which has been in existence for more than 30 years.

The SWFs of oil-producing countries have benefited from higher crude oil and natural gas prices. Asian SWFs are seeing growth because they have experienced a big boom in exports.

In the case of the oil-producing countries, most of the oilfields are owned by the government or government-owned entities. If they were corporations, such as Exxon Mobile or Total, the massive revenues likely would lead to share buybacks, higher dividends, or reinvestment in other areas. But when it's the Saudi Arabian government, the money accumulates in the SWF because there are still large surpluses after the government has invested in infrastructure, social services and so on.

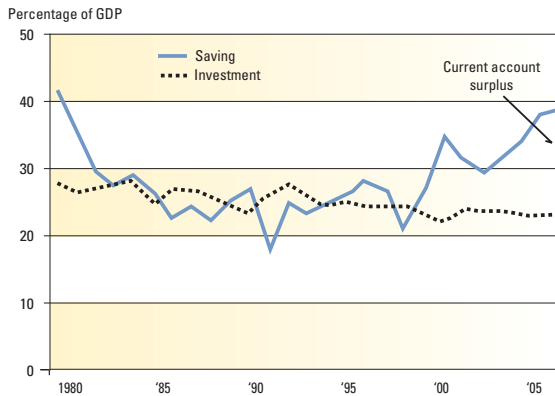
The Federal Reserve Bank of New York estimates that oil-producing countries received revenues of US\$1 trillion last year, a significant increase from US\$700 billion in 2002. The bank calculates that the oil-producing nations are now recycling roughly US\$40 billion a month into capital markets – mostly into safe, liquid global government bonds of the U.K., Europe and the U.S. (see Chart 3).

In China, the central bank is artificially keeping the yuan from appreciating in order to maintain the country's export competitiveness, which is creating huge surpluses. In March, the People's Bank of China reported reserves of US\$1.2 trillion, an amount that's growing at a rate of about US\$400 billion a year. To a smaller extent, the same thing is also happening in India, Vietnam, Bangladesh, and South Korea – all countries that are experiencing a massive influx of money because of exports.

The SWFs in these countries are faced with the same dilemma as those in the oil-producing countries. All are government-run entities that can't distribute their windfall to the people directly, and while they have domestic needs, there's just too much money flowing in to be absorbed by domestic investments.

Since the SWFs need to earn a return on their money, they have turned to global government bond markets. But, the sheer size of their investments means these funds are less sensitive to price. This has led to the oil-producing countries competing with China and the rest of Asia for the same investments. As a result, bond prices have been bid up and there's been a huge dampening effect on yields because there hasn't been a commensurate rise in the supply of government debt. The SWFs have artificially distorted the price of bonds and have been crowding Signature – and every other fixed-income manager – out of the market.

Saving and Investment by Oil Exporters



Source : International Monetary Fund (IMF); Organisation for Economic Co-operation and Development (OECD); author's calculations

Note: Values for 2006 are based on IMF and OECD forecasts.

Chart 3: According to the Federal Reserve Bank of New York, savings for oil exporters have increased markedly in recent years, from roughly 28% of GDP in 2002 to 39% in 2006. At the same time, domestic investment spending as a share of GDP has barely budged. As a result, the increase in savings has been allocated entirely to more foreign asset accumulation.

Meeting yield hurdle rates for fixed-income managers becomes increasingly difficult when government yield curves are flat or inverted. Suppose you're a fixed-income manager for a life insurance portfolio and you need to produce a 6% return in order to match assets and liabilities. However, you are faced with short-term bonds at 4%, long-term bonds at 4% and everything in between at 4%. So how do you achieve a 6% yield?

Initially, institutional investors turned to high-quality corporate bonds, and then lower-quality corporates, and then high-yield and emerging markets bonds – but there was always excess demand. That's because corporate America cleaned up its balance sheet from 2003 and 2005, so there wasn't much in the way of new corporate bond issues even as demand was increasing. This resulted in an ever-tightening environment for credit spreads along the “waterfall” of traditional yield enhancing products.

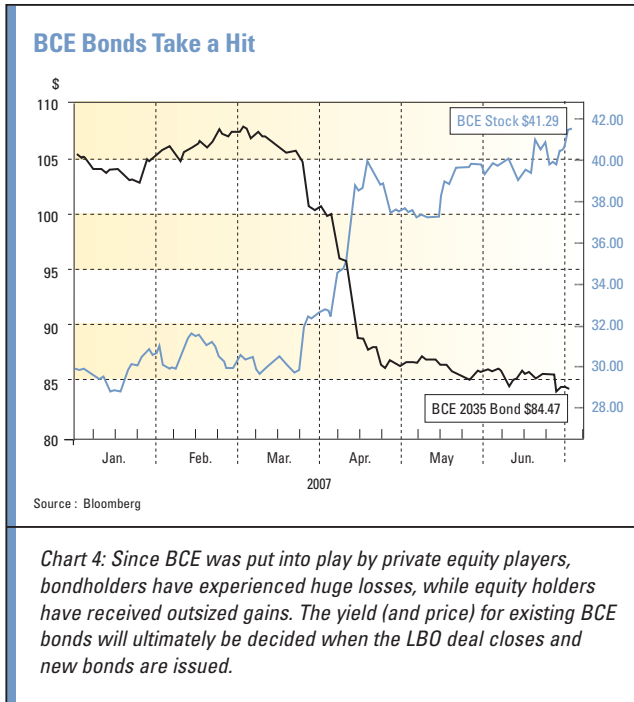
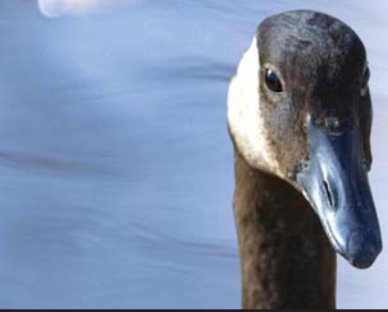
That's what led to the massive demand for new yield products – and Wall Street rushed to fill the void with structured credit products. The idea was to use synthetic securities, asset pools and copious amounts of leverage to produce historical rates of return. Collateralized debt obligations (CDOs), collateralized loan obligations (CLOs), and asset-backed securities were Wall Street's solution to the lack of yield. By packaging up assets – sub-prime mortgage loans, for example – and adding leverage, investment banks could satisfy the yield requirements for investment grade buyers, while the other tranches would be sold as higher risk.

Along the way, traditional debt standards or covenant protection on investment-grade bonds became nearly non-existent as fixed-income managers snapped up anything that was providing a spread over government bonds. Any corporate bond that was issued by a well-known name, such as TransCanada PipeLines, the banks, Sobey's or Bell Canada, created a feeding frenzy. Traditional covenants, change of control clauses and leverage tests were all left behind or dropped.

LBO cycle reintroduces corporate debt

And then the leveraged buyout (LBO) cycle started. Private equity companies looked around and saw low yields, tight credit spreads and an insatiable demand for higher yield. They found under-levered corporations with pristine balance sheets and lots of cash. While these companies were generating a huge amount of profit and cash flow, their return on equity wasn't high enough because there was simply too much equity. So private equity would step in and buy one of these companies by loading it up with debt. But it would still have the same amount of revenue and free cash flow – and with reduced equity levels, it would be generating a higher return on equity.

And this is where corporate bondholders ran into trouble. The investors who had loaned money to the corporation



without any constraints or covenants got the short end of the stick because they had no protection when the company changed overnight from being under-levered to highly indebted.

This is what's happened with BCE and Bell Canada bonds (see Chart 4). BCE will change substantially as it goes from a BBB-rated investment grade entity with 1-1/2 times debt to equity, to potentially six times debt and a single B rating, which would put it into the speculative grade range.

Bond rating companies currently have BCE and Bell under review with negative implications and will not be issuing a new rating until the deal closes in early 2008.

Signature's funds had no material exposure to any long-term Bell Canada bonds or Telus bonds, which the market also punished as guilty by association. As the conditions for a LBO cycle materialized, we looked at all of our corporate bond holdings to determine the likelihood of a takeover.

Admittedly, this is an inexact science, but we attempted to avoid LBO candidates because a takeover poses huge risks to investment-grade bonds. Unfortunately, the LBO wave has caused some collateral damage to the entire corporate bond market.

It's difficult to predict where it will end. Having been burned, corporate lenders are becoming much less complacent and more aware of the risks. There is approximately US\$250 billion worth of financings in the pipeline to be funded over the next few months. Only with a reduction in leverage, a return of proper covenants and more rational pricing will this mountain of debt clear the market. Problems could arise if a big LBO transaction fails to be funded, raising the risk of a credit crunch, which would have negative implications for the broader economy and equity markets.

Clearly, the current market conditions require a multi-asset class capability by investment managers. This is one of Signature's competitive advantages. Our fixed-income team is focusing on developments in the structured credit markets even though we have no direct exposure. Our current assessment is to modestly reduce risk with an intention to redeploy capital when the opportunity presents itself. We remain fundamentally bullish on the prospects for decent global growth.

At Signature, our goal is to sustain capital gains for our clients. We have added significant value in this equity bull run over the past four years by staying in the pro-growth saddle. We intend to preserve this value creation.


James Dutkiewicz, Portfolio Manager
Signature Advisors