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Annual Report & Directory
Managers of U.S. Assets for Canadian Plan Sponsors

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Now, before we start ripping off those nicotine patches, dumping the light beer down the drain, and reserving a table for three meals, plus snack time, at Mickey D’s, we should stop and think.

Certainly, the study from the Public Library of Science Medicine Journal that says preventing obesity and smoking doesn’t reduce healthcare spending could be a clear invitation to those of us with those vices to allow them to become habits.

The study found that since healthy people live longer, they end up costing the healthcare system more. On average, healthy people live 84 years and end up costing the healthcare system about $417,000 from age 20 on. Smokers live about 77 years and cost $326,000 while obese people live about 80 years and cost $371,000. Because both the smokers and the obese people died sooner than the healthy group, it costs less to treat them in the long run.

Turning Vices Into Habits

Of course, we have to remember that anyone can have fun with numbers. It reminds us of the story of the accountant interviewing for a job who, when asked ‘what one plus one equaled’, replied “What do you want it to equal?”

If nothing else, the study suggests that if we are successful with our smoking and obesity prevention programs, it may mean that people will just have a higher chance of dying of something more expensive later in life. For example, lung cancer is considered a cheap disease to treat because its victims don’t live long. So you could get that smoker to stop only to have them get Alzheimer’s where they may survive longer and cost more.

These numbers also fail to take into account things like days lost from the job due to the unhealthy lifestyles or the cost of replacing a worker who becomes incapacitated or dies suddenly.

Gallow’s Humour

On the other hand, we’ve always been somewhat attracted to gallow’s humour. Consider the plan sponsor concerned about the future liabilities of their Defined Benefit pension plans or benefits adequacy of their Defined Contribution pension plans. Maybe he’s thinking of suggesting to the HR department that instead of wellness programs, free doughnuts and cigarettes might be more appropriate given the pension situation. It’s not that unreasonable. Remember, Bismarck picked age 65 as the age when the first public pension plan kicked in because few people lived to that age in 19th Century Germany.

Regardless the pension savings that might result from such an approach, the other significant cost to employers is healthcare benefits. In this day of ever-increasing and more expensive drug therapies and aging workforces, keeping employees healthy must be a priority if only to try to arrest those escalating costs. Indeed, there are now employers who have worked with their group insurers to design plans where those who make appropriate lifestyle decisions pay less for their healthcare benefits. Of course, this study may have those same employers frantically looking for ways to get rid of their post-retirement benefits.

No Definitive Studies

The problem is that there are no definitive studies either way. Projections about obesity costs are frequently based on guesswork, political agendas, and changing science. For every smoker who dies young, there is the smoker who lives to be a hundred and attributes his longevity to his habit.

As well, more and more, we are learning about the impact of genetics and the environment on our health and longevity.

So we need to take these findings with a grain of salt and proceed as we have been – trying to help people stay healthy by making appropriate lifestyle decisions.

By Joe Hornyak
Executive Editor
WHAT IF IT WERE EASY FOR MEMBERS TO MAP THEIR RETIREMENT?

Doesn’t it seem essential that group retirement plan members be well-informed and properly guided?

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**Integra**

Joan Johannson is president and managing director of Integra Group Retirement Services. She joined Integra in 2004 as managing director, group retirement services, and has more than 20 years experience in the financial industry. Charles Swanepoel is managing director, institutional sales, and Barbara Coulter is managing director of institutional client services at Integra Capital Management. Swanepoel joined the firm in 2000 as senior vice-president specializing in global and international investments. During her 20-year career with the firm, Coulter has been instrumental in developing, directing, and growing its record-keeping services, administration systems, and plan member services.

**Teachers’**

Bill Royan is vice-president, relationship investing, public equities, at the Ontario Teachers’ Pension Plan (Teachers’). Previously, he was with Lehman Brothers in New York, where he held senior roles in its mergers and acquisitions group and its equity strategies unit. David McGraw is senior vice-president and chief financial officer. He joined Teachers’ in 2004 as vice-president. Neil Petroff is group senior vice-president, investments. Since joining the plan in 1993, he has held progressively senior positions, mostly recently as senior vice-president, tactical asset allocation and alternative investments.

**CPIB**

Alain Carrier is managing director (Europe), private investments, for the Canada Pension Plan Investment Board (CPPIB). With more than 15 years of financial industry experience, he was most recently managing director at Goldman Sachs & Co. in its investment banking division in London. Colin Carlton is vice-president, investment research, at the CPP Investment Board (CPPIB). His previous positions include global practice leader, asset consulting, at Towers Perrin; chief investment officer at both RBC Private Investment Counsel and CT Investment Management Group; and, most recently, vice-president and investment counsel at Perimeter Capital Management.

**Natcan**

Donald Couture is vice-president, national sales, institutional business development (Eastern Canada), for Natcan Investment Management. Most recently, he was vice-president, institutional investment services, at Franklin Templeton Investments.

**Mercer**

Jordan Berger is head of Responsible Investment (RI) for Mercer in Canada. He has spent the last 10 years working with the Ontario Public Service Employees Union (OPSEU) as supervisor of strategic planning, policy development, and benefits. Kelly Gauthier is an associate in Toronto. She spent four years as a management consultant and worked for CARE Enterprise Partners in social venture capital.

**Schulich School**

George Klar is a finance instructor at the Schulich School of Business at York University. Most recently, he was a vice-president and executive director at MFC Global. He has also held senior positions at Legg Mason and Beutel Goodman.

**CIBC World Markets**

Richard Nesbitt will be the chief executive officer of CIBC World Markets as of February 29. He has served as CEO of the TSX Group since 2004.

**Corporate Benefit Analysts, Inc.**

Jim Wager is senior pension consultant at Corporate Benefit Analysts, Inc. His primary focus will be pension consulting and new business development.

**Watson Wyatt**

John Abbott is a senior consultant in the compensation practice at Watson Wyatt Worldwide. Based out of its Calgary office, he will serve clients in Western Canada. Previously, he led the development of compensation strategies for a number of large corporations in Western Canada.

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Attraction Strategies Not Dependent On Benefits

Pension and benefits are important elements when it comes to retaining Canadian employees, says Steven Osiel, vice-president, total rewards, for Pal Benefits. However, unlike in the U.S., they are not an important factor when it comes to attracting employees. Speaking on applying total rewards strategies to small- and mid-sized companies at the 2008 HRPAO Annual Conference & Trade Show, he said while they are a good idea, they can be at or below the market when it comes to attracting employees. However, employees who do not offer pension and benefit programs which are competitive may have a harder time retaining employees.

Buschau Review Continues

The judicial review of OSFI’s decision allowing Rogers Communications Inc. to reopen the pension plan that was at issue in Rogers Communications Inc. v. Buschau is continuing. Robert D. Gibbens, of Laxton Gibbens & Company, which is counsel for the Buschau plan members, says a hearing is set for March 11 and 12 in Vancouver, BC, before the Federal Court Trial Division. Members are seeking a review of a Supreme Court of Canada ruling that found the decision on whether the pension plan could be reopened rested with OSFI. Following that decision, OSFI allowed Rogers’ request to re-open the plan to new members and denied the members’ contention that the closed plan should be terminated and any surplus distributed to them.

OECP Releases Policy Papers

The policy papers commissioned by the Ontario Expert Commission on Pensions (OECP) as part of its research program have now been released and can be found at http://blakes.com/english/practiceareas/pensionsOECP/pensions_OECP.asp. The OECP commissioned 17 research projects in total, many of which provide cross-jurisdictional analysis on topics ranging from the funding, taxation, and governance of pension plans to comparative models of risk-based industries and guarantee funds.

Responsible Investment Catching On

A growing number of market participants worldwide are now considering the benefits of responsible investment (RI), says Jane Ambachtsheer, head of responsible investment for Mercer. Speaking at a CPBI Fundamentals seminar, she said environmental, social, and corporate governance (ESG) factors have been proven to significantly impact investment earnings and fiduciaries should, therefore, work to manage the related risks and opportunities. Historically, RI was seen as a barrier to fiduciary responsibility. Now, with factors such as climate change and greener consumer demands taking form, ESG issues are real and evidence suggests they can affect shareholder value in both the short and long term.

Northern Trust Partners With youDevise

Northern Trust has an exclusive, worldwide partnership with financial applications company youDevise to offer funds of hedge funds daily portfolio management data. Typically, funds of hedge funds can only get this type of information from their administrators on a monthly basis. Northern Trust becomes the first global asset servicer to adopt youDevise’s Hedge Information Provider 2.0.

Cost Containment Top Concern

Cost containment has emerged as the top concern of plan sponsors of non-union salaried Defined Benefit pension plans, says the ACS Buck Consultants’ 2007 Canadian Pension Survey of Defined Benefit Plans. Marc-Andre Vinson, a senior consultant in its retirement practice, says the result is not surprising given the “hostile climate” that has reigned over DB plans in recent years. He says plans have recently started to take aggressive action to contain these costs. Most are keeping their DB plans intact for existing plans, but “basically ate their young” by introducing Defined Contribution plans for their new employees.

GRS Earns Awards

Sun Life Financial Canada Group Retirement Services (GRS) business ended 2007 with two honours, recognizing its commitment to understanding and responding to plan members’ needs. The Service Quality Measurement Inc. recognized its customer care centre with world class status as part of its 9th Annual Most Prestigious North American Call Centre Service Quality Award of Excellence. It also won Best in Show from the Insurance and Financial Communicators Association for its retirement plan communication program for its members.

CAP Guidelines Reviewed

The Joint Forum of Financial Market Regulators has launched a voluntary survey to assess the extent to which its 2004 Guidelines for Capital Accumulation Plans have been successful in achieving their original objectives. CAPs include Defined Contribution registered pension plans, Group RRSPs, Group RESPs, and deferred profit sharing plans. The survey could help determine if any of the guidelines need to be modified. The survey can be found at https://www.surveymonkey.com/s.aspx?sm=bpPCFPY7zRHpRWQAE1Ug_3d_3d.

Sponsor Focus Changes

Pension plan sponsors must now focus on financial risk management, instead of financial returns, says Scott Clausen, a principal and actuary in Mercer’s retirement business. Speaking at its annual Pension Outlook and Fearless Forecast, he said that, historically, plans added value through the mismatch of assets and liabilities. Today, they need to find ways to reduce short-term volatility and long-term costs.
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**Pensions Post Meagre Gains**

Canadian pension plans suffered reverses in the final two quarters of 2007 as the spreading global credit crunch hurt stock market performance, says a survey by RBC Dexia Investor Services. Canadian pension funds lost 0.5 per cent in the quarter ended December 31, returning a paltry 1.5 per cent for the year. However the soaring loonie and spiking energy prices, against a backdrop of tightening global credit and recessionary pressures in the U.S. “meant, after four consecutive years of double-digit annual returns, some weakening was in the cards,” says Don McDougall, director, advisory services.

**Mental Health Depletes Human Capital**

Mental health conditions are depleting the human capital of Canadian companies, says a research review by Dr. Mark Attridge, a leading writer/researcher in the area of mental health and its impact on the workplace, commissioned by Wilson Banwell PRO-ACT Human Solutions. ‘The Quiet Crisis: The Business Case for Managing Employee Mental Health’ shows that mental health conditions – depression, bipolar mood disorder, social anxiety and phobias, panic disorder, schizophrenia, and suicide – affect one in five employees. Employees with undiagnosed or under-treated mental health conditions often struggle valiantly to stay on the job. Despite their best efforts, many of them experience lapses in productivity, unscheduled days absent, physical illnesses, and alcohol and/or drug addiction.

**MacKinnon One To Watch**

The Ontario Court of Appeal decision in MacKinnon v. Ontario Municipal Employees Retirement Board made some comments regarding the scope of duties of service providers to a pension plan which make this proceeding one to watch, says the Pension Group at Borden Ladner Gervais LLP. The court found that it is not “plain and obvious” that a real estate management corporation was not an agent of a pension plan and it is possible for a party to be subject to fiduciary standards under the Ontario Pensions Benefit Act, but not under the common law or the related party provisions of the Federal Investment Regulations. However, this decision means only that the issues are headed to trial as the court was ruling on a summary judgment motion where it must assume all the facts as stated by the plaintiffs are true.

**SWFs Need Transparency**

Sovereign Wealth Funds need the same kind of transparency, mission statement, and arms-length legal structure and governance as regional and national pension plans, such as the CPPIB, says Keith Ambachtsheer, adjunct professor and director of the Rotman International Centre for Pension Management. In a roundtable co-sponsored by the centre and the Institute for International Business @ Rotman entitled Sovereign Wealth Funds: What in the world are they? he said since many were created almost by accident as a way to use funds generated by national trade imbalances, they lack a purpose, unlike pension funds which are there to provide income in retirement. Like pension funds, they should also be required to provide full disclosure of their investment holdings so these funds can be properly evaluated.

**Correction**

In the October Money Manager’s Report in Benefits and Pensions Monitor, the Website address for Tetrem Capital Management should read www.tetrem.com.
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For the financial realities of life.
Pricy new pharmaceuticals continue to challenge sponsors – prompting many to take on a variety of cost-cutting actions, while making sure claimants’ needs are met.

New brand name, specialty, or breakthrough drugs typically hit the market at lofty prices these days, which can seriously inflate health plan expenditures. It’s growing concern, especially as medical research makes strides and introduces more new drugs to the progressively aging baby-boomer population.

Sponsors, however, say they’re exploring effective ways to minimize these costs and are reporting some promising results too.

Generic substitution is a popular, long-standing method to curbing the cost of high-priced drugs. Many drug plans throughout Canada currently restrict coverage to the lower-costing generic drugs available on the market; drugs which have the same medical effect or are ‘bioequivalent’ to more expensive brand name versions.

Making Use Of Generics

Raymonde Bolduc, director of compensation and benefits for Rothmans Benson and Hedges Inc., says they’re getting set to apply generic substitution measures of their own. As of April 1, 2008, she says her group will make generic drug alternatives mandatory to all salaried employees, which includes about 500 plan members. If, however, a generic drug doesn’t exist for a certain medical problem or isn’t available to a member, they will be reimbursed for the brand name instead.

“The main motivation behind making generic drugs mandatory is to achieve cost containment in the long run. This will ensure we will be able to continue to offer good competitive benefits in the future,” Bolduc says. “We felt we had to do something and, at the same time, we felt that a formulary would be too restrictive.”

In contrast, Brian LaBelle, international health and welfare consultant for Convergys Corporation, says its managed two-tier drug formulary has been working effectively for some time now. About two years ago, it implemented a formulary – applicable to about 11,000 employees – that covers a specific list of eligible drugs, functioning on two levels. The first tier includes a list of preferred and generic drugs that, if prescribed, are covered 80 per cent. The second tier is reserved for newer, brand name drugs, which are covered 50 per cent.

“The tiered system has definitely helped. You’d expect with cost increases and healthcare going up the way it has, our health claims would go up. But they have been pretty much flat over the last couple of years,” LaBelle says.

Formularies Showing Results

In fact, the move to a two-tiered managed drug formulary has saved it approximately eight per cent on prescription drug/healthcare costs since implementation. That translates to about $400,000 a year and has helped limit increases from other plan enhancements made over the years too, LaBelle says.

Rather than using a multi-tiered system, Connie Dickson, director of benefits operations for the Actra Fraternal Benefit Society, says its carefully managed formulary is showing results too. At the beginning of 2003, it launched a formulary covering one defined list of preferred drugs for members. With about six to 10 new drugs coming in every month, she says its formulary has to be reviewed and updated frequently.

“Prescription drugs represent a major portion of our benefit costs which we’re carefully monitoring… Our formulary has been very effective for a number of years and there has been significant cost savings to our membership,” Dickson says.

Other Effective Measures

Another successful cost-cutting measure taken by her group, introduced in March 2007, is a cap placed on the amount of prescription drugs allowed. For about 8,000 of its eligible members, there is now a maximum reimbursement amount which will vary among members under the plan. Dickson says that, so far, members are reacting positively to the caps outlined and that it’s proving to be an effective way of minimizing the ongoing problem of new drug costs.

Eliminating the need for expensive drugs, altogether, is also a solid way to deal with the problem. Labelle says that this year his organization will consider partnering with a drug company to provide its employees with on-site cholesterol screenings. The idea is, of course, an indirect way of handling drug costs but, thinking long term, the strategy makes a lot of sense and is a great way to ensure expenses don’t get out of hand down the road.

“Ultimately, if we increase awareness of cholesterol levels, then our employees might want to control their cholesterol and have healthier lifestyles and, ultimately, that helps our health claims and in keeping them a bit lower in the future,” Labelle says.
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In a recent report, the Canadian Diabetes Association (CDA) stated that many people with diabetes face undue discrimination in the workplace due to the limited understanding that others have of the condition. The report suggests that Canadian employers are less likely to hire or promote a candidate with the condition due to fears of lost productivity and absenteeism. For these reasons, people with diabetes are choosing to avoid workplace embarrassments by hiding their condition. Fortunately, with a little education, employers can come to realize that their fears are largely unfounded.

Getting To Know Diabetes
Diabetes is a disorder in which blood levels of glucose are high because the body doesn’t release or use insulin adequately. There are two main types:
- **Type 1 diabetes** (insulin dependent diabetes) results when the pancreas produces little or no Insulin at all. Most people with this condition have it before age 30.
- **Type 2 diabetes** (non-insulin dependent diabetes) occurs when the pancreas continues to manufacture insulin, but the body develops resistance to its effects, resulting in insulin deficiency. It may occur in children and adolescents, but usually begins after age 30.

Serious Effects
Diabetes is the leading cause of death by disease and can lead to other health problems such as stroke, kidney failure, and heart disease. In addition, it has a host of complications and risks. Hypoglycaemia, the most common complication, is the most misunderstood and feared by those with a limited knowledge of the condition. It occurs when a person with diabetes has low blood glucose which happens when the body’s insulin lowers blood sugar too much or when the person has just exercised or missed a snack or meal. It must be treated quickly because within minutes it can become severe, leading to increased confusion and coma. Symptoms include clammy or sweaty skin, shakiness, blurred vision, dizziness, and lack of co-ordination. It can be treated with as little as a few tablespoons of honey or a cup of orange juice.

Scary But True
So how prevalent is this condition in the Canadian workforce? Well, you may have an employee with diabetes and not even know it as two million Canadians have the condition. As well, there may be many more people who are undiagnosed. An employee who has Type 2 diabetes, the most common form, will exhibit symptoms such as:
- thirsty all the time
- urinating a lot
- blurry vision
- weight loss

On the other hand, many employees who have undiagnosed Type 2 diabetes may not have any of these signs. This is why people should be tested regularly. Studies show that employees at risk of Type 2 were able to reduce that risk by 58 per cent by exercising moderately and by losing about six per cent of their body weight.

Cultivating Awareness
Awareness of the condition in the workplace is crucial to maintaining a healthy environment for all employees, whether they are living with diabetes or not. Fortunately, the CDA is taking pro-active steps not only to manage diabetes, but, in the case of Type 2 diabetes, to work to prevent it. The organization has created a ‘Healthy Workplace Initiative’ program to educate senior management of corporations. The program encourages employers and management to adopt the essential principles of comprehensive workplace health promotion which will help prevent the onset of Type 2 diabetes.

Unmanaged diabetes can negatively affect an employee’s daily activities. However, given the appropriate accommodation and the right level of support from both employers and co-workers, the employee with diabetes can be productive and live a healthy, normal life.
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With recession fears in the U.S., rumours of possible downgrades of bond insurers, and return expectations dampened after the January 2008 sell-off, it is time to review the longer term perspective for equities.

Today, in both Canada and the U.S., equity risk premiums are at their highest level in the past 40 years implying that a great deal has been discounted. On a cash and earnings yield basis, equities offer excellent returns compared to T-Bills and bonds.

At the same time, global liquidity remains at an all-time high and short-term interest rates are falling (See Figure 1). Investors have an excellent long-term environment to invest in equities.

Instead, we find that the true risks today are found in bonds and in the desperate search for the ‘risk-free’ yield advantage of one to 200 bps over Libor. The result of this search has lead to a near record compression in spreads and yields too small to compensate for the risk of capital loss. We believe further large losses in the high yield markets are coming as almost 48 per cent of all U.S. corporate bond issues this year were rated B- or lower and historically 50 per cent of bonds rated B- or lower default within 10 years.

In Canada, the bond story is not one of defaults, but of erosion of capital due to inflation. Real returns for 10-year Government of Canada bonds are 175 bps today, near an all-time low. Most importantly, Canada’s unemployment rate is now at a 30-year low pushing wage settlements into the four per cent range. The last time wage settlements were rising at this rate (1991), 10-year government bonds yielded nine per cent. Today that number is four per cent.

… But Poor Index Earnings

With excellent risk premiums supported by liquidity and falling short-term interest rates, the key to success is to find companies with earnings growth, a task requiring true skill today.

In Canada, slowing commodity prices and a higher currency have negatively affected corporate earnings. TSX Com-

Now Is Time For Active Management

On The Value of Active Management

Because equities are undervalued, but index earnings are negative, we believe that now is an important time to employ active management and to avoid cap-weighted indices.

Significant dislocations caused by credit market stress, opportunities presented by rapidly changing curren-

For investors with risk budget constraints or short-term liquidity requirements who are comfortable with alternative investments, now is the time to allocate to long/short or market neutral strategies. This is preferable by far to hiding in cash or bonds or trying to enhance returns with lower quality credits.
The wave of consolidation that occurred in the mid-1990s resulted in a number of strong players in today’s Canadian asset servicing market, creating healthy competition and greater choice of services for clients. Continuous product innovation, technology advancements, and skilled professionals providing exceptional relationship management are just a few of the benefits pension plan sponsors and their participants can experience.

In response to changing markets and increased investment strategy sophistication, asset servicing offerings have expanded beyond traditional custodial safekeeping to include multi-currency accounting and pension administration; benefit payment and retiree services; performance and risk analytics; and revenue enhancing opportunities from securities lending, commission recapture, and cash management. This complement of offerings will likely expand again in the near future as investment strategies become more complex, clients increase their asset allocation to global markets, and reporting and regulatory requirements become more demanding.

In this environment of healthy competition, leaders in asset servicing will deliver new products and services designed to meet and exceed clients’ needs.

Experiencing Value

With increased regulatory, governance, and compliance requirements, pension plans need a variety of flexible and robust asset servicing tools and information. Real time, accurate data, supported by knowledgeable asset servicing professionals, will help sponsors to address these requirements which will contribute to the effectiveness of their plan management and reporting requirements. Robust online reporting tools can help sponsors monitor their investment manager’s trading activity and asset class exposures on a daily basis to further reduce risk and achieve greater operational efficiencies.

Asset servicing providers can also support plan sponsors’ investment processes as these sponsors move into alternative strategies to increase returns. By offering faster processing, accounting, and reporting on derivative, private equity, and hedge fund investments, asset servicing providers can also facilitate disclosure and understanding of the performance and risks inherent in these asset classes.

Additional alternatives to increase returns include flexible collateral and cash reinvestment policies in securities lending programs, cash management, transition management, and commission recapture services. These program offerings and related reporting are available from most major Canadian asset servicing providers.

Pension funds also maintain relationships with a growing number of pensioners. To address their needs, asset servicing providers offer flexible and cost effective benefit payments processing and disbursement reporting capabilities. Efficient pensioner service support through knowledgeable call centre specialists and online tools are also becoming a core offering of asset servicing providers.

Not only are plan sponsors looking to increase returns with global investment opportunities, they are becoming more international in their relationships with parent companies and subsidiaries. Multi-national organizations look to their asset servicing providers for cross-border solutions, combined with deep local market knowledge, as they navigate through these new markets. The best Canadian asset servicing providers help their clients realize the full integration of global pension plans by leveraging global scale and integrated product suites across jurisdictions.

A Bright Future

As we look to this year and beyond, sponsors will continue to face challenges such as market turmoil, increasingly complex reporting requirements, and pressures to increase revenues. Yet, when partnered with the right asset servicing provider, Canadian pension plan sponsors will also experience an unprecedented level of quality service delivery and breadth of capability to help them manage their plans more effectively.

We expect that the industry will remain vibrant with strong competition and a sharp focus on the evolving needs of pension plan sponsors. Asset servicing providers with global reach and scale, the commitment and ability to make sustained technology investments, broad product capability, and flexible, attentive servicing will be the providers of choice for pension plan sponsors in coming years.

Thomas C. MacMillan is president and chief executive officer of CIBC Mellon (www.cibcmellon.com).
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Administrators of pension plans carry a heavy weight on their shoulders. It’s vital that they protect the personal information of their clients.

A common approach to protecting sensitive information in corporate databases is to code or configure security policies into each individual application that can connect to the database. This is complex and costly to maintain because any change in security policy governing the data must be applied to each individual application.

Furthermore, meeting ever-more stringent compliance requirements is difficult, if not impossible, to achieve with this piecemeal approach due to the lack of centralized visibility over security policies and access activity.

Protect Access
Consider the case of plan administrators at one of the leading pension plans in Canada. Its systems were developed 10 years ago. At first, the plan had a small number of systems and technologies with data-centric security requirements. This made coding authorization policies into applications manageable, if time-consuming, process. Now, this task was consuming huge amounts of time and resources.

As well, the plan’s management team discovered that its existing security tools no longer addressed the fundamental need of protecting the data itself.

The plan administrators determined that an entitlement management solution would offer centralized access control and visibility, allowing them to deal effectively with growth and to protect much more data based on the context of access.

In addition to protecting sensitive information without requiring custom coding, it was critical to the plan administrators that the entitlement management system work with its new service-oriented architecture (SOA). Plus, the services had to be managed in a way consistent with the rest of the system. It didn’t want one approach for securing services and another for securing applications. Everything had to fall under one security umbrella.

To achieve a level of consistency, the Canadian pension plan used the entitlement management solution as a foundation for its other systems and applications. It took the approach of delivering the entitlement infrastructure first, so it was able to migrate both existing and newly developed applications over to the infrastructure, in that way ensuring a smooth migration.

Unique Approach
And in a unique approach to implementing an entitlement management infrastructure, the pension plan manages access to services at the SOAP (service-oriented architecture protocol) action level which will give it really fine-grained authorization capabilities on its services. It should enable the plan to have highly secure, dynamic entitlements working on the system, right from the start.

By abstracting fine-grained data authorization policy from core application logic and delivering it as an XACML (Access Control Markup Language) standards-based service, it is possible to deploy entitlement management on both a per-application and enterprise-wide basis quickly and effectively. This approach allows development teams to create highly secure, dynamic entitlements right from the start, at a fraction of the time and cost of custom development. At the enterprise level, security teams can administer a consistent policy while risk and audit teams are able to review and change policies to meet compliance requirements. The benefits of this design approach include the ability to make updates easily, to assure the consistent application of security policies, and to audit for compliance.

Because ‘money matters,’ it was critical that the new system be simple enough to allow non-developers to administer entitlements. In periods of growth, organizations have to make the very best use of their human capital. Talented developers should be used to deliver new services and functionality, not to administer entitlements.

Rajiv Gupta is vice-president and general manager, policy management business unit, at Cisco (rajivgup@cisco.com).
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What does rocket science have to do with pension plans? You might be surprised!

When it comes to pensions, very little happens overnight. The truth is, not much happens in a year. But we all make small decisions every day and one day we wake up, look around, and say to ourselves, ‘How did we get here? This isn’t where I thought we were headed!’

That feeling may be familiar to sponsors of Defined Benefit pension plans who find the plans they thought they were managing are managing them. You might ask ‘when did a contractual promise of a retirement income shift to a trust-based commitment to provide income plus the ownership of assets?’ It certainly didn’t happen overnight.

‘DB refugees’ who now sponsor Capital Accumulation Plans may have the queasy feeling that this experience is about to repeat itself as they discover their supposedly ‘risk-free’ CAPs offer no end of operational risks. When did that happen? When did sponsors lose control of their promises?

Less Troublesome Future

A quick look at a bit of rocket science might help us pinpoint some answers and point the way to a less troublesome future for group retirement plans – whatever their design.

Whenever a spacecraft is launched, it is understood that course corrections will need to be made to fine-tune the trajectory. Rocket scientists have their own jargon and refer to these as Trajectory Correction Maneuvers (TCMs). During many months or years of travel over hundreds of millions of miles of space, the spacecraft’s path will need to be adjusted slightly – possibly several times – to make sure it arrives at its planned destination.

A good example is a robot spacecraft called Phoenix, launched last summer to land on Mars in 2008. Like any interplanetary spacecraft, Phoenix’s course was mostly set once the launch vehicle fell away. From that point on, the spacecraft is ‘falling’ through space and can make only very small corrections in its trajectory by firing its small engines or thrusters. To make these TCMs, the rocket scientists must measure, with a high degree of precision, the exact location of Phoenix and compare it with where the mission’s flight plan says the spacecraft should be.

As you would expect, to correct any discrepancy, scientists must compute the direction and magnitude of the vector required to correct to the desired trajectory. An opportune time for making the TCM must be determined. Sooner is better than later. A smaller magnitude of change would be required, for example, immediately following a planetary flyby than would be required after the spacecraft had flown an undesirable trajectory for many weeks or months.

Firing The Thrusters

Last August, Phoenix’s first TCM was performed. It involved firing the thrusters for a little over three minutes. Before the TCM, Phoenix was traveling (relative to the sun) at 74,400 miles per hour (that’s fast). After the TCM, it was going 41 miles per hour faster (that’s not much of a change). Consider how slow that acceleration is. A family minivan can go from zero to 60 in less than 10 seconds. However, adding just 41 miles per hour to 74,400 miles per hour illustrates how a small adjustment playing out over vast distances can make a big difference. Scientists estimate that without the TCM, Phoenix would have missed Mars by 590,000 miles!

This analogy applies easily to the financial side of retirement planning. After all, just as rocket scientists work out their TCMs, actuaries continuously update the funding parameters of the pension plan to correct for the effect of changing economic factors such as interest rates, salaries, capital market returns, and other business factors. You could say that valuing a pension plan involves a succession of mid-course corrections.

But, there’s a deeper lesson to uncover, involving the subtle effect of less obvious forces at work. Getting where we want to go requires that we correct for minor factors that have a major impact over time.

For rocket scientists, determining the path of a spacecraft is an incredibly complicated calculation that has to take into account the changing gravitational effect of the bodies that tug on the spacecraft – even the effect of asteroids needs to be factored in. We might imagine that inertia keeps everything in space going in a straight line, but gravitational
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effects in the solar system make for a trajectory that is anything but a straight line.

In the same way, the promises written into pension plan texts are subject to the constant pull of outside forces – such as social changes, legal precedents, and accelerating plan member expectations. We’ve seen this with the trajectory of DB plans over the last 30 years or so.

Did those employers who established DB pension plans for their employees many years ago ever imagine where those plans would end up today? Promises and engagement can always be misconstrued, but the real problem only arises when the errors are not challenged promptly. The shift happens very gradually, day by day and year by year, as the nature of the original intent becomes confused and a new sense of entitlement takes hold. In the case of DBs, the promise at the heart of the pension plan was eclipsed by the instrument used to guarantee it.

Pension Security Trust
A refreshingly compelling and lucid vision of how the DB model can be set back on course was presented to the Ontario Expert Commission on Pensions by the Canadian Institute of Actuaries (CIA). The CIA proposed the use of a Pension Security Trust that would be separate from, but complementary to, regular Defined Benefit pension plan funds. As its name implies, it would be used to help guarantee the benefits promised in the pension plan. Plan sponsors could use the trust to increase funding levels and enhance benefit security for plan members, but if contributions were subsequently found not to be needed to fund benefits, they could be released back to the plan sponsor. Although the CIA’s proposal does not push the concept quite so far, it could be argued that the entire DB pension fund should be considered a ‘pension security trust’ – at least, for the contributions made by the plan sponsor and the earnings thereon.

In any case, by defining a new model for pension funding, the CIA is proposing a course correction that could re-focus future legal battles over surplus pension assets and help put DB plans back on their original path. These course corrections can be as needed – and as useful – for CAPs as well.

For example, by design, a Defined Contribution pension plan or Group RRSP does not promise a specific benefit at retirement. Instead, it allows employers to assist their employees to set aside a little money every payday and have it accumulate for when they stop working. In such a scenario, the sponsor fulfills its commitment every pay period when the defined amounts are placed in the designated accounts for future use by the members. However, recent talk of ‘replacement ratios’ and ‘adequacy’ of benefits has begun to exert a pull on the limited engagement of simply setting money aside for retirement.

It seems that some people consider a DC pension plan, or even a Group RRSP, as inherently promising a retirement income. They interpret the words ‘pension’ or ‘retirement’ to signify an engagement to provide ‘an adequate lifetime income.’ If you sponsor such a plan and it is, indeed, your intention to provide a certain level of income, then you rightfully should worry about the ‘adequacy’ of contributions, the level of investment earnings, and the length of holding periods.

On the other hand, if the intention of your DC pension plan or Group RRSP was based on the more traditional meaning of the words ‘retirement savings,’ take note: you may be hurtling towards a vastly different destination. You should implement, as soon as possible, your own course correction. If you don’t act before it’s too late, your pension board members may find themselves in a place they never intended to be … being called to account for the (in)adequacy of the benefits. Like a misguided spacecraft, without small course corrections early on to set it back on target, the misunderstood pension plan will drift towards a destination far different from the original plan.

Nudge Any Plan
And therein lies the problem. Acting over time, the ‘gravitational tug’ of uncorrected expectations – the oh-so-Canadian concept of entitlements – can nudge any plan way off course.

What have we learned from the rocket scientists? We can sum it up without jargon:

- Whether you know it or not, you are always in motion: don’t let your path be left to the chance effects of forces outside of your control.
- Know where you are trying to get to before you start.
- Carefully point yourself in the right direction.
- The launch is important, but will not, by itself, guarantee you get where you want to go.
- Even minute forces can have a significant influence if they act over a long period of time.
- Always keep track of where you are.
- Always keep in sight where you are going.
- Be prepared to make multiple adjustments.
- Sooner is better than later. If you wait too long, the cost of the adjustment might be more than you can afford.

And finally, when someone asks you what you do for a living, you can smile and honestly tell them, “What I do is a little like rocket science…”

Christopher Cartwright is a vice-president at The Financial Education Institute of Canada (ccartwright@feic.ca).

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Currency movements can have truly significant – dare we say tremendous – effects on the short-term returns generated by foreign assets, especially, these days, U.S. assets. Yet, many pension plan sponsors and investors often fail to consider currency issues when determining their investment strategies.

There are several schools of thought pertaining to currency management. With philosophies ranging from laissez faire to the micro management of exposures, investment practitioners and plan sponsors are bombarded with a plethora of potential approaches to managing currency exposures.

As is often the case, markets provide investors with reasons to question long-held beliefs through periods of outsized returns/losses. The current decade has seen the value of the Canadian dollar set record lows and historical highs relative to the greenback (see Figure 1). Thus, the time has come for Canadian investors to re-examine currency management practices.

The Loonie Serves A Wake-Up Call

In 2007, the Canadian dollar appreciated vigorously against several of the world’s main currencies, ranking among the best performing of the first three quarters of the year. It even broke records when, toward the end of the third quarter, it stood at multi-decade highs against its U.S. counterpart. Yet, fourth quarter market volatility caused an abrupt and extensive retracement, pulling the loonie down to parity with the greenback, and back up to end the year at 1.0073. As a result, returns on unhedged foreign investments suffered significantly.

Conflicting actions taken by the Bank of Canada (BoC) and the U.S. Federal Reserve (Fed) over the summer – while the BoC raised its interest rate to 4.5 per cent, the Fed cut its discount rate by 50 basis points – are likely to have contributed to the reversals throughout 2007.

The strength or weakness of a currency has very real economic impacts. Note the effects of the dollar’s recent appreciation on inflation and domestic interest rates. Canada is an exporting nation. A broad number of economic sectors – including industry, technology, and resources – are challenged by a strong currency.

Currency markets are paying no heed to the fact that authorities are advocating that the exchange rate between the Canadian and U.S. dollars could be sustained below parity. As this next transition unfolds, fundamental considerations will become key in establishing a new – and perhaps lower – market-based equilibrium rate for the loonie.

Currencies: A Zero-Sum Game, Really?

One school of thought on currency movements implies that, in the long run, net returns to currency movements must be zero. Therefore, one person’s gain is another’s loss and, on the whole, attempting to profit from currency trading will generate a loss equivalent to trading costs in the long run.

The basis for the zero-sum game assertion lies in knowing that currencies cannot move in only one direction forever and, therefore, revolve around a flat axis. Because a currency does not represent a growing economic interest, it does not carry a defined market risk premium.

The fact that net overall currency returns amount to zero over the long run is extremely important. Yet, plan sponsors should avoid jumping to the conclusion that zero net long-term return justifies zero management attention being paid to this matter. Currency volatility in the short term will have a significant impact on

By: Michael Quigley & Martin Leclair

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In a world economy refashioned by globalization, it is only natural that the reserve currency (the U.S. dollar) be the recipient of excess global savings. This, in turn, has allowed the U.S. to consume more than it produced, leading to well-known external account deficits. Additionally, it provided financial markets with the fuel to develop more sophisticated credit instruments and lend on more generous terms. Some of these new credit instruments and practices have now been proven unsound and unsustainable. Logic dictates that the credit expansion phase will most likely be followed by a period of contraction. Until recently, investors were expecting the U.S. Federal Reserve to act to avoid a recession. Today, the debate centres on how deep a U.S. recession could be and its impacts on global economic growth. The Fed currently faces a long list of formidable challenges. It must deal with a slowing domestic economy, a credit contraction, and challenges related to unknown structured credit exposures while having to take into account inflation trends.

The Fed’s main intervention tool is the federal funds rate. Lowering it beyond a certain point will create renewed pressure on the U.S. dollar. The problem and related risk lies in the fact no one knows where that point is. U.S. financial authorities’ ability to stimulate the economy could, therefore, eventually be constrained by the unwillingness of the rest of the world to continue to accumulate further dollar reserves.

Plan Sponsors, Beware Of The Unmanaged FX Risk

For many plan sponsors, currency management is an unfamiliar component of their overall asset universe. If not ignored entirely, the currency management segment is often delegated to asset managers with only broad instructions and little monitoring. Only a minority of pension plans have implemented an explicit policy on currency management.

A strengthening Canadian dollar, the recent rise in global currency volatility, and the recent realization that foreign exchange exposure is not, in the short-term, something that can be completely ignored should lead to a change in sponsor attitude.

Managing uncompensated currency risk now ranks higher on sponsors’ to-do lists. Currency risks can be managed passively or actively in an effort to enhance risk-adjusted returns. Passive management of these risks can reduce volatility, allowing the risk savings to be allocated elsewhere in the portfolio. Alternatively, currency exposures can be managed actively in an attempt to generate pure alpha.

Recent currency movements have reminded plan sponsors and investors of the importance of treating currency exposures as an asset class. While alpha generation in this area is probably best left to overlay and tactical approaches, risk management techniques pertinent to all other classes should be applied systematically and dynamically by investment managers.

Michael Quigley (mquigley@natcan.com) is senior vice-president and director, distribution, and Martin Leclair (mleclair@natcan.com) is vice-president, institutional asset management, at Natcan Investment Management.
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Convergence of investment styles is leading to a requirement for higher processing standards

Everyone is searching for alpha. A decade ago, it seemed as if every investment portfolio was heading toward some form of indexation, as passive funds gained momentum at the expense of active managers who had failed to beat the index. Yet, the rules of the game changed when hedge funds entered the collective consciousness of the industry. All of a sudden, investors realized there was a wealth of additional opportunities that held out the promise of benchmark-beating performance. From hedge funds to weather derivatives, property to private equity, institutional investors have enthusiastically, if belatedly, discovered the attractions of alpha-based investment strategies.

This mainstream shift away from relative passive benchmark returns (beta) to absolute returns (alpha) has been the recurring theme of the investment industry in the 21st century. The motives are not hard to determine. Stung by the quadruple whammy of a protracted bear market, low interest rates, longer life expectancy, and tougher regulatory oversight of pension plan deficits, investors have looked to alternative assets to deliver superior investment performance. As a result, money has moved rapidly to take advantage of these opportunities as investors have refocused their asset allocation strategies to build in a higher exposure to absolute return products.

Dramatic Transformation

The transformation of the investment environment has been dramatic. Hedge funds are no longer the preserve of family offices and ultra-high net worth individuals. Infrastructure projects are increasingly popular with pension plans. Real estate investment funds are recording phenomenal asset growth as investors allocate more money to property. Private equity has become a high-profile business, not only because of its growing influence in the corporate world, but also because of its ability to generate superior returns.

As these alpha-based strategies took hold, the conventional wisdom was that investors should use specialist managers, spawning a whole new breed of boutique firms that ran lean and hungry operations, charging healthy fees, and disclosing little about their modus operandi or trading strategies. Good performance was critical to the investor base, trading off the need for transparency. But two factors changed all that:

◆ the institutionalization of the alternative investment sector
◆ the emergence of hybrid managers and the subsequent convergence of investment styles

Institutional investors have been enthusiastic entrants into the alternative space and their demands for transparency, and operational and risk management excellence, have acted as a timely reminder to the industry that standards have to rise. Historically, funds used to be run to suit the requirements of the manager rather than the clients. There was little information available, reporting and valuations were infrequent and paper-based, and operational complexities were solved simply by adding more people to handle the transactions. While this might have been adequate for the largely private client base, the needs of institutional investors, such as pension plans and endowments, are much more stringent. Among many new demands, they want to see straight-through processing as the rule rather than the exception; regular independent valuations; performance and risk analytics; evidence of best execution; and electronic interfaces rather than paper reports.

Moved Rapidly

To their credit, specialist alternative managers have moved rapidly to satisfy these new demands, with many
Mellon Transition Management Services

For further information please contact

Mark Keleher  415 975 2334
San Francisco  mkeleher@mcm.com

Jamie Cashman  215 553 4436
Philadelphia  jamiecm@mcm.com

John Egar  416 643 5137
Toronto  johneg@mcm.com

David Hanlon  617 722 7229
Boston  davidjhs@mcm.com

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acknowledging that the best way to improve the operational and risk infrastructure is to outsource to third-party administrators. That, in turn, has led to the relatively recent entrance of global custodians into the alternative investment administration business, operating alongside independent providers and prime brokers. Outsourcing middle and back office functions has been the preferred route for many alternative fund managers, both large and small.

The second factor behind the drive to improve standards and transparency was the realization by the traditional long-only funds that they could also be players in the alternatives market. Mutual fund managers are now using long/short strategies and structured products as part of their overall offering for mainstream retail funds. New products, such as 130/30 funds, are evidence of the ambitions of traditional managers, as is the significant growth in the use of OTC derivatives as a means of hedging and creating exposures.

As can be seen from Diagram 1, the two worlds are rapidly converging. Even within the alternatives sector, we have already seen examples of convergence as hedge funds, for example, participate in private equity transactions. The lines are becoming blurred. We can no longer fit managers into neat little boxes that classify them as equity, fixed income, cash, or alternatives special-ists. Even the largest buy side firms have transformed themselves into many-to-many providers, capable of accommodating both alpha and beta requirements.

Brave New World

In this brave new world, there is a clear challenge — making everything work together seamlessly for the client. In many ways, the advent of highly complex investment strategies and tradable instruments can be compared to the growth in global equity investing in the 1980s and 1990s. Then, as now, the trading desks were in danger of running ahead of the ability of their back offices to administer the transactions and investments. With complexity comes cost, risk, and manual processing. Just as the industry spent many years implementing straight-through processing solutions for cross-border equities clearing and settlement, we now need to make similar improvements across the entire alternative investment space.

There are some significant challenges ahead if the industry is to achieve that goal. Clients and their administrators need to work in partnership to build solutions that are flexible enough to handle the growing number of asset classes and instrument types, especially those involving OTC transactions or structured products. To survive this test, administrators and their clients will have to develop strategies that raise service standards, create capacity, reduce processing risk, and improve operational efficiencies. We all know that adding more bodies is not the answer, however talented those bodies may be. What is required is the same spirit of innovation and collaboration that led to the enduring efficiency gains of the 1990s. If we can achieve that, alternatives will continue to generate excitement, across not only the front office, but also the middle and back offices.

José Santamaria is director, business development, at RBC Dexia Investor Services (jose.santamaria@rbcdexia-is.com).
Short-extension strategies represent a clear advantage for institutional investors seeking consistent equity returns with volatility that is similar to that of a long-only portfolio. While the amount of risk can be controlled in a short-extension strategy, the types and sources of risk are somewhat different from long-only strategies.

Given the relative newness of these strategies, many investors continue to grapple with understanding the four primary risks that accompany limited shorting approaches:
◆ tracking error
◆ shorting
◆ leverage
◆ factor risk

Managers selected for short-extension strategies must have well-considered investment methodologies to quantify and mitigate each of these risks.

Tracking error measures the amount of risk that any strategy takes relative to the benchmark and is not unique to just short-extension strategies. It is probably the most important risk measure for any benchmark-driven investment approach.

Many quantitative and fundamental managers use commercially available, long-term risk models that are based on monthly data used to forecast annual tracking error. Expecting a long-term risk model to explain daily or weekly performance invites contradiction. Most managers recognize that short-term performance of an individual security or a portfolio is very noisy and not likely indicative of longer-term performance. However, if managers or investors are concerned about short-term performance due to market volatility, then short-term risk models and/or simulation analysis should be used to explain short-term returns.

Shorting is a risk that investors must consider when selecting a short-extension manager. Securities selected for shorting have twice the expected volatility of securities that are held long.

Underperform

This is because securities chosen for shorting tend to be companies without positive earnings or cash flows that have likely underperformed their peers. These factors tend to make the security prices more sensitive to good and bad news since the future of these companies is highly uncertain.

There are several key factors that we believe impact a long/short manager’s effectiveness:
◆ First, when shorting a security, the manager needs to account for the cost to borrow the individual security.
◆ Second, a manager who takes concentrated and subjective short positions is likely to have a lower information ratio, and less success in a short-extension strategy, than a manager who follows a more diversified approach to portfolio construction. Therefore, we believe that holding many diversified securities and managing them in a risk-controlled fashion is preferred when managing short-extension portfolios.
◆ Finally, because equity returns are fat-tailed and skewed towards large positive returns, we believe that the manager (and investors assessing their short-selling skills) needs to pay more attention to the shorts than they do stocks held long from a risk-management perspective.

Investor’s Exposure

There is a misconception that the use of leverage adds to the risk of a short-extension strategy. These strategies clearly use leverage. However, leverage does not necessarily increase tracking error or the beta.
of the portfolio in the context of short-extension strategies. Leverage increases the investor’s exposure to the underlying investment alpha source (that is, the manager’s skill). Managers who can exploit this leverage may be better able to meet investors’ increased appetite for risk-adjusted alpha.

Through the use of a risk model and optimizer, short-extension managers have the ability to target a specific tracking error comparable to that of a long-only portfolio.

Each level of leverage has an optimal level of tracking error – defined as the level of both leverage and tracking error that will maximize the information ratio. Certain levels of leverage will dictate a higher tracking error and alpha. It is ultimately the investor’s decision whether or not to increase leverage and risk.

Unlock Alpha

Giving managers the ability to short affords them the opportunity to unlock alpha while reducing common factor risks such as capitalization, industry, or country exposure. This observation may be fairly intuitive after we consider small cap securities and the long-only portfolio.

Significant alpha opportunities exist within securities that comprise small percentages of the benchmark weight. Those alpha opportunities exist in both undervalued and overvalued small cap securities. In order to capitalize on undervalued securities, the long-only manager will overweight them. For the securities that are overvalued, the long-only manager will underweight them or not own them at all. Given the long-only constraint, however, the underweight is necessarily limited to the benchmark weight which will be small for a large portion of the securities in a given market-cap-weighted index. Notably, many indices have a significant number of securities that represent a small weight of the index. Underweighting those small cap names will not impact the long-only portfolio significantly since they only comprise a small portion of the benchmark.

This small cap scenario – the ability to take strong, active, long positions and the inability to create significant negative positions through the use of shorts – creates unintended factor risk in the long-only mandate, increasing net exposure to smaller names of the benchmark as a direct result of the long-only constraint.

On the other hand, the long-only manager does not necessarily have the same concern with large cap stocks. For those securities that comprise a larger percentage of the benchmark weight, a manager can significantly underweight large cap stocks that are unattractive and offset the overweight positions for the relatively more attractive large cap names. As a result, the long-only manager will avoid having unintended net large cap exposure relative to the benchmark.

Unlike long-only strategies, the ability to short securities allows the manager to fully capture both positive and negative alphas, even for small cap names. Furthermore, since the underweight arising from the manager’s ability to short can offset the overweight, the manager is not forced to take on unintended net exposure to small cap securities relative to the benchmark.

‘The Right Mix’

Research has shown that in the absence of transaction and financing costs, increasing the level of leverage will create a superior portfolio in both absolute and risk-adjusted performance. As leverage increases in a short-extension mandate, investors can increase their exposure to the manager’s alpha model. However, the optimal level of leverage needs to strike a balance between an investor’s risk constraints and hurdle rate. The most important variables in determining the optimal level of leverage and active risk include the following:

◆ Composition of manager’s alpha model – The quantity and market capitalization of the securities on the manager’s buy and sell lists are key determinants of the optimal level of leverage required. If the list of shorting candidates tends to be weighted toward smaller capitalization stocks, then the gains from shorting are greater and the optimal level of leverage may be higher. This is because large cap stocks ordinarily would suggest lower levels of leverage and tracking error needed to optimize a portfolio.

◆ Type of mandate – Of all of the factors discussed, one of the most important is the ability to buy, sell, and short securities included in the universe, but not included in the benchmark. By enabling managers to place bets in similar companies outside the benchmark, leverage can be increased substantially more than in a benchmark-only mandate due to the increased number of stocks that the manager has to choose from.

Investors are best served when they begin a mandate by stating the desired alpha target and then allowing the manager to structure a portfolio with the appropriate level of leverage and tracking error that is necessary to pursue that level of excess return.

Finally, a quantitative approach to managing short-extension strategies may be preferred over a fundamental approach. The skills needed to short securities (and especially those comprising smaller weights in the index) have a significantly larger impact on generating excess returns than securities held long in the portfolio, even after accounting for transaction costs.

Tony Elavia is a senior managing director and chief investment officer and Steve Landau is a managing director for product development at New York Life Investment Management (nyliminfo@nylim.com)
A few years ago, you carried out a governance review of your pension plan. You established a pension committee that includes senior human resource and finance officers, laid down written procedures as to the decision-making path, adopted policies as to conflict of interest and the payment of expenses from the plan, and sent around a tentative meeting schedule for the coming year.

You gave the members of the pension committee a large binder of materials that included the current plan text(s), the funding agreement, investment contracts, the Statement of Investment Policies and Procedures, the most recent actuarial valuation report, and your governance polices and procedures.

Who the ‘you’ is in the foregoing scenario will vary from company to company, but ‘you’ are very probably the senior human resources officer of the company who has been given responsibility for the operation of the pension plan. In order to accomplish the foregoing, you had assistance from a consultant or lawyer or both and you had buy-in and, possibly, specific direction from the board of directors, who were made conscious of the potential for personal liability.

Signs And Portents
With the aging of our workforce and greater awareness of pension matters, many pension plan members are taking an active interest in their plan by asking for a role in the governance of the plan or pressing for a money purchase arrangement. Members may even be complaining about their contributions to the plan (and the company’s contributions).

Perhaps members of the board or the pension committee are asking questions. They are concerned about insurance and personal liability indemnities. They could be worried about the investment of the pension fund in derivative instruments that they do not understand.

Or the regulators are taking an interest in your plan. You have received a letter from the Financial Services Commission implying your investment policy may not be appropriate, given the plan’s solvency deficit or they are urging you to address the surplus issues arising from a partial wind-up that occurred years ago.

When nudged by the restiveness of the members, the board, or the regulators, it occurs to you that you don’t have a written contract with your actuary. You are operating under a trust agreement that no one has looked at for years. Or maybe there’s a draft, but it has never been signed. Come to think of it, the staff member who always understood how the plan is administered has recently retired.

Other matters that may be calling out for a tidy-up:

◆ Your Statement of Investment Policies and Goals has not been seriously considered for years
◆ A past amendment to the plan has never been finalized and filed
◆ You’re not sure if your pension records are backed up (or if the back-ups are kept somewhere off-site)
◆ Your pension records are kept in an unlocked filing cabinet near the water cooler

◆ You could not find any records for an individual who terminated employment 20 years ago and claims to have a deferred pension
◆ Your new actuary has been complaining about poor data
◆ You’ve read there may be some problem with paying expenses from the plan (which you have been doing for years)

Current Issues In Plan Governance
Current issues in plan governance include the payment of expenses from the pension fund. Recent judicial decisions do not deal as comprehensively as might be wished with the use of Defined Benefit surplus to pay employer contributions to a Defined Contribution plan component. Plan administrators also have to be aware of privacy issues with the protection of privacy legislation and should have a policy for record retention. Pension plans are forever, or so it seems when it comes to record retention. There may be a niggling worry as to whether your plan is technically a multi-employer plan and thus not eligible for
coverage by the Pension Benefit Guarantee Fund. There are other issues requiring legal review including whether the plan permits contribution holidays or whether your plan can be merged with another.

How Do You Conduct A Governance Review?

It is strongly recommended that there be an annual governance review of your pension plan(s). An annual clean up and fix-up is appropriate.

In the course of this review, of course, you have to address the problem areas you have identified. You should also ask your consultant and/or pension counsel for their views on the areas to be addressed and for an update on legislative, judicial, and regulatory developments as they affect your plan(s). You are probably already receiving the relevant information; you need to bring it all together and deal with it comprehensively.

You should also reflect upon whether your carefully designed and documented policies and procedures are being followed. You may remember that the pension committee last year actually held only two of its scheduled semi-annual or quarterly meetings. The minutes of the meetings that were held were issued just in time for the next meeting. Moreover, although the board of directors received an oral report on the pension plan, a comprehensive written report was neither prepared nor presented.

Scheduling pension committee meetings so that they actually take place can be a challenge in some organizations, especially when members work in different locations. Getting enough ‘face time’ with the board of directors can be another challenge in some organizations. Getting minutes of meetings out in a timely manner can be difficult.

Governance guidelines have been issued by the Canadian Association of Pension Supervisory Authorities (CAPSA). Such guidelines are imperfect. A pension plan could be governed well and run well in practice and still be in breach of the guidelines. It is best to protect yourself against allegations of breach of duty by either ensuring compliance or being in a position to explain to a regulator or the court why the governance of your plan departs from the guidelines, but still works well. Consider taking the useful self-assessment questionnaire in the guidelines, which can reveal gaps in knowledge or procedures, annually.

Remember to document the annual governance review. A well-documented governance process and a well-documented governance review process can go far to minimize liability if something goes wrong. Consider Governance Policies And Procedures

You may have to modify some of your policies and procedures to ensure that they are followed and that they are effective. Governance policies and procedures must reflect the reality of the operation and decision-making as to your particular pension plan(s). Further, they must be designed in recognition of the particular individuals who are involved in the various aspects of plan governance. Otherwise, they will not be followed. In a litigious situation, and litigious situations in respect of pension plans are arising increasingly, having excellent and well-documented governance policies and procedures that are not followed can be more dangerous from the standpoint of personal liability than having none at all.

In a review of governance policies and procedures, each participant, from the board of directors to the pension committee to the staff who administer the plan, should participate and the views of your outside advisors should be sought. Their views should be sought on subjects including:

- Does the decision-making follow the path that is set down?
- Have the plan and the fund been managed efficiently and effectively?
- Does everyone understand his or her role?
- Do the procedures fit with the personalities and expertise of the individuals involved?
- Is the information given to participants in the process sufficient, understandable, and timely?
- Have there been glitches in the process?
- Have personnel changed? If so, is the decision-making path still appropriate?
- Have new participants been given the training and information they need to carry out their roles?
- Is there, or should there be, a role for plan members in the governance structure?
- Are there adequate indemnities and fiduciary insurance?

Who Will Ever Know?

If all this sounds unduly picky or even alarmist, it is not. Governance issues can and do come up. They tend to rear up and bite when there is a sale of a business and you have been asked for a Certificate of Compliance.

But there are other situations where questions will be asked. For example, expect to have to account for your governance procedures if you propose a plan merger to which plan members object to the point of complaining to FSCO and retaining counsel.

Other situations where you can expect questions include a wind-up or partial wind-up and a surplus withdrawal, where counsel for the members goes looking for all the skeletons in your closet. And you will certainly be defending the governance of your plan if the solvency of your plan goes south and, first, the Financial Services Commission of Ontario and then the members start looking around for someone to blame and to sue. Watch out if there is an allegation of (or there has, in fact, been) improper or inappopriate or non-arm’s length investments using pension funds or, for whatever reason, the plan member or beneficiaries retain legal counsel to advise about claims under the plan.

Personal Liability – The Spur To Good Governance

The question of personal liability of directors and officers tends to arise particularly in insolvency situations where the members and regulators are looking around for someone to blame. Remember, directors and officers can always be prosecuted or sued for a breach of the standard of care under Sections 22(1) and (2) of the Pension Benefits Act (Ontario), which can apply to senior staff as agents of the plan administrator as well as to the plan administrator (usually the company) itself. By the time there is insolvency, it is too late to remedy past omissions.

However, any situation that attracts member scrutiny can lead to governance issues being raised.

To date, the greatest risk of liability of pension committees or boards of directors has been in connection with the investment of the pension fund. However, there is an increasing risk of litigation associated with funding. Plan governance, as it impacts on funding issues, is a developing and complex area that deserves special treatment beyond the scope of this article.

Good For You And Your Plan

Even without external pressure, there are good reasons for an annual governance review. Good plan governance saves money through improved administration of the plan and the fund; the risk of mismatching of investments and plan liabilities is reduced; the personal liability of the directors, officers, and staff is minimized; and you save embarrassment with the members or regulators. Where there is good communication, plan members appreciate better what is a very valuable employment benefit.

Pricilla H. Healy is with Pallett Valo LLP (phealy@pallettvalo.com).
There are many factors which affect the ongoing management of a private drug plan. New drug additions may increase overall plan costs or merely shift market share of drugs within the same therapy class. First-time generic drugs can help alleviate the pressure on overall plan costs as these are often significantly less expensive than the brand drug with equal therapeutic value. A review of the new drugs introduced in 2007 illustrates a familiar trend of more costly, specialized drug therapies.

Although fewer new drugs were approved in 2007 than the previous year, the trend towards developing high cost therapies to treat common chronic conditions with high claims utilization or to treat rare conditions affecting a small number of patients continues.

Notable Additions
These are some notable additions to the plan in 2007.

Elaprase is the first enzyme replacement therapy for the treatment of Hunter syndrome. Hunter syndrome is a rare genetic disease (affecting approximately 30 to 40 males in Canada) that is caused by the absence or insufficient levels of an enzyme called lysosomal enzyme iduronate-2-sulfatase. Without this enzyme, cellular waste products accumulate in tissues and organs, causing them to malfunction. Elaprase is the only treatment option that may slow the progression of the disease; all other treatment options merely address the symptoms. The annual cost per patient is approximately $525,000. Due to the risk of severe allergic reactions, this drug is administered in the hospital setting and is not expected to have an impact on the private drug plans. Prior authorization or online hospital drug programs can reduce the risk of such claims being paid under private drug plans.

Rasilez (aliskiren) was approved in December 2007 for the treatment of high blood pressure. Rasilez belongs to a new class of drugs called renin (key enzyme that regulates blood pressure) inhibitors, the first new drug class for high blood pressure in almost 10 years. High blood pressure is the highest ranked therapy class in terms of overall cost and claims within ESI Canada’s drug plans. Rasilez will compete with drugs such as Altace (ramipril) and Avapro (irbesartan) which work on similar mechanisms in the body.

Although the overall costs of managing this therapy class have decreased with the launch of generic versions of Altace, the introduction of Rasilez may offset these savings and expand the therapy class if its novel approach to managing high blood pressure proves to be effective in long-term outcome studies.

Lucentis (ranibizumab) is a new biologic drug used to treat wet age-related macular degeneration (wet-AMD), a degenerative disorder of the retina (image forming region of eye) that could lead to loss of vision. Lucentis is given as an eye injection. Approximately 280,000 Canadians over the age of 50 have wet-AMD. Current treatment options for wet-AMD include photodynamic therapy with Visudyne (verteporfin) and Macugen (pegaptanib sodium). According to studies, Lucentis is the first drug to improve vision in patients with wet-AMD and show better outcomes compared to Macugen. Depending on the dosing regimen, the annual cost per patient for Lucentis ranges from $9,450 to $18,900 compared to $9,450 for Macugen. The impact on private drug plans will depend on how Lucentis is used in clinical practice, although its cost could be higher than Macugen.

Champix (varenicline) is the second oral smoking cessation drug to be marketed in Canada, Zyban (bupropion) being the first. In clinical studies, Champix was almost twice as effective as Zyban at 12 weeks in achieving abstinence from smoking. Champix is priced at an average of $3.56 per day whereas Zyban costs $1.85 per day. Despite this cost difference, Champix is expected to have minimal impact on private drug plans as most plans have a dollar or quantity maximum on smoking cessation products.

Exubera was the first inhaled insulin approved for the treatment of diabetes. It was anticipated to be a blockbuster drug due to its novel route of administration and its ability to reduce the number of daily insulin injections. Unfortunately, due to factors such as concerns regarding long-term complications (lung damage, carcinogenicity), no therapeutic advantage over injectable insulin, and poor sales in other global markets, the manufacturer decided to cease marketing it worldwide.
Plan Management Strategies

The costs of these new drugs may seem alarming, but tools are available to plan sponsors to manage the incremental costs of new drugs. Strategies for plan sponsors to manage these new drugs will vary depending on the type of drug, their indications, their place in therapy, and route of administration.

For example, a tiered managed plan design encourages the use of safe, clinically efficient, and cost-effective drugs. Plan members that utilize the preferred drugs on the first tier would experience reduced out-of-pocket costs. As for the non-preferred drugs, plan members would experience higher out-of-pocket costs. This type of formulary will protect the plan from paying for high cost medications that have unproven increased therapeutic value.

Prior authorization programs can be used to ensure that only Health Canada approved indications are reimbursed, that the drug is administered in an appropriate setting (hospital or infusion clinic), or the drug is available for patients who have failed the first line therapies. This program protects plans by only paying for drugs that are being used appropriately and should be covered by private plans.

Co-ordination of benefits can be used to reduce drug plan costs by ensuring that claims for spouses/dependents are submitted to the appropriate primary payer first.

New Generics

Another tool to help reduce the rise of overall drug costs is to encourage members to use generic drugs when they are available.

The introduction of new generics each year helps to reduce overall drug plan costs. Although Health Canada may grant a notice of compliance, an approval to market a drug, this does not guarantee that the drug will be marketed that year. Sometimes the brand manufacturer challenges the approval and the litigation which ensues can delay the launch of the generic for years. Table 1 summarizes the launch or approval of first-time generic drugs in 2007 and the following are notable first-time generic drugs for 2007.

Rabeprazole is the generic version of the brand drug Pariet, a proton pump inhibitor indicated for the treatment of stomach ulcers and reflux. Pariet is the second brand drug in this therapy class to have a generic, the first was Losec. This therapy class is among the top five therapy classes within ESI Canada drug plans. Pariet was ranked 24th by drug cost and 34th by total claims paid for 2007.

The first generics for the oral birth control therapy class were introduced in 2007. Of the two birth control drugs, the introduction of generic Alesse will have the most impact on private plans as it is the most prescribed oral birth control drug in ESI Canada plans for 2007.

Pioflutamine is the generic of Actos, a drug to treat Type 2 diabetes. This drug was ranked 31st in drug cost for 2007. Avandia, a drug in the same therapy class as Actos, was associated with an increased risk of heart attack and other cardiovascular diseases. It is unknown whether these risks may also be associated with Actos. Until this is known, prescribing may become more prudent with this therapy class.

Perindopril was ranked 66th by drug cost and is the generic for Coversyl, an angiotensin converting enzyme (ACE) inhibitor used for high blood pressure and other cardiovascular conditions. This adds to the list of generic drugs within this therapy class. The most significant being Altace (ramipril) which was ranked ninth in drug cost and third in claims for 2007.

Generic Drugs Approved, But Not Available

Although approval was granted by Health Canada to market generic versions of Celebrex, Viagra, and Accupril in 2007, generic manufacturer GenMed is actually a division of Pfizer, the original brand manufacturer for these drugs. It is possible that the brand drug manufacturer is strategically protecting its patent as there are no plans to market these generic versions in the near future.

Even with a significant number of generic drugs coming to market, plan sponsors still need to use strategies available to them in order to take full advantage of these new generics. One of the strategies available would be the use of mandatory generic substitution plans. This tool will help take immediate advantage of lower cost (usually 30 to 40 per cent less than brand drugs) generic drugs as soon as they are available.

Pipeline Drugs For 2008

Over the next few years, the trend to high cost, specialized drugs will continue. These drugs will treat rare or terminally severe conditions such as genetic disorders and cancer.

The following pipeline drugs are anticipated to be marketed within the next two years and may have an impact on private drug plans:

LymphoStat B (belimumab) is a biologic drug for the treatment of systemic lupus erythematosus (SLE) and rheumatoid arthritis. SLE is the most common type of lupus, an autoimmune disease that affects the connective tissues of the body and is characterized by swollen, painful joints and skin rashes.

Table 1

Table 1 First Time Generic Approvals For 2007

<table>
<thead>
<tr>
<th>2007 Cost Ranking</th>
<th>2007 Claim Ranking</th>
<th>Brand Name</th>
<th>Generic Name</th>
<th>Common Use(s)</th>
<th>Drug Market Status</th>
</tr>
</thead>
<tbody>
<tr>
<td>19</td>
<td>33</td>
<td>Celebrex</td>
<td>Celecoxib</td>
<td>Pain and Inflammation, Osteoarthritis</td>
<td>Not Available</td>
</tr>
<tr>
<td>24</td>
<td>34</td>
<td>Pariet</td>
<td>Rabeprazole</td>
<td>Stomach Ulcers/Reflux</td>
<td>Available</td>
</tr>
<tr>
<td>30</td>
<td>11</td>
<td>Alesse</td>
<td>Aviane 21/28 (levonorgestrel 0.1mg/ethinyl estradiol 0.02mg)</td>
<td>Birth Control</td>
<td>Available</td>
</tr>
<tr>
<td>31</td>
<td>138</td>
<td>Actos</td>
<td>Pioglitazone</td>
<td>Diabetes</td>
<td>Available</td>
</tr>
<tr>
<td>39</td>
<td>129</td>
<td>Zyprexa</td>
<td>Olanzapine</td>
<td>Schizophrenia, Bipolar Disorder</td>
<td>Available</td>
</tr>
<tr>
<td>63</td>
<td>861</td>
<td>Flonase</td>
<td>Fluticasone Propionate</td>
<td>Seasonal Allergy</td>
<td>Available</td>
</tr>
<tr>
<td>66</td>
<td>72</td>
<td>Coversyl</td>
<td>Perindopril</td>
<td>Cardiovascular Disease</td>
<td>Available</td>
</tr>
<tr>
<td>92</td>
<td>81</td>
<td>Cefzil</td>
<td>Cefprozil</td>
<td>Bacterial Infections</td>
<td>Available</td>
</tr>
<tr>
<td>98</td>
<td>100</td>
<td>Prinivil</td>
<td>Lisinopril</td>
<td>Cardiovascular Disease</td>
<td>Available</td>
</tr>
<tr>
<td>109</td>
<td>196</td>
<td>Viagra</td>
<td>Sildenafil</td>
<td>Erectile Dysfunction</td>
<td>Not Available</td>
</tr>
<tr>
<td>125</td>
<td>150</td>
<td>Accupril</td>
<td>Quinapril</td>
<td>Cardiovascular Disease</td>
<td>Not Available</td>
</tr>
<tr>
<td>179</td>
<td>216</td>
<td>Zestoretic</td>
<td>Lisinopril &amp; Hydrochlorothiazide</td>
<td>Cardiovascular Disease</td>
<td>Available</td>
</tr>
<tr>
<td>193</td>
<td>159</td>
<td>Min-Ovral</td>
<td>Portia 21/28 (levonorgestrel 0.15mg/ethinyl estradiol 0.03mg)</td>
<td>Birth Control</td>
<td>Available</td>
</tr>
</tbody>
</table>
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FEATURED SPEAKERS
TUESDAY MAY 13, 2008 AT 8:30 PM
Shouldn’t Canadians Have the Right to Choose?
Dr Brian Day
The Canadian Medical Association President. Dr. Brian Day, has a cure for Canada’s sick medicare system: private-sector surgery clinics.

TUESDAY MAY 13, 2008 AT 4:30 PM
Opportunities Without Borders
Jim Leech Leo de Bever
Ontario Teachers Pension Plan Jim Leach and Victorian Funds Management Corporation Leo de Bever will discuss the types of global investments being made by pension plans all the while exploring the burning question: “Where do we go from here?”

WEDNESDAY MAY 14, 2008 AT 8:30 AM
Global Markets, Global Politics & Global Risk
Ian Bremner
Eurasia Group president and the creator of Wall Street’s first-ever global political risk index. Ian Bremner is a sought after adviser on international risk management who reads the global political and economic landscape.

WEDNESDAY MAY 14, 2008 AT 10:00 AM
It’s a Small World After All
Plan Sponsor Round Table
Bombardier Inc. ETIENNE BRODEUR, Manulife Financial SYLVIE CHAREST, RBC Dexia Investor Services Trust CONNIE COLANGELO, Magna International Inc. ROBERT LANDRY will discuss the developing and implementing of a pension and benefits program for the global workplace; the group will be joined by CBC Television WENDY MESLEY as moderator.

FORUM Golf Day
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Don’t miss the opportunity on Monday, May 12th to golf at Glen Abbey, home of the 2008 Canadian Open. A special rate of $185 is being offered by CPBI to all FORUM delegates. The fee covers bus transportation, access to the driving range, lunch, green fee and golf carts.

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which can lead to swollen joints, anemia, and kidney failure. It is most common in women and is estimated to affect 150,000 Canadians. Also, it is being studied to treat rheumatoid arthritis patients who have failed prior therapies.

**Treanda** (bendamustine) is an intravenous infusion drug to treat chronic lymphocytic leukemia (CLL), the most common adult bone marrow and blood cancer. Most patients are over the age of 50 and it is estimated that 1,500 new cases are diagnosed each year in Canada.

**Cayston** (aztreonam lysinate) is an antibiotic drug used to treat bacteria in the lungs for patients with cystic fibrosis (CF), a chronic debilitating genetic disease. A major characteristic of CF is the production of abnormally thick, sticky mucus in the lungs that traps bacteria and predisposes patients to lung infections. Currently, there is no cure for CF. Treatment is aimed at controlling symptoms and preventing further damage to lungs from infections. Approximately 3,000 Canadians have CF. Cayston is administered via inhalation, a novel route of administration for this therapy class.

Both LymphoStat B and Treanda are administered via intravenous infusion and would most likely be given in a hospital setting or infusion clinic and, therefore, should be covered by the provincial hospital budget. Cayston can be self-administered with a portable nebulizer and will most likely appear on private drug plans. The annual cost of these therapies is unknown at this time.

With advanced technologies, it is inevitable that new high cost and specialized drugs will continue to appear on the market. Despite their greater cost compared to conventional treatments, it is important to acknowledge that some of these new drugs do provide significant clinical advantages to patients.

Although these new drugs can be extremely costly, there are tools available to plan sponsors to effectively manage the utilization of these new drugs. These include managed formularies, which set out which cost-effective treatments will be preferred choices, and prior authorization, whereby specialized drugs will only be reimbursed according to specific criteria.

In addition to these cost containment measures, generics can play an important role in decreasing overall drug costs. In order to fully take advantage of the generics that are introduced as brand name drugs before they lose their patents, plan sponsors should encourage their use by implementing mandatory generic substitution plans.

Yen Nguyen is manager, clinical services, at ESI Canada (tynguyen@express-scripts.com).

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Affordable drug plans and catastrophic coverage will be addressed at a *Connex Health* session February 28 in Burlington, ON. A panel will explore how the number of high cost treatments and the market for them is expected to grow as well as reimbursement options for individuals who require them. Visit: www.connexhc.com

Mindpath’s 2nd Annual Alternative Investments and Absolute Return Strategies for Institutional Investors takes place March 4 in Toronto, ON. Again this year, institutional investors will have the opportunity to meet with senior investment managers during the afternoon Meet-the-Manager roundtable discussion forums. Contact: Dan Jerred at 416-929-MIND (6463) (Toll Free: 1.877.929.6463) or jerred@Mindpath.ca

The International Foundation of Employee Benefit Plans’ Benefit Communication and Technology Clinic will address the key issues involved in communicating with participants. Sessions will include understanding how the changing retirement and healthcare landscape impacts communications programs and the changing role of technology in communicating employee benefits. It takes place March 10 and 11 in Miami Beach, FL. Visit: http://www.ifebp.org/benefitcommunication

More than 10,000 people, including 200 CEOs, are expected to attend The GLOBE Foundation’s 10th Event. GLOBE 2008 will be held March 12 to 14 in Vancouver, BC. It centers around three main themes – corporate sustainability, energy and climate change, and building better cities. Visit: www.globe2008.ca

Presented in partnership with the London Business School, Hedge Funds seeks to explain why hedge funds have been so attractive in recent years and to provide some insights into whether this performance is sustainable. This CFA Institute event takes place March 17 to 19 in London, UK. Visit: www.cfainstitute.org/conferences

Advances in Asset Allocation 2008 is a joint seminar with the EDHEC Business School. It will offer participants tools for optimizing asset allocation. This CFA Institute event takes place March 17 to 19 in London, UK. Visit: www.cfainstitute.org/conferences

With benefit plans playing a vitally important role in employee attraction, retention, and satisfaction, HRPAO Professional Development Programs is offering ‘Benefits 101.’ Seminar topics include short- and long-term disability, health and dental benefits, income protection benefits, death benefits, post-retirement benefits, and flexible cafeteria-style plans. It takes place April 10 in Toronto, ON. Visit: www.hrpao.org

Managing absence and disability will be the focus of the HRPAO Professional Development Program ‘Managing Absence and Disability 101.’ The course serves as a how-to guide on properly managing employee absences due to illness or injury. It takes place April 14 and 15 in Toronto, ON. Visit: http://www.hrpao.org/

Why, what, when, and how workplace health and wellness initiatives can be measured will be the focus of Connex Health’s ‘Employer Forum 2008: Measuring for Success.’ Researchers and practitioners will explore how benefit costs can be addressed through workplace health and plan design. It takes place April 30 to May 2 in Niagara on the Lake, ON. Visit: http://www.connexhc.com/

The 4th Annual FPL Canadian Electronic Trading Conference will take place May 5 and 6 in Toronto, ON. The conference addresses the ever-changing challenges and opportunities facing participants in the electronic trading marketplace. Visit: eTradingCanada.ca

The National Institute Of Pension Administrators will celebrate its 25th anniversary at the 2008 NIPA Annual Forum & Expo May 5 to 7 in Las Vegas, NV. Designed by retirement plan professionals, sessions will examine cash balance plans, Defined Contribution plan design, and valuation of alternative investments. Visit: http://www.nipa.org/

Compensation strategy and philosophy as part of a total rewards framework will be among the topics covered at HRPAO Professional Development Programs’ Compensation 101. Areas covered include how to conduct job analysis, evaluations, and salary surveys; creating a pay structure; and linking pay to performance management. It takes place May 6 in Toronto, ON. Visit: http://www.hrpao.org/

Research for the Practitioner VII: The Research Foundation of CFA Institute Annual Workshop will examine topics in the growing area of behavioral finance and will feature cutting-edge research from leading investment management practitioners and academics. This CFA Institute event takes place May 11 in Vancouver, BC. Visit: www.cfainstitute.org/conferences

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Jim Carroll, an international futurist and trends and innovation expert, will address whether or not the Canadian life and health insurance industry is keeping pace at the LOMA Canada Annual Conference. It takes place June 12 in Toronto, ON. Visit: http://www.lomacanada.ca/en/conference/index.htm

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Let’s be realistic here. Combining the words ‘history’ and ‘finance’ to describe a book’s contents might seem to be a sure way of relegating it to the remainder bin. However, William Goetzmann and Geert Rouwenhorst, both professors of finance at Yale, have edited a wonderful coffee table volume (yes, still more words that don’t seem to belong with ‘history’ and ‘finance’) titled ‘The Origins of Value: The Financial Innovations That Created Modern Capital Markets.’ Aside from wonderful colour pictures of bonds issued by countries that have been erased from the map centuries ago, it reminds us that whatever financial event challenges us today, was mirrored sometime hundreds of years ago.

Take today’s interest by many pension plan sponsors in inflation-protected bonds. A chapter by Robert Shiller, the beha-vioral finance guru, explains that the first inflation-indexed bonds were issued by Massachustts during the Revolutionary War more than 225 years ago. They were issued to soldiers as a form of deferred compensation. At that time, there had been army mutinies due to the loss of soldiers’ pay values from wartime inflation. These bonds were linked to pay as an early form of the consumer price index: a basket of goods that were defined as equivalent to soldiers’ pay in the future. The end of the war, and presumably of inflation, lead to their demise, where they stayed dormant for another two centuries before being revived in Canada and the United States in the 1990s.

Perhaps, the most interesting chapter comes from James Poterba, from MIT, who traces the history of annuities. While the public and private pension world can trace its history back to Otto von Bismarck’s Old Age and Disability Insurance Bill of 1889, strategies to fund retirement stretch back thousands of years and annuities can be found back in ancient Rome. Contracts known as ‘annua’ promised a stream of payments for either a fixed term, or for life, in return for a single up-front payment.

Usury Laws

Annuity contracts later played an important role in the Middle Ages in areas where usury laws were in place which established legal maximum interest rates. Since annuities involved a measure of risk, they were not seen as simple loan con-tracts and were used to actively circumvent these usury ceilings.

From about 1650, annuities became one of the most popular financial instruments, as governments started issuing annuity contracts to finance wars and, later, some public works projects. Around the same time, the pricing of annuity contracts, and estimates of individual longevity, became more rigorous as some of the major mathematical and scientific minds of the 17th and 18th centuries became attracted to the field including Nicholas Bernoulli and Edmund Halley (the astronomer who discovered and named Halley’s comet).

As the annuity market developed new products, it attracted speculators who saw a market that had frequent mis-pricings. In the early 1800s, speculators searched for healthy old men – particularly in Scotland where mortality rates were perceived to be low – and paid for annuities for these healthy individuals. These seniors were, in turn, provided with medical care, food, and other benefits by annuity speculators. Their care was paid for from the annuity payments, with a substantial profit remaining for the speculator.

Financial Drain

Eventually, governments found that making annuity payments, especially when they had been under-priced initially, would be a financial drain to the public purse. The public sector moved out of the market and private companies moved in. However, the widespread appeal of annuities really never returned. As public and private pension plans took force, the private annuity market dwindled to where it sits today.

Poterba’s chapter in this book reminded us of the ‘annuity puzzle,’ which was discussed in this column in August 2007 when we tried to explain why people today don’t hedge against longevity risk through the purchase of annuities. This is all the more puzzling given the popularity of annuity products a few hundred years ago.

Still, if history shows us anything, it illustrates that today’s hot financial product is tomorrow’s historical footnote.

It also shows us that we can reach back in time, take a long ignored financial product, and realize that today is the right time for its re-introduction. And that is where profits can be made, which is a goal that has been sought all throughout history.
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