Men Should Test For Prostate Cancer
Group TFSAs Have Sluggish Start
2009 Price Action Went To Extremes

Benefits and Pensions Monitor
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Annual Review And Forecast
The Past – The Present – The Future

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Suddenly Stopped
She has been on leave from her job diagnosed with major depression. When her monthly sick-leave benefits suddenly stopped, she supposedly contacted the insurer and was told that pictures posted on Facebook were part of the reason. The pictures that she had posted showed her having a good time at a male stripper show, at a birthday party, and on a vacation in the sun.
Her contention is that the photos should not have been used to discontinue her benefits and that they showed her being happy at a particular moment, not the depression she suffered before or after those photos. In fact, it was on her doctor’s advice that she was going to bars and taking vacations as he had prescribed ‘having fun’ to help her forget her problems.
She claims her Facebook profile is locked and only people she approves can look at what she posts. But how do you control that once you put them into the public domain? After all, this is social networking.
Using photo evidence to detect benefits fraud is not new. Employers hire private detectives to snoop on employees they believe are guilty of benefits fraud. Estimates are that more than $5 billion is lost each year in Canada to healthcare benefits fraud and abuse! Since even a few improper claims can drive up an employer’s benefit costs, at a time when employers are struggling to keep benefit costs down, it is not hard to see why they and their insurers are looking everywhere for evidence they come across?
Consider Legislation
In all of these, aren’t we overlooking the real problem? Why are so many people compelled to share their private lives in public? We’ve gone from passing out vacation pics to co-workers around the water cooler to uploading personal details of our lives onto the world wide web which we know is rife with attacks from hackers and others stealing financial and personal information.
The fact is that if you don’t want people to see embarrassing information about yourself, you don’t tell, upload, post, or tweet it.
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Call For OAS Increase
The federal government should increase Old Age Security benefits to help offset the lack of retirement income from private sources facing many Canadians, says a report for the Canadian Centre for Policy Alternatives. It says increasing OAS payments is the best approach to help working Canadians who do not have workplace pensions and are not saving enough for retirement. To offset the increased cost of higher OAS benefits, the government should consider reducing taxpayer subsidies to RRSPs and workplace pensions as only 38 per cent of employed Canadians have a workplace pension.

Tools To Fix System In Place
The tools and system are already in place, all that is needed is the resolve to make the changes necessary to make Canada’s pension system work, says Neil Craig, a senior pension consultant at Stevenson and Hunt. Speaking at the CPBI Ontario region’s ‘Pension Summit,’ he said the proposal for super-funds is not the solution and could cause a lot of unemployment in the financial sector as employers cut staff to keep costs down. One necessary step to increase pension plan coverage in the country is to get employers involved by, for example, offering them incentives to establish plans and contribute to them. Employee participation in plans jumps from 10 per cent to 85 per cent if the employer contributes to the plan, he said.

Leadership Needed On Pensions
John Tory is calling on governments to tell the truth and lead the country out of the current pension and retirement savings crisis. The former leader of the Ontario Progressive Conservatives told Mindpath’s ‘4th Annual Top Advisors Investment Strategies Symposium’ that leadership is about anticipating problems and providing solutions to them, not reacting when it becomes a crisis. However, in terms of the pensions and retirement savings crisis, he is not seeing leadership from anyone. Solutions must start with honest discussions, he said, however, among people in public life there is a disinclination to be honest and “level with” people.

Manulife Enters China
Manulife Financial has signed an agreement to purchase Fortis Bank SA/NV’s 49 per cent ownership in ABN AMRO TEDA Fund Management Co., Ltd. The new joint venture, which will be called Manulife TEDA Fund Management Company Ltd., will provide traditional retail and institutional asset management across the Chinese market. The asset management industry in China is expected to become one of the largest in the world in the coming decade. Current industry assets under management of US$338 billion are forecast to grow significantly and exceed US$1 trillion by 2014.

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\[
\sum_{i=1}^{11} (\max(\alpha_i) + \min(\sigma_i^2))
\]
BMO Completes Acquisition
BMO Financial Group has completed the acquisition of the group retirement record-keeping business of ICMC Group Retirement Services Inc (Integra GRS), a subsidiary of Integra Capital Management Corporation. The acquisition gives it an entry into this business and allows it to make available a full suite of its investment products as further investment options for capital accumulation plan sponsors and members. Joan Johannson, president of the acquired business, will continue as president of BMO Group Retirement Services.

Pension System Poorly Positioned
Almost nine out of 10 (89 per cent) of Defined Benefit plan sponsors believe Canada’s pension system is either poorly positioned or average when it comes to Canada’s future pension prospects, says an RBC Dexia Investor Services survey. It also found 41 per cent of respondents cited investment risk as the type of risk they are most concerned with, while shortfall risk (the risk of pensions not generating sufficient returns to offset obligations) ranked a close second, at 36 per cent. In 2010, almost half (48 per cent) indicated that their main focus will be on aligning future liabilities with assets, while 38 per cent said they expected low returns to continue to be a significant challenge. While plan sponsors were generally pessimistic about the current Canadian pension system, the survey revealed that 72 per cent of respondents rank Canada’s pension system as equal to, or better than, other systems globally.

Addenda
The following was not available for inclusion in the ‘SRI Directory’ which appeared in the September issue of Benefits and Pensions Monitor:

SCEPTRE INVESTMENT COUNSEL LIMITED David Pennycook, President; 26 Wellington St. E., 12th Floor, Toronto, ON M5E 1W4 PH: 416-866-2479 Fax: 416-367-8716 eMail: dpennycook@sceptre.ca Web: www.sceptre.ca Products or Services: Endowment Foundations, Trust Pooled Fund, Segregated accounts

The following was not available for the ‘Annual Report on Money Managers’ in the October issue of Benefits and Pensions Monitor:

VONTOBEL ASSET MANAGEMENT, INC. Jeffrey Kutler, Director - Institutional Clients North America; 1540 Broadway, 38th Floor, New York, NY 10036 PH: 212-415-7058 Fax: 646-792-4356 eMail: Jeffrey.kutler@vusa.com Web: www.vusa.com

The following was not available for inclusion in the ‘Pension & Benefits Consultants Directory’ which appeared in the June issue of Benefits and Pensions Monitor:

WESTCOAST ACTUARIES INC. Stephen Cheng, Managing Director & Senior Consulting Actuary; 908 – 1166 Alberni St., Vancouver, BC V6E 3Z3 PH: 604-730-1898 Fax: 604-730-1886 eMail: stephen@wainc.ca Web: www.wainc.ca Consulting Services: DC Pension Plans, DB Pension Plans, Actuarial Services, Performance Measurement, Manager Search, Policy Development, DB Pension Plan Administration, DC Pension Plan Administration Client Profile – 1 to 100 Employees: 1,596 101 to 500 Employees: 2,100+ Employees: 1 Professional Staff: 15

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T
here was excitement surrounding the proposed Tax Free Savings Account (TFSA) tabled in the 2008 federal budget. The completely new tax-sheltered investment vehicle – made available to any Canadian over 18 this year – would deliver greater tax-efficient savings flexibility for any ongoing lifetime need. It was also expected that many capital accumulation plans would add a group TFSA to their product line-up in 2009.

However, as some plan sponsors reflect upon the TFSA’s inaugural year, they’ve found that interest among Canadian employees to be modest, at best. And, according to feedback, employers haven’t been implementing group TFSA in great numbers.

Bad Timing
For Ellen Vlieg-Paquette, vice-president, administration and finance, for King’s University College in Edmonton, AB, the introduction of the TFSA was simply subject to bad timing. “It’s unfortunate that the TFSA was introduced right as interest rates were dropping," she said. “But, there are economic cycles we have to go through, so I think interest will pick up when rates rebound.”

Participation in its group TFSA has been “minimal” and its employees – probably more or less representative of the general population, have simply not reacted well from the get-go.

Given this year’s economic conditions, salary freezes, and overall “belt-tightening,” employees didn’t have the will to contribute, says Karrina Dusablon, director, education centre and global management group retirement savings, for Desjardins Financial Security. Participation in the group TFSA available to Desjardins employees has been “slow and gradual.”

As for the plan sponsor clients her division serves across Canada, those offering group TFSA saw small, if any, contributions, she says. Given the lower rate of liquidity among employees this year, many employees have not been making maximum contributions to RRSPs and have, therefore, been reluctant to contribute into their group TFSA.

Older Participation
From what she’s seen, it’s not younger, lower income employees contributing to TFSA this year. Instead, most participation is coming from middle- to older-aged individuals with higher salaries who are looking for another place to get preferred tax treatment on earnings after maxing out on pension or RRSP contributions.

Although the short-term accessibility of a TFSA should appeal to younger individuals – who may see the payoff of a group RRSP or pension plan as too far off to get excited about – it simply hasn’t yet resonated with that group, says Neil Craig, senior pension consultant, Stephenson & Hunt. He is also finding that group TFSA are appealing more to management level and senior executives, “who have more to contribute and who are typically more investment savvy than rank and file employees.”

In fact, some employers are recognizing this appeal among senior executives, Craig says, and encouraging more participation from that segment. A number of his plan sponsor clients are implementing “perks” or bonuses which employees are encouraged to deposit into group TFSA. Members, of course, still pay tax on the bonus, but it is seen as a nice add-on by employees.

Employer Uptake
As an additional savings option, or as simply another layer to an overall group savings package, plan sponsors are finding that a TFSA can go a long way with employees, Craig finds. Only a small percentage of his group retirement clients have implemented a group TFSA so far, but interest is picking up.

After a tough financial period, organizations will want to differentiate themselves among other employers and demonstrate their innovation and commitment to employees – and a TFSA can deliver that at no real cost to the employer, he says. He expects a fair number of plan sponsors to work in group TFSA alongside DC pension plans, group RRSPs, and deferred profit sharing plans.
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According to Prostate Cancer Canada, prostate is the most common form of cancer amongst men and one in six are affected annually. It is expected that approximately 25,500 males will be diagnosed this year alone. However, this does not include the large number of cases that go undetected.

The good news, however, is that prostate cancer is largely curable if caught and treated in the early stages.

Exact Cause Unknown

Although the exact cause is unknown, it is believed to develop from a combination of dietary, environmental, and hereditary factors. Left untreated, prostate cancer cells can spread to other parts of the body and cause secondary tumours. Men with a family history of prostate cancer are at greater risk of developing the disease.

The effects of cancer are severe and extend far beyond the person being diagnosed. On a national scale, cancer serves as a major economic burden to society on various levels. As past studies have illustrated, cancer is one of the top four categories that represents more than half of the total indirect costs of illness in Canada. Furthermore, it has also been found that men account for more than 60 per cent of the total value of lost production due to premature death and cancer is the top-ranking cause of lost production among males.

Contributing Factors

According to the Prostate Cancer Canada and the Prostate Cancer Foundation websites, a few of the major contributing factors to prostate cancer onset are age, weight, and environment.

The risk of developing prostate cancer increases with age. Though possible, it is extremely rare to be diagnosed with prostate cancer before the age 40. In fact, only one in 10,000 men under the age of 40 will be diagnosed, whereas the rate shoots up to one in 15 for ages 60 to 69. Men should discuss their prostate cancer risk with their doctor when they turn 40 and most should start having yearly digital rectal exams and PSA tests starting at age 50. Individuals in high-risk groups (for example, if the disease runs in the family) should start getting tested earlier.

Research has also found that obese men are two and a half times more likely to die of prostate cancer than men who are of average weight with the same stage of cancer and age. Belly fat is particularly dangerous to a man’s health. Hormones produced by belly fat affect the ability of cells to properly take up insulin. In turn, this resistance to insulin results in the overproduction of insulin and insulin-like growth factor (IGF), both of which are potent stimulants for prostate cancer growth.

Working in certain environments can increase a man’s chances of developing prostate cancer. Research has shown that firefighters, for example, are in a higher risk group for developing prostate cancer. It is believed that there is a direct connection between the chemicals they are exposed to when they put out fires and their increased risk.

PSA Test

The use of the PSA test for the diagnosis of prostate cancer became more widespread in Canada around 1990. The test is now covered by many provincial health plans and the adoption of PSA tests has helped achieve a 25 per cent decline in prostate cancer-related deaths. Although the test is not foolproof, it is the best early detection tool available. Men who are at high risk of developing the disease should discuss testing with their physician.

There are a number of ways that employers can work towards preventing or early detection of prostate cancers. Providing information about prostate cancer through pamphlets, emails, or other resources can go a long way in creating awareness and helping employees understand their risk for getting the disease.

The Importance Of Prostate Cancer Testing

By: Caroline Tapp-McDougal

Caroline Tapp-McDougal is the publisher of Solutions: Canada’s Family Guide to Home Health Care and Wellness and the author of The Complete Canadian Eldercare Guide (solutions@bcsgroup.com).
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Normally, the saying ‘two for the price of one’ is associated with a good deal, something to be desired. Across global financial markets, ‘two for the price of one’ also nicely describes the price action in 2009 – periods of both extreme distress and incredible euphoria. Whether it was something to be desired is another matter.

The poor returns of 2008 continued across a variety of asset classes through March 9 of this year. Equities were particularly distressed while fixed income markets began to stabilize late in 2008. However, since early March, we have seen strong rallies across typically ‘riskier’ asset classes in what can be described as a once-in-a-lifetime bull market for a number of them.

**Biggest Moves**

These types of reversals have not been seen in decades. In some cases (such as equities), asset classes witnessed their biggest moves since the 1930s.

Such rapid market turns would seem to indicate that we have avoided the worst possible outcome of the economic/credit crisis and are on our way to a more typical cyclical recovery. The question is, are we?

Most of the market’s fourth quarter 2008 liquidity-related issues were addressed through the massive and co-ordinated efforts of governments and central banks around the world. In total, fiscal ‘stimulus’ packages aggregated to approximately four per cent of global GDP (see **Chart 1**).

Monetary (including quantitative easing) and bailout programs (including banks, Fannie Mae/Freddie Mac, GM/Chrysler, AIG) provided further fuel to remedy the worst of the credit market woes.

As a result, credit spreads collapsed and funding markets opened wide. Corporate issuers have taken advantage of the opportunity and, in our opinion, behaved wisely by extending borrowing maturities to capitalize on the historically low interest rates while at the same time providing themselves with enhanced financial flexibility.

What we feel has been neglected throughout, and fear will guide in the future, is massive leveraging – first in the consumer sector of several developed nations and, as these same consumers pull back, their governments. Recent actions in both areas are likely to result in lower secular growth rates and we believe present the greatest risk to a return to sustainable global growth.

**Record Highs**

Consumers across many developed countries had supported spending, not through incomes, but through borrowing. Household debt levels reached record highs in many countries, notably the U.S. and the UK.

Some may question this obsession with the consumer. However, we do not think this concern is overdone given the household’s importance to most economies (typically representing between 50 per cent and 70 per cent of a country’s GDP) in other words, as goes the consumer, so goes the economy.

The mathematics of consumer deleveraging are clear. By way of example, if we assume the U.S. consumer needs to repair their balance sheets to pre-2000 levels, they need to pay down roughly $5 trillion in debt (reducing household debt from 97 per cent of GDP to 65 per cent). If this is accomplished through increased savings, many years will be required to reach the point of stability. Should the U.S. savings rate rise to its long-term average of eight per cent of income (it is currently five per cent), approximately $800 billion will be saved annually, implying a six-year debt pay-down. Slower economic growth will likely be the side effect of this prudent activity, as savings become money no longer spent.

**Kindness Of Strangers**

A corollary to the retreating consumer lies in the resurgent government sector. However, with the government generally accounting for 20 per cent or less of GDP, its spending must grow by three per cent to counter each one per cent decline in consumer spending. While countries with excess savings, such as China, are able to provide such a boost without borrowing, most developed nations have resorted to the kindness of strangers and stepped up their borrowing. The hope is that by the time the government needs to withdraw, spirits should be such that the consumer is ready to pick up the baton.

We feel the amount of stimulus in the pipeline today and that is likely to flow over the next six to nine months will boost the world economy. We differ with the consensus view in that we see government efforts as unsustainable and doubt that consumers will be in shape, or in the mood, to take over when the government steps back.
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2009 came in like a lion and appears to be going out like a bull. The financial crisis and recession which followed in 2008 came to an end in March as markets started to rally and headed back up towards previous levels.

Then, at the end of November, Statistics Canada reported a third consecutive month of GDP growth, technically ending the recession in Canada.

Not surprisingly, thoughts now are turning to what was learned during the recent financial crisis and this year’s ‘Review & Forecast’ issue reflects that.

David Lester, head of institutional sales for asset management at NT Global Advisors, Inc., wonders about the lessons pension plan sponsors have learned from the past 12 months.

The biggest news of the year was the Supreme Court of Canada decision in Kerry Canada and Mark Newton, a partner at Heenan Blaikie, discusses the ramifications of this decision.

Peter de Auer, president of Cluster Asset Management, examines how the goals of investors and money managers are not always the same.

This year’s Review & Forecast also looks at using group insurance to enhance employee benefits, lessons for Defined Contribution pension plan sponsors coming out of the financial crisis, the outlook for EAFE, commercial real estate trends, and indexing.

So, start the new year off right by gathering some insights about what happened in 2009 and what’s in store in the months to come from the pages that follow.

If history does repeat itself, then it is the wise individual who learns from the past. Will this be true of pension managers and the historic market collapse of 2008? With markets in some form of recovery, we are about to find out if global financial turmoil has lessons for our pension management processes or if we are doomed to repeat the mistakes of our past.

At the start of the year, many plan sponsors were unsure if, in fact, their pension plan was still on a financially viable track. The capital markets sell-off hit all asset classes, severely impacting funded status, and there was no clear path to returns that would make up the losses. Thankfully, a market recovery started in March 2009, easing some of the financial difficulty plans are facing. Sponsors, a bit dizzy from the ride, have regained their composure. If they have learned any lessons from the past, they have also started contemplating new strategies that take into account the impact of the past 18 months of turmoil.

Lessons From History

So what are the lessons from the financial crisis? First, while the stock market fall was severe as compared to previous corrections, the up-and-down patterns experienced by equity investors is nothing new. The main difference between this correction and ones faced in the past 60 years is the absolute low level of interest rates sponsors are forced to face during this crisis. Since the 1980s, interest rates have dropped by 18 per cent, which has made pension promises very expensive to secure for members.

This leads to a second lesson. Low interest rates over the past 20 years, coupled with benefit plan improvements, aging plan demographics, and beneficiary longevity, represent a continuous period of unparalleled liability growth that should be defined as the pension industry’s biggest problem. Few plan sponsors now question the need to manage their pension plan with a new set of objectives which more properly match assets with liabilities.

The old model of evaluating assets in isolation harkens back to a time when liabilities were not a main concern. Many of us were schooled in the belief that pension plans are vehicles with enormous life spans and, consequently, should be managed with a long-term decision framework. While this may or may not be prudent for public pension plan stewardship, the folly of this logic has become obvious for private pension plans and programs supported by a finite capital base.

Today, sponsors should clearly understand that pensions have both short- and long-term expenses that need to be properly monitored and managed, particularly in preparation of times of great volatility. Liability-driven investing is a decision-making framework which requires sponsors to consider their financial resources and how they relate to their pension obligations. While the concept is becoming more familiar, plan sponsors need to understand that liability-driven investing is more than an investment decision.

Radar Screen

Plan design changes are on the radar screen at many organizations to deal with the current financial predicament, starting with a search for more optimal portfolio structures to add incremental levels of return. Some plan sponsors have expanded their selection of asset classes for diversification away from the equity premium and corresponding volatility. While all these efforts are worthwhile, there are many people who are taking a wait-and-see attitude to pay or grow their way out of this problem – much
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rates do not start rising soon.”

However, it will be quite detrimental for the industry if rates are unlikely. As one large plan sponsor recently told me, “Interest rates can remain low for extended periods of time – just look at Japan’s most recent history. However, it will be quite detrimental for the industry if rates do not start rising soon.”

Hoping for better times to come, while a human trait, is not one by which successful businesses are run. Back-up plans, contingencies, and gaming theory all play a role in the business world. Unfortunately, an organization’s business planning and strategy capabilities are not always deployed to the pension investment world, which tends to be governed by procedures and the desire not to be seen as reacting to the markets. However, events can force organizations to adapt, and it is not unreasonable to say that executive management teams could be removed if they ran their businesses in the same laissez-faire way in which many manage their pension investment programs.

Active Plan Governance

The third lesson from the recent turmoil is that a new focus on assets and liabilities requires a more proactive approach by pension boards and trustees, as well as managers. Plan governance is an issue which the industry cannot put to rest, despite a lot of talk. In this new environment, each plan sponsor needs to conduct a self-assessment and understand what happened in their organization’s governance and decision-making process that led to the results obtained over the past year. For plan sponsors who have decided that they are going to start managing their plan more proactively, here is a list of action items that can serve as a template for review:

◆ Look closely at corporate goals and objectives and cross reference these with your pension goals. Make sure that these goals fall into separate duration categories, including short- and medium-term objectives, and ensure that they are documented and monitored.

◆ Update all statements of investment policies and procedures and other plan governance documents as required. We have just experienced a very difficult market environment and committee reactions and decisions to the market meltdown should be incorporated into the working documents and procedures.

◆ Spend time on portfolio construction. Historically, diversification was based on domestic equities and fixed income and then branched out to include international and U.S. equity allocations as well. Given the historic trends of correlation of traditional asset classes, sponsors need to invest their energies in identifying ways of achieving broader diversification – both within and between asset classes.

◆ Examine the costs of running your program. Fees become a more important consideration in a lower return environment, and all aspects of your pension program should be reviewed to achieve optimal efficiency. This can include requests for information or quotes on your actuarial, custodial, and consulting relationships. In addition, your active management programs should be carefully evaluated to ensure that you are benefiting from the active management fees you are paying your investment managers.

◆ Be prepared to take action when required, particularly on portfolio rebalancing and verifying that investment managers are in compliance with investment guidelines, including performance standards. If properly established goals have been set, then committees will need to take action when goal milestones are reached, such as certain funding levels obtained or targeted interest rates levels are experienced. While institutional investors should make their decisions in a thoughtful and diligent fashion, changes in the nature of capital markets demand an active approach that is more time sensitive than committees may be accustomed to. Ad hoc meetings will become more the norm as committees grapple with the concept of real-time pension plan management. Failing that, committees will be required to delegate more responsibilities to parties able to act on their behalf in a timely fashion. As plan sponsors consider the effort involved in this more active approach, it is worth recalling that just a decade ago, the decision that many faced was how to spend their plan surplus. At that time, the choices included a contribution holiday, improving plan benefits, or some combination of the two. Accounting professionals referenced pension income as the money shareholders supposedly earned by sponsoring pension plans and not as the income pensioners earned for their years of service.

Times have indeed changed.

David Lester is Northern Trust’s head of institutional sales for asset management at NT Global Advisors, Inc., Canada.

LEGAL

Kerry: A Clear Case For Pension Reform

By: Mark Newton

Who would have known in 1954 as an employee of the Canadian Doughnut Company that your employer would end up in a protracted legal battle over the use of assets in the company’s pension fund, all the way to the
Investments returning much more than expected. Investments delivering far beyond the reward for the risk assumed. Truly superior investments earning coveted “alpha returns” that measure performance and define success of active managers in Canada’s venture capital industry. Every year, CVCA – Canada’s Venture Capital & Private Equity Association – recognizes and celebrates the achievements of CVCA members achieving outstanding investment success. The CVCA’s annual “Deal of the Year Award” competition in the venture capital category selects winners with the most significant return during the twelve months ending June 30th.

2009 WINNERS
BDC Venture Capital, Caisse de dépôt et placement du Québec and Solidarity Fund QFL won CVCA’s 2009 award for their joint investment in ViroChem Pharma, Inc. The group first invested in ViroChem Pharma in April 2004, and upon exit in March 2009, the investment had generated an internal rate of return (IRR) of 68% and a multiple of 5.4 times original investment.

2008 WINNER
In 2008, Covington Capital won CVCA’s award for its investment in PlateSpin Ltd. Covington, which manages over $400 million in assets, first invested in PlateSpin Ltd. in March 2003 and upon exit in 2008, the investment had generated an internal rate of return (IRR) of 117% and a multiple of 18 times original investment.

2007 WINNER
GrowthWorks, which specializes in the management and growth of regionally based venture capital funds, won the 2007 award for its investment in Galleon Energy Inc. Their investment in December 2002 generated an internal rate of return (IRR) of 134% and a multiple of 7.6 times original investment.

ABOUT THE CVCA
Representing the industry for over 30 years, CVCA – Canada’s Venture Capital & Private Equity Association – represents more than 1800 individual members. Its member funds manage the majority of Canada’s pools of capital designated to be committed to venture capital and private equity investments. CVCA members collectively manage over $73 billion. Discover why investing in CVCA members has been the smart move for many pension fund managers – and find new Canadian investment opportunities that can achieve those truly superior “alpha returns.”

Meet and greet 500+ VC & PE industry leaders in Ottawa at CVCA’s Annual Conference from May 26-28, 2010
Supreme Court of Canada? What do doughnuts have to do with pensions? Well, Kerry (Canada) Inc., a successor to the Canadian Doughnut Company, has likely been asking itself these questions.

The issues before the Supreme Court of Canada in Nolan v. Kerry (Canada) Inc., released on August 7, 2009, were:

◆ To what extent may pension plan expenses be paid from a pension fund?
◆ Under what circumstances are contribution holidays in respect of a Defined Benefit pension plan permitted?
◆ May such contribution holidays be extended to a Defined Contribution component of the pension plan?
◆ May the costs of litigation be paid from the pension fund?
◆ How much deference should courts give to pension tribunals?

The decision in Kerry is far from rocket science, it is more like doughnut science. Many in the pension industry did not expect the decision to reach the Supreme Court of Canada, following a strong decision at the Ontario Court of Appeal. While the decision is good news, there is little surprising. Following are the main points to be gleaned from the decision:

◆ Administrative expenses may be paid from a pension fund

There is a presumption that pension plan and pension fund expenses may be paid from a pension fund, unless the pension plan documentation states otherwise. In any question of this nature, current and historical versions of the pension plan text, trust agreements, other custody agreements, and employee booklets must be reviewed to determine whether the plan sponsor may have bound itself to paying such expenses directly rather than from the pension fund.

Then, each expense item should be reviewed to determine whether it is an expense incurred in the administration of the plan. This can be a small amount of fees incurred in a feasibility study to introduce a DC component, not allowable expenses payable from the pension fund. Those fees did not concern the administration of the plan, but rather concerned a potential amendment to the plan. They were fees incurred by the employer in its role as plan sponsor rather than as plan administrator.

Whatever distinctions may have arisen from the Court of Appeal decision between fees and expenses, third parties and those incurred internally by the employer, have been erased. If an employer chooses to undertake certain pension functions internally instead of outsourcing to a third party, the employer’s expenses may be charged to the pension fund. This practice is not new. Caution, of course, must be exercised to validate such expenses and to ensure they are reasonable.

Another aspect of this case worthy of note are its comments on the “exclusive benefit” wording in the trust agreement. There has been a misconception that this term means that assets in a pension fund may not be used for a particular purpose when there may be a secondary benefit accruing to persons other than members, in this case, arguably, to the employer. The court confirmed that ‘exclusive benefit’ should not be construed to mean that no one but the plan members can benefit from the use of pension funds. In this case, the payment of plan expenses was necessary for the continuation of the pension plan. The payments were permitted even though there may have been a benefit to the employer.

◆ Contribution holidays are permissible and extend to the DC part of a pension plan

The issue of taking contribution holidays under a DB plan has been settled since the Supreme Court of Canada’s decision in 1994 in Schmidt v. Air Products. The one difference in this case was that the pension plan document did not explicitly refer to determining the employer contributions on the basis of actuarial calculations. The employer contributions were simply to be sufficient to provide for the benefits under the plan. The court, thankfully, confirmed that actuarial analysis is still needed even without a specific reference in the plan documents. Therefore, contribution holidays would be permitted where there were sufficient assets in the fund.

The more contentious issue concerned the use of surplus assets in the DB part of the pension plan to satisfy contributions to the DC part of the plan. The Financial Services Tribunal had held that the plan would have to be amended retroactively to include the DC members as beneficiaries of the pension trust. This was done. This permitted the company to use the DB assets for the benefit of the DC members, as DB and DC members were all members of the one plan and they were all beneficiaries of the same trust fund.

◆ Costs may not generally be awarded from a pension fund

Under the Financial Services Commission of Ontario Act, 1997, the Financial Services Tribunal may award costs only against a party to the proceeding. As the pension fund was not a party, costs could not be awarded against the fund. Even if the pension fund were a party to the proceedings, costs may not be awarded against a pension fund in the case of adversarial litigation. Pension funds, therefore, may not be used to bankroll litigation.

◆ The courts should defer to decisions of pension tribunals

The courts have been grappling with the issue of how much deference to give to specialist tribunals such as the Financial Services Tribunal. Generally speaking, courts apply a reasonableness standard. In other words, the Tribunal’s decisions will only be overturned if they were unreasonable. A stricter standard will apply only in cases of statutory interpretation, which was not the case in Kerry.

Each one of the issues dealt with in Kerry could (should) be clarified in legislation, thereby increasing certainty in the administration of pension plans and reducing the volume of unnecessary litigation. Governments across the country have the benefit of expert counsel who are willing to assist with policy formulation and legislative drafting. Unfortunately, though, on account of government inertia, this sort of needless litigation continues and many employers have abandoned DB pension plans partly for this reason.

Too many employers, after having innocently established pension plans, perhaps decades ago, have been unwilling victims entangled in the web of pension regulation or embroiled in seemingly endless pension litigation. Many of the issues before the courts in the last several years and many of the inconsistencies in pension laws across the country should be dealt with and simplified through a concerted effort at pension reform.

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A PARTNER YOU CAN TRUST.
There is a fundamental discrepancy in the goals of investors and management. Investors are measured on return on investment – essentially changes in the price of a company’s shares – over defined time periods. Management is held accountable for achieving this goal, despite the fact that it has no influence on this factor.

Management’s influence is confined to the achievement of corporate goals stated in financial terms. A short, and by no means exhaustive, list can be divided into two categories – specific to the company itself and relative to its peer group.

Profit Margin
A very short list of objectives includes return on equity, various profit margin calculations, and volatility of returns.

In order to understand the reasons for the discrepancy, one needs to answer the question of what determines the factors used by the market in setting the direction and price of stocks.

The subject is vast and needs to be boiled down to a workable examination. In each case, both long and short (respectively defined as one- and four-year) periods are considered.

Industry literature focuses on a common sense overall approach – companies producing superior financials will outperform both their peer group and the market.

In an article in the December 2007 issue of Benefits and Pensions Monitor, the author attempted to outline the great difficulties inherent in being a long-term investor. One of the principal problems is that investors are judged on one- and four-year results, both periods quite short in the life of a company. In addition, few money managers (as well as corporate CEOs) have tenures even this long.

Further, short-term stock market volatility (say 50 per cent ranges each year) often swamps long-term results.

The case of Encana illustrates the difficulties. Management has consistently positioned the company to be a superior long-term performer. This has involved ‘trading’ expensive assets for cheaper lines of business (selling oil producing properties for natural gas ones, when the price of oil was out of line with its historical relationship with gas). Long-term no doubt brilliant, but shorter term selling winners to buy losers has resulted in poor relative performance. Should management be rewarded or penalized?

Few Comparisons
Theoretically, truly superior long-term corporate performance is thought to be rewarded through higher stock valuation. However, even this is difficult to prove statistically, particularly in the Canadian context with few comparisons available. Beyond the banks, few other major groupings offer strict comparability.

Longer term, the consensus appears to be that the best managed bank is TD. However, the bank underperformed in periods when the Ontario economy did poorly.

One can argue that management should have diversified the bank’s geographic base, but would it then have performed more in line with the average?

Looking at time periods consistent with management’s ability to restructure to optimum mix of business (five to 10 years), a buy and hold strategy would have placed TD in second and third positions amongst its peer five-bank group.

For those arguing that the Bank of Nova Scotia is the best bank, its record over the same time periods was third and first.

Lowest Price
Buttressing our case, CPMS, in a series of Globe and Mail articles, has consistently held that the best way of outperforming the sector is to buy the lowest price to book bank. By definition, this is precisely the opposite of being the best managed bank.

The conclusion is that except in the case of truly long-term investors (say a pension fund with a positive cash flow and understanding trustees) stock prices should not be used to judge management. As indicated earlier, stock prices must be used to evaluate the money managers, but they should be used for that purpose only.

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In the wake of one of the most challenging economic periods in recent times, it is not just your average Canadian consumer that is emerging from the ashes with a new sense of frugality. Businesses
across all sectors are running tighter ships and keeping costs at a bare minimum, even if the signs are pointing to a more robust economy in 2010.

Increasing employee benefits without significantly increasing their cost is one way businesses have raised their competitive value among industry peers. Specifically, offering group insurance, whether for an employees’ home or automobile, can be added to a company’s benefit package without adding to their bottom line.

**Attract New Employees**

As the competitive landscape becomes clearer in the next quarter, businesses will once again be looking for ways to attract new employees and keep their existing employees happy. Offering a meaningful voluntary home and auto insurance program with money-saving benefits and expert insurance advice and service – at no direct cost – can help give one company an advantage over another.

Group insurance is typically offered to employer groups and professional and alumni associations. But what makes group insurance attractive to employees, whether existing or prospective? And what makes up a high-quality group insurance program?

**Cost is a primary factor** for employees especially as frugality has become fashionable. When evaluating benefits offered, preferred group rates are just one of the ways policyholders can benefit from group insurance. Most companies will offer various discounts on top of the competitive rates. One innovative approach is to reward diligent drivers and conscientious homeowners. Choosing to have an approved home security system and remote fire alarm system or having a hybrid vehicle can add up to great savings.

Beyond cost, flexibility, customization, and customer service, there are other factors that any company should consider when choosing a group insurance provider for their employees.

Here are some questions that should be considered by any business looking to add group insurance to their benefit offering:

- Can the insurance provider offer no-hassle and efficient, high-quality service, where employees receive straight answers to their questions?
- Who is eligible under the group insurance policy? Can it be extended to the children of employees? Their partners? What happens after retirement?
- Is there a dedicated account manager that will keep you up-to-date on your group insurance program?
- Are the limits and coverage flexible, or can they be tailored to your employees’ needs?
- Is there a third-party intermediary or can the policyholder deal directly with the insurance provider to get expert insurance advice that explains their options in simple to understand language?
- Does the insurance provider offer a complete marketing plan and prepare all the required material?
- What are the payment options for the plan members? Are they fixed or flexible?

Additional services from a group insurance program can also add to the value of this employee benefit. For example, insurers may offer an international assistance network providing fast, direct access to a full range of competent medical and professional help, 24 hours a day, 365 days a year. This type of program may even help employees by notifying their family, employer, or doctor back home of their situation or state of health or give them information about their family if they are away.

**No Additional Cost**

These services are the types of benefits employees appreciate and there is no additional cost to the employer. Running a tighter ship to keep costs under control does not have to mean chopping employee benefits. Businesses have to ensure the cuts they made to remain competitive will not hinder their ability to retain and attract talented and valuable employees. Adding or enhancing your group insurance needs is an easy way to add competitive value to your organization and give peace of mind to your employees.

Jean R. Lachance is chairman, Affinity Market Group, at TD Insurance Meloche Monnex.
Lessons For Plan Sponsors

By: Colin Ripsman

Last year, 2008, was a catastrophic year for investors around the world. The U.S. real estate market collapse led to a crisis in the financial sector, which resulted in the instability of some of the most historic and stable global financial institutions. This crisis triggered a freezing up of the credit market and the onset of a global recession. Investors, whether institutional or retail, found nowhere to hide.

For Defined Benefit pension plan sponsors, 2008 represented the worst of times. Significant drops in equity markets, accompanied by falling interest rates, resulted in large increases in funding obligations, at the same time that companies were facing significant earnings pressure.

For Defined Contribution plan members, 2008 highlighted the extent of the risk assumed by members under their plans. For many DC plan sponsors, it re-enforced the rationale for opting for a DC plan in the first place. For DB plan sponsors, this provided additional impetus to consider a shift to DC structures.

Periods of extreme market underperformance can act as a stress test for an existing investment structure. Are there any lessons upon which DC plan sponsors can draw for structuring line-ups for their employees? Where is the direction of the market in terms of future innovation in DC investment structures?

The Evolution Of DC Investment Structures

Over time, plan sponsors have seen an evolution in DC investment line-ups in response to changes in thinking, improved recordkeeping flexibility, and industry innovation.◆ Stage 1 – No Investment Choice

For many years, balanced funds were the investment strategy of choice since their blend of equity and fixed income asset classes provided a balance between risk and return.

◆ Stage 2 – Limited Choice

Over time, plan sponsors recognized that a traditional balanced fund, although appropriate for many members, was not the right option for others. As a result, DC plans started introducing a basic range of funds (a money market fund, an equity fund, and a balanced fund), so that plan members could tailor their asset mix to meet their needs.

◆ Stage 3 – Broader Choice

As recordkeepers began expanding the investment offerings available on their line-ups, plan sponsors began expanding their plan offerings to include regional equity funds and often multiple funds in individual asset classes with different styles. Typical investment line-ups grew from four or five funds to 10 to 20 funds.

◆ Stage 4 – The Introduction of Life Cycle Funds

Life Cycle funds were designed to simplify the investment selection process by introducing a diversified single fund investment that was more tailored to the needs of the investor. The first generation of Life Cycle funds were target risk funds, which offered a series of balanced funds with different asset mixes, ranging from a conservative (lower equities) to a more aggressive asset mix (more equities).

Target Date Funds (TDFs) were later introduced to address the major shortcoming of target risk funds, the requirement to calibrate the funds initially, and on an ongoing basis, with the help of a risk questionnaire. TDFs consist of a series of balanced funds that use a dynamic asset mix path (or glide path) to provide members with an optimum asset mix that changes over time. The proportion of the fund invested in equities is reduced over time as the target retirement date approaches.

Over the last few years, we have seen:

◆ TDFs gain in popularity and in share of total assets
◆ TDFs increasingly being used as the designated default investment choice for members who fail to provide investment direction under the plan
◆ Companies rationalizing or reducing the number of individual investment options offered in addition to the TDF funds

Performance Of TDFs During The Market Correction

Recently, TDFs have come under scrutiny in the U.S. as a result of their performance over the course of 2008. Of particular concern to U.S. regulators was the broad range of returns across funds with similar target retirement dates, especially those funds designed for current or imminent retirees. Looking at the Morningstar U.S. Investment Performance Database covering TDF Funds with 2010 target dates, performance for the 2008 calendar year ranged from -41.84 per cent to -3.61 per cent, for a performance differential of more than 38 per cent. This huge performance disparity was largely driven by the significant differences in equity weightings.

These issues were not as pronounced in Canada where TDFs have a much narrower range of equity weightings. In contrast to the U.S. market, the equity range for Canadian institutional 2010 funds tends to run in the 35 per cent to 60 per cent range.

Lessons From 2008

The lessons drawn from the U.S. experience with TDFs should be heeded by Canadian plan sponsors. They include:

◆ All TDFs are not created equally

It is important to look closely at what lies under the hood, including the underlying asset classes, portfolio managers, and mandates.

It also includes an assessment of the glide paths. Some glide paths may be more suitable for an aggressive workforce (perhaps one that is younger and more highly paid) while others for a more risk-averse workforce (older, with lower savings levels).

◆ Members must understand that TDFs are not risk free investments

Where TDFs are offered as the default option, members may wrongly conclude that the investments are risk free. Still,
other members misinterpret the target date to imply a guaranteed benefit at the fund target date. As a result, members were surprised by the negative returns. It is important that the member education material clearly outline the nature of the TDF investment, including the nature of the investment risk associated with the option and the expected risk and return as well as target equity weightings across the glide path. By providing full disclosure and comprehensive education, the plan sponsor can better manage expectations around the performance of the plan’s TDF option.

Future Direction And Innovation

It is important to remember that TDFs are not a panacea. They are investment solutions that impose structure around the asset mix decision and provide effective diversification from dollar one. For DC plan members who choose the default option, TDFs represent a better choice than the typical defaults. For investors who are disengaged or unlikely to adjust their portfolio regularly with their advisor, they represent a superior option to a static mix which will quickly become out of date. For these reasons, TDF funds are likely here to stay.

In the aftermath of the 2008 market correction, we will likely see some enhancements or changes to TDF funds and DC line-ups, in general. These changes may include:

◆ Enhanced Decumulation Options
   This may include longer glide paths that model the asset mix to support the decumulation period (factoring in the expected withdrawal patterns into retirement). The range of decumulation options, to support the regular ongoing withdrawal pattern necessary to support income needs in retirement, will also increase.

◆ Better Inflation Linkages
   As concerns over long-term inflationary pressures increase, TDFs will explore ways to introduce enhanced inflation linkages. This can be done by incorporating allocations to asset classes that offer better inflation protection, such as real return bonds and real estate, or by incorporating real liabilities or payment streams in the asset liability models that are used to derive future glide paths.

◆ Minimum Guarantees
   Many felt that the pricing of guarantees prior to the market correction was so high that it eroded much of the value of the guarantee due to the persistent drain on the expected investment return. The market correction acted to further stimulate investor demand for market based products that would guarantee a minimum value. At the same time, it highlighted the potential financial impact and cost of such guarantees in extreme market corrections. As a result, we can expect to see an increase in the pricing of guarantee-based products in the future. It will be important to re-evaluate the cost/benefit analysis of market guarantee features after this re-pricing occurs.

The recent market downturn has made some of the risks associated with equity
investment more concrete to DC members. At the same time, it has highlighted some of the differences in construction of different TDF. Target date funds will continue to be a staple under DC investment structures, since they assist unsophisticated DC members to impose and maintain a reasonable asset mix structure.

However, we can expect to see significant evolution and enhancements to these products to increase the degree that they can be tailored to the needs of specific DC plans and individual DC members.

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**INVESTMENT**

Commercial Real Estate: Past, Present & Future ...

By: Neil M. Meikle & Peter Cuthbert

Thankfully the Canadian recession has been mercifully short in comparison to other G8 nations and, when compared to our southern neighbors, we could be forgiven for thinking that things are not that bad after all. Labour markets have shown remarkable resilience, even managing to post some job gains in recent months, and our housing market has neatly swerved the sub-prime induced price falls witnessed in the U.S. Add this to the fact that the much-heralded Canadian banking system has trod a nimble path through the most traumatic financial period in more than 50 years, and we can almost be proud of our performance.

However, Canada has not emerged completely unscathed and there have been casualties along the way. Alberta, recently the economic powerhouse that led the nation, has seen its rapid growth reverse led by a fall in natural gas and oil prices. The Ontario automotive sector has been dragged down by the woes of The Big Three and the anemic spending of the U.S. consumer. Across the nation, job losses in manufacturing and construction have been heavy and Ottawa has to operate with a national budget deficit for the first time in more than a decade.

What was happening in commercial real estate?

The proverbial bull was on the charge. In the third quarter of 2008, the national office vacancy rate was at 6.3 per cent and the industrial market a mere 5.8 per cent vacant, levels among the lowest in the last 20 years. Rental rates were spiking with some office markets experiencing increases of more than 30 per cent in 2007 alone. The transactions market was also red hot with more than $30 billion of real estate deals done in 2007 as buyers gorged on cheap debt.

However, as we entered mid-2008, it was obvious that there were problems on the horizon. The Canadian economy was entering a period of recession and commercial real estate markets were not going to be immune.

How has real estate fared in this economic storm?

The answer is it could have been a lot worse as, fortunately, the Canadian markets entered the recession from a position of strength. Since the start of 2009, we have seen vacancy rates rise in the majority of markets with the national office vacancy rate hitting 9.4 per cent. Rents have followed suit, effectively falling by more than 20 per cent in some industrial markets. The transaction market came to a standstill as owners refused to accept that their assets had fallen in value, dramatically in some cases, and the few buyers that remained in the market were looking for unrealistic discounts.

But, it has not all been bad news. A select few markets have performed admirably. Ottawa has arguably the strongest industrial and office markets in the country, having seen minimal deterioration, and even some recent improvement in vacancy and rental rates. One of the key factors in the better-than-expected performance of the nation’s commercial real estate markets has been the lack of new space delivered to the market.

In previous cycles, the impact of a glut of construction has been keenly felt. Luckily, this time around, with the exception of localized issues in downtown Calgary, AB, and Toronto, ON, it will not be a significant factor.

So what does this mean for real estate going forward?

As the economy starts to turn around, we are anticipating that opportunities to acquire real estate will be some of the best in the last 20 years. The unprecedented speed of the downturn caught many property owners, and potential investors, unaware. Already we are starting to see transaction market activity increase as investors start to pick off quality assets as, and when, they come to market.

The pricing spread between Class A and Class B/C assets, which was almost nonexistent in the boom years, has re-emerged as investors chase prime assets and lower quality opportunities become less desirable. With capital waiting on the sidelines from the likes of institutions, REITs, and private buyers, we expect prime assets to continue to achieve better than expected prices in the near term.

It should also be noted that we are not forecasting a flood of distressed assets to come to market at pennies on the dollar, but for the informed fund manager we anticipate promising opportunities. Occupier markets have no doubt weakened, however, astute tenant management can help limit the impact.

What’s going to drive the commercial real estate recovery?

A number of factors will contribute including economic recovery and the resultant improvement in fundamentals, attractive yields, and investor demand. While the Canadian economic recovery remains fragile, we are expecting things to continue slowly improving. The govern-
ment has been astute in its use of stimulus packages when compared to its U.S. counterparts and, as a result, Canada will not be burdened with same levels of debt that could haunt the U.S. for decades. This all points to an orderly recovery and, while significant downside risks remain, the general trend towards economic growth will create demand for real estate. Firms need offices, industry needs warehouses, and consumers need somewhere to spend their money!

Investors looking to diversify their portfolios are likely to be drawn by commercial real estate’s compelling yield, especially when compared against historically low interest rates. Although the majority of income is expected to remain robust, there are likely to be a number of tenants vacating and some downward pressure on net operating income as a result. To counter the drop in rental rates, a tactic that property operators have been using recently is short-term lease renewals to ensure that when rental growth does return to the market, they are able to take advantage of the upside.

As mentioned previously, the anemic transaction market is starting to show some signs of life and, while we are not forecasting a near term increase in capital values, we believe we are approaching the bottom, signified by a narrowing of the buyer seller gap and an increase in transactions. As capital values begin to stabilize, the healthy return from income will materialize again and total returns will return to positive territory as the majority of incomes remain in place, as seen historically in IPD data (see Chart 1).

So now is the time?

As 2009 draws to a close, and Canada’s economy continues to recover, many of our trigger indicators are starting to point towards real estate.

However, the market outlook is not without risk. An investor’s ability to correctly assess and underwrite leasing/occupancy risk over the near term will be a key value added component and, ultimately, will separate the winners from the losers. The adjustment in the underlying real estate fundamentals may have been brutally sharp, but as vendors begin to accept the reality of what has happened to them and their assets, there are likely to be some outstanding opportunities.

There are not many investors who can claim perfect market timing in portfolio decisions, however, looking back on 2010 it is likely that they will agree that they picked the opportune time, in a 10- to 15-year cycle, to increase their real estate holdings.

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However, the market outlook is not without risk. An investor’s ability to correctly assess and underwrite leasing/occupancy risk over the near term will be a key value added component and, ultimately, will separate the winners from the losers. The adjustment in the underlying real estate fundamentals may have been brutally sharp, but as vendors begin to accept the reality of what has happened to them and their assets, there are likely to be some outstanding opportunities.

There are not many investors who can claim perfect market timing in portfolio decisions, however, looking back on 2010 it is likely that they will agree that they picked the opportune time, in a 10- to 15-year cycle, to increase their real estate holdings.

Neil Meikle is Standard Life Investments’ North American direct real estate analyst, based in Edinburgh, Scotland (neil_meikle@standardlife.com) and Peter Cuthbert is vice-president, real estate, Standard Life Investments (Real Estate) Inc., based in Toronto, ON (peter.cuthbert@standardlife.ca).

Investors looking to diversify their portfolios are likely to be drawn by commercial real estate’s compelling yield, especially when compared against historically low interest rates. Although the majority of income is expected to remain robust, there are likely to be a number of tenants vacating and some downward pressure on net operating income as a result. To counter the drop in rental rates, a tactic that property operators have been using recently is short-term lease renewals to ensure that when rental growth does return to the market, they are able to take advantage of the upside.

As mentioned previously, the anemic transaction market is starting to show some signs of life and, while we are not forecasting a near term increase in capital values, we believe we are approaching the bottom, signified by a narrowing of the buyer seller gap and an increase in transactions. As capital values begin to stabilize, the healthy return from income will materialize again and total returns will return to positive territory as the majority of incomes remain in place, as seen historically in IPD data (see Chart 1).

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Indexing can be a powerful tool for investors. It’s inexpensive to manage, absolutely transparent, and a naturally well-diversified approach to the market. More important, there is strong evidence that index investing, in the long run, outperforms active investing.

Over the past 30 years, index investing has become increasingly popular with both large institutions and retail investors through index mutual funds and, more recently, the growth of exchange-traded funds or ETFs. The majority of these funds
follow traditional indices such as the S&P 500 and S&P/TSX 60, which are market capitalization weighted.

Fundamentally Flawed

However, despite all their benefits, traditional cap-weighted indices are fundamentally flawed. As a stock’s price increases, so does the weight of the stock in the index. This means investors using these indices are forced to allocate more of their portfolio to overvalued stocks and less to undervalued stocks – exactly the opposite of what common sense investing suggests. A great example of this for Canadians is the Nortel effect in 2000 when Nortel represented more than 30 per cent of the S&P/TSX at the expense of many other great companies.

The market doesn’t always get it right, so why do we invest assuming it does?

In fact, there is a growing movement by institutional and retail investors globally toward a new form of indexing – ‘Fundamental Indexing’ – that’s designed to improve upon cap-weighted indices.

Four Factors

Fundamental indices weight stocks based on their fundamental value using four factors of company size – sales, cash flow, dividends, and book equity value. Under fundamental indexing, unless companies grow their cash flows, dividends, sales, and book value faster than the rest of the economy, they do not receive additional weighting.

This has been a considerable enhancement. Historically, the FTSE RAFI Fundamental Index Series, which is considered the global benchmark in fundamental indexing, has outperformed their respective market-cap indices – on average by two to four per cent per annum, globally. These indices have accomplished this with lower risk. Active portfolio managers have had difficulty beating traditional indices, now they have to face even tougher performance hurdles.

With the launch of fundamental index-based ETFs and investment strategies in Canada, Canadian institutional and retail investors now have an alternative to both traditional passive indices and higher-priced active funds.

Som Seif is president and CEO of Claymore Investments, Inc.

The outlook for global equities has improved considerably over the course of 2009, thanks in large part to better-than-expected growth in many emerging market economies. As the global recovery takes hold in 2010, exposure to EM growth is likely to play a key role in the relative fortunes of the developed world’s equity markets.

Meanwhile, the U.S. economy – the traditional locomotive of world growth – appears vulnerable to a number of headwinds including excessive consumer and government debt, an impaired banking system, and a chronic current account deficit that is slowly correcting.

Under the circumstances, the appeal of the emerging markets is obvious, as seen by the strong rally in these markets in 2009. However, emerging equity valuations now appear somewhat more expensive on average, compared to the non-U.S. developed markets.

In our view, these same trends – relative U.S. economic weakness and multiple expansion in the emerging markets – have created attractive potential opportunities in the EAFE (Europe, Australasia and Far East) universe. We have identified a number of EAFE companies that are highly geared to EM growth, but whose earnings potential has yet to be fully recognized.

The Growth Gap Widens

Contrary to the widespread pessimism last year when many feared the financial crisis would lead to a 1997/98 style debacle in the emerging markets, the growth differential between the major developed and developing economies actually widened in 2009 and is expected to narrow only slightly in 2010.

EM stability, in turn, has had positive implications for global growth – and, more particularly, for resource-dependent economies such as Australia and Canada. A better outlook for EM capital goods spending is also brightening the recovery path for Japan and continental Europe, although structural and demographic factors continue to limit growth potential in both cases.

Like most, we expect the U.S. economy to return to growth in 2010. However, the pace of the U.S. expansion is expected to lag the global growth rate. While demographic and structural factors suggest the U.S. will outpace both Europe and Japan next year, it is unlikely to be by the same margin investors came to expect in the last two recoveries.

Although shorter-term currency movements are virtually impossible to forecast, sluggish growth, heavy external financing needs, and asset valuations that do not appear especially compelling all suggest the secular trend towards U.S. dollar weakness is likely to continue over the medium to longer term – barring either a major reversal in fiscal and monetary policy or a renewed financial crisis, neither of which we regard as likely.

Under this scenario, unhedged U.S. investors could benefit from a tailwind of currency appreciation in most non-U.S. asset markets.

For Canadian investors in U.S. assets, on the other hand, this trend could translate into an adverse currency headwind, as the loonie is more likely to continue appreciating along with the world’s other resource currencies.

EAFE Valuations Attractive

On a forward price-to-earnings basis, the relative appeal of the EAFE countries is less than obvious – and in Japan’s case not visible at all. However, both Europe and Japan appear much more attractive based on through-the-cycle earnings. Alternative metrics also provide a more favourable picture of relative valuation.
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◆ **Price-to-Book** – Although cross-border comparisons between companies can be tricky due to differing accounting standards, we believe price-to-book can provide a useful measure of aggregate market valuation. As of the end of September, Japan appeared cheapest by this metric, followed by Europe.

◆ **Dividend Yield** – Yields were quite high in Europe, on average, and relatively reasonable in Japan (given the country’s ultra-low interest rate environment). EM yields, by contrast, were extremely low on a historical basis.

We also find it striking that European firms on average have been able to maintain return on equity at close to 10 per cent, on average, despite an extremely hostile cyclical environment. Given the cost-cutting trends now underway in continental Europe, we believe ROE could rise into the mid-teens as the recovery progresses.

### Regional And Sector Perspectives

Because our investment process is bottom-up, the geographic and sector allocations in our portfolios are a residual of the individual stock selection process. That said, there are some distinct patterns to the opportunities being created by the factors outlined above:

◆ We have maintained a steady and significant overweight to Pacific ex-Japan, reflecting the region’s leverage to China’s growth and generally positive demographic trends. Australia in particular appears highly geared to an Asian manufacturing recovery due to its resource wealth.

◆ Our underweight position in Europe is largely a function of the dim prospects in the UK domestic economy. In continental Europe, by contrast, we are finding a number of positive restructuring stories, as companies move more aggressively to rationalize costs and refinance debt.

◆ Since the market trough in March, we have found a number of opportunities in the consumer discretionary and information technology sectors, as well as in defensive sectors such as healthcare and energy, where the underlying earnings stability of some companies appears to have been underestimated.

While EM equity valuations remain reasonable, they no longer present the compelling case they did at the bear market trough. By contrast, a number of developed markets and stocks still appear relatively cheap, based on metrics such as price-to-book and dividend yield. Going forward, we think this creates greater potential for upside surprises.

Current economic and earnings forecasts are even more tentative than usual, however, creating the potential for substantial downside as well as upside surprises. Under the circumstances, strong fundamental research and skilled stock picking will be critical to investment success.

**Raymond A. Mills, Ph.D., CFA, is lead portfolio manager for the T. Rowe Price Non-U.S. Equity Value and Non-U.S. Equity Core Strategies (wendy.brodkin@troweprice.com).**

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**LETTER**

**TDFs One-fund Solution**

I share your disbelief expressed in the editorial ‘A Question Of Choice’ in the October issue of Benefits and Pensions Monitor at not offering a one-fund solution as an option with its pros and cons clearly outlined. Given that such a program would be exempt from the CAP guidelines, it would clearly be beneficial to plan sponsors not currently in compliance, although it would obviously add some additional fiduciary responsibility.

That said, the easiest way around the problem is the no touch, low touch, and custom option. TDFs are the no touch and default stream; low touch for those somewhat engaged; and then custom for the advanced or fully engaged member. This model allows for everyone to have their choice or no choice as they see fit.

One problem with the proposed multi-employer route is that a common fund approach is not always best for everyone as some members are truly risk averse (to the point of becoming ill) so even a ‘professionally managed balanced fund’ might not always be the answer, but you are right it should be an option.

Neil T. Craig, BA, RPA
Stevenson & Hunt Insurance Brokers Ltd.
PIAC has been the national voice for Canadian pension funds since 1977. Our 134 member funds are responsible for the oversight of over $892 billion in assets on behalf of millions of Canadians. PIAC’s mission is to promote sound investment practices and good governance for the benefit of pension plan sponsors and beneficiaries.

PIAC is a forum for education and the exchange of member ideas, and through its research and advocacy activities, is the leading voice on legislative and regulatory issues affecting pension investment and governance.

Professionals responsible for the investment direction of their organization’s pension funds are invited to request a membership information package.

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Chris Caswell, manager, compliance of benefit plans, at Rio Tinto; and Eleanor Marshall, vice-president and treasurer, Bell Aliant; will be on the panel of plan sponsors at the CPBI Ontario Region’s ‘Pension Investment Forecast 2010.’ Other panelists are Leo de Bever, chief executive officer, AIMCO; and William W. Moriarty, president and CEO, University of Toronto Asset Management. The session will also feature presentations from Jonathan Tetrault, of McKinsey & Company, who will set the stage with an overview of the investment trends in the industry; Dr. Marlene Puffer, managing director, Twist Financial Corporation, who will talk about the trends in liability driven investing (LDI) and some practical considerations in this environment; and Malcolm Hamilton, of Mercer, who will offer his thoughts on the Defined Contribution plan challenge. It takes place January 13 in Toronto, ON. Visit: http://www.cpbi-icra.ca/en/event_details.ch2?event_id=812

CPBI Ontario’s Benefit Ball takes place February 4 in Toronto, ON. The annual networking charitable event for the pension, benefits, and investment industries raises funds for the Crohn’s and Colitis Foundation of Canada. Contact: 877-599-1414 or ontario@cpbi-icra.ca

February 22 Real estate, infrastructure, private equity, hedge funds, and currency hedging will be among the strategies examined at The 4th Annual Alternative Investments for Institutional Investors Conference. Sponsored by Benefits and Pensions Monitor and MindPath, it will feature industry thought-leaders who will share their views on the latest trends, information, and investment opportunities. It will also feature ‘Meet-the-Manager Roundtables’ where investors will have the opportunity to meet informally with a selection of chief investment officers and senior portfolio managers. It takes place in Toronto, ON. Visit: http://www.mindpath.ca/
It is a great time to be a follower of behavioural finance, which attempts to explain markets and their movements by looking at psychology and other disciplines to understand how people make financial and economic decisions in the real world. What used to be thought of as a heretical challenge to the established idea of market efficiency has now gone mainstream.

One of the movement’s proponents, Richard Thaler, has a New York Times bestselling book about how to gently “nudge” people into making better decisions. Thaler’s co-author, Cass Sunstein, has been appointed as President Obama’s head of the Office of Information and Regulatory Affairs. Both authors have been nominated for Time Magazine’s annual list of the 100 Most Influential People in the world.

Another is Robert Shiller, another behaviouralist, and the man who coined the phrase “irrational exuberance.” He has, for years, spoken of the unsustainability of prices in the housing market. Markets have proven him to be correct.

Mainstream Economic Thought

Along with behavioural ideas entering mainstream economic thought have come some real world applications.

On the pension side, much of the new focus on Defined Contribution plan design draws from behaviouralist work. We now understand that too many investment choices confuse people rather than helps them, and that default options are important since this is the path of least resistance that large numbers of people will take. In the United States, the Pension Protection Act of 2006 endorsed both auto-enrolment in DC plans and the behavioural underpinnings for it.

Anybody having survived the past two years should question how rational markets really are. And anybody looking back at financial history may well conclude that rationality has been the anomaly in the markets, not irrationality. Yet, there are two thoughts that arise from this:

- **Before We Start Making Decisions For Others, Recognize That We Are Human Too**
  We are all human, and thus suffer from the limitations and biases often noted by behaviouralists. So how are we to overcome these tendencies that we are quick to point out in others? How is the personal financial planner going to separate out their own biases towards short-term rewards and commissions as they guide their client? How do we, as plan sponsors, overcome agency theory, group think, closet indexing, and the desire to postpone key decisions as we go about our jobs?

While the social engineers in us might be attracted to behavioural finance work in an attempt to guide plan participants to take courses of action we have decided are in their best interest, we should ask ourselves why we are so certain that we know the right answers to the decisions that others are making — to paraphrase Walt Kelly’s Pogo ‘We have met the enemy of rationality, and he is us.’

- **Herds Are Often Right**
  Most investors, if forced to describe themselves, would use words like ‘rational,’ ‘disciplined,’ or even ‘contrarian.’ There is certainly more to be gained by being thought of as a leading thinker, uncovering investments that are overlooked or underappreciated by others. I have yet to see anyone advertise that their fund or service is one which merely ‘follows the herd.’

However, this ignores the very real truth that sometimes the herd is right. Momentum certainly exists in many markets and at numerous points in time. For many years, you could have made a lot of money by joining the herds as they bid up the price of assets ranging from homes to equities.

Rational Markets

Behavioural finance has a lot to offer us. You can make money on the behavioural side (Thaler runs an asset management firm that seems to do quite well by looking for and exploiting market anomalies). However it is not an ‘either/or’ situation when it comes to understanding how behavioural finance fits in with general market theory built around rational markets. Markets can be mostly efficient and rational some (or perhaps much) of the time, yet these same markets can also be prone to prolonged periods of irrationality, momentum, and trending. Remember that markets are merely reflections of our own actions, which combine both rational and more human actions on a daily basis.

THE BACK PAGE

By: Jim Helik

Jim Helik is co-author of ‘Strategic Wealth Conversion,’ a textbook published by the Canadian Securities Institute. He also teaches at the School of Business, Ryerson University in Toronto.
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