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Pharmacies in Ontario were very fast off the mark in launching their campaigns against the Ontario government’s move to lower generic drug prices in the province.

The news came in the Ontario Budget. By the end of that week, pharmacists were asking customers to send a post card to the legislature showing their displeasure. The message, however, was a bit wide of the mark. They warned of fewer stores, less staff, longer wait times, fewer services such as home delivery, and less time with the pharmacist. Of course, the message from the province was lower costs for generic drugs.

For the average consumer, it seems an easy choice.

In most circles, this was greeted as welcome news because Canadians, as a whole, pay higher costs for generic drugs than what is charged in other countries.

The other mystery was the inaction of private plan sponsors to come together collectively and negotiate lower prices. We are seeing that now in the Maritimes where employers such as Bell Aliant, J.D. Irving, and Michelin Tire are banding together to try to cut the cost of prescription drugs.

Left out on their own are those who need prescriptions filled, but do not belong to any plan. For them, pharmacies were reportedly charging more than the price paid by the ODB or set by the PBNs. Granted, it probably amounted to less than a couple of million people in the province, but they had no voice, no leverage, and were paying the most.

Three-tier System

The province is saying that it will level the playing field. However, we have no way of knowing if it means that the price for generics has to drop to the ODB rate of 25 per cent of the price of the original brand name drug. Will we still have a three-tier system where the ODB pays 25 per cent and the PBN price is cut in half as is the price for non-plan members, who will still pay the most?

On the other hand, the government says it will compensate pharmacists through increased dispensing and service fees. However, there were no details on who will set these fees and what, if any, limits there will be. In many cases, the dispensing fee is an out-of-pocket expense for those on a drug plan and those without. And while initial estimates are that the savings for employer plans will be eight per cent immediately and 16 per cent within two years, depending on the plan design, the reality is that plan members may end up digging a little deeper into their pockets to pay for their prescriptions.

By Joe Hornyak
Executive Editor

jhornyak@powershift.ca
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Russell
David Feather is president and managing director of Russell Investments Canada Limited (Russell Canada). Prior to joining the firm, he was president of Mackenzie Financial Services Inc. and was responsible for leading the company’s distribution efforts, sales, product management, and sub-advisor investment management relationships. He has also worked in the economic strategy group at Ernst & Young and in corporate and government banking at the Bank of Montreal.

bfinance
Jean-François Milette is managing director, Canada, for bfinance. He was previously with Dexia Asset Management where he was vice-president and senior relationship manager of its Canadian operations. Prior to that, he was with MFC Global Investments as vice-president, institutional investments for Eastern Canada.

Pharmacy Foundation
Bessie Wang is president of the Canadian Foundation for Pharmacy. She is director of professional services at TELUS Health Solutions. The foundation is a national charitable organization that supports innovation in pharmacy practices.

Comprehensive Benefit Solutions
Michael Trowell is assistant vice-president at Comprehensive Benefit Solutions Limited. He is responsible for business development and client services in its benefits and retirement consulting practices.

OPTrust
Jordan Berger is director, policy compliance, with OPTrust’s Private Markets Group. He was previously head of responsible investment, Canada, with Mercer Investment Consulting. OPTrust is a jointly-trusted pension plan with assets in excess of $11 billion, serving more than 80,000 current and former employees of Ontario’s direct and broader public service.

Standard Life
John Gerbrecht is regional vice-president, sales – western region, group insurance at Standard Life. He has more than 20 years of group insurance sales experience in Western Canada and has spent the past 13 years working with both brokers and consultants in mid and large case markets.

SSgA
Peter Lindley is president and head of investments for State Street Global Advisors (SSgA) in Canada. He joined the firm in 2005 and has served as head of investments and fixed income and as a senior portfolio manager on the fixed income team. Previously, he served as co-head of global markets for Deutsche Bank Canada. Denis Senécal is head of fixed income and cash in Canada. He was previously with Caisse Centrale Desjardins, where he was a vice-president in treasury, responsible for asset-liability management, securitization, and interest risk management.

Green Shield Canada
Ray Gollmer is chief administrative officer at Green Shield Canada. He will oversee all head office operations including information technology and claims administration. Steve Moffatt is senior vice-president, sales and marketing. He has held progressively senior positions with the firm. Cindy Barrett is vice-president, information technology. She has IT experience both on the supplier side with IT consulting and the client side with IT management.
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Fund Trustees Fined
Nine trustees of the Canadian Commercial Workers Industry Pension are being fined $202,500 for investing too much of the fund’s money in questionable Caribbean hotels and resorts. The Ontario Court of Justice fined the trustees for breaching the Pension Benefits Act. The court found the trustees exceeded the legal investment limits of 10 per cent of the plan’s assets in one area by approving investments or loans of almost $20 million to RHK Capital and PRK Holdings from 2002 to the end of 2003. This represents the biggest collective fine for breaking pension laws in Ontario’s history.

Standards Must Be Co-ordinated
Global standards need to be co-ordinated to help prevent future financial crises, says Ralph R. Layman, president and chief investment officer – public equities, GE Asset Management. Speaking at the Toronto CFA Society’s ‘The Financial Crisis: Impact on Theory and Practice’ session, he said the amount of leverage that was available in the system prior to the crisis had finance professionals developing new products to take advantage of this. However, part of the process was looking for places where the regulation was easiest. This needs to be shored up, he said, and regulations harmonized and made universal.

Cost-of-living Increases Cut
The Nova Scotia government will limit cost-of-living increases to the pensions of retired government workers in a bid to save up to $200 million a year. Finance Minister Graham Steele says that the Nova Scotia Public Service Superannuation Plan is unsustainable in its current form as it only has 69 cents for every $1 it pays out. The pension fund now pays out more money than members and the government contribute and that gap is widening. It will have a negative cash flow after 2028 if there are no changes. Cost-of-living increases will be limited to 1.25 per cent a year for five years, starting January 1, 2011.

Government Creating Health Trusts
The federal government is planning to amend the Income Tax Act in order to create a new type of taxable trust – an employee life and health trust, says Eckler GroupNews. The proposed legislation includes rules regarding the timing of deductions of any pre-funding of such a trust by an employer and allows the trust to deduct, in computing its income, all amounts paid from the trust to employees or retirees in respect of benefits, even if employees receive those amounts tax-free. The benefits would receive the same tax treatment (generally tax-free) in the hands of employees as if they had been paid directly by the employer. If the trust’s costs (including payments to employees) exceed its revenue for a particular year, the excess will be treated as a business loss, subject to a special three-year carry-back and carry-forward mechanism. The department of finance is requesting comments on the draft proposals. The deadline is April 30.

GWL Develops National Claims Service
Great-West Life has signed an agreement with TELUS Health Solutions for the development and implementation of the first national eClaims exchange service for extended healthcare providers across Canada. Once implemented, the extended healthcare provider community will be able to submit electronic payment reimbursement requests directly to Great-West Life right at their point of service, offering increased convenience and flexibility for plan members while reducing the environmental impact of paper claims. The initial release, planned for the second half of 2010, will focus on providers such as physicians, chiropractors, and vision care providers, before broadening out to include the wider range of healthcare providers.

UTAM Changing Strategy
The University of Toronto pension and endowment fund will change its investment strategy and investment management structure as a result of its 30 per cent loss in 2008. In a letter to faculty and staff, David Naylor, the university’s president, says a newly-created investment committee will review the asset allocation and performance benchmarks. Control of the University of Toronto Asset Management Corporation (UTAM) – which invests the university’s pension and endowments funds – will move to the university senior administration. UTAM has $1.98 billion in assets under management.

Market Neutral Provides Stability
Market neutral strategies may provide stability relative to other hedge fund strategies, says Joseph Morgart, senior vice-president, alternative investment strategies, Pyramis Global Advisors, a unit of Fidelity Investments. Speaking at the Benefits and Pensions Monitor and Mindpath ‘4th Annual Alternative Investments for Institutional Investors Conference,’ he said despite a strong 2009, few strategies made up for their 2009 losses or made money. Of those, market neutral’s consistent low volatility over market cycles and low correlations with traditional and alternative investment is set up to continue to provide returns. He said it can be used as a replacement or complement to fixed income, an alternative investment core strategy, or as part of a liability investment strategy.

Addenda
The following was not available for the Managers of U.S. Assets for Canadian Plan Sponsors directory in the February issue of Benefits and Pensions Monitor: RCB Investment Management Michael Adam Smith, Senior Vice-president; 11111 Santa Monica Blvd., Ste. 1700, Los Angeles, CA 90025 PH: 310-689-2714 Fax: 310-478-8495 eMail: msmith@rcbinvest.com Web: www.rcbinvest.com Total U.S. Assets Under Management For Canadian Pension Funds: $139, M
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Canadians Counting On Pensions

Half of Canadians (54 per cent) expect their pensions – whether a pension from an employer (29 per cent) or a government pension (25 per cent) – to be the single, largest source of income in retirement, says the 20th Annual RBC RRSP Poll. However, one-in-five (19 per cent) do not know what kind of pension plan they have. Canadians expect part-time or occasional work (26 per cent) and income from their own investments (24 per cent) to be supplementary sources of income during retirement. On average, retirees have a goal of nearly $270,000 as the amount of money required for a comfortable retirement, down from nearly $450,000 in 2007. People not yet retired think they will need nearly two and half times that amount, or almost $660,000, down from almost $900,000 in 2007.

Wellness Programs Paying Off

Debra Wight, manager, employee health, safety, and benefits for the township of Richmond Hill, ON, attributes its wellness programs to a 3.9 per cent decline in the number of drug claims made against its benefits plan in 2007 and 2008. During that same time, its drug costs rose only 3.5 per cent compared to a 13.9 per cent increase in the 2001 and 2002 period. She told the CPBI Ontario region’s ‘1st Annual Benefits Outlook’ session that the township started its wellness efforts in 1998 when it moved to a flexible benefit plan and was looking for other ways to keep its benefit costs down. It uses a variety of tailored programs ranging from an annual fitness challenge to health fairs and onsite fitness programs to shift the focus away from money and onto the health of the employees. This has helped make its employees engaged and it is cited for other results such as an absentee rate which is 30 per cent lower than the national average.

Court Rejects Wind Up Bid

The Ontario Court of Appeal has rejected a bid by pension plan members to wind up their pension plan, says a Borden Ladner Gervais ‘Newsletter.’ In Lomas v. Rio Algom Limited, the parties to the case agreed that the Supreme Court of Canada’s decision in Buschau v. Rogers Communications Inc. precluded the court from winding up the plan directly, but the members argued that the court could still require the employer to initiate wind up proceedings under the statutory procedure in the Pension Benefits Act (Ontario). The court of appeal rejected this argument, holding that to make such an order would be contrary to both Buschau and the scheme of the PBA which provides only the employer and the Superintendent of Financial Services with the power to initiate wind up proceedings.

Institutions Taking ETFs To New Levels

Institutions are returning to exchange traded funds (ETFs) and taking them to new levels, says Som Seif, president and CEO, Claymore Investments Inc. Speaking at the Toronto CFA Society’s ‘Exchange Traded Funds: Why Invest?’, he said today’s ETFs are also attractive because they can provide exposure to just about anything an investor is seeking, in a simple and efficient manner. However, today’s market volatility means investors can no longer buy two or three ETFs and expect to retire happy in 30 years.
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After the hits taken by traditional, long-only investment strategies during the market meltdown, many pension plans may be considering different ways of generating returns. That means, according to some, sponsors are now seeing alternative asset classes in a new light.

Although there is still varying degrees of uncertainty among plans, there is now a more open attitude toward non-traditional investments, says Arti Sharma, senior vice-president, Americas, at Thomas Murray Ltd. Given the volatility of the past year or so, she believes institutional clients are recognizing that traditional strategies “such as public market securities may not be able to give them the alpha they are looking for.”

Especially for funds $5 billion and up, alternatives have become more a part of investment strategies, she says. And in the past couple of years her firm has seen allocations to alternatives of anywhere from five to 15 per cent.

Like A Marriage
Grace Wong, manager, external portfolios and risk management, Canada Post, agrees that some alternative asset classes do indeed hold real potential, but that plans should participate carefully. She says her group is currently active in alternatives – such as real estate, private equity, and infrastructure – and plans to ramp-up its commitment to each. Yet, she stresses it is expanding cautiously and wants a firm understanding before moving forward.

“Given the nature of alternatives, it’s very much like a marriage. You have to know who you’re dealing with first and what sort of history is involved before you can believe that they’ll do what they say they’ll do,” Wong says.

While sponsors are perhaps considering alternatives more closely, many are still sticking to the traditional strategies they know and, in some cases, are outright resistant to the notion, according to one senior consultant, (who did not wish to be named) at a Toronto investment firm serving multi-employer trust funds and public sector organizations.

Raising Comfort Levels
Although she believes there is exciting potential in alternatives, it’s going to take a fair amount of time and education before the majority of her institutional clients become more comfortable. However, comfort levels with real estate and infrastructure, in particular, are improving, she says, which are good introductory steps for sponsors to take toward the alternative investment sphere.

Right now, there is a sense that when a consultant brings up a non-traditional investment approach, “it’s only to increase their own revenue,” she says. However, if plan sponsors start hearing the benefits of alternatives from other internal sources, such as other sponsors and colleagues or at professional forums/conferences, real progress can be made. “It just needs to be more commonly talked about in the industry overall.” And that’s why ongoing discussion and educational events covering alternatives is so important, she says.

Gino Reina, vice-president and director of research for Segal Advisors, Inc., finds that discussion on alternatives has started to pick up again among sponsors, especially on the private equity side rather than the hedge fund side. While alternative and traditional investment strategies alike were hit hard during the credit crisis, he feels there is a growing amount of curiosity out there on “how to take advantage of what just happened and the potential rebound ahead, through alternatives.”

Right Position?
For example, in the wake of the credit crisis, corporate distress debt is a growing area of interest as private equity investors are stepping in instead of banks to provide loans to businesses in need at “very” attractive rates. Many are recognizing alternative investment opportunities like these, Reina says, but sponsors wonder if they’re in the right position to take part.

First of all, you have to ask yourself if you’re willing to take on a longer-term approach, Reina explains, since alternatives such as private equities are fairly illiquid. However, sponsors shouldn’t underestimate their ability to take on longer-term strategies, he warns.
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Arthritis usually brings to mind the joint pain associated with ‘wear and tear’ and aging. Although osteoarthritis is the most well known variant, there are many other types that affect both young and old such as fibromyalgia, scleroderma, Ehlers-Danlos syndrome (EDS), or Paget’s disease. In fact, nearly 4.5 million Canadians live with some form of arthritis and it is the leading cause of disability in Canada today. Health Canada estimates that by the year 2026 there will be six million Canadians with some form of arthritis.

Arthritis costs Canadians nearly $4.4 billion annually with $3.5 billion of this sum related to reduced productivity due to lost work days and short- and long-term disability. Long-term leave accounts for almost 80 per cent of related costs, with 70 per cent of these expenses incurred by individuals between the ages of 35 and 65.

All types of arthritis are characterized by pain. Unlike some ailments or injuries which only impede specific activities, many forms of arthritis can make almost any task incredibly difficult. The fine motor movements that comprise the day-to-day activities of the workplace – such as taking notes, typing, or using a telephone – could become excruciating, painful, or challenging.

Source Of Support

The workplace can also be a source of support if employers promote activity and healthy choices. Exercise can be easily incorporated into day-to-day routines with simple stretch breaks and repositioning. Walking stretches back and leg muscles and joints that can become stiff from sitting, so a lunchtime walking group could be formed with co-workers. Employees with arthritis should be encouraged to consult with a doctor or physiotherapist to create an exercise routine that’s right for them before participating in activities that are too strenuous.

It is important that those with arthritis know where to turn for help – people who are educated about their condition feel they have a better sense of control. A well-researched information package on exercise and joint pain is available through Arthritis Society locations across Canada. In Ontario, the society offers free occupational therapy, physical therapy, and social work services for those with a confirmed diagnosis. Distributing pamphlets, encouraging people to attend the pain management seminars, and including pertinent information in an office-wide email are all excellent ways to keep employees informed.

Another good idea is to host a lunch and learn with an invited representative from the Arthritis Society. If an entire workplace understands the emotional and physical aspects of arthritis, they will be able to effectively offer support and be sensitive to the needs of affected co-workers.

Working With Arthritis

Maintaining productivity while reducing risk is key regardless of whether an individual has osteoarthritis, rheumatoid arthritis, or lupus. The best way employers can support those affected is to provide an inclusive, understanding environment. By educating co-workers and encouraging open, frank dialogue that encourages sharing and support, employers can provide surroundings where those with arthritis feel accommodated and confident in their roles.

Aid And Support

As arthritis is a permanent diagnosis that has serious financial, emotional, and physical consequences, employers will likely be called on to assist and accommodate affected workers. The Arthritis Society offers a number of support options such as the self-management program, a series of classes that cover topics such as pain management, assistive devices, and how to speak to employers, doctors, and family members about the diagnosis. Arthritis sufferers who develop coping mechanisms can complete tasks effectively without strain and often need fewer sick days, meaning they can take advantage of their success rates.

Workers may also not be as tempted to downplay the severity of their pain for fear of jeopardizing their jobs. Honesty about their needs and concerns is encouraged as there are job accommodation strategies that acknowledge the condition, yet still allow employees to work. In many cases, tasks can be rebalanced to assist workers experiencing flare ups. Reducing the role of joint damage and increased pain, and ensuring optimum on-the-job safety, is pivotal to success.
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There is change afoot in the way strategic asset allocation is being set by Defined Benefit pension plans. Behind this change lies the growing awareness of liabilities and the rising importance of funded status in the asset allocation policy decision.

For an increasing number of plans, we find that asset allocation policy is not set and then left unchanged until the next review. Instead, it is tied from the outset to the funded status and automatically reduces the amount of risk that is taken as, and when, the funded status improves. This approach is known as liability-responsive asset allocation – LRAA.

This development is particularly relevant to mature plans, including closed and frozen plans. That’s because the asset allocation decision is quite different for a fully-funded mature plan than for one which is underfunded. Once a mature plan is fully funded, it will typically not take significant risk in its asset allocation policy. After all, the benefit that stands to be gained from taking that risk can be small, contributions cannot be reduced below zero, and it can be difficult (or tax-inefficient) to return surplus to the plan sponsor. The risk/return trade-off is stacked in favour of low-risk investment strategies for such a plan.

Mature Plan

However, a mature plan that is not fully funded does have an incentive to take risk. For it, an increased expected average return on the assets can help to close the funding gap without placing as great a burden on the plan sponsor, so extra risk can be worth taking (provided, of course, that it is accompanied by an expected higher return).

So a plan that is not fully funded may well choose to follow the type of asset allocation policy we have traditionally seen among pension plans – some fixed income, but a large slew of equities and possibly other types of return-seeking assets too. The big difference from the traditional situation, however, is that these plans only want to have that policy for as long as they need it (until they are fully-funded). They want to change the policy automatically when the situation changes, so LRAA makes a lot of sense for them.

The background to this approach is described in more detail in a paper ‘Liability-responsive asset allocation,’ published in April 2009. The response to the concept has been strong. In part, that is because it is intuitive. Risk should only be taken for a good reason and once the purpose in mind has been met, it no longer makes sense to take the risk.

Another reason for the strong interest to date is that LRAA represents a clear and disciplined path toward full funding and it defines the steps needed to preserve that position once you get there. It is a strategy clearly focused on the goal of full funding.

A typical LRAA schedule may look something like Chart 1.

### Typical LRAA Schedule

<table>
<thead>
<tr>
<th>Funded status</th>
<th>Equity or return-seeking allocation</th>
<th>Liability-matching fixed income allocation</th>
</tr>
</thead>
<tbody>
<tr>
<td>110%</td>
<td>20%</td>
<td>80%</td>
</tr>
<tr>
<td>100%</td>
<td>25%</td>
<td>75%</td>
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<tr>
<td>95%</td>
<td>30%</td>
<td>70%</td>
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<td>90%</td>
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<td>60%</td>
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<tr>
<td>80%</td>
<td>45%</td>
<td>55%</td>
</tr>
<tr>
<td>75% or less</td>
<td>50%</td>
<td>50%</td>
</tr>
</tbody>
</table>

Implementation

The implementation of an LRAA policy requires certain processes to be put in place, including regular monitoring of funded status and the required authorizations to act in response to changes. Implementation of an LRAA policy should also be integrated with any special catch-up contributions that may be paid by the plan sponsor. The payment of special contributions changes the funded status of the plan and also provides an opportunity to effect an asset allocation change incurring only one-way trading costs rather than the two-way costs that would be required to move to the new policy by selling one asset and buying another.

In summary, LRAA is proving to be an important development in the way that DB pension plans are going about defining their asset allocation policies.

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As of December 31, 2008
As of December 31, 2009
Global imbalances – large trade deficits in advanced economies offset by large trade surpluses in emerging economies – dominated policy discussions until early 2007, when the immediate threat of global financial collapse displaced this massive medium-term challenge. Today, after lying dormant for two years, the debate is reviving and appears to be more consequential than ever.

This paper details our view that exchange rates are the fulcrum on which global trade is balanced. Global imbalances will likely resurface unless China decides to allow sufficient renminbi (RMB) appreciation. We believe the sharp rebalancing seen during the past year is largely illusory and will reverse once temporary factors pass. We expect China to allow a gradual appreciation trend of the RMB within the next six months. This should lift other regional currencies with it and help attenuate global imbalances. It may also augment the returns in U.S. dollars of Asian local currency denominated investments.

Emerging Asia And The Safety Of Creditor Economics

Global imbalances are just a reflection of domestic imbalances within two of the world’s largest economies – the U.S. and China. China runs a trade surplus because it saves more than it needs to fund domestic investments. In contrast, the U.S. runs a trade deficit because it fails to save enough (Exhibit 1). Thus, domestic imbalances within China and the U.S. are mirror images that offset one another. More importantly, U.S. and Chinese domestic imbalances are also co-determinants, meaning imbalance in one economy encourages imbalance in the other – one cannot permanently improve without improvement in the other. There is an ongoing debate over the nature of co-determination. Are excess savings pulled in by profligate U.S. consumers who fail to save enough or are they pushed out by cautious Chinese authorities in search of a safe place to store newfound wealth?

The Push Argument

The rise in U.S. household spending (and the savings shortfall) is an endogenous response to the massive inflow of purchasing power ‘pushed out’ from emerging Asia. As the opening quote suggests, the root cause of

Global Imbalances

If we are wrong and China chooses to maintain its U.S. dollar peg, global imbalances should resurface. The U.S. government failed to take appropriate fiscal measures earlier in the decade in response to large capital inflows. Rather than conduct countercyclical fiscal policy as an offset – a standard IMF recommendation – the U.S. ran a more pro-cyclical fiscal policy. We are skeptical whether any lessons have been learned and believe the U.S. is subject to greater systemic vulnerabilities as a result. It is possible that global imbalances should culminate in a sudden stop of inflows of capital to the U.S. Given existing appreciation pressure, a diversified exposure to emerging Asian local currency bonds funded from U.S. dollar assets would serve as an extraordinarily cheap form of insurance against the threat of a U.S. dollar sudden stop.
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global imbalances is the rapid generation of wealth in emerging economies, especially Asia, on a scale never before witnessed. The push argument implies that the ultimate resolution of global imbalances is up to emerging Asia. Its decision whether to retain its newfound wealth or send it abroad for storage will affect asset prices and volatility in advanced economies tremendously over coming years. The push argument should not excuse highly indebted governments in the U.S., UK, and Europe from putting their fiscal houses in order – limiting government spending would be the best defence against fiscal houses in order the U.S., UK, and Europe from putting their fiscal houses in order – limiting government spending would be the best defence against future capital inflows. It does imply that the net creditor nations (emerging Asia) which generate the bulk of the new wealth drive the dynamic.

China’s exchange rate regime is the mechanism that pushes out its newfound wealth. An undervalued RMB facilitates China’s export-led growth strategy and is the impulse behind transmitting its excess savings to the U.S. The rest of emerging Asia must remain competitive with China and is following China’s lead on currency regime.

As China’s economy expands, the government must sequester an increasing amount each month in order to keep the RMB pegged at current levels. From 2000 to 2008, Chinese per capita GDP grew by roughly nine per cent per year, a cumulated gain of 100 per cent. In comparison, U.S. and European per capita GDP grew by roughly 1.5 per cent per year, a cumulative gain of just 10 per cent. So China’s per capita GDP expanded 10 times as much. Yet, the RMB gained just 20 per cent on the U.S. dollar. The situation is even more problematic for the eurozone. The RMB depreciated by 17 per cent against the euro.

Unless authorities permit significant RMB appreciation, we suspect imbalances will worsen as financial conditions normalize. The consequences of China’s decision would fall disproportionately on U.S. dollar based investors rather than the Chinese themselves, as Keynes recognized. He wrote that “the main burden of adjustment [falls chiefly] on the country which is in the debtor position on the international balance of payments.” In an ideal world, the main burden of adjustment would fall on the creditor economies (emerging Asia) to expand imports rather than the debtor economy (U.S.) to contract imports, thereby avoiding a deflationary/recessionary rebalancing.

Rational Decision
Emerging Asia’s decision to build large foreign currency reserves was a rational decision given economic realities. That decision was rewarded last year and the incentive to build even larger reserves has increased with the recent financial crisis. However, the consequences of this decision fall disproportionately on investors in debtor economies that are dependent on emerging Asia’s excess savings. Rogoff and Obstfeld (2009) state that “Chinese [exchange rate] policy is subsidizing the country’s export of current consumption power in the world asset markets, thereby keeping world real interest rates below their true equilibrium levels.” Should China decide to permit the RMB to appreciate, allowing consumers to realize more purchasing power, real yields would rise in the U.S. and other economies that had been recipients of these inflows, all else equal.

In 2005, Alan Greenspan rattled over the “conundrum” that longer-dated Treasury rates were not rising despite a rising Fed funds rate. The Economist magazine captured concerns well when it wrote, “The yield on 10-year bonds is currently lower than before the Fed started to lift interest rates in June 2004. America’s sovereignty over its monetary policy has, therefore, been eroded, with a given rise in short-term rates producing much less monetary tightening than in the past. To that extent, global monetary policy is increasingly being set in Beijing as well as in Washington.” That same year, Warnock and Warnock found that U.S. 10-year rates were about 90 basis points lower than they would have been had foreign capital inflows to the U.S. remained at historic averages. We are not saying that real interest rates need to rise anytime soon; quite the contrary since we believe foreign capital inflows will resume. However, it is valid to ask whether the U.S. housing bubble would have been so pronounced if longer-dated real interest rates hadn’t been driven below equilibrium levels. It would be more concerning if China chose not to appreciate or simply to appreciate insufficiently. In this event, we would expect elevated tail-risk and a possible (though improbable) chance of a U.S. dollar sudden stop.

‘Sudden Stop’
Coined by Guillermo Calvo, the term ‘sudden stop’ describes the situation where an over-reliance on foreign funding ends abruptly, often with tremendous damage to the debtor economy. This has been a repeated problem for emerging economies, but a rare problem for advanced economies. Then again, it was considered rare for advanced economies to suffer severe banking crises until last year.

Steady erosion in confidence could yet escalate into a stampede by foreign creditors to reduce dollar holdings. Identifiable triggers include breaching some critical level of the debt-to-GDP ratio or a perceived threat to the Federal Reserve’s independence. Under this scenario, the dollar would lose significant value, real yields would soar, and riskier asset prices would plunge. Investors could profit handsomely from a diversification into the currencies of net creditor nations, particularly emerging Asia. We find predictions of such a scenario alarmist and improbable. Still, China and other net creditor nations will eventually reach a saturation point where they no longer want to hold U.S. dollar assets. It is impossible to know in advance where that threshold will lie, but it draws nearer with every tick higher of America’s debt-to-GDP ratio.

We believe that reallocating funds toward fast growing, net creditor nations away from slow growing, net debtor nations will be an efficiency enhancing strategy in many cases. The Chinese economy casts a wide influence across the region and we would expect RMB appreciation to encourage broad-based appreciation across much of emerging Asia. A diversified exposure to local Asian bonds offers compelling risk-reward potential. Economists at the Petersen Institute estimate that the RMB requires a one-off appreciation of roughly 15 to 25 per cent to resolve existing imbalances. In addition, the RMB would have to appreciate by roughly seven per cent on an annual basis to keep pace with per capita GDP convergence. Substantial currency gains on top of underlying bond yields would then combine for potentially healthy total returns. While difficult to quantify, the position could add further value from its properties as a hedge against a U.S. dollar sudden stop.

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The economic downturn of the past year may be coming to an end, but things will not return to the way they were. The financial crisis put a sharp point on the challenges facing Defined Contribution plans and many industry stakeholders question whether DC plans can deliver adequate benefits. Understanding the lessons of 2008 and evolving in the face of them will be essential to future success.

**Things Are Different Now**
Most DC account balances will take a long time to recover from the 2008 stress test. A significant number of members close to retirement may never be able to achieve their pre-crisis projected benefit levels. There is greater public awareness and appreciation of the risks of DC plans than ever before.

Workers are likely to be even less prepared for retirement than before. According to Statistics Canada, although the rate of personal savings increased in 2008 versus the year before (to 4.7 per cent of disposable income at the end of 2008), it is still well below savings levels observed in the last recession when Canadians saved 13 per cent of disposable income. If significant numbers of older workers end up delaying their retirement, this could mean lack of opportunities for the next generation. Meanwhile, unemployment levels remain high and many employees may have to settle for lower paying jobs.

On the other hand, if the market rebounds and there is a sudden rush of pent-up retirements, this may precipitate talent shortages. Either way, companies will face challenges in managing talent.

In addition, DC plans across the globe are on the regulatory radar like never before. In Canada, the Department of Finance is soliciting input on enhancing the legislative framework for pension plans including default fund ‘safe harbours’ and moving from fiduciary to good faith standards. Some provinces (notably Alberta and B.C.) are proposing the introduction of personal accounts, positing that many employees choose not to join their employer’s DC plan because of the expense, administrative burdens, and risks associated with these plans.

**The Lessons Of 2008**
Through all the market turmoil, plan members seem to have remained largely inactive. Certainly, many inquired about their account balances and how the funds offered in their DC plans were performing, but few took action. This cannot be interpreted as a good thing. If members were truly motivated by a desire to stay the course and focus on the longer term, they should, in theory, have taken action to re-balance their assets towards riskier asset classes which were falling in value. Few took action and those who did mostly transferred out of risky asset classes (equities) and into lower risk, lower return investments (bonds, cash). By becoming even more risk averse, they likely locked in their losses and missed the significant equity market recovery in the first nine months of 2009.

A likely explanation for DC plan member inertia is that members were simply not engaged and failed to understand the impact of the market crisis. Many studies show that a significant proportion of DC plan members admit they do not have the knowledge or skill to plan for retirement.

Governments in many countries are now acknowledging that a lack of financial literacy among plan members is an issue. In Canada, for example, the Department of Finance has launched a campaign to educate members about their pension plans, and the government is considering introducing mandatory financial literacy programs for all future members. The goal is to ensure that members are better equipped to make informed decisions about their retirement savings.

**Wasn’t DC Supposed To Be Easier Than DB?**

**By: Oma Sharma**

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eracy may be the real problem. Plan sponsors too, are coming to the realization that members’ lack of understanding is a key challenge. In late 2008, a Mercer pulse survey of plan sponsors revealed that taking steps to improve member understanding of their investment choices, options, and long-term savings objectives, and a review of the overall DC fund line-up to confirm suitable diversification of the fund options, were the top two actions plan sponsors were planning to take in response to the market crisis.

Yet, the way plan sponsors define their role in the context of their DC plans is revealing. In Mercer’s 2009 Global Defined Contribution Survey, the majority of respondents see themselves as facilitating retirement savings, rather than aiming to ensure that DC plan members have adequate retirement income.

Clearly, if plan sponsors see themselves as facilitators, the onus shifts to plan members to ensure they are saving enough and supplementing the DC plan to reach their retirement savings goals. Plan sponsors should still be motivated to play a key role in providing access to tools and education, and ensuring that members are as prepared as possible to make informed retirement saving and investment decisions. After all, if DC plan members retire with insufficient retirement income, governments will need to step in to supplement their incomes, and higher taxes are likely.

Taking Action On All Fronts

Action on several fronts will address the weaknesses that have emerged globally with DC plans. Retirement systems around the world are under review and gearing up for significant structural changes. Some themes are emerging:

- Increased regulatory oversight of DC plans including more legislation to protect plan members and to encourage plan sponsors to take action to improve DC plan outcomes and regulatory initiatives to improve financial literacy throughout the population
- Greater incorporation of behavioural finance concepts into the design and administration of DC plans
- Increased education and support for DC plan members making the transition into retirement, including new investment products

Governments across the world have acknowledged that employees are not saving enough for retirement. In several countries, legislation will increase the level of retirement savings through the introduction of personal accounts. In the UK, such legislation will take effect in 2012 and will include auto-enrollment and required employee and employer contributions. In Canada, several provinces are considering the introduction of personal accounts. These types of initiatives will be complemented by regulatory initiatives to improve financial literacy. For instance, the province of Ontario recently announced plans to introduce financial literacy into the school curriculum.

On the topic of member behaviour, there is now a significant body of academic research supporting the contention that DC plan members do not make rational decisions and, instead, repeatedly make judgmental errors which negatively affect DC plan outcomes. For example, one common error is inertia, or the failure to make a decision or change it as personal circumstances change. Another is hindsight bias, which is the tendency to select the funds that have been performing well most recently. This can lead to selling low and buying high. The idea behind this research is that if these behavioural biases are understood to exist, then they should be exploited to the benefit of DC plan members.

Behavioural Biases Commonly Observed

Behavioural finance concepts are being applied to DC plans in a number of ways such as the inclusion of target date funds in DC fund line-ups and their use as default investment options for members who do not provide investment instructions. While they are not without challenges, target date funds can help overcome inertia, hindsight bias, performance chasing, and many other behavioural biases commonly observed in DC plans that can result in poor DC plan outcomes.

The addition of automatic features is one way that plan sponsors can address inadequate participation by DC plan members. For instance, studies show that if an employee does not join the DC plan initially, he or she is unlikely to join later. Auto-enrollment is one possible remedy. Similarly, automatic escalation of contributions can help overcome the tendency of some members to choose a low level of contributions initially and not revisit their contribution elections as their salary increases.

As well, on the one hand, plan sponsors are increasingly adopting workarounds like these to help passive and non-engaged members to achieve a better result from the company DC plan. On the other hand, plan sponsors say they want members to understand how to save enough to reach their own retirement goals. These are two different, but complementary, objectives and it will be interesting to see if plan sponsors can integrate both approaches as they set out to meet the needs of a diverse plan member audience. Engaging and educating DC plan members will need to be based on targeted communication strategies that are linked to actual member behaviour in the DC plan and benefit adequacy measures.

DC investment structures are also in line for significant change, expansion, and customization. For example, the design of target date funds is already evolving to include asset classes — such as alternative investments and REITS — as a means of reducing risk through improved diversification. Further evolution is likely.

New retirement income products are also coming on stream to help members to manage the risk that they will outlive their retirement savings. One such product is guaranteed minimum withdrawal benefit funds, already available through at least two major Canadian insurers. In a 2009 PIMCO DC consulting survey, more than 75 per cent of respondents indicated that they have begun thinking about adding guaranteed products to their DC fund line-ups. Looking forward, DC plan members will eventually be able to choose from a variety of post-retirement products with institutional pricing and DC plans may further evolve to provide a portion of DC plan benefits through a lifetime income vehicle, unless the plan member opts out.

Last but not least, there is likely to be renewed regulatory focus on fee disclosure requirements and better guidance provided on the provision of investment advice to DC plan members.

As the DC market evolves and becomes more complex, plan sponsors will have to invest significant energy into keeping abreast of new products and solutions and changing best practices in DC plan design and management. The future is now — and the success of DC plans will depend on adapting to an ever-changing reality. Did anyone ever really believe that DC was going to be easier than DB?

Oma Sharma is national partner and leader of Mercer’s DC investment consulting business in Canada (oma.sharma@mercer.com).
A growing awareness of the role of health and wellness information and resources in the daily lives of Canadians. Retail outlets often now showcase a health and wellness section that contains products that were previously located in other sections of the store. This marketing trend has also been witnessed online.

So, what has this heightened awareness of health and wellness issues meant to Canadian employers, employees, and the carriers that provide group benefit programs?

Well, for insurers, it has meant a lot more than repackaging and reshuffling of existing products and services. It has meant a shift in mindset from only providing timely and efficient claims payment services to becoming a source for reliable and relevant resources and information that can help plan members lead healthier, more balanced lives.

As insurers constantly look for ways and avenues to respond in providing benefit management solutions to employers, they realized it was not just trips to retailers that was causing a heightened awareness of health and wellness among the general public. Every day, millions of Canadians go online to locate general health resources and to find information about specific workplace concerns.

In fact, a January 2009 Ipsos Reid study revealed that 70 per cent of online Canadians visited a health-care website in the previous year. This confirms the opportunity to add cost effective value to group benefit plans by including reliable and accessible online health and wellness resources for both plan members and administrators. When these resources are made available by insurance carriers, plan members know that they are getting credible, validated information on which to base their health and lifestyle decisions.

We Are In A Period Of Change. The workforce is changing. According to the 2006 Canadian Census, the median age of the Canadian worker surpassed 40 years old for the first time. While the increase from a median age of 39.5 in 2001 to 41.2 in five years may not sound like a lot, it means that employees will continue to have changing health and lifestyle concerns, meaning that employers will face a different set of workplace productivity and absenteeism issues.

The value of group benefits to the workforce is also changing. The 2009 sanofi-aventis Healthcare Survey revealed that more than half the employees surveyed said they would choose their benefit plan over an additional cash compensation of $15,000 per year. This provides Canadian employers with a unique opportunity to provide health and wellness as part of their benefit plans to enhance employee health, retention, and productivity.

Health and stress-related absences cost Canadian employers billions of dollars a year. Factor in things such as the changing and
aging workforce and the pace of the workplace and daily lives and it clearly indicates absences can increase and impact an organization’s productivity and profitability.

According to a 2008 Buck Consultants survey of worldwide organizations which included 50 Canadian employers, the top domestic objectives for implementing wellness programs were to attract and retain employees as well as to improve worker productivity and morale.

Regardless of the size or sector or demographics of a business or organization, these objectives apply and complement the overall goals of insurance carriers in providing health and wellness resources and information as part of benefit plans.

Zero Dollars

The Buck Consultants survey also showed that employers (worldwide) spent only an average of $130 per employee in health promotion and wellness initiatives, and that this annual per employee cost ranged widely, from zero dollars to more than $500.

What this shows is that the implementation and promotion of workplace health and wellness initiatives does not have to be expensive or complicated.

It may be as simple as organizing a walking clubs or offering nutrition events and seminars.

With a changing workforce comes a different set of concerns. For example, cancer is projected to become the leading cause of death worldwide this year and is now the number one physical cause of long-term disability in the workplace.

On an emotional level, issues such as dealing with aging loved ones and changing financial and other life concerns can also impact an employee’s ability to be present and productive at work.

This is why insurance carriers have furthered their commitment to providing services such as employee assistance plans, mental health tools, second medical opinion services, and cancer and other health support programs.

Cost Of Benefits

Integrating these types of services into benefit programs further fits the approach that providing employee health and wellness solutions can help employers manage the cost of benefits.

The advantage of these types of services is that they support employees when they need it the most. That is because, despite the quality and accessibility of preventative and educational health and wellness resources and initiatives, there are times when specific health and life events require direct access to professional support, expertise, and guidance.

These services can complement disability and health offerings and further encourage timely and successful returns to work by supporting employees in managing and recovering from specific, life altering situations.

As Canadians continue to be more conscious about their health, it is important that insurance carriers and their employers continue to provide effective, accessible, and reliable health and wellness information, resources, and initiatives as part of employment and group benefit plans.

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In the U.S. and Canada, the employer-sponsored retirement plan has been the centrepiece of the tier II retirement system. And it has been evolving quickly – faster in the U.S. and UK than in Canada – to one that is focused less on providing income through Defined Benefit plans to one providing wealth through Defined Contribution plans. Today, far more retirement wealth in the U.S. exists in the DC system than the DB system. At year-end 2008, there were US$1.9 trillion in DB assets versus nearly US$2.7 trillion in DC assets.

This evolution has been slower in Canada. In 2006, of private sector Canadian employees with a pension plan, 73 per cent had DB plan coverage. But, that’s still only 17 per cent of the Canadian private sector workforce.

Evolving Quickly
The voluntary employer-based system has never had universal coverage and now we find that we’re evolving quickly from an income-based to an investment-based model. We have to ask ourselves: is this the best way to ensure a financially secure retirement for millions of baby boomers? Can we design better retirement models that go beyond today’s DB and DC system?

The Society of Actuaries has been leading an effort to rethink retirement systems with its ‘Retirement 20/20 initiative.’ ‘Retirement 20/20’ has considered the needs of the retirement system by looking at the needs, risks, and roles of key stakeholders – the individuals who will retire, society (future taxpayers), employers, and markets. We have done this by considering how best to align roles with skills for those stakeholders and looked at the role of signals, self-adjusting mechanisms, market hedging instruments, and other tools. In that process, we’ve realized that the structure of the tier II retirement system comes down to whether retirement wealth is looked at as insurance or an investment and what the roles of choice and default should be in the system.

Insurance Or Investment?
Society (future taxpayers) wants a retirement system that provides secure income for the greatest number of individuals at the lowest cost to future taxpayers. One disadvantage of an investment-based system is it can produce a wide distribution of results. Some people will save a lot and invest wisely, while others will either not save enough, make poor investment decisions, retire before they expect (and with fewer assets than they thought), or simply experience bad luck in the capital markets. Those folks who do poorly may turn to the government for additional assistance. The government will then be faced with increasing taxation of workers and may have to consider raising taxes on the retirement assets of those retirees who were wiser and more fortunate.

A second concern with an investment-based system is that people see their retirement assets as personal wealth to be bequeathed to children. However, preservation of wealth does not allow individuals to take advantage of risk pooling mechanisms – primarily annuitization – that will derive the most income from that wealth. And individuals – and society – lose when individuals don’t take advantage of risk pooling. After all, should those individuals outlive their assets, it is society (future taxpayers) that will pay the price.

So, society clearly does better with insurance because insurance protects future taxpayers against the risk of retirees outliving their assets and demanding higher benefits from CPP/QPP and other social programs.

However, what about individuals? Don’t most individuals prefer DC plans because they create investment wealth?

Surveys in the U.S. have shown that individuals like their DC plans. Yet, a November 2008 survey by the U.S. National Institute on Retirement Security found that 44 per cent of DC plan participants were not confident they’d have enough money in their DC plan for retirement.

Insurance Protection
While individuals may prefer investment wealth, individuals need the insurance protection against outliving their assets. And, if given the choice, individuals won’t voluntarily seek insurance protection. (In the U.S., most individuals keep their DC assets as a single sum and draw from it as needed).
There are many reasons why individuals won’t annuitize. First, they underestimate their own life expectancy. Then, even when they do know their life expectancy, they often don’t understand they have a 50 per cent chance of outliving their life expectancy. Individuals also confuse drawdown strategies (removing four per cent per year from an account) with annuitization. Some think both strategies provide lifetime income, but don’t realize the drawdown strategy won’t protect them in the case of market downturns or living to 95. And finally, we also know from focus groups that individuals tend to have planning horizons of only a few years.

What about markets and employers? Do they prefer investment or insurance? In theory, both employer and markets should be agnostic. Either system should allow employers to attract, retain, and retire employees and markets should not care if investments are made through insurance vehicles or investment vehicles.

However, we’ve seen, again particularly in the U.S. regulatory environment, that employers today clearly prefer to sponsor the investment model (DC) over the insurance model (DB). Based on how we’ve structured our retirement system, the DC model puts less risk, particularly financial risk, on the employer as sponsor than the DB model. In the insurance (DB) model, the employer faces the risks of bad outcomes, including interest rate movements, equity market declines, unexpected inflation, and mortality improvements (individuals living longer than expected). An employer-sponsored pension plan is, for all purposes, an insurance subsidiary – albeit one that only provides annuities to its employees. Add to this the complexities of funding requirements, market valuations, benefits costs, and fiduciary responsibilities, and many employers are unable (or unwilling) to sponsor DB plans.

Additionally, in Canada, there are solvency funding requirements and ownership of surplus that can further complicate the administration of a DB plan.

In the investment model (the DC plan), the employer’s contribution to the retirement system is essentially the same as cash compensation. All risk – investment, interest rate, inflation, mortality – is borne by the individuals with their DC account. While the employer still has administrative and fiduciary responsibilities, these are significantly less than with a DB plan. From a risk management perspective, a DC plan is a far better deal for employers than a DB plan.

**Choice Or Default?**

The issue of choice in the system has several dimensions:

- How much choice is included in the system?
- How much is default?
- How do you frame the choices you’re asking stakeholders to make?
- Do you encourage or discourage certain choices?
- Who pays when bad choices are made?

Choice, within an insurance based system, is costly. Actuarially, pooling individuals with no opt-out option maximizes the benefits of pooling and gives everyone the same benefit and minimizes administrative costs. But, limiting choice doesn’t allow individuals to customize for their situation. How do the stakeholders view choice?

Society is indifferent between choice and default, but to the extent that choice increases the cost of the system, society may prefer defaults. Choice can increase cost by increasing the baseline cost of the system through anti-selection and increased administrative costs. As noted earlier, choice can increase the disparity in retirement wealth levels, forcing increased taxation of wealthier retirees to pay for the poor choices – or bad luck – of less wealthy retirees.

Individuals say they want choice, but tend to make poor choices. They don’t understand the risks they face in retirement and behavioural economists have shown that individuals tend to make poor choices, even with increased education. A system purely driven by individual choice is likely to fail. We’ve already seen that DC plans work better in accumulating assets with auto-enrolment and default investment funds.

Employers are largely indifferent to the degree of choice individuals have, but they have strong preferences for their own choices. We’ve argued that employers ought to have more choice with regards to the role they play in the retirement system. Today, they have few choices – to sponsor or not to sponsor a plan. What if employers could also offer their employees access to the system without having to bear any of the risk or responsibility of plan sponsorship? The employer role could be expanded to allow the employer to offer education, access to a plan, funding toward a third-party’s plan, or sponsoring and funding their own plan. One criticism of the employer-based tier II system is many employers, particularly small employers, have not been able to sponsor plans. In Canada in 2006, of the 4.6 million workers in pension plans, 58 per cent were in plans with more than 10,000 active members and only four per cent were in plans with fewer than 100 members. Opening up choice for the employers might expand access to the retirement system for employees of smaller employers.

Capital markets like choice because it drives innovation. But, choice, for an individual, can lead to poor decisions. There are many sophisticated investment products available that provide different combinations of investment risk and longevity protection. This variety can make it difficult for consumers to compare prices and make informed decisions. Some standardization of products would allow consumers to better compare cost and quality of providers for a limited range of products, while allowing insurers and other financial products companies the ability to continue to innovate.

**Risky Business**

Retirement is risky business. And since actuaries are the original risk managers, our goal is to design the best possible retirement system to meet the financial risks most of us may face in retirement. To date, we’ve developed our goals – what a retirement system needs to accomplish. Currently, the ‘Retirement 20/20’ initiative is looking for new models.

Emily Kessler is a senior fellow, intellectual capital, with the Society of Actuaries (ekessler@soa.org).

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**Toronto Chapter Of ISCEBS Elects New President**

(Left to Right) Wayne Murphy, CEBS (The PBAS Group) hands over the reins to Neil Morrison, CEBS (Equitable Life). Morrison was elected president of the Toronto Chapter of the International Society of Certified Employee Benefits Specialists (ISCEBS) at the chapter’s recent annual general meeting. Murphy will serve on the board as an officer and past president.
Since the 2005 removal of foreign content restrictions, Canadian pension plans have increasingly invested abroad to exploit the greater investment opportunities available. In the process, sponsors have had to decide whether to hedge the currency risk that these new opportunities introduce. During the past six years, the Canadian dollar has been very volatile reaching parity with the U.S. dollar. Depending on their particular circumstances, some have chosen to hedge, others have not. In some cases, however, investors have not been fully aware of the complexities of the hedging process and have formed incorrect expectations about what it can achieve.

It is understandable why such misconceptions exist. Many investors are relatively new to currency hedging and the industry often presents a simplistic portrayal of the practice. Misleading terms like ‘currency neutral’ are used, implying that currency risk can be completely neutralized, when this is not the case. Appropriate tools, such as hedged benchmarks, are only now becoming widely used and knowledge of their existence remains spotty.

What is required is a clear and comprehensive description of the costs and limitations of currency hedging, the factors that affect hedged performance, and the performance measures that should be used. This way, the context of potential gains and losses in hedged investments can be better understood and a more accurate judgment rendered.

The Misconception: A Perfect Hedge

Foreign market returns consist of the underlying market returns plus the impact from translating those returns into Canadian dollars (the currency risk). The misconception, for some, is that the hedging process removes the currency risk from the equation so that the returns of their hedged market investments will equate to the local market (the foreign index) return.

In actuality, the local market return is but one component of the total hedged return and the hedged return can be affected dramatically – for good or ill – by other factors. These include the interest rate differential, which represents the cost of hedging, and the residual currency effect, which reflects the limitations, or imperfections, of the process.

In certain market conditions, these factors can combine to produce significant short-term losses. Fortunately, such results are the exception, but we have experienced exceptional times of late and some hedged investments have been dramatically affected.

The Interest Rate Differential

First, it is important to understand that there is always a cost for hedging. Though some might suspect that transaction and management fees are primary contributors to the cost, in fact they add little. Typically, the bid/ask spread and management fees add less than 0.15 per cent to the costs.

So, in general, when we refer to the cost of hedging, it is the interest rate differential that is being addressed. This refers to the difference between the interest rates of the currency pair and it affects the pricing of forward contracts used in hedging. The forward settlement takes the current foreign exchange (FX) rate and adjusts for the difference in the short-term interest rates. Depending on the countries involved, this difference can be positive or negative.

Typically, the range is +/-2 per cent. When Canadian interest rates are higher, you are compensated for hedging the currency, and when our rates are lower, the reverse will be true. For example, if interest rates are three per cent in Canada and two per cent in the U.S., then Canadian investors hedging their U.S. equity portfolios back into Canadian will receive a one per cent rebate on the prevailing FX rate.

Historically, there have been times when the interest rate difference has been large and it has had a major impact on hedged returns. Recently, however, interest rates – both Canadian and foreign – have been at historic lows, so the interest rate differential has had a negligible effect. This has not been the case, unfortunately, with the residual currency effect.
Residual Currency Effect

The residual currency effect reflects the reality of imperfect hedging. Regardless of how frequently a hedge manager rebalances a portfolio, it is impossible to be perfectly hedged at all times since the market is continually in flux. There is always a time lag between the movement of the market and the rebalancing, and that lag will result in a certain amount of the portfolio being exposed to currency risk.

For example, say $100 invested in foreign markets, fully hedged (a 100 per cent hedge), increases in value to $105. That $5 gain – the residual amount – will remain unhedged and exposed to currency fluctuations until the next monthly or quarterly rebalancing occurs. Typically, the difference this exposure creates is not very big and it vanishes upon rebalancing. However, times have been far from typical. During periods of sharp market movements, the level of variance may be greater and this is what has occurred most recently.

The Reality: A Worst-case Scenario

Since the financial crisis began, global markets and currencies have experienced extreme volatility. When currency fluctuations are dramatic, and markets move in the opposite direction from their home currency, the impact on the effectiveness of currency hedging efforts will be more pronounced.

Exhibit A illustrates the severity of this impact during the worse period of the financial crisis. The blue bars show the difference between hedged and unhedged returns for the S&P 500. In less volatile times – early in the chart – the hedged return is almost indistinguishable from the local return. This is the norm. As the crisis hits, however, underlying markets. This combination had a major impact on performance. In 2008, this is exactly what happened and the fully hedged Canadian investors lost 2.66 per cent relative to the local market return which gained 21.86 per cent.

For investors who were anticipating the return of the local market, learning that their hedged returns (over the last six years) were ceased less (-7.03 per cent) an unexpected and unpleasant surprise. This outcome was better than the alternative of losing -21.59 per cent due to the translation effect had investors chosen to remain unhedged.

A More Realistic Appraisal

Understanding the costs and limitations of hedging is one step towards making good judgments on the performance of hedged investments. Another is to use the appropriate tools to measure the effectiveness of the hedging in place.

If investors have been surprised by their hedged returns, it may be that they were not using the correct benchmark to measure their performance. Some investors, familiar with daily exchange or spot rates, may use these to envision what their hedged returns should look like, though this unrealistically disconnects the hedging from the underlying market. Others turn to the foreign index as their benchmark, perhaps unaware of the availability of the hedged counterpart. Fortunately, industry use of hedged benchmarks for measuring currency hedging programs is growing and becoming a best practice. Typically, these benchmarks rebalance on a monthly basis.

Investor expectations can be managed much more effectively by using a hedged benchmark that combines the effect of the currency hedge as well as the performance of the underlying equities to measure their performance. A comparison of, for example, the S&P 500 local and hedged returns will show that tracking error is usually minimal, but there are rare times when it will be significant. A hedged benchmark incorporates the true cost of hedging and accurately measures the effectiveness of currency mandates.

An Imperfect Process

Currency risk can be mitigated by hedging, but it can never be fully eliminated. This does not mean that currency hedging is a pointless endeavour; it may be useful depending on your particular situation. And, of course, depending on market conditions, these mitigating factors may have positive, rather than negative, effects on your returns.

Again, in most cases, the differences between hedged and the local market return will be minimal. However, the recent financial crisis created a perfect storm where the impact of the rebalancing lag on returns was greatly magnified. It is important to understand the full context of how and why those losses occurred. Investors who remain unaware may find themselves misjudging their manager or hedging program by misattributing performance and then taking action based on this serious misunderstanding.

If you hedge, make sure you are fully aware of the possibilities. Being well-informed will ensure that your expectations are realistic, your benchmarks correct, and your judgments sound.

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Healthcare strategies and current and proposed legislation affecting plans will be among the areas covered at the International Foundation of Employee Benefit Plans' ‘Canadian Legal & Legislative Update.’ It takes place April 29 and 30 in Toronto, ON. Visit: http://www.ifebp.org/Education/1060canupdate.htm

The International Foundation of Employee Benefit Plans will bring together authoritative global professionals at its ‘Certificate in Global Benefits Management.’ Topics to be discussed include cross-cultural/diversity benefit issues relating to international assignments and international pooling/offshore retirement plans. It takes place May 3 to 7 in New York, NY. Visit: www.ifebp.org

‘Partners in Prevention 2010: Ontario Health & Safety Conference & Trade Show’ will open with two pre-conference events on May 3 including the ‘Small Business Forum 2010’ which will help small businesses discover how to improve the profitability and sustainability of their business. The conference runs May 4 and 5 in Mississauga, ON, and features sessions and workshops on healthy workplaces, workplace violence, ergonomics, major hazards, legislation, and more. Visit: www.PartnersinPreventionOntario.com

The 8th Annual Employer Forum on Employee Health will look at creating an effective and targeted employee health management strategy through benefits design and innovative health and wellness programs. ‘Targeting Your Strategy for Maximum Impact’ will take place May 13 and 14 in Ingersoll, ON. The Connex Health event will feature experts who have developed targeted interventions and who will explain how to align business strategy to employee health and wellness. Visit: www.connexhc.com

Presentations from George Akerlof, 2001 Nobel Laureate in Economics, and Mark Anson, president and executive director at Nuveen Investments, Inc., will be among the 27 sessions at the ‘CFA Institute Annual Conference.’ Workshop sessions will cover topics such as equity analysis, fixed income analysis, portfolio management, ethics, alternative investments, firm management, and private wealth management. It takes place May 16 to 19 in Boston, MA. Visit: http://www.cfainstitute.org

‘Sharing Innovations: Developments in Retirement Plan Design and Communications’ will be the theme of the ACPM Ontario Regional Council’s ‘Spring 2010 Session.’ Featured speakers include Ian Genno, Towers Watson; Marcia McDougall, Hewitt Associates; and Neil Murphy, Ontario Teachers’ Pension Plan Board. It takes place May 18 in Toronto, ON. Visit http://www.acpm.com

Researchers, policy-makers, and leaders in occupational health from across the country will be participating in the Canadian Association for Research on Work and Health (CARWH) conference. The theme for the conference is ‘Worker Health in a Changing World of Work.’ Opening the event is Katherine Lippel, Canada research chair in occupational health and safety law at the University of Ottawa, who will address the invisibility of the health consequences of precarious employment. It takes place in Toronto, ON, on May 28 and 29. Visit: http://carwh2020.iwh.on.ca
ow has the recent financial turmoil affected those long-term performance graphs that chart the superior performance of equities over decades and decades? Elroy Dimson, Paul Marsh, and Mike Staunton, of the London Business School, answer this question with some recent data to update their 2001 book "Triumph of the Optimists" which looked at 100 years of stock data of all kinds.

Are stocks, especially U.S. stocks, still the place to be? Their data shows the following:

**The U.S. Is Still The Dominant Equity Market**

In 1899, half of the world’s stock markets (as measured by market capitalization) were accounted for by two countries – the United Kingdom at 31 per cent of the world’s market cap and the United States at 19 per cent. One hundred years later, the United States was the largest market (46 per cent) with Japan at 13 per cent and the United Kingdom at eight per cent. By the end of 2009, the U.S. was still the largest, now at 41 per cent, with both the UK and Japan at eight per cent each.

**Emerging Market**

Growth, especially recently, came from the emerging market category which was only five per cent in 1899, eight per cent 100 years later, and now (2009) about 15 per cent.

**Emerging Market Equities Have Still Performed**

Emerging market stocks slightly underperformed over the longest 34-year period that the authors could determine (an annualized return of 9.5 per cent compared to the developed world markets return of 10.6 per cent). Overall, emerging markets underperformed in the 1976-1987 period, but outperformed the market averages since then. This outperformance is highly end-date sensitive. At the end of 1998, emerging markets were behind their developed parties, had pulled ahead by 2002, had five more years of above average performance, were still ahead by 2008 though at a smaller gap, and then pulled ahead last year. Individual emerging markets are also, on average, still much riskier than individual developed markets, though their relative risk has continued to fall over time.

What about the non-correlation benefits of holding emerging market equities in a portfolio? Correlations between pairs of emerging markets have risen sharply over the past 30 years, from close to zero (no correlation at all) to about 0.55 today. The correlation between emerging markets and developed markets has also risen over time, with the sharpest jump since 2000. Today’s estimate of 0.91 is the highest it has ever been, but, of course, any correlation of less than one indicates that there are potential benefits to the overall portfolio of holding some emerging market equities.

**It Still Pays to Invest In Equities … Over The Long Term**

Investors can still benefit from the equity risk premium. Since 1900, the authors estimate that global equity markets have had real returns of 5.4 per cent annually for equities, compared to 1.7 per cent for bonds, and 0.9 per cent for U.S. T-bills. Volatility (standard deviation) was highest for equities at 17.8 per cent per year, compared to 10.4 per cent for bonds and 4.7 per cent for U.S. T-bills.

**Equity Risk Premium**

While this difference between bond and equity returns (the equity risk premium) was 3.7 per cent for the long term, it shrank to only 0.9 per cent for the period from 1960 to 2009. Over more recent periods, it paid to hold bonds instead of stocks, as the equity risk premium for 1985-2009 was a -0.9 per cent and for the last decade of 2000-2009, it was also negative at -6.6 per cent.

The returns of U.S. markets were better than world averages and the authors caution about placing too much reliance on the excellent past performance of U.S. stocks. Since 1900, the U.S. market had real returns of 6.2 per cent annually for equities, compared to 1.9 per cent for bonds and 0.9 per cent for U.S. T-bills. The equity risk premium of 4.2 per cent for the 1900-2009 period, shrank to 0.7 per cent for the 1985-2009 period, and declined to -7.4 per cent during 2000-2009. Canada’s returns fell between U.S. and world averages. Since 1900, the Canadian market has had real returns of 5.8 per cent annually for equities, compared to two per cent for bonds. The equity risk premium of 3.7 per cent for the long term, shrank most recently, but far less than for U.S. and world markets, only dropping to -2.0 per cent for the 2000-2009 period.
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