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Benefits and Pensions Monitor – June 2010
Customized **fixed income** solutions

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Kudos to the Organisation for Economic Co-operation and Development (OECD) for realizing that market downturns can have an impact on the retirement savings of Defined Contribution plan members.

Its working paper, ‘Assessing Default Investment Strategies in Defined Contribution Pension Plans,’ looks at the specific glide paths of lifecycle strategies to determine their impact on retirement income outcomes.

It found that strategies with excessively low (less than 10 per cent) or high (more than 80 per cent) exposure to equities are generally inefficient compared to lifecycle strategies that feature exposure to risky assets before switching to safer fixed income products in the last decade of accumulation. As a result, it says well-designed lifecycle strategies can “help protect pension benefits from extreme negative outcomes...”

And while it is hard to disagree with that, the real management outperforms lay management. Yet, over the past decade, some of our best managers of Defined Benefit pension plans underperformed when markets go down. So isn’t it reasonable to accept the premise that lifecycle funds will suffer too?

Remember too, one ignored advantage of the DC plan is that there are no limits on surplus and no contribution holidays. Whatever is in the plan stays in the plan, earning more.

And that is why some of these concerns about benefit adequacy are kind of ridiculous. The first problem with benefit inadequacy is not switching assets from riskier assets to safe ones as plan members age. It is not about market collapses. It is about members not putting enough into their plans, as a recent report from TD Economics points out.

And, to compound matters, we have governments talking pension reform and retirement benefits adequacy at the same time as they allow withdrawals from

Can You Protect Against Market Downturns?

question is ‘how can any DC default strategy protect members from market downturns, especially those as severe as we saw in early 2009?’

The fundamental flaw is that with DC, when you retire can be as important as anything else. If you retire when markets are high, you do well. If you retire when they are down, you don’t do as well. Plus, even if you are in a default plan which has a glide path where equities are turned into bonds as you get nearer to retirement, the outcome of your plan at retirement will be influenced by market prices as you convert from equity to fixed income.

However, there are other considerations.

To start, there is growing concern that the glide path in most lifecycle funds may no longer be relevant. People are living longer, they are living healthier, and the cost of medical care and drugs is escalating. The increased return potential from equities may be needed well into retirement.

Lay Management

In their favour, default funds are professionally managed and the record shows that professional
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Green Shield
Sherry Peister is chair of the board of directors of Green Shield Canada. She became a member of the board in 1997 and has served as vice-chair since 2007. She is a consultant pharmacist involved in pharmacy practice enhancement and has an active practice in an independent community pharmacy.

bfinance
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Barclays
Michael Wilson is chairman and Bruce Rothney is head of Barclays Capital, Canada. Wilson will be responsible for managing its client relationships in Canada. Most recently, he was ambassador of Canada to the United States from 2006 to 2009. Rothney is responsible for broadening the Canadian franchise and the management of various business lines in the region. Most recently, he was deputy chairman of RBC Capital Markets.

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Dunhelm
Jim Clark has formed Dunhelm Consulting, a consulting services firm providing communications, reputational review, product development, and market research to institutional investment managers. He has more than 20 years of experience in the Canadian institutional market.

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Guardian
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Sun Life
Kathy Seliga is vice-president, actuarial, responsible for the strategic direction of the actuarial aspects of the group benefits business at Sun Life Financial. She has more than 15 years at the company. Greg Davis is vice-president, finance, for group benefits which he joined in 2007. He is responsible for the accounting and financial aspects of the group benefits business.
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Savings Could Hit 12 Per Cent

Based on Ontario’s announced changes to what all Ontarians will pay for generic drugs, estimates indicate that employers will see the Ontario portion of their prescription drug plan costs drop by approximately nine per cent to 12 per cent within two years, absent other market changes, says Hewitt’s ‘Health Care Check-Up eBulletin.’ There are a number of key steps employers should take immediately to ensure the savings aren’t eroded by other market factors. For example, the exact savings for each employer will depend on the generic utilization under the plan. For plans that already use design features such as mandatory generics and managed formularies, the savings from these changes will be greater. For employers who have considered the implementation of managed drug programs in the past, the potential savings from these features are now substantially increased. All employers should re-assess the use of drug management plan design features to ensure they are maximizing the savings now available through lower-cost generic drugs.

DC Members Need Default Strategies

Defined Contribution members risk dramatic fluctuations in retirement income unless they adopt default strategies that reduce the impact of market shocks, says an Organisation for Economic Co-operation and Development working paper. It says similar strategies should become the default for individuals who make no active investment choice. ‘Assessing Default Investment Strategies in Defined Contribution Pension Plans’ found strategies with low exposure to equities (less than 10 per cent) and those with high exposure to equities (more than 80 per cent) generally proved inefficient. However, lifecycle strategies that have constant exposure to risky assets during most of the accumulation period, switching to bonds in the last decade before retirement, produced adequate results, providing higher expected benefits for a given level of risk than other lifecycle strategies. The OECD paper also found lifecycle strategies perform better than fixed portfolio strategies when the contribution period is short, for example 20 years. Longer contribution periods reduce the benefit impact of lifecycle strategies.

Due Diligence Focuses On Fraud

Too much diligence into hedge funds is now focused on detecting fraud, says Christopher Addy, president and chief executive officer at Castle Hall Alternatives. Speaking at the CIBC Mellon Presentation Series, ‘Hedge fund investing today,’ he said since the Madoff affair, most due diligence is aimed at preventing funds from investing in another one of these schemes. However, frauds happen in other areas of financial markets and will likely happen again, he said. The best measure to avoid it is by carrying out proper due diligence into, for example, the quality of the managers.

Growth Opportunity Well-underpinned

The long-term growth opportunity in emerging markets is well-underpinned by demographics, says Douglas Gooding, head of client portfolio management for Invesco Global Strategies. Speaking at the Invesco ‘Investment Forum’, he said investors should view these markets differently now because they are no longer driven by ripple effects from the U.S. economy or commodities. In fact, the recent financial crisis was a good test for the resilience of emerging markets economies. The share of total consumption by emerging markets consumers has been rising steadily in recent years and personal consumption exceeded spending in the U.S. for the first time in 2008. As well, their banks are in outstanding shape and do not have to take on risk to ensure growth.

DB Needs Risk Sharing To Survive

If Defined Benefit pension plans are to survive, they will need more risk sharing between employers and plan members, says Elizabeth Brown, of Hicks Morley. Another possibility is that the DB promise will become a thing of the past replaced by a target benefit with no guarantees it will be there. Speaking at its ‘2010 Toronto Client Conference,’ she said while the economy is recovering from the financial crisis in 2008, DB plans are not because their problems date back prior to the crisis. A prolonged period of low interest rates, tax rules which prohibited surplus beyond a certain threshold, two decades of contribution holidays or improving employee benefits, and people living longer are among the reasons pension plans have not recovered and continue to be underfunded. And while governments across the country are wrestling with reforms to save DB pensions, she said the reality is that only eight per cent of workers in the private sector have a DB plan. Governments are acting as if they anticipate widespread use of DB plans when the reality is quite different, she said.

Coverage Problem Has Target Group

Pension coverage in Canada is a targeted problem, says Scott Perkin, president of the ACPM. Speaking on ‘ACPM Advocacy: Taking the Pension Debate Forward’ at the ACPM’s ‘Sharing Innovations: Developments in Retirement Plan Design and Communications’ session, he said the problem is the lack of coverage for the self-employed and those working at small businesses. The targeted group is one in need of assistance as low income earners’ retirement needs will be met by CPP and OAS while high income earners can look after themselves. He said the ACPM believes several large plans operating in multiple jurisdictions would provide the flexibility and choice of savings that experts contend would meet the needs of these employers and individuals. However, he said until the coverage issue is resolved, government is unlikely to proceed with pension reform.
BMO GRS Enhances LifeGard
BMO Group Retirement Services (BMO GRS) has enhanced its LifeGARD program with a suite of new employee benefits — Group Banking services — provided across Canada through the Bank of Montreal’s branch banking network. Now, plan sponsors can offer both group retirement savings programs and a line up of banking services and personal loans with the advantage of group buying power. As part of this program, plan members will enjoy important savings on their every day banking, personal loans, and personal savings as an added layer of benefits beyond the group retirement savings program.

Make It Easier For Employers
Government needs to make it easier for employers, including small- and medium-sized enterprises, to step up to bat and do more for their employees, says Joseph Iannicelli, president and CEO of The Standard Life Assurance Company of Canada. Speaking at the Canadian Club of Toronto, he said Canadians should be given greater access to workplace retirement plans. “If every workplace with 20 employees or more was required to provide a group plan, it would ensure that 80 per cent of private sector workers have access to a group plan, compared to only about 50 per cent currently.” This could be done by allowing any employer, including self-employed workers, to participate in a single Defined Contribution plan for multiple, unrelated employers. The financial services industry also must continue to be a pivotal player in interacting with and educating the consumer, he said. It can offer fewer products with better explanations of which financial objectives are met, the degree of risk associated with the product, and a realistic analysis of what taking that risk means to the consumer.

Arthritis Takes A Toll
Thirty-two to 50 per cent of those with rheumatoid arthritis leave the workplace within 10 years and 50 to 90 per cent leave within 30 years of the onset of the disease, says Diane Lacaille, associate professor, division of rheumatology, at the University of British Columbia. She told the ‘Connex Health Employer Forum’ that other impacts include sick leave and temporary work disability. She said European studies show that those suffering from arthritis lose 22 to 82 days a year because of the ailment. The yearly cost of work disability from arthritis and musculoskeletal disability in Canada is more than $14 billion. Employers can help, she said, by having a better understanding of the disease, encouraging good medical care, and providing a supportive environment.

Drug Coalition Launched
Towers Watson has launched the Canadian Rx Coalition, a new way for employers to manage employee drug plans through a co-operative alliance with other Canadian plan sponsors. Membership in the Canadian Rx Coalition will give organizations control over their pharmacy benefit plans. Members of the coalition will have access to better ways to proactively manage pharmacy costs and deliver optimal care, including collaborative purchasing and much improved transparency of the deal terms available to them through their pharmacy benefits manager. In addition, step-by-step approaches for drug utilization management, disease management, formulary development, and other efforts will have a sustainable, long-term impact on overall costs, quality, and individual health outcomes.
Uniquely supporting staff, promoting healthy choices, and accommodating work-life balance – all key elements of a wellness program – can lead to many important benefits for individual employees and for organizations as a whole.

Yet to encourage new, healthy attitudes among workers, you need to closely consider the characteristics of your employees and their work environment. That means the tools and initiatives used to achieve your wellness goals should be tailored specifically, says Abbie Hodgson, manager of consultation and benefits for the Mountain Equipment Co-op (MEC).

The member-owned retailer of outdoor gear employs a staff of about 1,500 across Canada, made up of mostly “young, energetic” workers. It regularly ranks high among various top employer lists in Canada because it addresses the needs, health concerns, and interests of its distinctively young workforce, Hodgson explains. “We offer quite unique programs to our staff based on our culture here at MEC. As a business we try to get people outdoors and we do the same for our employees.”

One of the most popular perks is an unpaid leave-of-absence arrangement offered beyond vacation. Ultimately, the aim is to keep young workers happy and engaged through wellness. As it has found over the years, Hodgson says staff that feel well supported by their employer will demonstrate it through loyalty, less turnover, and at less cost to the organization overall.

“We know when somebody is not happy in their role it feeds into other aspects. Our goal is to ensure that we do as much as we can to support our employees and their job satisfaction.”

Main Objective

Minimizing absenteeism through wellness is also a main objective for Const. Josie Hollingshead, in the training unit at the Niagara Regional Police Service (NRPS). She points to studies done by other police services that directly link participation in at-work fitness programs to less sick time – and a significant amount of money saved, she says.

Of course, greater fitness levels among staff also equates to less stress on the job, in turn leading to a host of other benefits. “If people start to run more and eat better, health improves, work productivity increases, and they’ll be sick less,” Hollingshead says.

As part of its commitment to improve and promote health, it is providing more incentives to take part in its voluntary fitness award program. Those that come out to take part in the four-part test of their fitness level now receive an ‘NRPS Hoodie’ along with an awards pin. Since the incentives were implemented, it has almost doubled the participation.

Sedentary Jobs

Another important wellness priority, she says, is addressing the large proportion of desk-bound civilian staff who, unlike more mobile officers in the field, lead sedentary jobs. For example, it has implemented Pilate’s, lunchtime Zumba, free family bowling nights, better access to gym facilities, and more education on leading a healthy lifestyle.

Stress among civilian and officer staff is the main culprit they’re trying to target, she says. So far, the programs are going “really well” and she believes that the number of stress-related issues and ailments will drop significantly as its wellness strategy improves.
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Think about your dream employee. He’s likely a hard-worker who’s not afraid to log lots of overtime to get the job done and trades his vacation time for cash – whatever it takes to get the job done. Right?

Wrong. The person you see as your ideal employee may just be a health crisis waiting to happen. Could your ideal guy or gal be getting burnt out, stressed out, and on the verge of a strained relationship with family and friends? Is his or her work suffering because of it?

Less Than Ideal

The facts speak for themselves. Expedia’s ‘2009 Annual Vacation Deprivation Survey’ found that 42 per cent of Canadian employees reported feeling stressed, tired, and vacation-deprived. We rank third on a list of the fewest vacation days allotted per year, and a whopping 24 per cent of us don’t use all of our vacation time. Studies also show that 10 per cent of Canadians don’t take any vacation time at all and, collectively, we leave 32 million vacation days unused.

Employees have any number of excuses for not taking vacation time. Among them are feeling guilty about taking time off (28 per cent), having too much work to do (11 per cent), not making plans far enough in advance (11 per cent), and wanting to exchange vacation time for money (12 per cent).

It may seem obvious that a good vacation is what we need to recharge our batteries, but research is now confirming what we’ve known for years. A 16-year study by the State University of New York at Oswego, found a strong correlation between taking an annual vacation and a significant reduction in the risk of heart attack, depression, and arthritis. In fact, it found that employees who took fewer vacations were 30 per cent more likely to die of a heart attack.

Experts also believe that time away from work helps promote self-awareness and reduces burn out. It can help employees reconnect with themselves and their families, which in turn encourages creative thinking.

Perhaps North Americans should take a cue from Europe. According to the World Tourism Organization (WTO), two of the most established economies in the world, France and Italy, rank the highest on the list of number of vacation days with 37 and 42 days per year, respectively. European business owners have no qualms about closing shop for a month in the summer – visitors to Spain in August will no doubt have realized this.

Making The Most Of Time Off

When an employee does decide to take a holiday, think about how you can help them to maximize the time off so that they come back feeling refreshed and ready to work. Tips for relaxing include ‘turning off’ the office – trying to avoid checking eMail and calling in too frequently.

Now re-imagine your dream employee. He or she has taken a vacation, is less at risk for health problems, and may even look happier and healthier. And all it took was a week off.

The Holiday Advantage

by Caroline Tapp-McDouggall

Caroline Tapp-McDouggall 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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ever since Muhammad Yunus was awarded the Nobel Prize in 2006, microfinance has been making headlines around the world. Now, thanks to the low default risk, stable returns, and significant social benefits associated with microfinance funds, more and more pension plans are opting to invest in them.

As the global financial crisis carved its swath of destruction through the world’s economies, there were casualties in virtually every asset class. Only a small handful of investment categories emerged unscathed. One such outlier was microfinance, a niche market that, although a relatively new kid on the block, has great potential. In fact, Swiss-based BlueOrchard, a leading administrator of microfinance products, estimates that over the next five years between US$10 and US$20 billion dollars will be needed to cover the demands of the world’s 500-million microfinance customers.

In 1983, Muhammad Yunus began issuing $20 microloans to some of the poorest members of the Bangladeshi population to provide them with a means of subsistence. The idea was a success. Not only were the vast majority of loans repaid, but a large number of borrowers were able to pull themselves and their families out of poverty.

Yunus founded the Grameen Bank which now serves more than seven-million poor Bangladeshi women. And 23 years after that first $20 loan, the simple, yet innovative idea earned Yunus and his bank a Nobel Peace Prize for their efforts ‘to create economic and social development from below.’ The idea has since been implemented with great success in a wide range of developing countries.

Microfinance customers have stories similar to that of an Egyptian woman named Gemeen who opened a snack bar in a Cairo suburb with an initial $50 loan more than two decades ago. Thanks to a small, but steady, stream of funding, she was able to expand her business. The profits generated from the business have helped her entire family. Her two sons are currently at university studying law and business management.

Socially Profitable Investment

Investing in micro-entrepreneurs is not a direct process. Microfinance funds invest money into microfinance institutions which act as intermediaries and administer the actual loans to micro-entrepreneurs in countries such as Africa, Asia, Eastern and Central Europe, and Latin America.

In recent years, since many of these microfinance institutions have continued to experience explosive growth, microfinance private equity funds were launched to respond to the need for equity. According to microfinance specialist Xavier Rielle, worldwide assets in this sector are currently estimated at US$50 billion.

Many institutional investors, European pension plans in particular, have been looking at microfinance as a new alternative asset class with a long-term investment horizon and have progressively integrated mature microfinance products or funds into their asset allocation. Microfinance funds offer institutional investors a ‘double bottom line,’ providing both a financial and a social return.

These funds are used primarily as auxiliary investments in a portfolio. In addition to not being correlated with other investment categories, they are also subject to lower volatility, thanks to their broad dispersion across many countries and sectors. This is demonstrated in the consistency of returns generated by these products in recent years. One of the world’s oldest and largest microfinance funds has achieved a cumulative return of more than 60 per cent (in U.S. dollars) since it was launched a decade ago. Even in the face of the market turmoil over the past two years, the returns on many of these collective investment vehicles have been positive, ranging from 2.5 per cent to more than 3.5 per cent.

Various ongoing indicators suggest that the recent period of financial turmoil could actually serve to strengthen the microfinance industry. The lower volatility, de-coupling arguments, and socio-economic impact of microfinance funds will continue to be interesting attributes for investors in the months and years ahead.

Christophe Vandewiele is head of Dexia Asset Management Canada (christophe.vandewiele@dexia.com).
Retirement income issues are at the forefront of crucial discussions that are taking place at the provincial and federal levels of government. The consultations are focused on ways to address the adequacy of retirement income for Canadians.

In order to inform this debate, the Canadian Institute of Actuaries created a task force which examined a number of proposals and has published its results in a white paper entitled ‘Government-Facilitated Retirement Income Plans.’

Who Is Affected?
Government-sponsored systems of Old Age Security (OAS), Guaranteed Income Supplement (GIS), and the Canada/Quebec Pension Plan (C/QPP) provide significant protection for low income Canadians. To ask this group to save further for their retirement would only add financial hardship now and little real benefit later.

Thus, the white paper is aimed at the approximately one-third of Canadians who are not using, or are unable to use, the systems available today.

The Range Of Models
The task force analyzed the following three pension system proposals and outlined the advantages and disadvantages of each:

◆ Smart Defined Contribution Plans – The Canadian Supplementary Pension Plan as proposed by Keith Ambachtsheer and the Alberta/British Columbia (ABC) provincially-facilitated plan.
◆ Plans to expand the C/QPP – The white paper examines, as one, proposals made by the Canadian Labour Congress (CLC), the National Association of Federal Retirees (FSNA), and the Canadian Association of Retired Persons (CARP) to expand the C/QPP.
◆ Target Benefit Plans – Systems proposed by the Ontario Expert Commission on Pensions (OECP) and the Nova Scotia Pension Review Panel fall under this category.

The Variables Reviewed
Several variables were determined to be important elements in evaluating any proposal for pension reform. For each variable, the white paper outlines advantages and disadvantages and optimal outcomes. The following variables were considered by the task force in evaluating the three proposals:

- mandatory versus voluntary
- DB versus DC
- public versus private
- pay-as-you-go versus fully-funded
- one-size-fits-all versus choice
- pay-out options
- portability

The Proposals
◆ Smart DC Plans I: The task force found this proposal to be one of the most attractive. It is logical to have an earnings floor below which no contributions are made so low income Canadians are not forced to contribute only to find extra benefits swept away in the GIS clawback. That said, the task force did have concerns. All of the plans reviewed create the possibility that many existing superior private plans may be replaced with less advantageous schemes.

There is a serious administrative challenge to getting this system operational as it is a scheme where enrolment is the default, but it allows workers to opt out.

While the task force agrees with the $30,000 earnings level before requiring contributions, some workers may view this as unfair.

There may be issues in forcing this scheme onto employers and workers and it will be a challenge to effectively deal with the appropriate communication leading up to a ‘stay-in or opt-out’ decision.
Other issues must also be addressed:
- Leaving all administration and investments to a public body such as the CPP Investment Board versus delegating major portions to private institutions
- Opting-out rules should be well-defined and simple to administer
- The possibility that participants might be allowed to transfer accumulated amounts from other plans could be administratively problematic

Finally, the task force believes this proposal should provide for a small number of investment options and allow an employer to make this coverage mandatory for his or her employees.

◆ Smart DC Plans II

While the task force understands the government will have to take action to facilitate the creation plan such as the Alberta/British Columbia provincially-facilitated plan, it sees no reason for it to be the plan sponsor. Thus, it supports the option that the administration be tendered out. Evidence indicates the private sector could administer such a plan effectively. However, advice given to participants must be completely unbiased. Thus, the advisory infrastructure should have no financial interest in the plan.

To help avoid anti-selection and minimize costs, the task force supports auto-enrolment. It also believes operating costs should be low and would expect annual expenses less than 0.5 per cent of assets.

This type of plan may require a minimum earnings threshold for eligibility. Lower income workers are ill advised to create small private savings funds which will only result in the loss of GIS benefits (along with similar provincial top-ups and other subsidies).

In a report entitled ‘Options for Increasing Pension Coverage Among Private Sector Workers in Canada,’ British Columbia’s finance minister put more meat on the ABC bones. Despite this, the task force has concerns about this report.

It estimates the CSPP will produce replacement ratios between 70 per cent and 75 per cent once government benefits are taken into account. However, the target under the Ambachtsheer plan is 60 per cent. The task force is wary of presuming contributions of 10 per cent of earnings in excess of $30,000 can produce even a 60 per cent replacement ratio in today’s market.

The task force suspects none of the CPP extensions identified in the report can produce the 60 per cent to 85 per cent replacement ratios advocated in the report without additional voluntary savings.

◆ Plans to expand the C/QPP

Expanding the C/QPP has some definite advantages. Much of the required infrastructure exists. Contributions can be made by macro payroll deduction and required individual adjustments can be made through one’s tax return. The investment capabilities of the CPP Investment Board (and the Caisse de dépôt et placement du Québec) already exist.

Clearly, the plan will benefit from economies of scale.

That said, the task force sees some issues with this approach to pension reform.

First, it opposes new benefits paid for by pay-as-you-go (PAYGO) financing. Benefits should be fully funded to avoid intergenerational inequities which would mean it would take 40 years before new full benefits can be achieved. This proposal has practically no near-term impact – which should be made clear to the public.

Plainly, full disclosure of the impact on C/QPP contribution rates is also a must and these estimates must be backed by acceptable actuarial analyses and projections.

Plans To Be Terminated

The task force worries this new ‘minimum’ benefit could soon become the ‘maximum’ total benefit. That is, by expanding the C/QPP to provide ‘average’ Canadians with retirement income security, the task force would expect many superior employer-sponsored pension plans to be terminated. This is not advantageous.

There is another problem inherent in these proposals. The contribution rate for the C/QPP is currently 9.9 per cent. If extended benefits are added on a fully-funded basis, these extended benefits would require a contribution rate of around six per cent. This is in contrast to today, where about four per cent of the current contribution rate goes to pay for legacy liabilities, that is, those benefits accrued in the period when funding was closer to a pay-as-you-go rate. Can we have a system where contributions up to the Year’s Maximum Pensionable Earnings (YMPE) remain at 9.9 per cent, but extended benefits above the YMPE will cost only six per cent?

The task force prefers an upward expansion of the plan by raising the YMPE rather than the benefit rate. The benefit rate is currently 25 per cent on earnings up to the YMPE. The FSNA proposal suggests if the rate were increased from 25 per cent to 70 per cent, contributions up to the YMPE would have to be 19.8 per cent versus 9.9 per cent today (shared equally between workers and employers). This would be a huge burden for low income workers and could also have a significant impact on the labour markets. Further, as with many of the proposals, the expanded C/QPP would do little or nothing for those who qualify for GIS benefits.

Since new benefits are to be fully-funded, as the plan matures the required contribution rate will be much more sensitive to the rate of return on the invested plan assets. Such an expansion would also affect existing employer plans.

◆ Target Benefit Plans

The Ontario and Nova Scotia proposals are predicated on creating a target benefit plan and creating large commingled asset pools for the participants in these plans.

Target benefit plans share the pension risks more evenly between plan sponsors and workers. For example, the task force does not believe it is necessary to guarantee full indexation for all benefits. The Ontario Teachers’ Pension Plan has been recently modified so future retirement benefits will only have 50 per cent indexation guaranteed.

In a target benefit plan, accrued benefits and/or pensions in payment could decrease in value. This would require amendments to provincial and federal Pension Benefit Acts (PBAs). The task force would further recommend that the Canada Revenue Agency (CRA) determine the Pension Adjustments (PAs) for such a plan as it would for a DC plan.

On the negative, the task force does not see how a target benefit plan could work if participants can opt in and out at will. This proposal would either have to be mandatory or have extremely limited rights to opt in and out.

Ontario and Nova Scotia also contemplated the commingling of plan assets (other proposals could also benefit from commingling). While such commingling is possible today, it happens rarely as unconnected entities have no easy way to co-operate to provide retirement income solutions. This is one example of where one would need government facilitation to make the new scheme operable.

Mandatory Model

The task force also expects plan trustees would control the investment of the pooled funds, not the individual participant. This accentuates the advantages of a mandatory model.

Finally, the task force believes there will need to be allowance for contributions that vary by age. This may require amendments to legislation and regulations.

The Canadian Institute of Actuaries has developed this white paper to provide perspective and inform the debate that is well underway at the provincial and federal level in Canada. The document provides some much needed analytical tools for assessing the feasibility and implications of three of the proposals being examined.

Robert Brown, PhD, FCIA, FSA, is chair of the task force on government-facilitated retirement income plans for the Canadian Institute of Actuaries.
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Plan sponsors of Defined Contribution pension plans devote a lot of time and energy explaining to members how their retirement savings programs can help them save for retirement. Since the publication of the ‘CAPSA Pension Plan Governance Guidelines,’ even greater efforts have been made to ensure that members have the information and help they need to make informed decisions, especially about determining the amount of their contributions and selecting their investment options. Sponsors have a duty to ensure that members are aware of the tools available to them and that they periodically review their retirement targets, risk profiles, and investment choices.

Sponsors and service providers offer the greatest amount of information to members at the time of plan enrolment. However, communication with members should continue beyond enrolment. Regular updates on an annual basis are important for members to review their situation and for sponsors to meet the CAPSA Guidelines. In fact, as members approach retirement, they should be encouraged to pay particular attention to their financial situation to ensure that they are on the right track for achieving their objectives. This is a critical time for them and more ‘catchy’ to reach members more effectively.

In the past few years, we have seen significant changes with regard to communicating with members at the time of plan enrolment. The next big challenge for service providers and plan sponsors is to more closely assist members who are getting ready to retire. In other words, once members have been persuaded to save for retirement, we need to assist them in managing their savings so they reach the proper level of income for their retirement.

We do find that, at retirement, members are required to make important and complex choices that will have a major impact on their lifestyle during retirement. Since, at that point, a sponsor is in the process of terminating its fiduciary responsibilities toward a member, sponsors may tend to neglect this important stage and, more often than not, leave members to their own devices.

Plan sponsors who wonder if it is their responsibility to offer resources to members so they can obtain retirement advice will no doubt be interested to know that most members appreciate assistance in accessing a qualified professional who can answer their questions and help them make choices. Members have even more confidence in a professional

## Creating Retirement Planners

A thorough review will reveal if they need to make any changes.

### Retirement Objectives

Statements are no doubt the main way that members track their progress. Some service providers offer statements that include a customized analysis of each member’s financial position and how they are progressing towards retirement objectives. This analysis becomes something of a ‘call to action,’ intended to prompt the members to react if they stray from their objectives. Moreover, service providers are always trying to perfect their information tools, enhance their messages, and make them even

who is chosen by their employer.

Most service providers, therefore, conduct retirement preparation seminars for employees within five years of retirement. These seminars can help to clarify financial and legal questions and also deal with the psychosocial aspects of retirement which may include:

- transitioning to a new lifestyle
- organizing daily activities
- adjusting to living full-time with your spouse
- joining networks
- dealing with aging

Financial issues might include:

- how to assess your savings strategy
- how to manage your savings after retirement
- how to evaluate the different payout options
- how to minimize the impact of taxation
- how public pension plans work

Seminars are an effective way of providing members with information and making sure they understand the various retirement concepts. At the same time, members can be encouraged to expand on their knowledge by using other planning information/tools which can be printed or presented in multimedia format. Providing information using more than one type of communication medium improves the chances that messages reach members.
Guides Designed For Members

Guides designed for members approaching retirement age generally deal with the following subjects:

◆ Budget evaluation at retirement

The rule of thumb is that an income replacement rate of 70 per cent of pre-retirement income will allow a member to maintain the same standard of living at retirement. In reality, this rate may vary from 50 per cent to 100 per cent, depending on a member’s salary level, lifestyle, and debt load. It is preferable for members to prepare a formal budget, starting with a list of their current expenses. They should evaluate how each expense may change in retirement. Some will decrease and some will remain relatively constant. Additional expenses, such as healthcare and leisure activity costs, should be anticipated.

◆ Identification of income sources

Once they have evaluated their expenses, members should compare them to the amounts they anticipate receiving from each source of income such as public pension plans, group savings, and retirement plans and personal savings.

◆ Evaluation of retirement income options

For members to maintain their standard of living and fulfil their retirement plans without a regular pay cheque, they must consider the retirement income options available to them, and know when and how to use them to maximum advantage. This is the stage when members start to truly establish a financial strategy for retirement.

Depending on their objectives, it may be advantageous for members to use some savings first while other savings continue to grow tax-free. They must, therefore, decide from what source they will start to draw their retirement income and in what quantities.

Certain Directions

The guides offered to members can point them in certain directions, but, unfortunately, there is no formula that is right for everyone, no ‘one size fits all’ approach. For example, members are generally advised to put off using their registered retirement savings as long as possible so those savings can continue to grow tax-free. It is also advisable that members who have a spouse with a significantly different retirement income take advantage of the tax benefit associated with income-splitting between spouses. Members are also advised to have an annuity in combination with withdrawals from RRIFs or LIFs. Annuities provide stable retirement income for basic expenses, while variable expenses can be paid from RRIFs or LIFs.

This information is designed to familiarize members with financial concepts related to retirement. This will help future retirees to get an idea of what suits them and to eventually prepare for a consultation with the professional who oversees their retirement plan.

Many members do not understand some of the most basic concepts of retirement planning. Almost all the latest industry surveys conclude that the percentage of workers who plan for their retirement – that is, who have an income goal for retirement and a plan for achieving it – is never more than 30 per cent. The time has come to change our message. Instead of trying to make members better portfolio managers, we need to help them become better planners and savers. We all want to retire sooner and we will, for the most part, live longer, so retirement saving plans and pre-retirement seminars are the key to helping members reach their retirement goals.

Are You Communicating?

Since many members do not understand some of the most basic concepts of retirement planning, it is essential that sponsors focus on their responsibility to provide as much information as they can. Continuing education efforts will result in members who understand their retirement plan, set an income goal for retirement, and establish a plan to achieve it!

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It is the job of any good consultant to anticipate markets and to be prepared to address emerging client needs. The actual adoption of those ‘emergent’ strategies or technologies – whether they are imported from Europe, the United States, or elsewhere in the world – is typically inspired by some fundamental regulatory reform, business, or demographic shift or compelling financial event. In many cases, it is the inspiration that is new, rather than the means by which that inspiration is addressed. There is nothing really new under sun.

By: Paul Harrietha

Nothing Really New Under The Sun

To that end, much of the consultant’s broader tool kit has been traditionally neglected – or set on the back burner given limited perceived need at the sponsor’s end. As it stands, many of the ‘new’ products and services being delivered to clients are anything but. They are derived largely from long-standing tools, concepts, or strategies. What has changed in many circumstances is the power of the accompanying technology – and our enhanced ability to capture, warehouse, manage, and exploit massive quantities of meaningful data effectively and economically. Coupled with smart (automated) diagnostic systems tools, this data mother-load gives progressive sponsors and their consultants an opportunity to better quantify and manage the emergent issues and risks – on both a member and organizational level.

Retirement

For pension plan sponsors, there is an emerging focus on the mitigation of investment and longevity risk (the risk that members will live longer than expected), both for Defined Benefit and Capital Accumulation Plans. With DB plans, the problem is that increased life expectancy – for the plan as a whole (systemic risk) or for select individuals (specific risk) – is increasing plan liabilities and, in turn, placing a greater burden on long-term investment performance. With DC plans it is the risk, on an individual basis, that members will fail to accumulate sufficient retirement savings to provide a meaningful income for the full duration of their extended lives.

In light of these risks, new tools are being developed that allow DB plan sponsors to manage longevity risk separately from investment risk. For example, Club Vita, launched by Hymans Robertson in the UK, is a subscription-based service that allows plan sponsors to better predict longevity for a specific member cohort (and the corresponding financial impact on the company’s pension plan) through the management and analysis of extensive comparative data.

Similarly, the introduction of longevity insurance – such as specific annuities that start payment at later ages (such as age 85) – offers compensation if the mortality for a plan is better than expected. Longevity swaps provide a hedge against plan members living longer than expected.

DC plan sponsors, particularly in the U.S., are using plan design features such as auto enrollment, enhanced employer contributions, and lifecycle-type investments to:

◆ help elevate member participation levels
◆ remove much of the direct responsibility (and fear) associated with managing personal investments

Sponsors are also using smart technology solutions (automated systems) to assess and influence the saving, contribution and investment behaviours of...
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individual plan members – based on their personal data. These robust diagnostic systems allow sponsors and their agents to:

- Perform demographic projections and analysis to help the employer better understand long-term health/pension/sick leave trends (as they pertain to their company) as well as to understand underlying trends in the emerging workforce (such as an evaporating middle management layer).
- Better understand the financial impact of changes to their pension plans, be it benefit changes, plant closures, early retirement windows, assumption changes, employment, and retirement patterns, etc.
- Assess employee behaviours, both on an individual basis and relative to established norms or objectives.
- Prompt automated and personalized communications delivered to those individual members whose behaviours lie outside of the established norms, especially as they pertain to contribution levels and investment allocations.

With the right tools in hand, employers can do much of the preliminary analysis in-house or rely on automated features to do the work for them. High-priced consultants only need to be invited to the table when deeper analysis or problem solving is required.

**Group Benefits**

Again, there is a growing emphasis on the management of financial risk, facilitated in large part through the availability of robust systems and associated strategies.

For example, ‘risk-sharing’ contracts are common in Europe and attracting renewed interest in the U.S. Meaningful risk-sharing deals – including traditional capitation, hold-harmless for inappropriate use, clinical outcomes, and refunds for adverse events – can take a number of forms depending on the product and the affected population.

Risk-sharing might be a bit of a misnomer, as they are more like performance guarantees. By way of example, Merck and Cigna in the U.S. announced a discount agreement for two oral medications for type 2 diabetes. Merck agreed to increase the discount on these drugs for Cigna enrollees whose blood sugar levels improved by the end of the year. Even bigger discounts are provided if Cigna’s claims data shows that these individuals have been medication compliant.

In Canada, similar risk-sharing deals would require a pharmacy benefits manager to have deals in place with pharmaceutical companies. At least one – Medavie Blue Cross – has been doing this. Pharmacy benefits managers already have access to the data on the medications that each of their enrollees take. The challenge is to get the affected individuals to report their blood sugar levels. There also needs to be a way to share the discount with plan sponsors.

Another idea out of the U.S. is ‘value-based insurance design’ (VBID) which is intended to:

- Encourage customer demand for medically necessary utilization of evidence-based, cost-effective medical services.
- Discourage demand and utilization of medical services with a weak evidence base or low value.

The approach involves creating clinically sensitive co-pay structures as a means of influencing buying decisions at the employee level. Key design concepts include:

- Lowering employee co-pays for services known to be of high value (such as beta-blockers post-heart attack, tobacco cessation programs).
- Lowering co-pays for patients as a reward for reaching certain treatment adherence levels.

Although VBID can be applied to any medical service, the most important one for Canadian sponsors would be on drug therapy co-pay designs for chronic diseases (especially diabetes and, potentially, hypertension).

Before employing either of these risk-sharing strategies, Canadian sponsors will need to clear a few hurdles, including pervasive concerns over privacy and discrimination. There is still a fair amount of resistance in Canada to mining data down to the individual level. With the robust systems in place – and the need to better manage benefit-related expenditures – it’s probably time for us to offer equal consideration to the needs and rights of the sponsor as a key source of healthcare funding in this country.

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**Care Needed To Select Governance Partner**

*By: Jeff Gray*

Pension committees are typically composed of management staff with core responsibilities which have nothing to do with pension governance and investment monitoring. For this reason, it is not unusual for pension committees to engage third-party consultants to periodically facilitate investment reviews. One could equate this to periodically getting different golf pros to help with your golf swing and expecting lasting improvement in your game results.

Organizations can best benefit from selecting a governance consultant that can work with them to build, manage, and regularly review their pension governance framework. This results in an overall framework that is facilitated by an expert in the various areas of required fiduciary responsibility. Periodic and fragmented use of professional support is generally less effective in terms of results and for the time required by pension committee members who are charged with responsibility for core operation activities. In short, plan sponsors should find a pension governance partner and work with them on a regular basis for all areas of plan governance to achieve the best results.

Another tip to effectively manage the governance process is managing plan governance documents and governance activity information. Pension committees often have an information oracle. However, having someone who manages the plan documents and history of governance activities may seem logical, but it does have shortfalls. Plan information is not always readily available to other committee members and the plan documentation is not always stored in a logical format to serve for historical reference.

To address the need to store and provide information access to multi-member/multi-location committees, we recommend custom portals for client programs. We believe that this is an improvement for information availability to committee members. Indeed, it is a wonder why this is not universally used by all plan sponsors.

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In 2009, there was no bigger story for Canadian pension plan sponsors than the Supreme Court decision in the Kerry Canada case.

Peggy McCallum, of Fasken Martineau, was involved in the case right from its beginning in 2000.

She joined Fasken Martineau in 1997 and is now a partner. Called to the bar in 1985, she practices exclusively in the pensions and employee benefits law area.

The nature of the law at Canada’s largest law firms is that by the time the case gets to arguments before the Supreme Court of Canada, it is the top litigators at the firms who take the spotlight.

Yet, when it comes to the complexity of pension law, there is almost always a pension lawyer in the background. In Kerry, that role went to Peggy McCallum, who was part of the team that put together the winning arguments in the landmark Kerry decision. Indeed, she was one of the team members who “gowned up” for the Supreme Court hearing.

In fact, McCallum was there at the beginning of the Kerry case, helping to craft the responses from the company to the unhappy former employees who had launched a letter writing campaign against the company’s pension plan changes.

Writing, of course, is second nature to McCallum. Before heading off to the University of Western Ontario in the late 1970s to study law, she was a well-respected Canadian journalist at the Globe and Mail.

Her involvement in pension law was unintentional, she says. She had set out to be a labour and employment lawyer. However, after spending her first year of practice at Mercer and learning the basics of pension plans, she couldn’t avoid the area once she moved to private practice. The high volume of corporate mergers and acquisitions in the late ‘80s, “all of which seemed to me to include pension plans,” says McCallum, “really cemented my career. There was no turning back.”

Newspaper Headlines

At that time, pension law wasn’t a recognized or distinct area of law in Canada. This was the time when the Ontario government was introducing its pension reform legislation, the current Pension Benefits Act.

“There were relatively few of us who were involved in commenting on the draft legislation,” McCallum says. “It was only in the mid-1980s that the Canadian Bar Association of Ontario established a pension section for the first time.” A committee of its members – including John Goodwin, John Solursh, Ian McSweeney, David Vincent, Mark Zigler, Murray Gold, and McCallum – made submissions to the government about the content of the reform legislation.

Granted, looking at the state of pension law in Canada today, she admits that they might have missed a few things, but at the time “everything was so new.”

Landmark Decision

While Kerry is being hailed as a landmark decision, McCallum does acknowledge that the Canadian pension landscape is somewhat fortunate it happened at all. She says that early in the process, the employee group was not represented by legal counsel and did not retain counsel until the middle of the hearing. Its counsel, Ari Kaplan, of Koskie Minsky, has said publicly that if the employees had had legal counsel from the beginning, “it’s very likely they would have gone to court directly as opposed to going through the FST (Financial Services Tribunal) route.” If that route had been taken, the Supreme Court may never have provided the guidance now hailed by plan sponsors and the industry as a positive step for pension plans in Canada.
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The group benefits industry needs to continue evolving and adapting technology to create new value for the market. If group insurers are to successfully anticipate and thrive in the ‘new normal,’ then now is the time for fundamental changes. This article will look at some recent innovations that are aimed at taking service delivery, technology, cost containment, and added value for clients to a new level.

Despite the variety of electronic claims submission options available to most group benefits plan members – drug cards, electronic dental claims, member submitted e-claims – paper claims continue to play a large role in the process. For example, Sun Life Financial alone handles approximately 90 million pieces of paper per year in its claims process, which is the equivalent of more than 800 trees.

Continued reliance on paper exists, in some cases, because the type of claim is complex and still requires a paper-based submission. In the vast majority of cases, however, plan members continue to submit paper claims because that’s their traditional method of submission.

The issue for the industry is that no matter how a plan member chooses to submit a claim, they expect the same level of accuracy, efficiency, and service. And that’s where the traditional methods of processing paper claims fall short.

**Horse And Buggy Processing**

With many benefit plans, paper claims are still manually processed at almost every step. For large insurance carriers, tens of thousands of claims are received weekly. These are stacked to await opening and processing. During this time, the claim is unlikely to be registered in the insurer’s system and no electronic record of it having been received exists. If it’s not recorded, the status of the claim cannot be confirmed should a plan member inquire.

Due to the manual nature of claims processing, during peak periods, days can elapse before the process actually begins. As with any manual transaction, the risk of error is a concern and mistakes can happen. This, again, can delay the proper payment of a claim.

Even after the claim has been adjudicated and paid, the paper form is stored typically for seven years. Should an audit, potential fraud, or member inquiry occur, it means that a labour-intensive process is needed to retrieve the claim information in paper form.

Most paper claims are processed this way in a timely and accurate fashion, but at considerable risk of a disconnect between a plan member’s expectation and what is actually delivered. To put it simply, members expect 21st century processing even if they submit their claims using a 20th century channel.

**Technology Is Key To Change**

The good news for plan members and sponsors is that recent innovations in scanning and data lift – using optical character recognition (OCR) technology – now make it possible to turn a paper adjudication process into a paperless one.

Under this new system, paper claims are still received by mail, but from that point onward technology takes over. Forms and receipts are scanned using sophisticated high-speed scanners and automatically entered into the claims processing system. Then, data lift technology automatically inputs key claims data into the online forms that are fed into the claims adjudication system.

For adjudication, the claim – which now exists entirely in electronic form – can be channeled immediately to the claims adjudicator and location that can complete the process most efficiently. This also makes the entire operation, after the claim has been received, completely virtual.

**Going Greener – Eliminating Paper Entirely**

The move from hard copy paper claims to a paperless claims process greatly contributes to ‘green’ initiatives by reducing an organization’s carbon footprint. At a time when environmental sustainability has become increasingly important, this new technology can help group benefits organizations achieve their corporate sustainability objectives and help set them up for success as responsible corporate citizens in an era characterized by environmen-
tal concern.

A part of the group benefits industry’s commitment to sustainability can be enabled through electronic claims processing. Since claims can now exist in electronic form, there is less dependence on paper and significantly less dependence on paper claims transportation to and from storage sites.

While we often think of the environmental impact of paper in terms of trees consumed, a more complete assessment would consider the impact of the end-to-end process, from raw materials to processing and distribution, and – at the end of the seven-year retention period for paper claims – disposal. In terms of storage of paper claims, beyond transportation, there is also an environmental impact associated with energy consumption from building operations in the sites where paper is stored. Through this new paperless claims technology, electronic submissions could eliminate claim forms and receipts, thereby saving an immense amount of resources and space if applied industry-wide.

Additionally, portions of claims processing work can be done remotely. This allows some claims staff to work from home, thus reducing travel and cutting down on energy resources at the claims office sites.

Paperless Future

Becoming virtually paperless doesn’t only apply to claims processing and adjudication. This new technology presents many opportunities to improve the course of business in the insurance industry, including greater efficiency and corporate sustainability.

Other paperless initiatives in the near future include the ability for insurance carriers to be able to offer clients the option of interacting with them – if they prefer – from their mobile devices and smartphones – whether it’s submitting their health and dental claims or simply checking their benefits plan coverage.

Over the next two to three years, smartphones are expected to double their market share and should account for more than 20 per cent of the cellular phone market.1 People of all ages are quickly embracing the smartphone as a multi-purpose technology capable of performing several different tasks. It will soon become the norm for individuals to handle their financial needs on the go through their mobile device, taking advantage of constant, instantaneous connection.

Benefits Are Many

It seems clear that the paperless method of handling claims provides plan members and sponsors with many benefits – fewer lost or misplaced claims, reduced data entry errors, and claims are tracked from day one, with quicker response times to plan member questions. The technology can also be used to more easily analyze a plan sponsor’s claims experience to help identify ways to reduce benefit costs.

The paperless processing method presents many benefits for the environment as well. Organizations can minimize their carbon footprint by reducing the amount of paper used, and decreasing the storage space and transportation that is required for claims and receipts. This new process enhances corporate sustainability practices and helps group benefits providers reach their corporate and environmental goals.

An additional advantage of having this new claims processing and adjudication technology is that it also provides insurers with other tools to help combat benefits fraud and abuse. In Canada, there is a significant amount of money lost annually to healthcare fraud and abuse, with some of the most common fraud schemes being false healthcare claims, altered receipts, eligibility misrepresentation, returning items after reimbursement, billing services not rendered, and misrepresenting services rendered. Fraudulent activities impose extra costs on group benefits plans, thereby increasing plan costs as well as the risk of a reduction or loss of coverage to compensate for lost funds. This claims processing innovation can actually help pinpoint suspicious claims automatically by detecting certain claims patterns. The technology has the ability to lift and use more data to detect suspicious activity instead of relying solely on manual or other means of fraud detection. Through the use of various technologies, tools, and resources, benefits carriers can leverage the use of deeper utilization profiling capabilities to more effectively detect and deter fraudulent claims going forward.

Significant opportunities exist for the group benefits industry to better utilize technology and innovation. It is making tremendous strides in leveraging technologies such as Optical Character Recognition (OCR) and data profiling. At a time when clients’ expectations continue to rise, innovative new technologies can provide value added support to business areas such as health and dental claims processing. Plan sponsors are seeking cost management solutions, so the ability to migrate towards overall claims management versus simply claims payment can be effectively enabled by using these evolving technologies.

Claims processing technology is just one of the tools being used to create a better experience for plan sponsors and members. As expectations continue to rise for faster and better levels of service, the industry

**Top Five Benefits of Paperless Claims Processing**

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<td><strong>Member Experience:</strong></td>
<td>Claims are processed faster, clients receive reimbursement sooner, and fewer claims are lost or misplaced</td>
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<td><strong>Sustainability:</strong></td>
<td>Helps benefits providers reduce their carbon footprint and achieve corporate and environmental sustainability goals</td>
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<td><strong>Customer Service:</strong></td>
<td>Easier tracking from the time claims are registered in the processing system, allowing for quicker response times to plan member questions</td>
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<td><strong>Fraud:</strong></td>
<td>Another tool to help insurers combat benefits fraud and abuse</td>
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<tr>
<td><strong>Accuracy:</strong></td>
<td>Decreases the number of data entry errors</td>
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1. www.marketreports.ca. Article “Smartphones to Take Over”, by Christine Perroud, 03/02/2009.

Stuart Monteith is senior vice-president of group benefits with Sun Life Financial.
George Soros, the hedge fund manager and proponent of reflexivity in investing, has been vocal in his thesis that the seeds for the next financial crisis or opportunity, (depending on one’s investment inclination) are sewn in the previous crisis as market participants create the circumstances for the next collapse or the next investment opportunity by stretching prices, leverage, and liquidity. As prices and risk move up and down, investors are encouraged to ask themselves where their investments are on the sine wave of opportunity. In other words they might ask: ‘Are we late to the party?’ or ‘Do we have the right investments for this stage of the market?’

This ‘timing question’ has been given more thought in a recent book by Andrew Smithers, ‘Wall Street Revalued.’ Smithers posits that negative serial correlation inherent in equity prices is observable, essentially giving statistical cover for the idea that high prices beget lower prices and constant ownership of equities may provide an inferior return relative to periodically repositioning the speculative portfolio. As prices move ponderously back and forth around ‘fair value’ over longer periods of time in response to large macro factors, one can infer that Smithers is making the case for retaining active investment managers who can invest long and/or short equities or, at the very least, there are times when one should be underinvested in a long only portfolio.

New World

In the new world of money management, institutional investors (clients) realize they must pay much closer attention to their investments, particularly investments that are not traded in public markets, but as private investment vehicles. While investment managers have a fiduciary responsibility to the investor, the reality is that these opaque investment relationships, strategies, and products – commonly called hedge funds – have often been sold, rather than bought. An investor participates based in large part on performance or pedigree, but is given little advice or guidance about the risks and returns going forward once invested, both at the macro level and the security level. Seemingly stable investment strategies have stumbled in reaction to new and different seismic activity which the investment manager did not anticipate.

The investor’s reaction to recent events has been to move to a more transparent model, the managed account. However, the investor now has responsibility to measure and assess the risks which are put clearly in front of him in the form of security level information and pricing. As well, in most cases, an institutional investor may have responsibility to understand the macro risks that are not security specific. The maxim “beware of what you ask for” is true in this new paradigm.

From Amaranth Advisors to Long Term Capital, Madoff, and probably hundreds more, whether staffed with brilliant traders or brilliant marketers, money management has disappointed and sometimes deceived the investor who can be overwhelmed by the sophisticated manager bent on asset gathering success. The investor client can’t completely rely on a superior due diligence process of the most intuitive accountant because there are risks that can’t be seen in a review of the historical return stream and the investment manager’s operation. Pre-investment analysis is an attempt to forecast the likelihood of future issues in a dynamic investment environment prior to the cheque being cashed and the investment made.

Live Conditions

To effectively invest, the investor client wants to be able to observe the account under live conditions, including unique conditions that the investment manager may not have experienced before. And they don’t want to see this as an academic exercise because history doesn’t repeat itself exactly and the investment manager’s response must be reviewed, although not necessarily second-guessed. The managed account permits the investor to understand the post-investment risk (which is, after all, the most significant risk) since the investor has at his fingertips an extraordinary amount of information on the investment manager and his positions.

If the institutional investor decides that participation in these alternative investment products is
worthwhile, he should be mindful of the effort required to develop and manage an investment portfolio on a fully managed account basis. The investor will want to beef up their knowledge and their involvement; these allocations cannot be ‘fire and forget’ as they now come with responsibilities. Accordingly, the investor needs the cooperation of the investment manager and their willingness to provide the type of information and response process that can assure the investor that the investment is being handled in a manner that is satisfactory.

Continuing Examination

The managed account process permits the continuing examination of skill or alpha. Periodically, managers may ‘lose their way’ as markets and circumstances lead their investment into blind alleys. Without real time detailed analysis, one has no clear understanding of the investment dynamic as periodic snapshots don’t permit investors to track the evolutionary integrity of the investment over time.

Some financial commentators believe there has been a permanent change in the investor’s appetite for returns, with pension funds ignoring the hedge fund industry and going back to basics. A look at recent history tells us the rapid return back to hedge funds following the Long Term Capital fiasco in 1998 surprised many market participants and this return to alternatives may happen again, given the urgency of achieving plan minimum returns. The prime pension fund directive is to make money to fund pension liabilities. If returns are to be had in alternative investments, pension funds must pursue the opportunity, but they must ensure that the hedge fund investment managers are doing what they say they will do. If hedge funds are to grow assets, they will have to be more diligent and respectful of the client’s investment interests.

While alternative investment forums routinely list the many risks of investing in the alternative investment space, the ability to monitor the minutiae of the investment manager’s security selections is the final differentiator in ensuring that one can determine when a manager has deviated from the mandate and risk profile. The ability to make the telephone call to the investment manager, essentially in real time, is a tremendous tool, but requires the cooperation of the investment manager. Providing a continuing stream of security-level trading information and responding to the client in a real-time basis can be an onerous task for the investment manager.

Security Selection

In this new environment, the investment manager should be prepared to defend their security selection if it appears out of their mandate, as well as respond to questions about levels of leverage, use of non-standard products, and anything else that would appear to not be in the mandate and require the consent of the client before use.

As an illustration, on review of securities and trading in an account, one may find that a manager will introduce a new strategy or style into their program with a small initial footprint. Essentially, client money is used in the early stages to develop a track record. If the program is deemed successful, it is then rolled out into a new fund. If the strategy is unsuccessful, it disappears from the record unquestioned. This is one of many issues that reveal themselves and there are many others that aren’t easily detectable with less than full managed account transparency.

In the past, investment managers could be content with knowing that ‘returns trump all’ – in other words, deliver good returns with low volatility and you will get a larger allocation, no questions asked. In this new environment, some institutional investors may seek a completely different relationship with the investment manager in the knowledge that major risks aren’t a function of volatility of returns, but are usually security or asset class specific. In turn, investment managers will find that their activities might be constrained from time to time by virtue of the new level of oversight provided to the investor.

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CONFERENCES

Senior executives examine how to protect their portfolios from future inflation erosion at the Investment Management Institute’s ‘Global Markets Forum.’ Topics will include analyzing risks embedded in global portfolios, global market opportunities through 2015, and infrastructure investing options. It takes place July 11 to 13 in Quebec City, QC. Visit: http://www.investmentmanagementinstitute.com/


How the issues impact pension funds and participants served will be examined at the International Foundation of Employee Benefit Plans’ ‘Canadian Investment Institute.’ It takes place August 15 to 18 in Whistler, BC. Visit: www.ifebp.org

The ‘Canadian Public Sector Pensions and Benefits Conference’ will be held immediately following the International Foundation of Employee Benefit Plans’ ‘Canadian Investment Institute.’ This conference delivers targeted and timely updates on the latest issues affecting public sector benefit plans. It takes place August 18 and 19 in Whistler, BC. Visit: www.ifebp.org

Given this time of unprecedented interest in the pension industry, the ‘2010 Association of Canadian Pension Management National Conference’ will address coverage, investment, economic, plan design, and funding issues through the framework of ‘Reaching Higher, Getting Stronger.’ Plenaries will be held on pension reform, the pension promise, and will Canadians be ready for retirement. It takes place September 14 to 17 in Whistler, BC. Visit: www.acpm.com

‘Thinking Organizations … Succeed’ is the theme of the Health Work & Wellness Conference 2010. It takes place September 29 to October 2 in Vancouver, BC. Visit: http://www.healthworkandwellness.com/

Dr. John Sloan, of the University of British Columbia, will examine the interaction between the elderly population and the medical system at the 31st annual Retirement Planning Association of Canada (RPAC) conference. Other speakers include securities lawyer Giorianne Stromberg, actuary Patrick Longhurst, and mutual fund veteran Tom Bradley who will contribute their insights on pension and investment issues. It takes place October 1 to 3 in Toronto, ON. Visit: www.retirementplanners.ca

A ‘Canadian Economic Overview’ will be the closing feature presentation at the CPBI 2010 Ontario regional conference. This year’s program will offer workshops in the three disciplines of pensions, benefits and investments. It takes place October 4 to 6 in Niagara-on-the-Lake, ON. Visit: http://www.cpbicra.ca/
The question before us today is straightforward, but not easy. What have we learned about how financial markets behave and what happens to them during what we now call ‘extreme events.’

Here are some thoughts that may point us to some answers.

Simple models often explain a lot of the behaviour of markets.

Complex mathematical financial models may have once been popular, but they suffered from many problems, over and above the costs and time involved in producing them in the first place. One problem was the issue of overfitting data (finding patterns that were essentially meaningless), with the greater problem the belief that the complexity of the model would lead to increased precision.

On the other hand, simple financial models have a lot to recommend them and also seem to work for large periods of time, though not every time.

Do market results still tend to follow a normal, bell-shaped distribution? The answer, generally speaking, is ‘yes.’ Is there reversion to the mean over time in many markets? Again, the answer is ‘yes.’

The academic literature is full of what are called ‘market anomalies’ to the efficient market hypothesis, which seem to still simply explain major elements of market behaviour. We know that there is a momentum element that seems to exist in equity markets and that stock picking using value, market capitalization, and global screens seem to outperform markets as a whole for many periods of time.

However, in extreme events, none of the above applies.

The past couple of years have shown that during periods of financial crisis, the simple rules didn’t apply. Correlations went to one and markets all went the same way – down. Extreme events seem to be getting extremer … those tails on the normal distribution seem to be getting really fat.

Simple models didn’t work during these times, but it was also true that complex models didn’t do a particularly good job of explaining things. This doesn’t mean that we toss out all the models that have worked in the past (and will probably work again in the future), but rather that we understand a little more about what happens during extreme events.

In extreme times, turn to human minds, not mathematical models.

A recent paper from Andrew Lo, at MIT, and Mark Mueller, from AlphaSimplex Group, ‘Warning: Physics Envy May Be Hazardous To Your Health,’ makes a few key points about the role of quantitative finan-

Do We Understand Financial Markets Now?

So what should we do when, to follow this analogy, the hurricane of economic shocks hits us? A key step is letting in the human element and recognizing that the world is not unfolding as the models would predict. “There may be little to do other than admit ignorance, but even this can be valuable from the perspective of corporate strategy …” as it will point out that the world is now different and should lead to a shift from quantitative modelling to deeper and more difficult reasoning, questioning, and reflection.
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