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Popular Perception
Is it any wonder then, that there is so much confusion in the market about hedge funds? And this may also help explain why when something goes wrong, the finger immediately points to hedge funds. A case in point is the 20-minute market meltdown in early May. At first, the feeling was it must be those darned hedge funds. In fact, it may have been a money manager selling a large order of e-mini contracts, liquid futures contracts which provide holders with exposure to the benchmark Standard & Poor’s 500 Index.

Further proof of the confusion over hedge funds is the popular perception that Bernie Madoff ran a hedge fund. After all, given the transparency issues around hedge funds and since no-one knew what Madoff was doing, it must have been a hedge fund. Fortunately, that transparency issue is clearing up as more institutional investors look at hedge funds and demand to know what they are getting into.

So what do these have in common?
According to Som Seif, president and CEO of Claymore Investments, Inc., they are simply a system of compensation. At an Alternative Investment Management Association Canada debate on hedge fund fees, he argued that the only thing the various strategies have in common is the fee structure. This can’t be very encouraging for an investor who wants to know what he is paying for, not just what he is paying.

By most popular definitions, they are also situations where a manager hedges some of the risks inherent in their investments using a variety of methods, most notably short selling and derivatives. That helps clear things up until we also learn the term ‘hedge fund’ is also applied to funds that do not hedge their investments. What?

Hedge funds may also be funds that use short selling and other ‘hedging’ methods to increase, rather than reduce risk, with the expectation of increasing the return on their investment.

Factor in all the various strategies and is it any wonder the average pension fund trustee, committee member, plan sponsor, administrator, and so on has a hard time getting their head around these things?

The bottom line is that the whole hedge fund industry would do itself a favour if it dumped the label ‘hedge fund’ and focused instead on the specific strategies. We appreciate that this is merely playing word games. After all, there are as many different classes of equities and fixed income as there are hedge fund strategies. Yet, we have more confidence in the former than we do the latter, and we can distill it down to equities and fixed income. We can’t do that with hedge funds.

General Term
Eliminating the broad general term ‘hedge funds’ and instead focusing in on families of strategies would enable investors to compare apples to apples, one arbitrage strategy to another. It might even enable them to compare returns across various strategies, keeping in mind that survivor bias does distort the returns reported by most indexes.

Right now, we’re dumping a basket of mixed fruit in front of investors and asking them to compare the returns reported by most indexes. When appropriate to their areas of expertise, interest or jurisdiction, the members bear no responsibility for the contents of the magazine.

What’s In A Name

Provided by PowerShift.

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*As of 31 December 2019
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Buck
Robin Pond is senior investment and CAP consultant for Buck Consultants. He is currently the chair of the investment advisory committee for the Financial Services Commission of Ontario. He has also been a contributor to Benefits and Pensions Monitor.

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Financial Advice Ignored

The Investment Funds Institute of Canada wants the Manitoba government to recognize the importance of financial advice as it considers strategies for strengthening the retirement income system. Its submission to Manitoba’s minister of finance, ‘Mechanisms for Expanding Pension Coverage and Retirement Income Adequacy in Canada,’ says reforms should look beyond pensions to a wider array of retirement savings solutions. It says much of the debate around income adequacy in Canada, too, has been overlooked in the debate. Savings outside of RRSPs. As well, financial advice as it considers strategies for strengthening the retirement income system so far has been overly focused on pension plans, ignoring non-registered financial assets accumulated by Canadian households such as tax-free savings accounts and other savings outside of RRSPs. As well, financial advice has been overlooked in the debate.

Two-tier System Impacts Plans

A move to a two-tier system of healthcare could have an impact on benefits plans. Cathy Smith, of Mercer, told the ISCEBS Toronto Arca Chapter seminar ‘Fundamentals of Pensions and Group Benefits’ that if employees turn to private clients to avoid long wait times at public clinics, they may look to their employer’s plan to cover the cost of that treatment. She expects governments in Canada to continue to offload services and drugs to the private sector. As well, the provinces are eyeing private clinics as one way to reduce their healthcare budgets.

BMO Expands Offering

As part of the ongoing enhancement to its ‘Governex’ program, BMO Group Retirement Services has expanded its open architecture platform to now offer a wide selection of BMO Mutual Funds. This initial offering provides a broad range of domestic and global investment options diversified by asset class, sector, region, and specialized mandates. This addition to its platform introduces 47 institutionally priced BMO Mutual Funds, all suitable as CAP investments. This new selection increases its overall open architecture offerings to 115 fund selections.

Government Proposing Use of Average Solvency Ratios

The federal government wants to introduce a new standard for establishing minimum funding requirements on a solvency basis that will use average – rather than current – solvency ratios. An Osler ‘Pensions & Benefits Alert’ says the three solvency ratios used in the determination of the average would be based on the market value of plan assets. Past deficiencies would be consolidated annually for the purpose of establishing solvency special payments. The new standard is intended to mitigate the effects of short-term fluctuations in the value of plan assets and liabilities on solvency funding requirements due to, among other things, volatility in the equity market and changes in interest rate levels, by allowing sponsors to better manage their funding obligations. It is seen by the federal government as a better alternative to extending the amortization period for solvency deficiencies.

GE Offers Commodities Product

GE Asset Management (GEAM) has launched its first commodities product for institutional investors. The GE Active Commodities strategy is an actively managed portfolio currently utilized as an investment allocation within the GE U.S. Pension Trust. It is an attractive investment option for those seeking to improve portfolio diversification, who want protection from unexpected inflation, and who are looking to participate in the current bullish long-term outlook for the asset class.

Fiscal Austerity Coming For Some

Europe and the U.S. are facing fiscal austerity in their futures, says Craig Alexander, senior vice-president and chief economist for TD Bank Financial Group. The question, he told those attending TD Asset Management’s ‘7th Annual Sharing of Knowledge Learning Series,’ is whether governments will do it voluntarily or be forced into it by financial markets. Governments are facing bigger deficits because of their stimulus spending during the financial crisis. While this has a positive psychological impact, he said there are risks associated with the timing and rebalancing of fiscal and monetary policy. However, he said the recovery is real, although fragile in industrialized countries.

PBM Must Offer Full Transparency

The Ontario government’s bid to gain control over the generic market make it more critical than ever for pharmacy benefits managers to offer plan sponsors full transparency in their pricing agreements and their capability to track and enforce all aspects of drug pricing on a day-by-day basis, says a Towers Watson ‘Client Advisory.’ The proposed reforms may, by changing the business model for retail pharmacies, pave the way for measurable savings from preferred provider networks, direct price negotiation for manufacturer rebates, and effective employer purchasing collaboratives. However, the reforms are targeted at ensuring savings for the Ontario Drug Benefit Plan (ODB) and leave private payers vulnerable to price hikes in relation to dispensing fees and mark-ups. So while group drug plan sponsors remain hopeful that this latest round of reforms will provide the answer to spiraling plan costs, it is not certain that these proposals will deliver savings, and they may increase plan costs.

Pier 21 Offers Global Equity Funds

Pier 21 Asset Management Inc. has launched Canadian-domiciled pooled funds for institutional investors of all sizes. The pooled funds are complimentary global equity strategies. The Global Value Pool is sub-advised by ValueInvest Asset Management, out of Luxembourg, and the WorldWide Equity Pool is sub-advised by Carnegie Asset Management, out of Copenhagen. CIBC Mellon has been selected as custodian and record-keeper for the funds.
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HOOPP Implements PALM
Ortect Finance has successfully implemented its asset liability solution for pension funds (PALM) for the Healthcare of Ontario Pension Plan (HOOPP). It was selected by HOOPP in April 2009 to develop a tailor-made version of the system modeling the specific requirements of the pension plan as well as Canada’s pension legislation. The system enables HOOPP to conduct risk and return analyses to support strategic investment decisions and policy requirements. HOOPP is one of the largest Defined Benefit plans in Canada, with more than 250,000 plan members and net assets of $31.1 billion.

Risk Disclosure Service Launched
RBC Dexia Investor Services has launched a risk disclosure service specifically tailored to help Canadian pension plans meet the risk disclosure requirements of CICA (Canadian Institute of Chartered Accountants) 3862. CICA 3862 stipulates that audited financial statements of Canadian pension plans must incorporate information on the risk arising from financial instruments to which the plans are exposed. The risk disclosure service aggregates risk exposure information at the plan level and provides data on the required risk areas detailed in the CICA 3862 guideline. It includes required risk disclosures in areas such as credit risk exposure based on agency ratings, foreign currency exposure and the effect of exchange rate movements, and asset sensitivity to relevant market indices.

Aberdeen Opens Toronto Office
After a 58-year hiatus, Aberdeen Asset Management has re-opened an office in Toronto, ON. Martin Gilbert, founder shareholder and chief executive, told a gathering in Toronto to mark the re-opening of the office that Aberdeen traces its roots in Canada back to 1875 with the North of Scotland Canadian Mortgage Company. It later expanded to Winnipeg, MB, and Calgary, AB. However, in 1952 it sold its business in Canada to Barclays. It has been active in Canada since its acquisition of Murray Johnstone 10 years ago. The office is located at 161 Bay St., 27th Floor, Brookfield Place, Canada Trust Tower.

Hedge Funds Compensation System
Hedge funds are actually a system of compensation for managers, says Som Seif, president and CEO of Claymore Investments, Inc. In an Alternative Investment Management Association Canada debate on hedge fund fees, he argued that the industry should adopt a fee structure that more effectively ties managers’ compensation to the performance of their funds. As well, base management fees – which were originally set up to cover operational, back office, and other overhead costs – have become a significant part of overall compensation for many managers. However, with large funds who have economies of scale, this fee should be scaled back to less than the industry standard two per cent.
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* 46% of employees would like more advice from their employers about their retirement. Source: Health is Cool! A 2009 survey by Desjardins Financial Security.
Canada’s retirement savings system is not working, as it should – that, at least, is the consensus among some sponsors. Yet, how exactly to fix the system and who should bear the responsibility of reform remains a point of contention.

Although momentum behind reform was strong last year, politicians have changed their tune as of late. Provincial finance ministers in Alberta, B.C., and Ontario have suggested recently that major pension reform is not a priority, that a slower incremental approach is more appropriate, and that the private sector should be given more time to improve retirement options before deciding on a government-led solution.

**Mandate More Savings**
Government leadership, however, is precisely what’s needed now, says Glen Roberts, manager of benefits and pensions for the Memorial University of Newfoundland. Governments make the rules around retirement savings so fixes and repairs fall squarely on them, he says.

Although he feels the current pension system does work well enough for those who have access and use it, “The problem lies, I think, with using the save, which could be the best answer out there. Left on their own, he believes too many people would not save enough or start early enough to provide for a secure retirement.

Fixing surplus ownership asymmetry – whereby sponsors must cover deficits while ownership of surplus remains questionable – should also be a focus for reform, he says. “Employers who are required to fund their plans and put extra money in during bad times should also enjoy the benefits of having a funded plan during the good times.”

**Individual Responsibility**
Too much government involvement, however, is not the answer for David Harding, regional sales director, pensions, Industrial Alliance Insurance and Financial Services Inc. Ultimately, it comes down to the individual to save, he says.

After 25 years in pensions, one fact remains for Harding – getting individuals to save for retirement, even when they have access to a sufficient group plan, can be difficult. He agrees that pension reform is needed, perhaps by mandating more savings from Canadians. However, he thinks a private sector approach with government support and where pri-
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Message sponsored by Benefits and Pensions Monitor.
Over the past few years, e-health, telehealth, or telemedicine have been advancing by leaps and bounds, facilitating diagnosis and treatment from remote locations, supporting education and training, and managing recordkeeping. These developments have many advantages for home care and workplace health as they enable patients to successfully manage chronic medical conditions and give injured workers a better chance of returning to work earlier.

Let’s take a peek at a few examples that will give us a glimpse into what’s happening.

◆ Situation 1: For those on the go
You’re an insurance adjuster. You spend half of your working hours in the office and the other half on the road. You’ve got a fast-paced lifestyle and a heart condition and your blood pressure is one of your biggest concerns. You keep forgetting to take your medication and your doctor has suggested you lose weight and regularly check your vitals.

Monitoring on the go? Here’s one more reason to love your BlackBerry. Data collection is now possible with BlackBerries and other smart phones. Simple devices such as blood pressure monitors can now take readings right in a patient’s own home or office. Key conferencing means it might not be necessary to leave the office to get some of the consultations you need.

◆ Situation 2: Instant care
You’re a busy team leader in an office and your psoriasis has been inflamed for the last week, but you’re reluctant to take an afternoon off to consult with a dermatologist.

Waiting and travel times to see a specialist can be prohibitive to obtaining timely, accurate diagnosis that improves comfort and quality of life for skincare patients. In the future, in many workplaces, you’ll be able to take advantage of the empty boardroom or visit the health centre to use teleconferencing equipment to put you in touch with health professionals. With visible conditions and even non-visible health issues which can be described, or pre-existing needs which require education and on-going management (such as diabetes or asthma), video conferencing is then sent for review by a health professional. These ‘just-in-time’ systems make it easy to catch early warning signs and reduce risks.

◆ Situation 3: The caregiver’s role
You’re a plant supervisor at a global manufacturing facility. Your mother is at home and quite frail. You’re worried all the time that she’ll have a fall while home alone.

According to Statistics Canada, approximately 1.65 million Canadians over the age of 45 provided care to a parent or in-law with a health issue or physical impairment in 2007. As the population ages, the number of Canadians acting as caregivers is on the rise.

Fortunately, as technology improves, information and care will become more efficient and accessible. Caregivers will be able to stay in touch and informed of their loved one’s conditions in a much more organized way. Electronic medical records will be easy to access and transfer between care providers. Homecare providers will be dispatched and tracked using RFID-enabled devices. For individuals living independently at home, an emergency response system can be invaluable. When the button is pushed, trained response centre associates will connect with the resident to assess their situation. Emergency help can be dispatched immediately from the call centre in time of distress, if necessary.

Techno Revolution: Telehealth In The workplace

The Future Is Friendly
Of course, telehealth and the use of innovative technology are predicted as key drivers in reducing overall healthcare costs. However, it goes without saying that there are distinct benefits for employers who embrace new applications and encourage early adoption.

For example, tele-health is a great educational resource. Getting expert advice or speakers can be difficult and costly; companies might not have the time or resources to host a ‘lunch and learn,’ or groups may be too small or remote. Now professionals can be accessed easily by eMail, live chats, webcasts, or teleconferencing, so sessions can be facilitated without having to leave the office and can be arranged to accommodate various schedules/shifts.

And, the best thing about these services is that they are available 24 hours a day, seven days a week and can often avert an unnecessary trip to the ER. ■

HEALTH MATTERS
By: Caroline Tapp-McDougall

Caroline Tapp-McDougall 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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¹ As at December 31, 2009, Invesco Ltd. had US$201 billion institutional assets under management. *Invesco and all associated trademarks are trademarks of Invesco Holding Company Limited, used under licence. ©Invesco, 2010.

Let’s talk. Call us to learn how we can bring the best of Invesco to your plan members.

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Liability driven investing (LDI) differs from a traditional policy portfolio approach in that an actual liability stream serves as the benchmark instead of a simple return target or a proxy based on market indices. Under an LDI approach, success is judged in terms of how closely investment returns track changes in the liability benchmark, rather than relative or absolute performance objectives. By taking on measured, compensated risk, an LDI portfolio can decrease a funding shortfall or build a reserve against unforeseen developments in the pension environment or capital markets, in effect reducing the true risk of the pension plan.

LDI turns the traditional pension framework upside down. Cash in an LDI setting can be a high-risk asset since its low duration provides little or no correlation with bond yield-driven swings in liability valuations. Long bonds, on the other hand, are typically considered low-risk because their values adhere more closely with changes in long-term liabilities.

**Tightly Matched**
LDI has largely come to be associated with passive or dedicated strategies, where income streams are tightly matched to the payment flow of liabilities. To minimize the variability of the asset/liability ratio under changes in interest rates.

Unfortunately, the liabilities are spread along the yield curve and purely extending duration can result in a structural mismatch which can lead to unwanted volatility in the asset/liability ratio relative to a pure flow match strategy under certain yield curve changes.

A superior approach is to analyze the performance of the assets and liabilities against a series of yield curve scenarios. The greater precision this provides not only improves the accuracy of the outcomes, but also provides a sound foundation for assessing potential active management strategies. It is our view that when building a liability driven portfolio, it can be advantageous to invest in corporate bonds whose credit is stable and the possibility of a credit event is remote. We believe in the use of credit products and would suggest that, at times, it can be advantageous to invest up to 75 per cent to 100 per cent in corporate bonds.

Longer-dated securities are more volatile from both the standpoint of duration and credit spread divergences. Miscalculations in credit risk assessment represent a much greater risk to a plan’s funded status than for comparable market duration bonds.

**Long Duration Corporate Strategy**

In our view, this is an unnecessarily narrow depiction of LDI principles and one that results in lost opportunities.

Where appropriate, we advise an active approach to LDI, allowing portfolios to vary from an immunized position to take advantage of opportunities to add value. The traditional method of relying on a single discount rate to value liabilities does not fully capture their often complex structure and true interest-rate sensitivity. In order to measure liabilities properly, we need to discount cash flows along a predetermined yield curve structure. We advise the use of a blended yield curve made up of various credits that correspond to the policy statement’s credit exposures.

We start with the objective of constructing portfolios that will perform similar to, or outperform, the plan’s liabilities as market yields change over time. This style of investing can be described as a dollar duration approach. A dollar duration approach requires that the asset’s duration target be adjusted to a number that will ensure that the change in the dollar value of assets approximates the change in the dollar value of the liabilities. This adjustment factor is the ratio of the assets to liabilities discounted at the predetermined yield curve. In theory, this should

Conversely it is more difficult to contemplate what a highly cyclical company like a retailer or an industry dependent on technological advances and heavy capital expenditures such as telecommunications will look like in the long-term.

**Fallen Angel**
When matching long dated asset and liabilities, one of the worst outcomes for the corporate bond portfolio is an impairment of principal either from a ‘fallen angel’ bond that is downgraded below investment grade and trades on a dollar basis rather than a credit spread basis and/or from a default. The resulting loss of duration from a bond default creates a duration mismatch in the portfolio. The fund may also be forced to manage that mismatch for a long time as credit default wind-ups can take two to three years. It is crucial in long-term corporate bond security selection to ensure that the corporation’s underlying assets and cash flows supporting the bonds are long-dated. As an example, it is fairly easy to fathom that a company that operates an electricity transmission network or a natural gas distribution network will still be standing and necessary 30 or 40 years from now.

By: Bruce Corneil, David Gregoris, & Sue McNamara

Bruce Corneil is a senior vice-president, fixed income, and David Gregoris, CFA, and Sue McNamara, CFA, are vice-presidents, fixed income, at Beutel Goodman.
Before the markets shuddered in the fall of 2008, pension funds were increasing their use of, and allocation to, alternative investments. While Canadian funds had not moved with the same conviction as their counterparts in the United States and around the world, momentum was developing.¹

For some, calling these investments ‘alternatives’ may seem like a contradiction. Although hedge funds are still infrequently employed by Canadian pensions,² private investment strategies such as private equity and private real estate appear in investment portfolios more regularly. Many other strategies have joined the big three in the ranks of alternative investments – examples include portable alpha, active currency management, tactical asset allocation overlays, convertibles, and infrastructure. While commodity- and timber-related companies comprise a significant weighting in the public equity S&P/TSX Index, there are also increased alternative strategies that utilize commodity and timber derivatives and real assets.

The financial crisis may have prompted a reconsideration even as alternatives were inching towards the mainstream. Uncertainty and fear became the predominant drivers of the public markets. These same emotions certainly gripped the psyche of institutional investors: some seeking safety and the comfort of familiarity. Many alternative investments experienced significant underperformance relative to historical standards and diversification seemed to matter less as correlations converged with the financial stresses in late 2008 (although we would argue that diversification remains a core component of alternative investment strategies). Hedge funds, real estate, and private equity all suffered along with public equities and sensational headlines around hedge fund fraud intensified whatever conservatism towards alternative investments already existed.

Alternatives: The Least Of Your Worries?

The numbers, however, tell a more nuanced story. While alternatives did falter and delivered short on long-term expectations, they generally performed better than many public equity markets during the global equity decline (see Figure 1).

These numbers point to a conclusion that may be surprising to many. Over the last 18 months, alternative investments often were the least of investors’ worries given declining pension funding levels and broader concerns with capital market conditions. Even during the greatest periods of stress, these various asset classes provided diversification.

This positive outlook is, of course, too simplistic. Like all investments, alternatives come with risk. However, during the financial crisis, some of the risks associated with certain alternative strategies produced extraordinary challenges.

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For more information on Alternative Investment Managers, visit www.bpnmagazine.com

Art For Investment’s Sake

Can art be considered an alternative means of generating a return using structured funds as vehicles for institutional investors? A paper entitled ‘Art As An Alternative Investment Asset,’ by Raya Mamarbachi, Marc Day, and Giampiero Favato, of the Henley Business School, looks at using art in portfolios in the interest of diversification. While the volatility and illiquidity of the art market make it hard to compare with more conventional investments, its low correlation with the equities market and desirable risk and reward ratio make it an attractive investment.

However, there is the question of its economic value. The price of art is as much an emotional value as it is an economic assessment.

For instance, some alternative investments, such as arbitrage hedge funds or private equity buyout funds, often relied heavily on leverage to obtain returns prior to the global market collapse, which, of course, amplified the downward slide of the equity markets. Additionally, during the financial crisis, some institutional investors had to scour their portfolios for liquidity; those with significant com-

By: Janine Baldridge & Tom Lappalainen
mitments to illiquid private investments found little help in this regard as would be expected.

More surprising was the magnitude of hedge fund co-investment risk. Investors seeking liquidity during the crisis forced asset sales at depressed prices or required hedge funds to enact policies to delay the return of capital until market conditions improved.

Has The Landscape Changed For Alternatives?

Alternative investments are being developed and managed by some of the most innovative and dynamic forces in the industry. Hedge fund success is often a result of insightful experts able to identify and capture new alpha opportunities. While private investment strategies generally have less flexibility to adapt to short-term opportunities, successful managers will shift their programs based on changing market conditions. When considering the landscape for alternatives, investors should expect evolution.

Even still, the stressed market conditions over the last 18 months have brought notable changes across the alternative investment spectrum. Pension funds with the ability to forego liquidity or withstand negative drawdowns stand out as favorable client propositions for some alternative investors and they should be rewarded commensurately. The more rigorous standards of institutional investors are becoming more common in alternatives and they will seek greater institutional alignment.

Institutional investors can, and should, now demand greater transparency and information flow from managers. Last year saw a variety of concessions; some were short term to entice existing investors to stay put or seek new investors to cover redemptions. Fundamental shifts within hedge funds, post-Madoff, have led investors to require greater separation of investment, administrative, and pricing activities. Information flow has improved and there is an increased willingness to provide more details in investor letters and onsite meetings. Additionally, the hedge fund industry is open to bringing in third-party aggregators and monitors to provide an outside view on risk. Within private markets, the primacy of capital has reasserted its strength and, in some situations, general partners are willing to discuss more favourable terms and better fee structures.

Pension funds should see the new landscape as more than a moment to change the terms of engagement – it is also one that is ripe with investment potential. New opportunities have arisen across the alternative investment spectrum, especially for those investors with capital who can navigate through uncertain and volatile times. Still, they must be willing to understand and manage their expectations for the underlying investment strategy.

The diversity of alternative investment strategies and breadth of products available within hedge funds and private investments requires institutional investors to develop appropriate risk and governance processes within their own organizations. The last two years have tested all risk management processes; alternative investments were certainly not immune, given higher degrees of investment freedom, security and product illiquidity, and higher leverage. Investors also face different governance challenges given increased strategy complexities, coupled with lower transparency levels. Investors must ensure the additional risks associated with alternative investments are identified and properly managed.

Do Alternatives Still Make Sense?

These investments continue to offer real diversification, an opportunity for excess return, and access to a set of investment opportunities not available through traditional investment strategies. As in the past, institutional investment programs seeking to invest in private markets should include a diversified approach and multiple vintage year commitments.

Private equity is notably different from public equity because of the close relationship between ownership and management, the ability of the owners to intervene if necessary, and the consequent alignment of interest. There are also particular opportunities available only through private equity partnerships such as venture capital investing, corporate restructuring, buyouts, and rescues from administration or bankruptcy.

In addition to the structural advantages that private equity can offer, market conditions continue to improve resulting in interesting new opportunities for investors. While some general partners focused on improving the financial and operating strength of key portfolio companies during 2009, other firms that were previously closed

Combining Appreciation With Pleasure

The following is an excerpt from an article entitled ‘The Wheels Haven’t Fallen Off These Investments,’ by Peter Volny. The entire article can be seen at our Private Wealth Canada web page, http://www.privatewealthmagazine.ca/index2010.html.

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assion; beauty; excitement; competition; high performance; prestige; exclusivity; special events; opportunities to meet like-minded aficionados – these are not words you typically associate with investments. How do you put a value on any of them individually, let alone combined?

You certainly don’t get those qualities with owning Microsoft or Google stock. However, you might by owning a 250GTO Ferrari, a Shelby Daytona Coupe, or a 1964 Pontiac GTO.

So how do you go about this type of investing? Well, just as in traditional stock market investing, there are two ways – you can do it yourself or you can hire an advisor. Either way the best place to start is by actually attending a few auctions, watching the action, walking about examining the cars, and talking to the many true experts who are always only too happy to offer advice.

So what about appreciation? In 1962, a brand new Ferrari 250 GTO, a race car you could also drive on the street, would have cost you US$18,000. A scant three years later in 1965, no longer truly competitive, but still a wonderful car, one could be acquired for a mere US$15,000. However, there were only 36 total GTO examples made, and just last year one sold privately for a rumored US$28.5 million. That’s 190,000 per cent appreciation in 43 years, far ahead of the TSX return of 1,053 per cent.
Horizons BetaPro Spread Exchange Traded Funds ("HBP Spread ETFs"), which combine long and short exposure, use leveraged investment techniques that magnify gains and losses, which may result in greater volatility in value. HBP Spread ETFs are subject to leverage risk, aggressive investment risk and price volatility risk, which are described in the HBP Spread ETF’s prospectus.

Each HBP Spread ETF seeks a return that is the sum of 100% of the performance of a specified underlying index, commodity or benchmark (the “target”) plus -100% of the performance of a second specified underlying target, for a single day. Due to the compounding of daily returns, an HBP Spread ETF’s returns over periods other than one day will likely differ in amount and possibly direction from the combined performance and inverse performance of the specified underlying targets for the same period. Investors should monitor their holdings, as frequently as daily, to ensure that they remain consistent with their investment strategies. Commissions, management fees and expenses all may be associated with HBP Spread ETFs. HBP Spread ETFs are not guaranteed, their values change frequently and past performance may not be repeated. All trademarks/service marks are registered by their respective owners and licensed for use by BetaPro Management Inc. and none of the owners thereof or any of their affiliates sponsor, endorse, sell, promote or make any representation regarding the advisability of investing in HBP Spread ETFs. Complete trademark and servicemark information is available at www.hbpetfs.com/pub/en/Trademark.aspx. Please read the prospectus before investing.
have re-opened to new investors. Though credit markets have stabilized some, private equity firms remain an attractive source of financing where more conventional lenders have not returned to the market.

As for the private real estate sector, the steep value declines caused by the global financial crisis and recession have created a more attractive entry point for core and opportunistic real estate investors. While most real estate markets have remained illiquid since the financial crisis, the few deals that have been completed have superior risk-adjusted return potential. Going forward, this trend is expected to continue for the next few years around the globe. Investors will be able to access new acquisitions at discounts to replacement costs and use realistic assumptions in their underwriting to meet return objectives.

Higher alpha-driven products, typically associated with hedge funds, continue to seek favourable risk-adjusted returns through active management strategies. Unlike traditional mutual funds or long-only equity mandates, hedge funds are unregulated and, therefore, can take advantage of unconventional techniques such as leveraging and short-selling without hindrance. The case for investing in a hedge fund ultimately rests on the selection of skilled managers. It should be noted, however, that the rewards awarded to successful hedge fund managers have brought some of the most skilled managers into the hedge fund space.

We expect the premium on skill to come forward in the current environment as the low-hanging fruit associated with the market downturn may no longer be available. Many hedge fund strategies experienced significant rebounds in 2009; some increased market exposures as stock and bond markets rose. However, others limited market exposures and captured positive excess returns through skillful security selection associated with long and short positions.

Alternatives And The Total Fund Approach

The term alternatives is, and will continue to be, a broad one that consists of a spectrum of returns, risks, liquidity, and leverage. Additionally, the changing landscape of products allows investors to seek strategies and terms appropriate for their objectives, time horizon, and risk tolerance.

Pension funds need to take a total fund approach to their investment policy and the thinking behind this approach is especially clear when investing in alternatives. Though some characteristics and risks may be more prevalent within certain asset classes, a holistic total fund investment and operational approach increases the potential to effectively manage challenges and opportunities.

For example, pension funds may be exposed to operational and investment risks associated with derivatives across multiple asset classes and products, including hedge funds, overlay rebalancing strategies, and private investments, as well as traditional fixed income and equities strategies. In addition, funds often have multiple exposures to risks associated with co-investing, illiquidity, and operations.

Investors must also identify and manage the risks associated with material thematic exposures at the total fund level. For example, distressed investing is a growing theme across asset classes. Traditional equity and fixed income managers may seek to increase exposures to lower quality corporate assets or structured securities. Private equity, real estate, and infrastructure firms are also finding attractive equity and debt opportunities with lower quality or distressed firms.

A total fund approach that helps identify and effectively manage all types of market exposures and risk factors can be especially useful. As alternative investment strategies continue to expand, they are overlapping. When investors find and understand the resulting connections, similarities, and commonalities, then they can more effectively manage risk and seize opportunity. And, then they will also be better able to unlock key sources of value from within their alternative investment programs.

Janine Baldridge is head of global consulting and advisory services and Tom Lappalainen is a Toronto-based senior consultant at Russell Investments.

2. IBID: 2009 hedge fund allocation: 2.5 per cent of total assets

Since 1993, the value of gold has increased three-fold, says Rodney Birrell, director of The Wine Investment Fund. Over the same time frame, the value of “fine wine” has increased 10-fold and the asset class is now producing returns of around 15 per cent per annum, according to the Fine Wines Investible Index produced by Livex, the fine wine exchange.

Speaking at the Hedge Fund Hotel’s ‘After-the-close’ event, he said interest in fine wine as an investment continues to grow globally, with increased interest from the institutional market. The portfolio valuations for the end of March for all the tranches of his fund were up anywhere from 3.1 per cent to five per cent for the month, a clear indication that it, too, has recovered from the financial crisis which saw spending on luxury items, such as fine wine, curtailed.

In wine investment circles, “fine wine” mostly means Bordeaux. The chateaus in that part of France have historically fixed parcels of land. However, the top Chateaux make only about 180 cases per acre and there are only about 40 investment grade Chateaux. Of these, only three or four vintages per decade make great wines. This means investment grade wines as an asset class represent a perfect inverse supply curve, says Birrell.

However, this is not a short-term investment. While gains were possible over the past two years, investments in fine wine should be viewed as mid to long-term commitments. At least five years should be considered the norm, with eight to 10 years being better.
Today, investors globally are rethinking their asset allocations. While 2009 provided some relief to Canadian pension plans as equities rebounded, many plan sponsors and consultants recognize that the standard 60 per cent equity/40 per cent bond mix has too much equity risk relative to liabilities. While the lost equity decade has pushed many plans into illiquid ‘alternatives,’ such as infrastructure or real estate, many Canadian plans are revisiting hedge funds as the liquid ‘alternative.’

A Changing Hedge Fund Industry
As Casey Quirk stated in April 2009, the hedge fund industry faced a ‘transformational crisis’ and was forced to address shortcomings in its business model to position itself as the future of active asset management. The industry currently has significant

Managed Account Structure
A hedge fund MAC, which typically mirrors a manager’s existing hedge fund, is similar to the way investors give mandates to long-only managers (as advisors to a portfolio with assets held by their custodian). Figure 1 shows an example of a MAC structure at a hedge FoF, which is tailored to the FoF’s specific restrictions. Thus, the manager can select securities, construct the portfolio, and execute trades, but has no control over assets or the MAC’s operations, which are managed by the FoF company using independent service providers (administrators, prime brokers). As a separate legal entity, each MAC is ring-fenced with its own corporate structure, registrar, bank accounts, books, and records, as well as independent governance through a board of directors.

Figure 1

Hedge Fund Investing Using Managed Accounts (MACs)

Key MAC Benefits
In addition to the governance and independence benefits of the structure, MACs give investors greater certainty around liquidity, control over the assets, and
position-level transparency. Therefore, MACs provide more detailed and timely information than pooled funds and clarity regarding performance attribution. This detailed information allows investors to monitor concentration risk and to quickly detect style drift or other trading anomalies. Key MAC benefits include:

◆ Control of assets: Since each MAC is a separate entity, there is no cross-liability with other MACs. If required, the investor can terminate the investment management agreement with the manager and take control of the assets.

◆ Transparency: All service providers coordinate regularly with both the investor and the manager and the investor can monitor positions and risk limits daily for risk management purposes (limits include approved instruments, sectors, margin-to-equity, equity leverage, VaR, etc.).

◆ Liquidity: MAC investors may benefit from favourable liquidity terms (liquid strategies, such as managed futures and long-short equity, can often be redeemed monthly).

Key MAC Considerations
MACs have limitations including:

◆ Tracking error: Refers to a performance difference between the manager’s pooled fund and the MAC. Monitoring a MAC’s tracking error against the fund is essential, as variations may indicate operational or investment issues.

◆ Additional cost: A MAC may increase costs relative to a pooled fund as they require increased services to manage. These costs vary depending on the hedge fund strategy, the level of MAC assets, the comprehensiveness of the risk monitoring, etc.

◆ Other issues: Since MACs are separate entities with their own service providers, they may present operational challenges for managers. Also, MACs may not be suitable for all hedge funds, such as those that only hold illiquid securities or hard-to-price assets. Nevertheless, there are MACs for all of the main hedge fund strategies.

In summary, MACs will continue to be a key part of the hedge fund industry, and many hedge FoFs are committed to continue investing in their MAC offerings. In addition to the control, transparency, and liquidity provided by MACs, large hedge FoFs with MAC platforms are well-positioned as solution providers, offering risk management oversight, bespoke and transparent investor reporting, and portfolio management advice.

Bernice Miedzinski is executive vice-president, institutional clients Canada, at Man Investments in Toronto (bmiedzinski@maninvestments.com).

1. Equity risk refers to both volatility and to large drawdowns (losses), which typically take significant time to recover.
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ARROW HEDGE PARTNERS INC. Mark Purdy, Managing Director & CIO; 36 Toronto St., Ste. 750, Toronto, ON M5C 2C5 PH: 416-323-0477 Fax: 416-323-3199 eMail: mpurdy@arrowhedge.com Web: www.arrowhedge.com Asset Classes: Fund of Hedge Funds, Long/Short and Credit Mandates, Customized Portfolio Solutions (Standalone Single Manager Hedge Funds principally through managed account platform) Ownership: 100% Employee-owned Managed Since: 2000

ARTERIS INVESTMENT MANAGEMENT Lisa Conrad, Director, Client Service; 5 Hazelton Ave., Ste. 200, Toronto, ON MSZ 2E1 PH: 647-477-4886 Fax: 416-934-7459 eMail: lconrad@arterisfunds.ca Web: www.arterisfunds.ca Asset Classes: Private Equity, Hedge Fund (Canadian), Hedge Fund (US) Assets Under Management: $260M

AURION CAPITAL MANAGEMENT INC. Christopher D.C. Wright, Vice-president, Business Development; 120 Adelaide St. W., Ste. 2205, Toronto, ON M5H 1T1 PH: 416-866-2420 Fax: 416-363-6206 eMail: cwright@aurion.ca Web: www.aurion.ca Asset Classes: Real Estate Portfolio Management, Global Hedge Funds, Infrastructure (Global, Mid-market Investments) Assets Under Management: $267M Ownership: Employee Group - 40%, DundeeWealth - 60% Relationshps: Aurion Infrastructure Inc. (subsidiary providing infrastructure investment management services) Managed Since: 1984

AUSPICE CAPITAL ADVISORS Basil D’Souza, Director of Business Development; Ste. 410, 744 4th Ave. S.W., Calgary, AB T2P 3T4 PH: 888-792-9291 eMail: info@auspicecapital.com Web: www.auspicecapital.com Asset Classes: Managed Futures; Active (alpha) and Passive (beta) Commodity Strategies; Quantitative Strategies in Commodity and Financial Futures; Diversified Strategy across Grains, Metals, Energies, Soft Commodities, Currencies, Interest Rate Movements, and Equity Indices; Institutional Experience in Energy Commodity Trading Ownership: 100% Employee-owned Relationships: Creator and investment manager for the Claymore Natural Gas ETF Managed Since: 2006


BLACKROCK Eric Levelle, Head of Canadian Institutional Group within the Global Client Group; 161 Bay St., Ste. 2500, Toronto, ON M51 2P4 PH: 416-643-4040 Fax: 416-643-4049 eMail: eric.levelle@blackrock.com Web: www.blackrock.com Asset Classes: Hedge Funds, Funds of Hedge Funds, Private Equity Fund of Funds, Structured Products (including CDOs and Private Debt and Equity Funds), Real Estate Products, Long Only Absolute Return Funds, Assets Under Management: $4,493.2M Ownership: Independent in ownership and governance, with no single majority stockholder and a majority of independent directors; Bank of America - 34%; The PNC Financial Services Group, Inc. - 24.3%; Barclays - 19.7%; Institutional Investors, Employees, and Public - 22% Relationships: Fund of Hedge Funds effort focuses on creating and structuring portfolios of hedge funds managed by unaffiliated firms Managed Since: 1994

BROOKFIELD ASSET MANAGEMENT INC. Eric Bonnor, Senior Vice-president, Private Equity Funds Group; Angela Vidakovich, Director, Marketing and Client Service; 181 Bay St., Box 762, Toronto, ON M5J 2P4 PH: 416-363-9491 or 416-956-5229 Fax: 416-365-9642 eMail: ebonnor@brookfield.com or angela.vidakovich@brookfield.com Web: www.brookfield.com Asset Classes: Infrastructure, Real Estate, Private Equity, Debt, Timberlands, AgriLand, Global Real Estate Securities, Global Listed Infrastructure Securities, Structured Products (ABS, RMBS, CMBS), Fixed Income (Core and High Yield) Ownership: Public Company Managed Since: 2001


DEXIA ASSET MANAGEMENT* Christophe Vandewiele, Head of Dexia Asset Management, Canadian Representative Office; 155 Wellington St. W., 6th Floor, Toronto, ON M5V 3L3 PH: 416-974-9055 Fax: 416-955-6226 eMail: christophe.vandewiele@dexia.com Web: www.dexia-am.com Asset Classes: Index Arbitrage, Risk Arbitrage, European Equity Market Neutral, Long Short Equities, High Yield Management, Credit Leveraged Loans, Managed Futures (CTA), Emerging Debt Arbitrage, Volatility Arbitrage, Convertible Bonds, Real Estate, Commodities, Internal Multi-management, External Multi-management Ownership: Holding Organization for the asset management activities of the Dexia Group (Dexia S.A.); it owns 99.94% of Dexia Asset Management S.A. (France) and 99.99% of Dexia Asset Management Belgium S.A. Managed Since: 1996


EIM MANAGEMENT (USA) INC. Brian Brooks, Director, Business Development; 750 Lexington Ave., 27th Floor, New York, NY 10022 PH: 212-371-9000 Fax: 212-371-9111 eMail: bbrooks@eimusa.com or businessdevelopment@eimusa.com Asset Classes: The firm develops and manages Fund of Hedge Fund Portfolios for their clients and maintains the ability to design customized portfolios across all asset classes and risk objectives. Assets Under Management: Fund of Hedge Fund for a Canadian Corporate Pension Fund: $45M, Canadian Financial Institution: $31M Ownership: Wholly-owned Subsidiary of EIM Group Managed Since: EIM Group - 1992, EIM USA - 1999


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FRANKLIN TEMPLETON INSTITUTIONAL Duane Green, Senior Vice-president, Institutional Investment Services; 200 King St. W., Ste. 1500, Toronto, ON M5H 3T4 PH: 416-957-6165 Fax: 416-364-6643 eMail:
GE ASSET MANAGEMENT INCORPORATED

GOLDMAN SACHS ASSET MANAGEMENT, LP
Steve McGuinness, Managing Director, Co-Chief Operating Officer; 200 West St., New York, NY 10282 PH: 212-902-1000 Web: www.gs.com Asset Classes: Hedge Fund of Funds, Direct Hedge Funds, Private Equity Assets Under Management: $1,186.7M Ownership: The firm is a Delaware Limited Partnership and Goldman Sachs Group, Inc. is the General Partner and Goldman Sachs Global Holdings, LLC is the Limited Partner. Managed Since: 1987

GREYSTONE INVESTED INVESTMENTS INC.
Louis Martel, Managing Director & Chief Client Strategist; 300-1320 Blackfoot Dr., Regina, SK S4S 7G6 PH: 306-779-6400 Fax: 306-585-1570 eMail: louis.martel@greystone.ca Web: www.greystone.ca Asset Classes: Canadian Real Estate, Canadian Mortgages Assets Under Management: $4,304.8M Ownership: Private Company, 68% owned by Employees Managed Since: 1988

GUARDIAN CAPITAL LP
Brian Holland, Senior Vice-president; Commerce Court West, 199 Bay St., Ste. 3100, Toronto, ON M5L 1E8 PH: 416-350-3146 Fax: 416-364-9634 eMail: brian.holland@guardiancapital.com Web: www.guardiancapital.com Asset Classes: Canada 130/30 Equity Fund, Global 130/30 Equity Fund Assets Under Management: $80M Ownership: Public Company Managed Since: 2007

GWL INVESTMENT MANAGEMENT LTD.
Patrick J. Clarke, Vice-president, Investment Counselling; 100 Osborne St. N., Winnipeg, MB R3C 3A5 PH: 204-946-8701 Fax: 204-946-8818 eMail: sara.mosher@gwl.ca Web: www.gwl.ca Asset Classes: Canadian Real Estate Investment Fund No. 1, Mortgage Investment Fund No. 1 Assets Under Management: $2,655.3M Ownership: 100% owned by The Great-West Life Assurance Company, which is controlled by Power Financial Corporation through its ownership of Great-West Lifeico Managed Since: 1966

HILLSDALE INVESTMENT MANAGEMENT INC.

HORIZON ETFS

HSBC GLOBAL ASSET MANAGEMENT (CANADA) LIMITED

INTEGRA CAPITAL LIMITED

INTEGRATED ASSET MANAGEMENT CORP.
David Mather, Executive Vice-president; 70 University Ave., Ste. 1200, Toronto, ON M5J 2M4 PH: 416-933-8274 Fax: 416-360-7446 eMail: dmather@iamgroup.com Web: www.iamgroup.com Asset Classes: Private Equity, Private Corporate Debt, Real Estate, Managed Futures, Hedge Funds Assets Under Management: $2.1B Ownership: Public Company, 75% owned by Management Managed Since: 1998

INVESCO LTD.
Bruce E. Winch, Senior Vice-president; 120 Bloor St. E, Toronto, ON M4W 1B7 PH: 416-324-7448 eMail: bruce.winch@invesco.com Web: www.institutional.invesco.ca Asset Classes: Real Estate Securities, Direct Real Estate, Private Equity, Distressed Debt, Absolute Return, Alternative Beta, Commodities Assets Under Management: $52B Ownership: Publicly-owned Company with 8% Employee ownership Managed Since: 1982

J.P. MORGAN ASSET MANAGEMENT (CANADA) INC.
Mark Doyle, Vice-president; 200 Bay St., South Tower, Ste. 1800, Toronto, ON M5J 2J2 PH: 416-981-9109 Fax: 416-981-9196 eMail: mark.x.doyle@jpmorgan.com Web: www.jpmorgan.com/pages/jpmorgan/am Asset Classes: Hedge Funds, Private Equity, Infrastructure, Real Estate/REITs, Currency (Active) Assets Under Management: $2,968.1M Ownership: Wholly-owned Subsidiary of J.P. Morgan Chase & Co. Relationships: From time to time, the firm co-invests with other managers but does not employ sub-advisors. Wholly-owned Subsidiaries Engaging in Alternatives - Highbridge Capital Management (Hedge Funds), Security Capital (Real Estate) Managed Since: 1971

JCCLRARK LTD.
Sean Wyn, Director of Marketing; 130 Adelaide St. W., Ste. 3400, Toronto, ON M5H 3P5 PH: 416-361-4533 Fax: 416-361-0128 eMail: swynm@jcclark.com Web: www.jcclark.com Asset Classes: North American Long Short Equity Hedge, Canadian Long Short Equity Hedge, Value Long Short, Specialty Situations Funds Ownership: 100% Insider-owned Managed Since: 2001 - Principal has managed long/short limited partnerships since 1982
KENSINGTON CAPITAL PARTNERS INC.
Senior Vice President, Institutional Clients, Canada; 70 York St., Ste. 1202, Toronto, ON M5J 1S9
Ph: 416-775-3655 Fax: 416-775-3601 Email: b.miedzinski@kcapinvestments.com Web: www.kcapinvestments.com
Asset Classes: Hedge Fund-of-funds (FoFs) - Diversified Hedge Fund, Long/Short Equity FoFs, Commodities FoFs, Global Macro FoFs, Managed Futures FoFs, Customized Hedge FoFs (using Managed Accounts); Single Hedge Fund Managers - Managed Futures, Credit Strategies, Natural Catastrophe Insurance-linked Securities Ownership - Publicly-owned (Man Group plc) Relationships: AHL (Managed Futures Manager) - 100% owned by Man Group plc; Ore Hill Partners (US Credit Manager) - 50% owned by Man Group plc; Nephila (Natural Catastrophe Risk (Insurance-linked Securities) Manager) - 25% owned by Man Group plc Managed Since: 1983

MARRET ASSET MANAGEMENT INC.
Senior Vice President; 150 King St. W., Ste. 2304, Toronto, ON M5H 2N7 Ph: 416-214-5800 Fax: 647-439-6471 Email: lmisner@marret.ca Web: www.marret.ca Asset Classes: High Yield Bonds Assets Under Management: $544M Ownership: Employee-owned Managed Since: 2000

MORGUARD INVESTMENTS LIMITED
Managing Director, Head of Distribution; 220 Bay St., 4th Floor, Toronto, ON M5J 1J9 Ph: 416-304-6001 Email: d.gregoire@morguard.com Web: www.morguard.com Asset Classes: Hedge Funds, Private Equity Ownership: Subsidiary of Jones Lang LaSalle Incorporated Managed Since: 1980

LASALLE INVESTMENT MANAGEMENT

LANDRY MORIN INC.
Executive Vice President, Institutional Clients, Canada; 70 York St., Ste. 1202, Toronto, ON M5J 1S9 Ph: 416-775-3655 Fax: 416-775-3601 Email: b.miedzinski@kcapinvestments.com Web: www.kcapinvestments.com
Asset Classes: Hedge Fund-of-funds (FoFs) - Diversified Hedge Fund, Long/Short Equity FoFs, Commodities FoFs, Global Macro FoFs, Managed Futures FoFs, Customized Hedge FoFs (using Managed Accounts); Single Hedge Fund Managers - Managed Futures, Credit Strategies, Natural Catastrophe Insurance-linked Securities Ownership - Publicly-owned (Man Group plc) Relationships: AHL (Managed Futures Manager) - 100% owned by Man Group plc; Ore Hill Partners (US Credit Manager) - 50% owned by Man Group plc; Nephila (Natural Catastrophe Risk (Insurance-linked Securities) Manager) - 25% owned by Man Group plc Managed Since: 1983

PANAGORA ASSET MANAGEMENT, INC.
Robert Job, Head of Business Development; 470 Atlantic Ave., 8th Floor, Boston, MA 02210 Ph: 617-439-6359 Fax: 617-700-2600 Email: rjb@panagora.com Web: www.panagora.com

PIMCO CANADA CORP.
Andrew Forsyth, President; 120 Adelaide St. W., Ste. 1901, Toronto, ON M5H 1J1 Ph: 416-368-3349 Fax: 416-368-3576 Email: andrew.forsyth@pimco.com Web: www.pimco.ca

PRESIMA INC.
Guillaume Racine, Analyst, Business Development; 1000 Jean-Paul-Riopelle Place, Montreal Herald Bldg., Ste. 400, Montreal, QC H2Z 2B6 Ph: 514-673-1412 Fax: 514-673-1378 Email: gracine@presima.com Web: www.presima.com
Asset Classes: Global Listed Real Estate Securities: Real Estate Investment Funds, Real Estate Operating Companies Assets Under Management: $565M Ownership: Caisse de depot et placement du Quebec - 95%, Gestion Nexco Inc. - 5% (nabinvest, the Direct Asset Management Subsidiary of National Australia Bank agreed on March 31st, 2010 to take full ownership of the firm subject to regulatory approvals.) Managed Since: 1998

PYRAMIS GLOBAL ADVISORS
Michael Barrett, Head of North American Institutional Sales; 483 Bay St., Toronto, ON M5G 2N7 Ph: 416-217-7584 Email: michael.barrett.pyr@pyramis.com Web: www.pyramis.ca
Asset Classes: Global Market Neutral, Global Real Estate Assets Under Management: $9.4M Ownership: 100% Privately-owned Managed Since: 1991* A Fidelity Investments Company

PyRAMIS GLOBAL ADVISORS* Michael Barrett, Head of North American Institutional Sales; 483 Bay St., Toronto, ON M5G 2N7 Ph: 416-217-7584 Email: michael.barrett.pyr@pyramis.com Web: www.pyramis.ca Asset Classes: Global Market Neutral, Global Real Estate Assets Under Management: $9.4M Ownership: 100% Privately-owned Managed Since: 1991

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aged Since: 1998

RUSSELL INVESTMENTS CANADA LIMITED Mike Sandrasagra, Senior Client Executive, Americas, Institu-
tional (Canada); 100 King St. W., Ste. 5900, Toronto, ON M5X 1E4 PH: 416-362-8411 Fax: 416-362-4494 eMail: msandrasagra@russell.com Web: www.rus-
sell.com/ca Asset Classes: Hedge Fund, Private Equity Assets Under Management: $697M Managed Since: 1986

SARONA ASSET MANAGEMENT INC. Gerhard Pries, President; 110-18 Froshibier Dr., Waterloo, ON N2V 2G7 Ph: 519-883-7557 eMail: gpries@saronafund.com Web: www.saronafund.com Asset Classes: Impact Investments in Developing Country/Emerging Markets, Private Equity Fund-of-Funds in M/SME sectors Own-

SEI INVESTMENTS Michael Chevalka, Director, Institu-
tional Sales, 70 York St., Ste. 1600, Toronto, ON M5J 1S9 Ph: 416-847-6370 Fax: 416-777-9093 eMail: mch-


STANDARD LIFE INVESTMENTS INC. Jay Waters, Vice-president, Central Canada; 121 King St. W., Ste. 810, Toronto, ON M5H 3T9 Ph: 416-367-2049 eMail: jay.waters@standardlife.ca Web: www.sli.ca Asset Classes: Canadian Real Estate, Mortgages, Private Equity, Global Real Estate, GARS Assets Under Management: $1,314.5M Ownership: Wholly-owned Subsidiary of Standard Life Investments Limited, a Wholly-owned Subsidiary of Standard Life plc Managed Since: 1969


STONEBRIDGE FINANCIAL CORPORATION Louis Belanger, Assistant Vice-president, Structured & Project Finacing; 20 Adelaide St. E., Ste. 1201, Toronto, ON MSC 2T6 Ph: 416-364-3001 x242 Fax: 416-364-1557 eMail: lbelanger@stonebridge.ca Web: www.stone-
bridge.ca Asset Classes: Private Debt Placement in: Infrastructure, Energy, Health, Environment; Lease Securi-
tization Assets Under Management: $1.5B Ownership: Employees Managed Since: 1999

SSQ FINANCIAL GROUP Martin Leclair, Vice-president; 5160 Yonge St., Toronto, ON M2N 6L9 Ph: 416-840-0507 x4699 Fax: 877-669-1881 eMail: martin.leclair@ssq.ca Web: ssq.ca Asset Classes: Commodities, Global Real Estate, Infrastructure, Global Tactical Asset Allocation, Benchmark Insensitive, Fundamental Indexes Assets Under Management: $97M Ownership: Privately-owned Relationships: 100% - Outsourced 100% - Independent Managed Since: 2005

SSQ INVESTMENT and Retirement


UBS GLOBAL ASSET MANAGEMENT David Coyle, Director; 161 Bay St., Ste. 3900, Toronto, ON M5J 2P1 Ph: 416-681-5200 Fax: 416-681-5100 eMail: david.coyle@ubs.com Web: www.ubs.com Asset Classes: Infrastructure - Global Direct; Real Estate - Global Fund-of-funds, US and European Direct and Global Listed; Hedge Funds - Single Manager Multi-strategy and Single Strategy, Multi-manager Fund-of-

Asset Management: $305M Ownership: Wholly-owned Subsidiary Managed Since: 1997

VERTEX ONE ASSET MANAGEMENT INC. David Wallin, Vice-president; 1920 - 1177 West Hastings St., Vancouver, BC V6E 2K3 Ph: 604-681-5183 Fax: 604-
681-5146 eMail: dave@vertexone.com Web: www. vertexone.com Asset Classes: Multi-strategy: Event Driven Focus - Merger Arbitrage, Capital Structure Arbi-
trage, Convertible Arbitrage, Distressed/High Yield, Option Strategies, Shorts, Longs, Private Placements, Special Situ-

WELLINGTON FINANCIAL LP Amy Olah, Marketing Manager; 161 Bay St., Ste. 2520, Toronto, ON M5J 2P1 Ph: 416-682-6002 eMail: aolah@wellingtonfund.com Web: www.wellingtonfund.com Asset Classes: Debt Fund Assets Under Management: $150M Ownership: G/PLP Structure Relationships: The firm is man-
ged by a partnership controlled by fund management and Clairvest Group Inc. Managed Since: 2000

YALETOWN VENTURE PARTNERS INC. Hans Knapp, Partner & General Counsel; 1122 Mainland St., Ste. 510, Vancouver, BC V6B 5L1 Ph: 604-688-7807 Fax: 604-
688-7031 eMail: hans@yaletown.com Web: www. yaletown.com Asset Classes: Early Stage Venture Cap-

Benefits and Pensions Monitor – May 2010 31
Since the mid-1990s, there has been a trend towards fully or partially converting Defined Benefit plans to Defined Contribution pension plans. While pension standards legislation allows either approach, it doesn’t deal exhaustively with DC plans. As a result, these plans have adopted two distinct approaches to investment and plan design – the multi-fund, member-directed approach and the single-fund, sponsor-directed approach.

The less popular single-fund approach places all assets into a fund that is selected and monitored by the plan sponsor, with plan members having no control over the investment process. Substantially similar to the approach observed in investing and monitoring a DB portfolio, this single-fund approach implicitly proceeds on the premise that all plan members, regardless of age or circumstance, are best served by a single investment strategy that takes a balanced approach to risk and return.

The dominant plan design among Canadian DC plan sponsors has been the multi-fund, member-directed approach, a mechanism whereby plan members are given a high level of responsibility for their retirement income strategies. Significantly, while such a multi-fund approach is generally perceived to pose less legal risk, this may not actually be the case.

Plan Sponsor Responsibilities

Regardless of the approach taken, the plan sponsor must adopt a written statement of investment policies and procedures and is subject to a statutory fiduciary responsibility in respect of investments. However, sponsor responsibilities under each approach are certainly not equal.

Consider that sponsors of plans designed under the multi-fund approach are subject to CAPSA’s CAP Guidelines, which prescribe a baseline of prudent fiduciary behaviour for plan sponsors. Although these guidelines are not law, they are very much a ‘quasi-statute’ and abiding by them is considered the best way for sponsors of multi-fund DC plans to show that they have met their fiduciary responsibilities to plan members.

The CAP Guidelines impose a wide variety of responsibilities on multi-fund plan sponsors, including the prudent selection of investment options and funds through which such options are offered, the prudent selection of investment managers, and the prudent monitoring of investment options and investment managers. The multi-fund plan sponsor is also responsible under the CAP Guidelines for maintaining ongoing disclosure and education and for ensuring the meaningful and timely ability of plan members to implement investment choices.

Specifically, the sponsor of a multi-fund plan must provide investment information and decision-making tools to plan members, ensure that an appropriate range of investment options are available, and monitor the continued suitability of those investment options. The sponsor is also responsible under the CAP Guidelines for choosing and implementing a default investment option, for taking steps to ensure that members understand and discharge their responsibilities, and for providing information regarding the characteristics of each investment fund offered. Finally, the multi-fund sponsor must establish policies and procedures for switches among investment options, as well as provide information on each investment option’s performance.

The responsibilities of the single-fund plan sponsor, on the other hand, manifest themselves quite differently. As mentioned, the single-fund plan sponsor must observe the statutory standard of care in investing the single-fund offered to plan members and must adopt and implement an investment policy. However, there is no issue of complying with the CAP Guidelines. Consequently, the single-fund can be invested much like a conventional DB fund diversified portfolio that attempts to balance risk and return. The fund offered by such a plan may also be a combination of funds, as long as the salient feature remains that the plan sponsor retains control of the investment process.
Legal Risks

Because sponsors of multi-fund DC plans have a greater variety of responsibilities, they may also be subject to more legal risk than sponsors of single-fund DC plans.

Consider the increased factors in play in the multi-fund plan design, many of which could lead to investment losses. For example, inappropriate disclosure leading to inappropriate investment decisions on the part of members might result in loss, as might inappropriate choices or retention of investment options or investment managers. Members may not be able to implement choices in a timely manner, which could certainly lead to investment losses, and there may be questions about the increased fees that seem to be associated with multi-fund plan designs.

In addition, the very important question remains as to the legal risk that a multi-fund plan sponsor bears when it gives control over pension investments to individuals who are not willing or able to exercise that control. Arguably, it might be a breach of fiduciary duty to hand over investment control to plan members where there is no reason to believe that plan members, even with the state of the art education and disclosure, will be able to make efficient and appropriate investment choices.

Conversely, while there are still legal risks in sponsoring a single-fund DC plan, it must be emphasized that the sponsor is not a guarantor and is not liable for ordinary course investment losses. For this reason, it is difficult to see how a plan sponsor could be successfully sued if it prudently selected and monitored a ‘balanced fund’ as the sole investment option for its plan. The main risk for the single-fund sponsor is liability in respect of negligent investment of the fund leading to non-ordinary course investment losses. In this regard, however, one envisions more extraordinary circumstances such as conflicts of interest or ignoring blatant mismanagement of the single-fund.

Other Pros And Cons

Outside of legal risk, there are a number of other pros and cons to consider in offering a multi-fund plan design. A strong argument in favour of multi-fund DC plans, whereby members select their own investments, is that such a plan design empowers plan members and avoids the paternalism of the single-fund approach. Accordingly, this plan design tends to be popular with members who have an interest in the investment process.

A further argument in support of the multi-fund approach is that its flexibility allows investment options to be personalized so that different risk-reward strategies can be pursued by members with different ages, life circumstances, and risk tolerances.

On the other hand, it is easy to pinpoint a number of downsides to the multi-fund approach as well. Because the multi-fund approach is more complicated, we anticipate that it is also more expensive to run. Consider, for example, that by using a single-fund approach, a great deal of the management fees associated with fund transfer services, website services, or investment training would disappear. Consider also that multi-fund plan design requires that a significant amount of time be devoted to investment education and management and this time will typically be taken away from working hours.

Further, the multi-fund approach is not popular with members who don’t understand or have interest in the investment process. Interestingly, some authors have suggested that these people make up the heavy majority of plan members, even where the educational background of the members is at the university level and they have been provided with a high quality of investment education. Most people are very busy and even where they are capable of doing so, they may simply not have either the time or the inclination to adequately manage an investment portfolio.

Finally, there is some empirical evidence to suggest that multi-fund plans do actually produce lower aggregate returns than single-fund plans, showing that, unsurprisingly, expert investors tend to outperform amateur investors.

The Alternative

As noted, neither the single-fund approach nor the multi-fund approach provides a perfect solution to the plan sponsor; the single-fund approach being unabashedly paternalistic and at odds with giving plan members greater ownership over their pensions, and the multi-fund approach suffering from the fact that most plan members are indifferent to ‘opportunities’ provided by the multi-fund plan design. One possible compromise would be for plan sponsors to take a ‘hybrid’ approach.

In this type of mixed plan design, the sponsor uses a single-fund default option for plan members generally, but permits multi-fund access to those who want it. Under the hybrid approach, the monies of most members are deposited into the default option, likely a balanced fund or compilation of funds, but plan members who opt to select their own investment options through the multi-fund approach are still able to do so provided they both undertake the required investment education and complete a waiver. Such a waiver would, among other things, require members to acknowledge their own responsibilities in respect of both asset allocation and properly educating themselves with the resources provided.

Theoretically, most plan members will opt for the single-fund plan design which, as discussed, will result in reduced legal risk and cost to the plan sponsor, particularly in conjunction with the required waiver for those opting into the member-directed multi-fund plan design. Such an approach may also be very useful for plan sponsors where the organizational culture of the workplace prevents them from moving towards a single-fund approach, even where it is recognized that the single-fund approach may, in fact, yield superior aggregate returns within the respective plan.

At a minimum, presenting the choice between the single and multi-fund approach and the waiver should bring home to plan members that they have personal responsibility for informing themselves and engaging themselves in the investment process. Hopefully, this will prompt plan members to pay greater attention to their pension investments or, alternatively, to leave their investments in the default option.

The hybrid approach should thus be considered by plan sponsors as an excellent option for reducing the legal risk associated with multi-fund plan design. The approach may well result in reduced costs to a pension plan, while addressing criticisms that the single-fund approach is overly paternalistic, allowing empowerment of plan members over their asset allocation where they so desire.

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Small to medium business (SMB) owners have had a lot on their minds over the last year. While many have been struggling to stay afloat, others have been expanding their workforce. To ensure that they attract and retain the best talent through these difficult times, some SMBs are offering competitive benefit packages that may also include a retirement benefit plan.

However, over the years, setting up this type of plan has become more complicated. One key issue is the selection of the investment funds that will be made available to the participants. Decisions need to be made about how many funds will be chosen, from which asset classes, which fund managers will be selected, and who will be responsible to make these decisions? Then, in light of the recent financial crisis, who will be responsible for monitoring the funds’ performance and for making necessary adjustments if there are losses? These questions are critical considering that many investors lost on average 15 to 25 per cent of their investment book value. There’s no one single answer, but a solution can be found by referring to the CAP Guidelines.

**A Compliance Guide For Small To Medium Businesses**

By: David Charbonneau

**A Guidelines Refresher**

Here is a short review to better understand the principles of the CAP guidelines and why the guidelines were created. The Joint Forum Working Committee on Capital Accumulation Plans was established in 1999 to review the education and support given to CAP participants who are given the responsibility to choose their own investments. The goal was to protect the consumer by ensuring that investing becomes more understandable and transparent. This would be achieved, in part, by defining the roles and responsibilities of plan sponsors, service providers, and plan participants.

The guidelines were also designed to ensure that plan participants were well-prepared to make their investment selections and that they were consistently provided information about the status of their investments.

When setting up a CAP, it’s important to understand the SMBs’ and/or plan sponsor’s expectations for the plan to ensure that you’re providing them with the best solution for their company. Plan sponsors should be encouraged to also know their employees’ retirement savings goals and investment profiles. This helps them to define the purpose of their plan in order to offer the most efficient retirement solution to their participants. For example, are they focused on attracting and retaining top talent, remaining competitive in a particular industry, looking to help employees save for retirement, or are they simply looking for a tax deduction?

The fund selection process runs much smoother when the purpose of the plan and the participants’ profiles are well-defined. However, there are still important considerations to be made during this stage:

- what are the key considerations involved with creating the plan
- who will lead the fund selection process
- who will offer advice about the funds to the plan sponsor

Usually, the intermediary supports the plan sponsor during this process by helping them to understand how the choices are being made for the participants.

Also, a higher level of governance can be achieved if a third party, such as a firm specializing in retirement plan development, is involved.

Here are some other points to follow to ensure the CAP’s smooth implementation and success:

- ensure that the fund management team has a long-standing successful track record
- have a solid understanding of their work-style and investment philosophy
- confirm that there will be effective communication with unit holders
- thoroughly research their fund’s performance history based on an appropriate benchmark
- confirm that the cost of managing the funds will be affordable

**Number Of Funds**

As part of the fund selection process, the SMB, plan sponsor, or the third party will have to decide on the number of funds to be offered in the plan. Having the right amount makes it easy for participants to
choose. Keep in mind that fewer investment choices may simplify the decision-making process for those who might otherwise be overwhelmed by having too much to choose from. Also, the correct number of funds means that the service provider can effectively monitor each fund’s progress.

Another solution for SMBs and/or plan sponsors is to choose pre-selected packages in which the funds are already carefully researched and selected. This choice is particularly empowering and reassuring for participants. In case a participant does not choose from one of the selected funds, the plan sponsor is required to ensure that a default fund is selected on behalf of the participant.

The plan sponsor is also responsible for making sure that there is a process to review fund performance and remove those funds that under-perform.

Selection Tools

Once the CAP plan has been created, participants will need to understand their roles and responsibilities. For example, they should understand how and why the plan has been created. Any associated contribution limits, available investment options, and fees should be clearly defined. They should also be made aware of the name of the service provider as well as the availability of calculators and other financial and research tools. They should also be required to evaluate their investment risk, select their ideal fund, and determine an affordable contribution amount.

Once the plan has been set up, participants will require ongoing support. For example, they should be provided with easy-to-use investment information and decision-making tools. They should also be provided with ongoing communication channels which could include individual or group meetings, call centres, plan website, and periodical mailings such as newsletters, account statements, and other plan related information. Most importantly, participants should receive periodic fund reviews. The purpose is to ensure that the plan is meeting everyone’s needs. These reviews should address questions such as:

- Are all the parties still maintaining their roles and responsibilities per the initial contractual agreement?
- Does the plan still meet the employer’s initial objective and are they still complying with the CAP guidelines?
- Is the service provider doing a good job of managing the plan?
- Are participants still able to consult the online tools and are they satisfied with the call centre ability’s to respond to their questions?

Analyze what needs adjusting and make the required changes.

Finally, a successful CAP is one in which all the responsible parties are diligently and correctly fulfilling their obligations. This includes ensuring that participants are enrolled in a retirement plan that they understand and that meets their needs. Most importantly, a successful CAP maintains the highest level of governance standards.

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Among the financial sector’s notable developments in the past decade, outsourcing investment operations has emerged as an important and durable trend. In the expansionary period leading up to 2008, the implications of rapid global growth and the need to focus on cost containment led many investment managers to view outsourcing as an attractive option for streamlining their business. In today’s turbulent economic climate, the struggle to reduce costs and achieve higher levels of efficiency has heightened interest in tapping the operational capabilities of third-party providers.

The surge in outsourcing arrangements has paralleled a long-term debate over the relative risks and merits of a strategy that is helping reshape the financial services industry. However, as investment managers grapple with considerable challenges and learn from the track record of outsourcing arrangements already under way, the terms of that debate are rapidly shifting. Today, the question is less about whether to outsource than about the best ways to proceed – and where its potential lies for delivering optimal results. This sentiment holds particularly true now given its applicability to widely varying markets and conditions.

### Key Benefits Of Outsourcing

Ten years of experience with third-party providers has helped to clarify the real benefits of a well-executed outsourcing strategy. In brief, outsourcing offers:

- **Significant cost reduction** – In a six-year study, Alpha Financial Markets Consulting determined that new outsourcing deals could reduce servicing costs between 15 to 20 per cent, while overall savings for outsourced operations average nine per cent compared with in-house operations
- **Deep technological resources**, allowing access to scalable, advanced-standard platforms
- **Reduced operational and compliance risk**
- **Access to new markets via partnerships with experienced providers**

While these benefits trace their roots to the expansionary years of the past decade, they have become even more attractive as markets have contracted.

### Early Drivers

Awareness of the need for third-party service providers first emerged in the investment management community as a by-product of the rapid growth in financial markets around the world through the mid-2000s. In addition to the sizeable equity markets during this period, alternative investments benefitted significantly from allocation strategies that directed large asset flows into hedge funds and private equity.

At the same time, a torrent of sophisticated products, notably over-the-counter (OTC) derivatives, appeared in the market.

Helping to fuel this enormous growth was an onslaught of legislative and regulatory developments, particularly in Europe, intended to encourage cross-border investing. This trend triggered two noteworthy developments that had a major impact on outsourcing:

- **the increasing prominence of offshore financial service centres specializing in the creation, marketing, and distribution of a wide range of funds**
- **the rise in cross-border systems, advanced technology, and the commitment and insight that the best providers can now offer.**

### Outsourcing Investment Operations: Partnering For Growth And Efficiency

By taking on large portions of an asset management firm’s investment operations, a third-party service provider can help the firm to hone its competitive advantage rather than devote resources to supporting non-strategic functions. What makes truly effective outsourcing possible are the fundamentals that define success: the rich combination of global systems, advanced technology, and the commitment and insight that the best providers can now offer.
activity led investment management firms in North America and the European Union to pursue international consolidation.

Through mergers and acquisitions, new financial entities emerged with operations in regional and world markets. These organizations depended on complex and often overloaded networks of legacy platforms and systems. With customers spreading across markets whose characteristics and regulatory requirements varied widely, firms found themselves facing daunting operational challenges.

For investment managers, this situation raised critical red flags. Increased levels of complexity in portfolios, customer needs, and markets (a natural outgrowth of globalization) enhanced the risk of operational failure in the absence of capable systems. However, the solution — new standards in technology, expertise, and service — required strategic focus and a deep commitment of resources, potentially diluting the core duties that asset managers owed their clients. Outsourcing promised relief on all fronts.

While outsourcing strategies were seen to apply across the full investment life cycle, middle-office functions were bearing the lion’s share of the pain as growth accelerated and investment firms morphed into new entities. The burgeoning number of interfaces linking custodians, brokers, clients, and others proved a drag on efficiency and accuracy, as well as a major factor in ballooning costs. Moreover, the abundance of complex alternative products resistant to easy valuation and processing required a high degree of manual handling. Delays and errors could take a heavy toll on confidence, as perceived risk levels escalated.

Outsourcing grew in popularity as third-party providers with world-class technology, including advanced platforms, introduced a new order of coherence to middle-office operations. At the same time, investors came to appreciate the value that independent providers represented in terms of pricing and compliance expertise. Outsourcing helped to ensure that the fruits of success would not be lost to inefficiency and high-cost administration.

Outsourcing For Challenging Times And Diverse Needs

As the economic climate turned stormy in 2008, new drivers pointed to outsourcing as a survival strategy for investment firms. With assets under management suffering severe contraction, margins have undergone additional pressure. Investment firms, only too aware of the significant expense associated with improving or maintaining processing platforms, for instance, are eager to find ways to shed costs without sacrificing quality of service to clients. The technological solutions that seasoned providers have devised to address challenges posed by the processing requirements of OTC derivatives and their associated functions underscore outsourcing’s benefits.

At the same time, questions about risk factors in the global financial system have become a greater preoccupation for regulators, asset managers, and investors alike. Operational and compliance risks stemming in part from servicing inefficiencies are receiving closer scrutiny than ever. With regulatory changes likely in the offing, proposed new accounting standards and reporting requirements and rules governing disclosure will add new levels of complexity to servicing functions. Additionally, investors uneasy with in-house oversight are demanding greater degrees of transparency in everything from pricing to reporting. The use of third-party providers offers fundamental solutions for mitigating risk.

Today, the advantages and flexibility of outsourcing prove themselves readily adaptable to the differing conditions and needs of Europe, North America, and Asia. In Europe, the growth in cross-border funds distribution, combined with continued consolidation, has argued in favour of the multi-market efficiencies that independent providers can offer. For investment managers in North America, the resources and experience of external providers offer a more efficient means of servicing complex portfolios on behalf of a global investor base. Asia, on the other hand, presents unique challenges given its diverse array of markets with little in the way of regulatory consistency. Providers with a global presence can lighten the servicing load.

Driving For Success

Looking at recent outsourcing arrangements, the characteristics that define a successful partnership, and what to look for in a provider, are becoming more apparent. Experience shows that strategic partnerships serve as the best foundation for outsourcing operations. A provider’s long-term commitment matters, as does its deep understanding of an asset manager’s core competencies and strategic goals. More than mere cost, getting these criteria right is likely to influence the degree of improvement, efficiency, and risk reduction that an outsourcing deal will achieve.

Along with the provider, the investment manager should involve the entire firm in a review of the investment cycle end-to-end, to understand its business needs and strategies, system strengths and deficiencies, technology and compliance requirements, and culture. A comprehensive review will decide which outsourcing model to work with — lift-outs, conversions, and component-based solutions being the likeliest candidates.

Technology is a key criterion for success, gauged by a provider’s commitment to investing the resources for staying abreast of the latest standards, as well as offering systems that are comprehensive, scalable, and flexible. Equally important is the capability to render global service that mirrors the scope of an investment manager’s assets and distribution networks, together with in-market expertise familiar with local practices, rules, and culture.

Perhaps no consideration can equal experience. Not only should a provider be consummately skilled in interpreting a customer’s business accurately, but the provider must also be adept at managing the complexities of the transition. The latter is an example of how the depth of partnering can truly become the predictor of success.

Looking ahead, outsourcing is set to become increasingly a mainstream strategy, with new providers joining established firms in the arena. However, as the economic shakeout continues, firms should carefully consider the financial stability and long-term viability of potential providers. Moreover, further consolidation may impinge on service offerings.

As outsourcing matures, middle-office functions may undergo commoditization, while the value of a provider’s data warehouse and reporting services to the front office may grow. It remains to be seen whether outsourcing can easily be shifted among providers, or the degree to which the market will favour niche or larger players. Certainly, the capabilities of larger providers with flexible and scalable offerings will remain highly attractive across the industry.

However, whatever shifts occur in the near term, outsourcing seems likely to continue to provide investment managers with strong tactical options for reducing expenses and operational risk to keep their strategic focus on pursuing growth.

Kevin Drynan is president, State Street Trust Company Canada, where he is responsible for the development and execution of key customer strategies for its investment servicing business. Ron Robertson is senior vice-president and managing director, responsible for investment servicing.

Most of us have the personal experience of working in a poor workplace culture. However, few of us have been given the opportunity to play a role in improving that environment. In today's competitive corporate world, enlightened organizations are open to discussions about the impact of workplace culture and are willing to initiate interventions that will address the negative influences within their organization. Those who take this approach understand the connection between a positive corporate culture and healthy, productive, and satisfied employees.

**Foundational Elements**

The contribution of corporate culture is one of two foundational elements that influence the extent to which employees are both healthy and productive in the workplace; the other is what the individual contributes. The corporate culture is driven by the organization or work and the physical and the psychosocial environment. This includes supervisory and management practices within an organization and behavioural norms and expectations among co-workers, as well as corporate policies and procedures. Individuals bring their health status, work/life practices, and their own beliefs, attitudes, and values to the workplace. The drivers within these two elements can positively or negatively contribute to the corporate culture and the health of employees within an organization.

In his work on the organizational sources of stress, Dr. Martin Shain found that there were four critical risk factors found in the workplace that are indicators of health outcomes – demand/control and effort/reward. Simply put, Dr. Shain found that when these four elements are out of balance, in many cases arising from conditions at work that affect mental health, there will be negative health consequences in the workplace that will also affect performance at work. This is illustrated in Figure 1.

When the balance of demand/control and stress/satisfaction is evaluated on an individual level, it is referred to as the Stress Satisfaction Offset Score (SSOS), a numeric value between -2.0 and +2.0; +0.50 being the healthy minimum. When the scores for groups of individuals or an organization are combined, the score is referred to as the Business Health Culture Index (BHCI). This index – along with other information about the distribution of work, policies, and processes within the organization – can help us understand the drivers and the impact of workplace stress for each organization that participates.

Leadership is often unsure how to take effective action to address culture issues in their organization and, as a result, managers, supervisors, and senior executives can be reluctant to enter into dialogue surrounding corporate culture and how to improve it. There can be a number of other reasons for this reluctance:

- Employees and supervisory personnel will not be willing to engage in the process
- Engaging employees in dialogue regarding culture issues will result in direct criticism of them or the supervisors and managers that report to them
- There will be a negative impact on them personally or on their supervisors and managers
- There will be no long-term change in response to employee concerns

These concerns are understandable and should be acknowledged. It is critical to address these issues in a non-confrontational basis and to implement a process where all participants will feel comfortable and safe. Only then will employees at all levels be willing to honestly enter into the process of identifying and implementing solutions that will address issues which are negatively affecting the mental and physi-
Any process should, at minimum, include:

- A corporate commitment at the highest levels in the organization to the discussion process
- A clear commitment at the highest levels that there will be no negative repercussions to employees, managers, or supervisors from participating in the process
- Providing individual divisional or departmental managers and supervisors the autonomy to implement solutions within their control with the support of their teams. Providing these solutions do not affect corporate policies, procedures, or labour agreements
- An agreement that individual managers and supervisors will not be singled out in discussions

Once these ground rules have been established, the process of addressing issues can begin. One large employer of 8,500 employees, located in the Greater Toronto Area, has been working for several years to develop and deliver a collaborative process across its nine divisions, with positive results.

**Healthy Minimum**

In 2006, this group’s initial results gathered as part of an employee health risk assessment process were scattered across the organization from above to well below the healthy minimum Business Health Culture Index (BHCI) score. The overall score for the organization was just below the healthy minimum. As a result of these scores and the recognized link to employee health, which was a critical focus for the organization, senior management made the commitment to address corporate culture in line with the launch of a comprehensive healthy workplace strategy.

The process to address organizational issues that are affecting employee health has taken place over several years and has included exploratory workshops and implementation working groups, followed by re-evaluation surveys. In each of the six of nine divisions that have been re-evaluated to date, BHCI scores have improved, as have many of the employee health indicators that were also measured. The process involves repeated face-to-face interactions at all levels of the organization over a period of time.

The first phase in the process following the initial culture evaluation was exploratory workshops held with managers, supervisors, and employees. More than 30 workshops were held with three, and sometimes four, for each division of the organization.

Workshops consisted of a presentation on the workplace health and culture strategy within the organization, followed by a review of priorities identified in the health risk assessment and discussion regarding solutions. Depending on the audience, the focus of each workshop was varied:

- The first workshop was held with managers and supervisors whose interest focused on the process and outcomes
- The second workshop was held with employees where discussion focused on the priorities identified in the health risk assessment and the potential solutions
- The third workshop was a combined management/employee workshop. The focus was for small groups of individuals to identify the feasibility of recommendations from the employee session
- The feedback from those participating in the process was very positive. Although, there were some initial concerns regarding confidentiality, these concerns were addressed and employees, supervisors, and managers actively participated. Managers were eager to offer their suggestions for improvements, not just for themselves, but for those that reported to them. Employees appreciated being asked for their opinion on what would improve their working experience and having an outside agency conduct the sessions. For some, it was their first exposure to the healthy workplace strategy within their organization and their first opportunity to express their opinions about critical components of the way their work and their working environment were structured.

Following the completion of the series of workshops for each division, priorities and recommendations were summarized in a report presented to senior management within the division. Common recommendations across most divisions in the organization included:

- Management training (communications, constructive criticism, distribution of workload, and addressing favouritism)
- Additional methods of recognition – formal and informal
- Regular divisional ‘town hall’ meetings to update employees on strategic direction, divisional accomplishments, etc.
- Additional training and career development opportunities
- Team building activities
- Health education and promotion programs
- Divisional implementation working groups were formed following the presentation of results to senior management. Each group consisted of a cross-section of managers, supervisors, and employees. They were given a mandate to identify, develop, and implement programs and strategies that were within the control of the management within their division – without requiring amendments to corporate policies, procedures, or collective bargaining agreements. Working groups were scheduled for re-evaluation in approximately 18 months to measure progress. In the interim, working groups were required to provide regular progress updates.

**Unique Programs**

Each division within the organization developed its own unique programs and strategies to address the priorities and recommendations of their employees. Some examples included:

- Additional management training on effective communication, constructive criticism, and the importance of verbal recognition
- Accountability for implementation of recommendations in management’s annual evaluations
- Adding career development and training objectives to annual reviews
- Communication and posting of training opportunities
- Regular town hall meetings
- Introduction of employee of the year award
- Monthly newsletters

Based on the evaluations that have been conducted to date, the process has been successful. Following approximately 18 months of activity, six of the original nine divisions have been re-evaluated based on their culture scores and several other criteria – including sleep, physical activity, stressors, management indicators, and performance at work. In each case, the culture score has improved as have several other indicators in the evaluation.

In addition to the survey results, there are visible indicators of success across the organization. Verbal interactions between employees and managers have improved, wellness boards display multiple program offerings, and managers, supervisors, and employees are eager to share their achievements. Workplace research tells us that there is a clear link between improvements in employee satisfaction, customer satisfaction, and corporate profits. But, this is only one measure of success. Success can be seen in offices, meeting rooms, corridors, and lunch rooms. Success is the face of managers and employees as you pass them in the corridors and they stop you with a smile, eager to share their latest achievements.

It is this workplace culture, supported by visionary management, which will make organizations like this one a healthier and more productive place to work for employees now and in the future – in other words, a better organization with which to do business and a better place to invest.

Denise Balch is president of Connex Health.
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Equity Market Neutral – An All-Weather Strategy

Market neutral strategies have been around for roughly two decades. But the more volatile conditions of recent years have increased interest among consulting firms, investment banks and money managers in how this relatively lower-risk investing method can be used to generate competitive returns.

The Attraction of Market Neutral Investing

As the name implies, market neutral strategies work by neutralizing as many risk factors as possible, including beta, currencies, market caps, sectors and regions. For example, in a well-constructed market neutral fund, if you’re long one dollar, you’ll be short one dollar, leaving no dollars exposed to the market. With all factors neutralized, the only issue that remains is whether the portfolio manager is good at picking stocks, both long and short.

Market neutral strategies also have the advantage of being very liquid, as they use exchange-traded equities to implement the strategy and avoid less liquid instruments like bank loans, credit default swaps, distressed debt, or high yield. Nor is there a need for much leverage.

As the Exhibit 1 indicates, the correlation characteristics of market neutral strategies are appealing, not only compared to traditional long-only equities and fixed income, private equity and real estate, but also to non-traditional approaches, such as other hedge fund strategies.

EXHIBIT 1
Low Correlations To Traditional & Alternatives Asset Classes

<table>
<thead>
<tr>
<th>TRADITIONAL ASSET CLASSES</th>
<th>ALTERNATIVE ASSET CLASSES</th>
</tr>
</thead>
<tbody>
<tr>
<td>HFR E: Equity Market Neutral</td>
<td>Equity Market Neutral</td>
</tr>
<tr>
<td>S&amp;P/TSX Composite</td>
<td>Convertible Arbitrage</td>
</tr>
<tr>
<td>S&amp;P 500</td>
<td>Dedicated Short Bias</td>
</tr>
<tr>
<td>MSCI EAFE (H)</td>
<td>Emerging Markets</td>
</tr>
<tr>
<td>FTSE EPRA/NAREIT Glb (G)</td>
<td>Event Driven</td>
</tr>
<tr>
<td>MSCI High Yield</td>
<td>Fixed Income Arbitrage</td>
</tr>
<tr>
<td>DEX Universe</td>
<td>Global Macro</td>
</tr>
<tr>
<td>DEX 91 Day T-bill</td>
<td>Long-Short Equity</td>
</tr>
<tr>
<td>Fixed Income Arbitrage</td>
<td>Managed Futures</td>
</tr>
</tbody>
</table>

As seen in the Graph 1, market neutral strategies can also provide solid risk-adjusted returns. In the past decade, they have provided returns similar to most hedge fund strategies, but without the high volatility associated with hedge funds. This same return pattern is evident over longer periods.

Quantitative or Fundamental?

There are two basic ways to pursue a market neutral strategy. The quantitative method, used by the majority of investors, looks at historic information, including earnings, valuation, share buy-back activities, and insider trading activities to try to predict the best companies to buy and to short in a portfolio. The other, or fundamental approach, looks at more fundamental research that might or might not be captured by quantitative tools. This approach tends to be more forward looking.

In general, quantitatively based market neutral strategies have not fared as well as fundamentally based strategies since 2007. In part, this may be because quantitative managers have tended to use the same algorithms and models, in effect chasing the same cheap growth opportunities and overcrowding the marketplace. Managers would be better advised to tweak their models and look in different areas for growth.

Putting Market Neutral into Practice

Despite this caveat, market neutral strategies produce results that compare favourably with traditional asset classes. Using various index data, market neutral strategies have, over the past four years, shown low to negative correlations with several traditional hedge fund strategies, including the convertible arbitrage, short-biased and event-driven strategies found in many clients’ portfolios. Similarly, market neutral compares favourably in terms of risk-adjusted returns or Sharpe ratios over longer periods.

Given these advantages, our clients use market neutral strategies in a variety of ways. More than 40% of them include market neutral strategies in their equity portfolios as a risk mitigation tool, for example. Whatever the application, they know market neutral strategies provide a liquid, low-leverage approach that can generate solid return potential with potentially lower risk.
Now is the time to capitalize on real estate if you’re an institutional investor, particularly in Canada, says Frank Mayer, chairman, Vision Capital Corporation. He was among a group of speakers at the Mindpath and Benefits and Pensions Monitor ‘4th Annual Alternative Investments For Institutional Investors Conference.’

He illustrated how Canada’s reduced debt, relative to other G7 countries, puts it in a strong position to engage in stimulus spending, and how the low interest rate environment has driven a rebound in Canadian housing prices. This, however, is in stark contrast to the U.S., where the real estate sector continues to struggle and where – most importantly – employment continues to decline.

In fact, Mayer said that rather than, “location, location, location,” it’s all about, “employment, employment, employment,” when it comes to investing in real estate. Jobs enable people to buy homes and spend which, in turn, create a need for housing, offices, stores, and factories. With Canada’s steady employment growth, the real estate outlook here seems promising.

**Frishman On Risk, Due Diligence**

In his keynote presentation, Zev Frishman, vice-president, global equity strategies, Ontario Teachers’ Pension Plan, advised funds to not fall in love with short-term performance. Not only is there evidence of alpha mean revision, but Frishman noted studies show managers hired to replace fired managers under perform, because they have reached the peak performance and are now starting to drop.

He also called risk management a “horizon issue” that needs to be properly quantified and administered in a more rational way among sponsors. He said many plans are overly concerned with risk on a product ‘stand alone’ basis and advised that sponsors should set risk budgets with a few limits rather than long, subjective “laundry lists.”

Regarding managers and due diligence, it’s paramount to obtain an understanding of their culture and its consistency throughout the organization, Frishman said. Get to know the manager’s corporate structure, ownership, key personnel, and compensation. Perhaps it’s wise to align interests with smaller, privately owned managers with few mandates, who are willing to stay small rather than engage in asset gathering and who might be keen on concentrating portfolios.

**Private Equity Opportunities**

From a historical perspective, it could be a big year for private equity if you’re an institutional investor, said Randy Bauslaugh, partner, pensions and benefits practice, Blake, Cassels & Graydon LLP. Strong returns are expected out of periods of dislocation and economic recession, like the one recently experienced. The high volatility in publicly traded securities and private business owners’ need to expand during a ‘credit crunch’ make it a favourable time for investors to take part.

Bauslaugh, along with David Rogers, partner, Caledon Capital Management Inc., outlined three forms of private equity investment – fund of funds, co-investment, or direct investment. The approach to take depends on the nature of the pension fund. A buy-and-hold investor who can handle illiquidity and can take a long-term approach can make a direct investment into private equity. However, if you need a more liquid investment and reduced risk, a fund of funds may be the appropriate vehicle.

**Market Neutral Strategies**

Joseph Morgart, senior vice-president, alternative investment strategies, Pyramis Global Advisors, explained how market neutral strategies generated the largest percentage of net inflows relative to its assets...
under management. Despite a strong 2009, few strategies made back their losses. Of those, market neutral’s consistent low volatility, peer market cycles and low correlations with traditional and alternative investments continues to provide returns.

“It’s an all-weather strategy in good and bad times,” he said, as equity market neutral avoided the extreme falls in 2008. 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.

**Discussing The Hedge Fund Industry**

Christopher Holt, director, industry relations, for the Chartered Alternative Investment Analyst Association (CAIA), was moderator for the ‘Hedge Funds Discussion Panel,’ covering its “major comeback” in 2009. Panelist James McGovern, CEO of Arrow Hedge Partners Inc., discussed how the industry is maturing, improving quality of managers, choices, and strategies available. He referred to the “cyclical nature” of the industry and how investing should always be lined up accordingly.

In the wake of the market turmoil, McGovern also said investors are turning to hedge fund managers who were able to survive the period and to larger-scale managers as well. The downside, however, is that many excellent small-scale managers are currently out there and are having a hard time attracting investors.

Panelist Joseph Morgart also examined the industry’s recovery and pointed to the fact that there would have never been an alternatives gathering like this one 15 years ago. A decade or so ago, hedge funds represented a smaller boutique of services available mainly to large institutions, but now opportunities are more readily available to more types of investors. The priority for the industry going forward will be to protect all investors through more transparency measures and compliance practices, he said.

**Institutional Investors Panel**

Moderator of the ‘Institutional Investor Discussion Panel,’ Janet Rabovsky, senior consultant for Towers Watson, showed how exposure to alternative assets continues to grow. The growth reflects a long-established trend and pension funds’ growing appetite for diversification, she said.

Panelist Michel Malo, managing director, investment strategy and co-chief investment officer, University of Toronto Asset Management, said you earn more by taking care of the downside than by focusing on the upside. When it comes to alternative asset classes, you can manage downside risk by incorporating tail insurance into portfolios. Some approaches include applying this into an existing asset allocation framework or incorporating a new asset allocation portfolio construction methodology. The other option, he said, is to hire a tail risk manager.

Lisa Melchior, managing director, OMERS Private Equity, outlined how it has gone about investing in several alternative asset classes such as private equity, infrastructure, and real estate. OMERS has been an active private equity investor since 1981 with a current target allocation of 12 per cent or $5 billion. In response to public market turmoil in 2001/2002, OMERS began a transition to increased alternatives, with a long-term target allocation of 21.5 per cent for infrastructure and 13.5 per cent for real estate.

Anthony Lennie, director of finance for Victoria University, shared his experiences on how to integrate alternatives into its investment mix. When dealing with committees on the subject, he said to be patient as progress can be “glacial” at times, get to know the consulting community well, provide education, and be realistic about what alternatives can deliver. So far, modeling consistently has shown that its risk reward profile improves through the addition of alternatives – creating a high level of interest amongst his committee members, he said.

George Di Falco is staff writer for Benefits and Pensions Monitor (gdifalco@powsift.ca).
The ‘CVCA’s 2010 Annual Conference’ will feature guest speakers including Mark Wiseman, executive vice-president, investments, CPP Investment Board; and Paul Renaud, CEO, OMERS Private Equity. It takes place May 26 to 28 in Ottawa, ON. Visit: http://www.cvca.ca/news/events/CVCAAnnualConference2010.aspx

David Garofalo, senior vice-president, finance, and chief financial officer, Agnico-Eagle Mines Ltd., will deliver a keynote address at the ‘2010 FEI Canada Conference.’ Garofalo, who is also Canada’s CFO of the Year 2009, will discuss the history, fundamentals, and re-emergence of gold. He will also provide an overview of the market for gold equities. It takes place June 9 to 11 in Victoria, BC. Visit: http://www.feicanada.org

How innovation is changing the face of socially responsible investment and how SRI is revolutionizing conventional investment will be the focus of the ‘Canadian Summit on Socially Responsible Investment.’ Sessions will look at cleantech, oilsands issues, public attitudes, advisor/client relationships, divestment versus engagement, and innovations in environmental social governance research and investment management. This year, the conference will feature the first annual Canadian SRI Lifetime Achievement Award to be given to an outstanding member of the Canadian SRI community. It takes place June 14 to 16 in Toronto, ON. Visit: http://www.socialinvestment.ca

Enrolment is now open for Humber College’s CAP training program. ACAP is offered in two, one-week modules, designed for anyone from CAP administrators to CAP decision-makers. Topics covered include ‘CAP Mechanics,’ which looks at the structure and design of CAPs and ‘CAPs & the Law,’ which examines how CAPs are regulated, including plan provisions, common law, legislation/regulations, and fiduciary duties. Sessions will be held June 14 to 18 in Toronto, ON, and June 21 to 25 in Regina, SK. Visit: http://www.humber.ca/ceb/eFlyers/ACAP.html

Information and solutions that organizations need in order to respond to major developments and concerns impacting pricing and reimbursement in Canada’s pharmaceutical industry will be examined at the 4th Annual Drug Pricing & Reimbursement conference. Sessions will provide updates on drug reform in Ontario, Alberta, Quebec, and Atlantic Canada and share perspectives on changes in the private payer market in Ontario and the impact on other provinces. It takes place June 15 and 16 in Toronto, ON. Visit: http://www.canadianinstitute.com/DrugPricing

Madame Justice Eileen Gillese, of the Ontario Court of Appeal, and Paula Cox, deputy premier and minister of finance and economic development, government of Bermuda, will be among the keynote speakers at the 2010 International Pension & Employee Benefits Lawyers Association conference. It takes place June 20 to 22 in Quebec City, QC. Visit: http://www.ipebla.org/2010_Quebec_Conference_Program

‘Navigating the New Normal’ is the theme of the CPBI Forum 2010. Sessions will focus on ‘the new normal’ that last year’s economic crisis created. It takes place June 21 to 23 in Halifax, NS. Visit: http://www.cpbi-icra.ca

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
Social And Environmental Innovation Driving New Investment Approaches

By Eugene Ellmen, Executive Director, Social Investment Organization

Innovation is the engine of economic growth. The creation of new products and processes is one of the drivers of new economic activity and job creation. But what about social and environmental issues? Is it possible to use innovation to help create a greener, more socially responsible world?

That is a topic that will be explored in detail at the next Canadian Responsible Investment Conference, which will be held in Toronto, June 14 – 16, 2010.

The conference is the national summit for the socially responsible investment industry in Canada. It brings together fund companies, asset management firms, institutional investors and advisors from across Canada to get up-to-date on the latest products and issues regarding socially responsible investment.

This year, the conference is focused on the question of innovation: what are some of the innovations changing the practice of SRI, and how is SRI creating innovations that are revolutionizing conventional investment?

One of the biggest of these innovations is cleantech. Global cleantech expert Nicholas Parker predicts there could be a “triple whammy” of opportunities for investors, entrepreneurs and service providers in this sector. Innovation will be needed to better integrate these opportunities into effective investment offerings.

Corporate engagement is another area of intense innovation. Socially responsible investment funds are engaging with companies operating in the oilsands and in other controversial areas to help improve corporate performance, and to reduce reputational and other risks over the long term.

And through these innovations, there continues to be a debate on the validity of the traditional SRI practice of divestment – identifying companies or sectors that operate in industries and activities that are clearly outside ethical guidelines. Cluster munitions is one such area, and the conference will explore others.

The expectation is that the conference will advance the state of the debate on these issues both in the SRI community and in the mainstream financial sector.
Sometimes the word “responsibility” comes with baggage, an implication that something must be given up to do the right thing. The sub-advisors to IA Clarington’s Inhance family of SRI (Socially Responsible Investing) funds do not accept the premise that responsible investing comes at the cost of performance.

THE SUB-ADVISORS
IA Clarington’s Inhance funds are managed by IA Clarington and sub-advised by the team of socially responsible investment managers at Vancity Investment Management Ltd. (VCIM). Innovators for more than 10 years in this rapidly growing field, the VCIM team has set the standard for investing responsibly.

ENHANCED PERFORMANCE
The IA Clarington Inhance family of funds are managed according to the belief that over the long term, performance will in fact be enhanced through the additional levels of screening that SRI demands.

By looking beyond corporate financial statements to the way companies interact with their communities and the environment— the sub-advisors endeavour to identify those companies that they believe are focused on long-term sustainability.

THE PROCESS
Extensive fundamental analysis of prospective investments is conducted. But they look beyond that too, and apply a thorough system of ESG (Environmental, Social and Governance) screens as well. Prospective companies are rated according to the following seven ESG performance criteria:

- Employee relations
- Diversity
- Environmental commitments
- Community relations
- Corporate governance & citizenship
- Human rights
- Sustainable products

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The latest dispatch from the various boards, panels, and commissions attempting to sort out the blame for our current financial condition comes from Jenner and Block, the court-appointed bankruptcy examiner looking at the fall of Lehman Brothers in 2008. Lehman was not only the largest bankruptcy in U.S. history, but its failure also marked the end of the line for traditional investment banking firms in the U.S.

While the report runs to thousands of pages, its 200-page summary leaves out the drama and personality conflicts and instead asks the key question that people have asked of all the financial firms who have suffered in the past few years – was the company a victim of changing and deteriorating conditions outside its control, or were there key mistakes made which led to huge investment losses and eventual bankruptcy?

‘Run On The Bank’

In Lehman’s case, while it is true that no firm can survive a ‘run on the bank,’ the reasons for this run were caused directly by some bad investment decisions. They included:

◆ An Increasing Appetite For Risk
Beginning in 2006, Lehman deliberately under-

took a strategy of fast growth which necessitated taking on increased leverage and greater risk. As markets began to turn against them in 2007, Lehman had a choice to either sell key investments at a loss or ‘double down’ and continue to invest. Lehman’s management believed that other financial institutions were retrenching at this time, so this was a key opportunity to improve their competitive position and it continued to buy. This turned out to be the wrong decision.

It is important to note that these decisions were not accidental or made in the heat of rapidly changing market conditions. The report notes that Lehman had sophisticated policies, procedures, and metrics in place to estimate its investment risks. Yet, none of these were seen as brakes. Lehman raised its firm-wide risk appetite limit three times in one year and, at many a key time, Lehman’s senior managers disregarded or overruled its own risk and limits.

Lehman’s compensation policies were supposed to penalize excessive risk taking. In reality, the company rewarded its employees based mostly on revenue, with far less consideration given to risk or cost implications.

◆ Asset Concentration Was a Problem
One of the key areas where management decided to ignore its own policies was in the area of investment diversification. As part of Lehman’s growth strategy, the company moved away from traditional investment banking activities focusing on transactions and, instead, became a principal in many investments. Unfortunately, these investments were in the fields of commercial real estate, private equity, and leveraged loans. Ultimately, Lehman exceeded its own risk limits by 70 per cent in the case of commercial real estate and by 100 per cent in leveraged loans. The decision to have a heavy concentration of illiquid assets – that were supposed to pay off over the long-term – meant that when market confidence was at its lowest, these assets could not be sold quickly enough.

◆ Less Than Full Disclosure Throughout
When it came time to sell, Lehman seemed to be more focused on managing the appearance of its balance sheet, rather than the actual balance sheet. Lehman used an accounting device known as Repo 105 to temporarily remove $50 billion of troubled assets from its balance sheet in the summer of 2008. Lehman didn’t disclose the use of this device to regulators, the rating agencies, investors, or even its own board of directors.

There is nothing inherently improper or illegal in using such ‘off balance sheet’ devices. However, with Lehman, their use was solely to manipulate the balance sheet. Lehman’s own accountants described the Repo 105 transactions as ‘accounting gimmicks’ and a ‘lazy way of managing the balance sheet as opposed to legitimately meeting balance sheet targets at quarter end.’ Rather than looking at a growing balance sheet issue, the concern was viewed as something to be ‘gamed.’ Window dressing came at the expense of understanding and removing the real investment problems at the company.

Hindsight Perfect
Hindsight, of course, is perfect. What is viewed today as massively poor judgment may have made perfect sense a few years ago. However, the result is that while Lehman did fail because it faced a crisis of confidence, this lack of confidence was rooted in the company’s own decisions to ratchet up the risk and use its own balance sheet to acquire illiquid assets for its own investment.

The company wasn’t an innocent bystander to a changing financial world. Management decided to bet the firm and it lost.
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