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Killing The Golden Goose

pension plan in British Columbia are the latest to take a stab at the goose. They are suing because they claim they were misled about the conversion from their Defined Benefit plan to a DC plan back in 1997. It is now costing them money. Chalk another one up for short-sightedness.

Frankly, if memory serves correct, there was a great clamour from members of a variety of DB plans to switch to DC plans back in the mid- to late-‘90s. Financial markets were roaring along with double-digit returns. When it came to the pension promise, visions of dollar signs danced in their heads. And, we stand to be corrected, but we believe even unions bought in on the promise of wealth from DC at that time.

Employers were also eyeing DC. The attraction was getting rid of the cost and bother of administering a DB plan. The sales pitch from providers was this is real easy, it is a turnkey operation. You send us a cheque each month for you and your employees’ contributions, and we do the rest.

Of course, over the next decade or so the reality set in. Employers were given a whole list of responsibilities to inform, educate, and communicate the responsibility and nature of their plans to their members, culminating in the Joint Forum’s ‘Capital Accumulation Plan Guidelines.’ Seems they weren’t too pleased about it.

Plan members found it was a challenge to properly manage their plans. They were being asked to comprehend strategies and investment techniques it takes financial advisors and analysts years to master.

And, of course, financial markets tumbled several times during the past decade wiping out years worth of returns and value from plans.

Sadly, in our society, the obvious option is to lay blame, to litigate. The legal profession has been warning us for years that action was coming over DC plans and it now appears to be coming true.

Indeed, while most efforts at crystal-ball gazing are futile – consider those forecasts of immense wealth for DC members at retirement and hassle-free pension plans for employers. Those failed to take

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CFA Institute
Margaret Franklin has started her role as chair of the board of governors of CFA Institute, the global association for investment professionals. She is currently the president and CEO of Kinsale Private Wealth Inc. and has more than 20 years of investment management experience with both institutional and private clients. She will be joined on the board by Beth Hamilton-Keene, director and portfolio manager at Mawer Investment Management Ltd.

OMERS
Warren Bell is executive vice-president and chief human resources at OMERS. Prior to joining OMERS, he held a variety of senior management positions in human resources over his 25-year career at TD Bank Financial Group. Most recently, he was senior vice-president, corporate human resources.

Sun Life
Isabelle Hudon is president, Sun Life Financial for Quebec. She brings more than 20 years of experience on the Quebec business scene to the company. Most recently, she was president of Marketel. Previously, she was president and chief executive officer of the Board of Trade of Metropolitan Montreal.

Teachers’
David Finnie is vice-president, investment finance – compliance, analytics, and performance; and Tony Kalvik is vice-president, investment finance – systems and data; at the Ontario Teachers’ Pension Plan (Teachers’). Finnie joins Teachers’ with more than 20 years experience in enterprise risk and capital management and was, most recently, a partner at RSD Solutions. Kalvik joins Teachers’ from PricewaterhouseCoopers where he was vice-president, banking and capital markets. Jeff Davis is vice-president and associate general counsel. Responsible for providing legal advice and representation in the management of the pension fund, he joined Teachers’ in 2004 and was, most recently, senior legal counsel, investments. Robert Breckon is senior advisor with knowledge and expertise in the health and life sciences industry at Teachers’ Private Capital, the private equity department of the Ontario Teachers’ Pension Plan. He has 30 years of merger and acquisition, corporate development, and operating experience in the global health and life sciences sector, most recently as senior vice-president, strategy and corporate development, at MDS Inc.

Desjardins
Denis Berthiaume is senior vice-president and general manager, wealth management and life and health insurance, at Desjardins Group. Previously, he was senior vice-president, retail markets, for a major international financial institution. This marks a return to the firm for Berthiaume as he spent 10 years with Desjardins Financial Security.

McCarthy Tetrault
Randy Bauslaugh is a partner in the pensions, benefits, and executive compensation group at McCarthy Tetrault. He has advised on numerous pension plan restructurings, wind-ups, and surplus distributions. He is chairperson of the International Pension and Employee Benefits Lawyers Association and a member of the editorial advisory board of Benefits and Pensions Monitor. He is also a member of the MEPP (multi-employer pension plan) consultation committee of the Financial Services Commission of Ontario, Canadian Bar Association, Ontario Bar Association, Canadian Pension and Benefits Institute, and the Association of Canadian Pension Management.

Highstreet
Robin Stanton has joined the institutional relationship team at Highstreet Asset Management. Most recently, he was director, investments, for the pension division of a Canadian financial services firm.
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Crisis Re-focused Pension Plans

The financial crisis of 2008-2009 has re-focused pension plans in North America, the UK, and Northern Europe on defining and solving the risk management challenges they face in the decade ahead, says research by Pyramis Global Advisors. The Pyramis ‘Global Defined Benefit (DB)’ research study found there is a great deal of concern in the market today about how best to assess risk and address it. As a result of the many lessons learned, plans are implementing new investment strategies and risk measures designed to meet their long-term goals. The top lessons learned from the financial crisis were the need for more downside protection, improved risk management, a better match of assets and liabilities, and a realization that they were less diversified than they thought. The top concern was their current funded status, followed by volatility and a low-investment return environment.

Mental Illness Expensive Disability

Mental illness is associated with more lost work days than any other chronic condition, costing the Canadian economy $51 billion annually in lost productivity, says a study from the Centre for Addiction and Mental Health. It calculated the actual cost of mental health leave and found that on average it’s double the cost of a leave for a physical illness. Results showed that the cost to a company for a single employee on a short-term disability leave due to mental health concerns totals nearly $18,000. Disability leaves due to physical illness cost nearly half of that for a leave due to mental illness.

Doubling CPP Creates Unbalanced System

Undue augmentation of one leg of the retirement savings stool will ultimately be to the detriment of the others, resulting in an unbalanced retirement system, says a Heenan Blaikie ‘Pension Pulse,’ as there is only so much money to be devoted to retirement savings. It says a Canadian Labour Congress call for doubling of C/QPP premiums would result in fewer dollars elsewhere. “Interestingly, the CLC message makes the point that only one in four people in Canada can afford to put money aside in an RRSP or tax-free savings account. If that is the case, it is difficult to understand how most people will have the capacity to make additional contributions to the C/QPP,” it says. As well, it is widely recognized that the employer-sponsored pension leg of Canada’s retirement system has been suffering and is now much weaker than it used to be. More focus of reform should be placed upon strengthening and expanding this leg of the stool, thereby restoring a better balance to the system.

IA Acquires California Insurer

Industrial Alliance Insurance and Financial Services Inc. has completed the acquisition of California-based Golden State Mutual (GSM). The GSM block of business involves 120,000 life policies with a face amount of close to US$500 million. For the year ended December 31, 2009, total premiums amounted to US$9 million and invested assets were US$70 million. Established in 1925, Golden State Mutual was the largest minority-owned life insurance company in California, providing traditional life insurance products to mid-market customers in 17 states.

Government Must Help Address Longevity Risk

Government should use public-private partnerships to address taxpayer exposure to Defined Benefit pension plan longevity risk, says a study from Swiss Re. ‘A short guide to longer lives: Longevity funding issues and potential solutions’ says that underestimating life expectancy by one year can increase a pension plan’s liabilities by up to five per cent. It is calling on governments to consider realigning retirement ages with life expectancy and providing...
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support for the longevity capital market following the unveiling of the Life and Longevity Market Association’s (LLMA) longevity index framework earlier last month. It says governments already work with insurers to address other financial risks, such as those associated with natural catastrophes, and could look to create a mutually beneficial resolution for longevity risk.

Companies Redesigning DB
Multi-national companies are looking for ways to redesign Defined Benefit schemes, but will cut contributions by 10 per cent in the process, says research by Mercer. Its ‘Scheme Design Survey’ of companies in the UK, U.S., Germany, France, Italy, and the Benelux countries found 33 per cent were looking to make changes to their DB scheme, but this would involve cutting contributions by 10 per cent on average. The average level of employee contributions, excluding additional voluntary contributions, is expected to fall to 5.5 per cent. The results indicate the evolution of “traditional” DB will continue as companies find innovative ways to keep their DB schemes open and resist closing to future accrual. The survey also found only 14 per cent had a DB scheme open to future accrual, while 38 per cent confirmed their schemes were closed to future accrual and 48 per cent said their schemes were closed to new entrants.

Teachers’ Commits To NXT
A $150 million equity commitment by Ontario Teachers’ Pension Plan (Teachers’) is providing additional growth capital for NXT Capital, LLC, a privately held middle-market commercial finance company based in Chicago, IL. The investment is being made through Teachers’ Private Capital, the pension plan’s private investment department. NXT Capital is led by former principals of Merrill Lynch Capital and was formed earlier this year with private equity funds managed by Stone Point Capital LLC, along with funds from the founding management team. NXT targets senior financing opportunities of up to $100 million.

Plan Definition Review Needed
The Organization for Economic Co-Operation and Development wants the International Accounting Standards Board to review the definition of DB and DC plans as they relate to international accounting standards. In commenting on an exposure draft of proposed changes to IAS 19, the OECD says some of its member countries feel that the current definitions do not fit well in the context of their national pension systems. For example, some member states have developed hybrid systems where the risk of the guarantee is divided between a Defined Benefit and a Defined Contribution arrangement. As a result, the OECD may look at reviewing its own classification system for different types of schemes early 2011 or 2012.

Corrections
In the June issue of Benefits and Pensions Monitor, the services directory listing for Morneau Sobeco on page 37 was incorrect.

The services listed should have included Investment Consulting, Performance Management, and Portfolio Modeling.

In the August issue of Benefits and Pensions Monitor, the listing for Seamark Asset Management in the directory of managers of EAFE and Emerging Markets assets for Canadian pension funds was inadvertently not included.

The listing follows:

SEAMARK ASSET MANAGEMENT LTD.
Darren Kosack, Senior Vice-president, Client Service & Marketing; 1801 Hollis St., Ste. 310, Halifax, NS B3J 3N4 PH: 888-303-5055 Fax: 902-423-1518 eMail: dkosack@seamark.ca
Web: www.seamark.ca

Benefits and Pensions Monitor apologizes for any inconvenience these may have caused.
Making the right mix of benefits available, across a national network of retail stores, calls for a strong awareness of workers’ needs, says Catalina Rodriguez, senior manager of employee relations for Best Buy Canada.

With about 19,000 employees across the country – the majority made up of young, part-time, in-store sales associates, as well as many full-time sales people – the main objective is to maintain the health and welfare of key demographics, while attracting other potential employee groups important to the retail brand, Rodriguez says.

“Our young workers bring a type of energy and freshness about technology that’s important to us, while our senior, more experienced workers bring maturity and salesmanship. You have to have that balance, so we try to design our benefits program to fit both sides.”

Accessible To All
To achieve its goal of becoming a retail employer of choice for young students in Canada, benefits and retirement savings must be reasonably accessible to all, she explains. In response, it has made its benefits

“Women are actually the biggest purchasers of consumer electronics. Although we attract a lot of men who are more into technology, we realize there’s an important connection between women being served by women who are knowledgeable of technology.”

Multi-faceted Strategy
Furniture and décor retailer IKEA Canada has also been developing its total compensation package “in a way that speaks to the majority” of its employees, says Jennifer Hagen, deputy HR manager. It typically attracts workers in the 25- to 45-age bracket, with 55 per cent of its staff women and 45 per cent men. Hagen describes its retail workforce as a wide-ranging cross-section of individuals with many diverse needs. Therefore, it requires a “multi-faceted” strategy.

“IKEA’s compensation package must always be for the many … it must have different dimensions that speak to our similarities and differences as a group of individuals.”

Out of the 2,708 employees at IKEA, 2,012 are part-time, so appealing to the younger segment is a priority. As a result, after one year, part-time workers

Other aspects to its benefits program, which are popular with IKEA employees, include:
◆ Subsidized meals throughout the day ($4 includes a meal, fresh salad, soup, dessert, and drink.)
◆ A bonus program for all co-workers based on annual goals
◆ Contributions of up to three per cent into workers’ RRSP plans
◆ Fifteen per cent discount on all IKEA products upon joining the company
◆ Co-worker Charge Program, which allows workers to make IKEA purchases on credit and spread the interest free payments over a period of nine months through payroll deductions
◆ Flex Work Arrangement Program including flex time, telecommuting, compressed work week, and job sharing
The Battle Between Risk And Regret

Moderator: Perhaps the place to start is with a discussion on inflation. Are we going to see inflation?

Toza Siriski: Within Canada, we know the Bank of Canada has established a target of one to three per cent and it has actually been pretty successful keeping within that range.

Our short-term view is we are less concerned about possibility of an inflationary environment; however, we are keeping a close watch on any significant developments that may change our viewpoint.

At the present time, we believe that the core inflation will keep within that range of around two per cent for, at least, another six to 12 months.

Bruce Grantier: I’d like to actually mention a couple sources which are interesting on this question of the inflation outlook.

The first is from Van R. Hoisington, president and senior investment officer of Hoisington Investment Management Company. At the recent CFA annual conference, he talked about the arguments why, despite huge monetary stimulus, we’re not going to see inflation in the near term – low money multiplier, a low bank credit expansion multiplier, and lots of slack in the economy.

The second is from the book, ‘Why Your World Is About To Get Smaller,’ by Jeffrey Rubin, former chief economist at CIBC World Markets. The main theme of the book is energy and other shortages. All cheap oil has basically been found and other longer-term shortages are looming which will put upward pressure on prices.

The bottom line is, as a bond investor, that doesn’t help much, but I think those are things to keep in the back of one’s mind in terms of inflation.

Gene Morrison: As Toza mentioned, in Canada, the expectation for inflation continues to be in line with the Bank of Canada’s target of two per cent. I would also say that despite the massive capital liquidity injections that have been made to U.S. banks, a lot of that money is not being lent as banks try to repair their balance sheets and capital ratios. That’s helping to keep inflation low and is even fuelling fears of deflation.

However, in the U.S., a lot of the consumers who might want a loan may not be creditworthy enough to get the loan and the ones who are most creditworthy are in the processes of de-leveraging. This is a major departure from where we were just three years ago where anyone could get a loan – even one they could not afford. We continue to see the fallout of easy credit playing out in the markets three years after the credit crisis began. There is an old adage that in order to get a loan you have to first prove you don’t need one. And that is exactly the environment we are in today, particularly in the U.S. So we’ve got all this money sitting on bank balance sheets. However, if that changes, and the money multiplier starts to rise, we could see inflation.

The other risk is if countries try to inflate their way out of their debt. There are only a few ways to get out of these massive debt burdens. The European countries are going down one path of using fiscal austerity measures now, but those are tough pills to swallow and I think it’s only a matter of time before we see additional quantitative easing by the ECB and Federal Reserve.

Moderator: So what does this mean for pension plans?

Siriski: From a pension plan perspective, you have to take into account how inflation impacts your liabilities which are usually different for public and corporate pension plans.

The retirement benefits in most corporate plans are not inflation linked. There is, however, inflation inherent in the liabilities in the

SPONSORED SECTION
form of salary increases: therefore, you need to factor in inflation assumptions into your asset mix to hedge some of the risk.

**Grantier:** Ontario Teachers’ annual report and public statements have said that their liabilities are like a 20-year duration real return bond, so they are highly sensitive to both inflation and real rates. That leads to another observation: the real rates that all bond investors and especially pension fund investors currently face in Canada are quite low and they worry about real rates declining further. Teachers’, for example, has a significant holding in real rate bonds and, given their real rate liability sensitivities, they, and others, are rightfully concerned about real rates going lower.

**Siriski:** The current low yield environment has substantially increased the liabilities of most plans. In addition, the search for higher returns to achieve your long-term expected rate of return has become more difficult. I believe some U.S. plans are still expecting seven, eight, or nine per cent rate of returns. Even though Canadian pension plans may be more conservative in their assumptions, it is going to be difficult for pension plans going forward.

**Bill MacLean:** Another perspective is many pension funds have a real rate objective which is in the four to 4.5 range. So, 1.4 is really a penalty rate. It means you have to make it up somewhere. So some investment committees are looking at alternatives to the really expensive real rates in the market. I was reading some literature talking about a value-added strategy which swapped real rate bonds in Canada for real rate bonds in Brazil. They go from 1.4 to six to seven per cent. That’s a reflection on the low rates in Canada.

**Siriski:** With the use of alternative strategies, you’re introducing new risks such as liquidity and transparency risk. This further increases the complexity in the management of pension plans.

**MacLean:** It comes down to one thing and we all call it risk. There are lots of things you can do, but, for the most part, you are introducing more risk and you have to be very conscious of the kind of risk you’re putting into your portfolio. There are many very well-educated boards that understand the nature of the risk return and the expectations of what that might mean in terms of returns going out. But, I see a lot more that don’t have that perspective and they’re very conscious of the risk and don’t want to take it.

**Siriski:** The other thing is the landscape is going to change very, very soon with the new accounting rules. Where it used to be a longer-term picture, it’s going to be a much more shorter-term picture. With these new accounting rules, that short-term variability of the pension plan is going to become a lot more important, especially for corporate plans.

**MacLean:** What I find with a lot of sponsors is it comes down to time horizon on your investment period. If you have a short-term perspective, such as three years in terms of your valuation matrix on your plan, when your contribution rates come in, you’ve got to look at the risk because you can’t manage that. If you’re very much old school – pension plans are long-term, 20-year duration-type vehicles – then there is a very different risk profile. That seems to be a big issue with clients, trying to figure that out.

**Morrison:** We’re seeing a battle of managing risk versus regret play out in the pension space right now. It used to be that corporate plan sponsors could have a long-term view and say ‘we can ride out the volatility.’ But now, with the impact to their balance sheet and the potential for parts of the underfunding to flow through U.S. income statements as part of phase II of FAS 158, the short-term implications of a volatile pension plan can have an outsized impact on the financial condition of a plan sponsor.

Yet, interest rates are so low that plan sponsors want to wait until long-term rates rise and then increase their allocation in fixed income. It’s understandable why a plan would want to wait. Interest rates are historically low, no doubt about it. However, there is a risk in waiting for interest rates to rise, especially if both equities and interest rates fall which is what has happened this year. Therefore, plan sponsors have lost funded status as assets have fallen and liabilities have increased. The fear of regretting a decision to move into fixed income, or lengthen the duration of their existing portfolio in this low interest rate environment, is exposing plan sponsors to a continued risk of loss of funded status.

Another key factor is the funded status of the plan. If the plan is 100 per cent, 95 per cent funded, it might be a little easier to rationalize a move to fixed income and nail that liability down. If you’re 80 or 90 per cent funded or somewhere in that ball park, you’re locking in that underfunded position and will need to make up for it with additional contributions.

**MacLean:** The key for plan sponsors is to have a game plan. We’ve always reacted to what the market’s done. We went through the internet bubble. We were all well-funded going in and then, things went the other way. We started getting through that, and here we are again, 2008/2009. If people have learned one thing, it’s you may not have determined which way you want to go on this issue versus how you want to set your plan up, but you should have a game plan.

**Moderator:** So how realistic is it to expect interest rates to rise at some point in time going forward?

**MacLean:** We have to be clear that there are a number of different interest rates. We always talk like it’s one interest rate. From T-Bills right out to 30-year treasuries and corporates and provincials, there are different levels of interest rates. Certainly through...
SPOTLIGHT ON

Fixed Income

the credit problems, there was a very different corporate interest rate than a government one. But, certainly there are going to be different interest rate levels for different pieces of paper. That’s going to be the big game going forward, trying to figure that out.

Morrison: As Bill mentioned, it really depends on which rate you are using. The Bank of Canada has begun to normalize short-term interest rates from their crisis levels. So they are directly influencing the front end of the curve, which has the additional impact of helping keep the long end stable as the bank maintains its credibility as a steadfast inflation fighter.

In addition to the credibility of the Bank of Canada, you have strong demand on the long end of the curve. Not only are pension plans competing with each other for long-term rate products, they’re competing against insurance companies who have always used them. So now you’ve got two competing forces that are going to be keeping those long-term rates down.

And while locking down LDI with fixed income products is beginning to take hold in the U.S. and Canada, we’ve seen the experience in the UK where plans migrated into long bonds when accounting rules were changed. It will be interesting to see how fast U.S. and Canadian pension plans do the same thing, the reaction of the insurance companies and what that all means for supply and demand, and the resulting yields on long-term corporate bonds.

Presently, rates across the curve are not only at cyclical lows, but at secular lows. At some point, just when the market begins to believe that these low rates will remain that way indefinitely, is when rates will finally reverse course and rise.

Moderator: Given the talk about the need to move to LDI, is there enough supply to meet the needs of pension plans and now, apparently, insurance companies?

Grantier: The work I have done on this suggests that the product supply of conventional bonds is not the problem because the supply of conventional bonds is huge compared to whatever demands there might be. The longest bonds, however – looking at the current DEX Index – have a duration of about 11 to 12 years. That’s not going to meet anyone’s pension liabilities. The supply problem is elsewhere. The availability of long duration real return bonds is not adequate and coupons or stripped bonds, which have long enough duration, are not available in adequate supply either.

So it’s really swaps and other techniques that you have to resort to get out to 16 or 20 durations, which is the typical range of most pension liability durations.

MacLean: I take a little umbrage with my colleagues when they say look at this LDI. We’ve been looking at liabilities for 30 to 40 years. Plan sponsors are smart people. They know about their liabilities and, correctly or not, back in the 1970s they made a decision to effectively have a balanced fund against a liability. For a long time, it really worked well because the balanced fund really did outperform that stream of long rates.

LDI is a new name, but the gist around it isn’t new for the most part. It is financial engineering to get the durations out and manage the convexity around the liability curve.

Our brethren in the UK and others who have been doing this under-stand you have to be very careful in terms of how you go about it and there is a problem with pure, outright product matching duration.

Siriski: We find, too, is that while there is product out there, the issuance is somewhat lumpy. In other words, you have issuers out there, but it’s hard to get a real diversified portfolio out on the long-end of the curve.

Using swaps on the U.S. side has been very effective, so effective that swap spreads are negative to treasuries. However, purchasing swaps in Canada isn’t as robust as it is in the U.S. It’s a similar story in the futures market. There is the strips market and there are several different ways to push duration of a portfolio out into a 15- or 16-year duration.

The other part is demand. If demand increases, that can create supply. If supply becomes an issue, or if demand becomes so great, governments will step in to offer supply.

Because when I deal with three different plans (Canadian, U.S., and UK plans), I actually have three different conversations for three different views on LDI. At the end of the day, to me, it’s a combination of physicals and derivatives, so a combination of the langs and the swaps. Do it, but in a context where you feel comfortable in how much liquidity risk you want to take and how comfortable you are around that counter-party risk and so forth.

LDI is a very interesting perspective. You have to start focusing it down a little bit more and really focus on how this plan is different from that plan. That’s why we have a lot of providers out there that can do these customized solutions, because there is no right path and there is no one doing the same thing. Everybody looks different and how they achieve their long-term objective is different.

MacLean: When we look at these LDI products, there is not one provider that can bring you a solution. For example, they may have a great bond group that can absolutely know how to structure it and put in the right things to match your liabilities, but, they don’t have enough good products that are non-correlated assets in their house to provide that.

Morrison: To build on that point, each plan sponsor is so idiosyncratic that there is no one-size-fits-all for LDI. It’s not a product, it’s really a solution that needs to be built and customized. I know from working with different plan sponsors that the duration, the stream of cash flows, the funded status, or their ability to make
Siriski: I also believe that some plans may have difficulty in understanding the performance results within an LDI strategy. You’re moving away from pure universes and benchmarks only, which they were very comfortable with, to something which they are far less familiar with. However, in my experience, the increased reporting of the liabilities has allowed us to better manage our plans.

MacLean: One of the things I see more and more is putting in liability benchmarks in actual performance reviews. In other words, sure, you’ve got the universe and the peer group comparisons, but you actually try to figure out what the liability looks like and put some sort of proxy for it in the actual report. It helps the committee understand because they can see it’s quite volatile. It’s a minimal thing, but it helps the committee to ask the next set of questions about how to minimize that risk.

Grantor: I agree that the committee mindset is really critical in this whole thing. I see a problem for corporate plans because a corporate plan could immunize right away and then it loses immediately the potential positive pension income which is a potential contribution to the balance sheet. Corporate plans think about that and realize this is a real consideration unless you just want to immunize and forget about the pension earnings.

I find, with all due respect, people tend to be a little glib about LDI and talk about it as some magic solution. But, it takes a lot of work; a lot of thought, careful research, and planning; probably a change in mindset; and the willingness to adopt new and unconventional approaches.

MacLean: I’m going to pick up on Bruce’s comment on them being glib about LDI. So many people say we have an LDI solution. It’s going into long bonds. Come on, there is so much more to it.

Moderator: What about alternatives such as core plus products?

MacLean: What’s happening is, going back to my 60/40 traditional asset allocation, 40 per cent of these assets have what, 3.5 per cent maybe, in terms of yield. You have an actuary telling you that you need six, something to that effect. So, you’ve got this gap on 40 per cent of your assets, but there is a huge gap on the interest rate side. Let alone the volatility of that bogie that you’re using to discount the liabilities.

So, when you look at a core plus product, yes, go and try and grab some extra return. It’s important and the compounding of that return is very important.

Having said that, what I see with a lot of core products is they’re taking on a lot more risk than the value-added. They are producing products that they don’t really have a lot of experience in, just to be able to say ‘here is credit.’

I’m not against core products, I just want to make sure the manager: one – knows what he’s doing; two – actually has a track record that I can look at to say that he actually adds some value; and three – is the risk, the underlying volatility and risk on that core, the plus part, worth it? If you can get around that, then yes, and there are certainly a number of products out there that do. But, you’ve got to watch out because there are lots that do not. They’re just adding risk to bolster the returns.

Morrison: And that’s a good differentiator. With core plus, the plus part is not just alpha. There is a lot of beta risk in there and, within those sectors, whether it’s high yield or emerging market debt or global, there are opportunities for alpha as well as beta so you could get a little of both.

We have clients who want to get the best of both worlds, so they look at building long duration ‘plus’ portfolios. This provides them with fixed income instruments which are a better hedge against the liability than equities and also offer a higher return potential that may help bolster a plan’s funded status. Of course, with the added return comes added risk.

The Long Duration Plus is just part of the LDI continuum. We’ve seen a lot of people go from DEX universe type products out to long duration. That’s the first step, just to get the duration a little more in line with the liability. Even with a portfolio comprised of 60 per cent equities and 40 per cent fixed income, extending duration can improve metrics such as your hedge ratio and lower the VAR or value at risk. Assuming your funded status is north of 80 per cent, you may look to increase the percentage of assets in fixed income from 40 to 60 to 70 in order to improve your hedge against the liability and lower your funding volatility all while keeping some equity exposure to continue to grow the funded status.

Then, when a plan is fully funded, they can get a little more exacting with solutions that are customized and tailored to the particular liability and match on key rate durations, for instance.

At any point, a plan sponsor may want to add in the plus component. It really just depends on the funded status and how tight the plan sponsor wants to manage the volatility of their funded ratio. There are countless ways to accomplish the goal, but the first step is developing a plan of attack and a consultant and investment manager can certainly help in that regard.
It is clear that emerging equities have outperformed global equities in most time periods over the last decade (see Chart 1). But there are many other reasons, aside from returns, to invest in this asset class.

◆ **Growth potential**

Thanks to a lower level of external private and public debt as well as lower budget deficits, emerging countries have better economic conditions and growth prospects than do developed countries. They grew by one per cent in 2009 versus minus three per cent in the developed world. They are expected to grow this year by around six per cent, versus two per cent for developed markets, and we expect this trend to continue.

As well, emerging countries will continue to benefit from ‘internal demand’ – that is, structural growth that is fuelled internally by demographics, increasingly-skilled workers, capacity for increased financial leverage, and increasing purchasing power. This internal demand from emerging economies will also be a key driver of world economic growth over the next several years.

In contrast, the developed world remains rife with macro-economic uncertainties. For example:

- Jobs will likely continue to shift from West to East due to the strong competitive advantage of the Yuan against the dollar and the euro.
- The announced government cutbacks in Europe are unlikely to fuel a significant resumption in private investment.
- The U.S. administration’s fiscal policy faces some difficulties in Congress and U.S. growth may continue to be suppressed by the high financial leverage of the private sector and the large current account deficit.

◆ **Still-attractive valuations**

In spite of their higher growth potential and their strong performance in the last few years, emerging equities continue to have PE levels similar to those in developed market equities. Some countries, such as Russia, are particularly cheap, while others, such as Brazil and Indonesia, have very attractive medium- and long-term economic growth outlooks with valuations that are either attractive or in line with other emerging markets.

◆ **Diversification benefits**

Emerging markets represent a significant diversification vehicle, allowing investors such as pension funds to gain access to a wide variety of markets while benefiting from very attractive returns and growth potential. Improving the depth and breadth of market exposure around the world can lower the overall risk of a portfolio.

◆ **Too big to be ignored**

Emerging equities are no longer viewed as a peripheral asset class. The solid growth in the emerging economies has resulted in the Emerging World becoming a sizeable part of the global GDP. If you adjust the currencies for purchasing power parity, emerging countries now represent about 53 per cent of the world GDP. As well, the weight of emerging markets in the MSCI All Country World Index is now 15 per cent and in the EAFE index it is close to 30 per cent. This is a portion of world equity capitalization that warrants serious attention.

◆ **Improved risk profile**

Many investors still perceive the risk of emerging markets to be relatively high. But, in addition to the genuine growth opportunities that emerging markets offer to Canadian pension funds, their risk has improved gradually in the last 10 years, save for the spike during the crisis. As risk perception changes, emerging markets should benefit.

So why use a specialist emerging markets manager? Many investors already have some emerging equity exposure through their international managers. However, there are strong arguments in favour of considering a specialist emerging markets manager:

- There are different performance drivers for emerging versus developed markets and a developed market manager may not have the needed special expertise. In particular, there are many complex macro, top-down issues to consider in emerging markets that aren’t present in developed markets.
- The breadth and depth of the emerging markets investable universe has increased significantly in recent years. Thus, developed market equity portfolio managers may find it more difficult to keep up their knowledge base as the emerging market world expands. Many developed market managers limit themselves to the largest 50 names of the emerging market index, leaving many important opportunities untapped.

- The growing capitalization of the emerging market investable universe means that these markets warrant specialized attention and expertise. Thus, the growing size, significance, and complexity of the emerging equity world calls for increased scrutiny and expertise in the management of emerging market portfolios.

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### Why Invest In Emerging Equities?

East due to the strong competitive advantage of the Yuan against the dollar and the euro.

- The announced government cutbacks in Europe are unlikely to fuel a significant resumption in private investment.
- The U.S. administration’s fiscal policy faces some difficulties in Congress and U.S. growth may continue to be suppressed by the high financial leverage of the private sector and the large current account deficit.

### Chart 1

<table>
<thead>
<tr>
<th>Index</th>
<th>1 Year</th>
<th>3 Years</th>
<th>5 Years</th>
<th>Since Jan 1, ’01 (9.5 Years)</th>
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<tr>
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<td>-1.0%</td>
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<tr>
<td>MSCI World (US$)</td>
<td>9.8%</td>
<td>-9.2%</td>
<td>0.9%</td>
<td>9.6%</td>
</tr>
</tbody>
</table>

### Benefits and Pensions Monitor – September 2010
We’ve done the math for plan sponsors and plan members!

Risk profile

Target date

Asset rebalancing and Lifecycling

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For years now, Canadians have heard tales of nightmares come true – workers falling to their deaths from ladders or seriously injuring themselves because of a slip or trip. The real tragedy is that most of these injuries are preventable. According to the 2004 Canadian Institute for Health Information report, falls are the second leading cause of injury-related hospitalizations for all ages, resulting in 29 per cent of injury admissions.

Statistics show that most falls (60 per cent) happen because of slips and trips. The remaining 40 per cent are falls from a height. Slips happen where there is too little traction between footwear and walking surfaces. Common causes are wet floors, weather hazards, (like snow covered walkways), loose rugs or mats, and walking surfaces that do not have uniform traction. Trips happen when a foot hits an object, resulting in loss of balance.

Steps For Prevention
Not only is fall prevention a good financial and moral choice, it’s the law. Occupational health and safety laws require employers to take precautions to protect workers and provide accurate information. To investigate it right away, determine the cause and find a solution.

Managers have to be proactive when it comes to fall safety. Special training may be required, especially for equipment like ladders. Popular topics for employee training may include equipment set up, inspection, storage, and maintenance.

The Employee’s Role
Employers are ultimately responsible, but employees should be educated on how to protect themselves. For employers, this means educating them on how to spot the hazards, or just providing a handout with helpful tips for fall prevention. Employees can prevent falls by taking their time and paying attention to where they are going, using a flashlight when entering a dark room where there is no light, ensuring that things they are carrying or pushing do not prevent them from seeing any obstructions, spills, etc, and reporting all slip, trip, and fall hazards immediately to your supervisor.

Remember that these injuries have heavy costs for Canadians, both emotionally and financially. A 20 per cent reduction in falls would translate to an estimated 7,500 fewer hospitalizations. The overall national savings could amount to $138 million annually, according to a 1998 study produced by SMARTSK. By implementing the safety precautions outlined above, we can achieve this.

Home Safety And Fall Prevention
So how can employers make a difference and how can employees stay safe?

Good housekeeping is the easiest way to help prevent trips and slips. This involves a keen eye and dealing with any potential dangers immediately. Some examples are:

◆ Cleaning all spills with hot, clean water
◆ Marking all wet areas
◆ Keeping walkways clear of clutter
◆ Tacking loose rugs to the ground
◆ Covering any cables that could be a tripping hazard
◆ Keeping working areas well lit

Changing or modifying walking surfaces is the next level of prevention. Recoating or replacing floors, installing mats, and advising employees to wear shoes with proper traction can further improve safety and reduce risk of falling.

Employer Responsibility
Employers should use fall protection programs which can include implementing a company policy that outlines rules for inspection and maintenance. Becoming familiar with laws and legislation is also a good idea. They should be able to identify all slip, trip, and fall hazards at the work site as well as instruct employees on how to spot and avoid them.

It’s not enough to just instruct employees on proper practices – managers should make sure that employees understand procedures and can follow them correctly. Once a fall program is in place, it’s important to take time to re-evaluate it to make sure that policies are working. If a fall does occur, be sure to investigate it right away, determine the cause and find a solution.

Benefits and Pensions Monitor – September 2010

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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Exchange-traded funds (ETFs) are commonly talked about in the mainstream media as a retail product. Low fees, transparency, liquidity, and simple access to diversification are among the very real benefits that have attracted the focus of retail investors in recent years. As the general awareness of ETFs has skyrocketed, so has the range of options available to investors.

But, this trend towards public adoption of ETFs coincides with another trend that has been taking place among institutional investors: namely, the growing realization that ETFs not only provide a cost-effective and cost-transparent way to achieve diversification, but also are invaluable tools in meeting the challenges institutional investors tackle every day.

The upsurge of interest in the products is occurring at a critical time for institutional investors. As markets remain volatile and long-term outlooks remain cloudy, all the hallmarks of ETFs – liquidity, flexibility, and simplicity, as well as cost-effectiveness – increasingly fit the needs of investors. According to a recent survey of U.S. plan sponsors and money managers by Greenwich Associates, the percentage of American pension funds, endowments, and foundations that report using ETFs has grown to about 14 per cent. That might seem low, but according to recent estimates institutional holdings represent roughly half of all total assets invested in ETFs in the United States. Additionally, almost 55 per cent of institutional investors now using ETFs expect their usage of them to grow over the next year, including nearly 20 per cent that expect the proportion of the assets held in ETFs to grow by five to 10 per cent.

In Canada, the results are similar. In our experience, institutional clients embrace the products as a tool in both the strategic and tactical challenges of effective long-term portfolio management. In fact, we expect institutional-held ETF assets will continue to grow as they have in the U.S. and Europe.

**Growth Of Adoption**

So why has ETF usage among institutional investors increased so quickly and how do we envision the growth of adoption going forward? The reasons are as varied as the approaches institutional investors take to generate value for those that have entrusted them with the task. One well-publicized reason for continued growth in the use of ETFs by institutional investors is the variety and number of ETF products now available. This has not just been a response to increased demand, but has been fuelling that demand. These days, ETFs provide access to a vast array of asset classes, geographies, and currencies including emerging markets, fixed income, and real estate. Such variety of options allows for their application in a wide spectrum of uses, including very specific cash equitization strategies. It’s important to remember – and particularly appealing to institutional investors – that they also offer intra-day liquidity and enhanced flexibility, allowing market participants to be much more nimble and surgical in the management of their assets. In today’s markets, where long-term returns are difficult to divine, the traditional advantages of ETFs over other investment vehicles are even more important and have been driving the increased adoption of these funds by institutional investors.

That said, the recent surge in ETF variety and number of ETF providers is, in fact, introducing a new degree of due diligence that needs to take place at the investor level. As with all investment vehicles, it is more important than ever to take a deep look at not only what an ETF name and ticker is, but who the provider is behind the fund. A strong provider will have the direct market depth, breadth, experience, and support structure available to not only properly construct a given ETF exposure, but also to manage the fund through all market environments. By accessing an ETF provider with a history of being a reliable partner in the ETF space, investors gain support from the due diligence phase right through to trade support both in and out. In the Greenwich survey mentioned earlier, the reputation of the company behind the fund was among the four most often cited selection criteria given by institutional ETF investors, the others being liquidity, benchmark and the fund’s track record.

**Increasingly Aware**

Over the past year, a number of themes have arisen with regard to ETF investing as institutional investors of all sizes are becoming increasingly aware of the benefits ETFs offer.
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increasingly aware that ETFs offer a flexible and efficient way to address the challenges of long-term investing in a volatile marketplace. ETFs are being used to implement a variety of strategic investment decisions, from the efficient adjustment of portfolio duration and plan asset class allocations to the execution of event-driven tactical strategies. In some cases, a manager may simply combine both traditional index investments with a matching, but more flexible, ETF exposure, to improve the overall level of flexibility within a portfolio or plan and to better equip it for more volatile markets.

Many institutional investors have adjusted somewhat outdated investment policy limits and restrictions around the use of index instruments to allow for an increase in the use of ETFs. As a result, and not surprisingly, the increased adoption of ETFs has gone hand-in-hand with the well-established trend towards more emphasis on beta investments.

There is more to it than that, however. ETFs are increasingly being used as a clear and efficient tool for alpha strategies, from the complex to the straightforward. As well, a renewed focus on transparency, flexibility, and risk budgeting has institutional investors using ETFs more and more to expand their investment strategies while managing towards a high standard of transparency.

As with many things, much can be understood by how institutional investors are using ETFs by looking at the numbers. Net asset flows are a good source of observable evidence that ETFs are being used to implement exposure across a wide range of asset classes, currencies, and geographies. Equities, not surprisingly, are still the most popular asset class, with more than $11 billion in net inflows for the first half of 2010 and $36 billion of net inflows in 2009.

In addition, institutional investors are becoming more comfortable with the wider array of ETF classes as they invest across the risk spectrum, from emerging market equities to corporate bonds and commodities. In aggregate, the total of assets under management held in ETFs exceeded $1 trillion for the first time last December, and more than 47 per cent, or $488 billion, was invested in iShares ETFs.

**Passive Target Allocations**

By venturing beyond equity ETFs, investors have gained simple and cost-effective access to some of the best-performing asset classes of the past few years. Many (some 28 per cent in the U.S. Greenwich survey) are employing ETFs to take passive investment positions as part of core-satellite investment strategies. For instance, a plan sponsor might take a position in emerging market ETFs to gain passive target allocations while simultaneously employing a manager to implement an active strategy. Notably, because there is not a minimum purchase size for ETFs, smaller funds are deriving the benefits of passive core allocation because they can implement asset allocation targets regardless of their size.

Meanwhile, among institutional investors, the broad trend towards adopting ETFs as a tool in their arsenal is underpinned by the regular use of the products for management of external managers. Many plan sponsors, for example, will use them to gain temporary market exposure to a given asset class while transitioning from one external manager to another. In such cases, ETFs can often provide a suitable ‘parking spot’ for funds, giving the plan sponsor time to search for a new manager while maintaining the integrity of the plan’s overall investment objectives. In fact, the use of ETFs to gain quick, flexible market exposure for cash holdings is also a common way to manage incoming assets or for assets awaiting distribution.

In both the U.S. and Canada, pension funds, endowments, and foundations are using ETFs in increasingly more sophisticated ways. They are being deployed to achieve efficient portfolio rebalancing and to generate additional return through the administration of the ETF holdings themselves. As all managers and plan sponsors know, moving in and out of relatively illiquid funds and/or individual securities to effect a rebalance can be extremely time-consuming and expensive. Many have discovered, however, that by using ETFs backed by a strong provider, they have the ability to tap into multiple levels of liquidity, helping to reduce both implementation time and cost when making broad asset-class changes.

For those plans that are active in securities lending, ETFs have an added significance, as they have the potential for additional return through the lending-out of the ETF unit itself. In some cases, securities lending revenue can completely offset or exceed the ETF’s expense ratio, making it a truly low-cost tool indeed.

According to Greenwich, nearly 30 per cent of U.S. institutions surveyed who do not use ETFs say they lack familiarity with them. That level of knowledge, both about ETFs and about their uses, is changing daily, it seems. It is always difficult to look into the future and chart an investment path, but for all the bumps along the way those tools that provide clarity, integrity, and flexibility will always be worth exploring.

Greg Walker is vice-president of institutional business at iShares, BlackRock Asset Management Canada Limited (iShares Canada_Institutional@BlackRock.com).
With employers worldwide continuing their shift away from Defined Benefit plans in favour of offering Defined Contribution coverage, Canadians are assuming greater responsibility – and risk – for their financial security at retirement. This article explores the current state of employer-sponsored capital accumulation plans in Canada and the direction plan sponsors anticipate taking in the coming years, based on insights from Towers Watson’s recent survey research.

Canada Compared To Other Countries

Statistics Canada data shows a sustained pattern of decline in DB plan membership as a percentage of the total workforce, accompanied by an increase in DC plan participation in the private sector. Since the advent of pension tax reform in 1990, the percentage of the workforce participating in a DB plan has declined from 41 per cent in 1990 to 32 per cent in 2009, while workforce coverage through either a DC or a hybrid pension plan has increased from four per cent to 11 per cent.

In reviewing pension design trends over this period, Statistics Canada reports that “the increased prevalence of DC plans is reflected in nearly all plan sizes, but almost exclusively in the private sector” – with DB-to-DC plan conversions, DB plan wind-ups, and introduction of new DC plans accounting for the trend.

Yet, DC growth has been slower in Canada than in other large developed pension markets worldwide. Canada compares only with the Netherlands and Japan in the high proportion (more than 90 per cent) of total registered pension plan assets remaining in DB plans compared to DC plans.

Key reasons why DC has not moved ahead as quickly in Canada as elsewhere include:
- the regulatory complexity of DB-to-DC conversions – particularly for employers with plan members in multiple provincial jurisdictions
- the lack of safe harbour rules, which might offer a degree of legislative protection for some of a plan sponsor’s decisions with regard to its new DC plan
- long-standing union opposition to changes that would reduce or replace DB coverage.

Nonetheless, the trend in Canada is clear – and in many private sector organizations that have not yet moved toward DC, shareholders and boards are increasingly questioning whether now is the time to make the move.

Plan Sponsor Outlook

To help assess current trends in capital accumulation plan (CAP) design, management and delivery, in early 2010 Towers Watson conducted a cross-Canada survey of organizations that include one or more CAPs in their total rewards programs. The survey results offer insights into the actions CAP sponsors are taking today to deal with short-term challenges as well as their future strategies for managing cost and risk in their CAPs.

Most CAP sponsors cite external market pressures (65 per cent of sponsors surveyed), financial pressures (54 per cent), and workforce and talent management objectives (56 per cent) as the top three issues driving their organization’s retirement plan decisions today.

Relatively few CAP sponsors surveyed believe that employees make informed decisions about their retirement savings (36 per cent), the investment of their retirement plan assets (32 per cent), or have realistic expectations about what income level their retirement programs will ultimately provide (23 per cent).

Two-thirds of plan sponsors believe CAP-related litigation may increase in the future. The reasons most often cited for future anticipated legal action on the part of plan participants are the realization of inadequate retirement income (72 per cent of sponsors surveyed), poor investment performance (63 per cent), and inadequate communication and education (60 per cent). This underscores a clear need for employers to manage the risks associated with CAPs more proactively.

Plan Design

Nearly half of the survey respondents (48 per cent) describe their corporate philosophy regarding the design of their CAP as offering a ‘facilitation’ role – providing members with the opportunity to retire with adequate income.

When asked to identify the top three objectives in designing their plans, the main two – by a significant margin – are competitive positioning (82 per cent of sponsors surveyed) and encouraging individual responsibility for retirement saving (61 per cent). Only 25 per cent of respondents are focused on targeting a particular level of replacement income – demonstrating that the majority of CAP sponsors are promoting individual responsibility for retirement saving.
ity rather than employer responsibility to save for retirement.

A diverse range of structures are used to determine employer contributions. There is no one ‘typical’ contribution formula and different employers will adopt different contribution structures in order to achieve their specific plan design and ‘messaging’ objectives.

Prevalent contribution structures include:

- for 32 per cent of survey respondents, a matched contribution, placing the responsibility for saving squarely on employees’ shoulders, while providing a meaningful financial incentive for employees to save
- for 20 per cent, an automatic base contribution, supplemented by an opportunity to earn a further match-driven contribution
- for another 20 per cent, a simple, flat employer contribution model, with no requirement or incentive for employees to contribute

Overall, the median plan design in many of the categories above would result in a maximum of roughly 10 per cent of an employee’s salary being set aside by the employer and employee in total. While a 10 per cent annual contribution rate may have provided an adequate level of retirement income replacement during the 1980s and early 1990s when interest rates were significantly higher than they are today, we question whether these contribution levels will be sufficient without additional unmatched contributions by employees in today’s persistently low interest rate environment. This question is particularly relevant for employees in middle to high income brackets and those who delay starting retirement savings contributions until their mid-career years. As experience over the last several years has shown, the retirement income that a CAP can deliver is highly sensitive to market conditions – potentially forcing plan members to delay retirement, accept a lower standard of living, or (if they have sufficient time) increase their savings rate.

In the U.S., auto-escalation features have been implemented in many plans to help address potential shortfalls in employee participation and contribution rates. While auto escalation is not currently permitted in Canada, a service- or points-graded contribution scale could achieve the same result. However, only a quarter of survey respondents currently use this type of plan formula in their design.

Communication And Decision-making Support

With a maturing CAP membership and increasing exposure to potential liabilities associated with assisting and educating plan members, good communication and modelling tools will become vital for both plan members and sponsors. Yet, although competitive positioning was a key objective for most employers in designing their CAP, only 16 per cent of CAP sponsors surveyed believe they have a communication plan that is fully integrated with their total rewards strategy.

Both ‘high tech’ and ‘low tech’ methods are important when communicating with employees. While the vast majority of CAP sponsors agree that high tech tools, such as the internet/intranet and online modelling tools are effective communication methods, more traditional, low tech approaches are still deemed effective by many – including the use of group meetings, call centres and newsletters.

The next generation of decision-making support and modelling tools being implemented by employers includes stochastic modelling (showing a range of outcomes, not just a single scenario), incorporates income from other sources (reinforcing the role the CAP is intended to play as one of a variety of retirement income vehicles), and goes beyond the accumulation phase to illustrate the anticipated depletion of accumulated CAP balances during the retirement years – helping plan members to understand more fully the risk of outliving their retirement savings and to evaluate the pros and cons of different savings levels, pre-retirement investment approaches, and self-managing their accumulated balances during retirement versus buying a life annuity. And, with the use of multi-media techniques, these more dynamic modelling tools can be made easier and more engaging for plan members to work with.

Investment Practices

Not surprisingly, our survey results reveal a wide range of differences in the investment line-ups of CAP sponsors. This is notably evident in the number of fund options being made available to members – with a median of 10 (counting target date and target risk fund series as single options), but with some sponsors offering only one investment option while others report more than 50 funds available.

In particular, target date funds have been an area of interest for many CAP sponsors and have increased dramatically in prominence in Canada over the last several years. Target date funds are the most prevalent type of new funds being added to investment line-ups, with 38 per cent of survey respondents now making them available to plan members.

The survey results also indicate a trend to move away from actively managed funds, particularly balanced and Canadian fixed income, into passive investment options. This reflects CAP sponsors’ dissatisfaction with their funds’ inability to navigate successfully through the market collapse and rebound, as 40 per cent of survey participants indicate replacement of underperforming funds as the reason for implementing changes to their investment option line-up.

The survey also reveals that engaging members to provide initial investment directions remains a continuing challenge, with 47 per cent of respondents indicating that 10 per cent or more of their members are being invested automatically in the ‘default’ option. While 31 per cent of respondents currently offer a balanced fund as the default option, there is an emerging trend to change the default option to target date funds. Of Canadian CAP sponsors surveyed, 24 per cent have already made this move and, of the 21 per cent of survey participants that are considering changing their default option over the next 18 months, 66 per cent are considering a target date fund series as the new default.

Managing Risks

Looking forward, CAP sponsors will – in addition to the design, communication and investment trends explored above – increasingly be focused on developing and using better tools to manage their plans more effectively. In discussions with leading CAP sponsors, we see increasing interest in management tools designed to provide ‘CAP health check’ information on plan member participation levels, investment patterns, and distribution elections, and ‘CAP valuation’ tools that will provide insights into how plan members are tracking toward retirement income targets that were set when the CAP design was initially developed and communicated.

Although a fundamental premise of CAPs is that plan members are empowered to take ownership of their retirement security, a significant degree of employee risk can accompany this opportunity. Employee risks have the potential to turn into employer risks. For employers that provide retirement coverage through a CAP, there is a strong business rationale to help plan members understand, manage, and mitigate these risks – not just during the accumulation phase, but also as plan members begin the shift from building wealth to preserving wealth as they approach and subsequently begin retirement.

C. Ian Genno is a Towers Watson consultant based in the firm’s Toronto office (ian.genno@towerswatson.com).
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¹ Combined AUM of Pyramis, Fidelity Investments and FIL as at March 31, 2010 (U.S. dollars).
² Resources described reflect the combined resources of Pyramis, Fidelity Investments and FIL as at March 31, 2010.

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Yes, it is possible that ethical investing can produce higher returns. For instance, America’s Social Investment Forum found in a “… review of 160 [U.S.] socially responsible mutual funds from 22 members of the Social Investment Forum (SIF) … that the vast majority of the funds – 55 per cent – outperformed their benchmarks in calendar year 2009, most by significant margins…”

In fact, most studies of ethical and socially responsible (SR) investing do find roughly similar or even sometimes higher returns when compared to conventional investing. And this is what reviewers concluded after examining thirty key academic and broker studies related to ethical/SR investing for the United Nations Environmental Programme (UNEP) Finance Initiative and Mercer in late 2007.

This means say, investing in defence companies with ‘stellar’ ethical/SR corporate attributes – if there are such companies – despite the company’s products not aligning with the investor’s values.

However, I suspect that with investors and governments increasingly demanding that companies report and improve upon their environmental, social, and governance (ESG) activities, in the future there will be fewer companies engaged in potentially damaging ESG activities. And, therefore, there will be a smaller number of industries and companies for ethical/SR investors to shun. Perhaps this sounds utopian, but these are indeed the trends.

The wake-up call of the BP oil disaster also adds fuel to the promulgation of ESG policies. Some alert ethical/SR fund managers, having studied and critiqued BP’s ESG activities, sold their BP stock prior to its oil spill.

One point that troubles most conventional investors concerning ethical/SR investing is the placing of personal values above profit – as seen in just released survey results from the Desjardins Group. “… [given] the choice between a conventional fund and an SRI [socially responsible investing] fund with a one per cent lower return, 85 per cent of investors would choose the SRI fund. Even if the return was three per cent lower, 58 per cent of investors would still choose SRI funds!” But, as the above research proclaims, giving priority to personal values can be positive for investing returns.

As investors realize that they can apply their ethical/SR values to investing and make similar or potentially better returns compared to conventional portfolios, investors everywhere will eventually favour ethical/SR oriented funds and investments. And the added benefit will be a better world for us all.
**ABERDEEN ASSET MANAGEMENT**
Renee Arnold, Head of Business Development, Institutional Business Development - Canada; 161 Bay St., 27th Floor, Toronto, ON M5J 2S1
PH: 416-572-2020 eMail: renee.arnold@aberdeen-asset.com Web: www.aberdeen-asset.com
**Managed Since:** 1995
**Clients:** 8
**Philosophy/Style:** Employs a bottom-up fundamental analysis with a focus on absolute return; invests in companies with sound fundamentals that pass investment criteria of quality and price; for SRI mandates, companies must also pass a screening process for acceptable social behaviour.

**ADDENDA CAPITAL INC.**
Joe DiMassimo, Senior Vice-president, Sales & Client Service; 36 Toronto St., Ste. 1050, Toronto, ON M5C 2C5
PH: 416-643-4000 Fax: 416-643-4049 eMail: j.dimassimo@addenda-capital.com Web: www.addenda-capital.com
**Managed Since:** 1992
**Clients:** 1
**Philosophy/Style:** Manages assets by using established styles, then applying SRI screens.

**BLACKROCK**
Eric Leveille, Managing Director; 161 Bay St., Ste. 2500, Toronto, ON M5J 2S1
PH: 416-643-4000 Fax: 416-643-4049 eMail: eric.leveille@blackrock.com or amg-rfp@blackrock.com Web: www.blackrock.com
**Managed Since:** Inception
**Philosophy/Style:** Manages fixed income, equity, real estate, liquidity, alternatives, and asset allocation/balanced strategies for institutional and retail clients. It believes that investment professionals using a disciplined investment process and sophisticated analytical tools will consistently add value to client portfolios.

**BNP PARIBAS INVESTMENT PARTNERS CANADA LTD.**
Simon Segall, CEO; 155 Wellington St. W., Ste. 3110, RBC Centre, Box 149, Toronto, ON M5V 3H1
PH: 416-365-3983 Fax: 416-365-3987 eMail: simon.segall@bnpparibas.com Web: www.bnpparibas-ip.com
**Managed Since:** 2001
**Philosophy/Style:** Offers range of sustainable investment solutions that add value by capturing new opportunities resulting from sustainable development, reducing emerging risks created by unsustainable development, supporting a higher degree of responsibility.

**CIBC GLOBAL ASSET MANAGEMENT INC.**
Michel Jalbert, Vice-president, Head of Institutional Business Development & Marketing; 1000 de la Gauchetiere W., Ste. 3200, Montreal, QC H3B 4W5
PH: 514-876-6907 Fax: 514-875-9364 eMail: michel.jalbert@cibc.ca Web: www.cibcam.com
**Managed Since:** 1986
**Clients:** 10
**Philosophy/Style:** Seeks companies whose shares are...
mispriced relative to their long-term outlook offer opportunities to add value; Style: Core with Value Tilt - searches for firms that rank highly in addressing social, ethical, and environmental concerns and with corporate practices (using Michael Lantzi Research Associates Inc.); eliminates socially unacceptable stocks based on client specific constraints and ethical requirements

CORDIANT CAPITAL INC. David G. Creighton, President & CEO; Ste. 2400 - 1010 Sherbrooke St. W., Montreal, QC H3A 2R7 PH: 514-286-1142 Fax: 514-286-4203 eMail: info@cordiantcap.com Web: www.cordiantcap.com Managed Since: 1996


2000 Clients: 6

ONT M5V 3L3
eMail: christophe.vandeweile@dexia.com Web: www.dexia-am.com Managed Since: 1996

Style: Long-term investment strategy that systematically takes environmental, social, and governance (ESG) criteria into consideration when making investment decisions to generate a competitive performance and to advocate responsible behaviour towards sustainable development.

F&C MANAGEMENT John Farley, Director, North America; 265 Franklin St., 16th Floor, Boston, MA 02110 PH: 617-426-9050 Fax: 617-426-3433 eMail: johnfarley@fandc.com Web: www.fandc.com Managed Since: 1998

Philosophy/Style: Governance and Sustainable Investment (GSI) team provides global coverage on a host of sustainable investment issues.

FIERA CAPITAL INC. Sam Reda, Vice-chairman; 1501 McGill College Ave., Ste. 800, Montreal, QC H3A 3M8 PH: 514-954-3300 Fax: 514-954-3235 eMail: sreda@fieracapital.com Web: www.fieracapital.com Managed Since: 2004

Clients: 2

Philosophy/Style: Active Fixed Income Universe - Fundamental internal research, independent of sell-side analysis and credit rating agencies, used for multi-strategy approach; Canadian equity anchored on precepts that dividend paying stocks outperform over time and that price paid matters, quality companies selected on a risk-adjusted basis; U.S. equity - research-focused approach identifies best of breed companies with a sustainable competitive advantage and growth potential, trading at attractive valuations; strategies are very similar to the traditional active fixed income, Canadian equity value, and U.S. equity strategies, but are subject to certain socially responsible constraints.

GENUS CAPITAL MANAGEMENT Christy McLeod, Portfolio Manager; 6th Floor - 900 West Hastings St., Vancouver, BC V6C 1E5 PH: 604-683-4554 Fax: 604-683-7294 eMail: cmcleod@genuscap.com Web: www.genuscap.com Managed Since: 2000

Philosophy/Style: Screened portfolios use the same investment approach as traditional mandates, but also integrate environmental, social, and governance factors to screen out companies that do not meet social and environmental criteria. Portfolios are diversified across sectors and industries.

HSBC GLOBAL ASSET MANAGEMENT (CANADA) LIMITED Francis Chartier, Head of Institutional Investments; Ste. 300 - 2001 McGill College, Montreal, QC H3A 1G1 PH: 514-286-4559 eMail: francis_chartier@hsbc.ca Web: www.leggmasoncan.com Managed Since: 1999

Philosophy/Style: Long-term investment strategy that systematically takes environmental, social, and governance (ESG) criteria into consideration when making investment decisions to generate a competitive performance and to advocate responsible behaviour towards sustainable development.

LEGAL MASON CANADA INC. David Greigore, Managing Director; Head of Distribution; 220 Bay St., 4th Floor, Toronto, ON M5J 2W4 PH: 416-594-2979 eMail: dgregaire@leggmasoncan.com Web: www.leggmasoncanada.com Managed For: More than 10 years

Philosophy/Style: Through affiliates, firm offers a range of strategies with the focus on socially aware investors. The portfolios cover multiple styles and market capitalizations in international equity, global equity, and U.S. equity.
investment expertise. SRI portfolios screen for alcohol, tobacco, gaming, armaments, pornography, and adherence to local employment standards. Screening is based on both internal and external research.

**NATCAN INVESTMENT MANAGEMENT**  Grace Di Meo, Vice-president, Distribution; 1100 University St., 4th Floor, Montreal, QC H3B 2G7 Ph: 514-871-7102 Fax: 514-871-7476 eMail: gdimeo@natcan.com Web: www.natcan.com Managed Since: 2004 - The firm created the Social Value Canadian Equity Fund in 2004; it has offered Responsible Investment services on a segregated basis since 1993. Clients: 68 Philosophy/Style: Buys out-of-favour stocks with attractive profit-enhancing catalysts to generate value added while limiting downside risk. Objective is to exceed the S&P/TSX Index in both financial and ESG performance practices while avoiding companies involved in controversial business activities.

**NORTHWEST & ETHICAL INVESTMENTS L.P.**  Robert Walker, Vice-president, Sustainability; 500-1111 West Georgia, Vancouver, BC V6E 4T6 Ph: 604-742-8320 Fax: 604-683-5190 eMail: bwalker@northwestethical.com Web: www.ethicalfunds.com or www.northwestfunds.com Managed Since: 1992 Philosophy/Style: Incorporates the thesis that companies integrating best environmental, social, and governance (ESG) practices into strategy, operations, and board oversight will provide higher risk-adjusted returns to shareholders and contribute to the creation of long-term sustainable value.

**PICTET ASSET MANAGEMENT LTD.**  John Maratta, Senior Vice-president; 1000 de la Gauchetiere W., Ste. 3100, Montreal, QC H3B 4W5 Ph: 514-288-0253 Fax: 514-288-5473 eMail: mtl-inst@pictet.com Web: www.pictet.com Managed Since: 1998 Philosophy/Style: Believes in building portfolios for investors that satisfy their environmental and social objectives for sustainable investment without sacrificing performance relative to a conventional active portfolio.

**SARONA ASSET MANAGEMENT INC.**  Gerhard Pries, President; 110-1B Frobisher Dr., Waterloo, ON N2G 2G7 Ph: 519-883-7557 Fax: 519-883-7557 eMail: gpries@saronafund.com or ddean@saronafund.com Web: www.saronafund.com Managed Since: 1953 Philosophy/Style: Market rate returns on private investments in emerging/developing country markets with social/environmental impact focus.

**SCEPTRE INVESTMENT COUNSEL LIMITED**  David Pennycook, President; 26 Wellington St. E., 12th Floor, Toronto, ON M5E 1W4 Ph: 416-866-2479 Fax: 416-367-8716 eMail: dpennycook@sceptre.ca Web: www.sceptre.ca Managed Since: 1993 Philosophy/Style: Market rate returns on private investments in emerging/developing country markets with social/environmental impact focus.

**PHILLIPS, HAGER & NORTH INVESTMENT MANAGEMENT LTD.**  Jason Milne, Manager, ESG Policy & Research; 20th Floor, 200 Burrard St., Vancouver, BC V6C 3N5 Ph: 604-408-6000 Fax: 604-685-5712 eMail: jmline@phn.com Web: www.phn.com Managed Since: Early 1990s; Pooled Community Values Investment Funds were launched in 2002. Clients: 1, plus a number of other non-pension SRI clients Philosophy/Style: Funds are modeled after ‘core’ funds and managed according to the Community Values Investment Principles, which are applied to a company’s environmental, social, and governance record. Investments are not made in companies that score poorly against the criteria in the investment principles.

**PHILLIPS, HAGER & NORTH INVESTMENT MANAGEMENT LTD.**  Jason Milne, Manager, ESG Policy & Research; 20th Floor, 200 Burrard St., Vancouver, BC V6C 3N5 Ph: 604-408-6000 Fax: 604-685-5712 eMail: jmline@phn.com Web: www.phn.com Managed Since: Early 1990s; Pooled Community Values Investment Funds were launched in 2002. Clients: 1, plus a number of other non-pension SRI clients Philosophy/Style: Funds are modeled after ‘core’ funds and managed according to the Community Values Investment Principles, which are applied to a company’s environmental, social, and governance record. Investments are not made in companies that score poorly against the criteria in the investment principles.

**PHILLIPS, HAGER & NORTH INVESTMENT MANAGEMENT LTD.**  Jason Milne, Manager, ESG Policy & Research; 20th Floor, 200 Burrard St., Vancouver, BC V6C 3N5 Ph: 604-408-6000 Fax: 604-685-5712 eMail: jmline@phn.com Web: www.phn.com Managed Since: Early 1990s; Pooled Community Values Investment Funds were launched in 2002. Clients: 1, plus a number of other non-pension SRI clients Philosophy/Style: Funds are modeled after ‘core’ funds and managed according to the Community Values Investment Principles, which are applied to a company’s environmental, social, and governance record. Investments are not made in companies that score poorly against the criteria in the investment principles.
**SEAMARK ASSET MANAGEMENT LTD.** Darren Kosack, Senior Vice-president, Client Relations & Marketing; 1801 Hollis St., Ste. 310, Halifax, NS B3J 3N4 PH: 888-303-5055 Fax: 902-423-1518 eMail: dkosack@seamark.ca Web: www.seamark.ca Managed Since: 1982 Clients: 1 Philosophy/Style: Integrates environmental, social, and governance issues into core investment approach; works with individual clients to ensure that the portfolio reflects the values of the organization.

**STANDARD LIFE INVESTMENTS INC.** Jay Waters, Vice-president, Central Canada; 121 King St. W., Ste. 810, Toronto, ON M5H 3T9 PH: 416-367-2049 Fax: 416-367-1329 eMail: jay.waters@standardlife.ca Web: www.sli.ca Managed Since: 1999 (globally) Philosophy/Style: Offers separate accounts according to the screening criteria specified by the client.

**TD ASSET MANAGEMENT INC.* Robin Lacey, Head of Relationship Management; 161 Bay St., 34th Floor, Toronto, ON M5J 2T2 PH: 416-982-6585 Fax: 416-944-6158 eMail: robin.lacey@tdam.com Web: www.tdaminstitutional.com Managed Since: 2007 Philosophy/Style: In a combination of companies from around the world viewed as (i) best-in-class with respect to environmental stewardship, stakeholder management, and/or corporate governance and/or (ii) emerging specialists in clean energy technology and resource efficiency. * A wholly-owned subsidiary of the Toronto Dominion Bank

**VANCITY INVESTMENT MANAGEMENT LTD.** Stephen MacInnes, Director, Mutual Fund Sub-advisory; 300-900 West Hastings St., Vancouver, BC V6C 1E5 PH: 604-871-5355 Fax: 604-877-4963 eMail: vcim@vancity.com Web: www.vcim.ca Managed Since: 2001 Canadian Clients: 2 Philosophy/Style: Integrated in-house investment team seeks companies that are leaders in progressive practices. The investment process incorporates environmental, social, and governance analysis with traditional financial analysis and portfolio construction to enhance returns through extra risk mitigation and added alpha.

**VONTOBEL ASSET MANAGEMENT, INC.** Jeffrey Kutler, Director, Institutional Clients, North America; 1540 Broadway, 38th Floor, New York, NY 10036 PH: 212-415-7058 Fax: 646-792-4356 eMail: jeffrey.kutler@vusa.com Web: www.vusa.com; SRI funds can be found on www.vontobel.com Managed Since: 2008 Philosophy/Style: Believes fundamental company analysis produces superior equity returns. Undervalued companies are identified by analyzing long-term cash flow expectations and assessing performance expectations embedded in the market price. Assessing global sustainability trends is integral to the cash flow analysis.

**WELLINGTON MANAGEMENT COMPANY, LLP** Susan M. Pozer, Vice-president & Director, Canada, Global Relationship Group; 75 State St., Boston, MA 02109 PH: 617-790-7441 Fax: 617-263-4100 eMail: smpozer@wellington.com or mig@wellington.com Web: www.wellington.com Managed Since: 1994 Philosophy/Style: Assists clients in the development of investment ‘screens’ or complete investment styles that seek to achieve specified investment goals while complying with restrictions.
INVESTING FOR THE SOUL Ron Robins, Founder & Analyst; 7625 Ronnie Cres., Niagara Falls, ON L2G 7M1
PH: 289-271-9873 eMail: ronr@investingforthesoul.com Web: http://investingforthesoul.com
Philosophy/Style: Company research and portfolio audits provided on the basis of environmental, social, governance, and ethical values selected by the client. The firm does not offer opinions based on financial analysis.

JANTZI-SUSTAINALYTICS Sarah Smith, Business Development; 215 Spadina Ave., Ste.300, Toronto, ON M5T 2C7
PH: 416-861-0403 Fax: 416-861-0183 eMail: contact@jantzisustainalytics.com Web: www.sustainalytics.com
Offered Since: 1992 Philosophy/Style: Independent environmental, social, and governance (ESG) research and analysis firm. Using Best-of-Sector approach, it provides research and analysis to clients.

MERCER RESPONSIBLE INVESTMENT Elisabeth Bourqui, Principal, Canadian Head of Responsible Investment; 1981 McGill College Avenue, Bureau 800, Montreal, QC H3A 3T5
PH: 514-841-2987 Fax: 514-285-8831 eMail: elisabeth.bourqui@mercer.com or responsible.investment@mercer.com Web: www.mercer.com
Offered Since: 2004
Clients: 5-10 at any time (project & retainer)
Philosophy/Style: Provides consulting services to clients who wish to consider environmental, social, and corporate governance (ESG) factors within investment decision-making and to clients seeking to incorporate ethical considerations or achieve social and environmental objectives alongside financial objectives.

RESPONSIBLE INVESTMENT GROUP INC.* Julie Payette, General Coordinator; 255 St. Jacques St., 3rd Floor, Montreal, QC H2Y 1M6
PH: 514-448-5558 Fax: 514-448-5558 eMail: jpayette@gir-canada.com Web: www.gir-canada.com
Offered Since: 2000
Clients: 14
Philosophy/Style: As a strategic advisor, firm is duty-bound to act in the best long-term interest of clients. The firm considers that fiduciary role requires it to take into account environmental, social, and corporate governance (ESG) issues that can have an impact on how investment portfolios perform.

* Proteus Performance Management Inc.

SOCIAL INVESTMENT ORGANIZATION Eugene Ellmen, Executive Director; 184 Pearl St., 2nd Floor, Toronto, ON M5H 1L5
PH: 416-461-6042 x111 Fax: 416-461-2481 eMail: ellmen@socialinvestment.ca Web: www.socialinvestment.ca
Offered Since: 1989
Philosophy/Style: Mandate is to advance the concept and practice of socially responsible investment in Canada

COMING IN OCTOBER
2010 REPORT & DIRECTORY OF MONEY MANAGERS
Closing date: September 27, 2010
In today’s investment environment, historic rules of thumb are being questioned. Appropriate investment strategies now must include determining fiduciary responsibilities and having a clear understanding of the drivers of risk and return. This means more focus is being placed on sustainable investing.

To look into the state of sustainable investing today, TD Asset Management and Benefits and Pensions Monitor brought together James Gifford – executive director for the UN Principles for Responsible Investment Initiative (UNPRI); Susan Enefer – manager of shareholder engagement as a member of the equity investment department for BC Investment Management Corporation (bcIMC); Kelly Gauthier – a member of Mercer’s responsible investment team; Thomas George – co-manager of TD Asset Management’s Global Sustainability Fund; and Maxime Zehrt – sustainability analyst at TD Asset Management.

Joe Hornyak, executive editor for Benefits and Pensions Monitor, is the moderator.
Sustainable Investing
a roundtable discussion

Moderator: What is environmental social governance (ESG) investing and how is it different from SRI and the ethical investing that preceded it?

Maxime Zehrt: The first generation of responsible investing was geared towards more ethical-type values. It is still ongoing and will continue to be in demand by those looking to invest with a principle-based approach. Traditionally, it was seen as the only way to invest responsibly. This type of investing was achieved by removing certain sectors or companies altogether, particularly the sin stocks – alcohol and tobacco for example.

This evolved into socially responsible investing where investors began integrating ESG factors more formally. It still involved some type of exclusionary screens by removing certain sectors, such as those deemed damaging to the environment or where there were concerns about social issues.

This, the third generation, is where we are currently seeing a lot of traction in the mainstreaming of responsible investing. Rather than looking at ESG in isolation and using negative screens, we are working towards integrating it in our investment process. Ultimately, we are interested in those ESG factors that assist us in identifying and quantifying new risks and opportunities that financial indicators alone are not able to capture.

Susan Enefer: At BC Investment Management Corporation, the evolution of responsible investing is apparent in the fact that we, as a mainstream investor, until a few years ago only understood SRI investing to mean exclusion.

Over the last five years, we have done further research and re-examination of that. We understand that an SRI strategy does not have to deal with exclusions. It can actually be more inclusive. That has been a very significant shift in the thinking that we have undertaken. It is from exclusion to the understanding that you can be an SRI or ESG practitioner with an inclusive policy.

James Gifford: The active ownership side is also a really important development.

Twenty years ago, active ownership was seen as an activist model or a very traditional ownership governance model. This, in some ways, has matured and now we are seeing shareholder engagement.

The role of responsible investors is encouraging companies to aspire to be world-class companies. This is an important part of this whole space, yet people tend to focus on the investment side. Just as important is the ownership side and what they do with the investment once they own it.

Thomas George: That evolution beyond exclusionary screens has been the key differentiator between traditional SRI and sustainable investing, allowing strategies to move from a niche to mainstream. By including all sectors we can truly seek best-in-class companies and it enables benchmarking within each industry group. Further to James’ point about active ownership and engagement, benchmarking helps establish best practices for companies that aspire to be world class.

Moderator: What are some of the other factors that have helped us move from ethical screens to ESG and sustainable investing?

Kelly Gauthier: More recently, there has been a lot of resistance to screening. Many of the mainstream players are fundamentally opposed to a constrained universe.

Once the methodologies evolved to best-in-class, to ESG integration as a whole, to being able to recognize that these extra financial criteria were not so much extra financial, but additional risk factors, then it was able to become much more of a mainstream play.

When you layer on top of that the active ownership side and pair it with everyday societal trends, ESG became more mainstream, less activist. It was what is in the newspaper everyday, what people are doing in their homes, in their lives. Those two pieces together provided momentum for this movement, bringing it on to a mainstream platform as opposed to a specialist platform.

Zehrt: A factor on the environmental side that has garnered the attention of both mainstream and SRI analysts was the introduction of a cap-and-trade in Europe along with a price on carbon. It’s a great example of an environmental factor that has really pushed internalizing a historical external cost for companies. This has led companies to think more deeply about efficiency and how environmental costs can flow through to the bottom line, either positively or negatively.

Gifford: The financial crisis actually raised awareness of the broader responsible investment movement as well. It has shaken the faith in the so-called ‘geniuses’ of Wall Street who have been telling us for decades that they
Sustainable Investing
a roundtable discussion

are all about maximization of profit – they are good fiduciaries and they are looking after your money.
What was demonstrated is just what a facade a lot of the practices that were being undertaken were in terms of protecting the long-term interest and financial security of beneficiaries.
It goes beyond carbon, it includes corporate governance and monitoring and reporting of all of your impacts. That is the type of company and the type of behaviour that will deliver long-term, stable, secure returns for beneficiaries rather than the behaviours that led to the crisis a couple of years ago.

George: That's exactly it. It's about rewarding companies that are taking the long view and exposing the facades that lead to crises, be they financial or even environmental such as the Gulf of Mexico oil spill. ESG analysis presents a framework to address risk factors that are outside the scope of financial statements today.

Enefer: It is somewhat disheartening from the investor point of view that we continue to lose economic value from poor ESG performance and ethical lapses. Why don't companies see benefits rather than burdens here? I wish I could point to more success stories and examples where we see alpha being added by forward-looking companies with good ESG practices. Instead, the responses to value-eroding issues like weak shareholder rights, poor labour practices, or climate change are usually developed from a crisis or from regulation that makes ESG performance a compliance exercise.

For right now, we are considering ESG in terms of the risk management element and how we assess management quality and the ethics and integrity with which they conduct their business.

George: Risk management is definitely one of the clearest applications of ESG analysis. With respect to alpha generation, a clean technology strategy is one way to potentially capture ESG alpha. It provides direct exposure to the enablers of the long-term environmental sustainability – clean water, efficiency, and alternative energy.

Gauthier: Mercer has produced two reports looking at the actual financial impact of investing in ESG. There were 36 studies included and only three of them found negative correlations to RI or ESG investing. Twenty were positive and the remaining were neutral. The evidence is there. It is just taking time to make its way to the fore.

Zehrt: Like other investment strategies, there is a range of responsible investment products to choose from. Sustainable investing is, however, not a magic bullet. ESG, in isolation, may not lead to outperformance. However, in combination with good industry characteristics and strong fundamentals, those companies which focus on the sustainability of their firm will likely be in a better position to uncover new trends and be able to manage risks more effectively given their broader view of their company.

Gifford: It is also important from the systemic side. Now, that might not be that relevant for an active manager with 50 stocks. But, if you have hundreds of thousands of stocks, then you are highly diversified and externality is being generated by one company and imposed on a catchment or an ecosystem or an atmosphere that is actually causing damage to thousands of other companies, leading to sub-optimal economic outcomes.

This is a really important issue for larger diversified investors and many of the clients of even smaller active fund managers. Environmental externalities lead to sub-optimal economic outcomes overall. These investors have, in effect, a slice of the global productive capital of the economy and they are being damaged by the results of these externalities. That is what they call the universal owner hypothesis.

Moderator: So how do you go about incorporating ESG practices and how do they add value?

Gauthier: We work with clients that are working on integrating ESG and taking their first steps which might, at the board level, mean dealing with policies and starting to wrap their heads around all this terminology.

Then, usually with our clients, the next step is something like getting involved with the UNPRI, looking at collaborations where they can start to learn about the space and where they can find other investors that have similar values that are trying to achieve similar goals.
Then, they are going to look at how they actually integrate ESG into their portfolios and what does that entail because that is a much larger undertaking, both philosophically and from a resource standpoint, for most asset owners.

Zehrt: One of the ways we look to incorporate ESG is through an internally-developed sustainability matrix, which uses a combination of factors across all ESG pillars. Together, these form the basis on how we assess a company’s management of its ESG capital. We provide these scores internally as an additional factor to consider and a way to stimulate conversation surrounding the company’s quality of management.

Through this analysis, we seek to uncover trends in the data, enabling us to better understand the additional risks companies may be exposed to. Opportunities may also come to the surface with the increasing understanding of longer-term structural ESG trends.

Moderator: Are metrics enough to determine a company’s sustainability?

George: The BP disaster fits very well here. The company was ranked best-in-class by many socially responsible funds and indices such as FTSE4Good and the Dow Jones Sustainability Index. The disaster really highlights some aspects of what the ESG industry is actually rewarding right now, which is the transparency and data found in glossy reports.

Currently, it is difficult to compare BP versus peers on a like-for-like operational basis, but we know BP reported a lot more data, so they got a few more points.

To me, there are a lot of lessons learned, positive and negative, but it is a controversy that could bring our industry forward. This is where ESG analysis can add real value.

Gauthier: One of the things that rang home to us about BP was that it reinforces the fact that best-in-class is one approach, but there are still some fundamental sector qualities that are not to be overlooked. Most of its reporting has been favourable, sector comparable, but in some areas we need to remember that it is still a massive oil producer and there is an inherent environmental risk there, as well as safety and community issues. This situation has brought that home, that we still need to consider what sectors we are investing in – and to what degree – and what risks that represents to your portfolio.

Gifford: Another key point with the BP disaster is a lot of the safety issues were a result of regulatory failure. Whether it be political donations or giving the executives of the regulator free holidays in Aspen, these are exactly the types of things that responsible investors would be horrified about had they delved deeply into it. Part of it is really getting to the bottom of what is poor corporate conduct that leads to the cutting of corners and short-term-ism. That is exactly what happened with BP.

Moderator: So are responsible investors considering if where they are investing their money is properly regulated?

Gifford: There are a whole lot of dimensions. One of them is obviously the basic due diligence in terms of ensuring you have considered the full gamut of risks. Another is active ownership, ensuring that management acts in the best interest of shareholders over the long term.

Then, there is the systemic side. Investors have a responsibility, just as all active in society do, to ensure that the system actually functions. What we saw in the regulation around oil drilling and in the regulation around financial markets was a failure of regulation leading to serious losses and financial damage.

Investors have a collective responsibility to at least play some part through industry associations or through the UNPRI and other global initiatives to really try to push good practice in these areas.

Enfeer: I am going to play devil’s advocate here and give you an illustration of where bcIMC tried for a decade, if not more, to make change at a macro level. We recently reduced our investment exposure to the Japanese market because we found there just did not seem to be an appetite or a willingness to bring fair and reasonable governance practices into its public equity market.

We have choices in where we place our capital and our capital will be placed in markets that welcome it and that value it. That decision about Japan was very much a difficult one to make, but it was largely based on governance concerns. We try very hard to make change, but there has to be a point where we say we are going to move on.

Moderator: Where is Canada in terms of ESG and sustainable investing?
**Gauthier:** Canada itself is dominated by a lot of bigger funds and then there is a smaller base of foundation and endowment funds so the market is a little fractured.

With respect to globally comparing Canada, we have seen that Canada has been moving at a nice, slow, steady pace. We would say that the Canadian market is probably on par with the U.S. market today in terms of integrating these concepts, across a majority of the largest public funds. However, we are not quite where Australia and the UK are, although we have been making good progress.

From what we know of the funds in Canada, most of the big funds in Canada are tackling this in one way or another. Everybody is aware of it. Everybody is trying to figure out their own solution to it, but everybody is more or less on board, which is what we want to see in terms of the development of the market as a whole.

**Moderator: What about the uptake globally?**

**Gifford:** We are just analyzing this year’s UNPRI survey and the increase in momentum is really unmistakable. There is just no doubt that this movement is going really strongly and just the self-reporting of our signatories of what they are doing from year to year is consistently increasing.

Just to give you an example of the number of signatories that are reporting now, we have almost double the number from last year and more than 400 of our signatories participated in the survey. Around 200 of them are publishing their results, also their responses, online, which is probably one of the biggest increases in investor transparency we have ever seen. Across the board, it is really fair to be quite bullish and optimistic about the momentum of this space.

**Moderator: What sort of strategies are asset managers using in terms of implementing ESG?**

**Enefer:** bcIMC is trying everything. We have a U.S. equity portfolio which applies negative and positive ESG screens in its company selection process. We have an engagement strategy for our overall global public equity portfolio. We have an environmental risk management strategy that applies to our real estate holdings. We plug into coalitions that consist of investors from around the world and we combine forces to make change in the market, in the companies, and even in the instruments in which we invest.

Responsible investment is a key component of our mission statement and our board-approved strategic plan, specific activities are mapped out annually in our operational plans on a per-department basis and they are acknowledged in our employee compensation program. People are being rewarded for the work that they do here on ESG which breathes a lot of life into our overall integration.

**Gauthier:** With the breadth of this subject area, a lot of asset owners and managers find themselves a little overwhelmed by what to focus on, they cannot wrap their head around everything and engage on everything. One of the approaches that seems to be taking shape a lot more is issue-specific – picking two or three issues that really align with the organization’s mission or goals and focusing on those. That gives them, once they have disclosed that, an excellent position to be able to defend themselves by saying ‘we are focusing on these issues, this is what we are going to surround ourselves with and we are really going to dive deep on these issues and, for now, we are going to leave everything else out of scope.’

**Moderator: What sort of strategies are we seeing investment managers bringing to the table?**

**George:** In terms of dedicated offerings, we have seen many sustainability and socially responsible focused funds launched at the retail level over the last several years. Dedicated clean technology funds have also been an area of strong growth over the last decade. Overall, the growth of these varying strategies has been driven by the underlying demand of investors.

With respect to integrating ESG analysis into traditional investment mandates, we’re at the point right now where education is paramount. We’re trying to help portfolio managers understand the ESG outliers – who those leaders and laggards are across each pillar – it helps start the dialogue, and ultimately isolating those outliers should provide better risk-adjusted returns.
Sustainable Investing
a roundtable discussion

Moderator: What will sustainable investing look like in the future?

Gauthier: Our goal is that we are working ourselves out of a job – that ESG becomes a well-integrated concept, it becomes another risk factor that managers and companies are looking at on the list of every other risk factor that they currently consider.

We hope it becomes less of an externality, less of a specialty subject area, and that it is just a part of everyday business.

George: Hopefully, when we look to the future, sustainability will be a fundamental part of the way the market values a company, enabled by the availability and standardization of ESG data. Management teams will be rewarded for both financial and sustainability achievements based on standardized metrics.

Moderator: So what is keeping us back from being there or getting there faster?

Gauthier: I would say a few things.

One is information – the availability of data and the consistency of information. Secondly is mindset, as there are still questions around fiduciary duty, which, from our perspective, have been dealt with, but lots of boards do not feel that way.

To a certain degree, we see some of those obstacles as being generational. Attitudes are changing slowly over time as they do with everything else.

Zehrt: We owe a lot of credit to the UNPRI for getting the message across and their success is evident with the ever-increasing membership.

My long-term view is that being a differentiator in ESG analysis will be key. All investors will be looking at it but, ultimately, the question will be who is doing it most effectively. Those firms taking an active approach now will likely benefit over time.

In the interim, there is eventually going to be a tipping point, with more investors analyzing it than less. This may be a few years away; however, it should at least be on investors’ radars.

Zehrt: Beyond our ESG matrix, which helps identify those outliers Thomas mentioned, we are also cognizant that being a responsible investor demands active ownership. Building upon our history of promoting good governance and actively voting our proxies, we have set up formal committees to tackle engagement issues.

We also feel our chances for success are higher when we partner with other institutional investors. As an example, the Carbon Disclosure Project we take part in allows us to seek pertinent information from companies with the collaboration of other investors. In order to truly push the dial forward on sustainability within the industry, so-called collaborative competition needs to occur.

Moderator: Are there examples where using ESG principles have steered investors away from an investment?

George: In a global context, regulatory risk is a key area where ESG principles help steer investors away from higher risk investments. The most concrete examples are found in the resource intensive sectors, with risk factors such as carbon or water management. The most efficient and innovative companies tend to be setting the regulatory agenda, anticipating rather than reacting.

Zehrt: Similar to fundamental analysis, which doesn’t depend strictly on financial ratios to drive a decision, we do not view ESG in isolation rather as an additional factor to consider in the investment process. All other characteristics that a prudent manager reviews need to be in place in order to drive a buy or sell decision. That said, all else being equal, ESG factors are increasingly becoming more important for those companies that are leaders amongst their peers and these companies will need to manage their ESG capital effectively in order to maintain leadership.

Gifford: We are not quite at a tipping point as the real tipping point is when quite a few large asset owners put this into their RFPs and very strongly discriminate in favour of funds and investment managers that have this capability and do it well.

It is starting to happen. The French Fonds de Reserve incorporates responsible investment capability into its RFP process and it is unlikely that you would get a mainstream mandate from the FFR unless you have this going along nicely.

Once we get to the point where that is really the way things are, then we really have fully embedded it in the market.
Enefer: On the smaller investor side, an issue of some concern is the notion that this is going to take a lot of resources. Yet, responsible investing is as simple as taking an active role in voting your shares. It is as simple as adopting a policy across your organization or across your fund and then asking for accountability towards it.

Gauthier: Increasingly, from our view, ESG is on the table and it is coming from two perspectives.

One is there has been some organic growth in the industry. We are rating ESG products across the market. Even on searches where ESG has not come up in the conversation with a client, that information is being put in front of the client. So they start to see it from the back door and say ‘oh, the ESG information is here, what does this mean and how do we use this.’

The other thing for small funds is collaboration. ESG organizations, for the most part, are so easy to join. They are easy to participate in. They do not take a lot of resources and it gives you such incredible leverage to be able to access and understand what is going on out there and get involved without a lot of resources. Until you get involved in it, you have no idea the power of what is available to you.

Moderator: With all the attention on China’s environmental record, how does an under-funded pension plan rationalize ESG principles with the potential returns from investing there?

Zehrt: Personally, I do not think they are mutually exclusive. Many large multi-national companies domiciled in developed countries see their growth coming from these emerging economies. Given their brands, they understand that managing ESG risks is paramount to protecting their reputation and demonstrate so by being leaders in sustainability reporting. Having these companies set the benchmark will no doubt increase the willingness of domestic companies to improve upon their own ESG practices.

There are also many companies in emerging markets that have already taken an active approach to sustainability. China Mobile, for example, is the largest mobile telecommunications group in the world and it leads on sustainability among emerging market companies.

George: Further to that point, the long-term development goals of China should strategically align with environmental sustainability. They are net importers of natural resources so efficiency should be paramount, making the principles of sustainability a natural fit in emerging markets.

The governance and social aspects of sustainability are the clear areas which can be developed further. With multi-national companies, we can push for greater transparency and accountability in these regions.

Gifford: Just in terms of the broader Chinese context in responsible investment, it is just a completely different environment from other places where funds tend to have more autonomy.

There are huge opportunities in these markets and whether a pension fund is underfunded or not, they will be looking for good returns.

But, the ESG risks are also probably the most material that you could come across. When you have a pollution event in China, it is a big deal and the impact on companies is huge. If you have a governance problem with corruption or whatever it might be, these are really big material issues.

A lot of the risk in investing in companies in emerging markets is very much around environmental, social, and corporate governance risks so these factors are even more important.

George: That is completely right, especially in emerging markets where governance risk is critical.

When we are looking at investments in those regions, if there is even the slightest governance folly, it is just a no-go. Ultimately, for those companies that have had issues related to corruption or fraud, the market tends to severely punish any mistakes.

I would say the market impact, related to corporate governance issues in emerging market companies, is much greater in terms of magnitude and volatility compared to their developed market peers. In the absence of a mature regulatory environment, transparency and trust are paramount.

Moderator: Are people still going to stick to their principles or are they going to get caught up in the exuberance of returns if we see a sustained market rally?
George: If we ever do go back to anything resembling the roaring ’90s, issues related to rapid urbanization and increased natural resource consumption will be critical. In an economic environment where oil and base metal prices are significantly higher than they are today, there will be real and tangible financial benefits of being more efficient. Ultimately, that will be a great driver of ESG.

Additionally, clean technology becomes that much more important in a world with tight natural resource supplies. The fundamental principles of sustainability are very aligned with a growing global economy.

Gauthier: I would like to think that the price of carbon and the carbon market is becoming mature enough that it is not going to disappear. Despite an economic recovery or even a boom, the carbon market is still there and there are opportunities in the carbon market. There are opportunities for companies to gain efficiency and there are opportunities for financial markets to make money on the carbon markets. Those opportunities are well enough in place. They are not just going to vanish.

Enefor: I cannot speak for the industry, but I know at this point in bclMC’s evolution, we certainly would never go to a profit-at-any-cost mentality. The ideas of prosperity and equity and considering as many risks as possible, financial and extra-financial, meets our mandate to deploy all reasonable means to keep our clients’ capital protected and their interests served. I believe that encouraging good ESG performance in the companies and markets in which we invest will always be a reason and reasonable strategy for bclMC.

Gifford: I cannot see this slowing down at all as there will always be cycles. Really the question – from each cycle, from each boom and bust, to the next one – is do we learn something. If this keeps going at the pace it is going, and we have to be realistic, we still have a long way to go, if we do have this type of activity really become mainstream, the next boom will be slightly less severe perhaps or certainly the companies will be watched much more carefully than perhaps in previous times.

Moderator: What are the key takeaways from today’s discussion?

George: On a positive note, it is great to hear that there are so many sponsors moving in the right direction and, ultimately, it is the weight of all of us moving together that gets us to that tipping point that Maxime was referring to. It really is just having everything on the radar. That is what gives me a lot of comfort, we’re moving in a direction that will enable greater transparency.

Gifford: We have to recognize how far there is still to go. When we do talk to people, whether it is funds in China or even traditional asset managers in the United States, they still have no idea – or have a very sketchy idea – about the conversation that we have just had. They think it is still about ethical screening and you are either a real investor or you are an ethical investor doing it for social or political reasons. This conversation is still very, very new to many mainstream investors.
Ah, the good old days when employee benefits were simple – one plan for all, modest utilization of a limited range of benefit options, and a relatively low payroll cost.

Today the scene is different. Costs continue to rise at a rate well above inflation. As well, employee attitudes have changed and they have a greater awareness of their entitlement. Costs are also increasing as the workforce ages and people live longer and incur a higher incidence of chronic health issues.

Benefit costs are no longer a minor consideration. They now account for eight per cent or more of payroll. Senior management is very aware of this increasing expense and is renewing its focus on cost management. The challenge is to achieve a competitive yet affordable plan.

**Healthcare Cost Trends**

The annual utilization and cost factors for health and dental plans are growing at three to five times the cost of inflation, or eight to 10 per cent. Prescription drugs continue to be the largest single expense in healthcare plans, running at 65 per cent to 75 per cent of total claims costs. Paramedical claims, which accounted for 10 per cent to 12 per cent of claims in the past, are now approaching 20 per cent in some plans. At the same time, disability claims are escalating due to an aging workforce. Steady increases in healthcare are simply not sustainable for many organizations, driving them to find new cost reduction strategies.

Employers are not the only ones struggling with rising costs. The Canadian Institute for Health Information says governments are facing projections that public spending per capita will double in 10 years from $5,500 per person in 2009 to $11,000 per person in 2019. Government downloading of costs to individuals is a growing trend and those who have employer-provided benefit plans look to their employer to pick up the cost.

**What Are Others Doing?**

The ‘2009 Mercer Leading through Unprecedented Times’ survey shows that 72 per cent of employers planned to address the drivers of healthcare cost increases, instead of making plan design changes or reducing plan benefits. Many viewed the current economic conditions as being short term and didn’t want to take action that could impact the attraction and retention of employees. One of the most common cost-cutting trends, considered by 63 per cent of survey respondents, is asking employees to contribute more to the costs of benefits programs.

Perhaps the biggest surprise in the survey is the 69 per cent who said they were likely to invest in wellness programs. There are a number of reasons for this including concern about their employees, hoping wellness initiatives will help reduce claim costs, and sending employees a message that they need to take more responsibility for their own health and for the cost of benefits.

**Active Plan Management**

Costs can be contained through active plan management. This involves understanding what is in the premium, benchmarking your plan, applying a strategic framework for managing costs, and implementing innovative cost containment measures.

The bulk of the premiums paid for group benefits cover the cost of disability, dental, vision, drug, and paramedical claims. Claims costs are a function of the plan design. The coverage offered under the plan and the cost sharing arrangement between employees and employer directly impact the cost of claims. Non-claims costs are the cost of operating the plan and account for 10 to 20 per cent of the total premium.

Benchmarking is crucial to making sound decisions on design, expenditures, and the overall competitiveness of the plan. Data on cost drivers such as drug utilization, EAP usage, and disability statistics needs to be examined to understand what is driving cost increases. Non-claims costs should also be reviewed to ensure the costs paid to insurers are appropriate and competitive. Determine where the plan stands relative to specific segments of the market and adjust it to meet new targets.

**Management Strategies**

A successful plan design reflects your organization’s corporate strategy, culture, and values. It is based on affordability, cost sharing, flexibility for employees, and an understanding that the
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benefits plan is one component of the total rewards package offered by the employer.

Each potential cost management change to the plan needs to be evaluated and weighed based on the effect it will have on costs, the impact it will have on the employees, and the ease of implementing the change. Any change made to the plan will have repercussions, whether the impact is broad-based and felt across the organization, or specific to segments of the employee population. Changes can be perceived as a take-away, or a reduction in the value of the plan, and employee retention must be considered. If the workforce is unionized, any changes can only be negotiated periodically.

Market The Benefit Plan
In some situations, it may be desirable to test the value of switching vendors or improving plan performance guarantees. The insurance marketplace is competitive and it may be possible to find a better arrangement. However, rate shopping alone is not necessarily the only reason to market the plan. If service to employees is unacceptable, or cost savings can be found in the operating costs, or if the plan design you want is not available from your current vendor, then marketing the plan to other vendors should be considered.

Switching vendors affects the entire

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**Consider Cost Sharing**

Cost sharing can be approached by charging higher premium costs to plan participants or by setting contributions to the employee’s earnings level or family status. An alternative method of cost sharing is to introduce co-pays. This engages employees to make conscious choices at the point of delivery of the service. However, all cost sharing strategies have a broad impact across the employee population and bring a high degree of disruption.

Cost savings can be achieved when flexible benefits plans are introduced as they enable employers to cap benefits expenditures. Employers can set the limit of what they can afford and are willing to contribute to the plan. Employees can purchase upgrades through flex credits or a healthcare spending account. Employees are required to contribute to the plan and, in exchange, they can make some of their own coverage choices. Flexible benefit programs can be more difficult to administer and communicate and these additional costs need to be considered in any plan design decision.

Drug plan cost increases can be off-set by introducing dispensing fee caps and deductibles. Drug formularies, or restricted lists of the drugs that are eligible for reimbursement, are also effective cost cutters. The impact on employees of drug plan cost management changes is very broad and brings a high degree of disruption. The cost savings potential is very high.

**Becoming Better Consumers**

Cost sharing strategies are popular methods of helping employees better understand the cost of their healthcare spending choices. It’s not just about cutting costs, it requires giving employees the information and tools to help them understand treatment options and the related price tag. The premise is that when employees pay a portion of the cost of a prescription, for example, and when they have the knowledge to make decisions, their behaviour changes and they become more effective consumers.

Once the cost-saving solutions are evaluated and prioritized, the next step is to communicate and implement the change.

**Communicating Change**

The importance of communicating to employees is often undervalued and overlooked. Employees need to understand the value of their total compensation, including benefits. Consider preparing total compensation statements showing the employees’ base and variable pay, group benefits, optional benefits, retirement benefits, and government sponsored benefits. There is an opportunity to build the employment brand as benefits are a valued element in the total rewards package.

Employers need to let plan participants know that they cannot afford to pay the entire cost of benefits. Many employees do not understand that group plans are not covered by insurance, but rather represent a real cost that must be paid by the employer.

Some things about the future are known. Steady increases in healthcare costs are simply not sustainable. Cost shifting from governments will continue as they are forced to ramp up cost management strategies. Plan cost drivers require analysis to understand the present state and future costs. At the same time, our culture of entitlement makes it difficult for employers to cut back on benefits.

The traditional view of benefits is no longer appropriate. Benefits must be presented to employees within the broader context of total compensation. Ultimately, the ongoing viability of benefits plans will depend upon the active plan management of long-term cost control measures.

Brian Lindenberg is a senior partner with Mercer’s health and benefits business (brian.lindenberg@mercer.com).
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Mitch S. Frazer, a partner at Torys LLP, and William Kyle, senior vice-president, group retirement services, at the Great-West Life Assurance Company, will be among the featured speakers at the ‘29th Annual ISCEBS Employee Benefits Symposium.’ Frazer will present a legislative update, and Kyle will look at the strength of CAPs in Canada’s retirement market. It takes place October 3 to 6 in Charlotte, NC. Visit: www.iscebs.org/symposium

A ‘Canadian Economic Overview’ will be the closing feature presentation at the CPBI 2010 Ontario regional conference. This year’s program will offer workshops in the three disciplines of pensions, benefits, and investments. It takes place October 4 to 6 in Niagara-on-the-Lake, ON. Visit: http://www.cpbi-icra.ca/

The Conference Board of Canada will release three research reports at its ‘Benefits Summit 2010!’ These reports will act as the foundation for the event that promises a comprehensive view of benefits trends and best practices, including how to use wellness programs to reduce costs and attract talent. It takes place October 27 in Toronto, ON. Visit: http://www.conferenceboard.ca/conf/10-0189/default.aspx

‘Benefits Over The Coming Decade’ will be examined at the ‘2010 CPBI Western Regional Conference.’ Dr. Jack Mintz, Palmer chair in public policy at the University of Calgary, will present his views for the development of pensions and benefits over the next decade. It takes place October 27 to 29 in Banff, AB. Theme of the conference is ‘Conquering New Peaks.’ Visit: http://www.cpbi-icra.ca/

David Feather, President and Managing Director of Russell Investments Canada Limited (Russell Canada) is pleased to announce that John Formusa has been appointed Director of Institutional Investment Solutions for Russell Canada.

Mr. Formusa joins Russell with a track record of success in managing institutional investments, investment portfolio construction and management, governance and consulting. He will be responsible for supporting the services offered to Canadian plan sponsors and other institutional investors on an array of investment strategies and solutions.

Russell Investments is a global financial services firm that serves institutional investors, financial professionals and individuals in more than 40 countries. Russell Canada was recently named the #1 fastest growing money manager in Benefit Canada’s 2010 Top 40 Money Managers Report.
The search for people to blame for the creation, and subsequent bursting, of the financial bubble continues. The large price swings in many capital markets, and especially the oil market in the past few years, have come to the attention of market regulators across the globe. Their rhetoric is often focused on punishing speculators or taming unregulated derivatives which must be causing this price volatility and movement of prices away from their natural, or fundamental, level.

The reality, though, is that price volatility is much more complex than many would think and is not easily attributable to villainous speculators, as two new pieces of research show.

The first piece comes from Hilary Till (who was the first to release a study a few years ago on the Amaranth hedge fund blow up, showing the extreme positions taken by the fund). In ‘Has There Been Excessive Speculation in the U.S. Oil Futures Markets?’, from the EDHEC-Risk Institute in France, she uses newly-released, fine-level data from the U.S. Commodity Futures Trading Commission (CFTC) to see whether there is more speculation than is required to meet the needs of commercial hedgers.

A Need For Speculators

Till makes an important point about speculators in financial markets. There is a vital role for speculators in that there might not always be a perfect balance between long and short commercial hedgers in any marketplace. Speculators are needed to bring the balance to the market. Thus, the goal is not one of producing a market of ‘no speculators,’ but finding if the number of speculators relative to hedgers has created an unbalanced market. If there are too many speculators, the result is a market mostly made up of speculators trading with other speculators, leading to increased volatility, and calling into question the legitimate need for futures markets as a place for participants to hedge their risks.

Using the historical agricultural futures market as a guide to the adequacy or over-abundance of speculation, Till found that the oil markets were generally well within this historic benchmark and that there was no evidence of “excessive speculation.” While there were some times (such as the summer of 2007 to 2008) when oil markets were dominated more by speculators (again, relative to hedgers), this was still well within historic ranges.

A broader analysis of 12 markets is found in a just released draft report from the Organization for Economic Co-operation and Development (OECD), titled ‘Speculation and Financial Fund Activity,’ by Scott Irwin and Dwight Sanders. The authors note that capital inflows into long–only commodity index funds from pension plans and endowments seeking non-correlated assets did increase dramatically recently, all at a time of sharply rising and falling commodity prices in world markets. It might seem natural to assume that the size of these speculative funds would overwhelm the true function of supply and demand driven markets that the funds invested in.

However, proving that the actions of these speculators have driven up the prices in the underlying markets has been very difficult. In reviewing the literature, Irwin and Sanders note that the strongest results come from one study which found some relationship between index fund speculators and price movements in only three of seven markets and concluded that the maximum impact of such indexing was a price increase of 15 per cent in the oil market – well under the 100 per cent increase in the price move of oil recorded in that year. Many other studies have found no impact from speculators at all.

Isolated Instances

Using the same dataset as Hill, except across more markets, Irwin and Sanders could not find any convincing relationship between the positions of speculative index traders and market returns. There were some few isolated instances in individual markets for some particular time periods (corn and feeder cattle markets among others), but nothing significant over the entire study period (June 2006 to December 2009).

These studies leave unanswered the key question of what has been the cause behind recent market volatility. We don’t know what has caused rapid price increases, but we do know what didn’t cause this – the action of speculators in the market. In fact, Irwin and Sanders found that increasing long positions of index traders actually lead to lower market volatility in the markets studied.

As Till noted, you need speculators and their activities to have a well functioning market. So if you are looking for villains to blame, you will have to keep looking.

What Causes Market Volatility?

THE BACK PAGE

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