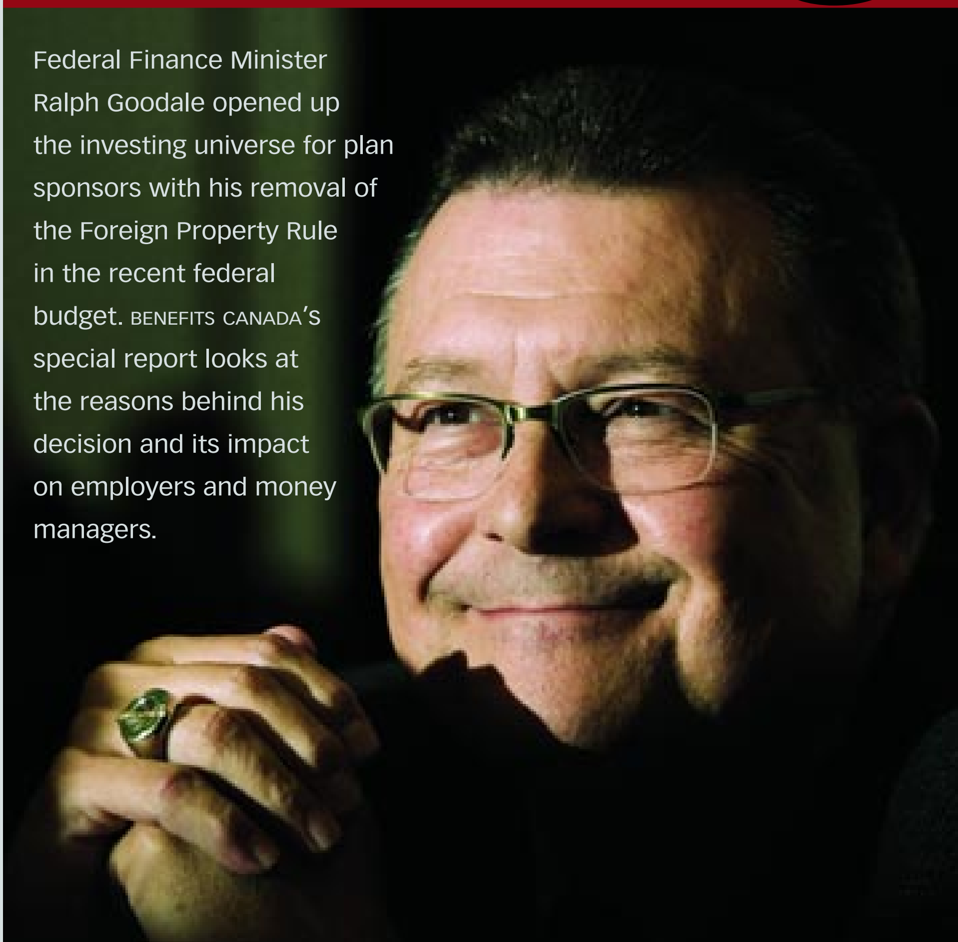
Good NEWS

Federal Finance Minister Ralph Goodale opened up the investing universe for plan sponsors with his removal of the Foreign Property Rule in the recent federal budget. BENEFITS CANADA's special report looks at the reasons behind his decision and its impact on employers and money managers.



Federal Finance Minister Ralph Goodale lived up to his last name on Feb. 23, 2005—the day he released a good news budget, abolishing the Foreign Property Rule (FPR) investment limit for tax-deferred retirement plans. "I do think it was the right thing to do at this time," said Goodale.

Plan sponsors couldn't agree more. They met the news with surprise and enthusiasm; with the removal of the 30% restriction, many will now have greater opportunities to diversify in both traditional and alternative asset classes.

Money managers with global and international products also supported the FPR's demise. With just under 13% of the Top 40's pension assets in non-domestic specialist mandates, the open-door investment policy will likely bring dividends.

But there are also losers. Synthetic investment vehicles, which are no longer needed in an unrestricted investing environment, are on their way out. And money managers that factored them into their sales equation will have to regroup.

BENEFITS CANADA's special report, which this year incorporates the *Top 40 Money Managers* report, examines the FPR's demise and the potential impact on the industry. While a clearer legislative picture will emerge in coming months, industry analysts, sponsors and consultants weigh in on the benefits—and the potential side-effects—of this important announcement.

—Anna Sharratt

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A budget bonanza

Finally, an end to foreign property constraints—but at a time when Canadian equities and fixed income lead the pack. What will the 2004 federal budget mean for BENEFITS CANADA'S

Top 40 money managers?

By James Lewis

The classical Greek thinker Heraclites mused that change is the only constant. Maybe so, but few in Canada's investment community foresaw the change that awaited them on Feb. 23, when federal Minister of Finance Ralph Goodale moved to end restrictions on foreign content in registered retirement plans.

In his budget speech, Goodale announced the Foreign Property Rule (FPR) limiting Canadian retirement funds to no more than 30% foreign holdings would be scrapped immediately. He went on to cite the need to "expand the investing universe for Canadians and offer them the potential to achieve greater diversification and a more secure future" as key considerations driving the move.

Money managers and consultants alike were caught off-guard by the impending demise of the 34-year-old restriction (the change still needs royal assent before it's passed into law). "We view it as a very progressive decision, but it was a complete surprise," says Keith Smith, president of Mississauga, Ont.'s GE Asset Management Canada (36th in the Top 40). "I don't think anybody in the industry expected it to be removed totally," echoes Dave Clapperton, vice-president and actuary at Aon Consulting's retirement practice in Toronto.

Even pension industry groups such as the Association of Canadian Pension Management (ACPM) and the Pension Investment Association of Canada (PIAC)—both of which had been lobbying for the removal of the FPR—were unaware of the government's plans. "We suspected that they would just raise the limit further," says Scott Perkin, ACPM's Toronto-based president. "We were quite pleasantly surprised that they decided to eliminate it altogether." Montreal's Russell Hiscock, chair of PIAC's government relations committee, says his organization "had been working very hard for a long time to achieve a breakthrough, and it happened [in] this budget."

While the FPR news will undoubtedly buoy the fortunes of those managers with strong global or international offerings, many investment managers have found it difficult in the post-tech bubble investment climate: one in eight companies on the 2003 Top 40 list didn't make it to the 2004 edition, for a turnover rate of 12.5%. Overall, the Canadian pension fund assets of the Top 40 money managers grew by 14.7% year-over-year—from $477.4 to $547.8—with the lower limit of this year's list

set at $3.5 billion by 40th-place firm Lincluden Management Ltd.

GE Asset Management was the hardest-hit in this installment of the Top 40, losing nearly 20% of its pension assets under management and sliding seven spots. Big winners included Connor, Clark & Lunn Financial Group and Letko, Brosseau & Associates Inc., each climbing four spots from last year's position.

A total of 36 individual new client acquisitions across multiple product lines helped fuel a staggering 50.8% increase—from $10.2 billion to $15.4 billion—in Connor, Clark & Lunn's Canadian pension assets under management, according to Warren Stoddart, managing partner at the Toronto firm (8th in the Top 40). "I guess what got the most press was the Canada Pension Plan appointment (a $500-million active overlay mandate), but all of our affiliates experienced growth in 2004," he says. That momentum seems to be continuing into 2005: so far this year, the firm has netted nine mandate wins, Stoddart says.

As a whole, BENEFITS CANADA'S Top 40 money managers as of Dec. 31, 2004 reflect the FPR reality: total Canadian pension assets under management at the 40 firms rang in at more than $500 billion, but only $64.5 billion of that—slightly less than 13%—was in non-domestic specialist mandates. Not surprisingly, because of geographic proximity and the relative size of its market, a large portion of that—$21.3 billion, or 33%—was devoted explicitly to U.S. equity mandates. Will our neighbours to the south continue to dominate Canadians' investment horizons? Perhaps not, if recent market performance is any indicator.

PAID IN CANADA

The FPR announcement came at a time when Canadian equity indices were shining relative to their foreign counterparts, particularly in the U.S. The S&P/TSX total return index gained 14.5% in 2004, compared to a gain of 10.9% for the S&P 500 total return index and 20.2% for the MSCI Europe, Australasia and Far East (EAFE) total return index. However, translated into Canadian dollar terms, the numbers are even less impressive: the EAFE index return was cut to 12.4%, while the S&P 500's gains shrunk to a tiny 3.3% due to well-publicized weakness in the greenback.

The relative outperformance of Canadian stocks, coupled with a strong loonie, may be part of the reason behind the timing of Goodale's announcement. (For more on the timing, see "It's about time," p. 51.) "Canadian resource stocks are currently doing exceptionally well, and therefore there's a lot of demand for Canadian equity," says Joel Fried, professor of economics at the University of Western Ontario in London. (For a full Investment Q&A with Joel Fried, see p. 49.) However, some were quick to note that the recent run of high equity returns in Canada is an anomaly when framed against the long-term investment return picture. "Historically, foreign markets have outperformed Canadian markets," says Aon's Clapperton.

Canada's capital markets were also starting to feel crowded and liquidity-constrained, due to pension heavyweights such as the CPP Investment Board and the Ontario Teachers' Pension Plan having to invest more than two-thirds of their assets at home under the FPR. "Some of these large public plans have too much money relative to the market opportunity to invest [it all] in Canadian equities," points out GE's Smith.

In the future, many Canadian investors are likely to test the waters

Immediate Changes

The elimination of the Foreign Property Rule (FPR) in Canada will likely show up in three key areas: allocation, types of investment products and currency management.

First, there will be new policy allocation decisions to be made. Without the restriction to use as a guide, plan sponsors and their consultants will need to make a conscious, supportable choice on the right level of non-Canadian holdings. No one can say for sure what that level will be, but it seems reasonable to expect it will be considerably higher than the roughly 26% the average pension plan has in place today.

Kevin Martino
Director, client services, UBS Global Asset Management in Toronto.

Second, there will need to be some soul-searching on available investment products. Balanced funds have long been popular, but the future will probably be about global balanced rather than the Canadian version that grew up under the FPR. It just makes more sense to be broadly diversified and open to other quality sources of both return enhancement and risk management now that the FPR is gone.

Finally, there will be ongoing concerns about currency. As foreign holdings rise, currency management will go from being a fringe hobby of large funds to a permanent structural preoccupation for most Canadian investors. This is currently the case with most small unconstrained markets around the world and Canada will be no exception.

There will likely be many changes over many years in response to the elimination of the FPR but we're expecting that these three; policy allocation, investment product choice and currency management, will quickly surface as the key issues.

by increasing foreign allocations in areas "where they are already comfortable," says Paul Malizia, senior investment consultant at James P. Marshall in Toronto. He adds that, recent underperformance notwithstanding, many pension funds are "probably looking at more specialized U.S. mandates: U.S. small cap, U.S. mid-cap."

ALTERNATIVE BENEFITS

Alternative investments, such as hedge funds, private equity, or infrastructure, may also end up net gainers as a result of the move, according to consultants.

"The next place they will probably start to consider is the more non-traditional asset classes, where the majority of investment options are [from] foreign providers," says Malizia. "They may have not considered those in the past because they wanted to keep the 30% in areas where they were most comfortable."

Jean-Philippe Lemieux, vice-president of products at Montreal's Standard Life Investments (26th in the Top 40), agrees: "Up to now, most of the foreign investments were made in liquid markets." One of the most illiquid asset classes—private equity—is predicted to be an increasing source of new business by some managers. "We closed our second fund in 2004, and we think that'll be a significant growth area in future years," says Connor, Clark & Lunn's Stoddart.

With the vast majority of strategies being geographically diverse investment vehicles, the FPR meant pension plan sponsors had to squeeze a hedge fund or fund-of hedge-funds allocation into the 30%. "Previously, it either had to be considered foreign content, because the underlying fund of funds was foreign content, or it had to be Canadianized, which meant additional cost," says Paul Robson, managing director at Northwater Capital Management Inc. in Toronto (22nd in the Top 40). Although it was initially founded as a synthetic foreign exposure firm dedicated to circumventing the FPR, Northwater Capital's product line now consists mostly of alternative investment strategies.

EMBOLDENED BONDS

Foreign fixed income asset classes—often forsaken for equities under the FPR—could also see an influx of new

money. Like equities, however, it's the homegrown issues that have posted some of the best returns: the Scotia Capital Universe of Canadian bonds gained an impressive 7.2% in 2004.

"If you look at the years since the tech bubble burst, except for 2003, fixed income has been a better-returning asset class than equities," says Jean Charbonneau, head of international fixed income for TAL Global Investment Management in Montreal (13th in the Top 40). He points out that Canada, with its budget surplus, should shrink as a debt issuer in the coming years, further limiting the domestic opportunity set for bond investors. "If you look at developed fixed income markets, in terms of market cap Canada is slightly less than 1% of the total world market cap," he

International Inventory

Today, they control more than half a trillion dollars in Canadian pension assets. But given the elimination of the FPR, how might BENEFITS CANADA's Top 40 Money Managers list evolve? In aggregate, the Top 40 reported $64.5 billion in a total of 391 non-domestic specialist mandates. But what would the Top 40 look like if companies were ranked solely on the size of their Canadian pension assets invested in non-domestic specialist mandates? JPMorgan Fleming Asset Management (currently ranked 21st) would take top honours with its $7.6 billion under management, including nearly $2 billion in Pacific Rim mandates. Collectively, the Top 40 manage $23.8 billion in non-North American active specialist mandates, $13 billion in U.S. active, and $8 billion in global active.

Non-Domestic Specialist Mandates

Rank	Company	Mandates	$ millions
1	JPMorgan Fleming Asset Management[1]	0	$7,641
2	AllianceBernstein Institutional Investment Mgmt.	43	$6,566
3	Capital Guardian Trust Co.	24	$6,360
4	TD Asset Management Group	126	$6,147
5	Brandes Investment Partners, L.P.	30	$5,050
6	GE Asset Management	11	$4,235
7	Franklin Templeton Institutional	17	$4,123
8	Barclays Global Investors Canada Limited	10	$3,828
9	UBS Global Asset Management (Canada)	11	$3,157
10	Sprucegrove Investment Management Ltd.	8	$3,150

Note: 1. Reported dollar amount only for non-domestic specialist mandates.

The custodian's view

Fees may rise with FPR's demise.

Plan sponsors may want to consult their custodian to determine how the elimination of the foreign property rule will impact their fund operations. Aside from ending any foreign content monitoring programs, risk, cost and revenue implications must be understood if expansion of direct foreign holdings is contemplated. Some sponsors may even restructure their investment arrangements.

Funds that plan to increase their direct investment in foreign securities should perform a due diligence review before entering new global markets. Settlement practices, foreign exchange restrictions, documentation requirements and tax treaties need to be understood, and depository risk assessments completed.

Stuart Plummer
Director, product management, marketing and communication, CIBC Mellon in Toronto.

Increased foreign holdings have cost and revenue implications. Global settlements and income collection, along with the associated paperwork, will mean higher custodial transaction and holdings fees. However, greater foreign holdings can make your portfolio more attractive to foreign security borrowers, with the potential for better securities lending income overall.

Many companies with several pension funds had jointly invested in trust structures. Some pooled fund trusts had allowed foreign content up to 51% overall but the investment regulations were very restrictive, with potentially severe penalties. With the new legislation pending, now may be the time to consider alternative structures. Elected master trusts are tax exempt and may be a viable alternative to pooled funds. Your custodian should be among the tax and other advisors you work with as you consider how your funds should adjust to this new environment.

says. "If you add on emerging markets, Canada is smaller still."

"Traditionally foreign equities is where you'd put your money [under the FPR, so] I think there'll be a slight shift into foreign bond specialists," says Doug Mahaffy, president and CEO of Toronto's McLean Budden Ltd. (6th in the Top 40), adding that U.S. issues are typically more liquid.

However, the past run-up in bonds looks set to slow considerably: projected mid- to long-term interest rate hikes will dampen bond returns going forward. There is also the currency conundrum: with bonds and other debt instruments denominated in a variety of currencies worldwide, Canadian plan sponsors will be taking on more currency risk the further abroad they go, especially as they venture into emerging markets. "That's not great when you do valuations every three or four years, and the currency is down significantly relative to the Canadian dollar," Robson says.

SYNTHETIC SUBSTITUTION

While change is constant, it also comes quicker for some than for others. An entire cottage industry evolved over the decades, devoted to doing an end-run around the FPR, and those managers who bet on the restrictions being a fixture of Canada's investment regulations will find their jobs in jeopardy. "I think certainly synthetics and clones, you won't have the need for," says Mahaffy.

"For the mainstream they're going to disappear," says Bill Chinery, managing director at Barclays Global Investors Canada (2nd in Top 40) in Toronto. Barclays was one of Canada's biggest suppliers of synthetic foreign exposure prior to the budget announcement, but is now in the process of discontinuing its synthetic indexing pooled funds. "Why would a client invest in a synthetic when they can buy the cash alternative now, and save the tracking error and everything else?"

However, while the practice of charging a premium to synthetically replicate an international pool of investments may fade into history, the use of futures contracts on foreign exchanges will live on. "I don't think synthetic indexing is dead: if people are considering sources of return that are non-Canadian dollar, synthetic indexing is the most natural way of hedging that foreign exposure," says Northwater Capital's Robson. "Similarly, if more people are considering non-Canadian dollar debt, then they seriously have to consider their currency exposure."

For his part, Chinery is confident the active management side of Barclays Global Investors Canada's business will pick up most—if not all—of the firm's current synthetic foreign content customers, once its synthetic foreign pooled funds are fully wound down.

SLOW AND STEADY

Will Canadian pension plans rush to take full advantage of the new universe of opportunity offered by the lifting of the FPR? The unanimous answer is "Not immediately."

"It requires plan sponsors to change their investment policies and procedures," says Aon's Clapperton, an often-lengthy process requiring a thorough review and approval from the pension fund's board of trustees. "I don't think there'll be a whole lot of immediate reaction to it," agrees Northwater Capital's Robson. "People [will] go back and look at their entire asset mix from an asset-liability perspective and figure out what they're going to do."

(Continued on page 44)

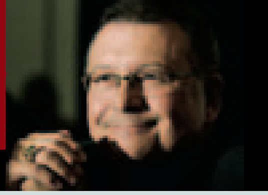
Top 40 Money Managers

As of Dec. 31, 2004 (millions)

			Total Pension Assets			
2004	2003	Company	2004	2003	%Variance	Total Assets
1	1	Caisse de dépôt et placement du Québec	$123,202.0	$97,190.0	26.8%	$165,360.0
2	2	Barclays Global Investors Canada Limited	$37,786.6	$30,210.1	25.1%	$51,003.5
3	4	TD Asset Management Group [1]	$30,326.0	$26,383.0	14.9%	$106,630.0
4	3	Phillips, Hager & North Investment Management Ltd.	$30,212.6	$27,436.5	10.1%	$50,378.8
5	5	Jarislowsky, Fraser Limited	$26,258.0	$23,536.0	11.6%	$44,114.0
6	6	McLean Budden Ltd.	$23,289.0	$21,363.0	9.0%	$33,480.0
7	7	State Street Global Advisors Ltd.	$21,410.6	$19,210.4	11.5%	$28,981.6
8	12	Connor, Clark & Lunn Financial Group	$15,434.5	$10,233.6	50.8%	$24,751.4
9	8	Greystone Managed Investments Inc.	$15,335.9	$13,398.9	14.5%	$21,919.7
10	13	Addenda Capital Inc.	$14,264.0	$9,860.0	44.7%	$21,404.0
11	10	Bimcor Inc.	$12,816.4	$12,518.0	2.4%	$12,816.4
12	9	UBS Global Asset Management (Canada)	$12,134.0	$13,144.1	-7.7%	$25,366.0
13	11	TAL Global Asset Management Inc.	$10,533.9	$12,165.0	-13.4%	$54,115.8
14	17	Beutel Goodman & Company Ltd.	$10,358.0	$8,581.0	20.7%	$11,750.0
15	15	AllianceBernstein Institutional Investment Mgmt.	$10,166.0	$9,510.0	6.9%	$17,452.0
16	16	Legg Mason Canada Inc.	$9,668.0	$9,508.0	1.7%	$12,745.0
17	14	Capital Guardian Trust Co.	$9,613.3	$9,732.3	-1.2%	$10,932.0
18	21	Franklin Templeton Institutional	$8,716.8	$7,466.0	16.8%	$15,928.0
19	18	Guardian Capital LP	$8,212.0	$7,522.0	9.2%	$15,336.0
20	22	Natcan Investment Management	$8,165.0	$7,441.0	9.7%	$28,533.0
21	20	JPMorgan Fleming Asset Management	$8,143.6	$7,474.5	9.0%	$9,523.2
22	19	Northwater Capital Management Inc.	$8,042.0	$7,494.0	7.3%	$8,344.0
23	24	GWL Investment Management Ltd.	$7,342.8	$6,760.6	8.6%	$14,410.9
24	28	Letko, Brosseau & Associates Inc.	$6,985.0	$5,429.5	28.6%	$10,957.0
25	25	New Brunswick Investment Management Corp.	$6,917.9	$6,233.0	11.0%	$6,917.9
26	23	Standard Life Investments Inc. [2]	$6,821.5	$7,179.8	-5.0%	$20,503.6
27	26	Bentall Capital	$6,771.0	$5,800.0	16.7%	$10,089.0
28	27	Sprucegrove Investment Management Ltd.	$6,650.5	$5,482.5	21.3%	$8,537.2
29		Wellington Management Company, LLP [3]	$6,028.0	$5,104.2	18.1%	$7,998.0
30	32	Brandes Investment Partners, LLC	$5,050.0	$4,421.0	14.2%	$12,949.0
31	33	AMI Partners Inc.	$4,781.0	$4,327.0	10.5%	$5,076.0
32	34	YMG Capital Management Inc.	$4,737.9	$4,244.4	11.6%	$15,057.1
33	30	MFC Global Investment Management	$4,323.4	$4,881.7	-11.4%	$87,208.8
34	36	SEAMARK Asset Management Ltd.	$4,124.3	$3,903.5	5.7%	$10,861.4
35	31	Sceptre Investment Counsel Limited	$4,107.1	$4,851.2	-15.3%	$6,365.3
36	29	GE Asset Management [4]	$4,020.7	$4,966.4	-19.0%	$4,544.0
37		AIM Trimark Investments	$4,004.0	$2,958.0	35.4%	$43,022.0
38		Leith Wheeler Investment Counsel Ltd.	$3,896.0	$2,700.0	44.3%	$5,206.0
39		Foyston, Gordon & Payne Inc.	$3,584.0	$2,745.0	30.6%	$7,178.0
40		Lincluden Management Limited	$3,538.0	$3,170.1	11.6%	$3,730.0
		Top 40 Total	**$547,771.3**			
		2003 Top 70 Total	**$477,382.3**			
		% Difference	**14.7%**			

Notes:

1. TD Asset Management Inc. and its affiliates
2. The total pension asset figure excludes $3,323.7 million and total asset figure excludes $5,177.9 million of U.K. assets managed by SLI in North America.
3. Total pension asset figure for 2003 has been revised.
4. Total pension asset figure for 2003 has been revised.



Highest asset growth

The Caisse again had the highest growth in pension assets, with a $2.6 billion increase over 2003 to $123.2 billion.

As of Dec. 31, 2004 (millions)

Fastest Growing ($) *

Rank	Company	Pension Assets 2004	2003	$ Growth
1	Caisse de dépôt et placement du Québec	$123,202.0	$97,190.0	$26,012.0
2	Barclays Global Investors Canada Limited	$37,786.6	$30,210.1	$7,576.5
3	Connor, Clark & Lunn Financial Group	$15,434.5	$10,233.6	$5,200.9
4	Addenda Capital Inc.	$14,264.0	$9,860.0	$4,404.0
5	TD Asset Management Group	$30,326.0	$26,383.0	$3,943.0
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9	Greystone Managed Investments Inc.	$15,335.9	$13,398.9	$1,937.0
10	McLean Budden Ltd.	$23,289.0	$21,363.0	$1,926.0

*NOTE: Among the Top 40 Managers only. As of Dec. 31, 2004.

Fastest Growing (%) *

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1	Connor, Clark & Lunn Financial Group	$15,434.5	$10,233.6	50.8%
2	Addenda Capital Inc.	$14,264.0	$9,860.0	44.7%
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10	Beutel Goodman & Company Ltd.	$10,358.0	$8,581.0	20.7%

*NOTE: Among the Top 40 Managers only. As of Dec. 31, 2004.

(Continued from page 40)

Although the investment and pension communities have been lobbying against the FPR practically since its inception in 1971, Clapperton notes that many plans didn't make the most of the room they had under the rule: "Let's be honest, most plan sponsors aren't even using up the full 30% foreign content limit that's there right now."

"I certainly don't expect [future allocations to foreign investments] to be 50% or 60% or 75%," James P. Marshall's Malizia says. "The liabilities still have to be paid in Canadian dollars." GE's Smith, in contrast, sees a definitive move to meaningfully higher levels of foreign content. "I would anticipate that we would probably see many Canadian pension plans going to 40% to 45% foreign content over the next two years."

Regardless of the speed with which Canadian institutional investors and money managers might act on their newfound freedom, one strong belief is clear: the move is definitely good news for retirement plan sponsors and members, especially those in underfunded plans.

"It will help in terms of diversification; it will help in terms of hopefully lower costs," says ACPM's Perkin. "I think the Finance Minister is to be congratulated," echoes PIAC's Hiscock. "It is a change that we think is going to be positive for all Canadians."

The conclusion? In the future, the Top 40 money managers will have a decidedly different look. And Canadian managers will have to adapt to stay in the game. **BC**

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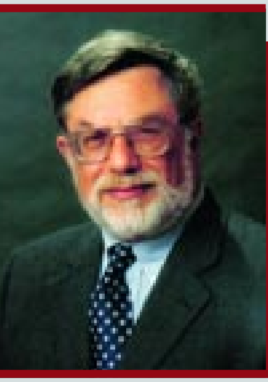
Q&A

By James Lewis

The FPR forfeiture

Foreign content limits may have cost retirement plan members $3 billion annually, says economics professor Joel Fried.



Joel Fried
Professor of economics at the University of Western Ontario and co-author of "The Foreign Property Rule: a Cost-Benefit Analysis", a report commissioned by The Association of Canadian Pension Management and the Pension Investment Association of Canada.

BC: *Can you tell us a bit about the history behind the Foreign Property Rule (FPR)?*
JF: The FPR in its current form on assets was initiated in 1971. Before that, there was a rule which was based on foreign income from interest and dividends. To avoid that constraint, pension plans began switching to equity; hence the change to the asset-based rule. It was initially set at 10% of book value, raised to 20% in the early '90s and later upped to 30% in 2000.

The rationale of the FPR is somewhat murky. The two major reasons given are that it supports the Canadian dollar and Canada's balance of payments, and that it also decreases the cost of capital to Canadian firms and therefore allows the Canadian economy to grow faster. The first of these economic arguments is inconsistent with the data: increases in the limit in the early '90s and in 2000 had no statistical or economic significance, or effect on the exchange rate.

If you think it through, what the FPR is doing is in some sense increasing the effective total cost of labour, including benefits, rather than decreasing the cost of capital. So, even if this argument of reducing the cost of capital were right, then workers would be paying a tax to subsidize domestic capitalists.

Workers do indeed gain from the removal of the FPR if they're in a pension plan, and most unionized workers are: the sponsors and the administrators of their plans certainly understand the cost of this restriction to members.

BC: *How about plan sponsors?*
JF: It's strongly in the interest of the sponsor to provide the best plan possible for their members, and the reason being is that pensions are part of one's total package of compensation—if you provide something that's less efficient, it's not in the firm's best interests if it wishes to hire and retain good people.

It's the convenience of the regulators—it's not at all in the member's or sponsor's interests. The FPR does not provide any benefits; sticking to it in principal, if not in fact, means that you are not doing your fiduciary duty.

BC: *Is the industry devoted to circumventing the FPR in jeopardy?*
JF: There's $27 billion [in clone funds], and [with fees] at 40 basis points on average, there's over $100 million removed right there in income to derivative suppliers. Certainly, the prices charged for those products are going to be reduced. [However, from a currency hedging perspective] there

Appropriate allocation

The percentage of non-Canadian assets will likely grow to 50% in the next three years.

If hedge funds were the story of the first half of this decade, then the foreign content abolishment will be the story of the second half for both for pension plan sponsors and investment managers. Looking at countries like Australia and Sweden, we would expect the percentage of non-Canadian assets to eventually settle in at 50% (from the present 25%) over the next three years. Plan sponsors will be 'dusting off' those recently-finished asset/liability studies to determine appropriate allocation.

This change should favour money managers that can provide global strategies. The remaining domestic managers without foreign capabilities will need to build them in-house or build alliances with other managers. We should also see an increase in U.S.-based managers coming into Canada. Clients will clearly have to develop formal hedging policies and managers will be required to provide active and passive currency strategies. We may see some acquisitions of domestic money managers by international managers as a cost-effective way of entering the Canadian market.

Bill Chinery
Managing director at Barclay's Global Investors Canada in Toronto.

While most of the assets will flow to foreign equity, a significant amount will likely be allocated to private equity and hedge funds. For some of the larger funds, infrastructure financing may garner some assets. It will be interesting to see if a significant amount flows to foreign bonds. Typically, this has not been a popular asset class even for pension plans domiciled in non-restricted countries because of the volatility of currency exposure relative to their liabilities. The big loser will clearly be Canadian equities, which may fall to around 15% to 25% of plan assets.

may still some desirable use for futures contracts on the S&P. For example, if you choose to have passive indexing, you hold the underlying Canadian securities, effectively denominating that asset in Canadian dollars. The other way to have a Canadian dollar hedge would be to buy the cash S&P and buy a futures contract for Canadian dollars to overlay it. It's not clear whether one's more expensive than the other, since both will be using futures contracts. The issue for Canadians is to separate out the decision where you want to hold your assets from what sort of currency you want them denominated in.

BC: *You opined in your paper that cancelling or removing the FPR could result in savings of $1.5 billion to $3 billion annually.*

JF: That is correct. Somewhere between $500 million and $2 billion comes from the possibility of improved long-run diversification among those funds and individuals that were constrained—either in principle or in fact—by the FPR. The remainder is attributable to cutting plan administration costs that resulted from the FPR.

More than that—and one of the areas in which we believe there will be significant gains—is that the FPR acted as a constraint on competition in the supply of mutual and pooled funds. It kept out foreign firms, because at the [earlier] lower percentage levels [such as 10% or 20%] the Canadian market wasn't large enough for non-resident managers to come in and provide some expertise.

Even with the movement from 20% to 30% (in 2000), you started to see greater competition coming in—that, ultimately, will be translated into lower fees across the entire industry. You should be seeing firms come in who will either partner or merge with a Canadian supplier, so that they could offer a full array of funds.

BC: *Do you think that we'll see people go out and overallocate temporarily to foreign content, or will we see a more cautious and conservative approach?*

JF: Evidence from the past doesn't suggest there'll be a mad rush. The fact is that Canadian fund managers in both the retail and institutional markets have an awareness of foreign markets through derivative investments, and are aware of what kind of foreign exposure makes sense for their fund.

There are other factors: for instance, it's all for the better if they're going foreign for greater asset diversification. Another issue is whether they're going to unnecessarily expose themselves to foreign exchange risk. Well, if some of your members intend to retire in Florida or southern France, then holding assets denominated in U.S. dollars or euros is not really a terrible risk; in fact, it's making your life a little bit safer.

So, I don't see individual investors or institutional ones making major changes immediately. There will be a slow change as people become more comfortable with these positions. Even investors in Britain—which is a bit more than twice the size of the Canadian market—hold around 50% of their assets in the U.K. So, there's this home country bias, which in part has to do with your consumption patterns when you retire.

BC: *That is the other part to this: Canada's demographic profile. From that standpoint this is probably a timely announcement…*

JF: Perhaps this movement on the FPR can be translated into some better understanding of how people make decisions in their own interest, and how plan sponsors act in their members' interest, [and] regulators [will] begin to make rules that are sufficiently reasonable and flexible. That is something all Canadians can benefit from. **BC**

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It's about time

Thanks to the Feds' decision to eliminate the Foreign Property Rule, plan sponsors have unlimited investment freedom. How are they taking the news?

By Caroline Cakebread

The pension industry was pleasantly surprised when federal Finance Minister Ralph Goodale announced the elimination of the 30% Foreign Property Rule (FPR) in his 2005-2006 budget in February. In a post-budget speech hosted by the Association of Financial Professionals of Canada, Goodale emphasized that removing the FPR is necessary in today's markets. "This is a limitation that began about 34 years ago with fundamental objectives, but I think we've moved well beyond that in this modern day and age," said Goodale at the luncheon in Toronto.

Whatever the government's motivation for ending the longtime restriction, pension plan sponsors can certainly reap the rewards. They will now be able to expand their investment base, increase their diversification and enhance the retirement savings of plan members. As Terri Troy, director of pension investments with Royal Bank of Canada in Toronto sums up, it "just makes it all simpler—so it's beautiful."

—Chandra Price

Jump for joy—it's happened at last. The most recent federal budget has removed one major albatross from the necks of Canadian plan sponsors by eliminating the 30% cap on foreign investment. A letter sent by the Pension Investment Association of Canada (PIAC) to federal Finance Minister Ralph Goodale in January clearly outlined the argument the institutional investment community has been making for years: the Foreign Property Rule (FPR) doesn't make sense and getting rid of it presents no threat to the health of the Canadian economy.

Indeed, studies such as the one conducted by the University of Western Ontario's professors David Burgess and Joel Fried conclude that the potential diversification benefits fostered by eliminating the FPR could add up to between $1.5 billion and $3 billion a year for Canadian investors, all while reducing risk (for an Investment Q&A with Fried, see p. 49). While

many believed the government would ease the cap in increments over a long period of time, no one thought this budget would see the foreign property limit abolished entirely. So why did the Feds suddenly decide to heed the cries of Canadian investors? And what does the change mean for plan sponsors?

David Gamble, a spokesperson for the federal Department of Finance in Ottawa, explained the motivation: "It was felt that the original Foreign Property Rule had already served its initial policy objective: supporting Canadian capital markets."

The aim of abolishing the rule was to enable registered pension plans, as well as individual investors, to achieve diversification, reduce risk and enhance the retirement savings of Canadians. Did the efforts of organizations like PIAC help make the change? Gamble says consultations were part of the budget process and the government has been keenly aware of the issue for some time.

Whatever the motivation, the fact remains: plan sponsors are very happy. Montreal-based Russell Hiscock, chairman of PIAC's Government Relations Committee and author of the January 2005 letter to Minister Goodale, was pleasantly surprised by the news. "PIAC has been advocating this for quite a few years," he says. "I made a number of visits to the government over the years [and] we've written letters. We tried to make the case that this is not a very sensible rule. I believe they drew the conclusion they'd have to make the decision some day."

He believes that, amidst research and arguments advocating the elimination of the rule, the decision became a "when" rather than an "if" scenario. Hiscock applauds Ottawa for having the courage to make the decision now, rather than waiting. "They deserve full credit for that," he says.

SO WHAT NOW?

Now that the pension industry has what it's always wanted, the question remains: what happens now? Stanley Hamilton, Philip H. White Professor Emeritus, Urban Land Economics at the Sauder School of Business in Vancouver, believes that the next step for plan sponsors is to look at their investment policies and see what makes sense. On the most basic level, he says, some defined benefit (DB) plans have internal investment policies that dictate that they invest to the maximum permitted foreign investment limit. "A change of this magnitude means everybody has to sit down and ask themselves, 'what's the right number?'" he says.

Mary DePaoli, Sun Life Financial Canada's vice-president, Group Retirement Services in Toronto, agrees that plan sponsors are going to have a lot of new information to absorb, particularly on the defined contribution (DC) side. "Plan sponsors need to get prepared for an onslaught of new investment vehicles to consider," she says. "They're going to have to go back to their pension committees and determine whether or not their current fund line-up is appropriate, given the fact that the world has changed."

DePaoli believes the onus is now on plan sponsors to have the right options ready for their DC plan members. "The Canadian market represents between just 2% and 3% of the world market capitalization," she asserts. "It's now really incumbent on plan sponsors to review the foreign equity options offered to plan members to ensure they have the opportunity to properly diversify."

While the budget still has to pass through a few more hoops to become law, many plan sponsors are already looking at making some changes. "We are going to look at global fixed income right away," says Terri Troy, director of pension investments with

Meeting goals

The FPR's demise will mean the Canada Pension Plan Investment Board will be less dependent on the Canadian economy. It will also positively impact the future pensions of 16 million Canadians.

The announcement of the removal of the foreign property limit in the recent federal budget was surprising and significant. The elimination of the 30% limit means the Canada Pension Plan (CPP) Investment Board can better achieve its long-term goal of helping to sustain the CPP for generations to come.

Ian Dale
Vice-president, Communications and Stakeholder Relations in Toronto

Taking away this investment constraint allows the Board to avoid being overly dependent on the Canadian economy. At the moment, almost 80% of the CPP reserve fund (about $60 billion) is invested in Canada. Through more international investment, we can further diversify the CPP reserve fund, reduce concentration risk to the portfolio and be better positioned to increase our long-term rate of return.

Last year, the CPP Investment Board announced its intention to gradually raise the amount of its international holdings. The removal of the Foreign Property Rule will not immediately affect the pace of our international diversification.

Eliminating the foreign property limit is helpful in improving the efficiency and effectiveness of the total portfolio and in reducing our portfolio costs. More importantly, we see the news as a very positive development for the future pensions of 16 million Canadians who participate in the CPP.

Royal Bank of Canada in Toronto, referring to RBC's DB plan.

"All of a sudden, the opportunity set has increased exponentially," she points out. "For example, Canadian investors now have more room to invest in foreign corporate bonds and real return bonds, such as U.S. Treasury inflation-protected securities. This is all very positive. Plan sponsors are going to have more opportunity for higher risk-adjusted returns net of fees which can only help the funded status of plans."

DePaoli also sees more DC plan sponsors taking a look at adding global bond funds. "Plan sponsors have historically looked at the 30% cap as a foreign equity issue on the premise that investors might want to keep their bond assets in Canada. This might change too."

"Plan sponsors need to get prepared for an onslaught of new investment vehicles to consider."

PROCEED WITH CAUTION

Like many others, John Poos, director, Global Pensions, with Nortel Networks in Brampton, Ont., says the company will be taking a close look at the asset mix in its DB plan in an effort to determine how much foreign content is right. In particular, he's looking at the issue of currency risk.

"We will be making a greater commitment to global assets," Poos confirms. "The issue for us is how much is the right amount and what is the appropriate hedging amount for Canadian currency." There's also the asset-liability dilemma. "We've moved our assets to more closely match liabilities—and that means Canadian long bonds." He says the decision to invest in the global market runs counter to the firm's decision to hedge the plan's liability growth. "We're going to have to be very careful in terms of how quickly we move away from that decision."

Slow and steady seems to be par for the course for many plan sponsors and how fast they move depends on the plan, says Troy. "There's no one right answer for anybody." For example, synthetic funds have been a mainstay for some plan sponsors looking to increase foreign exposure. Many look to replace these with the real deal: actual foreign content.

"The people who really wanted foreign already have it," says Hamilton. However, plan sponsors who shied away from derivatives in the past might now choose to move money into foreign content because they can do so directly. "[The elimination of the FPR] just makes it all simpler—so it's beautiful," says Troy.

THE DC CHALLENGE

There will also be changes to be made on the DC side. For example, how should plan sponsors be communicating this information to

their DC plan members? "Whenever we speak to employees, we always talk to them about the advantages of maximizing the foreign content limit to properly diversify," DePaoli says. "If they follow the rule of thumb that Canada is only between 2% and 3% of world cap, does that mean plan members should now interpret that as needing to invest 97% of their assets outside the country? No, but it leaves the big education question: what really is the appropriate amount?"

Poos agrees the DC side of the plan will be a challenge. "We need to first revisit our DC option to determine whether or not we have reasonable investment vehicles for plan participants that will allow them to invest internationally," he says. "Having done that, there will be some risks we'll need to address in terms of education."

Poos says he'll also be looking to his recordkeeper to be more involved in education and monitoring: "We will have some challenges ahead in monitoring along with the CAP guidelines and we'll be looking to our providers to be more active participants in the international market field for us."

INDUSTRY-WIDE CHANGES

While some changes will happen at the plan level, many believe there will be even more changes industry-wide as plan sponsors look for money managers with international capabilities and contacts. While non-Canadian managers see this as a huge opportunity, Canadian managers without the necessary global product line-up could see a huge outflow of assets, says DePaoli.

Terri Troy agrees that big changes could await money managers: "I think there's going to be consolidation in the industry," she points out. And there will be new needs; global credit capabilities and currency overlay strategies will be top of mind for many, says Troy.

So, as the investment village becomes more global for Canadian investors, it is certain that plan sponsors will be making changes to their asset mix to reflect the new options they have. From fixed income to equities, the world is now definitely their oyster. **BC**

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Fine Tuning

The proposed elimination of the FPR will allow Canadian pension sponsors to implement more efficient and cost-effective portfolios.

By Peter Muldowney and Brian Dayes

With no foreign property investment constraints, Canadian pension investors will have the opportunity to review their long-term asset mix allocation and investment manager structures. For defined benefit (DB) plans that already have higher foreign exposure through synthetics or pooled fund trust structures, the removal of the FPR may only result in fine tuning. For all other DB plans and sponsors of capital accumulation plans (CAPs), the removal of the limit will allow for enhancement of overall portfolio management. There are five key considerations:

1. Better diversification, but not uniformly – Opportunities provided by unrestricted access to foreign markets allow for better diversification in the equity component of a pension portfolio over the fixed income component. Global equity markets provide a significantly broader opportunity set from which to generate investment ideas and would mitigate trading challenges. Foreign fixed income markets may provide a useful source of diversification. Sponsors should consider whether a better role of the fixed income component of a DB plan is to provide a closer matching to liabilities.

2. The end for synthetic products? – Synthetic index funds will in many cases be replaced with lower-cost stock index funds. Rumours of their demise are greatly exaggerated. Synthetic structures can play a role in DB plans by providing liability matching strategies that preserve the additional expected return from equity markets—"beta transport"—and to enhance return in combination with alternative investments—referred to as "alpha transport."

3. Alternatives, anyone? – For sponsors using or considering alternative investments such as private equity, hedge funds and real estate to be included in the pension portfolio, the elimination of the FPR will facilitate the allocation and therefore access to a broader range of foreign alternative investments.

4. Currency spoils the party – The FPR's demise will increase the spotlight on currency risk management. Currency impact has had a material effect (positive and negative) on foreign investment returns. Currency risk management will be an even more important issue for pension plans to consider, and the 'active vs. passive investment' debate should be extended to the currency management program.

5. Simpler communications – For capital accumulation plans (CAP), the elimination of the FPR will allow sponsors to focus member communications on the merits of diversification, rather than on foreign limit compliance.

The implications for balanced funds and lifecycle funds that are popular with CAP investors will need further consideration, as will appropriate Canadian and non-Canadian allocations and currency exposure implications. Plan sponsors will need to monitor the developments and communicate implications to members. **BC**

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Exploring opportunities

Post FPR: fewer synthetics and more demand for global fixed income.

I commend the government on its swift action with the FPR. Investors will now be able to diversify outside of Canadian markets without using costly derivatives. The investment opportunity set will increase, which will allow for higher risk-adjusted returns net of fees, which will help to alleviate the funded status of plans.

Terri Troy
Director of pension investments with Royal Bank of Canada in Toronto

Prior to the elimination of the FPR, investors got around the restriction with costly derivatives strategies. However, this resulted in higher management costs and exposure to the risk of counterparties.

Once the removal of the FPR is passed into law, investors will replace synthetics with non-synthetic equity funds (e.g. physical equity funds) to reduce costs. Secondly, pension plans will explore opportunities to improve risk-adjusted returns net of fees. I predict greater demand for global fixed income mandates. However, global credit research capabilities will be key to a successful global fixed income program. Look for consolidation of Canadian fixed income managers with foreign counterparts. Over the medium term, Canadian equity mandates will probably gradually move towards North American mandates, and then truly global equity mandates.

PENSION planning

Mission Accomplished

By Keith Ambachtsheer

After an arduous 20-year lobbying effort, the much-despised Foreign Property Rule is finally dead. Much good will come of its passing.

By restricting the free flow of Canadian pension savings for over three decades, the Foreign Property Rule (FPR) directly cost Canadians billions of dollars in foregone returns in their pension and RRSP funds. For example, in a 1995 critique of the FPR, I placed the 1985-1994 cost at $20 billion for Canadian pension funds alone.

As is often the case with market restrictions, the indirect costs of the FPR may have been just as high, if not higher. For example, how do you put a cost on the lack of incentives for Canadian suppliers of pension fund and RRSP investment services (e.g., money managers, investment bankers, custodians) to become full-fledged participants in the global financial markets? Or, how do you put a cost on the design and implementation of all the convoluted pension fund and RRSP fund strategies put in place merely to circumvent the FPR's limitation on investing outside Canada?

More choice

Plan sponsors should never have been restricted in investing outside of Canada.

I wish I knew who to thank for the elimination of the Foreign Property Rule (FPR). But now that it is done, it seems such an obvious thing to do. I recognize that some people may want to keep money invested in Canada—particularly pension money. However, pension plans have been able to skirt the FPR, investing outside of the country for more than a decade because they believe it is in their best interests—whether to seek better returns or for more diversification. Why have constraints in place when there are legal ways to get around them? Pension plans with long time horizons and with members' best interests at heart have made a conscious decision to invest outside of the country. They should have always been allowed to do so.

John Clarke
Treasurer and assistant comptroller, Syncrude Canada Ltd, Fort McMurray, Alta.

Most of us do not know the time and effort it takes to monitor and manage funds with FPR constraints. There are costs involved, which most people fail to recognize or consider in their investment choices. Presumably, pension plans will simplify their structures and have a higher return which will benefit employees. And fund managers will structure funds with the best stocks without being constrained by the FPR and this will lead to better-performing and/or more diversified funds. Banks and regulators will no longer need to monitor the mix of funds, letting them focus on more relevant issues—and reduce fees.

The announcement will make members work harder; they will have to choose from a different range of funds than they have today. They will also have to decide if they want to stay as invested in Canada as they are today or move outside of the country. I think more choice and fewer constraints can only help pension plan member and individuals. After all, they will be the ones who will have to live with the results.

DOUBLE JEOPARDY

Maybe the greatest irony of all is the likelihood that the FPR did not even lower the cost of capital in Canada over the course of the last 30 years. There are two reasons to hold this view:

• Firstly, the FPR forced Canadian funds to hold more local securities than they would have on their own, causing them to extract a risk premium 'surcharge' on their Canadian holdings.

• More importantly, the FPR sent a signal to foreign investors to stay away, leading them to under-invest in Canada relative to other developed capital markets.

Ironically, the FPR was also set to undo much of the good work Canada did during the 1990s to reform the finances of the Canada Pension Plan (CPP). The cornerstone of CPP reform is the build-up of a financial reserve fund that will eventually finance 25% of future benefit payments, with the other 75% continuing to come from future payroll deductions.

Clearly, the size of future payrolls depends heavily on the future health of the Canadian economy. The FPR would have forced most of the financial reserve fund to be invested in the Canadian economy, and thus also be dependent on the Canadian economy's future health. From a risk management perspective, such a 'double jeopardy' makes no sense at all.

With the complete elimination of the FPR in the recent budget, all of these costs, inefficiencies and unnecessary risks have been swept away. As a result, fund return enhancement and diversification strategies can now be implemented without any restrictions on foreign investing. The Canadian investment services industry must now become globally competitive. Convoluted, expensive FPR-circumvention strategies have lost their rationale. Foreign investors are already looking at Canadian financial markets with renewed interest. The CPP Investment Board can now devise investment strategies for the CPP reserve assets which take into account the reality that the CPP's biggest assets continue to be future payroll deductions for Canadian workers. For all this, federal Finance Minister Goodale deserves to be congratulated.

LESSONS LEARNED

Before we close the book on it, it is worth asking what the FPR tale has taught us:

• The FPR story confirms the truth in the dictum not to interfere with free market outcomes unless there are very, very good reasons.

• The second reality is that every long journey begins with a single step. It was over 20 years ago that a few of us sat together in a room and decided to begin a lobbying effort with the ultimate goal of abolishing the FPR.

• Lobbying for effective pension legislation and regulations should be seen as a never-ending challenge. Clearly, articulated positions and perseverance are key.

The final chapter of the FPR tale proves that every once in a while, lobbying efforts produce a major payoff. This is one of those times. **BC**

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THE law

A pleasant surprise

The FPR's removal means simplified administration and greater opportunities for investment of retirement plan assets. **By Paul Litner**

It is nice to be able to report on a legal development that is good news for plan sponsors. The federal government's 2005 budget gave the Canadian pension industry a proposal to repeal the Foreign Property Rule (FPR) applicable to tax-deferred retirement plans, through future amendments to the Income Tax Act (ITA).

The elimination of the current FPR should simplify plan administration, reduce investment costs and facilitate a broader array of investment opportunities for pension plans. In fact, this proposal, once enacted, is likely to have a much larger impact on the industry than the Monsanto case.

The FPR imposes penalty tax on plans where investments in foreign property exceed 30% of the cost amount of the plan's assets. Foreign property consists of shares and debt issued by non-resident entities, as well as investments in certain (Canadian and foreign) trusts and partnerships.

Many different kinds of innovative investments have been created over the years to help pension plans achieve increased international exposure without exceeding the 30% FPR. These have included derivatives and synthetic investments. But these approaches are

often more costly than investing directly in the underlying asset, usually due to management fees. The elimination of the FPR will undoubtedly cause plan administrators to, over the next year, reconsider the need for these structures. Repealing the FPR will also enable registered plans to invest in a wider range of pooled fund trusts and partnerships, many of which are currently considered to be foreign property under the ITA. However, the government intends to release a consultation paper which may propose rules/limits on investments in flow-through entities such as partnerships and income trusts. In addition, proposed new tax rules dealing with non-resident trusts and foreign investment entities are still under consideration.

Post-FPR, there are also interesting legal considerations for those who invest pension plan assets. A pension plan sponsor's overriding legal duty is to prudently invest the plan's portfolio of assets; prudence includes ensuring that assets of the plan are adequately diversified. While the FPR was in place, it would have been difficult to criticize a plan sponsor for investing plan assets in Canada to avoid incurring a penalty. Once the FPR is eliminated, however, penalty tax will not be relevant and sponsors will have to review their investment policies to determine the appropriate level of exposure to foreign investments.

Sponsors must also consider the related risks associated with currency fluctuations and how to manage those risks with increased international exposure. With defined contribution plans, sponsors will need to re-evaluate the range of investment options offered to members. If increased foreign investment is contemplated, members will need to be educated on the risks and benefits.

The proposed repeal of the FPR is effective for 2005, but will not become law until the legislation is actually passed by parliament. While there is a risk the proposal will not ultimately become law, this is unlikely. Plan sponsors should hold off making any major changes until the draft legislation to amend the ITA is available. Once a sponsor does decide to act, it will be necessary to review plan documents and to consider amendments.

Although it raises a number of legal issues, for the most part, the elimination of the FPR can only be described as good news for those who administer and invest pension assets. **BC**

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