As institutional investors delve into emerging markets, the documentation can be complex and tedious—but custodians can help

By Brooke Smith

As eurozone nations continue to struggle with debt, many predict that emerging markets will continue to outperform developed markets in 2013. Brazil, Mexico, Russia and Thailand will likely see 3.5% to 4% growth; India, 5% to 6%; and China, 8%, according to Warren Jestin, chief economist with Scotiabank, speaking at the Economic Club of Canada’s annual outlook event in January.

Over the past 25 years, emerging markets have returned 11.5% (CAD) compared to single-digit performances from the TSX, the S&P 500 and the MSCI EAFE Index, according to data from Morningstar’s EnCorr and Zephyr’s Style Advisor. Add a low interest rate environment to the mix and it’s no wonder institutional investors are increasingly focused on adding emerging markets to their portfolios. In fact, the December 2012 Pension Fund Asset Allocation Survey from financial services firm bfinance indicates that for the first half of 2013, 17% of respondents are looking to increase their allocation to emerging market equities; over a three-year period, that number increases to 24%. And 31% of global institutional investors in the survey indicated “potential higher returns” as their top rationale for investing in this space.
But while most seasoned institutional investors can find their way around the mechanics of moving into a developed market, figuring out the ins and outs of emerging markets isn’t as easy. “There are a lot of countries out there, and not all of them are as good at communicating changes in their marketplace as quickly as we might expect in our home market,” says Scott MacDonald, head, pensions, insurance and sovereign wealth strategy, with RBC Investor Services. “Some markets have more well-established protocols for when they make changes to rules in their marketplace; others are less sophisticated, so those protocols are less clear to investors.”

That complexity is part of the reason emerging markets are classified as such even though many of them are actually quite developed, says Julie Cays, chief investment officer of CAAT Pension Plan. “They’re not quite as efficient on the operational side of the investment process.”

Hot Docs
Fortunately, custodians can help navigate these challenges efficiently, says Arti Sharma, principal with Mercer. “It starts when the [investor] first decides to go into these markets. If documentation [e.g., a certificate of incorporation or power of attorney document] is not done correctly at the start, then the implications downstream can be quite an administrative nightmare and can have a negative impact on performance.”

Sharma says that support provided by custodians varies: custodians prepopulating forms electronically versus institutional investors filling out forms longhand.

Northern Trust is fully aware of the importance of technology. The custodian is putting workflow and automation technology in place this year, which will allow completion of all forms electronically and will streamline the process.

“There is a whole workflow capability associated with it, so we can tell clients exactly where their documentation is in the process,” says Rob Baillie, president and CEO of Northern Trust Canada,
who adds that most of the industry is moving toward electronic delivery. For those that aren’t, Baillie says “it is becoming more and more challenging, especially as the number of markets that investors are in, and the number of clients that are in those markets, grow on a regular basis.”

Citibank is currently prepopulating as much information as possible into documentation for its clients. Gurmeet Singh Ahluwalia, Canada head for securities and fund services with Citi, says this work helps free up plan sponsors for more important activities. “We want to allow our clients to focus on their core competencies: working with their pensioners and investing and growing alpha. Prepopulated information includes information on the sponsor, the individual portfolio, tax status—whatever we have on file, we will put into the documents as appropriate to save our client’s time.”

There are more challenges within the documents themselves. Although the custodian can help the plan as much as possible with interpreting questions asked on the document, Kevin Rorwick, chief financial officer with CAAT Pension Plan, says that some questions can pose a particular challenge, even for custodians. For example, for investing in India, pension plans have to declare whether or not they are a Protected Cell Company or a Segregated Portfolio Company or do not “have an equivalent structure by whatever nomenclature”—without any definitions provided.

“Because most pension plans in Canada share a similar structure, it makes sense for a custodian to seek one answer for all of its clients,” says Rorwick.

He would also like to see custodians provide additional guidance with these questions, especially if many of the custodian’s clients are asking the same questions. “Even providing a template example,” adds Cays. However, Rorwick admits that this could be tricky because if the custodian gets that wrong, there could be legal implications for the custodian.

Proper documentation can also play a role in tax reclaims—getting tax money back to the home country of the investor. There can be delays in this process if custodians don’t initiate the reclaim right away (some may, for example, do so every three months), or if an investor’s account and documentation isn’t set up correctly (e.g., the document has expired, is not presented at the time of the account set-up or is missing) from the moment they enter a new market. These delays can be costly for investors.

Sharma points to a recent example, in which a pension plan is attempting to repatriate $20,000 from its account in Taiwan. However, the plan didn’t have the correct information in the documentation, thus slowing the process. The client was advised by its global custodian to hire a local tax advisor, she explains. But this will cost the plan twice as much to get its money out of Taiwan. (At press time, the client was still deliberating what to do.)

But sometimes hiring a local tax advisor is the only way to go, as the reclaiming process can take years. “Fortunately, for our clients,” says Baillie, “it’s been well worth it. It’s been effective in helping to move forward.”

Expires Dates
Expiration dates, introduced on these clients’ documents (e.g., a certificate of incorporation) in recent years, have also posed problems. Proxy voting is one area that can be affected. “Brazil changed its requirements [for proxy voting] about three or four years ago, and a lot of custodians let the documentation [stating that as at that record date, the investor is a valid shareholder and allowed to vote] lapse, so a lot of clients missed out on the proxy,” says Sharma. “The change was announced, but custodians just assumed that what they had filed with the local market was evergreen.”

That’s where global custodians have to ensure that documentation is going to be kept current. Automated processes will help, sending reminders to the client service relationship manager to let him or her know of upcoming documentation renewal. “If there’s no reminder, [the institutional investor] has every right to
go back to the [custodian] for not living up to its responsibility as a custodian.”

**Subcustodians**

While knowledge of the documentation and the rules lies with the custodian, subcustodians that are on the ground in particular emerging markets and are familiar with the local regulations are a vital link between the custodian and those markets.

“There is a risk that the subcustodian in some of the emerging markets may not be as well established or trained or experienced in operating a particular market,” says Rorwick. However, custodians, afraid of reputation risk, adhere to strict requirements to select subcustodians.

Custodians investigate these emerging markets: everything from visiting local regulators and various government departments to the stock exchange and the depository. This information is then collated for their clients.

“We provide a global custodian credit rating publication for our clients, and it goes through all our subcustodians that we use around the world. We rate the organizations and post their capitalization,” says Kevin Drynan, senior vice-president and managing director of State Street’s global services business in Canada.

But while custodians do spend a lot of time in researching and selecting their subcustodians, Rorwick says pension plans should still ask risk-related questions of the custodians they work with, such as What are you doing to monitor your subcustodian network?

Of course, even with an appropriately careful subcustodian selection and vetting process in place, unforeseen events such as fraud or bankruptcy of pension assets under custody as of June 30, 2012 (Billions)

<table>
<thead>
<tr>
<th>Company</th>
<th>Canadian Pension Assets Under Custody</th>
</tr>
</thead>
<tbody>
<tr>
<td>State Street</td>
<td>$391.7</td>
</tr>
<tr>
<td>RBC Investor Services1</td>
<td>$364.0</td>
</tr>
<tr>
<td>CIBC Mellon Global Securities Services Company</td>
<td>$266.7</td>
</tr>
<tr>
<td>Desjardins Trust</td>
<td>$113.7</td>
</tr>
<tr>
<td>The Northern Trust Company, Canada</td>
<td>$87.1</td>
</tr>
</tbody>
</table>

1 Formerly listed as RBC Dexia Investor Services

Note: Includes pension assets of Canadian operations invested in Canada, the U.S. and non-North American markets

Source: Companies participating in Benefits Canada's/CIIIN annual Custody Report Survey

---

**PENSION ASSETS UNDER CUSTODY**

**ON THE GO AND IN THE KNOW**

Now it’s even easier for participants to stay on top of their retirement savings with quick and easy access to their account information. A better participant experience anywhere, anytime with yourwaymobile.ca.
NO FAILURE TO COMMUNICATE

Most custodians communicate with their clients through phone or email regarding any questions at the account level—and it typically will go to their custodian contact (the client relationship manager), rather than to the local market expert. But wanting to get information right from local markets around the world offers unique challenges.

“First of all, if the custodian doesn’t have a branch in the local market, it has to bounce around before getting to the subcustodian, and then back to the custodian before getting to the client,” says Gurmeet Singh Ahluwalia, Canada head for securities and fund services with Citi. But Citi is building Network Direct, a tablet application that allows clients to see their portfolio in detail, as well as connect with Citi market experts in the local markets. “It provides clients with contact information for their relationship manager but also the ability to connect with the Citi experts directly in the local markets. This may include different ways of communicating, like email or video conferencing through Skype or FaceTime.”

40 years of providing top corporations with customized financial education through seminars, individual financial planning and online solutions.

Roland Chiwetelu, CFP, Consultant
Financial Education & Employer Services
Toronto

To learn more about how T.E. Wealth is helping employers, please visit www.tewealth.com/employers/

Geopolitical Challenges

While investing in countries with unstable infrastructure can be daunting, institutional investors know that, in time, the markets will evolve and the kinks will be ironed out. However, geopolitical uncertainty is always a consideration in developing nations. For instance, the 2011 regime change in Egypt kept the market in that country closed for almost two months and led to new government policy, including greater regulation around foreign exchange limitations.

Along with that was Egypt’s concern about monies owned by members and family of its former regime. It wanted certification that beneficiaries of the CAAT Pension Plan were not on Egypt’s freezing or seizure list. “We had to run through our entire list of beneficiaries of all the pension plan members—active and retired—and make sure they weren’t on Egypt’s list, and report to Egypt if we found any,” says Rorwick. While CAAT automated the checking procedure, several hundred potential matches still needed to be manually compared. The whole process took about two days. (Incidentally, CAAT did not have any members on the seizure list.)

Although an atypical example of a geopolitical challenge, the task was onerous. “And I’m not sure how often clients think about the geopolitical social
unrest that can come into play in these investment strategies,” says Baillie.

**A Word About Fees**

Typically, custodians charge clients higher fees for safekeeping assets and settling trades in emerging markets. Generally, this is because the capital markets infrastructure (trading, clearing, settling and holding investments) for these countries is not yet fully developed, making it more expensive to invest and trade, says Linda Bernard, senior vice-president, investor services, with Thomas Murray, a custodian watchdog. Logic suggests that fees should drop as the market becomes easier to navigate. “But as those markets evolve, the global custodians are not necessarily adjusting clients’ fees,” says Bernard. “When we’ve been asked to benchmark client fees, we see that—especially for emerging markets that have evolved—clients are paying fees that are not in line with current market rates.”

The reality, however, isn’t that simple, says Drynan. “It’s no secret that the interest rate environment for custodian banks has posed huge challenges. With that, there’s a greater reliance on custody fees, be it from subcustodian to custodian or custodian to client—these are things that all factor in,” he says. “So I wouldn’t say there’s any prescribed formula to custody fees going up or down based on a market evolution, but based on a lot of universal circumstances that need to be considered broadly.”

Because Citi’s emerging market subcustodians are, for the most part, Citibank branches, incremental costs for their subcustodians are lower, says Ahluwalia. The local subcustodian is a Citi branch in approximately 60 countries out of the more than 90 that Citi is in. “We feel that having a large subcustodial network, and being on the same global platform, gives us a benefit in speed, access and costs that we can pass on to our clients,” he says.

Whichever custodian a pension plan is working with, however, Rorwick says there is always room for fee negotiation. “Pension plans should negotiate aggressively with custodians to recognize any fee reductions as emerging markets evolve,” he says.

Investing directly in emerging markets (rather than investing through funds) isn’t the right decision for every pension plan. Aside from the investment risk, even the paperwork can be foreboding. In fact, one Northern Trust client began the process to invest in India but walked away as the initial process proved too long and onerous.

But other plans have seen that, with the right custodial help to reduce the logistical headaches, the benefits of taking a position in these markets can be worthwhile. “Yes, there is some time and effort involved in filing these [documents], and there is a registration fee involved in India, [for example],” says Cays. “But for a fund our size, those amounts and the time expended—we hope—are small relative to the amount of return that we could generate by being in a growing emerging country.”

Brooke Smith is managing editor of Benefits Canada. brooke.smith@rci.rogers.com