

# The Long and Winding Road

## Canadian Institutional Investing in an Unconstrained Environment

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# Top 10 Signs There is No Foreign Investment Limit

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10. Your Canadian Equity Manager is owned by an American firm
9. Global Schmobil.....We Got Oil
8. CBC and NBC combine to become CNBC
7. The S&P/TSX is now simply the S&P
6. President Bush's new ranch is in Calgary
5. Tim Horton's buys Starbucks
4. Everyone has 100% Global Portfolios.... Hey, that's what they pay us to say
3. The Canadian dollar has topped
2. Chairman Bernanke moves the BOC rate up a quarter
1. 50% of the S&P500 Index is composed of Income Trusts



## Topics

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- Current institutional perspective

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- Where are we going?

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- The next leg of the strategy cycle

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## A Quick History Lesson on the FPR

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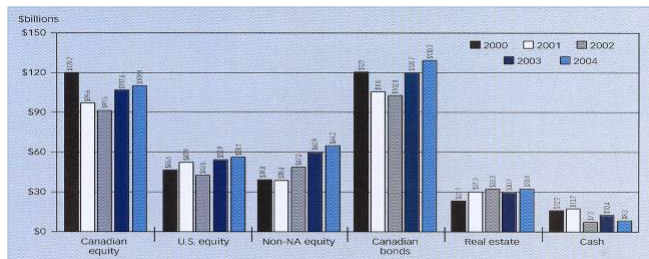
- Before December 1991
  - 10%
- After December 1991
  - 2% Increments to 20% in 1994
- 2000
  - 30%
- Current Mix
  - Sponsors and Managers

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## The Evolving Portfolio

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	1999	2000	2001	2002	2003	2004
<b>Canadian Equity</b>	<b>36.0%</b>	33.1%	29.5%	28.1%	27.9%	<b>27.1%</b>
<b>U.S. Equity</b>	<b>11.3%</b>	12.8%	14.8%	13.4%	14.5%	<b>14.4%</b>
<b>Non N. A. Equity</b>	<b>13.1%</b>	10.9%	11.4%	14.4%	15.8%	<b>15.9%</b>
<b>Canadian Bonds</b>	29.7%	33.3%	31.1%	31.6%	31.3%	32.3%
<b>Real Estate</b>	6.5%	6.4%	9.3%	10.2%	7.9%	8.3%
<b>Cash</b>	3.4%	3.5%	4.1%	2.2%	2.7%	2.1%



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Source : Benefits Canada's 2005 Survey of the Top 100 Pension Funds

## Surveys, Surveys, Surveys

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### Sponsors\*

- 72% Do Not Expect to Increase Foreign
- Less than 18% Invested Beyond Limit

### Managers\*\*

- 45% Do Not Expect to Increase Foreign

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\* AON Survey  
\*\* Mercer & AON Survey

## What's Wrong With This Picture?

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**What - Me  
Worry?**

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## What's Going On?

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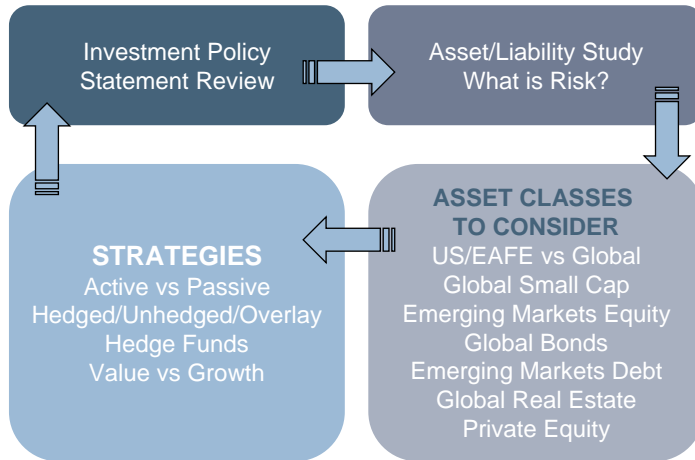
- Home country bias
- Manufacturing ownership structures
- Canadian equity market performance

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## Where Are We Going?

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### For Consultants – “Ka-Ching”



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## Where Are We Going?

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### For Sponsors

- Canada is 2 – 3% of “World Markets”
- Major Red Herring Issue
  - “Our Liabilities Are In Canadian Dollars”
- Reflects
  - Asset/Liability Misunderstanding
  - Investment Decision Making Naivety

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# Asset/Liability Misunderstanding

## Optimization Models are Based on...

- Expected Returns
- Risks
- Correlations

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# Asset/Liability Misunderstanding

Period of Analysis: 1970 - 2004

## Nominal Annualized Returns

	CPI (%)	Cash (%)	Bonds (%)	Canadian Equities (%)	Global Equities (%)
Annualized Returns	4.8	7.7	9.7	10.0	10.9
Annualized Risk (Standard Deviation)	1.5	1.1	6.4	16.5	13.9

## Correlations

	Cash	Bonds	Canadian Equities	Global Equities
Cash	1.00			
Bonds	0.03	1.00		
Canadian Equities	-0.06	0.27	1.00	
Global Equities	-0.02	0.20	0.68	1.00

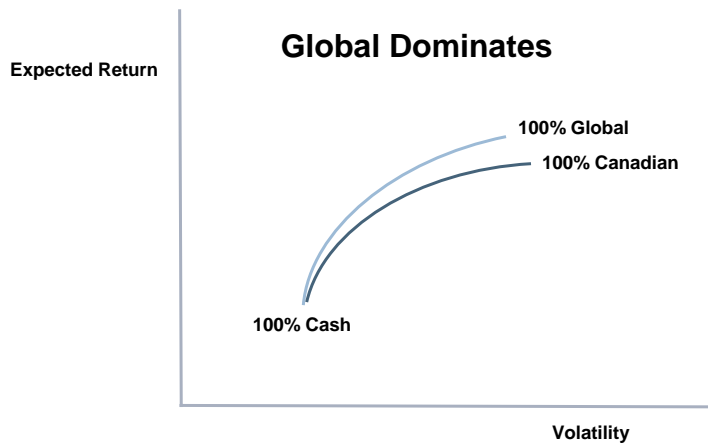
**Note:** Asset Classes are requested as follows:  
 Cash = Canadian Treasury Bill Rate  
 Canadian Equities = S&P/TSX  
 Bonds = SC Universe  
 Global Equities = MSCI World

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# Asset/Liability Misunderstanding

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## “Classic” Asset Only Optimization Results

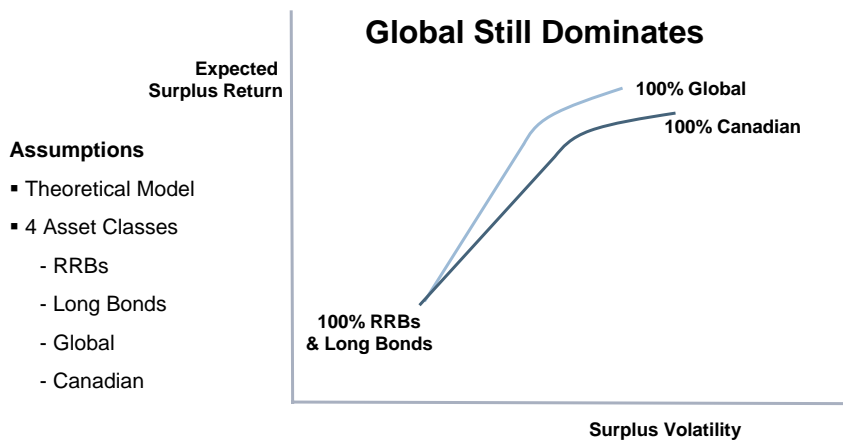


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# Asset/Liability Misunderstanding

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## Asset/Liability Optimization



### Assumptions

- Theoretical Model
- 4 Asset Classes
  - RRBs
  - Long Bonds
  - Global
  - Canadian

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## Asset/Liability Misunderstanding

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Are Canadian Equities Significantly Better Correlated  
with Canadian Liabilities than Global Equities?

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No!

- Risk minimizing solution – Long Bonds & RRBs
- Equities create a mismatch
- What will improve the odds of “beating” actuarial assumptions?

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## Investment Decision Making Naivety

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Cognitive Error

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- “Allowance” phenomenon
- Saving for spending or saving for saving?

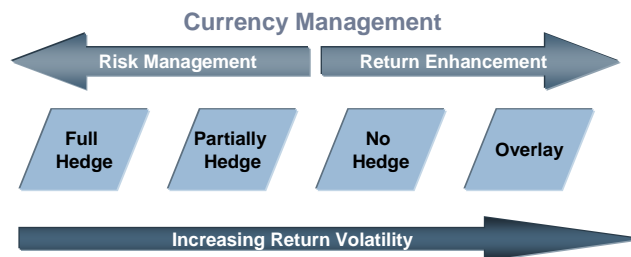
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## Investment Decision Making Naivety

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### Mis-Specification of the Problem

- The currency issue is multi-dimensional
  - Expected Return
  - Risk
  - Correlation



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## The Currency "Red Herring Issue"

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### What Drives Exchange Rate Values?

"...the international finance profession has not yet been able to produce theories and, as a consequence, empirical models that allow us to explain the behaviour of exchange rates with a reasonable degree of accuracy".

Source: "Viewpoint: Towards a Solution of the Puzzles in Exchange Rate Economics: Where Do We Stand?" by L. Sarno, Canadian Economics Association, August 2005, page 674

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## Where Would You Prefer to Invest?

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### Sector Concentration Risk is Large

Sector Weights: World vs Canada

	MSCI World	S&P/TSX		MSCI World	S&P/TSX
<b>Energy</b>	<b>10.25</b>	<b>27.07</b>	<b>Health Care</b>	<b>10.39</b>	<b>1.32</b>
Energy	10.25	27.07	Health Care Equip. & Services	3.12	0.43
<b>Materials</b>	<b>5.40</b>	<b>14.27</b>	Pharmaceuticals & Biotech.	7.27	0.89
Materials	5.40	14.27	<b>Financials</b>	<b>23.88</b>	<b>30.77</b>
<b>Industrials</b>	<b>10.24</b>	<b>5.60</b>	Banks	11.26	18.60
Capital Goods	7.46	1.70	Diversified Financials	6.27	3.84
Commercial Services	0.84	0.38	Insurance	4.51	7.98
Transportation	1.94	3.52	Real Estate	1.84	0.36
<b>Consumer Discretionary</b>	<b>11.79</b>	<b>6.34</b>	<b>Information Technology</b>	<b>11.03</b>	<b>4.70</b>
Automobiles & Components	2.12	1.00	Software & Services	3.56	0.91
Consumer Durables & Apparel	2.12	0.39	Semiconductors & Semiconductor Equipment	2.01	0.37
Hotels, Restaurants & Leisure	1.47	0.65	Technology Hardware & Equipment	5.45	3.43
Media	3.25	3.23	<b>Telecommunications Services</b>	<b>4.45</b>	<b>4.73</b>
Retailing	2.83	1.05	Telecommunications Services	4.45	4.73
<b>Consumer Staples</b>	<b>8.36</b>	<b>3.64</b>	<b>Utilities</b>	<b>4.22</b>	<b>1.56</b>
Food & Staples Retailing	2.13	2.97	Utilities	4.22	1.56
Food, Beverage & Tobacco	4.74	0.67	<b>Top 3 Sectors</b>	<b>46.70</b>	<b>72.11</b>
Household & Personal Products	1.49	0.00	<b>Bottom 3 Sectors</b>	<b>14.07</b>	<b>6.52</b>

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## Where Would You Prefer to Invest?

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### Benchmark Concentration Risk is Large

Top 10 Stocks – The World

MSCI All Country	Index %	Sector
Exxon Mobil Corp	1.8	Energy
General Electric Co	1.6	Industrials
BP	1.1	Energy
Microsoft Corp	1.1	Information Technology
Citigroup	1.1	Financials
Johnson & Johnson	0.9	Health Care
Pfizer	0.8	Health Care
HSBC Holdings (GB)	0.8	Financials
Bank of America Corp	0.8	Financials
Vodafone Group	0.8	Telecommunications
<b>Top 10</b>	<b>10.9</b>	

Top 10 Stocks – Canada

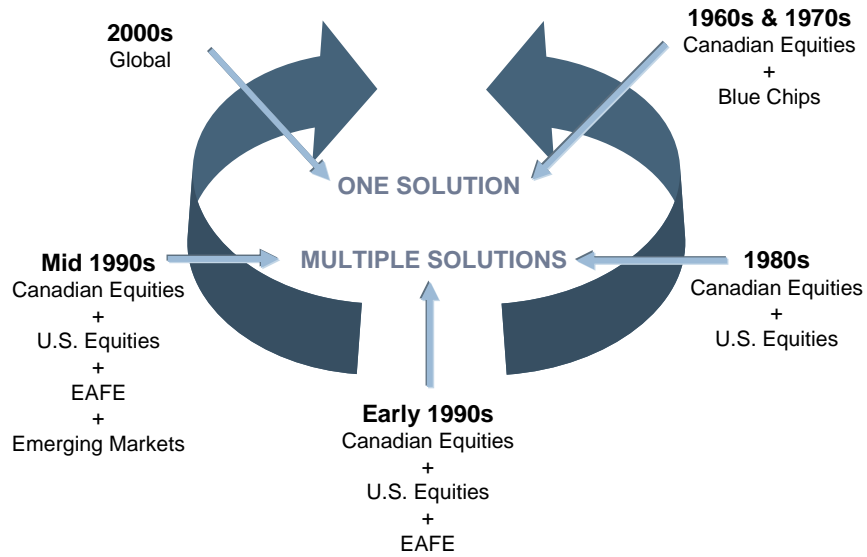
MSCI All Country	Index %	Sector
Encana Corp	5.3	Energy
Royal Bank of Canada	5.0	Financials
Manulife Financial	4.5	Financials
Bank of Nova Scotia	3.9	Financials
Toronto-Dominion Bank	3.7	Financials
Suncor Energy Inc	2.9	Energy
BCE Inc	2.7	Telecommunications
Bank of Montreal	2.6	Financials
Canadian Natural Resource	2.6	Energy
Sun Life Financials	2.3	Financials
<b>Top 10</b>	<b>35.5</b>	

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As at September 2005

# The Strategy Cycle

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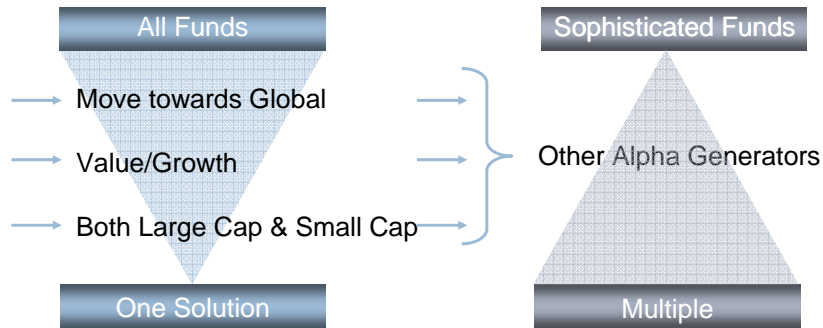


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# The Next Leg on the Strategy Cycle

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## For Equities



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## The Next Leg on the Strategy Cycle

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Sophisticated Funds Focusing on Beta Reducers & Alpha Enhancement Strategies including:

	Alpha Enhancer	Beta Reducer
Global Small Cap	✓	
Global Fixed Income	✓	✓
Emerging Markets Debt	✓	✓
Global REITs/Real Estate		✓
Private Equity/Infrastructure		✓

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## Global Portfolio Holes

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What We Know about Equity Asset Pricing

- Average stock returns are explained by a 3-factor model
  - Market factor
  - Style factor
  - Size factor

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## Global Portfolio Holes

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### Conventional Approach to the Global Allocation Question

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- Typical non-domestic institutional choices
- Global
- U.S. and international
  - ⇒ Possible U.S. Small Cap

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## A Global Small Cap Allocation Because...

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- There is a Size Effect
- Compelling Potential for Alpha Persistence
- Broaden out Opportunity Set
- Diversify Sources of Excess Returns
- Limited Competitors

*...a leading edge strategy*

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## There is a Size Effect Around the World

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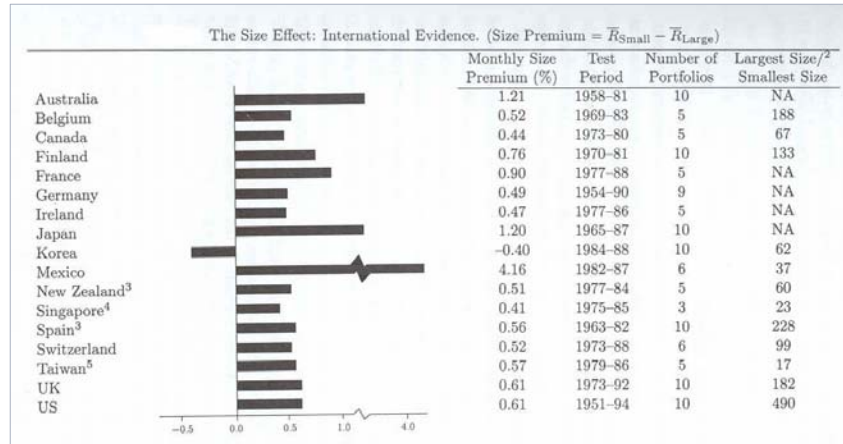


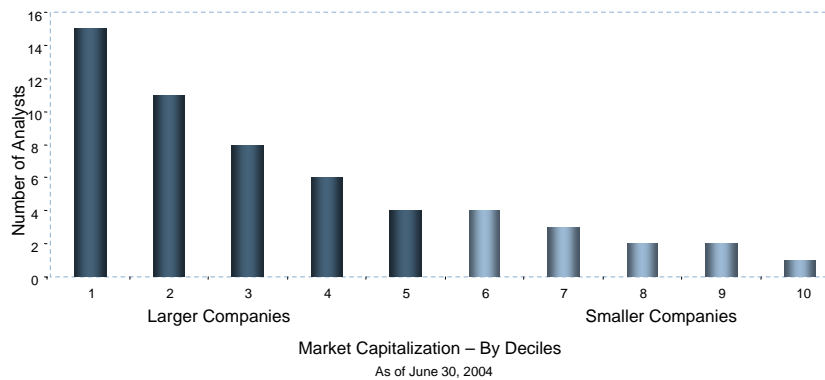
Chart Source : Security Market Imperfections in World Wide Equity Markets, published by Cambridge University Press, 2000, Part 1, The Cross Section of Common Stock Returns: A Review of the Evidence and Some New Findings, by Gabriel Hawawini and Donald B. Keim, Page 11, Table 2,

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## Why the Small Cap Alpha Potential Will Persist

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### Small Companies are Under-Researched



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Source: FactSet Universal Screening

## Broaden Out Opportunity Set...

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- Increased Exposure to Global Equity Universe
- More Stocks/More Countries

	S&P Citigroup World <US\$2B Index	MSCI Global Index
Number of Securities	6,789	2,019
Number of Countries	62	22
Market Capitalization Weighted Average	1.28*	68.78*

\* In Billions

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## Not An Emerging Markets Bet

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Major Country Holdings as of August 31, 2005

Country	Small Cap Index	Large Cap Index
United States	45.45	52.57
Japan	15.01	9.86
United Kingdom	7.44	11.43
Canada	6.60	3.39
Australia	4.17	2.34
South Korea	2.54	-
France	1.81	4.25
Germany	1.61	3.03
Netherlands	1.59	1.47
Hong Kong	1.39	0.77
Switzerland	1.37	2.99
Sweden	1.36	1.06
Italy	1.22	1.76
Singapore	1.17	0.38
Finland	1.17	0.64
Spain	0.96	1.71
Denmark	0.84	0.36
Norway	0.79	0.35
Belgium	0.63	0.59
Greece	0.46	0.27
New Zealand	0.41	0.10
Bermuda	0.16	-
Slovenia	0.09	-
Portugal	0.09	0.13

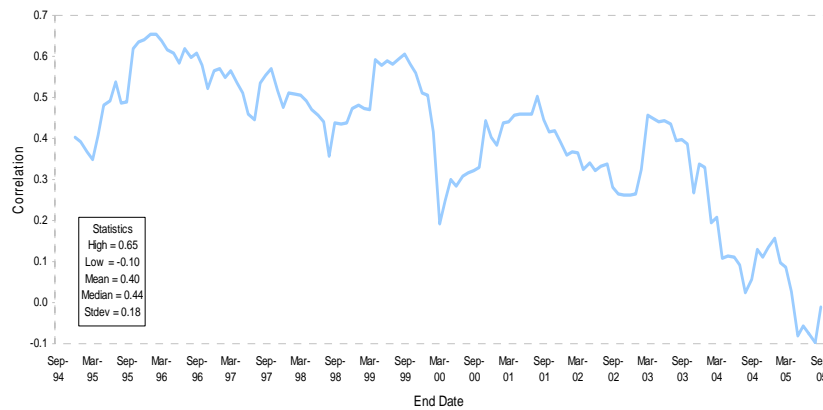
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## Diversify Sources of Excess Returns

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### Cap Factor More Important than Style Factor at Times

ABC Global Small Cap vs. ABC Global Large Cap



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Source: Factset Research Systems Inc., as of June 2005

## Global Fixed Income Opportunities Galore

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Strategy	Benchmark	Approx. Duration (yrs)	Excess Return Target
Global Aggregate	LB Global Aggregate	4.8	100-200 bps
Global Credit	LB Global Credit	5.0	75-125 bps
Global Sovereign	Citigroup WGBI	5.8	100-175 bps
Global Inflation Linked	Barclays Global Inflation Linked	9.0	75-100 bps
European Aggregate	LB European Aggregate	5.1	75-100 bps
Emerging Markets	JP Morgan EMBI Global Diversified	3.0	LIBOR + 500 bps
U.S. Low/Intermediate Duration	ML 1-3 G/C, LB Intermediate G/C	1.5	75-100 bps
U.S. Core	LB US Aggregate	4.3	75-100 bps
U.S. Core Plus	LB US Aggregate	4.3	100-150 bps

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## Fixed Income...No Longer Boring

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### Fixed Income Market Comparisons

	Lehman Global Aggregate	Scotia Capital Universe
Market Cap (Cdn Bn)	24,894.08	601.44
# Securities	10,037	944
# Corp Issues	4,904	555
# Countries	57	1
# Currencies	22	1

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## Diversification Benefits of Global Fixed Income

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### Low Correlation to Other Assets

	SCU	S&P/TSX	S&P 500	MSCI EAFE	MSCI World
<b>Scotia Capital Universe</b>	1.00	0.20	0.14	0.11	0.13
<b>Citigroup WGBI</b>	0.24	-0.23	0.00	0.32	0.21
<b>Citigroup WGBI Hedged</b>	0.23	-0.27	0.12	0.11	0.12

Data from July 1985 – June 2005 Inclusive

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Sources: Citigroup, Merrill Lynch, Scotia Capital, S&P, MSCI, and Lehman Brothers

## Global REIT's

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### Potential for Further Risk Reduction

	Stocks	Bonds	Private RE	REITs
Stocks	1.00			
Bonds	0.34	1.00		
Private RE	0.12	-0.17	1.00	
REITs	0.26	0.32	-0.8	1.00

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Source: Ibbotson, based on 1980-2000 data

## Questions & Answers

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- DC Lifestyle/Lifepoint Programs?
- "Traditional" Balanced Managers?
- Outstanding opportunities
  - Global Small Cap
  - Global Fixed Income
  - Emerging Markets Debt
  - Private Equity/Infrastructure
  - Global REITs/Real Estate
- How long does it take to change a paradigm?

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# Thank You

## What is Emerging Market Debt?

- Emerging Market Debt primarily represents claims on cash flows of governments in “developing” markets
- Market reborn in 1990 following a 50 year absence
- Bonds issued by countries with low or middle income per capita
- Initially, all bonds were denominated in “hard” currencies (USD, EUR, JPY, etc.)
- Bonds denominated in local currencies have become increasingly important
- Bonds denominated in local currencies have become increasingly important