

December 19, 2007

ECONOMIC INDICATORS Canada

	Dec. 2006	Nov. 2007	
GDP ⁽¹⁾	2.8	2.9 ⁽²⁾	↗
CPI ⁽¹⁾	1.6	2.4 ⁽³⁾	↗
Unemployment	6.1	5.9	↘

United States

	Dec. 2006	Nov. 2007	
GDP ⁽¹⁾	2.9	2.9 ⁽²⁾	-
CPI ⁽¹⁾	3.2	4.3	↗
Unemployment	4.5	4.7	↗

(1) Year-over-year % variation
(2) September 2007 (3) October 2007

Sources: Statistics Canada, U.S. Dept. of Commerce, U.S. Dept. of Labor Statistics.

EQUITY INDICES

% Change	2007 in local currency	2007 in C\$	
S&P/TSX	5.9	5.9	↗
S&P500	3.5	-10.3	↘
Russell 2000	-4.3	-17.1	↘
Nikkei	-11.5	-19.4	↘
S&P 350 Europe	-0.5	-6.0	↘

INVESTMENT POLICY AND ALPHA

Last week, we noticed an insightful article in the Benefits Canada magazine (a standard reading for pension executives) by Robin Pond, a partner at the major pension consulting firm Morneau Sobeco.

The author explains at length the typical pension plan process for building an asset mix policy. The first step is to determine the required rate of return to provide for present and future pensions, given the plan's total assets and regular contributions from the employer and active employees. The second step is to adjust the portfolio's asset mix policy to align its expected return with the required rate of return.

For example, let's imagine a pension plan with a required long-term return of 6.50%, and a 60% equity / 40% bond policy asset mix. The author assumes that equities can be expected to return 7%, versus 4% for bonds. The plan's expected return would be the weighted average of equity and bond expected returns, or 5.80%. We therefore have a return shortfall of -0.70% (5.80% - 6.50%).

The most straightforward way to bridge this return shortfall is to increase the equity weight to 83%, which would enhance the expected return to 6.50%. The problem is that such an aggressive asset mix would result in a portfolio volatility that is far in excess of what most pension sponsors are willing to accept. So, a number of pension plans simply bridge the return shortfall by assuming that their investment managers will produce an excess return over the market, or "alpha" in investment jargon.

The author deems this practice inappropriate, and we agree. The problem with alpha is that all investors cannot beat the market at the same time: an investor's excess return must be achieved at the expense of another investor. Pension funds cannot expect to collectively do better than mimic the market's performance. The author concludes: "One of the most unrealistic aspects of the pension industry is that every pension plan sponsor expects to outperform the market".

From this analysis, we draw our own conclusions for individual investors. First, every investor should have quantified financial goals, which are necessary to determine the required rate of return of their portfolio. Secondly, if the current asset mix leads to a return shortfall, the investor faces three alternatives: increasing the risk (and expected return) of the portfolio; increasing his savings or reducing his financial objectives. But certainly, relying on a positive alpha return is not the solution.

This was the last Economic Pulse for 2007. We wish our readers a very happy holiday season. The Pulse will resume its tenth year in January.

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