



Pension Watch

A CUMIS Life Insurance Company Publication

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The last edition... of Pension Watch we looked at defining “Risk”.
This edition looks at “How to Manage a Portfolio”.

How to Manage a Portfolio

Markets by nature will always fluctuate in price. Movement in price can be emotional for some investors, and leave them wondering how to react to changes, and re-structure an asset mix to reflect future concerns.

The concept of asset allocation within an investment portfolio is often misunderstood. Many people think it means diversification, commonly known as ‘not having all your eggs in one basket’. In fact, asset allocation deals more with the proper mix of assets in your portfolio. Common types of assets are cash, fixed income, and equities. To determine the correct asset allocation the investors must consider their long run objectives and their comfort with risk, and then manage the mix through market fluctuations.

One approach to managing asset allocation involves attempting to shift assets in anticipation of market changes, trying to ‘out-guess’ the market. Equities, bonds or cash may be shifted dramatically based on predicted changes in markets. But attempting to guess or predict market changes, and alter a portfolio mix in anticipation of such changes, rarely boosts returns. Trying to be a ‘market-timer’ — moving in and out of investments as market conditions change on a short-term basis — could in fact have a serious negative effect on your portfolio performance. Overwhelming evidence indicates that market-timing is not an effective way to increase returns. One study concluded that an investor would have to be right on a market forecast 75% of the time just to break even after the cost related to miss-timing and transaction fees.

A different asset allocation technique known as ‘strategic asset allocation’ provides a more managed approach, with a successful long-term record.

Strategic asset allocation is a process of deciding which asset classes will be included in a portfolio and determining the target percentage to allocate to each asset class. The mix is then

adjusted to the targets as the asset values fluctuate over various market cycles. The objective is to determine an asset mix that has a high probability of meeting an investor’s return requirements within a level of risk they are willing to accept.

Prior to determining their asset allocation, investors need to review their investment goals and their risk profile. The goals of investors vary and as a result so will asset allocations. Your age and stage of life are important when considering the ability to absorb risk. A younger person who does not need the capital for a long period of time is in much better position to recover from a possible decline in the future.

Strategic Asset Allocation

- Strategic asset allocation determines the long-run asset mix. The asset mix is the most important factor in achieving long-run returns and therefore should be addressed with care.
- Strategic asset allocation is based on long-run expectations of returns of cash, bonds and equities.
- The strategic asset mix is not influenced by short-term fluctuations in the markets.
- Each asset mix considered in a strategic analysis represents a different level of risk. A lower tolerance of risk should translate into a more conservative asset mix.
- Strategic asset allocation differs from a buy-and-hold strategy because transactions are required to rebalance the asset mix as financial market movements change relative asset values in the portfolio.

The process of rebalancing a portfolio on a regular basis is key to successful strategic asset portfolio management. It is not enough just to establish an appropriate mix, and then ignore the portfolio. The key is to analyse the mix once or twice per year, or after dramatic market changes. Asset classes that have shifted from the targets should be rebalanced by buying or selling to re-align the mix within the established guidelines.

CUMIS

RETIREMENT SERVICES

PERFORMANCE COMPARISON

For The Period: Ending March 31, 2003	3 Months %	1 Year %	3 Year %	5 Year %	10 Year %
ACTIVELY MANAGED FUNDS					
Balanced Fund	-4.1	-11.6	-2.8	1.5	8.0
Canadian Equity Fund	-4.3	-18.8	-5.5	0.4	9.5
Overseas Equity Fund ^{(1) (2)}	-15.3	-30.4	N/A	N/A	N/A
U.S. Equity Fund ⁽²⁾	-9.3	-31.7	-15.6	-6.5	7.0
Dividend Income Fund ⁽³⁾	-3.7	-12.8	10.6	8.2	16.7
Short-Term Bond & Mortgage Fund	-0.1	7.1	7.3	6.3	N/A
Bond Fund	-0.3	10.1	8.3	6.8	8.8
Canadian Money Market Fund	0.7	2.7	4.0	4.4	4.8
CUMIS FUND					
Retirement Security Fund	5.9 ⁽⁴⁾	5.9	6.4	6.8	7.5
PASSIVELY MANAGED FUNDS					
S&P/TSE Composite Index Fund ⁽⁵⁾	-3.5	-17.5	-11.0	-1.8	N/A
U.S. Equity Index Fund ^{(2) (6)}	-10.3	-30.7	-16.1	-3.3	N/A
EAFE Equity Index Fund ^{(2) (7)}	-14.7	-29.5	-19.1	-6.3	N/A
Universe Bond Index Fund ⁽⁸⁾	0.7	9.2	7.7	6.2	N/A
Conservative Balanced Index Fund ⁽⁹⁾	-4.3	-6.9	-2.2	2.0	N/A
Moderate Balanced Index Fund ⁽¹⁰⁾	-4.9	-11.5	-5.5	1.3	N/A
Aggressive Balanced Index Fund ⁽¹¹⁾	-5.6	-16.5	-9.3	-0.6	N/A
INDICES					
S&P/TSX Composite Index	-3.5	-17.6	-11.1	-1.9	7.8
S&P 500	-9.8	-30.5	-15.7	-3.1	10.2
MSCI EAFE	-14.5	-29.4	-19.2	-6.5	3.6
ScotiaMcLeod Universe	-0.7	9.2	7.6	6.2	8.4
30 Day T-bills	0.7	2.6	3.8	4.2	4.4

(1) Overseas Equity Fund merged with Euro-Pacific Equity Fund March 9, 2001

(2) Subject to Canada Customs and Revenue Agency Foreign Content Limit of 30%

(3) Only available under group RSP and DPSP contracts

(4) Annualized

(5) Fund Inception: October 1999. Performance prior to November 1999 is for TSE 300 Equity Index Fund

(6) Fund Inception: January 2000. Performance prior to February 2000 is for Barclays U.S. Equity Index Fund - Canada

(7) Fund Inception: June 1999. Performance prior to July 1999 is for EAFE Equity Index Fund B

(8) Fund Inception: October 1999. Performance prior to November 1999 is for Universe Bond Index Fund

(9) Fund Inception: August 1999. Performance prior to September 1999 is modeled using the benchmark asset mix and index returns

(10) Fund Inception: June 1999. Performance prior to July 1999 is modeled using the benchmark asset weights and index returns

(11) Fund Inception: August 1999. Performance prior to September 1999 is modeled using the benchmark asset weights and index returns

NEWS FROM THE GOVERNMENT

Old Age Security

Old Age Security (OAS) benefit rates are increased for the April to June 2003 quarter.

Basic OAS benefits, paid to people age 65 and over, are \$456.08 per month. The Guaranteed Income Supplement is \$542.03. The Spouse's Allowance and the Widowed Spouse's Allowance are increased to \$809.14 and \$893.31 respectively for the April to June 2003 quarter.

Federal Budget 2003

On February 18, 2003, Finance Minister John Manley tabled the 2003 federal budget (the Budget). This Budget, which has been widely characterized as setting out Prime Minister Chretien's legacy, contains provisions of interest to retirement plan sponsors, including:

- Increases to existing registered pension plan (RPP) and registered retirement savings plan (RRSP) limits; and
- New registered retirement income fund (RRIF) type payouts from money purchase RPPs.

RPP and RSP Limits

The budget proposes the following increases in the RRSP and RPP limits:

- The money purchase RPP limit will be increased to \$15,500 for 2003, \$16,500 for 2004 and \$18,000 for 2005. Corresponding increases will be made to the maximum pension limit of \$1,722.22 per year of service for defined benefit (DB) RPPs, thus raising the limit to \$1,833 in 2004 and \$2,000 in 2005. The DPSP limit will remain at one-half of the money purchase RPP limit.
- The RRSP limit will be increased to \$14,500 for 2003, \$15,500 for 2004, \$16,500 for 2005 and \$18,000 for 2006.
- The RPP and DPSP limits will be indexed to average wage growth starting in 2006, and the RRSP limit will be indexed starting in 2007.

The proposed RPP/RRSP limits are summarized on the next page. It appears that as the maximum accrual limits for DB RPPs are phased in, they will be effective for all years of service for individuals who retire after the effective dates.

Under many plan documents, the maximum pension limit is written to refer to the DB limit under the Income Tax Act (ITA), so the limit in the plan will increase automatically if the DB limit under the ITA is revised. If the plan simply provides that the maximum DB limit is \$1,722.22, the plan sponsor will need to amend the pension plan if the decision is made to pass the permitted increase on to current plan members for both past and future service.

The Budget documents state that the rule for calculating past service pension adjustments under defined benefit RPPs will be modified to provide an exclusion for benefit increases arising directly as a result of increase to the maximum pension limit. However, where the increase is deferred to a future plan amendment, it is not clear if this amendment will have to be made within a specified period in order to fall under this exclusion.

Furthermore, organizations with Supplementary Employee Retirement Plans (SERPs) which top up RPPs may find that their SERP falls under the definition of a pension plan under the provincial pension standards legislation if the RPP has maximum benefit limits which are lower than those introduced in the Budget documents.

Plan sponsors should also be aware that a retroactive increase in the maximum DB pension limit to \$2,000 by 2006 could have significant financial impact on RPPs both from a funding (i.e. cash contribution) and accounting standpoint. The magnitude of the increase in funding requirements and pension expense will depend on:

- How generous a pension formula each plan has;
- The number of plan members who are currently impacted by the ITA limits; and
- Whether there is a top-up SERP against which the RPP acts as an offset.

A retroactive increase in the maximum allowable pension can have a particularly significant cost impact in the case of a high earning individual with long service. Plan sponsors should also be aware that the commuted value of benefits for employee terminations after the Budget date may also increase depending on plan language, creating a windfall for some employees.

Many employees and most employers will be pleased that the government has recognized that RPP/RRSP limits are too low, and has taken steps to address the problem. However, the net result will increase the maximum earnings that can be fully tax-sheltered in generous RPPs from \$86,111 to only \$100,000 in 2005. This still does not compare favourably with the U.S. (U.S. \$200,000) or the UK (£97,200). Furthermore, restrictions on RRSP savings limits for well over a decade have inhibited the ability of baby boomers to accumulate retirement income during their prime working years.

RRIF-Type Payouts from Money Purchase RPPs

Members of money purchase RPPs generally have two options on retirement. They can purchase a life annuity with their money purchase account or they can transfer the account to an RRSP or a registered retirement income fund (RRIF).

To provide increased flexibility on retirement the Budget proposes to allow money purchase RPPs to pay pension benefits in the form of the same income stream currently permitted under a RRIF. This measure will allow money purchase plan members to choose to benefit from the flexibility a RRIF offers without having to assume greater responsibility for investment decisions or to pay higher investment fees typically charged on individual plans.

A member will be required to withdraw from their money purchase account a minimum amount each year beginning no later than the year in which they attain age 70. The minimum amount will be determined in accordance with the existing rules that apply to RRIFs.

This measure will also permit the transfer of funds back into a pension plan by former members who had previously transferred

their money purchase account to an RRSP or, RRIF, subject to the new RRIF-type payout requirement.

These changes are permissive only and plan sponsors will be able to choose whether they wish to adopt these provisions. Plan sponsors and administrators may also be wary of assuming additional responsibility and fees to accommodate retired or terminated employees.

The proposed changes will apply after 2003, however, it remains to be seen whether provincial pension legislation will be amended to allow for partial payouts directly from DC RPPs.

Tax Pre-Paid Savings Plans

In representations to government, certain groups proposed the creation of tax pre-paid savings plans (TPSPs). In a TPSP, no deduction is provided on contributions (in this sense, the income tax on contributions is pre-paid), but the investment income in the plan and withdrawals are not subject to tax.

The government intends to review and consult with respect to these issues in order to assess whether TPSPs could be a useful and appropriate mechanism to provide additional savings opportunities for Canadians.

	Money Purchase RPP Contribution Limits	RRSP Contribution Limits	Defined Benefit Maximum Pension Benefit
2003	\$15,500	\$14,500	\$1,722
2004	16,500	15,500	1,833
2005	18,000	16,500	2,000
2006	18,000*	18,000	2,000*

* Indexed to average wage growth

The RRSP limit will be indexed to average wage growth starting in 2007.

Pension Watch is intended to provide general information only.
It is not intended to provide specific advice or recommendations for any individual.

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