



Pension Watch

August 2003

The last edition... of Pension Watch we looked at “How to Manage a Portfolio”.
This edition looks at “Questioning a Retirement Rule of Thumb”.

Questioning a Retirement Rule of Thumb

The world of investing includes a number of financial formulas, some referred to as a “rule of thumb”, which investors may follow. One rule of thumb that should be questioned, however, relates to the adjustment of asset mix when a person enters retirement.

This rule says an asset mix at retirement should be shifted more toward fixed income investments (bonds) and away from equities based a percentage formula of “100 minus your age”. Using this basic formula, a portfolio for someone aged 65 should shift to 65% bonds and 35% equities. By age 70, the person would have 70% bonds and 30% equities; by age 80, it would be 80% bonds and 20% equities.

While some circumstances may direct such a shift in asset mix, the reasoning behind the change should have little to do with following a simplistic rule of thumb, and more to do with proper portfolio construction. A “one-size fits all” formula may provide the wrong investment approach and in fact may be a disservice to the investor.

Why? For one reason, if an investor is comfortable with equity investments – and experienced in their fluctuations – maintaining a healthy equity component may be the best investment approach, regardless of age. Equities provide the basis for investment growth, an important consideration for retirees since they should strive to maintain the purchasing power of their capital over inflation.

The second reason is our average life span continues to increase – we are living longer. In fact, a 65 year old female can expect to live to age 85, while a man’s average life expectancy is 80. This may represent 15 to 20 years or more past normal retirement age. Such a time frame is considered adequate for ownership of equity investments.

The time frame grows even further with couples and where investments “roll-over” to the surviving spouse upon death. In the case where investments roll-over to a younger wife, the time frame

may be longer indeed, due to the tendency for females to live longer than males. Another reason to question the formula is that bonds can be almost as volatile, and in some time periods more volatile, than equities. A reliance on bonds in an effort to dampen volatility may prove to be erroneous, and in fact lead to greater fluctuation, as compared with a more appropriate asset mix.

A portfolio should be built based on a number of considerations, one of which is anticipated returns. At some points in an economic cycle, interest rates may be expected to trend up or down. The exposure to bonds should be influenced by the anticipated trend and expected risk and return.

A balanced portfolio has about 35% to 45% bonds, an allocation that has been found to be effective in achieving diversification, income, and lower volatility. While this may be a good range for many, a portfolio allocation should be based on other considerations.

The proper asset mix for an individual investor should be based on personal objectives, cash flow needs, liquidity needs for short-term expenditures, time frame, risk tolerance, and preferences on tax considerations. A mix should be established and monitored to be effective – rather than relying on a simple rule of thumb.



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RETIREMENT SERVICES

PERFORMANCE COMPARISON

For The Period: Ending June 30, 2003	3 Months %	1 Year %	3 Year %	5 Year %	10 Year %
ACTIVELY MANAGED FUNDS					
Balanced Fund	8.1	2.7	-1.6	3.1	8.4
Canadian Equity Fund	10.1	0.7	-4.5	2.5	9.9
Overseas Equity Fund ^{(1) (2)}	10.1	-16.3	N/A	N/A	N/A
U.S. Equity Fund ⁽²⁾	6.3	-11.5	-13.4	-5.9	7.5
Dividend Income Fund ⁽³⁾	12.0	6.8	10.3	10.3	17.1
Short-Term Bond & Mortgage Fund	3.1	7.9	7.8	6.8	N/A
Bond Fund	5.0	12.1	9.2	7.5	8.9
Canadian Money Market Fund	0.8	2.9	3.8	4.4	4.7
CUMIS FUND					
Retirement Security Fund	5.8 ⁽⁴⁾	5.9	6.3	6.7	7.4
PASSIVELY MANAGED FUNDS					
S&P/TSE Composite Index Fund ⁽⁵⁾	10.6	-0.2	-10.3	0.6	7.8
U.S. Equity Index Fund ^{(2) (6)}	6.7	-10.6	-14.0	-3.4	N/A
EAFE Equity Index Fund ^{(2) (7)}	10.3	-16.3	-15.8	-5.4	N/A
Universe Bond Index Fund ⁽⁸⁾	5.0	11.1	8.8	6.9	N/A
Conservative Balanced Index Fund ⁽⁹⁾	6.2	1.9	-1.0	3.0	N/A
Moderate Balanced Index Fund ⁽¹⁰⁾	7.8	0.4	-4.2	2.7	N/A
Aggressive Balanced Index Fund ⁽¹¹⁾	8.8	-2.1	-8.0	1.1	N/A
INDICES					
S&P/TSX Composite Index	10.6	-0.3	-10.4	0.5	7.8
S&P 500	6.6	-10.3	-13.7	-3.1	10.7
MSCI EAFE	10.2	-16.3	-16.0	-5.5	3.4
ScotiaMcLeod Universe	5.1	11.3	8.8	6.9	8.5
30 Day T-bills	0.8	2.8	3.6	4.1	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 July to October 2003 quarter.

Basic OAS benefits, paid to people age 65 and over, are \$461.55 per month. The Guaranteed Income Supplement is \$548.53. The Spouse's Allowance and the Widowed Spouse's Allowance are increased to \$818.85 and \$904.03 respectively for the July to October 2003 quarter.

New Unlocking Provisions in Alberta

On May 14, 2003, Alberta amended the Employment Pension Plans Regulation (the "Regulation") to permit unlocking of pension funds for reasons of financial hardship. The newly added Section 41.1 applies only to a Registered Retirement Savings Plan established before 1987, a Locked-in Retirement Account, a Life Income Fund, or a Locked-in retirement Income Fund that is subject to the provisions of the Alberta Employment Pension Plans Act (the "Act") and the Regulations. It does not authorize withdrawals of locked-in money that has not been transferred out of a Registered Pension Plan.

The Alberta Ministry of Finance implemented the new unlocking provisions in response to requests from persons in financial hardship. According to the Alberta Ministry of Finance, the new Regulation was modeled on hardship unlocking provisions in Ontario. However, an analysis of the Alberta Regulation reveals subtle yet significant differences from the provisions originally enacted by Ontario.

To unlock funds, the plan holder must both complete an Application for Access to Alberta Locked-in Funds due to Financial Hardship and provide the supporting documentation described in the Act. Funds may be unlocked if financial hardship is demonstrated according to one or more of the following eight criteria:

- Risk of eviction, for the individual or spouse/pension partner, from a principle residence due to rent arrears;
- Risk of mortgage foreclosure for the individual or spouse/pension partner;
- Requirement for first and last months' rent for the individual or spouse/pension partner;
- Uninsured medical and dental expenses to treat an illness or disability of the individual or spouse/pension partner;
- Requirement to make alterations to a home to accommodate a disability of the owner, spouse/pension partner, or dependent;

- Expected income is less than two-thirds of the current Year's Maximum Pensionable Earnings (YMPE);
- Requirement for funds to pay income tax arrears; or
- Any financial hardship that the Alberta Superintendent of Financial Institutions deems sufficient to justify unlocking of funds.

As noted above, Alberta's new unlocking provisions resemble many aspects of those introduced by Ontario in May 2000. For example:

- The unlocking criteria are substantially the same in both provinces and take into account financial hardship of the fund holder, his or her spouse/pension partner or dependent;
- The maximum amount that may be withdrawn because of low anticipated income in both jurisdictions is \$19,950 (50% of YMPE for 2003), minus 75% of the plan holder's expected income for the 12 months following the date of application. This means if a plan holder's income is equal to or exceeds \$26,600 (two-thirds of YMPE for 2003), no withdrawal may be made; and
- Both provinces permit amounts to be withdrawn as a lump sum or in monthly installments.

However, there are also several significant differences between the approaches taken in Ontario and Alberta:

- Ontario does not allow unlocking to pay income tax arrears, nor does it grant discretion to the Superintendent of Financial Institutions to unlock funds for reasons other than those specifically enumerated in the regulations;
- The Alberta application warns applicants that a withdrawal of funds from a locked-in account may result in the loss of a plan holder's entitlement to income support programs. The Ontario application has no such warning, although the FSCO internet site does include comparable language;
- For all hardship categories except low income, Ontario limits each applicant to one application in a 12-month period. The Alberta Regulation does not have this limit; and

- The 10-page Alberta application is considerably less complicated than the 42-page Ontario application. Alberta makes use of simple checklists, and has modest requirements for supporting documentation, but Ontario requires the plan holder to provide detailed descriptive documentation for each category of hardship. For example, an applicant in Ontario who wishes to unlock funds for renovations to a principal residence must provide a detailed description of the renovations and a statement from a licensed physician that the renovations are necessary to enable the person to access the residence or to be mobile or functional in the residence. In contrast, the Alberta application requires only a medical doctor's written opinion that person for whom the renovations are being made has an illness or disability that is expected to last one year, plus written confirmation from the applicant that the renovation is not covered by public or private insurance.

Ontario's fee structure is another important factor that distinguishes it from the new no-fee Alberta system. In order to recoup the costs of processing hardship applications, the Ontario application requires the plan holder to pay a fee of one per cent of the amount withdrawn with a minimum fee of \$100 and a maximum of \$500. However, it could be argued that an application to withdraw \$50,000 from a locked-in plan does not cost five times as much to process as an application to withdraw \$10,000.

In fact, the Ontario unlocking fee may be vulnerable to a constitutional challenge, based on a 1998 decision of the Supreme Court of Canada (the "Court") which struck down an ad valorem (based on value) probate fee levied under regulations to the Ontario Administration of Justice Act.

The Court found that because there was no "correlation between the amount charged for grants of letters probate and the cost of

providing the service... the levy is a tax and not a fee". As a direct tax, the Court found the fee to be unconstitutional because direct taxes must be an act of the provincial legislature, not by regulation. Since the fee for processing unlocking is authorized by regulation and has an ad valorem structure that arguably amounts to a tax, it could be attacked on the same basis.

The Alberta Ministry of Finance advised that it implemented the new unlocking Regulations in response to requests from persons in financial hardship and that it focused on ensuring that Alberta's unlocking provisions would be "user-friendly", simple to administer, and free of charge. The Ministry of Finance indicated that the new unlocking provisions are regarded a "first-step", and that a comprehensive review of locking in is planned. The Alberta Superintendent of Financial Institutions will establish an advisory committee on locking-in with employer and employee representatives, and a "neutral chair". Public consultation on locking-in may be expected within the next few months.

It will be interesting to track the evolution of the less-bureaucratic Alberta initiative as compared to the system currently in place in Ontario. It also remains to be seen whether other Canadian pension standards jurisdictions will enact comparable provisions in the near future.

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It is not intended to provide specific advice or recommendations for any individual.

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