THE CANADIAN FINANCIAL MARKETS AND THE REMOVAL OF THE FOREIGN PROPERTY RULE

The impending removal of the Foreign Property Rule (FPR) has very interesting implications for the structure and pricing of the Canadian capital markets. While it should theoretically improve long term returns for Canadian investors, we believe it will dramatically alter the longer term financing prospects of Canadian issuers. All things being equal, the pricing of the securities of larger Canadian issuers should fall into line with global peers. This will remove the “Made in Canada” premium on the bonds and stocks of many Canadian issuers. Diversification considerations and the structure of the Canadian investment management industry could mean that securities of Canadian companies with largely domestic operations could fall below global valuation levels as Canadian institutional investors adjust their portfolios to the new reality. This implies higher financing costs for Canadian issuers. Removal of the FPR will also result in a reduction in the profitability of Canadian financial institutions. Portfolio adjustment to the FPR should be negative for Canadian investment dealers as Canadian equity underwriting and trading declines. Asset management and trading fees will decline as foreign investment managers are substituted for Canadian investment managers in equity portfolios. The dominant position of Canadian investment banks in the Canadian debt markets will be eroded by increased investment by Canadians in the bonds of foreign issuers and increased issuance by foreign entities in the Canadian dollar debt markets. Given an extensive consultative process, we imagine that the complete removal of the FPR would have provoked a massive lobbying effort against it by those negatively affected, especially the Canadian banking sector. The shocking speed of this development and the strong political support for the budget in a minority Parliament make it very likely to pass. Thoughtful investors will prepare for the new Canadian investment reality.

The Canadian dollar bond universe under the Foreign Property Rule (FPR) was a small and insulated place. Pension and RRSP registered accounts largely used their scarce foreign property availability for foreign equities and limited their bond managers to Canadian issuers. High Canadian real interest rates meant Canadian bond market returns were excellent compared to foreign markets, without the currency volatility. The performance experience of foreign currency mandates and “currency overlays” was good on paper but bad in practice. This kept sponsor mandates close to home in Canadian currency and interest rates.

The Foreign Property Rule (FPR) under the Canadian Income Tax Act distorted the portfolios of Canadian retirement and pension funds by legally mandating restrictions on the amount of foreign property that could be held by these funds to 30%. The initial reasoning behind the FPR was to promote investment by registered plans in Canadian securities in exchange for the deductibility of contributions to these plans. Non-registered (and non-deductible) savings and retirement plans have always been able to invest in foreign securities without restriction. Registered plans operate under the FPR which was raised from 10% to the current 30% over time as a result of lobbying by the pension industry. The proposed federal budget provides for the complete removal of the FPR. This has major consequences for the Canadian financial markets.

Corporate finance theory tells us that companies should only retain their cash flows if they have profitable projects to invest in. Otherwise they should return the excess cash from their operations to their shareholders to allow them to maximize their returns by reinvesting in other companies that have profitable projects. A Canadian company that is able to find profitable projects should be able to constantly reinvest in its own projects and deliver retained earnings increases that will increase its share price and credit ratings. There are many Canadian companies that have been able to do this. These companies usually have large foreign investment bases. Foreign investors like their prospects and often the Canadian capital markets have been unable to completely fund the financing demands of these issuers and they have financed abroad, particularly in the U.S. markets.

Theory also tells us that investors should raise their foreign investments to increase their returns and lower their portfolio risk through diversification. Registered Canadian investors could have already accomplished this under the FPR by investing in Canadian companies with significant international interests. In this case, the impact of the removal of the FPR would be small. Canadian companies with profitable foreign operations are already highly valued with significant foreign investment, especially in the technology and resource sectors. The problem is that many large Canadian companies have been unable to find profitable projects and they form large parts of the Canadian equity and bond indices due to the artificial restriction of the FPR. Why own the stocks and bonds of all five Canadian major banks when better value and perhaps better managed foreign competitors beckon?

Canadian Bonds Match Canadian Liabilities
Analysts have commented recently that in countries unconstrained by an FPR, a “home preference” for pension funds seems to be to keep 50% in domestic assets. This makes sense since the liabilities of a pension fund, its promise to pay pensions to its members, are denominated in its home currency. A Canadian pension plan’s liabilities are valued in Canadian dollars using Canadian interest rates. Dropping interest rates and rising liability values in the late 1990s now have pension plan sponsors considering raising their fixed income weightings to “match” their liabilities which are valued entirely in Canadian currency and interest rates.

The “asset planning” vogue of the 1990s, using historical returns and correlations to establish policy asset mix, increased pension plan equity exposure towards 70% at the expense of fixed income which dropped towards 30%. The consensus strong returns forecast for foreign equity markets, their Canadian liabilities and the good historical returns from Canadian fixed investments caused plan sponsors to substitute foreign for Canadian equities as the FPL increased from 10% to 30%. This makes for a “normal” policy asset mix of 40% Canadian equities, 30% foreign equities and 30% in fixed income.

This already high equity weighting of most Canadian pension plans make it difficult to cut back their Canadian fixed income exposure. It is also unlikely that plan sponsors will take advantage of the dropping of the foreign property limits to make substantial investments in foreign currency bond issues. Indeed, Canadian plan sponsors have been able to invest in foreign currency bond issues of Canadian issuers for many years. The poor returns and volatility of foreign currency bond mandates relative to Canadian fixed income mandates have not made this an attractive asset class.

Canadian Equities Will Be Under Pressure
We believe that pension sponsors will adjust to the FPR removal by moving their foreign equities significantly higher at the expense of Canadian equities. Based on their heavy exposures to recent “Made in Canada” disasters like Laidlaw, Loewen, Bre-X and Nortel, which formed a significant part of the Canadian equity universe, pension plan sponsors clearly understand the benefits of global equity diversification. At the height of the 2000 technology speculation, Nortel was over 20% of the widely used TSE 300 benchmark index. Sponsors might choose to hedge the currency risk, as many currently do, but they will be selling Canadian equities in favour of foreign equities. Canadian equity issuers will be affected differentially by this substitution of foreign equities for Canadian equities as sponsors adjust to the world after repeal of the FPR.

Canadian commodity producers already sell most of their output on the global markets and operate internationally. Foreign investors have long owned Alcan, Inco and other Canadian companies for their resource bases. These stocks already trade relative to their global peers and the prospects for the global economy. The change in the FPR should have little effect on them. It is the large capitalization and lower prospect companies with largely Canadian operations that will bear the brunt of the change. Canadian banks, utilities, and telephone companies will see their valuations move into line with their global peers. Diversification also dictates that Canadian investors should prefer foreign companies at the same valuations as their Canadian equivalents to reduce their exposure to the Canadian economy.

Safe But Sorry
Bell Canada Enterprises (BCE), the widely held telephone conglomerate, has been the historically safe but sorry choice for FPR restricted Canadian investors. BCE will likely suffer in comparison to its global peers. The FPR kept Canadian investors captive in this telephone giant that has had a penchant for investing its relatively safe cash flows in ill advised and loss generating diversifications like its 1980s ill-fated Daon real estate play and Teleglobe, its 1990s global long distance loser.

The affected Canadian companies could even cheapen more than theoretically should be the case as the initial phase of portfolio restructuring takes place. Many Canadian institutional investors are over invested in equity sectors that form a large part of the S&P TSX index but are a smaller proportion of foreign and global indices.

The current structure of the Canadian investment management industry will make the transition problematic. Institutional clients and their consultants usually “benchmark” their fund exposures to “asset classes” and then hire specialist managers for each asset class. A typical investment policy would see Canadian equity managers limited to Canadian equities benchmarked against the S&P TSX index and foreign equity managers managing foreign portfolios against foreign equity benchmarks such as the EAFE or S&P 500 indices.

Institutional clients could give their Canadian equity managers the ability to invest in foreign equities. It is more likely that they will take assets from their Canadian equity managers and increase their foreign equity exposure with their existing international managers. Most Canadian plan sponsors went through the process of selecting international managers in the 1990s as the FPR moved up to 30% and they largely chose foreign investment managers. They are comfortable with these managers and more importantly are at the low end of their fee schedules. Additional funding to their existing international managers will be the cheapest way for sponsors to increase their foreign equity allocations. This will require Canadian equity managers to sell Canadian stocks to fund the investment in foreign equities with the foreign managers. Even if this portfolio restructuring is done through derivatives, it will essentially involve the sale of Canadian stocks and the purchase of foreign stocks.

As Canadian investors increase their benchmark weightings in foreign equities, the shift will be massive. Indexed sellers will be selling $240 million of Canadian bank stocks for every $1 billion they invest in the Morgan Stanley Europe, Asia and Far East (EAFE) index which does not include Canadian stocks. Implementation of this shift could be problematic. Clients could implement the change by transferring the Canadian stock portfolio to a foreign manager and allow replacement of the domestic stocks over time when superior foreign opportunities are available. They could also gradually lower the weighting in Canadian equities over time to avoid disruption. Our many years of managing money convince us that this “gradualist approach” is unlikely to happen.

The potential for large changes in relative valuations and the amounts of assets involved make “sooner” better than “later”. Pension plan sponsors and their consultants will be able to quickly adapt their benchmark portfolios without the FPR constraint using their asset planning software. The portfolio shifts involved will be taken out of the hands of the portfolio managers and given to the “portfolio implementation” specialists, largely out of New York, who handle the transitions between portfolio managers by selling the current holdings and buying the portfolio of the new managers using “baskets of

shares".

A Bumpy Flight!
Portfolio implementation programs could make it a bumpy flight for many widely held Canadian stocks. The problem will be even more acute with indexed investors who will probably implement derivative strategies using the most liquid securities in the representative indices. While these factors will not have a huge effect on the large global stocks in the target indices, there could be substantial downwards pressure on many Canadian large capitalization stocks that are large components of the S&P TSX index.

Canadian resource companies and successful international operators will be protected to some extent by their large foreign shareholdings and their inclusion in foreign and global stock indices. In the current hot commodity markets, foreign investors and even foreign acquirers will keep the valuations on these Canadian companies comparable to their global peers. Largely domestic Canadian companies could have to raise their dividend yield to protect their share prices.

The current plight of indexed investors and companies affected by the foreign property changes is a little bit ironic, considering the move from the more cyclical and commodity TSE 300 index in 2002 to the new S&P TSX index which emphasizes more domestic and less cyclical stocks than its predecessor. Bay Street's response to the Nortel fiasco of contracting out the index construction to S&P now seems like an impending loss in value for those indexed or "closet indexed" to the S&P TSX index.

Canadian Fixed Income
Given the expected propensity of Canadian plan sponsors to invest in Canadian dollar fixed income assets, we believe that the major change in the Canadian bond market due to the removal of the FPL will be increased issuance by foreign issuers. Canadian bond investors should be able to obtain lower default risk for their portfolios at higher yields by investing in foreign issuers. The preference for Canadian registered investors will be to obtain this exposure in Canadian currency and interest rates due to the Canadian nature of their fixed rate liabilities.

Large sophisticated Canadian investors such as financial institutions already "asset swap" into foreign credits by hedging the foreign currency and interest rate risk through the derivative markets. Registered plan sponsors have been limited in their asset swaps under the FPR due to their use of their foreign content exposure for their equity portfolios.

It is possible that Canadian pension plans will extend their fixed income mandates into foreign issuers by allowing hedging back to Canadian interest rate exposure. In buying foreign issues and hedging back into Canadian interest rate exposures, the investor takes greater risks than the credit risk of the particular issuer. Derivative hedging introduces exposure to the pricing and liquidity of the swap markets and credit exposure to the swap banks. In optimistic financial markets like the present ones, the consensus dictates these risks are trivial.

Experience has shown that financial turmoil can cause severe dislocation in these markets. The pricing and liquidity of these hedges means that the average investment policy statements would consider the asset swaps under the illiquid asset category which currently precludes many plans from even participating in domestic private placement issues. This means that Canadian plan sponsors will likely leave the headache of hedging to the swap banks. We expect that financial intermediaries will bring foreign issuers into the Canadian bond market and provide these issuers with cheap funding in their native currencies. Global investment dealers will propose Canadian dollar issues to clients when it is tactically cheap funding for them. Canadian clients will buy foreign credits in Canadian currency when their spreads are attractive compared to Canadian issuers with the same credit rating.

Many Canadian bond investors are restricted by their client investment policies to investing in A or higher rated bonds. The purchase of the Canadian Bond Rating Service in 1999 by Standard and Poors meant the "harmonization" of Canadian credit ratings to international standards. Many A rated Canadian issuers were downgraded to BBB status. The shrinking pool of Canadian A rated issuers led to an artificial

demand for A rated Canadian credits. This resulted in lower relative interest rates (tighter yield spreads) for Canadian issuers than would otherwise be the case. As more foreign issuers access the Canadian debt markets, domestic Canadian bond issuers will pay more for their financings. We believe that the banks, utilities, auto finance, provincial and municipal bonds will suffer by comparison to their international peers.

There is also a considerable diversification aspect to consider. Many “core” Canadian fixed income managers have made a good living by holding large amounts of bank subordinated debt and more recently the capital securities (essentially preferred shares) of all five major banks. At 8-10% per issuer, these managers have held 40-50% of their portfolios in Canadian banks. This has given them additional yield to outperform the bond market indices but speaks volumes of the exposure of this sector to more highly rated foreign alternatives. While it might have seemed unreasonable for plan sponsors to limit exposure to the Canadian bank sector under the FPR, it might now seem a bit quaint not to limit this exposure.

A reasonable question to be asked is why would foreign issuers find it cheap to issue in Canada? The answer is that Canadian fixed income investors will have a substantial pool of investment capital seeking foreign issuers in Canadian dollars. When it is attractive funding, given relative credit spreads and swap spreads, investment bankers will earn ample fees by meeting the demand. The Canadian boom in Income Trust issuance is a shining example of the juxtaposition of demand and investment banking bonuses.

As opposed to their Canadian equity portfolio management brethren, Canadian bond managers should do reasonably well after the FPL is removed. Foreign issuers will come and go in Canadian dollars depending on the attractiveness of the swapped cost to them in their local currencies. Foreigners will still buy and sell Canadian dollar bonds depending on their currency outlook. The large pool of long-term Canadian dollar investment capital will still be managed by those with experience and expertise in the Canadian dollar debt markets.

As foreign issuance in Canadian dollars fluctuates with funding costs and foreign investors move in and out of Canadian dollar debt, the result will be more volatility of credit spreads. This means more profit opportunities for the more skilled and active portfolio managers. The increased number and variety of issuers suggest that credit and valuation skills will increasingly be in demand from plan sponsors.

Lower Profits for Canadian Banks
The removal of the FPL is an overall negative for the profitability of Canadian investment dealers and their bank parents. Canadian investment dealers have a significant advantage in underwriting Canadian equity issues for sale to Canadian clients because of their superior contacts with both Canadian issuers and clients. The poor showing of international dealers like Goldman Sachs and Morgan Stanley in the Canadian market in the 1990s is testament to this. Their global reach was not compensation for their lack of a Canadian distribution network. Most closed their Canadian operations after being shut out of domestic underwriting and now cover Canadian clients from
New York.

Reduced demand for Canadian equities from Canadian investors will mean lower equity underwriting and trading revenues for Canadian investment dealers because it is unlikely to be replaced by increased foreign equity trading and underwriting by Canadian dealers. As we discussed above, Canadian institutional investors are likely to continue to use their established foreign investment managers for their increased foreign equity portfolios. These foreign investment managers will continue to purchase and trade their foreign equities through the larger international dealers and stock exchanges.

Canadian investment banks should seek to expand their foreign equity underwriting and trading capacities to compensate for the reduction in their Canadian revenues. This has historically been a difficult road for Canadian investment banks. When a Canadian company issues equity in foreign

markets, it usually chooses a large international investment bank as the lead manager to access their large international distribution network. Foreign companies seldom use a Canadian investment dealer to issue equity to foreigners for the same reason. Canadian investment banks have had a troubled record in international expansions. Given the entrenched and dominant positions of the major international investment banks, they are usually forced into dubious acquisitions, risky business areas and questionable staffing. The 1990s foray of CIBC into the United States and the RBC-DS London based Enron financings come to mind. The removal of the FPR will mean increased participation in foreign equity underwritings by Canadian dealers for their retail distribution networks, but they will likely take a less lucrative and subordinate role in the underwriting syndicate than in domestic Canadian deals.

In the Canadian debt markets, the advantage of the Canadian investment dealers has been overwhelming. With their superior corporate and investment banking relationships with Canadian domestic issuers, they have dominated domestic Canadian debt issuance.

The repeal of the FPR will mean more foreign issuers will issue debt in Canadian currency when it is advantageous. The key relationship will be the contacts in the treasury areas of prospective issuers. Clearly, international dealers with global investment banking contacts will be superior in this regard.

Some Canadian dealers have developed excellent Eurobond operations, which issue foreign currency bonds to European investors. These dealers have essentially sold Canadian dollar debt to foreigners. These operations have also given them the capability to underwrite issues in other currencies such as the New Zealand and Australian dollar for sale in to European investors. These Canadian dealers lack the extensive network of global investment banks but they do have the contacts with Canadian clients. This should help them develop the contacts with potential Canadian dollar issuers.

Conclusion

The repeal of the FPR is a bold move that will permit Canadian investors to maximize their investment returns at a lower level of risk. The timing of the move is politically and financially astute, as it comes when Canadian financial assets are in demand by foreign investors. This should hopefully remove some of the upwards pressure on the Canadian dollar and help to ease the adjustment for Canadian investors and issuers. The captive demand under the FPR for the securities of many Canadian issuers will disappear and could lead to sharp downwards pricing pressure on some Canadian stocks and bonds. It will eventually raise financing costs for Canadian issuers and will likely reduce the profitability of the Canadian financial sector.

Given an extensive consultative process, we imagine that the complete removal of the FPR would have provoked a massive lobbying effort against it by those negatively affected, especially the Canadian banking sector. The shocking speed of this development and the strong political support for the budget in a minority Parliament makes it very likely to pass. In any event, the political picture is fairly obvious: “Voters happy with unlimited foreign content in their RRSPs versus helping the big banks?” The new Canadian investment reality is here to stay. Thoughtful investors will seize the opportunities created by the removal of the FPR and protect their portfolios from the downside.