Investment Governance

Good Practice Checklist

Governance Structure

1. Existence of critical decision-making bodies e.g. Board of Directors, Investment Committee, In-House Investment Team, External Investment Managers etc.

2. Clear division of roles and responsibilities - approval, supervision, performance review and management functions (additional for pension plans: independence of the governing body from plan sponsors)

3. Effective delegation practices

4. Existence of decision and/or approval authority limits

5. Checks and Balances

    a. Appointment of persons of diverse backgrounds and expertise to decision-making bodies
    b. Formal lines of reporting by the decision-makers to stakeholders

6. Existence of conflict of interest guidelines for key investment staff, investment committee and/or Board

7. Disclosure mechanisms for conflicts of interest as they may arise

8. Existence of personal trading rules for investment staff

9. Adequate knowledge and skill sets - Internally qualified investment personnel and/or use of external professional investment managers

10. Existence of ongoing education for decision makers and investment staff

The "Good Practice Checklist" is a guide to assist readers with a better appreciation of prudent practices as generally applied in the investment field, and is not intended to be prescriptive, as standards may vary based on the size, nature or objectives of investment funds and/or whether the funds are segregated or pooled, indexed (passive) or non-indexed (active), etc.

11. Number of External Investment Managers or Multi-Manager or Specialist Manager Structures, subject to size of fund and investment objectives

12. Existence of succession plans for decision makers and investment staff

13. Existence of business continuity plan to address disaster recovery or periodic disruptions of the financial markets

Investment Philosophy and Policies

14. Implementation of investment or financial management operations policy and procedures, which are approved by Board of Directors or appropriate authorized personnel

15. Investment objectives are clearly articulated (may include performance objectives, tolerance for risk, time horizon, liquidity needs, financial constraints, regulatory constraints etc.)

16. Asset allocation and underlying risk are aligned with investment objectives

17. Implementation of policy or principles for portfolio rebalancing, and regular portfolio rebalancing to align to benchmark or tactical asset allocation (in particular, for large investment funds or pension plans)

18. Investment mandates to external managers are clearly articulated

19. Investment strategies, policies and procedures are reviewed by governing body generally, at least annually, and more frequently if required

20. If services of external investment managers are enlisted, the existence of policies or principles for manager selection, and portfolio allocation amongst managers

21. Experts or investment consultants are engaged to help shortlist and select external investment managers and/or to review investment policies (in particular, for large investment funds or pension plans)

22. Selection of investment managers is via open or pre-qualified competitive processes (RFP, ITQ etc.)

23. Implementation of Investment Policy may take into account:

    a. Active versus Passive (Indexed) Fund Management – Passive management uses an investment style that matches an investment fund's composition and performance to a published index for the asset class (e.g. TSE300), whereas active management with better access to market information chooses customized stock selection to consistently and systematically beat the market.
    b. External versus Internal Fund Management - External management has the benefit of arms-length relationship with the governance structure, whereas internal management may provide better control over the fund's investments
    c. Balanced Manager Structure, where one or more managers manage entire fund based on permitted categories of investment, versus Specialist Manager Structures, where the plan sponsor sets and manages the asset mix and selects individual managers to manage all or a portion of the assets in each asset class
    d. Number of managers, e.g. a multi-manager structure to appoint specialist managers who employ complementary investment styles or partially offsetting styles in specific asset classes,
    e. Style diversification, which is the practice to select more than one manager in an asset class with styles that offset.

Management of Risks

24. Pre-defined strategic asset allocation and/or tactical asset allocation

25. Implementation of asset allocation benchmarks in alignment with investment objectives

26. Key types of investment risks at portfolio level are considered[1]:

Risk Types	**Risk Control Considerations**
Active Management Risk	Active managers attempt to enhance returns by taking a position relative to the market or benchmark. Active management risk is the risk that the active position will have a detrimental impact on investment results.
Commodity Risk	Changes in commodity prices (e.g. oil and gas) may affect the value and earnings of related companies, or may affect the value of the Canadian dollar, thereby indirectly impacting investment returns on foreign assets.

[1] Reference Source: "Pooled Investment Portfolio, Product Description, March 2008" published by BCIMC

Risk Types	Risk Control Considerations
Concentration Risk	Diversification will reduce exposure to individual firms and systematic risk[2]. The more concentrated the underlying holdings, the lower level of diversification. Concentration risk may also arise from an equity market being dominated by individual companies (e.g. Nortel constituting a greater than 30% weighting of the TSE Composite Index, or have a heavy weighting in certain sectors).
Construction Risk	Construction risk is the risk that mortgage proceeds are advanced and the building or improvements are not completed. Construction risk is mitigated by using experienced developers, obtaining construction engineer evaluations, requiring high pre-sales/pre-leasing levels and sufficient profit margin levels, as well as, requiring borrowers to pledge additional assets to provide further security.
Credit Risk	Credit risk is the risk that a borrower, tenant or derivative counterparty fails to honour contractual obligations and default on payment obligations. Credit risk can be reduced through asset diversification, restricting investments to low risk issuers (e.g. government, high quality corporations) and/or through the use of collateral (e.g. mortgages).
Derivative Risk	While derivatives can be useful instruments in managing risk (e.g. hedging), or to ensure the portfolio stays fully invested (managing cash flow) or to facilitate large investment transactions (managing the asset mix), and/or to enhance returns, there are also certain risks that can result from the use of derivatives: 1. Credit risk associated with certain derivative contracts e.g. forward contracts, swaps), whereby the derivative counterparty may fail to honour its contractual obligations; 2. Exchange-imposed trading restrictions and/or market liquidity issues that may reduce a portfolio's ability to enter into derivatives or to close out a derivative position; and 3. No assurance that using derivatives to hedge risks (e.g. currency or equity markets) or to enhance returns will increase investment returns.
Environmental Risk	Environmental risk is the risk that a property's value decreases due to environmental contamination. Mortgage or real estate investments are made subject to evaluation of an environmental audit report from a qualified professional.

[2] Systematic risk is the risk inherent to the entire market or entire market segment. Also known as "un-diversifiable risk" or "market risk"

Risk Types	Risk Control Considerations
Equity Risk	If an equity portfolio has concentrated share holdings, it has firm-specific or unsystematic risk[3], which can be reduced through expanding the holdings or investment diversification. Equity investment returns are also influenced by the general economic situation and outlook, as well as the outlook for the sectors, or systematic risk.
Equity Market Risk	A maximum percentage weighting in equities – keeping fully invested, and not over-reacting to declining equities markets. Diversification among many equity markets, including the U.S. Europe and Asia.
Foreign Currency Risk	Changes in exchange rates will impact the return from investments denominated in another currency. Currency risk can be mitigated or eliminated by hedging (e.g. forward contracts).
Country Risk	Investing in foreign markets may entail additional risks, such as a foreign country having different accounting, auditing, legal, and/or reporting standards. There may be less reliable economic statistics or less transparency and/or reduced accountability in regards to corporate governance or securities regulation.
Index Fund Risk	Pooled funds are intended to provide participating unit-holders with a similar risk and return profile as a market index (e.g. S&P 500). Some indexes are more concentrated (e.g. by company or sector) or are composed of higher risk assets. There can be significant differences in the risk profile of various index Pools. As a general rule, a full replication index (e.g. hold all the underlying issues) has a lower tracking error[4] than a stratified sample approach, due to a lower active management risk.
Interest Rate Risk	The longer the term to maturity in a bond, the more sensitive the price of the bond to changes in interest rates. Changes in interest rates will also affect other asset classes e.g. equities and real estate. Some interest rate risk may be mitigated by matching the duration of assets and liabilities.
Inflation Risk	Mitigation of secular inflation through a significant equity exposure and high inflation pass-through vehicles including real return bonds, mortgages etc.

[3] Unsystematic risk is company or industry specific risk that is inherent in each investment.
[4] Tracking error is the difference between a portfolio's return and the benchmark or index it was meant to mimic or beat. Tracking error is sometimes called *active risk*.

Risk Types	Risk Control Considerations
Liquidity Risk	Some assets are by their nature difficult to sell in the open market and forcing a sale may result in significant losses. Reduced liquidity may also arise from legal restrictions, nature of the market/investment, lack of buyers, settlement terms, or for some other reason. Compensation for reduced liquidity can be via higher rates of returns over time.
Funding Risk	Utilization of generous contribution levels. Maintaining a surplus of assets to liabilities with remedies for a significant shortfall.
Underlying Fund Risk	Significant redemption of a pooled fund might require significant sales and thereby trigger capital gain or losses, or affect market prices in the short term. Conversely, large cash inflows may result in higher than desired cash positions and pose a drag on performance. Underlying fund risk may be mitigated by establishments of certain cash limits.
Manager Risk	Diversification among several managers. Rigorous manager selection process including review of the managers' oversight controls.
Maverick Risk	Utilization of full-service high-calibre external managers with tight oversight controls.

27. Asset Class Policies (in particular, for segregated investment funds) –
    a. Quality – Investment must be investment-grade rated by a recognized rating agency;
    b. Diversification – The fund's total exposure to investments in each asset class or category must be limited at time of purchase
    c. Liquidity – Liquidity will be maintained by investing in the most marketable and liquid types of securities and by limiting equity holdings to securities listed on major exchanges.
    d. Duration – Limitations set on the duration of the fixed income portfolio.

28. Asset Class Policies (in particular, for segregated investment funds) - typical implementation of investment criteria, approved risk levels and investment limits (range) for all asset categories:

    a. Money Market Instruments – Quality (investment grades), Diversification (category limits for each investment grade) & Liquidity Parameters

b. Bond Investments - Quality (investment grades), Diversification (category limits for each investment grade & individual security limits), Liquidity and Duration Limit Parameters

c. Mortgages - Quality (credit risk), Diversification (category limits for each mortgage type, size of mortgage, type of real estate and/or location) and Duration Limit Parameters

d. Equities – Type (common and preferred shares, common stock equivalents, income trusts, exchange traded funds, depository receipts, and equity derivatives e.g. futures, options, equity swaps), Diversification and Liquidity Parameters

e. Real Estate – Quality, Diversification (category limits for each property type, location and property risk), Liquidity and Leverage Parameters

29. Encumbrances and indebtedness against the portfolio or short-selling is either limited (based on strategy or circumstances) or not permitted

30. Prudent use of derivatives, e.g. to hedge portfolio risks or to enhance portfolio returns, but not permitted to lever the portfolio or increase portfolio risk, or extend asset class weights outside the stated asset mix ranges in the investment policy

31. Existence of hedging against foreign exchange exposures, as appropriate

32. Stipulation of minimum credit rating for counter-party risks

33. Regular internal and compliance auditing, at least quarterly

34. External audits, at least once a year

35. Transparency and full disclosure (fund information including audit results)

Monitoring and Reporting Practices

36. Frequency of reporting, as appropriate – e.g. monthly (for account information, portfolio values etc) , or quarterly (for performance results)

37. Frequency of comparison of actual asset allocation to targeted/ benchmarked asset allocation, as appropriate, generally weekly or monthly

38. Comparison of actual investment returns to investment return targets/ benchmarks, generally monthly

39. Performance attribution is reviewed at least quarterly, to identify and quantify sources of return, and where and to what extent risk exposures that are taken have successfully generated returns (i.e. how successful is the investment process).

40. For performance attribution (return and risk), a benchmark suitable to the investment strategy or style is specified in advance, as appropriate, generally once a year (in particular, for large investment funds or pension plans).

41. Frequency of performance reviews, as appropriate, generally quarterly

42. External investment managers comply with the Global Investment Performance Standards (GIPS) or accepted industry standards, for measurement and presentation of investment performance

43. Evaluation of Investment Managers - The performance of external investment managers are regularly monitored and reviewed, in compliance with investment policy, generally quarterly, but at least annually. The investment monitoring encompasses:

    a. An assessment of current market conditions;
    b. An evaluation of the performance of the Fund;
    c. An assessment of the performance of each component of the Fund mandate;
    d. Compliance with investment policy;
    e. A summary of conflict of interest reporting activities; and
    f. A breakdown of investment management fees.

44. Existence of principles for reducing assets allocated to or termination of investment managers who under-perform relative to prescribed benchmarks or peer group, fail to comply with investment policy or mandate, have style deviation or drift, regulatory infractions, experience loss of key investment personnel or have ownership changes

45. Calculations of investment returns are based on market values derived from independent pricing sources and are time-weighted to reduce the influence of external cash flows. Return calculations follow the standards established by the CFA Institute.

46. Review of fees and expenses - Expense ratios are regularly monitored and/or benchmarked

47. Full disclosure of performance review results

Pension Plan Trustees

48. Trustees are selected with care and prudence and are effective

49. Trustees receive training or education necessary to update their level of knowledge and understanding about pensions and investments

50. Trustees make reasonable and diligent effort to determine that service providers act with appropriate skill, competence and diligence

51. Trustees disclose all real or perceived conflicts of interest

52. Trustees consult with professional or expert advisors from time to time, as required

53. Trustees regularly investigate and ensure that pension plan has updated policies and procedures to maintain compliance with laws and regulations that govern the pension scheme

54. Trustees develop disciplined decision rules for hiring, firing and retaining investment managers that foster a long-term investment focus consistent with pension plan investment policy statement

55. Trustees act in the best financial interest of the pension scheme. Pension plan investments, loans and other pension plan financial decisions must be made in accordance with the *Pension Benefits Standards Act* (*PBSA)* and the regulations and in the best financial interests of plan members, former members and other plan beneficiaries.

Additional Pension Plan Investment Policies and Actions

56. Appropriate reconciliation of portfolio values between external and internal records

57. The performance of Custodian and other service providers (e.g. administrator) is reviewed at least once a year.

58. Policies for security lending, if used to generate additional portfolio income

59. Regular reports to external stakeholders, e.g. pension plan members