Pension News

UBC Faculty Pension Plan
Fourth Quarter 2008 Edition

The Financial Crisis – Part II

The financial crisis that started in 2007 and deepened last summer was far from over by the end of 2008.

The 3rd quarter newsletter described the beginning of the crisis, from what first appeared to be a problem in just a small sector of the U.S. residential real estate market, to a much bigger problem that led to the failure of some of the largest financial services firms in the U.S. The fourth quarter saw the problems in the financial services sector broaden into the economy as a whole, and beyond the U.S. to the entire world. This article examines the deepening of the financial crisis in the fourth quarter.

The importance of credit

It has been said that "money makes the world go round." To be more precise, the world's financial system revolves around credit. Individuals and families use short-term debt such as credit cards and lines of credit to finance routine daily purchases; they use longer-term debt such as bank loans and mortgages to finance larger purchases such as cars and houses. Without access to credit, family living standards wouldn't be close to current levels.

Corporations use short-term debt to manage their day-to-day transactions, cash flow, purchases and routine expenses, and use long-term bonds and debentures to expand their operations, by building new facilities and expanding beyond their home base. Without access to credit, daily operations and expansion would be funded only from cash, and companies would remain very small, if they could exist at all.

The greatest users of debt are governments, who finance their operations and create government infrastructure with the use of both short- and long-term debt. Government of Canada debt currently exceeds $400 billion.

Credit is crucial to economic activity, and in the fourth quarter, worldwide access to credit almost disappeared.

The credit crisis

Lehman Brothers was a large, well-respected financial institution with substantial investment operations with individual, business and government customers. It was a surprise when Lehman Brothers failed in September 2008, but even more of a surprise when the U.S. government declined to rescue it as it had Bears Stearns and Merrill Lynch earlier in the year. Now no one felt they could completely count on any borrower, even a large financial institution, to remain solvent and fulfill its obligations.

With concerns mounting about bank solvency, some banks experienced runs as depositors withdrew their investments. Because financial institutions are supported by investors' deposits, the loss of assets by depositor withdrawal damaged the banks' financial ratios, leading to some financial institutions failing to comply with legally required capital and reserve levels.

Even governments struggled. Iceland had to be rescued by the International Monetary Fund (IMF). The Icelandic government had nationalized all its commercial banks that had engaged in aggressive, but ultimately disastrous, banking practices, which in turn overextended the government's finances and led to depreciation of the Icelandic currency and the virtual bankruptcy of the country.

One important measure of credit reliability is the TED spread (**T**-Bill **E**uro-**D**ollar), which is a measure of credit risk for inter-bank lending. Historically, the TED spread had been close to 1%; in October 2008 it spiked to more than 4%. The TED spread is a measure of how

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much the banks trust each other to repay their debt, and clearly that trust had disappeared. If the banks couldn't count on each other to repay their obligations to each other, then few lenders could count on any other borrower. So credit froze.

The credit freeze had immediate and far reaching consequences. Individuals and businesses who needed cash for short term needs couldn't fund those needs, even if their finances were sound. As the credit crisis became an economic crisis, jobs were lost in most countries around the world, even Canada, which has soundly managed and regulated banks. Industrial capacity utilization dropped to its lowest rate in the past 20 years.

As it became clear that the economy was in decline, that businesses were going to be less profitable or would suffer losses, the stock market fell. Financial services firms, especially those in the United States, were particularly savaged. Investors fled the stock market and highly leveraged hedge funds were forced to sell holdings as lenders called their debt, which added to the downward pressure on stock prices. Stock markets globally fell 30% to 40% in 2008.

Governments and central banks to the rescue

With the collapse of credit, governments worldwide understood the need to unfreeze credit or face an economic collapse of historic proportions. The fourth quarter saw heroic efforts by governments around the globe trying to restart the credit system through a broad range of measures.

Most of the developed countries' central banks cut their interest rates to encourage commercial banks to drop theirs, to try to unfreeze credit. By the end of December, U.S. government short-term bond yields had dropped virtually to 0%, although corporate bond yields remained very high.

Perhaps the best-known measure was the U.S. government's Troubled Assets Relief Program (TARP). TARP was intended to allow financial companies to sell their toxic assets to the government – mostly sub-prime mortgages and the manufactured investment creations derived from these mortgages – to remove the poor quality or the difficult-to-value investments from the financial institutions' balance sheets, replacing them with cash, so that these financial institutions would appear healthy and sound, as if they had never invested in junk.

Other measures included guaranteeing bank deposits, as in Ireland, to restore investor confidence in banks.

By strengthening the finances of these institutions, the governments hoped that the financial institutions would then conduct their business anew – lend money to individuals, corporations and governments who needed money – to continue their operations as they had before the collapse. That was the theory.

The problem with TARP and some of the other measures was that some of the financial institutions preferred to keep the government cash to repair their own businesses. After applying the prudent lending standards they always should have applied, these institutions now recognized that not all borrowers would repay their loans, and they were reluctant to lend. The financial rescue had been directed at the financial institutions, to fix them, so that they would conduct business. But if they wouldn't conduct business, the rescue measures were futile.

Fiscal measures

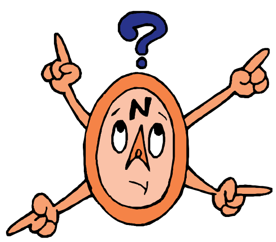
The first steps taken by governments and their central banks were monetary measures: trying to restore the movement of capital, improve lending, encouraging spending, primarily through the management of interest rates. Such tactics would be successful only if participants in the economy responded in the desired fashion: by consumers consuming, by producers producing, leading to economic expansion, fuller employment and less economic distress. The measures don't work if the participants in the economy retrench, which they typically do in an economic decline; the impact of monetary measures on the economy may take months or years to take effect.

Fiscal measures are actions taken directly by government, by increasing their spending through public works and infrastructure or by reducing taxes. As the fourth quarter closed, governments worldwide were considering a wide range of fiscal measures of historic proportions; many were waiting for the Obama inauguration in the United States, and the implementation of a U.S program.

Where to from here?

There has been considerable commentary about the economy and the direction it will take, from a wide range of financial experts and non-experts, with forecasts ranging from economic devastation worse than the Great Depression to expansive economic growth within a few months. No one really knows, of course.

Many fear a repeat of the Great Depression of the 1930s, pointing to the collapse of the real estate market that occurred both in 1929 and in 2008, the ensuing stock market crash that occurred in both periods, which in the 1930s led to a prolonged economic decline, deflation and unemployment. But there are differences. In the 1930s governments initially increased taxes and interest rates (instead of reducing them), exacerbating the problem. In 2008 and anticipated for 2009, governments are applying massive monetary and fiscal stimuli to try to restore the economy. And although some banks have failed this past year, there hasn't been the massive bank failure as in the 1930s.



Some commentators fear a repeat of the 1970s, an era in which the United States was fighting an expensive foreign war and when there was a sharp spike in oil prices, high unemployment and high inflation. Although the U.S. is again fighting an expensive war and there was an oil price spike in 2008, oil prices are now back to pre-spike levels. Furthermore, interest rates, rather than being in double-digits as in the 1970s, are at their lowest levels in 50 years.

Other commentators point to Japan's experience in the 1990s (their "lost decade"). After the great Japanese expansion of the 1970s and 1980s in which many Japanese companies became world leaders in their industries, Japanese real estate became the priciest worldwide. Japan's ensuing real estate collapse and banking failure led to economic stagnation and deflation (falling prices). But there are differences between the Japanese economy of the 1990s and the global economy today: the Japanese real estate bubble was vastly bigger than the U.S. bubble, the Japanese banks were slower at recognizing the losses, and the Japanese government did not apply the massive economic stimuli that are being applied worldwide today.

Optimists point to the growing economies of China and India, the globe's future economic powers, who are still increasing their production of global goods, and still have an expanding, consuming middle class. Although China and India, too, have suffered with the economic downturn, some view it as a temporary lull, with expansion returning shortly, leading to a restoration of the global economy.

But no one really knows. Most financial experts agree that the current recession, which has been in place in the U.S. for more than a year, will extend well into 2009 and possibly 2010. The good news is that as of early January, the TED spread, described earlier in the article as reaching very high levels in October, has returned to more normal levels. Yet the timing and speed of the recovery is far from clear. Although credit continues to improve, the economic deterioration is almost certain to remain for some time. The last chapter to the Financial Crisis is still to be written; the first quarter newsletter will likely have Part III.

This article was prepared by Satanove & Flood Consulting Ltd. Comments should be sent to: fpp@hr.ubc.ca

Contribution Limits for 2009

The contribution limit for pension plans in 2009 is 18% of income, to a maximum of $22,000. Contributions over the maximum will be deposited to the Supplemental Plan. Further information on the Supplemental Plan can be found on the FPP website at www.pensions.ubc.ca/faculty/. Please contact Jim Loughlean at 604-822-8987 or e-mail him at jim.loughlean@ubc.ca if you would like additional information about your contribution limits or the Supplemental Plan.

Market Volatility Information Session in December 2008

The Trustees conducted an information session "The Recent Market Volatility and Your Faculty Pension Plan" on December 11, 2008. The presentation and minutes of the session are available for viewing on the FPP web site www.pensions.ubc.ca/faculty under "Updates from the Pension Office."

Election Results

On January 28, 2009, the FPP Board of Trustees elected Mr. Joost Blom as Chair and Dr. Rob Heinkel as Vice-Chair for the 2009 calendar year. Professor Blom was appointed to the Board on July 17, 2003 and Dr. Heinkel was first elected to the Board in January, 1990.

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Financial Planning Lecture Series

The following lectures are sponsored by the UBC Faculty Association in conjunction with UBC Continuing Studies:

February 4	UBC Faculty Pension Plan Investment Market Update/Investment Strategies
February 11	Tax and Business Planning for the Professional
February 25	When Can I Afford to Retire?
March 4	Investment Strategies for Uncertain Times
March 11	Understanding Vancouver's Real Estate Market

All lectures are from 12:10 pm to 12:55 pm in Wesbrook 201, 6174 University Blvd. All members of the Faculty Association are invited to attend these informative sessions – no advance registration is required.

Workshops Offered by the Pension Administration Office

You & Your Pension Plan

If you are a new member or wish to learn more about the Plan, we host seminars to cover all aspects of the UBC Faculty Pension Plan.

Understanding Your Retirement Income Options

For members approaching retirement, this seminar is helpful as it explains the various options available.

If you are interested in either of these sessions, please check our website for dates and times. If you have any questions or wish to register for one of these workshops, please call Jim Loughlean at 604-822-8987 or e-mail him at jim.loughlean@ubc.ca.

Faculty Pension Plan Open House

The Faculty Pension Plan is having an Open House on Tuesday, June 9, 2009 from 2:00 – 4:00 pm in the Arbutus Room at the Ponderosa Centre, 2071 West Mall. Please join us and meet the trustees and staff of the FPP. At 2:30 pm, Joost Blom, Chair of the Faculty Pension Plan, will do a presentation on the performance and accomplishments in 2008 and outline the Plan's initiatives for 2009. Please confirm your attendance with Kathy Pang at 604-822-8100 or e-mail kathy.pang @ubc.ca

Market commentary

The fourth quarter of 2008 saw huge losses in the equity markets regardless of geographic location. Losses in the 20% to 25% range (in local currencies) were the norm for the quarter as de-leveraging, investor fears and the slowing global economy drove down equity markets. Many countries experienced their worst annual market declines since the 1930s.

The Canadian market at -22.7% suffered one of its worst quarterly returns ever in the fourth quarter. Of the ten sectors in the S&P/TSX index, only Consumer Staples made a gain during the quarter. The hardest hit sectors were Financials, Energy, and Information Technology, all down between 27% and 30% for the quarter. The sharp decline in the price of oil, by more than 70% from the summer's high, was a telling sign of the slowing economy and reducing demand for resource stocks. Small cap stocks, down more than 45% for the year, suffered the worst.

The U.S. stock market dropped 22% in the quarter, the Financial sector leading the downturn. Due to the significant drop in the Canadian dollar, this translated to -10.3% in Canadian dollars. The U.S. government and central bank announced more huge bailout programs and eased monetary policy in an attempt to improve investor confidence. The MSCI EAFE index was down 8.0% in the fourth quarter and was -32% for the year in Canadian dollars.

The fourth quarter was more favourable for fixed income portfolios with the Dex Universe Bond index up 4.5% for the quarter. Government bonds significantly outperformed corporate bonds as investors fled to higher quality bonds. Long-term bonds were strongest, up 5.2% for the quarter. Short- and mid-term bonds, up 4.3% for the quarter, also performed well.

Performance of Funds for periods ending December 31, 2008

	3 Months	1 year	3 years	5 years	10 years
Balanced Fund - gross	-6.42%	-13.00%	0.76%	4.51%	4.94%
Balanced Fund - net	-6.53%	-13.45%	0.31%	4.05%	4.50%
Composite Index 1	-5.61%	-12.19%	0.48%	4.28%	4.66%
Bond Fund - gross	1.90%	2.73%	3.31%	4.50%	5.41%
Bond Fund - net	1.85%	2.41%	3.07%	4.25%	5.15%
Composite Index 2	3.89%	5.70%	4.12%	5.18%	5.81%
Canadian Equity Fund - gross	-20.51%	-30.69%	-2.75%	5.41%	6.94%
Canadian Equity Fund - net	-20.59%	-30.99%	-3.15%	N/A	N/A
Composite Index 3	-22.70%	-32.55%	-4.36%	4.16%	5.69%
Foreign Equity Fund - gross	-10.12%	-26.48%	-7.25%	-1.69%	-0.93%
Foreign Equity Fund - net	-10.23%	-26.83%	-7.64%	N/A	N/A
Composite Index 4	-7.81%	-24.28%	-5.71%	-0.89%	-0.74%
Short Term Investment Fund - gross	0.57%	3.12%	3.88%	3.35%	3.99%
Short Term Investment Fund - net	0.53%	2.99%	3.72%	3.17%	3.74%
Composite Index 5	0.54%	2.57%	3.65%	3.17%	3.61%

Composite Index 1: *33% DEX Universe, 10% S&P/TSX, 5% S&P/TSX,5% S&P/TSX 60 Capped, 15% S&P 500, 15% MSCI-EAFE, 2% DEX 91-Day TB, 10% IPDCPI, 5% DEX Real Return Bonds*

Composite Index 2: *86.8% DEX Universe, 13.2% DEX Real Return Bonds*

Composite Index 3: *25% S&P/TSX, 50% S&P/TSX Capped, 25% S&P/TSX 60 Capped*

Composite Index 4: *48% MSCI-EAFE, 48% S&P 500, 4% DEX 91-Day TB*

Composition of Funds as at December 31, 2008

	Market Value ($ Millions)	% of Fund
Balanced Fund		
Equities - Canada	180.5	19.7%
Equities - U.S.	139.3	15.2%
Equities - EAFE	108.0	11.8%
Absolute Return Hedge Fund	20.0	2.2%
Real Estate - Canada	101.6	11.1%
Fixed Income	315.3	34.5%
Real Return Bonds - Canada	46.7	5.1%
Cash & Short term	3.3	0.4%
Total Balanced Fund	914.7	100.0%
Bond Fund		
Fixed Income	30.5	87.1%
Real Return Bonds - Canada	4.5	12.9%
Total Balanced Fund	35.0	100.0%
Canadian Equity Fund	56.6	100.0%
Foreign Equity Fund		
Equities - U.S.	14.0	54.1%
Equities - EAFE	10.8	41.7%
Absolute Return Hedge Fund	1.1	4.2%
Total Foreign Equity Fund	25.9	100.0%
Short Term Investment Fund	66.9	100.0%