Pension News

UBC Faculty Pension Plan
Second Quarter 2009 Edition

The Financial Crisis – Part III

The financial crisis that started in 2007 and deepened in 2008 is still far from over. The 3rd and 4th quarter 2008 editions of Pension News described the beginning of the crisis, as the U.S. real estate crisis broadened into a worldwide economic crisis, leading to massive action by governments and their central banks; this edition examines the current state of the crisis.

A Recap

The economic crisis started with the collapse of the real estate market, initially in the U.S., then in other developed countries. As the real estate crisis grew and the recession hit, unemployment increased; out of work families could not pay their mortgages, exacerbating the problem. Houses were abandoned; home construction stopped.

Investors who had purchased securities consisting of bundled mortgages found their investments losing value. Large, levered financial institutions saw their asset values become almost worthless. There was uncertainty as to which financial institutions were sound; some were bailed out, others weren't. Depositors worried about the safety of their investments.

With confidence in credit-worthiness gone, lending stopped. Individuals and corporations with cash flow needs could no longer meet their day-to-day cash requirements even if they were creditworthy. Even governments struggled; late in 2008, Iceland had to be rescued by the International Monetary Fund (IMF). As the credit crisis became an economic crisis, more jobs were lost and industrial activity fell.

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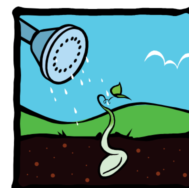
Governments worldwide understood the need to unfreeze credit or face total economic collapse. As 2008 ended and 2009 started, policy makers worldwide began dramatic measures to restart the credit system through a broad range of measures. Some governments guaranteed bank deposits, lent the banks huge sums and even acquired ownership positions in financial institutions. Governments started printing more money. Central banks cut the interest rates at which they lent to commercial banks so that the commercial banks would drop rates to their customers. The U.S. government bought toxic assets from financial institutions to sanitize their balance sheets. Governments hoped that the financial institutions would once again lend money to individuals and corporations who needed money to operate, to reverse the decline in economic activity and employment.

Green shoots

Given the sharp decline in global economies, and the trillions of dollars injected into the system by governments to reverse the slide, analysts have been intently examining a wide range of economic and financial indicators to see whether the government actions have been effective. Statistics studied include employment levels, industrial capacity utilization, shipping activity, manufacturers purchasing levels, housing starts and sales, surveys of consumer confidence, durable goods orders, increases in inventory and economic output. Any improvement in a statistic is widely reported, and announced by politicians as a sign that the government actions were a success. These early signs of recovery have been called "green shoots."



The initial steps taken by governments to restore confidence in the credit markets can be considered a

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partial success. The U.S. government conducted "stress tests" of 19 of the largest banks to determine how they would perform under further financial pressure. None of them failed, although the study found that some of them needed additional capital. The TED spread, which measures credit uncertainty between financial institutions (as described in the 4th quarter 2008 edition of Pension News), was restored to near its historic range, from extreme levels. Some U.S. banks have repaid the loans given to them by government, some are reporting profits, and some financial institutions are once again paying big bonuses to their executives. Confidence in the banks has been restored.

But the economy remains a mess. The Canadian unemployment rate reached an 11-year high of 8.6% in June; Canada has lost nearly a half million full-time jobs since the October labour market peak. The Canadian economy (as measured by gross domestic product) shrank by 1.4% in the first quarter of 2009, and has probably declined further in the second quarter (the results are not yet available). Levels of consumer bankruptcies and consumer loans and credit card delinquencies continue to rise. The situation is worse in the U.S., with the U.S. economy contracting for a third consecutive quarter in the first quarter of 2009, and the unemployment rate reaching 9.5% in June, the highest level since 1983. New car purchases have declined sharply worldwide, leading to the U.S. and Canadian government bailouts of General Motors and Chrysler. The European and Japanese economies are struggling as well; growth in the developing countries of China and India is now much lower than before the start of the crisis.

Despite vigorous action by governments and their central banks to restore credit, lending activity by banks to corporations and individuals remains depressed. The initial effort by central banks to reduce the cost of credit to businesses by reducing the cost of funds to banks, to encourage banks to lend to businesses, proved to be insufficient to make credit widely available to businesses when the banks were unwilling to lend. If businesses could not borrow, or the cost of the loans was out of reach, the hoped-for economic recovery would stall. To fix the problem, governments have stepped in with "quantitative easing" (the latest term to enter the popular lexicon) to try to manage bond interest rates between issuers and investors. The bond market is like any other market, with buyers and sellers. If there are a large number of seekers of financing, each competing against the others for financing from relatively few investors, the corporations must issue their bonds at a higher interest rate to attract investors. Some central banks such as those of the U.S. and England are (with freshly printed money) buying bonds from the bond market, referred to as quantitative easing, to reduce the supply of bonds within the bond market, to lower the interest rate that investors could demand, so that corporations can borrow. The impact remains to be seen.

The stock market

Much analysis is done to uncover a relationship between the economy and the stock market. One theory, supported by empirical evidence, is that the stock market is a "leading indicator" of the economy: the stock market will rise roughly six to nine months in advance of expected improvements in the economy and will drop roughly six to nine months before an economic decline.

The explanation of why the stock market is a leading indicator is simple: when corporate profits increase, the value of the corporation's shares should increase; when profits decline, the value of the shares should drop. A savvy investor anticipating a favourable future change in the prospects of a company might invest before the favourable impact of the change becomes apparent, while the price is still relatively low, to benefit from the rise in the share price when the favourable change becomes known. If this assessment becomes widely held, the price of the stock will rise in anticipation of the improvement. Conversely, if the assessment is negative in absence of a public announcement, investors may begin selling; if this view becomes widely held, the share price will tend to drop. As investors have the

most to gain by correctly anticipating changes in the prospects of companies **before** the changes actually occur, investment analysts focus on future prospects. Consequently, the share values will often move months in advance of the actual appearance of change in a company's prospects.

Most of the stock markets worldwide were increasing in value in the early part of 2008; the Canadian market, in particular, performed well, reaching a peak in June. Energy and commodity stocks rose sharply, as developing countries such as China and India were growing rapidly, requiring commodities for their growth. Although it was already recognized in early 2008 that the U.S. housing bubble was about to burst, there was a belief that the emerging economies were going to "decouple" from the U.S. economy, with the developing economies continuing to grow, even if the U.S. economy declined.

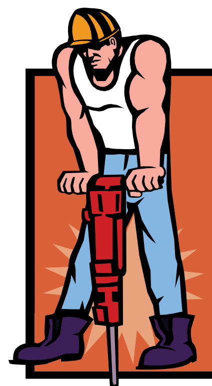
The "forecast" by the stock market at its top in June 2008 of a coming economic peak a few months hence was close to the mark, as economic activity and employment reached their peak in the fourth quarter of 2008. Stock markets worldwide then slumped, slowly at first through the summer of 2008, and then sharply in September through November, bouncing up a bit in December, back down again in January and February reaching a new bottom in early March. From the peak in June 2008 to a multi-year low in March 2009, most global stock markets dropped by about 50%, reflecting a forecast by the stock market that the economy was going to decline enormously. And indeed, the economic statistics from the fourth quarter of 2008 and the first half of 2009 were grim.

The stock markets worldwide rebounded from their March lows, increasing through the end of March, April, May and early June, rising a total of nearly 40% of the value at the bottom (restoring 20% of the original value at the top). If stock markets truly lead the economy by six to nine months, then the stock market is forecasting a sharp rebound in the economy by the fourth quarter of this year. But if the advent of internet trading and the massive amount of information that is available to individuals at their home computers have turned the stock market into a casino, rather than a leading indicator of the economy, the follow-the-herd mentality might override the underlying economic principles. The theory that the stock market is a leading economic indicator will be tested by the end of the year.

Where to from here?

"Where to from here?" of course is the trillion dollar question. The U.S. government has spent more than $1,000,000,000,000 to stimulate their economy; China, roughly one-half that; Europe in the multi-billions and Canada more than $40 billion. The credit system appears to be restored to some extent, but the economy is still in recession. Unemployment is high. Some financial experts, including Warren Buffett, have said that with unemployment potentially reaching 11%, a second round of stimulus may be required.

The importance of employment to the economy should not be understated. With employment, there is income; income creates demand for goods and services; demand for goods and services leads to the production of goods and services; and the production of goods and services leads to more employment. Additional employment reinforces the whole loop in a virtuous circle, adding more income, production and jobs. Conversely, unemployment creates greater job loss in a negative loop. The employment level is a key measure of the health of an economy, and much of the government stimulus, including spending on infra-structure, has gone towards creating employment.



No one knows for sure whether the economy has in fact turned around. Toxic assets estimated to exceed $1 trillion remain to be washed out of the system. The government stimulus packages will create employment in the short term, but will increase government debt, taxes and potentially inflation over the long term.

There are systemic challenges: the U.S. accounts for more than 17% of the world's consumption. When part of this demand was financed in the past by homeowner real estate equity, the U.S. consumer was able to sustain a large amount of the world's economic growth. With U.S. consumers now repairing their personal

balance sheets, saving instead of borrowing, U.S. consumer demand will be down, which will continue to suppress global economic production and employment.

Not only is the U.S. running a large fiscal deficit, it is also running a large trade deficit with China. U.S. consumers bought Chinese goods with U.S. dollars; Chinese investors invested their U.S. dollars in U.S. Treasury Bonds. China now holds close to a trillion dollars in U.S. Treasury Bonds. It is in China's interest to maintain the value of these holdings by continuing to acquire U.S. dollars through export trade to the U.S. But if they should no longer consider the U.S. government to be creditworthy, and begin liquidating their holdings of U.S. bonds, the impact on the global economy could be cataclysmic.

As was stated at the end of Part II: there has been considerable commentary about the economy and direction it will take from a wide range of financial experts and non-experts. No one really knows, of course.

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

Trustee Election

Annually, in November, an election is held to select two trustees for the upcoming two year period. A Notice of Election is sent to all members in September, asking for candidates. If you are interested in running or are nominating a candidate, please be advised that the forms must be in the Pension Administration Office by the first week of October.

Faculty Pension Plan Workshops

The Faculty Pension Plan offers two regularly scheduled seminars – one provides general information about the Faculty Pension Plan and is of interest to new and existing members. The other provides information about the Plan's retirement options and is suited to members who are approaching retirement.

The **General Information** seminar is on October 30th from 1:00 pm to 3:00 pm.

The **Retirement Options** seminar is on October 2nd from noon to 3:00 pm.

To register for these seminars, or to learn more about them, please contact Jim Loughlean at 604-822-8987 or jim.loughlean@ubc.ca.

Faculty Pension Plan Board Members

Mr. Joost Blom, Chair, Law 604-822-4564

Dr. Robert Heinkel, Vice-Chair Commerce 604-822-8347

Dr. Joy Begley, Commerce................ 604-822-8527

Dr. Joyce Boon, Biology/ Physical Geography........................... 250-807-9545

Dr. Joanne Emerman, Cellular & Physiological Sciences 604-822-2969

Dr. Neil Guppy, Sociology 604-822-3670

Dr. Kai Li, Commerce 604-822-8353

Mr. Al Poettcker, UBC Properties Trust......................... 604-731-3103

Faculty Pension Plan Staff

Executive Director – Investments
Mr. Mike Leslie 604-822-6429

Executive Director – Operations & Secretary to the Board
Ms. Cheryl Neighbour......................... 604-822-8112

Correspondence/Queries:

UBC Faculty Pension Plan
#235 – 2075 Wesbrook Mall
General Services Admin. Building
Vancouver, B.C. V6T 1Z1

Reception....................................... 604-822-8100
Jim Loughlean 604-822-8987
Louise Mah...................................... 604-822-6015
Frances Lu 604-822-8647
Fax Line... 604-822-9471
Email:... fpp@hr.ubc.ca

Web: http:// www.pensions.ubc.ca/faculty

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Market commentary

The second quarter of 2009 reflected a reversal in fortunes as all major stock markets had very strong returns from lows reached in early March, 2009. The market sentiment seemed to improve as fears of a potential depression lessened and the major central banks provided significant stimulus to their economies.

The Canadian equity market was up 20% in the second quarter which boosted the year-to-date return to 17.6% and almost a 39% gain since the March 2009 market lows. All of the industry market sectors had positive returns for the quarter, except Telecom (-1%). Financials and Info Tech were the strongest performing sectors for the quarter while the market's heavy weighting in Energy was also a positive factor for the market returns.

The U.S. stock market had a strong quarter (+7.0% in C$), again due to reduced investor fear of a depression and media talk of a potential cyclical recovery possibly by early 2010. This has led to a reduction in the year-over-year market decline from more than -24% at the beginning of the quarter to the current -15.5%. International equities, as measured by the MSCI-EAFE index, returned 15.8% in C$ in the second quarter and are now slightly positive (+1.6%) year-to-date. Returns for the second quarter were positive across most countries in the EAFE index.

The second quarter was also positive for bonds with the DEX Universe Bond index up 1.3%. Long-term bonds were the strongest segment (+2.3%) while Real Return bonds also had a reasonable 1.3% return for the quarter. The big story of the second quarter was the very significant outperformance of Corporate bonds over Government bonds. This was largely a result of a renewed investor appetite for risk and also the lessening of liquidity concerns with these bonds.

Performance of Funds for periods ending June 30, 2009

	3 Months	1 year	3 years	5 years	10 years
Balanced Fund - gross	7.76%	-10.08%	1.52%	4.64%	4.96%
Balanced Fund - net	7.64%	-10.51%	1.05%	4.17%	4.51%
Composite Index 1	7.80%	-8.75%	1.47%	4.32%	4.50%
Bond Fund - gross	3.19%	4.48%	5.76%	5.38%	5.95%
Bond Fund - net	3.10%	4.15%	5.48%	5.12%	5.69%
Composite Index 2	1.27%	5.65%	5.89%	5.63%	6.17%
Canadian Equity Fund - gross	19.41%	-23.49%	0.55%	7.39%	8.11%
Canadian Equity Fund - net	19.26%	-23.83%	0.13%	N/A	N/A
Composite Index 3	20.00%	-25.43%	-0.35%	6.71%	6.47%
Foreign Equity Fund - gross	11.06%	-20.56%	-7.77%	-2.62%	-1.92%
Foreign Equity Fund - net	10.92%	-20.96%	-8.14%	N/A	N/A
Composite Index 4	10.91%	-17.73%	-6.30%	-2.27%	-1.84%
Short Term Investment Fund - gross	0.08%	1.67%	3.36%	3.17%	3.70%
Short Term Investment Fund - net	0.04%	1.52%	3.21%	2.99%	3.47%
Composite Index 5	0.08%	1.38%	3.13%	2.98%	3.40%

Composite Index 1: *33% DEX Universe, 10% S&P/TSX Capped, 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*

Composite Index 5: *DEX 91-Day TB Index until Aug 2007, DEX 30-Day TB Index commencing Sep 2007*

Composition of Funds as at June 30, 2009

BALANCED FUND	**Market Value ($ Millions)**	**% of Fund**
Equities - Canada	195.4	20.8%
Equities - U.S.	138.5	14.7%
Equities - EAFE	127.2	13.5%
Absolute Return Hedge Fund	21.3	2.3%
Real Estate - Canada	90.7	9.6%
Fixed Income	311.9	33.2%
Real Return Bonds - Canada	48.4	5.1%
Cash & Short term	7.5	0.8%
Total Balanced Fund	940.9	100.0%
BOND FUND		
Fixed Income	37.7	86.7%
Real Return Bonds - Canada	5.8	13.3%
Total Bond Fund	43.5	100.0%
CANADIAN EQUITY FUND	73.6	100.0%
FOREIGN EQUITY FUND		
Equities - U.S.	13.6	49.9%
Equities - EAFE	12.4	45.7%
Absolute Return Hedge Fund	1.2	4.4%
Total Foreign Equity Fund	27.2	100.0%
SHORT TERM INVESTMENT FUND	66.2	100.0%