

# *Alberta Heritage Savings Trust Fund Business Plan*



THE RIGHT DECISIONS FOR CHALLENGING TIMES

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The Business Plan was reviewed and approved by Treasury Board on January 28, 2002 and by the Legislature's Standing Committee on the Alberta Heritage Savings Trust Fund on February 13, 2002.

## BACKGROUND

### INTRODUCTION

- ◆ The Alberta Heritage Savings Trust Fund (the Heritage Fund) was created in 1976 as a means to provide savings of non-renewable resource revenue. The Heritage Fund grew from a portion of Alberta's oil and gas revenue being deposited into the Fund since inception in 1976 and until 1987. As well, prior to 1982, the Heritage Fund kept its investment income.
- ◆ On January 1, 1997 the Heritage Fund was restructured in response to a public review of the Fund. The restructuring included a new governance structure as well as the establishment of new investment objectives and performance measures. The Heritage Fund's first business plan was implemented in January 1997.

### FISCAL CONTEXT

- ◆ Assets and income of the Heritage Fund are fully consolidated with the assets and revenue of the Province. For fiscal planning purposes, and under the *Balanced Budget and Debt Retirement Act* of 1995: (i) consolidated Heritage Fund income is included in the determination of the Province's budget surplus, and (ii) Heritage Fund assets are netted off gross liabilities in determining the net asset position of the Province.
- ◆ The *Fiscal Responsibility Act* (FRA) sets out a legislative schedule to eliminate the Province's accumulated debt in no more than 25 years. The FRA amended the *Alberta Heritage Savings Trust Fund Act* to grant the Minister of Revenue the discretion to protect the real value of the Heritage Fund when revenue is sufficient to do so.

### PURPOSE

- ◆ This is the sixth business plan for the Heritage Fund, which amends the previous business plans and incorporates updated financial information and income forecasts. This plan sets out the broad objectives of the Heritage Fund as expressed in the legislation, specific investment objectives, goals and strategies to achieve the Heritage Fund's objectives, and performance measures.

## 2002 - 05 BUSINESS PLAN

The business plan incorporates the following changes:

1. Heritage Fund exposure to real estate and private equity has been increased. Absolute return strategies have been introduced to continue the focus on the long term. Research has demonstrated that increasing exposure to real estate, private equity and absolute return strategies can create a portfolio with improved risk/return possibilities even after the additional investment costs associated with these assets are taken into account. Furthermore, a 15% exposure phased in over a 2-year period, and composed of 2% in private equity, 3% in absolute return strategies, and 10% real estate, can be justified towards improving portfolio risk and return. A 15% exposure is also in line with other North American endowment funds.
2. Consistent with the changes in the weightings for non-traditional asset classes new benchmarks and new benchmark allocations have been selected. In choosing a benchmark to measure investment performance, it is appropriate to distinguish between the policy benchmark for each asset class (i.e., the benchmark used in calculating the

total fund benchmark); and the manager benchmark (i.e., the benchmark used to assess the performance of the manager(s) within each asset class). This approach is being used with small cap investments. For Canadian Small Cap, the policy benchmark is the TSE 300, while the manager benchmark is the Nesbitt Burns Small Cap Index. The policy benchmarks for the real estate, private equity, and absolute return strategy asset classes are inflation, as measured by the CPI index, plus 5%, 8%, and 6%, respectively. Benchmarking these investments at the policy level to a spread over inflation is consistent with the objective of endowment funds to generate a return that will protect the real value of the fund and facilitate spending over this amount. The basis for the manager benchmarks for each asset class is as follows:

- ◆ **Real Estate** - Russell Canada Property Index (RCPI) is a total return index based on holdings across 14 Canadian institutional real estate investment advisors. RCPI is the current Canadian manager benchmark and in the absence of compelling reasons to do otherwise, it will be retained until it is replaced by a more viable alternative. For U.S. real estate the National Council of Real Estate Investment Fiduciaries (NCREIF) has been chosen for physical, or traditional real estate investing. This index is similar in construction to the RCPI. The National Association of Real Estate Investment Trusts (NAREIT) is used for investments in publicly traded real estate investment trusts and measures the total return of all 198 REITs currently trading on the NYSE. Both indices are widely accepted benchmarks for institutional real estate investing.
  - ◆ **Private Equities** - With no private equity benchmarks in Canada, the TSE 300 + 2.5% will be retained as the manager benchmark for this asset class. This is the current benchmark used in the Private Equity Pools (PEP and PEP98) product description. In the U.S., the widely recognized Venture Economics index is used as the manager benchmark.
  - ◆ **Absolute Return Strategies** - The three major absolute return strategy indices are Hedge Fund Research (HFR), Managed Account Reports (MAR) / Zurich and Credit Suisse First Boston (CSFB) / Tremont. These benchmarks are median manager surveys based on a pool of firms. The decision as to which index to use should be made in consultation with the selected fund-of-funds manager(s). An informal survey of fund-of-funds managers has indicated that CSFB/Tremont is the preferred choice.
3. The Transition Portfolio transfer is maintained at \$3.6 billion annually or \$300 million per month. As the Endowment Portfolio now exceeds the Transition Portfolio the Transition Portfolio's focus has moved to providing greater liquidity to facilitate the transfers to the Endowment Portfolio. This requires the Portfolio maintain short-term assets that act as a drag on the total fund performance. To maintain the Heritage Fund performance and reduce the "cash drag" the transfers will continue as indicated so as to liquidate the Transition Portfolio by August 2002. This allows flexibility to take advantage of market conditions or opportunities without compromising the discipline of "dollar-averaging" (the systematic investing of funds over time) used in the transition.

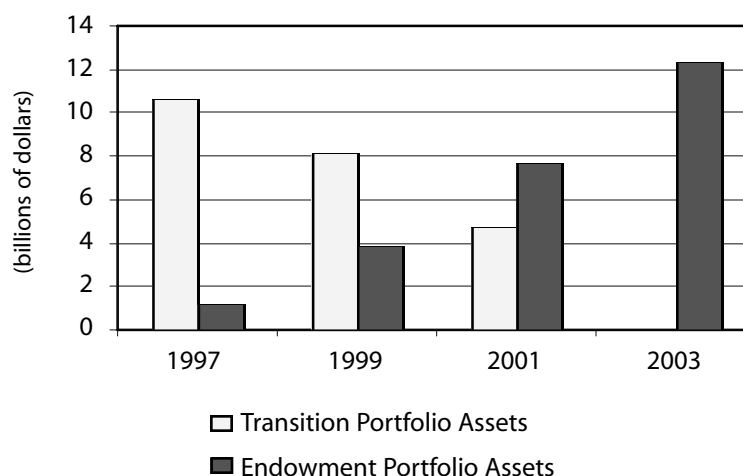
## HERITAGE FUND STRUCTURE

The **mission** of the Heritage Fund is as follows:

"To provide prudent stewardship of the savings from Alberta's non-renewable resources by providing the greatest financial returns for current and future generations of Albertans".

- ◆ The government keeps its books on a consolidated basis and therefore the Heritage Fund income is included in consolidated income for the Province. Consequently, the level and variability of Heritage Fund income is important to the government's fiscal plan.
- ◆ Income will vary significantly from year to year for the following reasons:
  1. An investment policy to maximize long-term returns implies a significantly higher weighting towards investments in equities in comparison to the equity holdings at the time the Heritage Fund was restructured. Equities have historically provided investors with higher total returns (dividends and capital gains) than fixed income investments, however, dividend rates in general are lower than interest rates thereby providing lower current income. The timing of realizing capital gains is also uncertain.
  2. The well-established capital market principle that increased returns, as provided by equity investments, are accompanied with increased risk or return volatility means that the Heritage Fund's income would be more variable.
- ◆ In order to provide for an orderly transition between the need for current income and long-term investment goals, the Heritage Fund was divided into two separate portfolios: a Transition Portfolio and an Endowment Portfolio.
- ◆ The Transition Portfolio is invested primarily in interest bearing securities to generate current income to support the Province's fiscal plan and to provide liquidity to facilitate transfers to the Endowment Portfolio. The Transition Portfolio has supported the Province's current income but now sees its role diminish as it is reduced in size and the Endowment Portfolio grows over the transition period.
- ◆ The Endowment Portfolio is invested in a diversified portfolio including interest bearing securities, Canadian equities, international equities, and real estate. The Portfolio is invested to generate long-term returns to support the Province's income and spending needs.
- ◆ The 1996-1997 re-structuring of the Heritage Fund allowed for a ten year transition where all assets would be transferred from the Transition Portfolio to the Endowment Portfolio by December 31, 2005 based on minimum annual transfers of \$1.2 billion. With the \$2.4 billion transfer for fiscal 2000-01, \$3.6 billion for 2001-02 and continuing into 2002-03 the Transition Portfolio should be eliminated by August 2002.

## SCHEDULE OF TRANSITION



### Alberta Heritage Savings Trust Fund Assets as at December 31, 2001

(thousands of dollars)

Fund Investments	Cost*	Fair Value
<b>Endowment Portfolio</b>		
Cash	\$ 55,727	\$ 55,727
Fixed Income Securities	3,486,391	3,473,252
Canadian Equities	2,139,208	2,411,013
United States Equities	1,915,255	1,794,950
Non-North American Equities	1,884,041	1,830,070
Real Estate	568,304	593,187
<b>Total Investments - Endowment Portfolio</b>	<b>10,048,926</b>	<b>10,158,199</b>
<b>Transition Portfolio</b>		
Cash	52,559	52,559
Fixed Income Securities	1,667,678	1,692,078
Provincial Corporation Debentures	160,900	231,265
	<u>1,881,137</u>	<u>1,975,902</u>
Loans		
Ridley Grain Ltd.	91,245	91,245
Vencap Acquisition Corporation	6,114	6,114
	<u>97,359</u>	<u>97,359</u>
<b>Total Investments - Transition Portfolio</b>	<b>1,978,496</b>	<b>2,073,261</b>
<b>Total Investments</b>	<b>12,027,422</b>	<b>12,231,460</b>
Due from the General Revenue Fund	218,892	218,892
Accrued interest and accounts receivable	30,005	30,005
Liabilities for investment purchases	(20,000)	(20,000)
	<u>228,897</u>	<u>228,897</u>
<b>Fund Equity</b>	<b>\$12,256,319</b>	<b>\$12,460,357</b>

\* Cost includes amortization of purchase price discount or premium.

## **GOALS, STRATEGIES AND OUTPUTS, OUTCOMES, AND PERFORMANCE MEASURES**

The legislated investment objective of the **Endowment Portfolio** is:

**Investments shall be made with the objective of maximizing long-term financial returns.**

- ◆ Given a long-term investment horizon, investment practice suggests that a mix of equities (including real estate) and interest-bearing securities best achieves the objective of optimizing financial returns as it provides enhanced returns and diversifies risk. A long-term investment horizon generally means 10 years, however, for investment performance comparisons a minimum period of 4 years will be examined. Emphasis on "long-term" in the investment objective is designed to help the investment manager continue to plan and execute strategies in a long-term context at times when short-term pressures exist.

The legislated investment objective of the **Transition Portfolio** is:

**Investments shall be made with the objective of supporting the government's short-term to medium-term income needs as reflected in the government's consolidated fiscal plan.**

- ◆ To support the Province's revenue needs the Transition Portfolio was required to generate a stable source of income. Consequently, it was important the assets be revenue generating, and not exposed to significant credit risk. Additionally, due to the transfer program, assets were required to be liquid (easily traded) so as to facilitate the monthly transfers to the Endowment Portfolio. This was accomplished by having a high quality portfolio of bonds and money market securities.
- ◆ The transition is nearly complete such that the current rate of transfer of \$300 million per month will eliminate the Portfolio, save policy loans, in less than a year. As such, the need for liquidity to match the monthly income and Endowment transfers continues to grow. The Transition Portfolio's size also means it is no longer able to generate a level of income consistent with the investment objective. However, the Endowment Portfolio contains a substantial holding in fixed income securities including bonds and mortgages. These assets provide a stable source of revenue to the Province, as does the income from real estate investments.
- ◆ In the past, the Transition Portfolio has been compared to the cost of the Province's debt. As the Transition Portfolio declines in size and the liquidity needs increase, due to the transfer program, this comparison has become less meaningful.

## GOAL 1: EARN INCOME TO SUPPORT THE GOVERNMENT'S CONSOLIDATED FISCAL PLAN

STRATEGIES/OUTPUTS	OUTCOMES	PERFORMANCE MEASURES/ BENCHMARKS																				
<ul style="list-style-type: none"> <li>◆ Invest Transition Portfolio assets in accordance with the investment industry standard "Prudent Person Rule" which assigns the investment manager responsibility to restrict investment to assets that would be approved by a prudent investor.</li> <li>◆ Invest in interest bearing securities (Canadian dollar issues; non-Canadian dollar issues would be swapped into Canadian dollars) that are rated at time of purchase a minimum of investment grade (BBB or equivalent) by a recognized rating agency or in the absence thereof by Alberta Revenue.</li> <li>◆ Maintain sufficient liquidity to accommodate the transfers to the Endowment Portfolio.</li> <li>◆ Limit investments to the various categories of interest-bearing securities (% of market value): <table style="margin-left: 40px; border-collapse: collapse;"> <thead> <tr> <th></th> <th style="text-align: center; border-bottom: 1px solid black;">Maximum (%)</th> </tr> </thead> <tbody> <tr> <td>Canada &amp; Guaranteed . . . . .</td> <td style="text-align: center;">No Limit</td> </tr> <tr> <td>Alberta . . . . .</td> <td style="text-align: center;">15</td> </tr> <tr> <td>Other Provincial Debt . . . . .</td> <td style="text-align: center;">55</td> </tr> <tr> <td>Municipal . . . . .</td> <td style="text-align: center;">5</td> </tr> <tr> <td>Asset-backed . . . . .</td> <td style="text-align: center;">15</td> </tr> <tr> <td>Private Corporate . . . . .</td> <td style="text-align: center;">10</td> </tr> <tr> <td>Public Corporate . . . . .</td> <td style="text-align: center;">35</td> </tr> <tr> <td>Mortgages . . . . .</td> <td style="text-align: center;">5</td> </tr> <tr> <td>Other Sovereign<sup>1</sup> . . . . .</td> <td style="text-align: center;">5</td> </tr> </tbody> </table> </li> <li>◆ Maintain the transfer of cash, short-term fixed income securities or other appropriate securities to the Endowment Portfolio at a \$3.6 billion annual rate. Cash forecasting is done to ensure that the appropriate type and amount of securities are available for transfer on a monthly basis (averages \$300 million per month).</li> </ul>		Maximum (%)	Canada & Guaranteed . . . . .	No Limit	Alberta . . . . .	15	Other Provincial Debt . . . . .	55	Municipal . . . . .	5	Asset-backed . . . . .	15	Private Corporate . . . . .	10	Public Corporate . . . . .	35	Mortgages . . . . .	5	Other Sovereign <sup>1</sup> . . . . .	5	<ul style="list-style-type: none"> <li>◆ A level of income to the government's fiscal plan without undue variation to the Province's bottom line.</li> <li>◆ Investments consistent with the objectives of the Transition Portfolio.</li> <li>◆ Orderly transfer of assets from the Transition Portfolio to the Endowment Portfolio.</li> </ul>	<p><b>Primary Performance Measure</b></p> <ul style="list-style-type: none"> <li>◆ The market value rate of return on the Transition Portfolio, which is included in the total return for the Heritage Fund.</li> <li>◆ Measuring performance on a market value basis is the accepted standard in the investment industry because it should lead to the best long-term investment management decisions.</li> </ul>
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<sup>1</sup> Would be swapped into Canadian dollars to eliminate currency risk.

(Continued . . .)



**GOAL 1: EARN INCOME TO SUPPORT THE GOVERNMENT'S CONSOLIDATED FISCAL PLAN**

STRATEGIES/OUTPUTS	OUTCOMES	PERFORMANCE MEASURES/ BENCHMARKS
<ul style="list-style-type: none"> <li>◆ Reduce the Heritage Fund's investment in Alberta provincial corporations, subject to liability management considerations.</li>   <li>◆ Reduce the Heritage Fund's investment in project loans. Remaining project loans include Vencap Acquisition Corporation and Ridley Grain Ltd. with a total cost value of \$97.4 million.</li>   <li>◆ The Endowment Portfolio has a minimum weighting of 25% of assets in fixed income investments.</li> </ul>	<ul style="list-style-type: none"> <li>◆ Debentures will be paid out on interest rate re-set dates and the proceeds will be re-deployed within the Transition Portfolio.</li>   <li>◆ Provides a stable source of income to the Province.</li> </ul>	

## GOAL 2: MAKE INVESTMENTS IN THE ENDOWMENT PORTFOLIO TO MAXIMIZE LONG TERM FINANCIAL RETURNS

STRATEGIES/OUTPUTS	OUTCOMES	PERFORMANCE MEASURES/ BENCHMARKS																																															
<ul style="list-style-type: none"> <li>◆ Invest Endowment Portfolio assets in accordance with the investment industry standard "Prudent Person Rule" which assigns the investment manager responsibility to restrict investment to assets that would be approved by a prudent investor.</li> <li>◆ To diversify risk and enhance expected returns, allocate the Endowment Portfolio assets among the following asset classes and within the noted ranges (expressed as a % of the Endowment Portfolio's market value): <table border="0" style="margin-left: 20px;"> <tr> <td style="padding-right: 20px;"><b>Asset Class</b></td> <td><b>Holdings (%)</b></td> </tr> <tr> <td>Interest-Bearing Securities<sup>2</sup></td> <td>25% to 45%</td> </tr> <tr> <td>Equity<sup>3</sup></td> <td>75% to 55%</td> </tr> </table> </li> <li>◆ Diversify investments within each subcategory of the asset classes set out above.</li> <li>◆ The Investment Operations Committee (see Attachment A) will recommend minimum and maximum holdings for the asset classes and review periodically the benchmarks to be used in measuring performance.</li> <li>◆ The Investment Management Division of Alberta Revenue will vary the allocation of assets within the above policy ranges based on the outlook for financial markets.</li> <li>◆ The Investment Operations Committee will determine the extent of use of external investment managers to manage portions of the Portfolio, and the criteria for their selection.</li> </ul>	<b>Asset Class</b>	<b>Holdings (%)</b>	Interest-Bearing Securities <sup>2</sup>	25% to 45%	Equity <sup>3</sup>	75% to 55%	<ul style="list-style-type: none"> <li>◆ The market rate of return on the Portfolio is expected to exceed the cost of the Province's debt.</li> <li>◆ The Portfolio is expected to generate a real rate of return of 5.0% at an acceptable level of risk over a moving four-year period.</li> <li>◆ Market rate of return is expected to be greater than a passively invested benchmark portfolio.</li> </ul>	<p><b>Performance Measure</b></p> <ul style="list-style-type: none"> <li>◆ The market value rate of return will be compared against the borrowing cost of the Province on a moving four-year basis.</li> <li>◆ The market value rate of return will be compared against the level of inflation to determine whether the long term capital market assumptions on which the investment policy is based are achieving the returns relative to expectations.</li> <li>◆ The market value rate of return will be compared against a "policy benchmark return" to determine the impact of fund management on performance.</li> </ul> <table border="1" style="margin-left: 20px; width: 100%; border-collapse: collapse;"> <thead> <tr> <th rowspan="2" style="text-align: left;">Asset Class</th> <th colspan="2" style="text-align: center;">Benchmark</th> </tr> <tr> <th style="text-align: center;">Policy Allocation</th> <th style="text-align: center;">Return Index</th> </tr> </thead> <tbody> <tr> <td colspan="3"><b>Fixed Income</b></td> </tr> <tr> <td>Money market</td> <td style="text-align: center;">2%</td> <td>SC 91 day T-Bill</td> </tr> <tr> <td>Bonds</td> <td style="text-align: center;"><u>33%</u></td> <td>SC Universe</td> </tr> <tr> <td>Total</td> <td style="text-align: center;"><u>35%</u></td> <td></td> </tr> <tr> <td colspan="3"><b>Equity</b></td> </tr> <tr> <td>Canadian Equity</td> <td style="text-align: center;">20%</td> <td>TSE 300</td> </tr> <tr> <td>U.S.</td> <td style="text-align: center;">15%</td> <td>S&amp;P 500</td> </tr> <tr> <td>EAFE</td> <td style="text-align: center;">15%</td> <td>MSCI EAFE</td> </tr> <tr> <td>Private Equity</td> <td style="text-align: center;">2%</td> <td>CPI + 8%</td> </tr> <tr> <td>Real Estate</td> <td style="text-align: center;">10%</td> <td>CPI + 5%</td> </tr> <tr> <td>Absolute Return Strategies</td> <td style="text-align: center;"><u>3%</u></td> <td>CPI + 6%</td> </tr> <tr> <td>Total</td> <td style="text-align: center;"><u>65%</u></td> <td></td> </tr> </tbody> </table> <ul style="list-style-type: none"> <li>◆ The market value rate of return will be compared against a sample of other large pension and endowment funds to measure whether the investment policy is resulting in competitive fund returns.</li> <li>◆ The returns on the real estate component will be adjusted to reflect a comparable calculation base as the Russell Canada Property Index.</li> <li>◆ Each external manager mandate is tied to an appropriate market index as a benchmark.</li> </ul>	Asset Class	Benchmark		Policy Allocation	Return Index	<b>Fixed Income</b>			Money market	2%	SC 91 day T-Bill	Bonds	<u>33%</u>	SC Universe	Total	<u>35%</u>		<b>Equity</b>			Canadian Equity	20%	TSE 300	U.S.	15%	S&P 500	EAFE	15%	MSCI EAFE	Private Equity	2%	CPI + 8%	Real Estate	10%	CPI + 5%	Absolute Return Strategies	<u>3%</u>	CPI + 6%	Total	<u>65%</u>	
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<sup>2</sup> Includes money market instruments, bonds and mortgages.

<sup>3</sup> Includes Canadian public and private equities, foreign equities and Canadian real estate. Foreign investments will be limited to 40% of market value.

**GOAL 3: TO IMPROVE ALBERTANS' UNDERSTANDING AND THE TRANSPARENCY OF THE ALBERTA HERITAGE SAVINGS TRUST FUND**

STRATEGIES/OUTPUTS	OUTCOMES	PERFORMANCE MEASURES/ BENCHMARKS
<ul style="list-style-type: none"> <li>◆ Release quarterly and annual reports on a timely basis.</li> <li>◆ Release summary reports of the Heritage Fund's investment activities and results for Albertans on a timely basis.</li> <li>◆ Publish the Heritage Fund Business Plan annually.</li> <li>◆ The Legislature's Standing Committee on the Alberta Heritage Savings Trust Fund will hold annual public accountability meetings around Alberta to report on the Heritage Fund's results and to answer questions on the Heritage Fund's performance.</li> </ul>	<ul style="list-style-type: none"> <li>◆ Improved understanding by Albertans of the management, operations and performance of the Heritage Fund.</li> </ul>	<p><b>Performance Measure</b></p> <ul style="list-style-type: none"> <li>◆ Timeliness of reports and public accountability meetings.</li> <li>◆ Satisfaction of Albertans regarding information provided about the Heritage Fund.</li> </ul> <p><b>Benchmark</b></p> <ul style="list-style-type: none"> <li>◆ Annual report will be released by June 30 of each year.</li> <li>◆ Quarterly reports will be released within 2 months after the conclusion of the quarter.</li> <li>◆ The Standing Committee on the Alberta Heritage Savings Trust Fund will hold public accountability meetings around the province in the fall of each year.</li> </ul>

## MANAGEMENT AND ACCOUNTABILITY

- ◆ A clear mission statement and investment objectives for the Heritage Fund have been established in legislation.
- ◆ A Standing Committee of the Legislature has been established to provide overall direction and evaluate the performance of the Heritage Fund and report regularly to Albertans.
- ◆ The Investment Operations Committee reviews and approves the Business Plan, quarterly and annual reports, and the investment policies for the Heritage Fund. The Committee includes a majority of private sector members with relevant financial and business expertise.
- ◆ Ongoing investment decisions will be made within Alberta Revenue consistent with the allocation of responsibilities set out in Attachment A.
- ◆ For each component of the Heritage Fund that is externally managed, an investment management mandate describing its purpose, goals and constraints will be established.
- ◆ The investment management mandates of external managers will be consistent with this Business Plan.
- ◆ The Auditor General is the auditor of the Heritage Fund.
- ◆ There are restrictions on the kind of investments that can be made. Heritage Fund assets are to be invested prudently and cannot be used directly for economic development or social investment purposes.

## INCOME AND EXPENSES

- ◆ The rates of return on, and the income from, the Heritage Fund have become more volatile as the Endowment Portfolio grows and as equity investments increase. While equity investments have historically, over long periods of time, provided higher rates of return than fixed income investments they are also significantly more volatile. Capital gains on traditional equity investments are not recognized as income until the investment is sold, so strong performance reflected in rates of return may not be reflected in income for some time. Unlike traditional equity instruments, income and expenses on equity index swaps are accrued as earned. As a result, market value gains and losses are realized as they occur.
- ◆ Following are current projections of the Heritage Fund income based on the assumptions noted. Actual results will vary from projected income depending on the extent to which actual interest rates and equity market returns vary from the assumptions used. Forecast gross investment income decreases over the fiscal plan period due to the lower interest rate environment and the increasing investment in equities in the Endowment Portfolio, which contribute lower "current income".
- ◆ The income projections **include**:
  - ◆ interest income
  - ◆ dividend income
  - ◆ capital gains or losses only when they are realized, such as when an investment is sold
  - ◆ income and expense on index swaps and interest rate swaps accrued as earned
- ◆ The income projections do **not include**:
  - ◆ unrealized capital gains

## Alberta Heritage Savings Trust Fund Income Forecasts and Underlying Assumptions

	2001-02	2002-03	2003-04	2004-05
<b>Forecast Annual Income (\$millions)</b>				
<b>Unconsolidated Investment Income</b>	<b>193.2</b>	<b>590.5</b>	<b>794.6</b>	<b>940.2</b>
<b>Consolidated Investment Income</b>	<b>161.9</b>	<b>572.6</b>	<b>777.6</b>	<b>924.2</b>
<b>Assumptions (%)</b>				
1. Interest Rates (nominal)				
Transition Portfolio (re-investment rate)				
Money Market (3 months)	0.9%*	3.2%	n/a	n/a
Bonds (2-3 year rate)	1.0%*	n/a	n/a	n/a
Endowment Portfolio				
Fixed Income Securities	1.55%*	6.18%	6.18%	6.18%
2. Equities				
Estimated Income Rates	-2.4%	4.2%	6.7%	7.9%
3. Rates of Return on Equities				
Canadian	2.28%*	7.14%	9.14%	9.14%
Foreign	2.79%*	9.16%	11.16%	11.16%
4. Endowment Portfolio Asset Mix				
Money Market	2%	2%	2%	2%
Bonds	33%	33%	33%	33%
Equities	65%	65%	65%	65%
<b>Sensitivity Analysis (\$millions)</b>				
1% change in yield**		50.8	45.5	46.4
1% change in equity returns		22.3	42.9	59.2

\* Quarterly rate based on annual assumptions

\*\*Does not include the potential effect of realized capital gains or losses

- ◆ Investment income is in part dependent on prevailing market conditions that are subject to occasional volatile movements. A significant portion of the current portfolio is invested in bonds, and has a predictable income stream. As these holdings mature, the future income will be increasingly dependent on the prevailing market conditions at the time of re-investment.
- ◆ The above income projections for the Heritage Fund are net of estimated investment expenses as outlined below:

### Alberta Heritage Savings Trust Fund Investment Expenses

(millions of dollars)

	2001-02	2002-03	2003-04	2004-05
Direct	1.8	1.8	2.0	2.0
External/Internal Managed Pools	7.6	10.0	10.0	10.0
<b>Total</b>	<b>9.4</b>	<b>12.0</b>	<b>12.0</b>	<b>12.0</b>
As a % of Assets	0.08%	0.10%	0.10%	0.10%

- ◆ The administrative expenses above include both direct and indirect administrative expenses, which include staff time, supplies and services and investment transaction and advisory services.

## **ATTACHMENT A**

### **HERITAGE FUND ALLOCATION OF RESPONSIBILITIES**

- ◆ The *Alberta Heritage Savings Trust Fund Act* sets out the governance structure for the Heritage Fund. The general division of responsibilities is described below.

#### **Standing Committee on the Alberta Heritage Savings Trust Fund**

(A Committee of the Legislative Assembly)

1. Review and approve annually the Business Plan for the Heritage Fund.
2. Receive and review quarterly reports from the Minister of Revenue on the operation and results of the operation of the Heritage Fund.
3. Approve and release the Heritage Fund Annual Report on, or before, June 30 following the conclusion of the fiscal year for which the annual report was made.
4. Review after each fiscal year end the investment activities and the performance of the Heritage Fund and report to the Legislative Assembly as to whether the mission of the Heritage Fund is being fulfilled.
5. Hold public meetings with Albertans on the Heritage Fund's investment activities and results.

#### **Treasury Board**

1. Annually review and approve the Business Plan of the Heritage Fund.

#### **Minister of Revenue**

1. Approve the Statements of Investment Policy for each portfolio, including any proposed changes thereto.
2. Approve and present the annual Business Plan of the Heritage Fund to Treasury Board and to the Standing Committee.

#### **Investment Operations Committee**

1. Review and recommend the Business Plan to the Minister of Revenue for transmittal to Treasury Board and the Standing Committee.
2. Review and recommend the investment policy statements for the Endowment Portfolio and the Transition Portfolio to the Minister of Revenue.
3. Review and recommend the financial statements and the Annual Report.
4. Approve the quarterly reports for transmittal to the Minister of Revenue.
5. Advise on the extent of use of external managers and the criteria for selection.

#### **Alberta Revenue**

1. Serve as investment manager of the assets of the Heritage Fund.
2. Prepare and recommend a Business Plan to the Investment Operations Committee and the Minister of Revenue.
3. Prepare, and recommend to the Investment Operations Committee and the Minister of Revenue, Statements of Investment Policy for each portfolio and any proposed changes to the investment policies.
4. Prepare a quarterly report on the investment activities and results of the Heritage Fund including income forecasts.
5. Prepare financial statements for the Heritage Fund.
6. Prepare the Annual Report of the Heritage Fund.

## **ATTACHMENT B**

### **DESCRIPTION OF BENCHMARK INDICES FOR THE ENDOWMENT FUND**

#### **Scotia Capital 91 day T-Bills Index (SC T-Bills Index)**

Reflects the performance of the Canadian money market as measured by investments in 91 day Treasury Bills.

#### **Scotia Capital Universe Bond Index (SC Universe Index)**

Covers all marketable Canadian bonds with terms to maturity of more than one year. The purpose of this index is to reflect performance of the broad Canadian bond market in a manner similar to the way the TSE 300 represents the Canadian equity market.

#### **Toronto Stock Exchange 300 Total Return Index (TSE 300 Index)**

An index of 300 stocks, in fourteen subgroups, listed on the Toronto Stock Exchange designed to represent the Canadian equity market. It is a capitalization-weighted index calculated on a total return basis.

#### **Morgan Stanley Capital International World (excluding Canada) (MSCI World)**

An index of over 1,470 stocks on 23 stock exchanges around the world designed to represent an international equity market (excluding Canada). The index is calculated on a total return basis, which includes investment of gross dividends before deduction of withholding taxes. The index covers about 60% of the issues listed on the exchanges of the countries included.

#### **Russell Canadian Property Index (RCPI)**

An index comprised of institutionally held real estate investments consisting of over 1,100 properties distributed across Canada.

#### **Standard & Poor's 500 Index (S&P 500 Index)**

Covers 500 industrial, utility, transportation and financial companies of the US markets, mostly New York Stock Exchange issues. It is a capitalization-weighted index calculated on a total return basis with dividends reinvested.

#### **Morgan Stanley Capital International Europe, Australia, Far East Index (MSCI EAFE Index)**

An index of over 900 securities listed on the stock exchanges of countries in Europe, Australia and the Far East. The index is calculated on a total return basis, which includes re-investment of gross dividends before deduction of withholding taxes.

#### **Consumer Price Index, Canada (CPI)**

A measure of the average change in Canadian prices over time in a fixed market basket of goods and services.

## ATTACHMENT C BUSINESS PLAN PERFORMANCE

### Alberta Heritage Savings Trust Fund (Combined)

(period ending December 31, 2001)

	Current Quarter	Nine Months	One Year	Four Years*
Actual Return	6.0%	3.4%	1.2%	5.3%

### Transition Portfolio

(period ending December 31, 2001)

	Current Quarter	Nine Months	One Year	Four Years*
Actual Return	1.7%	5.2%	7.4%	6.1%

### Endowment Portfolio

(period ending December 31, 2001)

	Current Quarter	Nine Months	One Year	Four Years*
Actual Return	7.2%	2.5%	-2.6%	6.2%
Benchmark	7.2%	2.8%	-2.4%	5.9%
Over (under) Benchmark	0bp	-30bp	-20bp	30bp

Actual Return	Weight	Current Quarter	Nine Months	One Year	Four Years*
Short-term Fixed Income	3.4%	1.0%	3.4%	5.0%	5.2%
Long-term Fixed Income	31.4%	2.2%	6.6%	8.7%	6.8%
Canadian Equities	23.7%	13.6%	2.4%	-11.1%	5.0%
US Equities	17.7%	11.6%	0.3%	-6.5%	7.0%
EAFE Equities	18.0%	7.4%	-6.8%	-16.2%	6.4%
Real Estate	5.8%	2.4%	5.7%	8.0%	8.8%
Total	100%	7.2%	2.5%	-2.6%	6.2%

Benchmark Return	Weight	Current Quarter	Nine Months	One Year	Four Years*
SC 91 Day T-Bill Index	2.0%	0.9%	3.3%	4.7%	4.9%
SC Universe Bond Index	33.0%	2.1%	6.2%	8.1%	6.5%
TSE 300 Index	23.0%	12.9%	2.3%	-12.6%	5.0%
S & P 500 Index	17.5%	11.9%	1.3%	-6.4%	8.6%
MSCI EAFE Index	17.5%	8.1%	-7.7%	-16.5%	3.5%
Russell Index (estimate)	7.0%	2.4%	7.6%	10.4%	12.2%
Total	100%	7.2%	2.8%	-2.4%	5.9%

\* Annualized



## ATTACHMENT D

### GLOSSARY

#### **active management**

Attempts to achieve portfolio returns greater than a specific index while controlling risk, either by forecasting broad market trends or by identifying particular mispriced sectors of a market or securities in a market.

#### **asset allocation**

The investment process by which the investment manager chooses or allocates funds among broad Asset Classes such as stocks and bonds.

#### **asset-backed securities**

These are debt instruments collateralized by a pool of assets such as automobile loans or equipment leases.

#### **asset (or investment) class**

Refers to a broad category of investments with similar characteristics (the typical asset classes are cash, stocks, bonds and real estate).

#### **benchmark index**

A statistical yardstick tracking the ups and downs of a particular market by monitoring a representative group of securities over time. For example, the Scotia Capital Universe Bond Index is a Benchmark Index that is designed to reflect the changes in the Canadian bond market.

#### **bond**

A financial instrument representing a debt where the issuer (corporation or government) promises to pay to the holder a specific rate of interest over the life of the bond. On the bond's maturity date, the principal is repaid in full to the holder.

#### **capital gain (or capital loss)**

The market value received on the sale of an asset, which is higher (lower) than its purchase price (also called cost). If an asset is bought for \$50 and sold for \$75, the realized capital gain or profit is \$25.

#### **diversification**

The allocation of investment assets within an Asset Class and among asset classes. In general, the greater the number of holdings within an asset class and among asset classes, the greater the diversification, which reduces risk.

#### **dividends**

Earnings distributed to shareholders of a company proportionate to their ownership interest.

#### **duration (or modified duration)**

Modified duration is a measure of price volatility and is the weighted average term to maturity of the security's cash flows (i.e., interest and principal), with weights proportional to the present value of the cash flows. Bonds with a longer duration are more price sensitive to interest rate changes than bonds with short durations.

#### **equities**

Equities are synonymously called stocks or shares and represent an ownership interest in a company (could be either a public or private firm). The shareholder normally has voting rights and may receive dividends based on their proportionate ownership.

#### **inflation**

Increases in the general price level of goods and services. Inflation is one of the major risks to investors over the long-term as savings may actually buy less in the future.

#### **interest-bearing securities**

An investment which is required to pay a fixed interest rate at periodic intervals such as bonds, mortgages and debentures.

## **ATTACHMENT D (continued)**

### **investment grade**

An investment grade bond is rated a minimum of BBB (or equivalent) by a rating agency, with AAA being the highest grade. Bonds rated below BBB are generally classified as being speculative grade and carry higher levels of credit risk than investment grade bonds (i.e., they have a higher probability of default on interest or principal payments).

### **long-term**

A long-term investment horizon in the context of the Endowment Portfolio means a period of time that would include two business cycles, which would generally mean about 10 years.

### **market value rate of return**

An annual percentage, which measures the total proceeds, returned to the investor per dollar invested. Total proceeds for market value rates of return = "money in the bank" plus paper profits or losses (paper profits or losses are also called unrealized capital gains or losses). "Money in the bank" means cash interest and dividends and realized capital gains or losses from selling the investment.

### **median return**

The median return of a group of investment managers reflects the return associated with the manager ranked at the 50th percentile (the 50th percentile is that point where half the managers had a higher return, and half the managers had a lower return).

### **money market instruments**

Debt instruments such as Treasury Bills or corporate paper with a maturity of less than one year.

### **mortgage-backed securities (MBS)**

A debt instrument that has an ownership claim in a pool of mortgages or an obligation that is secured by such a pool.

### **mortgage investment**

A debt instrument collateralized by real assets (e.g., a building) and requiring periodic payments consisting of interest and principal.

### **nominal rate of return**

A measure of the earnings performance of a fund measured in current dollars.

### **passive management**

Buying or investing in a portfolio that represents a market index without attempting to search out mispriced sectors or securities. The opposite of Active Management.

### **portfolio**

A collection of investments owned by an investor.

### **real rate of return**

The nominal rate of return minus the rate of inflation.

### **realized/unrealized**

Terms generally used to describe capital gains or losses. A gain or loss is generally realized when an asset is sold; prior to sale the gain or loss is unrealized and it is only a potential or "paper" gain or loss.