
Alberta Heritage Savings Trust Fund

BUSINESS PLAN 2003-06

TABLE OF CONTENTS

Background	387
Introduction	387
Fiscal Context	387
Purpose	387
2003-06 Business Plan	387
Management Discussion and Analysis	388
Increase Private Equity and Absolute Return Strategies	388
Reduce Canadian Equity Component	388
Increase Foreign Content Limit	388
Heritage Fund Structure and Investment Objective	388
Goals, Strategies and Outputs, Outcomes, and Performance Measures	390
Management and Accountability	392
Income and Expenses	392
APPENDICES	
A: Description of Benchmark Indices for the Heritage Fund	395
B: Business Plan Performance	396
C: Glossary	397

The Business Plan was reviewed and approved by Treasury Board on January 22, 2003, and by the Legislature's Standing Committee on the Alberta Heritage Savings Trust Fund on February 11, 2003.

BACKGROUND

Introduction

- The Alberta Heritage Savings Trust Fund (Heritage Fund) was created in 1976 to save a portion of non-renewable resource revenue. The Heritage Fund grew from a portion of Alberta's oil and gas revenue being deposited into the fund from inception in 1976, 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. The restructuring included a new governance structure as well as the establishment of new investment objectives and performance measures.
- In the fall of 2002 the Minister of Revenue conducted a public consultation on the future mandate of the Heritage Fund in the form of a survey mailed to all Alberta households. The government's response to this consultation will be announced in due course.

Fiscal Context

- Assets and income of the Heritage Fund are fully consolidated with the assets and revenue of the Province. Page 393 shows the forecast income of the Heritage Fund on both a consolidated basis and an unconsolidated basis.
- In 1997, the new Heritage Fund Act included a provision to retain a portion of the Heritage Fund's income in the Fund to protect its real value. In 1999, the Fiscal Responsibility Act (FRA) set out a legislative schedule to eliminate the Province's accumulated debt by no later than March 31, 2025. Debt elimination is currently well ahead of schedule. In order to maximize funds available for debt repayment, the FRA amended the Heritage Fund Act such that, until the accumulated debt is eliminated, the Minister of Revenue has discretion in retaining income to protect the real value of the Heritage Fund.

Purpose

- This is the seventh 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.

2003-2006 BUSINESS PLAN

The business plan incorporates the following changes:

1. Increase investments in private equity and absolute return strategies.
2. Reduce Canadian equity investments to accommodate the increase in private equities and absolute return strategies.
3. Increase the foreign investment limit from 40% to 50% of market value.

MANAGEMENT DISCUSSION AND ANALYSIS

Increase Private Equity and Absolute Return Strategies

Research has demonstrated that increasing exposure to non-traditional asset classes can create a portfolio with improved risk/return trade-offs even after the additional investment costs associated with these assets are taken into account. A 5% increase in exposure, phased in over a three-year period, composed of a 3% increase in private equity and a 2% increase in absolute return strategies, will be implemented to improve portfolio risk and return. An increased exposure to non-traditional asset classes is in line with the policies of many other North American endowment funds.

Reduce Canadian Equity Component

The Canadian equity exposure will be gradually reduced by 5% over a three-year period.

The increased allocation to private equity and absolute return strategies will be accommodated by a reduction in the allocation to Canadian equities. The majority of this increase will be achieved through investment in international products.

Increase Foreign Content Limit

The increased allocation to private equity and absolute return strategies, as well as part of the current allocation to real estate will be invested primarily outside Canada. To accommodate these changes, the foreign content limit for the Heritage Fund will be raised from 40% to 50%. The Heritage Fund is not subject to Foreign Property Rule limits under federal income tax legislation, and as such, has no federally prescribed limit on foreign content.

International investing for a Canadian endowment fund is essential when constructing a diversified portfolio that will, over the long term, provide the highest level of return for a given level of risk.

The reasons for international investing are:

- Canada is only 2% of the world equity market;
- Rates of return on foreign securities often have substantially exceeded those for Canadian securities;
- Diversification with higher amounts of foreign securities can help reduce portfolio risk.
- Increased foreign equity exposure can help offset limitations in the Canadian market by participating in industry sectors generally not available in Canada, such as auto manufacturing and defense.

HERITAGE FUND STRUCTURE AND INVESTMENT OBJECTIVE

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 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:
 - An investment policy to maximize long-term returns implies a weighting towards investments in equities. 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 and the timing and magnitude of realizing capital gains is also uncertain.
 - 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 is more variable.
- The Heritage Fund is invested in a diversified portfolio including interest bearing securities, Canadian equities, international equities, private equities, absolute return strategies and real estate. The Portfolio is invested to generate long-term returns to support the Province's income and spending needs.

The legislated investment objective of the Heritage Fund is:

To maximize long-term financial returns of the fund subject to regulations and a reasonable and prudent avoidance of loss.

- A long-term investment horizon is interpreted to be 10 years. Given a long-term investment horizon, investment practice suggests that a mix of interest-bearing securities, equities, real estate and alternate asset classes best achieves the objective of optimizing financial returns as it provides enhanced returns and diversifies risk. 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. For investment performance comparisons a minimum period of 4 years will be examined.

HERITAGE FUND ASSETS AS AT DECEMBER 31, 2002

(thousands of dollars)

	At Cost ¹	Fair Value
Cash	\$ 185,868	\$ 185,868
Fixed Income Securities	3,664,532	3,791,559
Canadian Equities	2,398,237	2,528,170
Foreign Equities	4,076,165	3,776,186
Real Estate	808,937	837,673
Absolute Return Strategies	279,480	282,233
Total Investments	\$ 11,413,219	\$ 11,401,689
Due from the General Revenue Fund	\$ 180,000	\$ 180,000
Accrued Investment Income	12,445	12,445
Administrative Expense Receivable	293	293
Accrued Liabilities for Investment Purchases	(530)	(530)
Heritage Fund Equity	\$ 11,605,427	\$ 11,593,897

¹ Cost includes amortization of purchase price discount or premium.

GOALS, STRATEGIES AND OUTPUTS, OUTCOMES, AND PERFORMANCE MEASURES

GOAL ONE

1 Make investments in the Heritage Fund to maximize long-term financial returns.

Strategies/Outputs

- Invest Heritage Fund 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.
- To diversify risk and enhance expected returns, allocate Heritage Fund assets among the following asset classes and within the noted ranges (expressed as a percentage of the Heritage Fund’s market value):

<u>Asset Class</u>	<u>Holdings (%)</u>
Interest-Bearing Securities ¹	25% to 45%
Equity ²	40% to 60%
Real Estate	8% to 12%
Absolute Return Strategies	3% to 7%

- Diversify investments within each asset class set out above.
- Alberta Revenue will vary the allocation of assets within the above policy ranges based on the outlook for financial markets.
- Reduce the Heritage Fund’s investment in project loans. Remaining project loans have a total value at cost of \$97 million or 0.9% of Heritage Fund fair value. The largest of these project loans is a \$91 million loan to Ridley Grain Ltd.

Outcomes

- The Heritage Fund is expected to generate a real rate of return of 5.0% at an acceptable level of risk over a moving four-year period.
- Market rate of return is expected to be greater than a passively invested benchmark portfolio.

Performance Measures/Benchmarks

Performance Measures

- The market value rate of return will be compared against the Consumer Price Index plus five percent to determine whether the long term capital market assumptions on which the investment policy is based are achieving the returns relative to expectations.

¹ Includes money market instruments, bonds and mortgages.

² Includes Canadian public and private equities and foreign equities. Foreign investments will be limited to 50% of market value.

- The market value rate of return will be compared against a “policy benchmark return” to determine the impact of fund management on performance.

Asset Class	Benchmark	
	Policy Allocation	Return Index ³
Fixed Income		
Money market	2%	SC 91-day T-Bill
Bonds	33%	SC Universe
Total Fixed Income	35%	
Equity		
Canadian ⁴	15%	S&P/TSX Composite
U.S.	15%	S&P 500
Other International	15%	MSCI EAFE
Private ⁴	5%	CPI + 8%
Total Equity	50%	
Real Estate⁴	10%	CPI + 5%
Absolute Return Strategies⁴	5%	CPI + 6%

- 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.

GOAL TWO

2 To improve Albertans’ understanding and the transparency of the Heritage Fund.

Strategies/Outputs

- Release quarterly and annual reports on a timely basis in simple, understandable language.
- Release summary reports of the Heritage Fund’s investment activities and results for Albertans on a timely basis.
- Publish the Heritage Fund Business Plan annually.
- The Legislature’s Standing Committee will hold annual public accountability meetings around Alberta to report on the Heritage Fund’s results and to answer questions on the Fund’s performance.
- Release results of the Heritage Fund consultation and government’s response.
- Include Heritage Fund information in new Alberta Revenue web newsletter (debut April 2003).

³ See Appendix A for a description of these benchmarks.

⁴ Canadian Equity, Private Equity, Real Estate and Absolute Return Strategies will be phased in over three years.

Outcomes

- Improved understanding by Albertans of the management, operations, investment philosophy and performance of the Heritage Fund.

Performance Measures/Benchmarks

Performance Measures

- Timeliness of reports and public accountability meetings.
- Knowledge of Albertans regarding information provided about the Heritage Fund.

Benchmark

- Annual report will be released by June 30 of each year.
- Quarterly reports will be released within 2 months after the conclusion of the quarter.
- Albertans are satisfied with their knowledge of the Heritage Fund, with 50% able to estimate the Fund's value.

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 recommends 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 are made within Alberta Revenue.
- For each component of the Heritage Fund that is externally managed, an investment management mandate describing its purpose, goals and constraints is established.
- The investment management mandates of external managers is 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 for economic development or social investment purposes.

INCOME AND EXPENSES

- 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.

- The following are current projections of 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.
- 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

Heritage Fund Income Forecasts and Underlying Assumptions

	2002-03	2003-04	2004-05	2005-06
Forecast Annual Income (\$millions)				
Unconsolidated Investment Income	(577.5)	442.9	642.0	739.4
Consolidated Investment Income	(595.4)	425.9	626.0	724.4
Forecast Fair Value of the Fund (\$billions)	11.8	12.0	12.3	12.5
Assumptions (%)				
1. Interest Rates on Fixed Income Securities		6.1%	6.1%	6.1%
2. Rates of Return on Equity				
Canadian (Public and Private)		7.0%	7.0%	7.0%
Foreign		8.0%	8.0%	8.0%
3. Rates of Return on Real Estate		7.0%	7.0%	7.0%
4. Rates of Return on Absolute Return Strategies		7.0%	7.0%	7.0%
5. Endowment Portfolio Asset Mix				
Money Market	2%	2%	2%	2%
Bonds	33%	33%	33%	33%
Public Equities	50%	48%	46%	45%
Private Equities	2%	3%	4%	5%
Real Estate	10%	10%	10%	10%
Absolute Return Strategies	3%	4%	5%	5%

Risks to the Investment Income Forecast:

1. If equity returns are lower than assumed, accounting investment income will be lower depending on the extent of the decrease in equity returns and the amount of turnover in the equity portion of the Heritage Fund.
2. If interest rates increase, the market price of bonds held by the Heritage Fund will decline. Accounting investment income will decrease depending on the extent of the interest rate increase and the amount of turnover in the fixed income portion of the Heritage Fund.

The preceding projections for the Heritage Fund are gross of estimated investment expenses as outlined below:

	2002-03	2003-04	2004-05	2005-06
	<i>(\$ millions)</i>			
Direct Heritage Fund Expenses	1.7	2.3	2.5	2.9
Externally Managed Investment Pools	11.8	12.6	13.5	14.5
Internally Managed Investment Pools	2.4	3.2	3.5	4.1
TOTAL	15.9	18.1	19.5	21.4
As a % of Assets	0.14%	0.15%	0.16%	0.17%

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

APPENDIX A

Description of Benchmark Indices for the Heritage 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 S&P/TSX represents the Canadian equity market.

S&P/TSE Composite Index (S&P/TSX)

An index maintained by the S&P/TSX Canadian Index Policy Committee that measures the total return on the largest companies that trade on the Toronto Stock Exchange. (Formerly the TSE 300)

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.

APPENDIX B

Business Plan Performance

Heritage Fund (Combined)¹

Period ending December 31, 2002

	Current Quarter	Nine Months	One Year	Four Years ²
Actual Return	4.8%	-6.8%	-6.1%	1.7%

Endowment Portfolio

Period ending December 31, 2002

	Current Quarter	Nine Months	One Year	Four Years ²
Actual Return	4.8%	-7.1%	-6.4%	2.1%
Benchmark	5.0%	-7.2%	-6.7%	1.5%
Over (under) Benchmark	(20bps)	10bps	30bps	60bps

Actual	Actual Weight	Rates of Return			
		Current Quarter	Nine Months	One Year	Four Years ²
ST Fixed Income	1.6%	0.9%	2.3%	2.8%	4.6%
LT Fixed Income	33.3%	2.4%	10.1%	9.4%	6.9%
Canadian Equities	21.5%	8.0%	-13.7%	-12.2%	1.4%
US Equities	16.8%	7.1%	-23.5%	-22.6%	-5.7%
EAFE Equities	16.2%	6.0%	-16.7%	-15.8%	-3.5%
Private Equities	0.8%	-3.1%	N/A	N/A	N/A
Real Estate	7.3%	2.5%	4.6%	6.2%	7.2%
Absolute Return Strategies	2.5%	1.2%	N/A	N/A	N/A
Total	100%	4.8%	-7.1%	-6.4%	2.1%
Benchmark	Policy Weight	Current Quarter	Nine Months	One Year	Four Years ²
ST Fixed Income	2.0%	0.7%	2.1%	2.5%	4.3%
LT Fixed Income	33.0%	2.3%	9.9%	8.7%	6.4%
Canadian Equities	20.0%	7.5%	-14.6%	-12.4%	2.0%
US Equities	15.0%	8.0%	-23.1%	-22.9%	-6.1%
EAFE Equities	15.0%	6.0%	-17.2%	-16.8%	-7.3%
Private Equities	2.0%	2.5%	N/A	N/A	N/A
Real Estate	10.0%	1.8%	7.0%	9.4%	10.5%
Absolute Return Strategies	3.0%	2.0%	N/A	N/A	N/A
Total	100%	5.0%	-7.2%	-6.7%	1.5%

Transition Portfolio¹

	Six Months Ended Sept. 30, 2002	Year Ended Mar.31, 2002	Year Ended Mar. 31, 2001	Year Ended Mar. 31, 2000
Actual Return	0.5%	5.3%	8.2%	3.0%

¹ All asset of the Transition Portfolio were transferred to the Endowment Portfolio in July 2002. The combined Heritage Fund return for nine months, one year and four years includes the past performance of the Transition Portfolio.

² Annualized

APPENDIX C

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.

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 Heritage Fund 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.