

Beyond the Rocks and the Trees: Canada's Other Golden Moments



In the 1990s, Canadians took pride in being labeled by the UN as the world's most livable country. In the early 2000s, they took pride in their men's and women's hockey teams finally achieving Olympic Gold. Now, they take pride in having the world's best banking system, according to the World Economic Forum. **By Scot Blythe**

Canada has long had a low profile on the global stage – call it the Great White Unknown.

“A lot of the banks have been very much domestically focused,” explains Patrick Blessing, Managing Director/Head of Prime Brokerage at Scotia Capital, an arm of the Bank of Nova Scotia, in Toronto. “Because of that, I don’t think the profile of the Canadian banking system was necessarily well known until the credit crisis, as various countries started bailing out their local banks and people started to realize that Canadian banks were completely immune from this.”

No Canadian financial institution required a government bailout. There was no mortgage meltdown – Canadian housing prices are tracking higher than ever. The government balance-sheet looks better than most. There was no credit crisis in Canada.

“We avoided it because we had much more prudent practices,” says Ian Russell, President and CEO of the Investment Industry Association of Canada, the lobby group for investment dealers. The banks were better managed than their global competitors, and they had less exposure to derivatives.

As the credit crisis finally landed on Canada's shores, he notes, “there was extra intervention from the Bank of Canada,” much like the intervention of central banks worldwide. But there was something else, too. “We had government that reacted effectively and in a timely way.” Within the space of three months, the Canadian government went from asserting that Canada would escape the Great Recession to launching a stimulus program that would lead to the largest deficit in Canadian history \$54 billion – 3.5 percent of GDP. Overall, Canada's stimulus measures will raise the debt to GDP ratio from 29 percent to 35 percent – the lowest among the G7 nations.

Canada's fiscal rectitude comes from hard-won experience, so much so that “deficit” has become almost a four-letter word. At the beginning of the 1990s, Canada's governments – federal and provincial – were racking up record deficits. The response of the bond vigilantes was harsh, while Wall Street mocked “the Northern peso.” Canada lost its triple-A debt rating as combined government debt approached 100 percent of GDP. It took till 1998 to balance the federal budget, a position

successive governments maintained until 2009.

That record of management, combined with relatively healthy balance sheets in the corporate sector, is attractive to international investors, suggests Paul Bates, a veteran of the Street and currently dean of the Degroote School of Business at McMaster University in Hamilton, Ontario. “A couple of years ago we were viewed, maybe simplistically, on the basis of the makeup of our economy and the relative value of the rest of our economy to the rest of the planet,” he explains. “I think what's come back into vogue, to put it in really simple terms, is how is the country's balance sheet. All of a sudden our balance sheet looks pretty good.”



No Mortgage Meltdown

Still, it was no sure thing. “I’m not sure whether this was the result of good planning or we just got lucky. I think it was a little bit of both,” says Bates. The Canadian mortgage market is more stringent than in some other countries. Despite that, Canada and the US have similar levels of home ownership – around 68 percent. One difference is that there is no mortgage interest deductibility in Canada.

“That may have been part of what saved us as well because the incentive to borrow less and pay it off sooner is greater in an environment where you don’t have any tax incentives to keep the mortgage longer or pay it off more slowly,” Bates explains. Second, because the banks are the dominant players, there's not much room for brokers who are paid for the number of mortgages they can originate. Coupled with that, property evaluation is more rigorous, to avoid “inflated values and a risk that a person is being encouraged to strap on more debt than they can reasonably afford.”

Is it a cultural difference? In Canada, there's long been a debate over rules versus principle-based regulation. As Julie Dickson, the Superintendent of Financial Institutions – who regulates the banks and insurance companies – warned in a recent speech: “Stricter rules, like substantially higher capital requirements, can create a false sense of security; an institution will never have enough capital if there are material flaws in its risk management practices. That is why supervision matters.”

Thus, while many think Canada is a model to catch up to, the



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Two of the 10 largest global life insurers

Three of the world's 25 largest banks and Canada's five largest banks

Three of the 50 top global pension funds

Operations of seven of the 10 largest global hedge fund administrators

The second-largest society of Chartered Financial Analysts

Source: Toronto Financial Services Alliance, Toronto

reality is that Canada is not a global pacesetter; instead it has been much slower to embrace the changes and innovations that have produced catastrophic results elsewhere – relying not so much on rules as a culture of prudence.

Capital Markets and Hedge Funds

A prudential – or better, a slow-moving – culture may have something to do with the boom and bust cycles of natural resources – a history that extends back to the earliest days of Canadian stock markets. It's one hedge fund analysts are well aware of.

"In the main, Canadian managers are long/short equity, and tend to be resource-oriented and small-cap-oriented," observes Tristram Lett, CIO and partner at Integra Capital Ltd., a Toronto institutional manager. "So what happens for an institution is that they look at the Canadian hedge fund industry as just a lot of beta. To them it is. To the foreigner ... we're alpha."

Despite its small market footprint – at about 3 percent of the world's stock capitalization – Canada has liquid markets, and the financial infrastructure to support them. Much of the financial markets activity is based in Toronto (see box on left). "Certainly foreign investors have been attracted by a strong Canadian dollar, and been attracted by the strength of the resource sector and the fact that that makes up such a large part of our index," says Peter Hayes, National Director of Canadian Alternative Investments Practice at KPMG in Toronto. "Obviously we have the skill set in Canada, both on the financing side and on the operational side of that. This has definitely served us well."

Nevertheless, Canada is a relatively inefficient market. "We are slower to react to information," says Scotia's Blessing. "News can come out on a particular company in the US and that would be immediately priced in, whereas in Canada often-times it takes a little while for investors to react to that information – or for that information to trickle out." That makes for an arbitrage opportunity – should nimble hedge funds grasp it.

The Canadian hedge fund industry is relatively small by global standards, and a late bloomer. In a recent academic study, Peter Klein, Daryl Purdy and Isaac Schweigert, researchers at Simon Fraser University in Vancouver and principals of KCS Fund Strategies Inc., note that "Our established system of securities regulation, stable banking industry and our strong economy provide a fertile environment for hedge fund trading strategies, particularly since our capital markets are relatively uncrowded."

Despite a slow start, the Canadian hedge fund industry has done surprisingly well. Over the period January 2005 to June 2009, an index of Canadian hedge funds KCS constructed returned 10.3

percent annually – double the returns of other hedge fund databases and significantly ahead of long-only indexes.

Financial Infrastructure

As the Canadian hedge fund industry has developed, it has pushed local service providers up the learning curve. Similarly, it has caused financial institutions with a global footprint either to add to their Canadian base, or to relocate some of their services from offshore to service both Canadian and international clients.

The credit crisis has certainly helped, particularly for Canadian prime brokers. "From a credit point of view, they'd be right at the top of the list," says Gary Ostoich, chairman of the Canadian chapter of the Alternative Investment Management Association and president of Spartan Fund Management. "It would be hard, especially a year, a year and a half ago, for many prime brokers outside of Canada to compete with the creditworthiness of a Canadian prime."

Since one of the chief functions of a prime broker is to provide financing, credit quality is obviously important. Canada's prime brokers are owned by the Big Six banks, Michael Newallo, head of prime brokerage at National Bank Financial, which is part of the National Bank of Canada, notes that in the US hedge funds have increasingly shifted from investment bank prime brokers to those who are part of a bank with a retail franchise.

Yet, it's not just prime brokers who have been building capacity. In fact, the financial infrastructure in Toronto is both deep and broad, Hayes says. What's more, not only are the skills here, but there are expatriates coming back from US, UK, offshore centers, which is bolstering financial services, and fund administration in particular.

"With respect to fund administration costs have become very high in many jurisdictions," says Hayes. "Then you factor in immigration policy, geopolitical risk and even natural disasters. It makes people think about where they want to be." While Canada is a small market in global terms, it is not an insignificant one. Pension funds manage over \$1 trillion in assets, and mutual funds another \$600 billion.

Bob Wallace, Head of Securities & Fund Services, North America, at Citi in New York, says Canada is an important outsourcing center. Citi bought a Canadian mutual fund administrator in 2005. "We also designate it as our offshore center to service investors in our offshore hedge funds because there is a great multilingual talent pool in Canada and the infrastructure to provide those services."

Institutional investors play a key role in the demand for financial services. For example, National's Newallo notes, they are less concerned

with receiving the best technology from their prime brokers. It's the data that counts. "There was a time when prime brokers tried to provide really sophisticated technology to their clients, from a reporting and a portfolio analysis perspective," he says. "Now what the customers are doing is importing raw data from their prime brokers and then putting it into their own sophisticated portfolio management systems."

That's part of a general shift to electronic trading. While the Toronto Stock Exchange was one of the first to abandon the open-outcry system, it has lately been joined by competitors – electronic communications networks (or in Canada, alternative trading systems). That, in turn has been accompanied by an increase in buy-side use of trading algorithms as well high-speed trading, mostly from US traders.

Moving Up in the Global League

"There's tremendous potential in Canada," Russell says, citing three reasons: solid financial institutions, a solid business climate and a solid economic climate. But there is one thing holding back Toronto as a global financial center. "You need to have a vision," he argues, and so far municipal politicians have not stepped up. "We need to encourage more entrants," he adds, not just for the sake of competi-

tion, but "to bring economic value into Canada."

Certainly, international investors get value from Canada. Its closeness to the US, says Wallace, means Citi can provide services "not only for Canada but also for other offshore locations because of the scale you can get out of Canada."

Adds KPMG's Hayes: "I don't think Canada gets enough credit sometimes for the strength of its financial services expertise. There's a bit of an education process needed to help people understand the strength of the financial services business that is here."

He hopes the Toronto Financial Services Alliance will help to change that. It's currently focused on furthering Toronto's role in the global financial services market, aiming to establish Toronto as one of the two leading financial clusters in North America and in the top 10 worldwide.

There's a famous Peter Ustinov quote about Toronto in the 1970s: New York managed by the Swiss. He intended it as a compliment to an orderly metropolis. Times have changed, and the old moniker of "Toronto the Good" is fading into memory. In its place, a "good" and orderly financial market has emerged. It's not perfect. But by and large it works – to the advantage of international investors. ■

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Peter Hayes
KPMG



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North America
Patrick Blessing, CFA
+1 416 945 5356
patrick_blessing@scotiacapital.com

Europe
Adam Jones
+44 (0) 20 7826 5885
adam_jones@scotiacapital.com

Asia
Gregory Smith
+65 6305 8333
gregory_smith@scotiacapital.com

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