MANITOBA PUBLIC UTILITIES BOARD

Re: MANITOBA PUBLIC INSURANCE COMPANY
GENERAL RATE APPLICATION
FOR 2009/10 INSURANCE YEAR

Before Board Panel:
Graham Lane - Board Chairman
Eric Jorgensen - Board Member
Alain Molgat - Board Member

HELD AT:
Public Utilities Board
400, 330 Portage Avenue
Winnipeg, Manitoba
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Pages 1106 to 1353

APPEARANCES

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Kevin McCulloch		)Manitoba Public Insurance
Raymond Oakes		)CMMG
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Nick Roberts	(np)	)Manitoba Used Car Dealers
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--- Upon commencing at 9:04 a.m.

THE CHAIRPERSON: Okay, good morning everyone. I see MPI is seeing the world from a different perspective today, that's good.

Mr. Williams, do you want to introduce your witnesses who are well known to the panel and most -- I think all of the parties.

MR. BYRON WILLIAMS: Yes, I'd like to re-introduce to the -- my far left, Dr. Wayne Simpson and to his immediate right is Dr. Derek Hum and perhaps Mr. Gaudreau could assists us by affirming Dr. Hum and having Dr. Simpson sworn please.

CAC/MSOS PANEL:

WAYNE SIMPSON, Sworn

DEREK HUM, Affirmed

(Voir Dire Commenced)

EXAMINATION-IN-CHIEF BY MR. BYRON WILLIAMS:

MR. BYRON WILLIAMS: Thank you, Mr. Chairman. And just for the Board's assistance, hopefully they have bound versions of the -- the evidence of the -- the witnesses. Whether or not the versions are bound, the page numbers I'll be referring to I'll -- I'll try and go to subheadings because I -- I realize that some of the people will have different pagination depending on their printer.

But I'm going to be -- what should be Tab 'A' or the statement of qualifications of -- of both Dr. Hum and Dr. Simpson. And I'm going to start with you, Dr. Hum.

Am I correct in suggesting that you're currently a Professor of Economics at the University of Manitoba and that you've taught a wide variety of courses over your lengthy career including money and banking, macro and micro economics and managerial economics?

DR. DEREK HUM: Yes.

MR. BYRON WILLIAMS: And you've also served as an adjunct professor in the MBA program at the Asper School of Business and in the School of Public Policy at Simon Fraser University.

Is that right, sir?

DR. DEREK HUM: Yes.

MR. BYRON WILLIAMS: Now just in terms of the money and banking course, I -- I -- would I be correct in suggesting to you - and this is certainly set out in your curriculum vita - that the money and banking courses you've taught, some have been at the third year level.

Would that be correct, sir?

DR. DEREK HUM: Yes.

MR. BYRON WILLIAMS: And in terms of intermediate macroeconomic -- or macroeconomics, you've taught intermediate macroeconomics, which would be at the second year level, sir?

DR. DEREK HUM: Second or third.

MR. BYRON WILLIAMS: And you've also been involved with teaching macroeconomics at the Institute of Canadian Bankers fellow program -- fellows program.

Is that right, sir?

DR. DEREK HUM: Yes.

MR. BYRON WILLIAMS: And urban land economics to the Real Estate Institute fellows program. Would that be correct, sir?

DR. DEREK HUM: Yes.

MR. BYRON WILLIAMS: I wonder if you can -- just let's focus on your work in money and banking.

I wonder if you can explain how your research and your teaching, and your work in money and banking, and financial systems or markets, relates to the issues outlined in your testimony.

How is that relevant, sir?

DR. DEREK HUM: Well, the -- the course money and banking is considered a sub-field in the area of economics. It has to do with the understanding of the institutions and operations of the financial system, and how it interacts with the regulatory body which, in this case, is the Bank of Canada. So that's what we talk about.

The control of the money supply; interest rates; exchange rates; lending practices and regulations imposed on the chartered banks by the Bank of Canada, and so forth.

MR. BYRON WILLIAMS: In your work on money in -- in this area, or others, what, if any, experience or reference do you have to investment practice portfolio theory, sir?

DR. DEREK HUM: Portfolio theory is one (1) topic that's cur -- covered in the curriculum of money and banking and finance. We tend to look at it in terms of the balance sheets of various institutions, such as the insurance companies, the banks, and so forth.

And portfolio theory is just a general set of tools that we -- we teach, or learn, in order to -- to elucidate the principles of how an individual or an institution would balance risk versus returns.

It's very, very general in terms of risk and return right now.

MR. BYRON WILLIAMS: Okay. And what --

we'll come back to that in just a couple minutes.

In -- in terms of your work researching, and also teaching in the area of macroeconomics, I wonder if you could indicate how, if at all, it rate -- it relates to the issues outlined in your testimony.

And perhaps with particular emphasis on issues such as inflation.

DR. DEREK HUM: Well if I had to pick the two (2) top subjects that is covered by macroeconomics, and taught in macroeconomics, it would be inflation and unemployment. Those are sort of the two (2) that are always talked about, and understandably because they are together.

I think it's no exaggeration to say that half the curriculum of macroeconomics is -- is concerned one (1) way or another with inflation, and inflation-related problem: stabilization of the economy, preserving the value of the currency, as well as the value of domestic money, and the mechanisms by which the Bank of Canada and the Department of Finance brings about stability in the economy while, at the same time, trying to reach as low a level of unemployment as possible.

MR. BYRON WILLIAMS: Thank you for that. I just want to turn to your education very quickly.

I understand you received your Bachelor's of Science in 1967 from Mt. Alison University. You completed your MA in -- in politics, philosophy, and economics, from Oxford in '69. And in 1972, you received your PhD in economics from the University of Toronto, sir.

DR. DEREK HUM: That's correct.

MR. BYRON WILLIAMS: And your Ph -- in -- in terms of your PhD, you were specializing in money and banking, and international finance, with a -- is that right, sir?

DR. DEREK HUM: Yes. The PhD program requires you to specialize in three (3) fields. Money and banking was one (1) of them, and international finance was the -- one (1) of the others, and my doctoral dissertation was on a very esoteric topic having to do with exchange rates.

MR. BYRON WILLIAMS: Well, I -- I hesitate to -- to tread into the subject of exchange rates, maybe in a Hydro hearing.

You're also a member of the National Statistics Council Canada. Is that right, sir?

DR. DEREK HUM: Yes, I am.

MR. BYRON WILLIAMS: And at a high level, without elaborating, you have some experience through your work on the University of Manitoba Staff Benefits

Committee as -- as well as the St. John's College Finance Committee in terms of investment portfolios.

DR. DEREK HUM: Yes.

MR. BYRON WILLIAMS: Would it be fair to say that you published widely in many areas of economics including some seven (7) books, twenty (20) monographs and one hundred (100) journal articles or book chapters, sir?

DR. DEREK HUM: Well, that's a numerical characterization, yes.

MR. BYRON WILLIAMS: Well substantively have you written specifically on investment portfolio theory; for example, your article Stock Price Cycles and Portfolio theory for the Trader in 1981?

DR. DEREK HUM: Yes. That -- that particular article is specifically related to the topic of Portfolio Theory.

MR. BYRON WILLIAMS: And would it be fair to say that you've been qualified as an expert witness in economics both by the Manitoba Court of Queen's Bench and the Saskatchewan Court of Queen's Bench, sir?

DR. DEREK HUM: Yes.

MR. BYRON WILLIAMS: And you recall being qualified as an expert before this Public Utility Board a couple of years ago.

DR. DEREK HUM: Very favourably.

MR. BYRON WILLIAMS: On a -- on the subject of Manitoba Public Insurance rate stabilization reserve, sir?

DR. DEREK HUM: Yes.

MR. BYRON WILLIAMS: Okay. Dr. Simpson, your turn. I understand that you're currently a Professor of Economics at the University of Manitoba, is that right, sir?

DR. WAYNE SIMPSON: Yes.

MR. BYRON WILLIAMS: And when I first met you and for many years, you served as head of the Department of Economics, namely, from 1997 until 2008; is that right, sir?

DR. WAYNE SIMPSON: That's correct.

MR. BYRON WILLIAMS: And would it be fair to say that over the years you've covered most of the spectrum in -- in areas of economics and particularly focussing on econometrics and microeconomics?

DR. WAYNE SIMPSON: Yes. And labour economics.

MR. BYRON WILLIAMS: And in terms of your education, would it be fair to say that -- accurate to say you completed your BA from the University of Saskatchewan and then your MSC in Economics followed by a

PhD in Economics in 1977 from the London School of Economics, sir?

DR. WAYNE SIMPSON: Yes, that's right.

MR. BYRON WILLIAMS: And you've also sat on the -- the -- for some period of time, just two or three years on the Manitoba Benefits Committee at the University of Manitoba which oversees the Investment Portfolio; is that right, sir?

DR. WAYNE SIMPSON: That's correct.

MR. BYRON WILLIAMS: In your other experience, would it be fair to say that you've also worked as an operations analyst for the Bank of Canada, as an economist for Labour Canada and for the Centre for the Study of Inflation and Productivity at the Economics Council of Canada, sir?

DR. WAYNE SIMPSON: Yes, I have.

MR. BYRON WILLIAMS: And you've written and published extensively in a wide area of topics related to economics including labour markets, program evaluation, urban problems and income maintenance, is that right, sir?

DR. WAYNE SIMPSON: Yes.

MR. BYRON WILLIAMS: And going to use Dr. Hum's words, numerically you've authored some three (3) books, more than fifty (50) peer-reviewed journal articles, as well as numerous papers and technical reports.

Is that right, air?

DR. WAYNE SIMPSON: Yes.

MR. BYRON WILLIAMS: Would one (1) of the articles you've written in a referee journal be Reducing Inflation in an Era of Low Inflationary Expectations which appeared in Macroeconomic Causes of Unemployment Diagnosis and Policy Recommendations?

Do you recall that, sir?

DR. WAYNE SIMPSON: Yes, I do.

MR. BYRON WILLIAMS: And also in a referee journal you published Is Hypo Inflation Good Public Policy in Canadian Policy?

DR. WAYNE SIMPSON: I did, yes.

MR. BYRON WILLIAMS: And you're currently on the Editorial Board of Canadian Public Policy and you have served on the Editorial Board of the Canadian Journal of Economics, sir?

DR. WAYNE SIMPSON: Yes.

MR. BYRON WILLIAMS: And you've been qualified as an expert witness by the Manitoba Public Utilities Board on two (2) separate occasions; one being with regard to the MPI Rate Stabilization Reserve and one with regard to economic issues related to the Payday lending issues, sir?

DR. WAYNE SIMPSON: Yes, I have.

MR. BYRON WILLIAMS: Thank you. Dr. Hum and Dr. Simpson, individually, I wonder if you can confirm that the -- your evidence was prepared under your joint direction and control and is accurate to the best of your knowledge and ability?

DR. WAYNE SIMPSON: Yes.

DR. DEREK HUM: Yes.

MR. BYRON WILLIAMS: And just to be clear, there is an Information Request Response, PUB-Coalition-1-1.

Would it be fair to say that you've reviewed that response but yet the actual response was prepared, to your knowledge, by Mr. Williams with some assistance from Mr. Greg Matwichuk of Stephen Johnson?

DR. DEREK HUM: Yes.

MR. BYRON WILLIAMS: Mr. Chairman, I'd ask at this point in time that Dr. Hum be qualified with recognition of his expertise as an economist with particular expertise on the subjects of money and banking in the financial market and macroeconomics; and that Dr. Simpson be qualified with recognition of his expertise in economics with particular reference to his expertise in areas such as labour markets, statistical theory, which -

- and including the handling of empirical data and evidence?

THE CHAIRPERSON: Thank you, Mr. Williams. Mr. McCulloch, do you have any comments?

MR. KEVIN MCCULLOCH: Mr. Chairman, just a couple of comments and...

(BRIEF PAUSE)

THE CHAIRPERSON: We'll take a two (2) second break.

(BRIEF PAUSE)

MR. KEVIN MCCULLOCH: Yes, Mr. Chairman, it -- it seems we now have one (1) operating microphone on this side and -- and Mr. Palmer won't need it at this stage of the proceeding so I'll -- I'll --

THE CHAIRPERSON: We're not trying to reduce your opportunities to participate.

CROSS-EXAMINATION BY MR. KEVIN MCCULLOCH:

MR. KEVIN MCCULLOCH: As I started to say, I -- I would never be foolish enough to -- to challenge Doctors Hum and Simpson in the areas of economics and their expertise there, but I have a few questions relating to the -- the type of study that was done and presented to the Board and -- and, in particular, their expertise in -- in that area.

I want to first deal with the statement of qualifications and in that statement, Dr. Hum, you mention that for three (3) years you were on the University of Manitoba staff benefits committee and I note that Dr. Simpson also served on that same committee in the period 2000 to 2002.

Were -- were you on this committee at the same time?

DR. DEREK HUM: No, we were not.

MR. KEVIN MCCULLOCH: And what size of committee is that? How many people on that committee?

DR. DEREK HUM: If everybody attended, it would be about fifteen (15) or sixteen (16), but not everybody attends every meeting.

MR. KEVIN MCCULLOCH: And also in your statement of qualifications, Dr. Hum, you list a report or rather a paper, "Stock Price Cycles and Portfolio Theory for the Trader," which you published in 1981 and that was put forward as a specific study or paper dealing with investment portfolios; is that correct?

DR. DEREK HUM: I did publish that paper.

I'm not sure why it was put -- what the description of it has been put forward. It -- we could give you a copy of that paper. It is a paper that is a theoretical paper on portfolio theory. I would characterize it as saying that it -- it falls within the -- the area of an extension to portfolio theory as is taught and understood.

MR. KEVIN MCCULLOCH: Have you published any papers since 1981 dealing specifically with investment or portfolio theory?

DR. DEREK HUM: No.

(BRIEF PAUSE)

MR. KEVIN MCCULLOCH: I correct -- I'm correct, I presume, in stating that neither of you, Dr. Hum or Dr. Simpson, are chartered financial analysts using the CFA designation.

Is that correct?

DR. DEREK HUM: That's correct.

MR. KEVIN MCCULLOCH: And I also understand, not only from your evidence so far this morning but from two (2) years ago, that you're not actuaries.

DR. DEREK HUM: No.

MR. KEVIN MCCULLOCH: Now the study that

you were asked to take a look at, which is called An Asset Liability Modelling Review, that -- that's a very specific and -- and focussed type of study, is it not?

DR. DEREK HUM: It's specific and focussed, yes.

MR. KEVIN MCCULLOCH: And it's focussed on looking at a company's liabilities, and trying to match the assets in the portfolio to allow the organization, or to assist the organization, in meeting those liabilities.

Is that correct?

DR. DEREK HUM: I'll accept that.

MR. KEVIN MCCULLOCH: And we heard evidence from Mr. Bell earlier in these proceedings that the conduct of such a study required a fair bit of modelling, computer modelling, I presume.

Is that correct?

DR. DEREK HUM: It does require, yes.

MR. KEVIN MCCULLOCH: In your analysis of Mr. Bell's study, did you do any such computer modelling?

DR. DEREK HUM: No.

MR. KEVIN MCCULLOCH: Again, was it basically you -- you looked at the results put forward by Mr. Bell, and you make comments on certain of those results.

Is that correct?

DR. DEREK HUM: That -- that was my mandate. I will (sic) not ask to replicate the results, or to do any computer modelling, but I would say that modern portfolio theory, and modelling of computers, with computers, are things that I have done in the past, and I am capable of doing.

I just was not asked to do it in this instance. So I want you to understand that they're within my skillset and experience.

MR. KEVIN MCCULLOCH: Fine, but I was just trying to get a flavour of what it was that -- what your directions were, and what your intention was, from the study.

DR. DEREK HUM: Absolutely.

(BRIEF PAUSE)

MR. KEVIN MCCULLOCH: Mr. Chairman, those are all my comments, and as I -- I said at the outset, I'm not here to -- to challenge the expertise of -- of Dr. Hum and Simpson, but I do believe, and -- and since I intend to make some points in -- in final argument, I do believe there's an issue as to the weight that their evidence should be given, and that was the purpose of my questioning.

THE CHAIRPERSON: We'll -- Mr. Williams...?

MR. BYRON WILLIAMS: Just in -- just for the -- my purposes, Mr. Chairman, we've asked that Dr. Hum and Dr. Simpson be qualified for those specific purposes, and I just want to make sure I understand MPI's position and I'm assuming that they're accepting their expertise in the areas that I've outlined.

MR. KEVIN MCCULLOCH: That's correct.

THE CHAIRPERSON: Thank you to both of you. Mr. Dawson...?

MR. ROBERT DAWSON: I have no objection to these witnesses being qualified as experts.

THE CHAIRPERSON: Mr. Kruk...?

MR. JERRY KRUK: No questions.

THE CHAIRPERSON: Okay. We will proceed. We will take into account the exchange between Mr. McCulloch and the witnesses.

(VOIR DIRE CONCLUDED)

THE CHAIRPERSON: Mr. Williams...?

EXAMINATION-IN-CHIEF BY MR. BYRON WILLIAMS:

MR. BYRON WILLIAMS: Yes, and I'm going to ask Dr. Simpson and Dr. Hum to turn to their report on the new target of MPI's investment portfolio dated September 3rd, and I'm going to ask you specifically to start off by turning to the introduction, which in the bound version should appear at page 2.

Do you have that, Dr. Simpson and Dr. Hum? I see your heads nodding.

Perhaps Dr. -- Dr. Hum, I can ask you -- I'm -- I'm going to turn you directly to -- under the introduction Point 3 and the statement:

> "This review is concerned only with selected aspects of the portfolio mix for MPI, to wit, whether the MP -- current MPI portfolio is efficient in the sense that it yields the highest return for a given level of risk. In other words, the review does not assess whether MPI should take more or less risk."

And I wonder if you could elaborate on what you -- you and Dr. Simpson meant by that statement, please.

DR. DEREK HUM:: I'm sorry, could you repeat that?

MR. BYRON WILLIAMS: I wonder if you could elaborate in terms of what you and Dr. Simpson meant by that statement.

DR. DEREK HUM: Okay. The -- the term "efficient" as applied in portfolio theory is a technical term. It basically says, Can you do better in terms of achieving a higher rate of return for a given level of risk or sometimes what is the same thing we phrase it, For a given rate of return have you got a portfolio that is the minimum risk? "Return" and "risk" can be defined more precisely later.

So a portfolio is efficient if, in fact, for a given level of risk you cannot get a higher rate of return. Everybody would like to have a rate of return on a portfolio of 50 percent with no risk, but that would be not only in -- not efficient, it's not feasible, so, we also confine ourselves only to the set of portfolios that can be constructed, that are feasible. They must be able to be obtained by combining instruments that are available in the market.

MR. BYRON WILLIAMS: Thank -- thank you for that.

And I'll come back to risk and return in one (1) second. You mentioned the word, "modern portfolio theory." It's come up a little bit.

Can you address the concept of diversification and how that fits within modern portfolio theories, sir?

DR. DEREK HUM: Modern portfolio theory is a very standardised term now. It's one (1) of the buzz words or catch phrases that we use in this -- the teaching of this. It's perhaps even an unfortunate term, but it probably dates back to the work of Markowitz who was -- the first time showed mathematically that you could structure a portfolio that would give you a rate of return and actually reduced your risk.

The risk was defined as the variability in the -- in the return on the portfolio. And he showed that you would do this by diversification. Diversification meant that you must have more than one (1) asset in your portfolio. If you have only one (1) asset, you're not diversified and you cannot get a lower risk or variance than whatever that security gives you.

But if you have more than one (1), it is possible through judicious selection of them to actually have the same rate of return, but lower risk. And the gains that come from that is known as diversification. This is the tactic or strategy and is the fundamental principle underlying what we call modern portfolio theory.

MR. BYRON WILLIAMS: Thank you for that. And you've talked a little bit about risk and in terms of -- just if you can follow that up just a little bit.

In terms of evaluating an efficient portfolio, how -- how do you do that? How do you evaluate that you have an efficient portfolio?

DR. DEREK HUM: I'm not sure I understand the question. It's -- it's efficient in the -- in the sense that it would dominate all other portfolios with the same level of risk and has a higher rate of return. And I guess the assumption that is implicit in economics and modern portfolio theory is that individuals, under those circumstances, would prefer the portfolio with the higher rate of returns. So it's -- so we take a very simple-minded notion that we evaluate it higher. We call it efficient.

MR. BYRON WILLIAMS: Okay. And I'll -- and I'll just -- in terms of risk, how is that defined or -- or measured?

DR. DEREK HUM: Well, in modern portfolio theory, as Markowitz first developed it, he defined it as the variance or standard deviation, they're sort of equivalent, of the stream of returns that you would get from that portfolio.

In layman's terms, you could think of it as if the rate of return to the portfolio is expected to be 5 percent, but it can vary anywhere from three (3) to seven (7), that spread on the -- this is not precise, but that spread is some notion of the risk that you're not going to get five (5), you might get three (3), but you could also get seven (7).

But statistically, we could define a precise measure called the Variance of Standard Deviation that represents the -- the spread of the rates of return that you would get around your average expected return.

MR. BYRON WILLIAMS: Thank you, Dr. Simp -- or Dr. Hum.

And, Dr. --

DR. DEREK HUM: We're interchangeable.

MR. BYRON WILLIAMS: Yeah. And Dr. Simpson, I'm -- you're both welcome to respond to these questions. I wonder, Dr. Simpson and Dr. Hum, if you could turn to Table 1 of your evidence which appears in the bound version at page 4, it's titled, Four Portfolio Mixes for MPI Compared.

Do you see that, Dr. Hum?

DR. DEREK HUM: Yes.

MR. BYRON WILLIAMS: Now, Dr. Hum, you mentioned a few moments ago that you were -- you were asked to discuss whether the current MPI portfolio is efficient and if I turn -- look at Table 1, I see on the second left-hand column the old target per MPI versus the -- the new target per -- per MPI.

And I wonder if you can discuss at a -- at high level the -- the major differences between the old target and the -- and the new target, please?

DR. DEREK HUM: Thank you. First of all, I constructed this table, or we constructed. I use I/we interchangeably so that it is our table.

And at a high level, and I know you'll have an opportunity to -- to ask for detail, the "O" target, if I confine myself to the three (3) major asset classes of fixed income, equity and alternative, it shows that the target was approximately, I'll round-up, 80 percent fixed, approximately 20 percent public equity and very, very small amounts in alternative, 0.5 percent.

If we compare that to the new target which is a target, the fixed equity is 60 percent, so, there's a decrease of 20 percent. Equity is roughly the same at 20 percent and the category of Alternative, the target is 20 percent, which is substantially higher than the 0.5 percent of the old target.

I have characterized this in my report as an improvement for MPI in the sense that they should, according to modern portfolio theory, expect a higher rate of return with this allocation. The new target, my understanding is that they have not yet got there but when they get there this allocation should provide a higher expected rate of return. But it doesn't come without cost and I suggest that it comes with a slight decrease in the liquidity of their portfolio of the new target as opposed to the old target.

MR. BYRON WILLIAMS: And as it -- apart from liquidity, are there other -- any other elements that, given the -- your expectation under theory that it -- it should yield a higher return, are there any other potential downsides to the -- to the new portfolio?

DR. DEREK HUM: Well, there are some downsides and -- and this is where we can get into the details and, particularly, I noted some areas of concern that -- that would worry me if I were faced with this movement to the new target. I am -- I don't know if you want me to talk about them or not.

MR. BYRON WILLIAMS: And -- and let me just stop you there for a second and just -- just to go back, though, you -- you talked about a slightly higher -- or a higher return.

In terms of risk based upon portfolio theory, what would be your expectation in terms of this new target?

DR. DEREK HUM: Well, I would characterize it as a higher risk as well because my characterization of bonds is that most people in the money and banking consider them relatively safe or safer than the alternative, which is equity and alternatives and so, therefore, if you reduced a proportion of your portfolio that's in the safe basket towards the others, you would expect the overall portfolio mix to be slightly less safe than it would be, because in the interim when -- and in the limit one could have 100 percent bonds. And then of course it would be very, very safe.

Most people would consider that extremely safe but one would not have probably expect as much return from that kind of allocation.

MR. BYRON WILLIAMS: Now let me -- and we'll come back to this subject later, but in the third line of this Table 1, you see a RRB and you'll -- I'm going to suggest to you that -- that's a reference to Real Return Bonds, is that right?

DR. DEREK HUM: Yes. It is. I -- I wrote the report, so, that's what I meant.

MR. BYRON WILLIAMS: Okay, that's good. Can you just at a very high level without elaborating at this point in time, identify the trend -- or the change, excuse me, not the trend, the change between the -- the old target in terms of Real Return Bonds and the new target?

DR. DEREK HUM: Well very, very simply, the old target had a positive allocation to Real Return Bonds. The weighting or -- approximately it was 12.5 percent is the proportion.

The new target has an allocation of zero so, therefore, when the portfolio is finally established under the new targets, there will be no Real Return Bonds in the new target allocation.

MR. BYRON WILLIAMS: Okay. Thank you for that. I want to turn and you can stay on this table for -- at least for the short term.

I want to focus now on -- on equities. And I'm going to suggest to you, you're right, you did -- you collectively produced this table.

You make reference in this table to both the Aon report and the Mercer report. Is that right, Dr. Hum?

DR. DEREK HUM: Yes. And those are in the -- the columns that are bracketed by the old target and new target.

MR. BYRON WILLIAMS: And going down to the Public Equity section, you've generally divided this material into Canadian Equity, US Equity and Foreign

Equity, is that right?

DR. DEREK HUM: That's correct.

MR. BYRON WILLIAMS: With reference to, you know, Aon first than Mercer, I wonder if you could offer any observations about the relative mix in terms of percentage between Canadian versus American and then Canadian versus all non Canadians proposed in both of these reports?

DR. DEREK HUM: Well, as the numbers indicate, the Aon report allocates 10 percent of the portfolio to Public Equity divided between 3 percent Canadian and 7 percent US.

The Mercer report allocates 25 percent of the portfolio to equity allocated evenly between -- I'm sorry, allocated 10 percent to Canadian, 10 percent US and 5 percent foreign.

The new target, just by way of comparison, of MPI as allocating 12 percent Canadian, 5 percent US, 3 percent foreign equity.

So if one looks at the numbers, I would characterize both the Aon report and the Mercer report as allocating a larger fraction of the portfolio to non Canadian equities, both of them agree that this is -- the number's different but both of them have this qualitative aspect to it.

The new target of MPI is the reverse, 12 percent Canadian versus 8 percent combined US and foreign. So their allocation is the opposite of the Aon and Mercer allocations.

So that is the qualitative distinction between the new target and the combined Aon/Mercer type of recommendation.

MR. BYRON WILLIAMS: At a high level which relative allocation do you prefer? Greater proportion at weight in non Canadian or greater proportion at weight in Canadian?

DR. DEREK HUM: I prefer the greater proportion of weight in non Canadian.

MR. BYRON WILLIAMS: And can you explain why at a high level?

DR. DEREK HUM: I would explain it in a two (2) stage process. One is that, first of all, under the diversification theorem it's better to be in both, okay? But that doesn't go far enough.

It's -- it's not the same thing as having a $2 billion portfolio in one and having one hundred dollars ($100) of it in the other one and, say, I've satisfied your condition of being in both markets.

So the actual proportions are important. The -- the -- then the question is: Why should the US or the non Canadian one have a larger proportion than the Canadian?

Well, there are two (2) reasons: One (1) is the Canadian equities, what I would call good or safe equities for this -- want of a better word let's call them "large cap" companies with large capitalization as opposed to startups or venture capital firms, the -- the amount of the total world or North American equities that are available that -- that Canada comprises is a very, very small fraction of the North American or global capital markets.

So there's a lot more choice involved and there's a greater variety of -- of these firms that you could invest in in US equity. So that would be one (1) point and, of course, foreign as well. There's a lot of international companies that are not North American.

And the second one is that -- is the diversification one. This can be slightly technical, but for now if you take it on faith, if you want to diversify and you've made up your decision that you're going to be in both markets, then what is the proportionate allocation between these two (2) markets that would give you the greatest amount of diversification in the sense of reducing the variance or risk of your total portfolio?

I'm not suggesting this as an iron rule, but mathematically the lowest risk point would be with an equal split. Okay? I'm not saying that every portfolio should be equal, but mathematically that's the case and as you move from a fifty fifty (50/50) split, then the diversification theorem becomes less powerful.

So obviously, from that perspective, if we confine ourselves to Canadian/US equities, the Mercer report, obviously, attempted to accomplish this by having the equal split.

Aon, obviously, had other considerations in their model so that they didn't do that and -- and the new target of MPI didn't do that, but that would also be an additional reason why one would want to examine the proportions as well as simple presence in both markets.

MR. BYRON WILLIAMS: And we're going to stay with this point for a couple more minutes.

If you could turn to your evidence, the heading about four (4) more pages in, the Amount of Foreign Equities in the MPI portfolio? In the bound version, it should be about page 8.

(BRIEF PAUSE)

MR. BYRON WILLIAMS: Simple bottom-line question: Do you consider the proposed allocation of the target MPI portfolio equities to be efficient?

DR. DEREK HUM: Where is this? Oh, that's the question?

MR. BYRON WILLIAMS: Yeah, I'm looking for your evidence. I'll ask the questions.

DR. DEREK HUM: I don't think it's efficient in the sense that I believe they could get for this similar level of risk a higher rate of return with an alternative allocation.

MR. BYRON WILLIAMS: And that's primarily for the reasons you've expressed previously.

DR. DEREK HUM: Yes, I think they are underweighted in the US market and underweighted in what I call the foreign market where I'm using "foreign" to exclude US.

MR. BYRON WILLIAMS: Okay. And again, at a very high level -- I'm not asking for specific investment advice but, at a general level, if you don't consider the proposed MPI target in terms of equities to be efficient, what might you consider to be a preferable approach?

And you may have already answered that, but I just want to make sure.

DR. DEREK HUM: Well, I -- I think I have answered that is that I would -- I would like to have seen, as a taxpayer, a greater weighting in US equities and a slightly greater weighting in foreign equities as well.

MR. BYRON WILLIAMS: Okay. Thank you for that.

DR. DEREK HUM: But I'm not recommending particular stocks.

MR. BYRON WILLIAMS: Thank you. Just a couple more points in this area.

MPI seems to say that -- and I'm interpreting their position, that Canadian equities have done better over the past little while than US equities.

Shouldn't that argue for a greater proportionate investment in Canadian stocks?

DR. DEREK HUM: That's very tricky because no stocks have been doing very well recently, but I understand. It depends on the time frame by which one refers to in making this comparison, and it also depends on your investment horizon.

My understanding of reading the material is they were referring to the performance of Canadian equities over the last five (5), six (6), seven (7) years. They weren't -- I am as -- I don't interpret that as being something that has been recorded since the beginning of record-taking about the markets.

And -- and I agree that that is the case. Canada in the last five (5), six (6) years has the benefits of a -- what we would have called a -- a tremendous demand in a particular sector, which Canada has compared advantages, which is commodities and raw materials.

And history shows that demand for commodities and raw materials is -- is not uninterrupted, it's cyclical. So for the period they have chosen, yes, Canada has done very well.

On the other hand, I understand that the philosophy underlying -- and I'll be corrected by counsel I'm sure if I'm wrong, that the intent of the portfolio is on a long-term horizon basis. They're not going to be trying to be active traders on a day-by-day basis on this.

And if I accept that the portfolio horizon is long term, then the most recent superiority of the Canadian market over the last little while becomes not a great consideration, partly because of the long horizon of the portfolio intent, and partly because of the fairly, I would say, localized and specialized reasons why the Canadian market has out performed recently.

MR. BYRON WILLIAMS: Okay. And just to turn to the issue of international equities for a second, you'll recall that Aon, in its recommendations, doesn't allocate anything for international equities.

Is that right? Your understanding?

DR. DEREK HUM: They -- they -- yes, they didn't.

MR. BYRON WILLIAMS: And you'll also understand that MPI makes some modest allocation to international equities. Is that -- is that right, sir?

DR. DEREK HUM: I believe the target is 3 percent. The new target's 3 percent.

MR. BYRON WILLIAMS: Between the Aon approach and the MPI approach, which do you prefer?

DR. DEREK HUM: The MPI approach.

MR. BYRON WILLIAMS: And why?

DR. DEREK HUM: Well, I am actually quite baffled by the -- the Aon recommendation, and I'm sure I'm not privy to all of the information and instructions that they have received. My understanding is that they just didn't bother to model it.

What I have said about the value of diversifying away from the economy and Canadian equities to include the US also is valid for the global economy.

Again, while the US is a large economy, and the North American is a large economy, it's still only a small part of the entire world. And it's very difficult to see that there would not in this third category -- I'll just call them foreign. By "foreign" I mean non-Canadian, non-US, that there would not be diversification gains to be had by including this third asset class. Aon did not do that so, therefore, their portfolios are restricted in terms of the ability to do this.

If we include it and MPI, I think has - I'm allowed to editorialize I'm an economic - wisely rejected the Aon recommendation there, and have included foreign equities, I think that shows a tremendous intelligence.

So it can't be that they are obsessive about staying in North America. So therefore the only question is: Is 3 percent enough, and 3 percent of the rest of the North -- non North American world seems to me is a very small proportion for a portfolio of the size of MPI which is about $2 billion.

It's not as if you can't afford to do it. It's a very small proportion. It's almost like -- it's almost -- token is of right now to say that the rest of the world is worthy of 3 percent of our investment intention.

MR. BYRON WILLIAMS: Just turning to the next page of your evidence and it should be just above the heading of Absence of Real Return Bonds.

And, Dr. Hum, I'm going to suggest to you that you make a reference to the fastest growing -- some of the fastest growing economies in the world including Brazil, Russia, India and parts of Asia sometimes known by the acronym B-R-I-C, BRIC.

DR. DEREK HUM: Mm hm.

MR. BYRON WILLIAMS: Do you see that, sir?

DR. DEREK HUM: Yes, I do.

MR. BYRON WILLIAMS: And I just -- thank you for that answer. And I just want to be clear, are you recommending that's where MPI should put its money or -- or is that illustrative just of the fact that there are -- whether MPI goes there, that there are some opportunities internationally?

DR. DEREK HUM: First of all, I want to make it very clear, I'm not going to recommend to MPI where to put their money at all; that's -- that's an unqualified statement on my part.

I -- I meant that as a followup sentence to my previous sentence which was the refusal by Aon to countenance international equity in our judgment is inexcusable. And if I left it at that, I'm sure somebody would have said, why. So I thought I would follow that up by illustrating that the fastest growing economies in the world are not Canada or the US.

They include other parts of the world. I use the BRIC simply because it is so well established now that it has its own acronym; that people realize that these are the fastest growing parts.

And then or course I did attempt to clarify, perhaps not adequately, in a footnote that there are other parts of the world besides those four (4) countries that people often find useful for investing purposes such as Britain and Sweden and Japan and so forth so on.

So, it was not meant as a recommendation at all. That would be a deliberate misreading of that sentence to suggest that I was recommending MPI invest in BRIC.

MR. BYRON WILLIAMS: Let's turn to Real Return Bonds for a couple of moments.

Just as a reminder and you've noted this in your -- your previous testimony, have you not, MPI's targets appear to be moving from a substantial position in Real Return Bonds to zero. Is that right?

DR. DEREK HUM: Yes, that's -- that seems to be the intent.

MR. BYRON WILLIAMS: And if -- we're just

-- in terms of the bound version of your evidence turning to page 9 the heading is Re Absence of Real Return Bonds in the MPI Portfolio.

Dr. Hum, at a high level can you advise the Board of your observations in this area?

DR. DEREK HUM: Yes. This recommendation by Aon was one that probably struck me as -- as the -- as the most worrisome from my perspective as -- as an economist.

If I might explain the economist often worry about, among other things, inflation. Inflation I -- I don't think I will catalogue all of the deleterious effects that high inflation can wreck on an economy and individuals and so forth. But Real Return Bonds is one of the instruments that is available in the market for individuals to, in some sense, hedge or ensure against a contingency of high and volatile inflation.

And that's what the instrument was created for. So for me to see Aon recommending that these not be held was, in some sense -- I had a very emotional reaction to this.

The Real Return Bonds means that should inflation be high and we can pick a -- a number, 6, 7 8 percent. I'm not talking about hyper inflation which is when the economist should reserve that term for tripledigit inflation, but high inflation, then nominal bonds essentially pays you the coupon rate or the rate of return that was written and agreed to.

Real Return Bonds are different. They pay you that rate plus an adjustment, according to a formula, what the rate of inflation is. So in that sense, you're protected against a contingency of unforeseen and unpredictable high inflation.

Government bonds are customarily thought by -- by most people as safe, very safe. They're very safe in the limited sense of having an absence of default risk. We don't expect the Government of Canada to go bankrupt as -- as -- and not honour their obligations, but that doesn't speak to the issue of inflation risk and that is why Real Return Bonds have this particular feature.

So that was why I suggested that the absence of Real Return Bonds is to me a flaw in the recommendations because it goes from 12.5 percent to zero (0) and if they meet that target, I don't have to run a computer program to reach my judgment that I don't think this is a good thing.

MR. BYRON WILLIAMS: Well, let me play devil's advocate with you for just a second, Dr. Hum.

You're aware that the Bank of Canada has targets for -- for inflation?

DR. DEREK HUM: Yes.

MR. BYRON WILLIAMS: And you're aware that certainly in the late '90s and the early -- earlier parts of this decade, the inflation did pretty well in terms of staying within those targets?

DR. DEREK HUM: It was benign, yes.

MR. BYRON WILLIAMS: So I'm going to suggest to you that the Bank of Canada has things under control and that your reaction to the -- the risk of inflation is -- is inconsistent with that reality?

DR. DEREK HUM: Well, that was a good suggestion. I don't know. I don't know if I should make the comment that during the period of tremendous control over the inflation the Bank of Canada was headed by an economist, David Dodge.

I could answer this in several ways but let me start off by the first way which is that your reference to an historical period in which inflation was benign, this is the last ten (10) years in which the Bank of Canada moved to what we call a policy of deliberate inflation targeting. They managed their policies in such a way as to keep the rate of inflation in Canada within a bound and the bound in this particular Bank of Canada regime, I'll call it "the Dodge regime," was between 1 and 3 percent.

The previous regime, at least on paper, was that of Mr. Crow (phonetic) who said he was going to crank it down to zero (0). Okay?

But if I push your memory of economic history back another ten (10) years from there, you might precord (phonetic) or remember that inflation rate was extremely high in the 8, 9, 10 percent, so dramatic that the government had to do all kinds of things beyond monetary policy. They had to set up in the Economic Council of Canada a special research firm, endeavour, on the study of inflation in which my colleague worked, the Centre for Study. They had to take such dramatic steps as impose wage and price controls.

I don't know if people remember this, but my point is, the period of history is not so long that certainly within my professional life and living memory, there are periods in which inflation has not been benign, so, that's the first period.

So the question is, pick your period. Okay?

The second point is that you may have faith and trust in the Bank of Canada in their resolve to keep inflation within those targets but there's no guarantee that they will, with the best of resolve, succeed because what the episode of the '90s told us during the OPEC cartel, despite great sincere resolve and tremendous talent, it is not possible to maintain a rate of inflation in Canada that was considered acceptable because most of the impetus for it was external to our country.

I refer in this particular case to the OPEC cartel but there could be other -- other causes that originate outside Canada and the Bank of Canada is, and let's be very blunt, Canada is a very small country in the scheme of things of the global economy, so the Bank of Canada itself may find themselves slightly impotent in terms of controlling inflation.

So the Bank of Canada is a wonderful institution and is trustworthy but despite all that there may be occasions in which, as history has shown us, they are not able to contain the inflation within their desired 1:3 ban. I mean this is -- this is good. Sometimes good people fail to meet their targets, so.

MR. BYRON WILLIAMS: Dr. Hum, and this is just a very small point of clarification, you -- you referenced the OPEC cartel in the '90s and did you mean the --

DR. DEREK HUM: '80s.

MR. BYRON WILLIAMS: -- '80s?

DR. DEREK HUM: '80s.

MR. BYRON WILLIAMS: And -- and perhaps the '70s?

DR. DEREK HUM: Yeah. I have a third point but it doesn't matter anyway.

MR. BYRON WILLIAMS: Well, let -- let me just go to that third point and certainly, Dr. Simpson, you've been quietly waiting as well, either one of you can jump in.

What, if any, observations might you make where -- let me suggest to you that we're in troubled economic times or in -- in the financial markets right now and does that affect your -- your conclusion in this area at all.

DR. DEREK HUM: Go ahead.

DR. WAYNE SIMPSON: Well, I think the fact that the Bank of Canada has set explicit targets shouldn't, you know, isn't really a change of policy. I mean, the Bank of Canada's policy has always been one of -- of low inflation. The inflation targetting is a -- is a new measure focused on transparency more than anything, basically saying that if inflation gets outside this band either at the top end of 3 percent or the bottom end at 1 percent, we're concerned and we will take action. And there are specific actions that they'll take in -- in financial markets.

That said, as Professor Hum mentioned, there are things happening in the bigger world that may cause them to take action and they may not be successful in the short term and we're seeing that now where inflation is -- is going above 3 percent, the Bank of Canada is taking action and where that will lead is really uncertain.

So in terms of the Bank of Canada's ability to control inflation, it's done well in recent years. It may be better at it than it ever was before. We think so. But we don't know what's ahead and we know that in the past at times inflation has gotten away in spite of the Bank of Canada's best intentions.

MR. BYRON WILLIAMS: Thank you for that. And probably back to you, Dr. Hum, I just didn't want Dr. Simpson's throat to get too dry from -- from lack of exercise.

MPI, as I understand, has suggested in -- in response to certain Information Requests that its future investments and real estate and infrastructure will essentially perform the same function as Real Return Bonds as a hedge against inflation but with a higher return.

How would you respond to that?

DR. DEREK HUM: Well, there is truth to that but partial truth. I -- I always just simply skip the first portion which is that, yes, but they're not really having any real estate investments at the moment, as I understand, this is their intention.

And -- and in my report I said, I obviously cannot analyze the real estate portfolio because there's nothing in it and I really don't know what is going to be in it and I don't think anybody knows at this point what the expected rate of return and what the range of variation in their returns they will get from their portfolio until we actually see it.

So we actually have to only appeal to what we know about the real estate market and the rates of return we get and real estate investment, in general, which of course may or may not be the exact composition that will be in the MPI portfolio. So I just don't know.

But on the issue of real estate in general as an inflation hedge, I think two (2) comments could be made: One (1) is that generally over the long run real estate has been a bit of an inflation hedge because it does keep -- is correlated with rising inflation more than obviously bonds that is not.

The difficulty I still have with this beyond the fact that I don't know what's in the real estate portfolio, but let's suppose it's the best real estate portfolio that one can imagine. All right?

I -- I will give them that. It's the best, no one can do better. I do worry about it in a portfolio the size of 2 billion that if this is going to be their inflation hedging strategy, you again have to be sensitive to what I call the proportions.

By asuing (phonetic) Real Return Bonds and only nominal ones, you have 60 percent of your portfolio exposed, if you like, to the contingency of high inflation. But, you said I'm unprotected because I have real estate. And real estate I believe is about 10 percent of the portfolio. Okay?

So bearing in mind that the proportions are important, so that if inflation however defined by MPI like say the CPI goes up, then in some sense to asue (phonetic) Real Return Bonds for 60 percent of your portfolio for a 1 percent increase in totally unexpected inflation, you're asking your real estate portfolio comprising 10 percent, 1/6th of that to compensate so that it would have to go up by 6 percentage points in order to -- to -- to allow that contingency to leave you in a -- a -- a safe position. So that is one of the concerns I have.

I don't disagree that real estate is a bit of an inflation hedge because it does perform well. It's correlated with inflation rates. When inflation becomes very high our real estate generally tends to also experience good rates of increase. It's not perfect but it's good. But it's the weighting factor again.

I think throughout -- one of the messages I'm trying to get is not rather the categorical presence or absence of a particular financial instrument class. What portfolio allocation is about is also the relative weightings that you give to these because that's what ultimately determines your rate of return and your risk.

I mean that's what modern portfolio theory is. You're worried about the total return and the total return is a weighted sum of the various asset classes you have.

You're worried at risk. The risk while it's not a weighted sum as a complex formula but it involves the proportions as well of your portfolio that's in the various asset class.

I mean, that can be mathematically shown to be the case so I'm going -- I -- I ask you to take that on trust. The proportions are important.

MR. BYRON WILLIAMS: Just a last couple of points on this area. You mentioned correlation.

If I were to compare the correlation of

Real Return Bonds to inflation versus the correlation of real estate, do you have any observations?

DR. DEREK HUM: Well the Real Return Bonds will have a higher correlation because the financial instrument is constructed that -- that way.

It doesn't say, well, if it goes up we may give you more money. It's actually -- it's constructed to give you the exact amount of money that compensate for the amount that inflation has gone up over their stipulated threshold.

MR. BYRON WILLIAMS: And just one last question of followup.

DR. DEREK HUM: Oh, sorry.

MR. WAYNE SIMPSON: I was just going to say on that point, you mentioned the -- the current circumstances a moment ago and we now have inflation higher, certainly above the 3 percent band. We don't know where it's going.
But temporarily it's higher.

We have real estate in the major markets in Canada - perhaps Winnipeg is an exception although I think it's softening here too and Saskatchewan - but the major markets in Canada real estate values are falling and Real Return Bonds, well, they must be increasing because they've indexed to inflation.

So, you know, the correlation between real estate returns and inflation is while positive, as Professor Hum said, but it's not perfect whereas the correlation between Real Return Bonds and inflation is by design perfect.

MR.BYRON WILLIAMS: One last --

DR. DEREK HUM: I would simply add, we're in very, very special economic circumstances so that I -- I don't think anybody should extrapolate from the last eighteen (18) months of economic performance to the long term, I hope.

MR. BYRON WILLIAMS: Just going back to your proportion point, you -- you discussed the -- the relationship of 10 percent real estate to 60 percent bonds. Let me throw in 5 percent for infrastructure as a theoretical hedge against inflation.

Would that change your conclusions at all, Dr. Hum?

DR. DEREK HUM: It changes my conclusion about the thrust of my answer because I also have no idea what is in this infrastructure box. I have no idea of his rate of return in the infrastructure box. I have no information on the variation on the rate of return on the infrastructure box.

So yes, there is a new asset class whose behavior, contents and correlation with anything else that I've -- know about their asset mix, I know nothing about.

So it would be rational to me to say that, yes, what -- what if they invested in infrastructure that's a white elephant and it's really a drag? On the other hand, you know, they may do very well.

But it still doesn't alter my point that the inflation protection offered by the not-yet-defined real estate and infrastructure is still an insufficient base to compensate for inflation that could be easily obtained on the bond portion of the portfolio.

MR. BYRON WILLIAMS: At a very high level, what would be your conclusions or recommendations in this regard?

DR. DEREK HUM: My conclusion is to repeat the exercise in rejecting Aon's recommendation with respect to Real Return Bonds and consider them.

MR. BYRON WILLIAMS: Just -- we're going to -- Mr. Chairman, we -- we should be finishing up in a relatively short time. We have a couple more subject matters I'd -- I'd like to get through and I think I could take us profitably to the -- to the coffee break and we -- and with your permission? I see you're -- you're nodding your head so I'm assuming that's okay.

Dr. Hum and Dr. Simpson, if you can just back up a couple pages in your evidence to the heading Re Universal Bonds versus Long Term Bonds, which is in the bound version of page 7.

And I don't wish to spend a -- a lot of time on this area, but Dr. Hum or Dr. Simpson, a very high level, do you have any comments about the relative merits of Long Term Bonds versus Universal Bonds -- Universal Bonds?

DR. DEREK HUM: I have comments in the context of MPI and Aon. I -- I assume that's the intent of the question?

MR. BYRON WILLIAMS: Yeah, not -- your answer is going to be better than the question. I appreciate that.

DR. DEREK HUM: Not whether these -- the -- on this, I -- I agree with the Aon position, which is that I prefer the Long Term Bonds as a strategy for MPI's portfolio, although I was quick to add in my last sentence the MPI position is defensible, however, if it gives them greater comfort.

Because currently the spread is -- is -- is not very -- very much, and -- currently. So it is the case normally over long periods, Long Term Bonds give a slightly higher rate of return than Universal Bonds, so since I assume they are both of the same risk class, approximately, I prefer the higher rate of return.

Or in the language of Modern Portfolio Theory, I can't see a perceptible increase in risk in going to Long Term Bonds over Universal Bonds and I prefer the higher rate of return.

MR. BYRON WILLIAMS: Just one other final point on this area. You'll -- you'll agree with me that you make some reference to the concept of laddering, or -- in -- in your evidence on this page, sir?

DR. DEREK HUM: Yes, I did. And you want to know the context?

MR. BYRON WILLIAMS: I -- I'm going to ask the context, and I'll -- was this -- was this -- were you recommending MPI adopt this, or was this kind of a conceptual illustration?

DR. DEREK HUM: No. As I said, I'm not making any recommendations. Not -- it was a conceptual illustration.

You'll recall at the very beginning when you asked me to characterize the new mix versus the old mix, which was my mandate, I characterized the new mix as a portfolio change, or re-allocation, that one would expect from Modern Portfolio Theory to give a slightly higher rate of return.

But -- I'm not sure how I phrased it, but as I will pithily phrase it now, but at a slight cost of decreased liquidity, because when it's fully implemented, I think most people agree that real estate and alternatives are not what you would call very liquid financial instruments.

And liquidity is defined by an economist as the ability to convert that asset to cash quickly and without capital loss. It's not a feature that's common to -- to real estate and infrastructure. It takes a lot of time to sell real estate. It takes a lot of time to sell infrastructure. And you may not get a -- a selling price that -- that -- that's absent of capital loss. So it's a liquid.

So I characterized the overall move as going for a slightly higher return, but slightly illiquid.

So, when I read the Aon report and its recommendation for Long Term Bonds, which I supported, I was confident that Aon did due diligence, and made sure that the asset and liabilities were sufficiently matched up and so that when they recommended these Long Term Bonds, they could be held in Long Term Bonds. It wouldn't be needed.

So therefore, my laddering suggestion was framed in the sense that if, in fact, the concern or discomfort with Long Term Bonds was the notion that, well, maybe they're not as liquid as I would like them to be and therefore I would wish Universal Bonds, my suggestion of laddering was that this is one (1) way, when fully implemented, you could also accommodate liquidity as well by investing in Long Term Bonds.

This is not something a small investor could do, but someone with a portfolio of $2 billion, it's -- it's quite practical to do.

MR. BYRON WILLIAMS: Thank -- thank you for that answer, Dr. Hum. And this can go to either Dr. Hum or Dr. Simpson, obviously.

In -- in terms of considering an optimal portfolio, can you provide an example of what may -- might be defined as a constraint? Either of you.

DR. DEREK HUM: A lack of money would be one (1). No, all kinds -- all kinds of constraints in adopting a -- a portfolio.

If -- if I were to set out to design an optimal portfolio, say for -- for me or for my wife, she would give me all kinds of constraints, beyond the fact that we don't have the money. She would say, I prefer to invest only in Canada and the United States and Australia. I don't want to invest in any place else.

And I might try to convince her that this is not a good constraint but she suffers from some excessive patriotic phobia - my wife's Australian, by the way - but if she holds fast, and say, I want to do this, I would accept that.

There are other kind of constraints which may be regulatory, such as -- and there are some that are basically prudence, and there are some, and I think these are the ones I would like to concentrate on, that flow from the principles of Modern Portfolio Theory.

And one (1) of them is: There are gains to be had from diversification. So if someone said, My constraint is I have to be entirely in one (1) country, then I would basically say, That would be a very, very severe constraint.

Economists often refer to problems like this as programming problems. I hasten to add programming does not mean computer program. It's a mathematical area common to management science, operations research and the programming problem is, essentially, finding the optimal allocation of resources.

A programming problem is not really considered well specified if you don't give the list of constraints. And the wonderful thing about the discipline of programming

-- I won't bore you with the technical details, it calculates what we call mathematically legronge (phonetic) multiplier or in common parlance call them shadow prices.

And what this discipline exercise does for you is to say, first of all, of all the constraints that you've given me, which ones are actually binding and which ones are not. The non binding constraints tend to be not worrisome so we don't worry about it, okay. So if someone says one of my binding constraints is that I've got to have at least ten dollars ($10) in the Canadian market. I can put it in my model but will probably not be binding in a portfolio of 2 billion.

On the other hand, if someone says I don't want any foreign equities, put that in the model, the programming model - remember this is mathematics, it's not computer programming - would calculate something called a shadow price. The interpretation of the shadow price, generically in mathematics, is the change in your objectives for a small relaxation of that binding constraint.

So in this particular case it would be perhaps the change in your rate of return or risk if this constraint were relaxed a little bit. In other words, if you were to allow me to invest in foreign equities, you take away that constraint, what would be the change in your rate of return?

So, in other words, rather than half a problem in which calculating the optimal portfolio is actually half of the problem, where I simply give you the menu of efficient portfolios, the programming formulation which -- into which the Modern Portfolio Theory is embedded actually tells you what is the cost to you of the constraints that you've given me.

Now, some of these constraints you can't do anything about. Such as we have to work with the Department of Finance. Okay. But if you say some of them maybe it's -- well, maybe you ought to know the cost of not having Real Return Bonds. Maybe you ought to know the cost of not having more than 3 percent foreign. I mean, this is what you would calculate.

MR. BYRON WILLIAMS: Okay, thank you for that. And with some trepidation and we'll do this quickly but I'm going to move into an area that I'm going to suggest is not your -- your area of expertise but it -- we're going to --

DR. DEREK HUM: Wayne's going to answer these questions then.

MR. BYRON WILLIAMS: Dr. Hum or Dr. Simpson, at a very high level, are you aware that as a consequence of relatively recent accounting rule changes there are different implications flowing to the net income line from the designation of certain assets in the MPI portfolio as held to maturity or available for sale or held for trading?

Are you aware, at a very high level, of that reality?

DR. DEREK HUM: We were not aware at the time we authored the report but since then, we have been made aware and we are now aware.

MR. BYRON WILLIAMS: Okay. And again, recognizing you're not professing any expertise in this area, you're -- you're aware, for an example, that unrealized capital gains in an asset designed as -- designated as held for trading might flow through to the net income line while unrealized gains in an asset designated as available for sale will -- will flow through to the other comprehensive income line at a high level?

DR. DEREK HUM: We were not aware of that at the time we wrote the report but we have since been made aware of that and we are now aware of that.

MR. BYRON WILLIAMS: And you're also aware that assets designated as held to maturity, a report on their book -- on their book rather than -- than their market value?

DR. DEREK HUM: Yes. The same answer as before.

MR. BYRON WILLIAMS: Given this accounting reality, is there the potential, or possibility, that there will be a different return and variability reflected on the net income line on the balance sheet than was calculated through the optimal portfolio?

DR. DEREK HUM: Very definitely, yes.

MR. BYRON WILLIAMS: I want to turn to your evidence --

DR. DEREK HUM: You -- you didn't want an answer, you just want --

MR. BYRON WILLIAMS: If you want to elaborate --

DR. DEREK HUM: No, no. No, I -- I was waiting for the follow up, which was: Explain to me. It doesn't matter.

MR. BYRON WILLIAMS: We're going to go to the -- a revenue stabilization suggestion, which should appear in the bound version on or about page 12, and specifically I'm turning to Table 2, which is titled -- which should be in the bound version at page 13, Examination of the Volatility of Total Expenses versus

Investment Income, 204 through 208.

DR. DEREK HUM: I have it.

MR. BYRON WILLIAMS: Okay. At a high level, Dr. Hum and Dr. Simpson, I wonder if you can discuss the point that you're making with this table, in terms of the relative fluctuation in investment income over the past four (4) years.

DR. DEREK HUM: I think the point we were trying to make, and we only were able to get from our information data for those years, is that if you look at investment income and its magnitude over those four (4) years, it's in the order of 108/109 million.

The total expenses for those same years averaged about 92 million, so, we picked total expenses because it was convenient and easily obtainable. There's -- there's no particularly economic theory behind why one would compare these two (2) columns. One could compare it with anything else that one thought appropriate.

But our point was this: The relative magnitude of total expenses and investment incomes are about the same, which we interpret as speaks to the importance of investment income, and why it would be very nice to have a portfolio that continues to generate high levels of investment income and, hopefully, with a very low variability.

We also were struck by the fact that the variability in these two (2) magnitudes are dissimilar, even though they have the same approximate level.

By way of illustration, we thought it cumbersome to try to calculate a variance, or standard deviation, with four (4) years of data.

The investment income has a range from seventy-seven (77) to a hundred and forty-five (145). The total expenses has a range between eight-five (85) and one hundred (100) -- or ninety-nine (99).

So you can see, and I hope without esoteric statistics, that investment income has a higher, what we would call, range of variation.

That was the point we were trying to make with that table, and then having made those points, if they are worth observing and exploring, we suggested, very briefly, how one might mitigate the volatility of investment income in order to align it with the range of variation that one would perhaps expect to be reviewed in total expenses.

MR. BYRON WILLIAMS: Okay, and I -- I thank you for that. Now one (1) -- one (1) point I just wanted -- or moving along from your analysis, and accepting that you've looked at recent history.

In -- in terms of moving out in -- in the future towards the MPI's proposed target range, in terms of the volatility of the investment income stream what, if any, observations might you make about the move to a higher allocation to equities proposed -- not a higher allocation actually, a higher allocation to alternative investment vehicles on your two (2) -- your basis?

I guess what I'm asking is: The -- the new portfolio proposed --

DR. DEREK HUM: More.

MR. BYRON WILLIAMS: -- more volatility?

DR. DEREK HUM: Well, the new portfolio didn't significantly increase equities. It -- it reduced bonds, and allocated -- if that's the right term -- it -- it didn't -- it didn't take the bonds and put it there, but the resulting allocation is not much change in equities, but a reduction in bonds, but then, an expansion in this new category called Alternative. Not a new category, but a greatly enlarged presence in the new category of real estate and infrastructure, the details of which I do not know what will be in those portfolios.

MR. BYRON WILLIAMS: So you're suggesting more volatility. Is that possible or a reasonable expectation?

DR. DEREK HUM: I think -- I think there would probably be consensus that there will be more volatility because there is a lesser emphasis on bonds moving into a category, the details of which we do not know much, but historically a category that is subject to greater volatility than is typically historically experienced with bonds.

So, I mean, I'm not trying to be -- to prevaricate but you're asking me to comment on the volatility of a box containing things that nobody's put anything in the box for me to see yet, so.

MR. BYRON WILLIAMS: Now just turning to your evidence, the next page, page 14, I'm going to suggest that you offer some comments at a conceptual level in terms of how one might theoretically address the issue of investment revenue stability.

Do you agree with that?

DR. DEREK HUM: Yes, that's the -- that was the intent.

MR. BYRON WILLIAMS: So just going to the intent, is this a complete plan of what you might recommend if -- if the Board thought the area was worthy of further exploration or is it a kind of a high-level look at the concept of levelizing investment income.

DR. DEREK HUM: Well, it's a -- it's an extremely high level recognisance look from a U2 plane. If it were a detailed plan on the ground, the volume of paper would be three (3) times this. So, yes, it's a very high-level look.

THE CHAIRPERSON: Is it that high, Dr. Hum? Is this not what the universities do with their endowment funds to maintain the stream of income going to scholarships and bursaries?

DR. DEREK HUM: I'm -- I'm sorry, I can't -- I'm sorry, could you repeat that, sir?

THE CHAIRPERSON: This ideas of draws off the investment fund to address the volatility, is this not exactly what universities do from their endowment funds to maintain the stream for bursaries and scholarships?

DR. DEREK HUM: Okay. I can answer that from a -- they do that in part but as a -- as I am on the finance committee of St. John's College, we don't have the same problem that is faced by MPI for a very good reason.

Our endowments and our scholarships are phrased in such a way, this may be -- maybe an economist drafted this rather than a lawyer, that the sum of the scholarships is defined to be the investment earnings from that trust fund in the previous two (2) years or so. So, therefore, the value of the award varies with the performance of the portfolio.

So we will never be in a position where we would not be able to give the fellowship. It's just that the amount of the award varies. So we -- we don't actually face that problem.

CONTINUED BY MR. BYRON WILLIAMS:

MR. BYRON WILLIAMS: I believe Dr. Simpson might have some comments.

DR. WAYNE SIMPSON: Yes. Yeah, I -- I think that to reinforce the point that the -- the Board is making is that there are kind of two (2) possible models here: One is one in which the St. John's model, for want of a better term, in which you basically say, whatever you get you spend; and the other model is one which says that over time we have -- we are able to expect a certain level of income with a substantial volatility and we're going to design a scholarship that will guarantee the student a certain amount of income. And that's precisely the -- the flavour of the recommendation that is in our -- our report, yeah.

So that's a very good -- a very good example of exactly what we had in mind.

MR. BYRON WILLIAMS: And just continuing on the line of real world analogies for a second, Dr. Hum, I think in your evidence, at least in a footnote, you -- you drew analogies to a fixed amount annuity.

Can you just help us with -- with that analogy as well, sir?

DR. DEREK HUM: Remember, analogies or metaphors are never perfectly exact, okay. But if -- if -- I approached it this way: You're concerned with an optimum portfolio. You go to all this effort and you are told that if you invest in this way, you will get this rate of return on an expected basis but you will have to suffer the consequences of this level of risk of volatility. You've chosen, you've accepted that, okay.

Everybody would like to have higher rate of return/lower risk but that's just not feasible. So you've made your decision and you lived with it. So that tells me, unless there's a severe amount of cognitive dissidence, you are happy with that rate of return, expected rate of return year after year after year.

Well, if you are happy with that then why not in order to insulate the volatility of the portfolio from the balance sheet considerations of a yearly investment income for operating, arrange to take that?

Now, people who often don't have that kind of discipline or have a distaste for that, in the past have always said in an annuity - and that was my analogy - here's the money, I'm sorry, I don't have more wealth and I would like a 20 percent rate of return. And they say no, you can't have that.

But, what we can do is we have calculated this is the amount of income we can give you on a level basis year after year which is sustainable and that might be useful to helping you for budgeting and consumption planning. And a lot of people say I like that. I like that. So the fluctuations that would occur in the portfolio is behind the screen, it's hidden. But they have the steady flow.

And my attempt was to trade on this analogy, the desire perhaps I'm wrong for steady income, not volatile income, that it's very easy to devise a mechanism in which you self stabilize your investment income that you know is going to vary year by year according to the vagaries of the investment atmosphere and context.

So if -- if you don't like this, spend what you make this your model; if that's not your preference then this is another high level mechanism to think about to explore.

As I said, I did not try to work out chapter and verse in detail because, obviously, if -- if the model is not really desired or wanted it, why would I go to all that trouble. But it's something I offer as a suggestion.

MR. BYRON WILLIAMS: Is there anything more you want to add on this specific suggestion, Dr. Hum?

DR. DEREK HUM: Wayne might.

DR. WAYNE SIMPSON: I don't think there's anything more complicated here than the standard problem that people more and more face when they accumulate a pension fund for themselves because more and more the defined contribution plans generate a -- a pot of money.

And the question then is: How do I want to take that money and when you go to see financial advisors they say, well, you have several options, one of which, is essentially to spend the money as you, you know, receive it within the restriction or constraints that the -- that the legislation, the pension legislation places on that.

And the other one is to draw an annuity. And annuity is designed in a fashion that will allow you to draw a certain amount of money every year to your expected death without -- without exhausting the fund.

And it -- those kinds of designs are certainly feasible in the context of -- of the investment fund that's here.

MR. BYRON WILLIAMS: Mr. Chairman, I have one (1) further question of clarification that I -- I want to -- to do and then I think I can -- I can close the direct examination.

If I might have one (1) minute with -- with the witnesses?

THE CHAIRPERSON: Yes, sure.

(BRIEF PAUSE)

CONTINUED BY MR. BYRON WILLIAMS:

MR. BYRON WILLIAMS: And, Mr. Chairman, this is just a question of clarification for Dr. Hum.

Dr. Hum, in your direct you -- you may have stated that the -- the international equities were -- were not modelled. I'm going to refer you just to the evidence of -- of -- and the Board does not need to turn there, but to the evidence of -- or the report of Aon page 16, the third bullet at the top.

And, Dr. Hum, is -- is it your understanding that in terms of international equities what Aon did in terms of its equity structure optimization analysis was to set 100 percent of the foreign equity allocations to US equities with international equities not included in the optimal portfolios?

DR. DEREK HUM: That's my understanding. I would take this on faith. And if I said something different, then I misspoke.

MR. BYRON WILLIAMS: Okay. Your mic wasn't on, --

DR. DEREK HUM: Okay.

MR. BYRON WILLIAMS: -- it is now though. It's okay. If you can just repeat --

DR. DEREK HUM: Oh, okay. Having had this brought to my attention, I'm aware that that's what they did.

Let me read this:

"They have sent 100 percent of the foreign equity allocation to US equity. International equities are not included in the optimal portfolio."

If I gave an impression that they did other than what Aon wrote that they did, I'm sorry.

MR. BYRON WILLIAMS: Mr. Chairman, thank you for this. This closes the direct examination of CAC/MSOS. I neglected to note that Ms. Desorcy was in the back studiously taking notes as she has been for much of the Hearing.

And my client -- or my witnesses are ready for cross-examination, although they would appreciate a -

- a brief -- brief rest break.

THE CHAIRPERSON: Okay, we will have a break, and we will come back with Mr. McCulloch. Thank you.

--- Upon recessing at 10:42 a.m.

--- Upon resuming at 11:04 a.m.

THE CHAIRPERSON: Okay. Welcome back everyone. Mr. McCulloch, it's your time at bat.

CROSS-EXAMINATION BY MR. KEVIN MCCULLOCH:

MR. KEVIN MCCULLOCH: Thank you, Mr. Chairman. In the initial stages, gentlemen, I would like to lead you through certain pages, and -- and references in your report.

And the first is under the introduction, and I'll again try to refer to headings because page numbers are not exactly the same from copy to copy, but under the introduction, you -- and throughout the report -- you bring in recommendations from the Mercer report -- the Mercer asset liability modelling study which was done over five (5) years ago.

Is that your understanding as to when it was done?

DR. DEREK HUM: Yes.

MR. KEVIN MCCULLOCH: And would you agree with me that a study done in 2008 would be more current and would reflect current study -- or sorry, current conditions more than a study that was done five (5) years ago?

DR. DEREK HUM: As a general rule, yes.

MR. KEVIN MCCULLOCH: Moving down in that introduction, it -- at number 3, you talk about selected aspects of the portfolio -- portfolio mix, and that -- to determine whether the current portfolio is efficient, and you say that the -- the study does not assess whether MPI should take more or less risk.

Just on that whole question of efficiency, I presume you're both familiar with -- with a term that I recently learned, and that is, the "efficient frontier"?

DR. DEREK HUM: Yes.

MR. KEVIN MCCULLOCH: And I'd like you, if you would, to turn to page 70 of the Aon report, and I ask the good graces of your counsel to -- to provide you with that -- that document.

(BRIEF PAUSE)

DR. DEREK HUM: Geez, I can't see that.

Okay, we'll see what the question is.

MR. BYRON WILLIAMS: And Mr. McCulloch, just --

DR. DEREK HUM: This is not in colour, okay. Remember that.

MR. BYRON WILLIAMS: Do you have colour?

DR. DEREK HUM: No, I don't have colour here.

MR. BYRON WILLIAMS: -- Mr. McCulloch, I'll just see if I can get my --

DR. WAYNE SIMPSON: Well, okay. Stick with grey, white and black we're okay.

MR. BYRON WILLIAMS: We'll just see if we can get Dr. Hum a colour version. He's got some visual issues so if you'll just bear with us for a second.

MR. KEVIN MCCULLOCH: Certainly.

DR. DEREK HUM: You answer those.

MR. BYRON WILLIAMS: I apologize. Please proceed.

CONTINUED BY MR. KEVIN MCCULLOCH:

MR. KEVIN MCCULLOCH: Now I wonder, sirs, if you could confirm my assumption, and my understanding rather, that all of those yellow boxes, the various portfolios running from 1 to 21 are all on the efficient frontier and would be termed optimal.

Is that your understanding as well?

DR. DEREK HUM: That's the envelope, right? I'm only cautious because I want to make sure I really see this quite well. But if the yellows -- where's the yellows, they're on the frontier so, therefore, they're all efficient from -- on the efficient portfolios.

MR. KEVIN MCCULLOCH: And -- and by the key at the bottom it shows the -- the yellow squares optimal portfolios.

DR. DEREK HUM: Okay. Then that -- yes.

DR. WAYNE SIMPSON: The only qualifier that the immediately occurs to us is that this is -- this is a set of portfolios that they considered so, obviously, there may be other possibilities that haven't been considered.

But within those that they considered, this would be the optimal set by definition, yeah.

MR. KEVIN MCCULLOCH: And in fact, would you not agree from reading the report that they considered many other portfolios but only reported on the ones that met the efficient frontier in this chart.

DR. DEREK HUM: I'll take that.

MR. KEVIN MCCULLOCH: For example, the

term "portfolio universe" with all the blue, whatever that -- diamonds or triangles, are other portfolios that were considered in the report.

DR. WAYNE SIMPSON: Yes.

MR. KEVIN MCCULLOCH: And if you look at Portfolio Number 11, you'll see a small blue triangle just below that and that represents, according to the chart, the modified mix Number 11.

Is that correct?

DR. DEREK HUM: That's what the chart indicates, yes.

MR. KEVIN MCCULLOCH: And are you aware that modified Portfolio Number 11 is the portfolio that was selected by MPI?

DR. DEREK HUM: Yes.

MR. KEVIN MCCULLOCH: And you'd agree with me, sir, that while it's not exactly on the efficient frontier it's fairly close?

(BRIEF PAUSE)

DR. DEREK HUM: I don't want to be difficult but it's not on the frontier I'd agree with; characterization of close if that is the distance you want to say close, it's close.

But there are closer ones and there are some that are not as close. I'm not trying to be difficult. This is -- I'm a mathematician, I like precision. It's not on the frontier. Unambiguously I agree. It is not the closest of all others. I'm really not trying to be difficult.

MR. KEVIN MCCULLOCH: No, and you've given the admission that -- assuming that you have an understanding of what I mean by close, that it is close to the efficient frontier but not on it.

And from that point of view Modified Number 11 is sub optimal as opposed to optimal.

DR. DEREK HUM: You said that exactly.

MR. KEVIN MCCULLOCH: One other point on the Introduction Number 5, you say:

> "We also assume that MPI does not have the option of having its investment portfolio managed by private sector professionals."

Are you aware, sir, that in fact the equity portfolios are managed by private sector managers?

DR. DEREK HUM: I am. Two (2) things, I also understand now that there is no equity manager currently. Am I correct? But in any case this statement was the total portfolio, the total portfolio.

MR. KEVIN MCCULLOCH: Well, that's just--

DR. DEREK HUM: The total portfolio -- or may be unambiguous -- I mean, the entire something like 2 billion dollars.

MR. KEVIN MCCULLOCH: So you're -- you're not challenging the -- the -- the position that the equity portion or some of the equity portion of the portfolio is managed by private-sector managers?

DR. DEREK HUM: No, no, not a -- not at all.

MR. KEVIN MCCULLOCH: But the bond portion is certainly managed by the Department of Finance and that's generally been the evidence not only this year but of previous years. Is that correct?

DR. DEREK HUM: I've been given that understanding, yes.

MR. KEVIN MCCULLOCH: Well, let's take your understanding a step further. In your research and -- and in your work on this, on this study, and I'm just going to ask you: Can you give me an indication as to -- to how long it took you to perform this study?

DR. DEREK HUM: Help me out. When -- when did we get the --

MR. KEVIN MCCULLOCH: Well, just weeks --

DR. DEREK HUM: I want to give an exact

answer. When -- let's say two (2) months. I mean, off and on.

MR. KEVIN MCCULLOCH: All right.

DR. DEREK HUM: With August -- August, September, October --

MR. BYRON WILLIAMS: And Mr. McCullouch we'll -- I -- I don't think you need a precise answer, but we -- we'll certainly undertake to -- just to make sure if Dr. Hum wishes to refine his answer, we'll share that with you, okay.

MR. KEVIN MCCULLOCH: That would be fine.

--- UNDERTAKING NO. 33: If Dr. Hum wishes to refine his answer, to so advise re how long it took to perform the study

CONTINUED BY MR. KEVIN MCCULLOCH:

MR. KEVIN MCCULLOCH: In listing the materials that you looked at as part of your study, I didn't notice any reference to the MPIC Act.

Did you -- did you look at the MPIC Act?

DR. DEREK HUM: I did look at the MPIC Act but I didn't list it there.

MR. KEVIN MCCULLOCH: Okay. And in

particular, sir, did you look at Section 12 of the MPIC Act and I'll --

DR. DEREK HUM: I don't recall the number of the Act -- the number of the section.

MR. KEVIN MCCULLOCH: Well, let me provide you with -- with some copies through your counsel. And in particular I'd -- I'd direct your attention to Section 12(1) and 12(2).

(BRIEF PAUSE)

MR. KEVIN MCCULLOCH: Now in 12(1), the section reads that

"The Corporation shall pay to the Minister charged with the administration of the Financial Administration Act, for investment, money in any reserve established under Section 19 of the Act, and such additional monies as are not immediately required for the purposes of the Corporation and are available for investment.

And what I would suggest to you, sir, is that that section clearly puts the Minister of Finance in charge of MPI's investment portfolio. Would you agree?

DR. DEREK HUM: I'd give my interpretation, but I'm not going to agree with a legal text, because I am not a lawyer. But --

MR. BYRON WILLIAMS: Just, Mr. McCulloch, if you're -- certainly we want -- we wish to be cooperative and -- and you can -- I -- I think you have the witness's answer. He understands the Department of Finance manages the portfolio.

The -- you -- you might get a concession from me on that point, but in terms of Dr. Hum, I think you're asking him to move a little bit -- in terms of interpreting the statute a little bit beyond what we brought him here for.

CONTINUED BY MR. KEVIN MCCULLOCH:

MR. KEVIN MCCULLOCH: Would you agree with me, Dr. Hum, that the governance of the investment portfolio is an important factor in determining the makeup of the portfolio?

DR. DEREK HUM: Yes.

MR. KEVIN MCCULLOCH: So then would you also agree with me that if the authority over the portfolio rests with the Department of Finance, many of the decisions with respect to the portfolio are in the governance of the Department of Finance?

DR. DEREK HUM: You have to break it down. I'm not sure I understand the question.

If you're saying that the Department of Finance calls the final shots or has the final authority, then I would agree that that is the interpretation I have.

MR. KEVIN MCCULLOCH: Okay. Well, let's assume that that's correct, that the Department of Finance calls the shots.

DR. DEREK HUM: Or government then.

MR. KEVIN MCCULLOCH: Or Minister of Finance, which ever. Would you agree with me that many of the comments in your report where you talk about comfort, MPI being comfortable with this investment, we're comfortable with that investment, that the comfort may, in fact, rest outside the Corporation and with the Department of Finance?

DR. DEREK HUM: That may very well be true. I used the word "comfort," if you read my report, in quotation marks and I believe I actually used the word "comfort," - it is not my normal terminology by the way - because I can't give you the exact page now, but I do recall that it was the term used by an official of MPI in explaining their position on investments about where they would...

Yeah, I used -- I put it definitely in quotation mark and I -- I recall blurring that phrase when going over the testimony in which some MPI official responding saying they weren't comfortable with a certain position that was recommended by Aon.

And I -- I accept the use of the word "comfort". It's not my term.

MR. KEVIN MCCULLOCH: All right. Let's move then to Section 12(2). And, again, I'm not looking for a legal interpretation from you but I would suggest that on a normal reading of that section that states that:

> "Monies that are paid to the Department of Finance under subsection (1) are to form part of the consolidated fund and invested in accordance with the Financial Administration Act."

Do you see that?

DR. DEREK HUM: Yes, I do.

MR. KEVIN MCCULLOCH: And would you agree with me that that might, depending on what's in the Financial Administration Act, put some constraints on where the portfolio is invested?

DR. DEREK HUM: It could. I'll take --

I'll take your word that there are things in the Financial Administration Act that could be interpreted, so.

MR. KEVIN MCCULLOCH: Well, rather than take my word, let's take a look at a section of the Financial Administration Act and, again, I'll ask your counsel's indulgence in passing over a few copies and, in particular, I direct you, sir, to Section 27 sub (2).

And in that section I would suggest that it lists the assets in which public monies or the securities in which public monies can be invested, and it's quite specific in (a) through (e) and then includes at the end a catch-all that says:

> "Securities authorized by or belonging to a class authorized by the Lieutenant Governor in Council,"

do you see that?

DR. DEREK HUM: Yes, I do.

MR. KEVIN MCCULLOCH: And do you read that section as being quite specific in the types of assets or investments that public money can be invested in?

DR. DEREK HUM: I -- I see it as a list. I wouldn't call it overly restrictive or permissive. It is a list.

I mean, securities issued by the government or a government agency is a very broad category. The Government of Canada or Provinces of Canada is a very broad category. The governmental country other than Canada or a government of a political subdivision of a country other than Canada, I mean, that could be almost the rest of the world, a financial institution is broad.

I mean, I -- I understand the -- the intent of the legislation but I wouldn't call it explicit in the sense of being a guide for choosing equity or financial instruments except in a broad sense.

MR. KEVIN MCCULLOCH: Well, let's look at subsection (e), where it talks about securities of a corporation which are rated in a high-rating category by a securities rating institution or Canada or the United States, and that is recognized as such by the investment industry in Canada or the United States.

Does that not reflect a constraint on the type of investment that might be available?

DR. DEREK HUM: It is a constraint in the sense that the Corporation must be rated.

MR. KEVIN MCCULLOCH: And might that be a constraint, for example, if the Corporation decided that it wanted to invest in companies on the Brazil, Russia, India or China exchange?

DR. DEREK HUM: If it's not rated by a rating agency or an institution in Canada or the United States that would be, yes.

But there are corporations not resident in Canada and the United States that are rated by rating institutions.

MR. KEVIN MCCULLOCH: And there are others which are not, is that correct?

DR. DEREK HUM: That's right. That's right. I -- I -- I can see at the very beginning I'm not making suggestions for stock choices.

MR. KEVIN MCCULLOCH: I don't believe I was asking you to, sir. I was just asking you whether you saw those as potential constraints for the portfolio.

DR. DEREK HUM: Of course they are. All of this legislation represents potential constraints for the portfolio.

MR. KEVIN MCCULLOCH: Now I want to refer you to the first table that you prepared, the four (4) portfolio mixes for MPI.

DR. DEREK HUM: Mm hmm.

MR. KEVIN MCCULLOCH: My first question, sir, is would you not agree that the portfolio mix that you show as coming from the Aon report and the one from the Mercer report are really quite diverse?

DR. DEREK HUM: They're different. They're different, yes.

MR. KEVIN MCCULLOCH: Well let's look at the Public Equity Provisions. The Aon report has a total recommendation of 10 percent for Public Equity while the Mercer report had a 25 percent recommendation.

Would you not agree that that's a significant change?

DR. DEREK HUM: Yes. I believe that is.

MR. KEVIN MCCULLOCH: And when you look at the -- deleting the Canadian equity from that Public Equity, if you just look at what was referred to I believe by yourself as foreign equity which includes US and foreign equity, the Mercer recommendation is 7 percent and the MPI new target is 8 percent.

Is that correct?

MR. BYRON WILLIAMS: Mr. McCulloch --

DR. DEREK HUM: No, no, you said Mercer. Did you mean Aon?

CONTINUED BY MR. KEVIN MCCULLOCH:

MR. KEVIN MCCULLOCH: Sorry, I meant Aon.

DR. DEREK HUM: Okay, so, yes. Yes. If you meant Aon then I agree. If you meant Mercer, then I don't.

MR. KEVIN MCCULLOCH: Obviously Mercer's recommending 15 percent in that combined --

DR. DEREK HUM: Yes.

MR. KEVIN MCCULLOCH: -- foreign equity portfolio.

DR. DEREK HUM: Yes, yes, I agree.

(BRIEF PAUSE)

MR. KEVIN MCCULLOCH: In his evidence given a couple of days ago, the author of the Aon report, Jeremy Bell, confirmed that, in his view, it was appropriate for an institution that had received an asset liability modelling study to -- to apply some discretion and to make some choices.

Would you agree with that?

DR. DEREK HUM: I would agree with that.

MR. KEVIN MCCULLOCH: So you wouldn't expect a company to blindly follow the recommendation of Aon or even Mercer?

DR. DEREK HUM: Absolutely not.

MR. KEVIN MCCULLOCH: I want to move to page -- sorry, I won't do a page number. I want to move to the heading Re Segregating Pension Assets and

Liabilities.

Now as I understand this, it -- it's your position that with a defined benefit pension plan there is no need to -- to segregate assets and liabilities.

Is that a fair representation?

DR. DEREK HUM: I wouldn't say there's no -- there's no imperative. You -- You may want to segregate them for other reasons but no imperative. No legislative imperative.

MR. KEVIN MCCULLOCH: And am I correct in assuming that in a defined contribution plan your answer would be very different?

DR. DEREK HUM: Yes, it would be.

MR. KEVIN MCCULLOCH: And you are aware, are you, that Manitoba Public Insurance is a participant in the civil service superannuation plan?

DR. DEREK HUM: Yes, I am and its pension plan is a defined benefit plan.

MR. KEVIN MCCULLOCH: Moving a little further on in your discussion on segregated pension assets and liabilities, you, in the -- in the paragraph that starts off, "Nonetheless I observe," you then make a comment or remark, you say:

"(a) the assertion concerning the similarity of the optimal portfolio mix

for the pension and non-pension
segments is debatable."

What assertion are you speaking about there?

DR. DEREK HUM: I can't give you the reference. I recall, in all of the voluminous testimony that I wrote, someone from MPI saying that the portfolio mix, he or she thought for the pension and non-pension segments would be not much different. As an academic I should be chastised for not having that reference but I'm willing to speak to the substance of that assertion but I can't give you right now who said that....oh, thank you.

MR. BYRON WILLIAMS: And -- and just --

DR. DEREK HUM: If you -- you bear with me, sir.

MR. BYRON WILLIAMS: And just, it is referenced --

DR. DEREK HUM: It --

MR. BYRON WILLIAMS: -- in your evidence.

DR. DEREK HUM: It is -- it is your number PUB/MPI 1/12, your response and just -- I got to read this now.

(BRIEF PAUSE)

DR. DEREK HUM: Okay. Here's -- I will

read the whole paragraph or just a relevant paragraph?
Okay, I will read the whole thing, just to...

"The Corporation has chosen not to adopt a separate investment portfolio and investment policy for its pension assets because these assets are relatively small compared to the Corporation's insurance assets. The benefit to developing a unique investment policy for the pension assets would be minimal. The pension liabilities have a longer duration than the insurance liabilities and, therefore, any investment policies specific to the pension liabilities would need to reflect that fact."

Second paragraph:

"It should be noted that if the pension portfolio were segregated and invested more aggressively a similar modelling exercise on the remainder of the assets would likely result in MPI selecting a more conservative asset mix for the remainder of the assets. So the total position between the pension and non-

pension funds would be similar to the
currently selected target mix."

That is the -- the response I have, obviously, at one time read but forgot to cite.

MR. KEVIN MCCULLOCH: But would you not also agree that that's a -- or a recognition that if the pension funds were segregated a different portfolio mix would be required?

DR. DEREK HUM: Well, yes. In fact, I would hope so.

MR. KEVIN MCCULLOCH: So how does that support the assumption that the pension and non-pension segments are similar?

DR. DEREK HUM: Wait a minute. This is -- that's not my position. What I read was a quote which was the MPI response. So I'm sorry if I gave you the impression that was my position. That was the response by MPI. My position is that they would be different.

I'm sorry if I gave you that impression. I was quoting from, not youspecifically, but MPI.

MR. KEVIN MCCULLOCH: I don't know whether we're quibbling over words here, but I'd suggest to you that that response indicates that the Corporation also agrees that if the funds were to be segregated the portfolios would need to be different.

DR. DEREK HUM: Okay, then we are -- I'm sorry, then we are totally agreed.

MR. KEVIN MCCULLOCH: Now, in the second bullet or subparagraph, you talk about pension liabilities currently totalling 137 million but will grow steadily. And you then make the observation:

"Would the management and monitoring of a separate pension portfolio of an amount similar in size to the RSR require any more attention or effort?"

Can you tell me what point you're attempting to make there?

DR. DEREK HUM: Perhaps my phrasing is not as elegant. I'm not a lawyer. I was simply making the point that -- that they're roughly about the same order of magnitude, you may disagree, a hundred and thirty-seven (137) and 128 million is about the same. And if management were willing to expend the effort in terms of research and conduct and investigation in how to deal with the RSR, then it shouldn't be that much more to spend the effort to manage a separate pension fund of about 128 million.

It was probably inelegantly phrased but it's not the same as the considerations if the pension fund were $2 billion. It's -- it's not a -- it's not that scale of effort.

MR. KEVIN MCCULLOCH: Well, unless the difference was going into my account, I can agree that one hundred and thirty-seven (137) and one hundred and twenty-eight (128) are pretty similar. But isn't the point to be made here that, first of all, the -- the RSR is commingled in the entire investment portfolio.

There's no separate investment effort provided for the RSR?

DR. DEREK HUM: That's right.

MR. KEVIN MCCULLOCH: And would you also agree with me that certainly the pension fund would grow, but one would expect that it would grow along with the overall size of the portfolio, so the percentage of the funds designated or held with respect to the pension fund would remain the same as both fund -- or as the fund grows?

DR. DEREK HUM: No, I think you -- you misunderstood me. My point was that they are both of a magnitude that would probably require no less managerial attention and effort.

MR. KEVIN MCCULLOCH: But in the current arrangement, the entire managerial effort is applied to the full portfolio, which includes the pension, the RSR and the balance of the portfolio.

DR. DEREK HUM: Yes, because it's all -- you know, commingled. But I was looking at -- see, the -- the -- the topic of this is if you did not have it commingled.

MR. KEVIN MCCULLOCH: And we agreed at the outset that there's, in a defined benefit pension, less reason to separate the funds than if it were a defined contribution plan.

DR. DEREK HUM: I think we are agreed.

MR. KEVIN MCCULLOCH: The next heading, "Re: Universal Bonds versus Long-term Bonds", I have a question about that phrase "universal bonds". Is -- is that the same as universe bonds?

DR. DEREK HUM: I don't understand what universe bonds is. I'm using the term universal bond as simply a -- to categorize a class of bonds that have different maturity dates. They're not all long term; they could include short term, they could include long term.

There is a particular index that is called either the Universe Bond Index or the Universal Bond Index and I'm using it in that context. I'm using it no more than to distinguish it from long-term bonds, which I will precisely define as bonds having a maturity of at least ten (10) years.

MR. KEVIN MCCULLOCH: And -- and, in fact, in -- in your footnote for a definition of Universal Bonds, you refer us to PUB 1-10(f) --

DR. DEREK HUM: Yeah.

MR. KEVIN MCCULLOCH: -- and, in fact, 1-10(f) talks about Universe Bonds, but I'm just wondering in -- in your view whether that's --

DR. DEREK HUM: That's probably a typographical error then if, in fact, the term "Universe" was used in that PUB note, which I don't have in front of me. But if that's the case, I meant -- I meant that term.

MR. KEVIN MCCULLOCH: And whether we're calling them universe or universal, would you agree with me that the --

DR. DEREK HUM: Let me -- let me see this. Okay, it is Universe Bonds. I'm sorry. I'll just blame it on my eyesight. Let's -- let's agree that it should be Universe Bonds.

MR. KEVIN MCCULLOCH: And can you -- or do you agree that the Universe Bond index includes bonds issued with government and corporate entities of all maturities short to long?

DR. DEREK HUM: Yes, it does.

MR. KEVIN MCCULLOCH: And would you also

agree that MPI's current bond portfolio includes bonds across the spectrum of maturity?

DR. DEREK HUM: Yes, it does.

MR. KEVIN MCCULLOCH: And are you also aware that the Department of Finance is involved in active trading to add value to the bond portfolio?

DR. DEREK HUM: Yes, I believe there's a 40 percent turnover rate but I'm not going to cling to that number, but they do trade.

MR. KEVIN MCCULLOCH: Okay. Moving on to the amount of foreign equities in the MPI portfolio and I just want to clarify in my own mind a response that -- that you gave to Mr. Williams near the end of -- of your evidence this morning and that has to do with it's now your understanding that Aon did include foreign investments in the study that was done and they just didn't appear in any of the optimal portfolios; is that correct?

DR. DEREK HUM: That's my understanding from reading the report, or having it pointed out to me.

MR. KEVIN MCCULLOCH: And I also understood you to say that you agree with MPI's decision in modified portfolio number 11 to include 3 percent for foreign equities over and above the 5 percent for US equities; is that correct?

DR. DEREK HUM: Yes, I -- well, I -- I approve of the decision. I think it is a better portfolio than had they not done that.

MR. KEVIN MCCULLOCH: I want to move to your comments, sir, with respect to the absence of real return bonds in the MPI portfolio.

And in that regard, I'd also like to refer you back to the chart, your Table 1, your four (4) portfolio mixes for MPI.

DR. DEREK HUM: Thank you.

MR. KEVIN MCCULLOCH: And again, please correct me if my terminology is incorrect, but it's my understanding that real return bonds provide a hedge against inflation?

DR. DEREK HUM: That would be what -- yeah, you could say it -- phrase it that way.

MR. KEVIN MCCULLOCH: And --

DR. DEREK HUM: They're indexed to inflation is how I would phrase it, but fine.

MR. KEVIN MCCULLOCH: All right. And I presume then that when you purchase a real return bond you pay for that guaranteed hedge against inflation?

DR. DEREK HUM: Yes, as -- as someone elegantly put it in a different context, there is no free lunch. You do pay for services which in this case is a hedge against future inflation.

MR. KEVIN MCCULLOCH: Now, we talked about the fact that in the new target portfolio for MPI there are assets included that also have an element of hedge against inflation; is that correct?

DR. DEREK HUM: An element of hedge, yes.

MR. KEVIN MCCULLOCH: And in fact, those two (2) that have the element of hedge against inflation would be real estate and infrastructure?

DR. DEREK HUM: In general, yes, but there's nothing in the portfolio now that I could claim with certainty that they will be hedged.

MR. KEVIN MCCULLOCH: You're quite right. I believe it was the evidence earlier this week or last week, rather, of -- of the MPI panel that to date there has been no movement towards the new modified number 11 portfolio?

DR. DEREK HUM: I -- that's my understanding.

MR. KEVIN MCCULLOCH: So when we're talking --

DR. DEREK HUM: We're talking generally now?

MR. KEVIN MCCULLOCH: Yeah. When we're talking, we're talking theoretically about if -- if and when the Corporation moves to this portfolio, these assets will have certain impacts?

DR. DEREK HUM: That's correct.

MR. KEVIN MCCULLOCH: And you'll agree with me that under the new portfolio the Corporation has maintained a 60 percent investment in bonds and it's only reduced, or taken out the 12.5 percent that was designated for real return bonds in the old target?

DR. DEREK HUM: Yes, they -- you -- MPI has maintained its total allocation of the portfolio of the bonds. They've changed the compositional mix of the elements that go into the bonds.

MR. KEVIN MCCULLOCH: So if we're looking at MPI moving away from real return bonds which provide a hedge against inflation, would you -- and that's 12.5 percent, would you agree with me that they're moving to 15 percent allocated to assets that may well provide a hedge against inflation?

DR. DEREK HUM: I wouldn't put it in terms of a one-for-one number. I understand how you got that number, because you have twelve point five (12.5) real return bonds, which is going to zero, and you're going from approximately zero to 15 percent combined real estate and infrastructure.

But I don't want to be too fastidious, but it is not a one-for-one because the real return bonds is a guarantee, if you like, of perfect hedge against inflation because it's built in the nature of the instrument.

When inflation goes up, the coupon rate is adjusted by exactly the amount of the inflation. So in some sense there's what I would call certainty in that.

On the real estate and infrastructure -- an empty box so far, so I can't really analyse it -- it will depend upon the particular talent of the manager to chose the right real estate and the right infrastructure, because it is not absolutely clear there will be a perfect one-for-one at all time correlation between the rise of the price of infrastructure and real estate with inflation on a year-by-year basis that a real return bond provides.

So your answer is correct, sir, and I'm just being pedantic by saying there's not a one-for-one numerical equivalence.

MR. KEVIN MCCULLOCH: Not until you see what infrastructure and real estate investments are entered into, and how they perform. Is that correct?

DR. DEREK HUM: That's -- absolutely. I -- I have no idea what's going to be in there, you're right.

MR. KEVIN MCCULLOCH: So is it -- would you agree with me that it's a possibility that the perfect correlation that you say comes from real return bonds and hedging against inflation, might be achieved through the investment in infrastructure and real estate?

DR. DEREK HUM: This is a lawyer's question. It is possible, but no historical empirical evidence from the past shows the degree of perfect correlation when gauged against the benchmark of the correlation degree that exists in real return bonds.

So as a practical economist, I'm tempted to say it's not really possible, but as a logical possibility, I won't rule it out, especially since we're talking about an asset class that I don't know anything about. I mean, I don't know the contents.

MR. KEVIN MCCULLOCH: And when you talk about benchmarking against real return bonds, does that benchmarking include the added cost that you pay when you buy a real -- real return bond?

DR. DEREK HUM: I hadn't thought about it either way, but in my report I indicated that -- and I indicated in testimony that you would have to get a lower rate of return from a real return bond than you would for the same comparable quality bond that's not indexed.

And if one wants to take that spread as

the cost, which I think is fair, then I indicated in my study that I characterized that as the price of the insurance that you pay for a contingency of high inflation.

Now that's my phrasing. It's not a standard financial term, but I think that's a good way to look at it.

Obviously, if you actually got more return from a real return bond absent that cost, the rational market would certainly have everybody buy real return bonds because they would get the inflation protection, and a higher rate of return.

And as someone once said in this testimony, nobody knows more than the market.

MR. KEVIN MCCULLOCH: Now turning for a moment to your draw suggestion as a means of stabilizing the returns from the investment portfolio, you do, quite fairly in your last paragraph -- and I have it as appearing just before the closing remarks portion, you make the observation that the draw strategy doesn't speak to the issue as to whether there will always be enough investment income in the first place.

And obviously, you -- you still agree with that statement?

DR. DEREK HUM: Oh, absolutely. You

don't have the income. Getting not enough income in steady streams doesn't solve your problem.

MR. KEVIN MCCULLOCH: And on a morning when the TSX dropped eleven hundred (1100) points --

DR. DEREK HUM: Did it?

MR. KEVIN MCCULLOCH: -- that's probably a fair --

DR. DEREK HUM: Did it drop eleven hundred (1100) points today? No, I'm sorry --

MR. KEVIN MCCULLOCH: Yeah.

DR. DEREK HUM: -- because then I'm going to excuse myself. I think -- I think this is one if it, absent today's numbers -- I will correct you. I think the largest day drop was around, no, between seven (7), eight hundred (800). It has never dropped eleven hundred (1100).

MR. KEVIN MCCULLOCH: Well, take it as -- as an assumption. I'm saying if, in fact, that was the sort of day we started out with at the TSX, the -- the possibility of having funds there to draw might be in jeopardy.

DR. DEREK HUM: I don't -- unless you tell me it dropped eleven hundred (1100), I'm telling you historically it has -- the largest day drop, single day drop was less than a thousand (1000). I will testify to that under oath.

MR. KEVIN MCCULLOCH: Well, the markets aren't closed yet and we can all check at noon hour but...

DR. DEREK HUM: That's why I wanted to be excused.

MR. KEVIN MCCULLOCH: Interesting discussion I think, Professor, with respect to the efforts of the Bank of Canada in maintaining inflation at least over the short --

DR. DEREK HUM: Short.

MR. KEVIN MCCULLOCH: -- previous term within its target of -- of 1 to 3 percent, if the government and the people of Canada are wise enough to maintain an economist in the position of head of the Bank of Canada, would you not agree with me that if that target is maintained, the lustre of the real return bonds diminishes somewhat?

DR. DEREK HUM: The answer is -- is yes. But I can't help but comment that the current head of the Bank of Canada is not an economist.

I was referring to David Dodge, the previous head of the Bank of Canada was an economist. You should take nothing from that response.

MR. KEVIN MCCULLOCH: And I won't pass it on. Are you aware, Dr. Hum and Dr. Simpson, that MPI budgets annually for an expected level of return from its investment portfolio?

DR. DEREK HUM: I would hope so, yes.

MR. KEVIN MCCULLOCH: And does that not compare to your proposal of -- of taking a draw if -- if, in fact, the Corporation budgets and anticipates that -- that that return will occur and asks this Board to approve rates accordingly?

DR. DEREK HUM: I -- I understand the question, I hope, but my answer is no. What you budget for is not necessarily -- I mean, I have been involved in budgeted processes where budgets, as Robert Burns says, go wrong the best laid plans of mice and men.

So what you budget for is fine but what you actually receive can be very, very at difference. And what my revenue stabilization suggestion was not -- it would facilitate the budgeting exercise but I intended it to be much more strong than that, which is that it's like they use that annuity language, it's a budgeting exercise but it's also going to be actually paid exactly that amount, whatever the day-to-day fluctuation of the portfolio performance that year. So it's more -- it's a little -- I meant it to be more strong than strictly a budgeting exercise.

MR. KEVIN MCCULLOCH: So when you did your comparison for Table 2, comparing total expenses against investment income over the past four (4) fiscal years, that didn't include checking what the Corporation had estimated or budgeted for investment income, did it?

DR. DEREK HUM: I did read -- I did read those other documents and in many years what you budgeted for and what you actually receive was not exactly bang on, to put it generously. So these numbers were actual because I wanted to demonstrate the real world expose fluctuation and levels of investment income and total expenses because otherwise I would be, to put it unkindly, commenting on your budgeting exercise, which I did not want to do.

MR. KEVIN MCCULLOCH: I'm going to go back for a short time to the Aon study and, again, I don't think you'll need colour for this one but if you look at pages 36 to 38.

(BRIEF PAUSE)

MR. KEVIN MCCULLOCH: And what we're dealing here -- with here is Appendix A, the assumptions that went into the various modelling and -- and results that were produced by Aon and, in particular, I want to direct your attention to the real estate and real return bond figures.

And real estate appears on page 38 --

DR. DEREK HUM: Yes.

MR. KEVIN MCCULLOCH: -- showing an expected return of 6.7 percent with a anticipated risk of 7.4 percent. Have you got that figure?

DR. DEREK HUM: Just one moment, just bear with me. Oh, standard deviation, you mean? Yes.

MR. KEVIN MCCULLOCH: Yes. And on page 36 where real return bonds are showing as having an expected return of four point seven (4.7) with a standard deviation of 8.3 percent, is that correct?

DR. DEREK HUM: That's correct.

MR. KEVIN MCCULLOCH: Now, would you not agree with me that, based on these assumptions, the investment in real estate involves greater return with lower risk?

DR. DEREK HUM: Based on those numbers, yes, that's correct.

MR. KEVIN MCCULLOCH: And based on these numbers might that explain why real return bonds don't appear in the Aon proposals?

DR. DEREK HUM: Undoubtedly, that's probably what drove the model results.

I might just add that I assume there is another appendix but I do recall there is another page where -- underlying all of this, but not on this page, the -- the assumption is that inflation will be 2 percent. It's not on this page.

MR. KEVIN MCCULLOCH: That assumption, though, includes a standard deviation?

DR. DEREK HUM: No, no, no. I'm sorry. I'm not making myself understood.

These -- these assumptions are predicated in a context in which it is assumed that, to phrase it picturesquely, Canada will not experience any inflation outside the ban. That -- that is one of the -- Aon's assumptions.

MR. KEVIN MCCULLOCH: Well, perhaps --

DR. DEREK HUM: And -- and I --

MR. KEVIN MCCULLOCH: -- it might be helpful if you refer to page 38 of the Aon Study.

DR. DEREK HUM: Okay.

(BRIEF PAUSE)

MR. KEVIN MCCULLOCH: And let me tell you that that --

DR. DEREK HUM: My -- my point is that

the Aon study assumed low inflation.

MR. KEVIN MCCULLOCH: But it -- it assumed low inflation of, according to the calculations on page 38 of 2.25 percent but apply to standard deviation of 1.1 percent.

DR. DEREK HUM: Yes, yes.

If I can -- you know, I want to be very helpful to the Board. I want to know that, you know, when you put these numbers out one should always ask where they come from. And the 2 percent is not my number, it's Aon's number. And the 2 percent was calculated by historical data using the current past nine (9) years of -- of inflationary experience in Canada.

And I just want to note that because it was my testimony that this is a period that, while not an aberrant, it's also a very special period of benign inflation. And I wouldn't want to think that this is going to be an immutable law of Canadian economic performance.

MR. KEVIN MCCULLOCH: No. Thank you, Dr. Hum. I -- I believe we do have your evidence on that point. I'd like to refer you now to the response to the PUB-CAC information request 1-1. And as -- as I understand it from your evidence, from your evidence this morning, Mr. Williams asked whether you'd had an opportunity to review that response and whether you were in agreement with what was set out therein.

DR. DEREK HUM: Yes. Did I make it clear that I'm not the author of this response?

MR. KEVIN MCCULLOCH: Yes, I believe both you and Mr. Williams made it clear that you're not the author.

DR. DEREK HUM: So I can totally repudiate this.

MR. KEVIN MCCULLOCH: That would be fine with me, sir. On page 3 -- and I'm looking under the heading of "Potential for Increased Volatility".

DR. DEREK HUM: Yes.

MR. KEVIN MCCULLOCH: And the second paragraph there, starting with "However --"

DR. DEREK HUM: Yes.

MR. KEVIN MCCULLOCH: Looking at that paragraph, would you agree with me that the suggestion there is that bonds designated as held for trading will increase volatility in net income?

DR. DEREK HUM: I -- I think I'd better get the last sentence again. Did you say bonds or assets?

MR. KEVIN MCCULLOCH: I said bonds.

DR. DEREK HUM: Okay, bonds. So you're -

- you're telling me that only bonds are in -- held for trading? Or shall I take that as given?

MR. KEVIN MCCULLOCH: Well, let's -- if you'd be happier or more comfortable with the terms "assets" let's --

DR. DEREK HUM: No, no, I --

MR. KEVIN MCCULLOCH: -- let's say assets.

DR. DEREK HUM: Okay.

MR. KEVIN MCCULLOCH: So assets designated as held for trading will increase volatility in net income?

DR. DEREK HUM: I want to be helpful. The -- the -- it's -- it's the -- the accounting rules with these two divisions held for trading and available sale together, together, combined together, in effect, I believe increases volatility, not just one segment but together. They -- would you like an explanation or not?

MR. KEVIN MCCULLOCH: No, I'm -- I'm going to ask whether -- would you agree that, in fact, it's only the held-for-trading designation that affects net income. Available -- available for sale does not have an impact on net income?

DR. DEREK HUM: Well, my understanding -- and you will correct me, I'm sure -- that those held in available for sale could be booked and taken into net income at discretion. Am I not correct on that accounting -- I'm not an accountant -- am I not correct in that?

MR. KEVIN MCCULLOCH: Well --

DR. DEREK HUM: Am I?

MR. KEVIN MCCULLOCH: I'm not an accountant either so --

DR. DEREK HUM: No, no, but --

MR. KEVIN MCCULLOCH: -- we'll just have to go --

DR. DEREK HUM: -- you must know the answer to your question.

MR. KEVIN MCCULLOCH: I didn't ask you whether -- whether they could be taken -- whether income could be taken --

DR. DEREK HUM: All right. Let -- let me -- let me try to be -- I don't understand the question then because, did you mean exclusively bonds or assets in -- held for trading would influence volatility without allowing me to indicate that -- that financial instruments in Available for Sale could also influence net income if you chose to book gains and losses?

MR. KEVIN MCCULLOCH: Well, again, I'm asking these questions in a fairly strict context, and per -- if --

DR. DEREK HUM: Okay, well it's --

MR. KEVIN MCCULLOCH: -- if you're agreeable --

DR. DEREK HUM: -- all right. All right.

MR. KEVIN MCCULLOCH: -- if you're agreeable, will you start with the -- just the simple question that: Assets designated as held for trading will increase volatility in net income?

DR. DEREK HUM: I don't want to mislead you, or the Board, so I will say, Yes and no, because you will not allow me to seek clarification of what is happening with the other half of the box called Available of (sic) Sale.

And it is my testimony right from the beginning that Modern Portfolio Theory tries to construct or minimize the variability by exploiting something called diversification.

So I have to be able to say that I have to bring into consideration the degree of diversification potential that is not in the other -- not in the box that you want me to talk about.

So I will say, Yes and no.

MR. KEVIN MCCULLOCH: Well maybe I can take another run at this one (1) from a slightly different angle.

DR. DEREK HUM: Please do.

MR. KEVIN MCCULLOCH: Would you agree that an increase in interest rates will both decrease the value of bonds and liabilities?

DR. DEREK HUM: At the present -- the present value, yes. It will not change the face value of the bond if held to maturity. You still get all your money back. It's the inner -- is that the answer you want?

MR. KEVIN MCCULLOCH: I want whatever answer you want to give me, Dr. Hum.

DR. DEREK HUM: Or would you -- no, forget it.

MR. KEVIN MCCULLOCH: Before I ask this next question, maybe I should put it this way.

Are either yourself or Dr. Simpson able to say whether designating bonds as held for trading will result in offsetting changes on the income statement, thus, mitigating the effect?

DR. DEREK HUM: What effect?

MR. KEVIN MCCULLOCH: The offset of liabilities and the value of the bond.

MR. BYRON WILLIAMS: Mr. McCulloch, just so I'm clear, are you asking about --

DR. DEREK HUM: If I understand the question, which -- which I do have the answer if I understand the question.

If you're saying that in a portfolio in which you have assets and liabilities, because that's what I'm going to assume, then when there's an interest rate change it will affect the present value of the bonds, the valuation of the bonds.

It will also affect the -- we use the jargon net present value, or whatever it is, of the street or future liabilities, so it will affect the value benchmarked, or marked at a point in time, of both assets and liabilities.

Is that -- is that what was your intent of the question? It affects both.

(BRIEF PAUSE)

CONTINUED BY MR. KEVIN MCCULLOCH:

MR. KEVIN MCCULLOCH: And can you agree, or -- or not, I'm not sure whether you -- you have the --

DR. DEREK HUM: I don't want to agree or disagree. I want to explain on a fairly -- I'm not able to do this in this context.

MR. KEVIN MCCULLOCH: Well the -- the

point -- the question I'm making is, or the point I'm making is: Would you agree that designated bonds -- designating bonds as held for trading would mitigate the risk of net income volatility because it has a similar effect on liabilities and the -- the value of the bonds?

DR. DEREK HUM: You're talking about net income now? You're talking about net income, not the valuation of the liabilities. In that case I would disagree.

I mean, you know, with all respect, I mean, I'm trying to really understand the question and I'm having difficulty because I'm coming from a framework that sees it in terms of Modern Portfolio Theory and it's very difficult for me to answer questions to your satisfaction and with honesty when you phrase it in terms of "take one small section of the portfolio, can you say with certainly this will be the effect of that," without allowing me to say, well, what am I allowed to assume about the rest of the portfolio? And I'm not trying to be obstructive here.

MR. KEVIN MCCULLOCH: Perhaps the -- the issue, Dr. Hum, is that unless you were able to respond to what impact designating bonds or assets as held for trading would have on the net income statement, the whole series of questions kind of collapses.

And it's my understanding that, at this point, you don't feel you're in a position to give me that answer.

DR. DEREK HUM: No, I disagree. I disagree. I -- I'm -- I am willing to give you an answer.

MR. KEVIN MCCULLOCH: Well then, what impact would designating bonds as held for trading have on the net income statement?

DR. DEREK HUM: Okay. I -- I think it would increase the volatility of net income on the balance sheet of MPI. I'd -- I'd have to give you a longish answer but if you're patient I can do that.

Would you like me to do that or would you like to ask me some more questions.

MR. KEVIN MCCULLOCH: Well, Dr. Hum, we're at ten (10) after 12:00 and perhaps this is -- would be an appropriate time for a lunch break, Mr. Chairman, and when we return, the balance of my cross-examination will be very brief.

THE CHAIRPERSON: Very good. Okay, we'll come back at 1:15. Thank you.

--- Upon recessing at 12:10 p.m.

--- Upon resuming at 1:16 p.m.

THE CHAIRPERSON: Okay, Mr. McCulloch...?

CONTINUED BY MR. KEVIN MCCULLOCH:

MR. KEVIN MCCULLOCH: Thank you, Mr. Chairman and I anticipate winding up very quickly.

In the -- throughout the report there's a number of references or comments that you don't have a lot of explicit statements governing MPI's investments preference -- MPI's investment preferences or goals and that there seems to be some information that -- that's lacking.

Have you had an opportunity to read the MPI Investment Policy Statement?

DR. DEREK HUM: Yes.

MR. KEVIN MCCULLOCH: So when -- when you make the comments throughout the report about not having enough information, does that relate more to not having information about how these new asset classes are going to be used or what -- what particular investments are going to fill each of these investment boxes?

DR. DEREK HUM: Well that would be some information, ideally, I would like to have but that was not really the specific reference.

I had in mind when I wrote that that I had no information from the documents or from the Investment

Policy Statements as to how the exact proportions were determined in terms of the three (3) major asset classes.

Aon's optimization model took that as a constraint or a guideline and I saw no discussion in Aon's report nor in the Investment Statement, understandably, as to why these proportions should be what they were.

So I have no idea how that was done and how that was determined because the standard exercise - which I realize this is not a standard situation - would be to find out what the optimal portfolio would be if it were totally unrestrained as to the proportions. And then see if you like it. Or there's some reason why you don't like it. So I had no information as to why that was the case. And -- and that was really what I meant.

I also saw no discussion of whether or not there was any consideration given or discussion on what I call some of the traditional objectives that are usually listed or considered in this kind of exercise.

For example, the Mean Variance Approach that I want the biggest return I can get at the smallest risk I have to bear, I mean that's pretty standard or customary. That reflects how the problem was first posed when the theory was developed.

But since then many institutions have

said, well, we actually want more than that or we want something different and often this is explicitly given a privilege in terms of the analysis and how it's conducted.

Some of the ones that I did elude to, for example, it wouldn't apply I would imagine to MPI but in the private sector one of the greatest fears is, I'm not so worried about being elated when my rate of return goes above what I expect it to be, I am very much distressed, however, if the rate of return goes way below what I expect it to be. This is usually modelled, if it were relevant, to the client.

Another one (1) that's very standard in this kind of exercise is: The thing I regret most is that the rate of return falls so low that I face insolvency, so, I will structure a portfolio to minimize that possibility. This is called the Minimum Regret Model.

So it's these kinds of informations that I found not enunciated in the documents.

MR. KEVIN MCCULLOCH: And you'll agree with me, will you not, that on the basis of the certain stat -- statutory provisions that we looked at this morning, that there's another director, and another partner certainly, as far as the MPI portfolio is, and that is the Department of Finance.

DR. DEREK HUM: Yes. They're your words, director or partner, whichever.

MR. KEVIN MCCULLOCH: Now I'm going to paraphrase, if I can, what I see as the conclusion of your report, and you can tell me if I'm right or wrong, and -- and correct me if I happen to be wrong.

But the way I read it, your report basically takes the position that the modified portfolio number 11 is an improvement over the existing MPI portfolio mix.

It's not what you would see as the possible optimal portfolio, but it's an improvement, and absent this other information that may give better direction to you, you're not able to draw any other conclusion.

Is that fair?

DR. DEREK HUM: Oh, I think -- I think it's fair except for the last phrase. I hate to be picky.

Yes, I've been unambiguously in my report that I thought the new mix is definitely an improvement over the old mix, even though you're not at the new mix yet. That being said, I said, It doesn't mean that it's perfect so, therefore, I have suggested a few areas that

I think would make it better than where it is now in terms of the new mix.

And I did confess that I do not have access to a lot of other information and considerations that could alter my assessment of it, but it was just your last summary phrase that I was -- just being a -- a language thing.

MR. KEVIN MCCULLOCH: And in reference to your comment that the Corporation isn't at the new portfolio mix yet, it wouldn't surprise you, would it, that with the study just being concluded, and -- and filed that it would take a period of time for an organization to move to this new mix?

DR. DEREK HUM: Oh, I mean absolutely. I mean I -- I would think -- I did not, and I would not, have expected this to have occurred overnight.

But I think the targets are indicitive, and I'm sure they may well be changed, but I think the targets are superior as targets than the old targets. And I am -- I have no advice to give to MPI as to the timing and speed of implementation.

MR. KEVIN MCCULLOCH: Those are all my questions. Thank you.

THE CHAIRPERSON: Thank you, Mr. McCulloch. We will move on now to Mr. Oakes.

Seeing no Mr. Oakes, we will go on to Mr. Dawson.

CROSS-EXAMINATION BY MR. ROBERT DAWSON:

MR. ROBERT DAWSON: I thought Ms. Everard would be ahead of me, but I'm pleased to step in. I have only three (3) questions for the witness panel.

I've asked similar questions, Professors Hum and Simpson, of Mr. Bell when he was here, so I'm interested in your views.

Can you tell me if there are any principles that relate to balancing risk and return that would apply only in the context of Crown Corporations?

(BRIEF PAUSE)

DR. DEREK HUM: I want to make sure, sir, that we understand the full import of that question, which is very deep. So could I ask you to repeat it?

MR. ROBERT DAWSON: Professor Hum, are there any principles relating to the balance of risk and return that apply only in the context of Crown Corporations?

DR. DEREK HUM: Well, I'll articulate a few, whether we call them principles or not we'll see because, you know, we wouldn't want to get hung up too much on this word. Crown corporations as opposed to private corporations usually have very special tax considerations that -- that would impinge on this type of analysis.

For example, private corporations are subject to whatever the regulations are of the Income Tax Act and the rules. Crown Corporations are also subject, but to a different set, and there have been occasions in the past where -- I don't want to use the word "political" but let me just use Federal/Provincial considerations come in terms of managing Crown corporation's risk and revenues.

I'm thinking particularly of -- of the equalization formula, where this is not something that I really want to get into, but it does not impinge on the private sector at all. But that would be one, so in a nutshell, Crown corporations might have to consider the risk that their revenues go into the equalization formula or not in a way the private sectors wouldn't -- never have this cross their mind. I'm not so sure these are the kinds of things you're looking forward to.

Crown Corporations are generally -- have an investment or an expected planning horizon that for all intents and purposes I would characterize as infinite, infinite. Whether or not they're around all the time, they expect to be around forever. There is that consideration.

So, I think these have some considerations in the risk-to-return-kind-of considerations, and the third one is that if I were to characterize with great, great violence to nuance, private sectors we usually characterize -- they want to make a profit, but they want to make a decent profit, a maximum profit, satisfactory profit, however, you wanted to phrase that.

Crown corporations usually do not have that as their main objective and many times they will -- from today's perspective of investing money into a portfolio to receive monetary returns, they will often forego what we would call monetary returns today for what an economist would call social returns; that is, there are returns or benefits to society that they take as their mandate that will dramatically impinge upon their willingness to -- to -- to manage what I call the financial portfolio.

So these are just -- just three off the top of my head, and I'm not so sure these are the kinds of things you were getting at.

MR. ROBERT DAWSON: That's exactly what I was getting at.

DR. DEREK HUM: Well, then I stop.

MR. ROBERT DAWSON: Now, Professors Hum and Simpson, I assume you've had a chance to look at what has been labelled in these proceeding the Aon report?

DR. WAYNE SIMPSON: Yes.

DR. DEREK HUM: Yes.

MR. ROBERT DAWSON: Would you agree with me that when reviewing the Aon report none of the considerations that you, Professor Hum, have just outlined, is actually explicitly taken into account.

DR. DEREK HUM: I -- I'll give a short answer, I guess I agree.

DR. WAYNE SIMPSON: They're not explicitly stated in the report; whether they're taken into account is less clear in some fashion. We don't know what instructions might have been to Aon that would encompass some of these considerations.

DR. DEREK HUM: Let me -- let me backtrack a little bit on my answer because Dr. Simpson always corrects me.

If I could be inferential on here, I am venturing, I assume Aon accepted instruction or took seriously the notion that we've got to have Mush Bonds in the portfolio.

And I'm sure they were given an

explanation, much more nuance than I can give, that this is not a negotiable element in terms of your selection of financial instruments to choose among.

MR. ROBERT DAWSON: Professor Hum, I don't want to cut you --

DR. DEREK HUM: In that sense I think they did take into account --

MR. ROBERT DAWSON: Professor Hum, I don't want to cut you off and -- and --

DR. DEREK HUM: Okay.

MR. ROBERT DAWSON: -- and put you on the spot and make you speculate because we actually have had the evidence of Mr. Bell on this subject.

I really was asking that one (1) specific question that you -- you've looked at it and you've agreed with me you have and you also say that there's no express statement of these considerations there.

So let me turn to what is now an invitation to speculate. Let us assume and you, of course, don't have this information. So I'm asking you to make certain assumptions.

Let us assume that there were no expressed instructions to consider a taxation or equalization for formulae or the infinite investment or planning horizon or the societal objectives as opposed to profit objectives. These are some of the principles you've mentioned.

Would that, in your view as an expert witness here today, undermine the validity of the conclusions that are put out in the Aon report?

DR. DEREK HUM: "Undermine" is too strong a word. It's just too strong a word. I would prefer -- I'll have to choose my word carefully.

I don't think it undermines it but it certainly would not --

MR. ROBERT DAWSON: How about lends a different flavour to the conclusions?

DR. DEREK HUM: Oh, thank you. Who said that?

MR. ROBERT DAWSON: The other MA oxon in the room.

DR. DEREK HUM: I -- I don't regard my pers -- I don't regard Aon report even in those terms as perfection and not capable of improvement.

As, you know, I mean obviously I tried to make some constructive suggestions.

MR. ROBERT DAWSON: And I have one last question and I suspect it will be for you, Professor Hum.

You've appeared before this Board before and today you've been qualified as an expert within certain areas and I think it might be useful to depart from the usual rules of cross-examination and invite your opinion on a comment.

What do you think about a notion that today's policyholders should be paying for the benefits that will accrue only to future policyholders of the applicant?

DR. DEREK HUM: I'm going to ask you who -- I'm sorry, to repeat such a concisely phrased question again. Today's --

MR. ROBERT DAWSON: Put on your white tie of subfost (phonetic) and pay attention. Should today's policyholders pay for the benefit that will accrue only to future policyholders?

DR. DEREK HUM: And you're inviting me to comment?

MR. ROBERT DAWSON: If you'd like and if you prefer not to, you needn't --

DR. DEREK HUM: No, no, no, no. It's --

MR. ROBERT DAWSON: -- but I suspect that you're qualified to do so.

DR. DEREK HUM: It's -- well, geez, I -- I'm going to apologize to everybody in advance.

If today's policyholders can only pay for the benefits that accrue to future policyholders, okay --

and I suppose today means you could also pay for today's policyholders, could you, but excluding past -- then that would have tremendous implications for an organization, and society in general.

Because if we were to interpret that strictly, today's policyholders could only be used for the benefit of future policyholders then, obviously, today's policyholders could not, under this rule, have benefit from any actions of yesterday's policyholders or cohort.

So it would be very restrictive because it would mean society as a whole could not benefit, for example, of the capital installed, and the human skills that's inherent of cultural institutions of today, because that was put in place by our ancestors, or our forebearers.

In a context of an organization that's ongoing on a financial sense, that means any retained earnings in that Corporation would not be allowed -- and some economists, by the way, argue this, that at the end of the day, all returned (sic) earnings for a fiscal year should be distributed to hold -- to the shareholders, and should the shareholders wish they can reinvest in the company, but this is not the practice often in the economy where firms decide to have retained earnings which are, of course, benefits paid by or earned by yesterday, and spend it today, and I guess you could call it a reciprocal obligation on their part where they also spend today for the benefit of those in the future.

Now I did apologize for this answer, did I not? But I don't really know if this is what you're getting -- society I don't think, or a company, could not operate with a strict interpretation as I have given of your question, and maybe that was not your intent.

MR. ROBERT DAWSON: I was simply taking advantage of the fact that we had your brain to pick, and I thank you for your time.

Thank you, Mr. Chairman, I have no further questions.

THE CHAIRPERSON: Thank you, Mr. Dawson. Mr. Kruk, do you have anything?

MR. JERRY KRUK: No questions, sir.

THE CHAIRPERSON: Thank you. Ms. Everard...?

CROSS-EXAMINATION BY MS. CANDACE EVERARD:

MS. CANDACE EVERARD: Thank you, Mr. Chairman.

Professors Hum and Simpson, if I can begin by directing you to page 2 of your report, please. Your introduction. You've stated in the paragraph numbered 1 that:

> "Both the portfolio mix recommended by Aon and that recommended by Mercer are still relevant for guidance for the Corporation in the sense that it has not specifically rejected either as no longer valid."

So are you suggesting that both of those reports, that is the Aon report and the Mercer study, should be still under the consideration of the Corporation?

DR. DEREK HUM: No, I said I made that assumption, and if I am wrong in that assumption, I will be corrected. But that was the documents that I was handed and asked to review, so I was assuming that the documents I was handed was still relevant. I just wanted to make that explicit.

MS. CANDACE EVERARD: So you are not suggesting that the Mercer report, in particular, should or should not be considered by the Corporation?

DR. DEREK HUM: Oh, I mean -- I -- I -- no. No, I make no suggestions either way.

MS. CANDACE EVERARD: Okay. If I could ask you then to turn back to the Aon report and page 70 on which Mr. McCulloch had some questions for you.

This is the chart that sets out the efficient frontier.

DR. DEREK HUM: I have it.

MS. CANDACE EVERARD: And Mr. McCulloch had some questions for you about the portfolio ultimately suggested by the Corporation and its proximity to the efficient frontier. And he I believe used the word, "close" and asked you to agree that the selected portfolio was close to the efficient frontier.

Would you agree that if the scale of this particular chart were altered, that the proximity of the selected portfolio to the efficient frontier would change accordingly?

DR. DEREK HUM: Let me see what's on the axis.

DR. WAYNE SIMPSON: You mean visually it would change, of course, yes.

DR. DEREK HUM: Visually, or did you -- or do you mean visually or do you mean --

DR. WAYNE SIMPSON: That's what you meant.

DR. DEREK HUM: Oh. Okay. Oh, I was looking at it from the point of view of what's on the axis, the percentages. Visually, yes.

MR. WAYNE SIMPSON: Just -- just on that point, I think the difference between the -- the blue point which is the portfolio mix number 11 and the frontier is about .1 percent.

DR. DEREK HUM: Okay.

DR. WAYNE SIMPSON: So -- so obviously, depending on what the scale looks like, that's going to be reflected no matter where you -- how you represent it but, yeah, it's going to change with -- as the scale changes and I -- what does that represent? $2 million I guess.

DR. DEREK HUM: It's more precise to say .1 percent than to say "close."

(BRIEF PAUSE)

MS. CANDACE EVERARD: Thank you. Now, I'll ask you to turn back to your own report and we'll continue moving through it. In particular, on page 4, there's a table that you've already looked at in your evidence today that compares a variety of portfolios.

The second column -- or actually the third column in the chart, the one entitled, "Aon Report," which sets out its recommendation, that would be the alternative recommendation put forward by Aon, would it not, as opposed to its first recommended portfolio?

(BRIEF PAUSE)

DR. DEREK HUM: Okay. Sorry. I'm going to leave it on. You'll have to listen to my heavy breathing.

I don't know what is called alternative. I gave the exact citation. Let's see.

(BRIEF PAUSE)

DR. DEREK HUM: Okay. Trusting you. It is this one. I -- I've got to check the numbers.

(BRIEF PAUSE)

DR. DEREK HUM: Yes, in -- in Aon's report it would be called "Alternative Recommended Portfolio Based on Assumptions from Aon."

MS. CANDACE EVERARD: Thank you. Now, you've given evidence that -- and it's clear from reading your report that it's your view that the new portfolio selected by the Corporation is generally an improvement over the old target, and you indicated I believe in your direct evidence with Mr. Williams that one (1) of the reasons for that was the increased return that it is anticipated will be gleaned from the new portfolio.

Can you elaborate and just set out for the record the various reasons why you believe the new portfolio is an improvement over the current mix?

DR. DEREK HUM: Increase in the expected return. What happens in the markets, I'm not taking responsibility for.

Very briefly, when you look at a portfolio that has many types of financial instruments in it, the return from the total portfolio is - I hope this is not too jargon - is going to be a weighted average of the returns that you get from each asset class.

If all the asset class returned the same rate of return, then it wouldn't really matter, but that's not the case and, historically, cash and bonds and things like that give a much lower rate of return than what we call equity and equity, in turn, can give a higher or lower rate of return than real estate or private equity or infrastructure. That really depends upon why selection is very hard to tell.

So obviously, if one moves an allocation more away from the asset class that gives a lower rate of return to one that, hopefully, gives a higher rate of return, the expectation is that the overall rate of return which is the new target would give a higher expected rate of return. And I hope that's clear.

(BRIEF PAUSE)

MS. CANDACE EVERARD: Thank you.

Let's turn now to page 6 of the report where the discussions with respect to pension assets and liabilities are set out in the segregation -- those items, page 6 it should be.

Now, the evidence on the record in this proceeding is clear that the Corporation is not presently considering a move to a defined contribution plan, and in this portion of the report there is reference to -- I'm looking at the fourth paragraph, the statement that:

> "As long as the plan is a defined benefit scheme, the prime concern of pensioners would be solvency which would be an unlikely risk in the context of the Corporation."

And in the same paragraph the additional point is made that one could argue that the investment portfolio of the Corporation gives a lesser return to pensioners than would a different allocation targeted towards maximizing pension benefits.

Can you comment on the implications of these factors, given that the Corporation has in place a defined benefit plan as opposed to a defined contribution plan?

DR. DEREK HUM: Okay. Thank you. I want to reiterate that this section should not be interpreted as a recommendation or advocacy for a defined contribution plan for MPI.

I know and accept that the pension plan is a defined benefit plan and I make the observation, as an economist, that -- that overall in Canada there is a movement towards defined contribution and away from defined benefits which is why I highlighted in the second paragraph, that you didn't quote, which is that I consider it an important question is whether MPI will soon or ever consider adopting a defined contribution plan design.

I think it's on the record, this is not in the near future, but, just as food for thought, I wanted to look at the implications of the pension funds being co-mingled with the rest of the investment funds and make the argument that as long as it's a defined benefit plan, the pensioners need not have the normal worries that -- that pensioners often have, which is, are the people who are managing my pension funds going to go bankrupt, will the company not have any money and so forth.

I take the position that MPI is not likely to go bankrupt or be insolvency, so, that the standard discussion about defined benefit plans is largely absent here. So that leaves only the question, again food for thought, is that: Are the pensioners, and I would call -- I think they are who I assume to be the beneficiaries of the pension plan, well served by having their pension monies co-mingled with the rest of the investment portfolio. As I said, the question doesn't arise because they're getting a defined benefit plan now.

But if we ask the question or if we go back to my programming analogy saying, well, what is the cost of this to the pensioners, would pensioners be, as food for thought, better off with a defined contribution system and with their pension funds invested in a separate fund and not co-mingled following the same rules that MPI is now following with their current asset mix.

Obviously, I'm not going to give a definitive calculation and answer to that, but, I would be more than surprised and shocked if the asset allocation of the two (2) organizations now separate, the pension fund managers and what I call the rest of the MPI portfolio, were to come on the basis of their objectives exactly the same allocation because I would assume that the pension owners have a much more restricted view of what they would like to achieve with their investment funds.

To put it crudely, I think they would like to get a big rate of return and very, very secure. And so that is why I made those observations and I know full well that it was not on the cards that you were going to switch from defined benefit to defined contribution.

And there is an extra -- mindful of Professor -- Mr. Dawson's question. There's an extra advantage that at least I think is an advantage. If I were a pension member of MPI's pension I think it's a matter of both confidence and transparency that if I knew that the funds for my pension were of a certain amount and not subject to the vagaries of the rest of the operations of MPI and -- but that is not strictly a monetary consideration.

That's all I wanted to say on that.

DR. WAYNE SIMPSON: Yeah.

MS. CANDACE EVERARD: And I think you've just answered or almost answered my next question. I wanted to clarify one of the exchanges that you had with Mr. McCulloch earlier dealing with what would happen if the funds were segregated.

If the pension assets were segregated, the Corporation has taken the position that if that were to occur, those assets would likely have a more aggressive mix than would the remainder of the portfolio.

And I take it that you agree with that and that's what I wanted you to confirm.

DR. DEREK HUM: I think that would be the likely scenario. I would agree with that.

MS. CANDACE EVERARD: Thank you. We'll move then to the next page of the report, the section that deals with Universe Bonds versus Long Term Bonds.

The first paragraph in that section reflects that Long Term Bonds are at a forty (40) year low and it's set out that MPI's choice not to invest in Long Term Bonds is a matter of timing and preference.

Can you elaborate on that point for the Board's benefit?

DR. DEREK HUM: Well, this is one of the cases where currently if you were just picking between these two (2) on the basis of rate of return or spread, there's not much to pick.

I mean it's -- but we must not think that what we now observe will be immutable into the future. If history is any judge and if the markets tend to review what the -- in the fullness of information the markets review, the yield curve which is a technical way of simply saying the rate of return on the long end versus the rate of return on the short end tends to have, most of the time, be upward sloping.

Meaning, you do get more from investing in the long end than in the short end. Even though at any given time such as now, you might think that's not much or is not worth it.

So, I was going on the assumption that the horizon for an organization such as MPI is very long term and so, therefore, I was exploiting, if you like, this historical empirical information that we do get more from the long term end.

But, I did indicate at the end that right now it -- the MPI position is defensible if it gives them greater comfort and, again, I hasten "comfort" was in quotation marks, it was not my term.

It's not a position if someone choses on the evidence we have today to pick Universal Bonds over -- Universal -- Universe Bonds over Long Term Bonds. I correct the spelling. It's not -- it's not an action for which one should bring condemnation. It's understandable.

MS. CANDACE EVERARD: So, Professor Hum, the time frame piece that you were just discussing is this infinite horizon that you've referenced in the second paragraph of that section?

DR. DEREK HUM: Well, I -- I was assuming that, yeah, you were buying -- well, you wouldn't buy Long Term Bonds unless you had a very long horizon, and so I'm assuming MPI has a long horizon, long investment horizon.

MS. CANDACE EVERARD: Now I just want to speak about this laddering suggestion that carries through the balance of this section of the report.

The Corporation has indicated on the record in this proceeding that it has a duration matching strategy which matches the duration of the bond investments with liabilities. And that in their view, this duration matching mitigates mismatched risk. And that given that scenario, or situation, the laddering approach that you've suggested is not necessary.

What is your view of that position?

DR. DEREK HUM: I don't have the exact figures on the distribution maturities of their assets and liabilities, but, it's certainly a plausible argument and, in fact, it would be the right thing to do.

And I think the whole point of matching assets and liabilities in terms of their term to maturity - in other words, when you have to pay the money - that's when the money that you've invested comes due for you to pay it is, in fact, what one ought to do.

I believe my interpretation was that Aon took that into account in their modelling, and when coming up with their recommendations as to the portfolio said, Additional to that, we believe your position is that you should have these kinds of bonds. And having taken that into account, they recommended Long Term Bonds.

So I assume they, with due diligence, solved that problem. They considered it. That's the whole purpose of an asset liability thing.

So as I explained earlier, and I'll just quickly repeat it, the only counter to that that I have usually been faced with is that some people have preferences for liquidity as opposed to the illiquidity element that is implied by Long Term Bonds.

And I have characterized this portfolio mix as achieving some higher expected return, but at some cost to liquidity.

So the laddering was simply a suggestion that within that context, it was intended to diminish the force of an expected argument that I don't like Long Term Bonds because I don't like the lock up on money for such a long period of time.

MS. CANDACE EVERARD: Thank you. We move then to the next page of your report, page 8, which deals with the amount of foreign equities in the portfolio of the Corporation.

You stated in the first sentence in the paragraph of that section that it's assumed that any foreign positions will be hedged.

DR. DEREK HUM: Yes, I assume that.

MS. CANDACE EVERARD: I'll just wait for you to get the page. Do you have the page?

DR. DEREK HUM: Yes, I do.

MS. CANDACE EVERARD: Okay. Now we've heard from Aon its recommendation that US equities should not be hedged given the relative size of the investment and the associated cost of hedging.

What is your view of that?

DR. DEREK HUM: Well, first of all, I know that the foreign exchange risk is hedged. I -- I find -- it's -- it comes down to the amount of risk that one is willing to tolerate.

It is always the case that when you invest in equity in a foreign country, you do so not only to receive the rate of return that they will give you, but you -- if you intend to bring the money home, and in domestic currency, you always are facing exchange rate risk. So I find that imprudent for large sums of money.

I'm not talking about, you know, the amount you invest in the credit cards when you go shopping, but what -- and -- and this is a significant amount of money in absolute terms that it would not be hedged.

And I would not want to cite current situation as illustrative of the variability, but I'm sure people in this room will remember not too long ago, I can number in less than the number of years on my fingers on one hand, the Canadian dollar was around seventy (70) cents and very recently, not too long ago, actually last year, we were above par and now of course it's dropped down and now it's costing us approximately almost $1.10. I haven't looked at it today to buy an American dollar.

That is a sort of swing within a short period of time for a portfolio whose mandate is supposed to be long term that would dramatically wipe out any extra gains you would get by trying to go from one (1) currency to the other. I mean, this is the sort of swing I find -- well, I personally -- let me say I personally find it a fairly unacceptable risk not to have it hedged.

MS. CANDACE EVERARD: On the same page of the report still dealing with this issue of foreign equities, you've noted that MPI, the Corporation, has a weighting of Canadian equities relative to foreign equities of some four to one (4:1)?

DR. DEREK HUM: Yes, roughly.

MS. CANDACE EVERARD: Which is contrary to the recommendation made by Mercer and that made by Aon?

DR. DEREK HUM: It is the reverse, yes.

MS. CANDACE EVERARD: And the Corporation has indicated that part of its consideration or the consideration of the -- its working group in not accepting Aon's recommendation were the historical returns on the US and Canadian equities?

(BRIEF PAUSE)

MS. CANDACE EVERARD: Is that -- oh, pardon me. Further, Aon did not support the Corporation's assertions that it looked to the returns in the Canadian market for the last nine (9) years in support of its decision on how to weight the Canadian equities.

Is -- is that something that you agree with?

DR. DEREK HUM: I -- I don't know I want

to address this in terms of endorsing or disagreeing with Aon. I -- I'd just like to say it positively.

I would definitely have higher weighting to American than Canadian as opposed to the reverse, which is what the new targets that MPI did and I don't really want to say, you know, three to seven (3:7), seven to three (7:3), four to eight (4:8).

I think I'm more comfortable qualitatively at this point simply saying, I believe those positions should be reversed. So in that sense, I agree with Aon, but not with the specific numbers necessarily. I wouldn't go that far.

In fact, I also agree with Mercer too because they're not totally comparable because Aon doesn't have any foreign equity and Mercer does and I prefer Mercer's position in including foreign equity. I hope that's clear.

MS. CANDACE EVERARD: I think so. Do you agree that a review of returns in the Canadian market should factor into one's decision to invest or not invest in Canadian equities?

DR. DEREK HUM: Oh, I think so, in -- in fact, if I understand the question which was: Should we not examine the rate of returns to Canadian equities in making a decision.

Unambiguously, I agree with that and, in fact, one (1) of my sources of unease is the way in which the structure of returns to the asset classes are used in the model. They don't actually look at the data as to what has happened, they just simply look at the interest rate on as a base and they add a fixed amount of unvarying premium to that and say that's the return for equities.

So that in many ways, mathematically, the whole of this portfolio exercise is being driven not by the actual or expected rate of returns of these asset classes but is actually being driven by a projection or prediction of where the interest rate is going. And I guess I'm not as happy with that but, obviously, that was the Aon report's assumption from whatever instruction or self selection they made. But I don't think there's this immutable law.

MS. CANDACE EVERARD: And have either of you gentlemen had occasion to do research or analyse the historical returns?

DR. DEREK HUM: Not -- not published research. Not published research. I have done research for my classes, for my teaching purposes and for my own trading and investment activity.

MS. CANDACE EVERARD: What's your view in terms of a time frame if one is to look at historical returns, what historical time frame should be reviewed?

DR. DEREK HUM: Well, Wayne is probably -- may have a different answer than I do but we economists, we take the longest data series we can get subject to some exogenous judgements as to why some parts of the data are not relevant. For example, you know, I wouldn't include World War II, the performance of the stock market in the data.

But we -- we tend to -- to look at that and we try to find patterns. We even try to detect breaks in patterns where it would be precarious to assume -- we use statistical tests where -- where it would be foolhardy to include certain amounts of data in our understanding. So the short answer is, we'll look at as much data as we can get our hands on, and we hope we do it sensitively to know which portions to disregard because they're outliers.

MS. CANDACE EVERARD: Now when you say that you wouldn't consider the period of time that included the Second World War, would -- would it be fair to say you'd go from the 1950s onward? Is that reasonable?

DR. DEREK HUM: Well, I -- I wouldn't include World War II, and I certainly would exclude the interwar years because of the Great Depression, although maybe that's coming back. I certainly would exclude -- yeah, for all the practical answer is, yeah, I would not go much beyond post-World War II. The markets have also changed dramatically, really, from probably the '60s on.

And in Canada -- well, these are the institutional facts. I think investment behaviour has changed dramatically from about the late '60s on simply because the introduction of capital gains tax and things like that.

So it's dangerous to go far back without knowing the institutional history of when certain things that you think would have had an effect occurred. And I think the introduction of the capital gains tax did have a tremendous effect on the stock markets.

MS. CANDACE EVERARD: Thank you.

DR. WAYNE SIMPSON: Just -- just on that point, I mean, I -- I guess one -- one of the things you might be getting at is whether the idea of just going back, say, ten (10) years arbitrarily is -- is -- is necessarily good or that's enough historical information. And I think in parts of our answer we've indicated that that may not, for example, give much idea about what -- how the stock market performs when inflation is -- is high as opposed to the last ten (10) years of relatively low inflation.

So depending on what the exercise is, both not only the duration back in terms of years, but the frequency with which you look at the data partly depends on -- on -- on what -- what the context is of your investigation.

DR. DEREK HUM: That's a better answer.

MS. CANDACE EVERARD: Thank you. Now, we also heard from the Aon witness that in his view the benefit of investing in the US and international markets is diversification and that the returns are about the same.

Is that -- do you -- do you agree with that or do you share that view?

DR. DEREK HUM: Well, I -- I wholeheartedly endorse the fact that diversification is a fundamental reason for doing that because -- I hate to belabour the point but in the modern portfolio theory which is founded on the notion of diversification, even if you had two (2) asset classes that always gave you the same expected rate of return, so that there's nothing to choose between the two (2) of them on the basis of expected rate of return, 5 percent, 5 percent, both the same, you would still want both of them in your portfolio if, in fact, those two (2) instruments, giving the same rate of return, had a correlation structure that reduced your risk, in this particular place specifically negatively correlated.

And so you can't achieve that with one (1) instrument. That's, as they say, putting all your eggs in one (1) basket. You just can't do that.

So even with the same return, I mean, this is the power of diversification theorem, you get less risk as a result. You don't get any more return. They both give you 5 percent, you still get 5 percent, but you get a less risk, smaller variance.

And that's the reason why modelling portfolio -- that's their main -- it's actually the main message why you would do it.

DR. WAYNE SIMPSON: Perhaps the other part of that question is we'd also -- we would expect that the US and Canadian markets over a lengthy period of time would give the same return because there's no constraints on people to invest in Canada or the US. So, obviously, money would flow from Canada to the US, for example, if Canadian returns were systematically lower.

So the -- the financial market virtually ensures that net of some small transaction costs perhaps the -- the two (2) markets will be comparable in terms of their returns.

So the model that he's talking about is precisely the model on which you would base your -- your judgment about your investment decisions.

MS. CANDACE EVERARD: Thank you. Let's turn over the page in your report, go to page 9, the first full paragraph on that page which begins with the phrase, "MPI's refusal to countenance" --

DR. DEREK HUM: Yes.

MS. CANDACE EVERARD: -- deals with your views on the US equity issue. And throughout -- about halfway through that paragraph there's reference to the issue being a matter of timing and probably be wise to take a position in US equities when those are inferior to the Canadian equity performance.

And then the last sentence reads:

> "In the long run regression to the mean suggests that this will yield superior return."

Probably should be returns with an S. Can you explain what you mean by "regression to the mean" and this issue of it being a matter of timing?

DR. DEREK HUM: That -- that paragraph should have been separated into three (3). I think we've covered the first part which was the fact that I think there should be a stronger presence in the US.

I introduced the notion that the fact that they can diverge is actually prima facie evidence of the reason to diversify because, in MPI's statement -- and I forget which interrogatory it was, they -- they suggested that -- that the Canadian returns are currently inferior to American returns as the approximate or one (1) of the reasons why they did not want to go further than that.

Therefore, within that context the concept of regression to the mean was introduced. Let me take thirty (30) seconds to explain this term.

It's a term common in statistics which basically says we -- we cannot predict sometimes the occurrence of a single event such as when I flip a coin, I don't know whether it's going to be heads or tails before it comes about.

But on the other hand if I flip -- it's a fair coin by the way -- if I flip it one thousand (1,000) times I roughly would expect it to be roughly half-and-half heads and tails because that is the expected or mean value. "Mean" means the average expected value.

So when you observe in real life statistics that seemed so far off what is the normal observation based upon repeated observations in the statistical series, the term "regression to the mean" means you have a higher expectation that the next little while the observations will be closer to the long-run average than shoot away from the long-run average.

So this phenomena is called "regression to the mean," unless there's a fundamental structural change in the relationship, World War, so sort of thing.

So the point being made was that the inferior performance of Canadian -- I'm sorry, in -- yeah, inferior performance of US equities being offered as a -- as a fact that's now observed, should not guide the decision for a long-run portfolio with a long horizon when I guess I'm referencing or trusting the notion that regression to the means suggests that we will not enjoy this presently observed position forever and ever.

MS. CANDACE EVERARD: So in the long run --

DR. DEREK HUM: We play the odds.

MS. CANDACE EVERARD: In the long run returns in the US and international markets are going to be better than the Canadian market?

DR. DEREK HUM: Well --

DR. WAYNE SIMPSON: No, I -- I think --

DR. DEREK HUM: At least --

DR. WAYNE SIMPSON: -- the --

DR. DEREK HUM: At least as good.

DR. WAYNE SIMPSON: If you take, say, the

US and Canada, just going back to -- to what I said before, you would expect that if -- if they diverge much that they will be coming back together very shortly. And that's essentially what -- what he's saying.

DR. DEREK HUM: He's very good. He's concise. But I set him up.

MS. CANDACE EVERARD: Okay. Let's turn to the real return bond issue which commences on the same page of the report, page 9. The Corporation has stated on the record that the transition out of real return bonds is likely to take several years or certainly could take several years. Would you say that a gradual transition into other inflation-adjusted investments would mitigate the risk of high inflation, a high inflation rate?

DR. DEREK HUM: What are those other --

DR. WAYNE SIMPSON: In real estate.

DR. DEREK HUM: -- instruments?

MS. CANDACE EVERARD: The Corporation says real estate and infrastructure.

DR. DEREK HUM: Infrastructure and real estate?

DR. WAYNE SIMPSON: Yes.

DR. DEREK HUM: Mitigate, I agree to; completely compensate for, I won't. So choose your verb.

DR. WAYNE SIMPSON: Well, I think the point is, if the intent is to hedge against inflation using an instrument, the argument is that real return bonds are the instrument to do that with.

If there are other considerations that make real estate and infrastructure more attractive, that's fine, but as a hedge against inflation they're not the best instrument to do that.

MS. CANDACE EVERARD: And -- and I appreciate that. And the question was directed at the timing issue --

DR. DEREK HUM: Oh.

MS. CANDACE EVERARD: -- the -- the transition. So do you have any comments with respect to what kind of a time frame you would recommend in terms of making that --

DR. DEREK HUM: Yeah.

MS. CANDACE EVERARD: -- transition?

DR. DEREK HUM: Infinite. My position is that they shouldn't do it. So my -- so my recommendation should be infinite time. It's --

MS. CANDACE EVERARD: No, I realize that. But if you leave that aside for the moment, just put it away for -- for a second and -- and indulge us, can you make some suggestions with respect to a transition time frame?

DR. DEREK HUM: I don't really want to because my understanding is the box containing real estate and infrastructure now is empty, empty, and I really don't want to be in a position of either recommending a time schedule in the absence of information about their willingness or preparedness or the availability of personnel to fulfill the kind of due diligence that will be required to move to that, and I'm sure they will do that with due diligence and -- and...

But it's not to be rushed. It's -- let's just -- let's just say that it's not to be rushed, given that you're going in that direction.

MS. CANDACE EVERARD: Okay. Thank you. Now the Corporation has said that, if inflation becomes a concern, going forward they'll have an ability to trade.

How would you say a higher inflation rate would impact the cost of acquiring real return bonds and the yields related to those bonds?

DR. DEREK HUM: Well, if inflation goes up, it'll probably not be a secret. It means that everybody will say, Inflation's gone up, and then a lot of people will say -- if they want to hedge against inflation, will look to, if not real estate or infrastructure, this kind of instrument.

So, therefore, my guess as an economist, unless the Bank of Canada refuses to make them available in sufficient quantity, is that the demand for them will -- will go up. They'll be -- we will be competing to buy them.

This is not a satisfactory answer, I'm sure, but it's -- it's the best I can do.

MS. CANDACE EVERARD: Okay. Now we know that the current asset mix within the Corporation provides for 12 1/2 percent in real return bonds, and that the proposed net as zero.

What is your view on what that number should be?

DR. DEREK HUM: I don't have a firm number, except that I don't believe it should be zero. I'm quite adamant about that, if I have to repeat myself the fourth time. But it's -- it's -- the -- the essence of portfolio theory is to trade it off.

And I respect MPI saying, We are trading off the real return bonds -- I would hope they said some portion rather than all of it -- towards a potential inflation hedge strategy of infrastructure and real estate.

But you put me in a difficult position of trying to tease out a number when I don't know what's in this other box, and -- and I -- I guess that's my reluctance.

If I -- if I knew, then I'd be much more forthcoming and helpful, except that I don't think it should be zero, which would -- broken record.

MS. CANDACE EVERARD: Do you have a view on any particular real estate or infrastructure investments that should not be put in that box, to use your phrase?

DR. DEREK HUM: Well, Chinese companies that produce milk powder would be one (1). I don't really want to answer that question.

I -- I said at the very outset, I am not here as an expert as to how you should choose individual stocks in equity, nor would I be here as an expert in how you should choose individual investment projects in infrastructure or individual items of real estate investment. I want to disassociate any claim of expertise for that selection.

MS. CANDACE EVERARD: Can you tell us whether there is any empirical evidence that you are aware of that compares the correlation between inflation, and real estate and infrastructure investments?

DR. DEREK HUM: Real estate and infrastructure I'm using in two (2) different ways, okay.

Infrastructure I'm thinking of things like airports and things like that, and real estate I'm thinking of commercial buildings, malls.

I'm not aware of the latter, but of the former there is a literature that -- depending on who you read, and for what period of time, some studies show that over the long run there's absolutely no correlation of real estate as an investment hedge, and others show, depending on the period, there is.

So it -- some of these studies you have to read very carefully because of the qualifications, because many studies were done using residential real estates, which I'm given to understand is -- is really not a focus with MPI.

So when you talk about infrastructures and commercial real estate such as shopping malls and airports, and all that, is I think, to my knowledge, very sparse evidence, not an evidence that I would characterize as allowing us to arrive as the same degree of consensus as we have with respect to the relationship between, say, bonds and equities as two distinct classes.

DR. WAYNE SIMPSON: The other thing is, a lot of the evidence is from the US and while sometimes evidence carries over nicely from the US to Canada, I think we've seen with recent -- in recent year -- the recent -- past year that, you know, circumstances in the US real estate market may be very different from Canada. So that -- I wouldn't want to make that carryover to Canada based on studies from the US.

MS. CANDACE EVERARD: Now can you tell us whether there are any ways in which investments in infrastructure and real estate have to be or should be managed to reduce the inflation risk relative to real return bonds?

DR. DEREK HUM: Well, the short and pithy saying is, try to get a sufficient ownership position so that you can actually control some of the price setting. This seems to be the strategy that's followed by the Canadian Pension Plan Investment Board. They don't just want to be a small partner, they try to get a substantial thing, so that you can actually have some say in the pricing of the product or whatever it is.

And the other one (1) is that, failing that, if you are a very small player, try to build in what we would call escalator inflation clauses. During periods of high inflation in the past, unions do it. They want the COLA clause built in. Renters do it; they put an escalator clause for rents.

And just to show you how mainstream it is, University of Manitoba professors built it in to their salary demand. So this is one way of trying to protect yourself by these other avenues other than real return bonds.

MS. CANDACE EVERARD: Thank you. Speaking a little bit about the inflation issue that was covered this morning, I believe I heard, if I heard your evidence correctly, the inflation is currently exceeding 3 percent. It's outside the -- the band of the Bank of Canada.

DR. DEREK HUM: Projected for the next quarter. I mean, you know --

DR. WAYNE SIMPSON: I think the month-to-month figures are -- are just over 3 percent at the moment.

DR. DEREK HUM: Yeah.

DR. WAYNE SIMPSON: Yeah, nationally.

MS. CANDACE EVERARD: Can you explain for the Board what the impact would be generally on the inflation rate in the event of a recession or poor economic times?

DR. DEREK HUM: Well, inflations are typically associated with low inflation and high unemployment. That's sort of what economists call recession. And I -- I take it you're not asking me to confirm we're in a recession.

The opposite of that, which is the contingency for which the real return bonds are designed, is when you actually have high inflation, which is usually characterized by -- by much more robust economic activities. Or if you measure it by the unemployment rate, it's usually associated with low unemployment rate, high capacity growth, things like that, tight labour markets.

So the short answer is, inflation will be high or low depending upon your tendency to be in recession or -- or high growth, robust growth. The economy is, we can say with certainty, does have its ups and downs.

MS. CANDACE EVERARD: Thank you. Let's go then to the final section of the report, or prior to the conclusion that is, that deals with revenue stabilization, and, in particular, page 14, which is the third page of that section. In dealing with -- and I'm looking at the fourth full paragraph on that page under the heading, so to speak, of the suggestion of an annual fixed amount draw of investment income.

It's indicated that,

"The intent of this practice is to achieve an element of revenue stabilization for the Corporation (not rate stabilization for rate payers)."

Can you explain the benefits, if any, of this proposal to ratepayers?

DR. DEREK HUM: The last -- the last benefit of the proposal for ratepayers -- of ratepayers. Well, gosh, I was hoping I wouldn't get into this which was the basis of the parenthesis. I did not want to talk a lot about rate stabilization for ratepayers but I did acknowledge in a footnote it's related.

The short answer is, insofar as the revenue stream to MPI is more predictable and stable, this should make their planning and budgeting and projection perhaps more predict -- all things being equal, I don't know what's going on with the rest of the thing -- and making a long series of assumptions which I think are quite reasonable, this should lead down the road to more stable rates because there would be less need to adjust for the wide variations that might otherwise occur on the annual balance sheet of the Corporation.

So as I said, a lot of this is the standard economist out, ceteris paribus, you know, keeping a lot of things common. I just can't think that how an increase in the instability of investment income could transform itself into a more stable rate setting environment, but it -- it's hard to imagine for me.

MS. CANDACE EVERARD: Thank you. Can you envision this proposal with respect to rate stabilization and this fixed draw being impacted by the fact that, in the Corporation's case, the portfolio is managed by the Department of Finance?

DR. DEREK HUM: My suggestion is just -- well, it is a suggestion but it was not fully fleshed out. I meant it in the spirit that I hope you will take it which was food for thought.

I observed that you've got a lot of instability here but you have the money. Meaning you've got a big enough portfolio that's generating an expected rate of return that is more than enough to cover what your expenses are.

And I approach it as simply, based upon my training and experience, what can I do to smooth this out? And so, therefore, if it has merit I don't think it would be very difficult to implement at all.

I just think it's -- it's almost axiomatic and automatic how one would go about doing that so I don't really think it was really worthy at this stage of setting out chapter and verse. But it's very easy.

In fact, if you want the thirty (30) second solution, take more data than I have analysed and create a estimate of what you think the expected return will be from your portfolio and implement some sort of weighted moving average of it.

And then allow an accounting procedure where you get excess funds. We just don't allow you to spend it. We just allow you to carry it forward for the next period.

In my other professional projects, I have been involved in designing and implementing mechanisms for the sole purposes of smoothing income flow. So I'm not saying it would apply here but the same principles would apply. I don't think it's that difficult. Insurance companies who sell annuities, they do it all the time.

(BRIEF PAUSE)

MS. CANDACE EVERARD: Thank you to both of you.

Mr. Chairman, those are my questions.

QUESTIONS BY THE BOARD:

THE CHAIRPERSON: Thank you. Before we go back to Mr. Williams, just a couple.

Dr. Hum and Dr. Simpson, just to remind us again, how important for the construction of the so-called efficient portfolio is the time frame of one's perspective?

DR. DEREK HUM: Well, anything that's very short you probably wouldn't really worry about it too much but you can construct optimal portfolios for any investment horizon. And I think someone with an investment horizon of as short as five (5) or six (6) years could benefit because within a five (5) or six (6) year period you would have been able to take advantage of -- of what I call that diversification theorem or factor, because movements in these various asset classes are subject to considerable volatility even within a period of five (5) or six (6) years, and so you would exploit that.

And certainly, a longer period, you would benefit not only from this diversification comfort but you would also benefit knowing that, if it's properly and confidently constructed, the diversification is kind of like working in the background even when you're not aware of it. But this is not to say that you should not be reviewing the mix periodically, and that's a judgment call.

THE CHAIRPERSON: Thank you. Just another general-type question: From my reading, the Aon report suggests that, I think it is Model 11 would produce something like, or expected to produce something like seventy-five (75) basis points of excess return.

And compared to the current portfolio which I think came in, depending on whether it is MPI's view or Aon's, zero to twenty-five (25) and that later models, as they leave the fixed-income side, seem to suggest a further excess return could be expected with some increased level of divergence.

Leaving that as just our background, would you say that most of society clearly is not represented by economists or CFAs and are not schooled in the history and ways of the market and not as acceptive of volatility?

DR. DEREK HUM: Well, we -- we certainly wish the first half of that statement, that the world is not populated by economists or accountants.

THE CHAIRPERSON: Most people are --

DR. DEREK HUM: Yeah.

THE CHAIRPERSON: -- not as acceptive of volatility as economists. That is fair statement, is it not?

DR. DEREK HUM: Well, I -- I have -- I take -- I take no exception to that, I think that's a true statement. But if I might add a slight little rider on it without being flippant, most people with $2 billion to invest would probably not be the typical economists or CFA or person who -- without this knowledge, or I would say editorially, they ought to seek advice and have this knowledge. Two (2) billion dollars is not -- well, it's a lot of money.

THE CHAIRPERSON: So, leaving the 2 billion aside, you would agree then that most people dislike volatility, that most people prefer certainty, if you like, over the occasional extreme fluctuations even if those fluctuations could be modelled to suggest that in the long haul they'll work out in the plus side?

DR. DEREK HUM: I -- yeah, most people --

DR. WAYNE SIMPSON: At what cost?

DR. DEREK HUM: -- are risk averse, is what --

DR. WAYNE SIMPSON: Yes.

DR. DEREK HUM: -- I think --

DR. WAYNE SIMPSON: Yes.

DR. DEREK HUM: -- what he's saying.

DR. WAYNE SIMPSON: I say --

DR. DEREK HUM: That -- that is the tendency of --

DR. WAYNE SIMPSON: That's right.

DR. DEREK HUM: -- of people is to be

risk averse, --

DR. WAYNE SIMPSON: That's right.

DR. DEREK HUM: -- yes.

DR. WAYNE SIMPSON: Averse.

THE CHAIRPERSON: Would you also say that most, generally speaking, insurance companies are risk averse?

DR. DEREK HUM: Well, yes. But there is -- there is another -- there is another aspect or theory of modern portfolio theory that I just don't really want to muddle the thing.

But the degree of risk aversion is generally considered in the literature a function of your wealth level, you know, the way in which economists study it, and -- and studies have tended to back that up, that people are much more risk adverse at low levels of wealth that they're dealing with or investing.

But when someone has much higher the risk aversion sort of diminishes because there's an element, to put it prosaically, an element of self insurance that is possible when you have a lot of money that you can't do when you don't have a lot of money.

So that's why risk aversion tends to vary with the size of portfolio.

THE CHAIRPERSON: That is an interesting

point. You would also have to say, presumably, that governments, generally speaking, are generally risk averse as are consumers, if you like?

DR. DEREK HUM: I'm letting you talk about that one --

THE CHAIRPERSON: Just a general point.

DR. DEREK HUM: -- the government.

DR. WAYNE SIMPSON: Well, I think in the sense that governments are voted in by consumers who are risk averse, they have to take that into consideration, yeah.

THE CHAIRPERSON: So just to complete this little circle if you like, so would you say that the average person doesn't necessarily react particularly calmly in situations of severe distress and that the average person would probably exchange the reasonable probability of a long-term gain for less volatility?

DR. DEREK HUM: Yeah. If we look at the -- this is probably what I would answer in the way of what is available as indirect evidence, if you look at the actual investment decisions of individuals.

And I don't believe this really applies to MPI but the average person with substantial -- the less than 2 billion, tend to put their money in more safe products, financial instruments like CD's and bonds and so forth, and they are less likely to put it into foreign equities, but they're not particularly adverse to putting it into Canadian or US equities.

But that investment profile or that investment preference I hasten to add is not one (1) that I would ever adopt in my analysis of what I think MPI is -- is likely to want to do.

THE CHAIRPERSON: Thank you, Professor Hum and Simpson. One last question. You both indicated that you were on the U of M pension plan committee that oversees their investments.

Would it be reasonable to assume that their portfolio reflects basically your thoughts with respect to real return bonds, long term bonds and investments in foreign markets?

DR. WAYNE SIMPSON: I think our service was long enough ago we wouldn't make that statement regarding their current portfolio allocation because it does change over time. It would have in the past, wouldn't it? Wouldn't it?

DR. DEREK HUM: All right. That's safe,

DR. WAYNE SIMPSON: Two (2) different paths. We didn't serve at the same time.

DR. DEREK HUM: We didn't serve at the same time, two (2) different paths.

THE CHAIRPERSON: You don't remember it being diametrically opposed to what you've recommended in this case?

DR. WAYNE SIMPSON: No.

THE CHAIRPERSON: Because they have a pretty big portfolio, don't they?

DR. WAYNE SIMPSON: Yes.

THE CHAIRPERSON: Or don't you?

DR. WAYNE SIMPSON: Yeah.

DR. DEREK HUM: I remember not allowing my name to be nominated for a second term because I didn't think I was making a very positive contribution to the Pension Board. And in terms of their investment portfolio, it's one (1) that I didn't think was particularly appropriate, as well. So I -- I did not continue to serve more than three (3) years.

THE CHAIRPERSON: Was that for the reasons that we discussed here, general risk aversion and --

DR. DEREK HUM: Not exactly, not exactly. It was a little more complicated than that. It had to do with the notion -- and -- and fair enough, they were devising their portfolio strategy on the basis of a -- a -- what they considered to be -- and legitimately, the average professor and -- and I felt that the average professor's profile was changing rapidly and, therefore, the -- the portfolio selections were not as attuned to the notion that baby boomers, people coming in, were having a very different concept of what they would require it, the degree of paternalism they should have in their management, then the cohort that was, at the time I served, fifty (50) or sixty (60) and about ready to retire.

THE CHAIRPERSON: Thank you, sir.

Mr. Williams...?

MR. BYRON WILLIAMS: Mr. Chairman, I wonder if I could have just three (3) minutes to consult with the witnesses. I have one (1), it appears to me, might be a typographical correction we can make and then I -- and then also one (1) additional question but I just wish to discuss it.

THE CHAIRPERSON: Okay, we'll just take the break now then.

MR. BYRON WILLIAMS: Thanks.

--- Upon recessing at 2:45 p.m.

--- Upon resuming at 3:05 p.m.

THE CHAIRPERSON: Mr. McCulloch...?

MR. KEVIN MCCULLOCH: Mr. Chairman, I was willing to wait until Mr. Dawson begins his cross, and I can file -- I have a number of exhibits -- unless they've already been distributed, in which case I'll try to find my copies.

(BRIEF PAUSE)

MR. KEVIN MCCULLOCH: Thank you, Mr. Chairman. We have responses to a number of undertakings, and with the Chair's permission the first one (1) is Undertaking Number 19, provide the actual amount spent on land from the forecast $8 million. That will go in as MPI Exhibit Number 18.

--- EXHIBIT MPI-18: Answer to Undertaking Number 19, provide the actual amount spent on land from the forecast $8 million.

MR. KEVIN MCCULLOCH: Undertaking Number 20, provide a breakdown of business process review expenditures. That's MPI Exhibit Number 19.

--- EXHIBIT MPI-19: Answer to Undertaking Number 20, provide a breakdown of

business process review
expenditures.

MR. KEVIN MCCULLOCH: Undertaking number 23, MPI to provide the data processing costs attributed to basic and associated with the business process review for a number of years, that's MPI Exhibit Number 20.

--- EXHIBIT MPI-20: Answer to Undertaking number
23, MPI to provide the data
processing costs attributed
to basic and associated with
the business process review
for a number of years.

MR. KEVIN MCCULLOCH: Undertaking Number 24, MPI to provide the amortization costs attributed to basic, MPI Exhibit Number 21.

--- EXHIBIT MPI-21: Answer to Undertaking Number
24, MPI to provide the
amortization costs attributed
to basic.

MR. KEVIN MCCULLOCH: Undertaking Number

25, MPI to provide the compensation costs, if any, attributed to basic, associated with the business process review. That's MPI Exhibit 22.

--- EXHIBIT MPI-22: Answer to Undertaking Number 25, MPI to provide the compensation costs, if any, attributed to basic, associated with the business process review.

MR. KEVIN MCCULLOCH: Undertaking Number 26, MPI to provide an estimate of full-time equivalence flowing from the basic program, MPI Exhibit Number 23.

--- EXHIBIT MPI-23: Answer to Undertaking Number 26, MPI to provide an estimate of full-time equivalence flowing from the basic program.

MR. KEVIN MCCULLOCH: Undertaking Number 27, MPI to provide the numbers regarding the budget to basic and corporate as of August 31st. That's Exhibit Number 24.

--- EXHIBIT MPI-24: Answer to Undertaking Number 27, MPI to provide the numbers regarding the budget to basic and corporate as of August 31st.

MR. KEVIN MCCULLOCH: Undertaking Number 28, dealing with police-reported information, deaths and other accident information, that will be MPI Exhibit Number 25.

--- EXHIBIT MPI-25: Answer to Undertaking Number 28, dealing with police-reported information, deaths and other accident information.

MR. KEVIN MCCULLOCH: Undertaking Number 29, MPI to advise, leaving aside the second-phase GDL, focussing on the second-phase training, two (2) other jurisdictions that are part of the broader survey, do they employ some form of second-phase training? Response to that undertaking is Exhibit Number 26.

--- EXHIBIT MPI-26: Answer to Undertaking Number

29, MPI to advise, leaving aside the second-phase GDL, focussing on the second-phase training, two (2) other jurisdictions that are part of the broader survey, do they employ some form of second-phase training?

MR. KEVIN MCCULLOCH: Undertaking Number 31, MPI to provide the differential for motorcycles for 2008 and how they've been -- how these numbers have been determined for 2009, MPI Exhibit Number 27.

--- EXHIBIT MPI-27: Answer to Undertaking Number 31, MPI to provide the differential for motorcycles for 2008 and how these numbers have been determined for 2009.

MR. KEVIN MCCULLOCH: And finally, Undertaking Number 32, MPI to indicate what the net income for basic will be in the first quarter, MPI Exhibit Number 28.

--- EXHIBIT MPI-28: Answer to Undertaking Number 32, MPI to indicate what the net income for basic will be in the first quarter.

(BRIEF PAUSE)

THE CHAIRPERSON: Mr. McCulloch, I think there's -- perhaps I've got it -- MPI Exhibit Number 28, is that Undertaking 31?

MR. KEVIN MCCULLOCH: Undertaking 32 by our count, Mr. Chairman.

(BRIEF PAUSE)

THE CHAIRPERSON: Thank you, Mr. McCulloch, we're fine now.

MR. KEVIN MCCULLOCH: Thank you, Mr. Chairman.

THE CHAIRPERSON: I was missing one (1) exhibit. Mr. Williams...?

MR. BYRON WILLIAMS: Yes. Hopefully just two (2) questions. One's a typographical one.

RE-DIRECT EXAMINATION BY MR. BYRON WILLIAMS:

MR. BYRON WILLIAMS: Dr. Simpson, we'll give Dr. Hum a rest, if you could turn to page -- well, the heading in your evidence, re: The Amount of Foreign Equities in the MPI Portfolio?

DR. WAYNE SIMPSON: Yes.

MR. BYRON WILLIAMS: And in the bound version it would be page 8?

DR. WAYNE SIMPSON: That's correct.

MR. BYRON WILLIAMS: And Dr. Simpson, I'll -- I'll turn your attention to subheading or the little "a," small "a" in the -- in the middle of the page. And you'll see in brackets, the statement:

> "As noted..."

Or you'll confirm for me that you see in brackets the statement:

> "As noted, MPI's new target portfolio favours Canadian over US equities on a four to one (4:1) basis."

Do you have any correction you would make -- wish to make to that -- that statement?

DR. WAYNE SIMPSON: Yes, if you -- you'll see from Table 1 that that is now -- should be three to two (3:2); it was simply a typo carried over from the old target, which was four to one (4:1).

MR. BYRON WILLIAMS: And -- thank you,

Dr. Simpson -- and just a final question. There's been a fair -- fair bit of discussion about real return bonds versus real estate in terms of the relative merits as hedges against inflation.

And just so I can understand the -- the position of yourself and Dr. Hum, given your -- your advice to retain a position in real estate -- excuse me, Real Return Bonds, are you suggesting that -- that the portfolio should have less in real estate and infrastructure? Or -- or what's your thinking in that -- that area?

DR. WAYNE SIMPSON: Well, this is a good point, because most of the discussion has been suggesting at least a tradeoff between Real Return Bonds and real estate and infrastructure. Well, that wasn't really the intent of -- of our discussion.

It's quite possible that the Real Return Bonds would trade off against other bonds in the bond portfolio and its percentage of the total portfolio would remain at 60 percent, but that there might be other -- other tradeoffs, too. So there was no -- you know, it's quite possible that real estate and public infrastructure could be added to the portfolio along with Real Return Bonds and both could have some effect in hedging against inflation.

MR. BYRON WILLIAMS: Thank you. Mr. Chairman, I want to thank all parties and the Board for their patience and thank Hum -- Dr. Simpson and Dr. Hum for their -- their evidence and ask that they be excused.

THE CHAIRPERSON: Yes, thank you very much, Dr. Hum, Dr. Simpson. Nice to see you again.

(CAC/MSOS PANEL STANDS DOWN)

THE CHAIRPERSON: We'll move now to -- thank you, Mr. Williams -- move now to Mr. Dawson. Do you want to relocate, Mr. Dawson, or do you want to do it from there?

MR. ROBERT DAWSON: I'll relocate, Mr. Chairman. Thank you.

MPI PANEL RESUMED:

WARD KEITH, Resumed

MARILYN MCLAREN, Resumed

DON PALMER, Resumed

OTTMAR KRAMER, Resumed

CONTINUED CROSS-EXAMINATION BY MR. ROBERT DAWSON:

MR. ROBERT DAWSON: Good afternoon,

members of the MPI Panel.

Ms. McLaren, I heard in the opening statement that your lawyer, My Learned Friend, Mr. McCulloch, thought perhaps I might be asking a bunch of irrelevant questions, and I must say I have tremendous respect for Mr. McCulloch and he's never wrong, so let me ask you: Do you like puppies?

MS. MARILYN MCLAREN: Yes.

MR. ROBERT DAWSON: Let's turn to an even more irrelevant question then, the role of the Public Utilities Board.

Would you agree with me that the primary function of this Board is to fix what we'll call just and reasonable rates?

MS. MARILYN MCLAREN: Yes, for the basic compulsory Autopac program.

MR. ROBERT DAWSON: And I'm going to suggest to you that there are especially three (3) considerations that this Board would take into mind, the first being what we'll call economic efficiencies, which would be a way in which to say that the monopoly under regulation is using its revenues in a way that is not wasteful, shall we say?

MS. MARILYN MCLAREN: Yes, I believe that's fair.

MR. ROBERT DAWSON: And of course another consideration the -- the Board fixing just and reasonable rates would consider itself to be looking at, would be to ensure that there are some fair returns for the monopoly under regulation?

MS. MARILYN MCLAREN: In a more general sense I think that would be fair. This particular monopoly in question is -- is mandated to break even.

MR. ROBERT DAWSON: And it certainly would be appropriate for this Board to consider, in fixing just and reasonable rates, appropriate cost allocation methodology.

It's it's appropriate for the Board to consider that, isn't it?

MS. MARILYN MCLAREN: Yes.

MR. ROBERT DAWSON: Would you also agree that given the fact that the -- that the applicant Corporation is a monopoly, that it doesn't obviously face competition, at least insofar as basic insurance is concerned in this province?

MS. MARILYN MCLAREN: Yes, the basic program is -- is a monopoly.

MR. ROBERT DAWSON: And would you accept that the function of the Board in many ways is to operate as a proxy for competition?

MS. MARILYN MCLAREN: I think in the broader sense of monopoly regulation that that probably is -- is true. I'm not sure the extent to which that -- that particular perspective has come into play in -- in these proceedings.

MR. ROBERT DAWSON: Well, I think what I mean by that is that without regulatory oversight and the fixing of just and reasonable rates, would it not be possible for any regulated monopoly, including this applicant, to, shall we say, assert or exert monopolistic pressure upon consumers who have no choice but to buy from you?

MS. MARILYN MCLAREN: Again, in a general sense. I don't know the extent to which that is true in this particular case, given that it is a particular product. It's an insurant -- an insurance program that is the monopoly in this case, not the Corporation. The particulars of that insurance program are specified in law through the MPIC Act and its regulations, so the opportunity to do some of the things that -- that you just referred to, I think, are somewhat limited, given that this is a program that's a monopoly and the specifics of the program are specified in law.

MR. ROBERT DAWSON: I think we can move on then.

You'll recall, I believe, that this Board ordered over the past years and also recommended that MPI implement a comparative benchmark study of the way in which it handles PIPP, Personal Injury Claims.

Am I correct?

MS. MARILYN MCLAREN: Yes, definitely.

MR. ROBERT DAWSON: And it's my understanding that the applicant has not filed that study.

Am I correct?

MS. MARILYN MCLAREN: Well, that's right but if I look back at the most recent order, and you know, not -- not only that but this one in particular, what we were asked to file is information with respect to the progress towards that goal. That we did.

MR. ROBERT DAWSON: So just for the record you're referring to last year's order, which I believe is one fifty zero seven (150-07).

Am I correct?

MS. MARILYN MCLAREN: That's the one.

MR. ROBERT DAWSON: You seem to have that order in front of you. Do you remember an order arising out of a rate application for the 2004 year in which there was an order for that benchmark study?

MS. MARILYN MCLAREN: I think that was

the '04 proceedings; for the '05 insurance year was the first year that that surfaced.

MR. ROBERT DAWSON: I'll accept that as -- as me being corrected, but with respect to that correction, do you agree that there was an order that there should be a comparative benchmark study file?

MS. MARILYN MCLAREN: Yes, that was the order, in 148/'04.

MR. ROBERT DAWSON: And that -- just -- not trying to belabour it, because I do want to move onto other things. I just want to make sure that I've got this. I know that Mr. Saranchuk and Ms. Everard covered most of the questions in this area; I just would like to summarize.

So with respect to that 2005 rate year application, the corporation did not file the ordered benchmark study.

Am I right?

MS. MARILYN MCCLAREN: Well, again, 148/'04 talks about filing a summary of the benchmarks established by the Corporation, and in the -- I believe it was in the '06 GRA, we filed a benchmark framework ,which was the work done to that point in time, which basically was our summary of the benchmarks which we intend to use going forward.

So that was -- we filed a summary of the benchmarks that we had established at that point; we did that in the next year's proceedings.

MR. ROBERT DAWSON: Okay. I -- I have your position and it's clear, and when you and I had a similar conversation in 2006, in the context of that year's rate application, we canvassed what was being done at that point, so I don't think we have to go into that any further.

If I could give Mr. Palmer the opportunity to clarify something that he may have misspoken. If he could be kind enough to turn to the transcript for the 29th of September at page 731. And this is just going to be one (1) line, so he may want to turn to it but I don't think anyone else need.

(BRIEF PAUSE)

MR. DON PALMER: I HAVE IT, YES.

MR. ROBERT DAWSON: It'S a conversation between you, Mr. Palmer, and Mr. Williams in which he's asking, among other things, about the benchmark study, I think. And specifically on page 731 at lines 18 and 19, you seem to give an answer, if I've read it correctly, that would suggest the Corporation is doing nothing with respect to the benchmark analysis.

So I'll play the role of Mr. Williams starting on page 731 line 14, where he says:

"And we don't have that more thorough
benchmark analysis though, Mr. Palmer,
because the Corporation is still
working on it. Is that right?"

And you can play the role of Mr. Palmer, and your reply at lines 18 and 19 is:

MR. DON PALMER: "We're not working on that, no."

Now, may -- may I clarify --

MR. ROBERT DAWSON: That's exactly now my next question. What did you mean by that, because it certainly sounds like you're smoking cigars on the bench besides doing work.

MR. DON PALMER: The clue to that, as I've learned in looking at these transcripts, is actually on page 730. So if we look at page 730 we were talking about TI.5, which is the comparison of MPI and ICBC and SGI. We weren't specifically talking about the benchmarks as they relate -- pertain to PIPP, which is what -- my understanding is that the orders pertained to, those PIPP benchmarks. This -- as far as my understanding, with the context that that question was being asked was not with relation to the PIPP benchmarks.

MR. ROBERT DAWSON: Thank you, Mr. Palmer. I just wanted to give you the chance to clarify what at least on the surface looked like a problematic answer.

MR. DON PALMER: Thank you for that, Mr. Dawson.

MR. ROBERT DAWSON: While I have you, Mr. Palmer, let me also try and give you a chance to redeem yourself. My Learned Friends Mr. Saranchuk, Ms. Everard, Mr. Oakes, and Mr. Williams, have all picked on you for not being Carnac the Magnificent, namely they've all pointed to various instances in which the Corporation has filed over the past years forecasts and projections and then they're somewhat disappointed that your forecasts and projections don't quite coincide with the way in which the real numbers turned out.

Would that be a fair, quick summary of what seems to have been happening so far?

MR. DON PALMER: There has been some questioning regarding the differences between actuals and forecasts, yes.

MR. ROBERT DAWSON: And in your reply, you've often said that forecasting and estimating and indeed making projections is not the same as making predictions.

Am I correct in making that distinction?

MR. DON PALMER: I don't recall saying that this year, but I know that I've said that in past years.

MR. ROBERT DAWSON: You did, however, say in reply to a question I believe from My Learned Friend, Mr. Williams, that where three (3) or four (4) years in a row show that the numbers are different than forecast or predicted, that may give rise to a trend or suggest that something may be wrong in the modelling.

Would that be fair?

MR. DON PALMER: I wouldn't characterise it as being something wrong in the modelling. I would characterise that as maybe being a change in the underlying environment. And if I may take a moment and -- and go down the road that Mr. Williams often goes and -- and talk about rolling dice.

And in a forecast, if I was going to forecast what the roll of a dice would be for year after year after year after year, I would say that that would be three and a half (3 1/2); that's the expected value of a dice roll. And that also means that that's a result that can never happen, but on a forecasting basis it'd would be perfectly accurate.

So in a given year, I might roll a one (1) and then I roll a two (2) and then I roll a one (1) again, and certainly those results are absolutely plausible and possible and, you know, not that unlikely. If I continue to roll ones (1s) and twos (2s) year after year after year after year, I certainly might start to suspect that my dice are loaded, that there is a fundamental assumption that's being made with regard to me rolling a fair dice that may not be completely accurate.

So at that time that you -- you look after two (2) or three (3) or -- or four (4), in the case of a dice, maybe more than that, years when you're under-forecasting and you start to investigation the reason why, we're now in the fourth year and that's -- we start to investigate the reason why. So -- so we are -- as we always do, monitor our assumptions and -- and that's no different this year.

MR. ROBERT DAWSON: I regret to say, Mr. Palmer, that I understood exactly what you were saying, which disqualifies you from writing and editing Professor Hum's next book.

Now, I see sitting forlorn at the end of the panel, Mr. Keith, wondering when, when will he turn to me and that moment has come for you, Mr. Keith. Let's talk about customer service.

You'd agree with me and perhaps you've had the opportunity to review some discussions that I've had with your predecessor, Mr. Bedard, but we'll focus on things that you know.

The Corporation keenly monitors the level at which customer -- customer satisfaction and service is provided; am I correct?

MR. WARD KEITH: Yes, that's correct.

MR. ROBERT DAWSON: And you do that largely first by establishing shall we say -- I use the word, "standards," but I know that in the course of asking my Information Requests there seemed to be some exception taken to that term. But what I mean when I say "standards" is there are certain benchmarks, certain expected performance levels, in short certain standards, that the Corporation sets for itself and it hopes to meet.

So would that be fair to say that that's a starting point in terms of measuring customer service and satisfaction?

MR. WARD KEITH: That's correct with respect to the customer service standards program. We also have surveys that we conduct of claimants and of customers with respect to their satisfaction with the services that we provide.

MR. ROBERT DAWSON: And you've anticipated the next portion of my question which does relate to surveys. I know through my earlier questioning of Mr. Bedard that these surveys also encourage the Corporation to test its actual service against hoped-for service and far -- as far as the public is concerned, in terms of their perception of what they're receiving.

Am I correct on that?

MR. WARD KEITH: Yes, I think that's accurate.

MR. ROBERT DAWSON: And I know that you're relatively new to your current position, but would you be able to confirm that really as far as it comes to establishing standards and so far as it comes to running these surveys, really not much in a general sense has changed over the past five (5) or so years?

MR. WARD KEITH: Yes, there are periodic changes and updates made to the service standards, as well as to the survey questions, but overall the framework is the same.

MR. ROBERT DAWSON: I notice over the years that when it comes to customer surveys, especially relating to PIPP claims and the way in which the Corporation handles those claims, that the standard or shall we say satisfactory measure that the Corporation sets for itself, seems to be considerably lower in percentage, overall percentage, than it is for other areas of customer service.

Is my overview correct?

MR. WARD KEITH: The range is generally 10 percent lower than property damage claims.

MR. ROBERT DAWSON: You'd agree with me that by setting a lower standard first you're presumably trying to model what is a reasonable as opposed to idealistic outcome?

Am I correct?

MR. WARD KEITH: Yes, I think the standard is intended to recognize that the claims are very different; the nature of the claim is very different than a property damage claim. The claim is itself more complex and the outcomes are typically quite different.

MR. ROBERT DAWSON: Would you expect -- accept rather -- would you accept, Mr. Keith, that another consideration is given that bodily injury is involved, the emotional consideration and impact upon the claimant may indeed be higher?

MR. WARD KEITH: Yes, and I had intended that when I spoke about the complexity of the claim.

MR. ROBERT DAWSON: Would you also agree

that those who are cynical might say that a lower standard also means that it's easier for the Corporation to reach that lower goal, rather than strive to reach more lofty goals?

MR. WARD KEITH: That may be the opinion of cynics, but it's certainly not the opinion of the Corporation.

MR. ROBERT DAWSON: You'd agree with me that as far as when I look at the annual report for example or any of the other documents that are filed the Corporation really does very little when it tries to substantiate the reason for this lower standard overall satisfaction level that it sets for itself in the context of personal injury claims, as opposed to any other bracket of claims that it handles?

MR. WARD KEITH: I'm sorry, could you repeat the question, Mr. Dawson?

MR. ROBERT DAWSON: Sure. Let me try and rephrase it more simply.

There's not much in the material out there that helps someone -- that helps someone essentially not be cynical, that helps someone see the point of view as to why the Corporation sets a lower standard when it comes to PIPP claims or the handling of personal injury claims, more precisely.

Would you agree with that?

MR. WARD KEITH: Well, I think in terms of these proceedings that we have provided the rationale for that -- for that target.

MR. ROBERT DAWSON: Okay. I have your answer.

In the course of the Information Request that the Manitoba Bar Association presented there were a number of Information Requests which made reference to the intake process by which claims are handled. And I don't think you need to turn to it, but just for the sake of the record I'll indicate that I'm talking about the First Round 24, and the Second Round 12, but we'll -- we'll just talk in general terms. If you'd like to turn to it I can wait. That's fine.

MR. WARD KEITH: That's fine, Mr. Dawson.

MR. ROBERT DAWSON: And in the First Round of Information Requests, the question was posed as to requesting a copy of the script by which your call centre handles claims that are coming in from, and the examples that were given in that were persons who might have coverage for only pleasure use or that might have a restriction on their driver's licence.

Do you remember that?

MR. WARD KEITH: Yes.

MR. ROBERT DAWSON: And in both cases the Corporation responded that there is no script.

Do you remember that answer?

MR. WARD KEITH: Yes.

MR. ROBERT DAWSON: And then later in the Second Round at Question 12, the Corporation clarified saying, well, there are instructions but there's not a -- a formal script.

Is that also correct?

MR. WARD KEITH: Yes.

MR. ROBERT DAWSON: So -- and again, this just by way of clarification, when you said "no script," really what you were saying is Dawson, you idiot, you've asked the wrong question, we don't give them a script, but we do give them instructions. That's really what you were trying to say but more --

MR. WARD KEITH: Yeah.

MR. ROBERT DAWSON: -- subtly?

MR. WARD KEITH: Yeah. Well, certainly the latter half of that.

MR. ROBERT DAWSON: The subtle part.

Let us take as an example an individual who calls the claim centre and, for example, has a restriction on the insured's driver's licence, shall we say, in may case, for example, I'm required to wear glasses.

Are you with me so far, Mr. Keith?

MR. WARD KEITH: Yes. Except that they wouldn't call the claim centre, they'd call the call centre.

MR. ROBERT DAWSON: All right. Thank you for the correction.

So when our bug-eyed friend calls the call centre and reports an accident, one (1) of the questions at some point the call-centre operator will ask is, were you wearing your glasses at that time.

Am I correct?

MR. WARD KEITH: Yes.

MR. ROBERT DAWSON: And if that person answers "Yes," then presumably the claim proceeds on to the next stage of processing, among other things; other questions will be asked.

Am I right?

MR. WARD KEITH: Yes.

MR. ROBERT DAWSON: And if the person were to answer "No," is it possible that the Corporation would refuse to -- to, well, to accept the claim as valid?

MR. WARD KEITH: Well, the -- the answer would be recorded in the claim system with a "No," and then the additional questions with respect to opening the claim would be asked and answered. And then if there were issues with respect to really any of the questions that were posed to the claimant then arrangements would be made through the call centre for an interview with an adjuster responsible for that claim.

MR. ROBERT DAWSON: So I'm just using the example of restrictions on a driver's licence, but your answer moves us helpfully forward to suggest that the claim centre does ask questions; the answers to which might give rise to problems for the claimant's eventual claim.

Am I correct?

MR. WARD KEITH: Yes, I -- yes.

MR. ROBERT DAWSON: And when a claimant contacts the call centre to initiate the claim, there's no information given by the call-centre operator as to the significance of these questions that are being asked, is there?

MR. WARD KEITH: There is certainly discussion around why the question is being asked, if that answers the question.

MR. ROBERT DAWSON: So when someone who has a restriction on their driver's licence calls to report a fender-bender, a helpful conversation is likely to occur along these lines. The call-centre operator will say: I'm about to ask you a question, the answer to which may disqualify you to your insurance coverage. Were you wearing glasses at the time of the accident?

Is that how it goes?

MR. WARD KEITH: No, I wouldn't think that's generally how it goes.

MR. ROBERT DAWSON: So when you say that there's a conversation what do you mean actually happens?

MR. WARD KEITH: Well, again there are no scripts but with respect to the instructions the call centre representative would likely inform the person reporting the claim that they are required to wear glasses or restrictive lenses while -- sorry, corrective lenses while operating a vehicle, and were you in fact wearing those corrective lenses?

MR. ROBERT DAWSON: So there would be a preliminary statement of a certain fact and then a question seeking confirmation of that fact.

That's how the call centre would treat these incidents, is that right?

MR. WARD KEITH: Again, generally, yes.

MR. ROBERT DAWSON: When you say generally, am I supposed to guess what? About half of the time?

MR. WARD KEITH: I wouldn't be comfortable in putting a percentage around it. Generally I think that the information is positioned so that the customer knows why the question is being asked.

MR. ROBERT DAWSON: The fact that you're not comfortable to give me a figure suggests to me that the Corporation doesn't actually track compliance with the -- of the useful policy that you're announcing here.

Would I be correct to say that there's no deliberate tracking of whether or not a preliminary statement of fact followed by a request for confirmation is ever asked in many of these cases?

MR. WARD KEITH: There is tracking of the calls that are received through the call centre.

MR. ROBERT DAWSON: That might be but that wasn't my question. I'm asking you do you bother to track the fact whether or not a call centre operator has stated in the way that you've illustrated this call should be handled, and basically complies with what is your expectation as to how it should happen?

MR. WARD KEITH: I believe that that -- my response would be that we do track that; that one (1) of the questions that we do track through our customer services standards program, which is done by supervisory internal audit, internal measure, is whether or not as part of reporting the claim the customer was given all of the information that they needed in order to -- to make their claim.

MR. ROBERT DAWSON: All the information needed. Who determines what information is needed?

MR. WARD KEITH: That would be determined on a claim-by-claim basis, as with on the front-side of the business, when we do surveys or measure customer service standards through the broker network, similarly depending on the type of transaction, based on the business exchanged at that time, was sufficient information provided for the customer to make an informed choice. That's related to the front-side of the business and there are similar measures on the backside.

MR. ROBERT DAWSON: At the risk of becoming philosophical, whenever one tells me that they're trying to test perception, I always wonder whether or not we're actually trying to answer the question whether or not it's what a particular customer thought was the information that's needed, or whether it's a reasonable person's objective assessment of what that person needed.

Which is it?

MR. WARD KEITH: It's both. There are internal measures, where we measure our expectation and then there are external measures where we measure from the customer's perspective, whether they believe they received the information that they required.

MR. ROBERT DAWSON: You prepared carefully for these hearings today, didn't you, Mr. Keith?

MR. WARD KEITH: I believe I did.

MR. ROBERT DAWSON: And am I correct to say that you're the head of the department that would oversee the way in which call centres try and provide information that customers need?

MR. WARD KEITH: No, that wouldn't be correct.

MR. ROBERT DAWSON: Point the finger to someone else then.

MR. WARD KEITH: Excuse me?

MR. ROBERT DAWSON: If it's not you, there are three (3) other bodies on the panel, who should I ask my question to?

MR. WARD KEITH: You can ask your question to me, but I'm not the person who is responsible for call centre operations.

MR. ROBERT DAWSON: Does the person --

MR. WARD KEITH: Sorry -- nor -- nor is anyone directly on the panel.

MR. ROBERT DAWSON: Does the person who is responsible for call centre operations report to you, Mr. Keith?

MR. WARD KEITH: No.

MR. ROBERT DAWSON: So, let's review this because now -- this was going to be a simple question but now I'm wondering if we're missing witnesses.

MS. MARILYN MCLAREN: Let me interject if I might, Mr. Dawson.

MR. ROBERT DAWSON: If you would?

MS. MARILYN MCLAREN: Think of the call centre as somewhat of an internal service bureau. They respond to questions from the public on any aspect of the Corporation's activities. They are not responsible in any way, shape, or form for establishing policy and expectations with respect to any of those lines of business or services.

A big part of what the call centre does, it not only answers questions about claims, it sets up new claims. It -- it establishes claims that customers report into the call centre.

Mr. Keith is responsible for the claims function with respect to establishing the expectations of the call centre with respect to the work they do there. So no, the manager of the call centre isn't on the panel.

The manager of the call centre reports to someone who reports to me, but the call centre is responsible for doing the work associated with claims reporting according to the standards of the claims division. Mr. Keith is responsible for that aspect of it.

MR. ROBERT DAWSON: I appreciate the clarification. I'm going to come back to you, Mr. Keith, because it seems that you're the one who sets the standards that are being measured there, am I right?

MR. WARD KEITH: Ultimately, I'm responsible for the standards that are in place, yes.

MR. ROBERT DAWSON: As long as someone's willing to fall on the grenade, I'm prepared to pull the pin.

What's troubling me, and I'm going to give you a chance to just explain yourself, is that when we began down this road, which I thought would take us along a scenic ocean view and instead ended up down a back alley where thugs are surrounding us, you told me that generally the call centre complies with your expectation that they'll state a fact and then seek confirmation of that fact.

Do you remember that? Do I have that right?

MR. WARD KEITH: Yes.

MR. ROBERT DAWSON: And then I said to you, Mr. Keith, what do you mean generally? Do you mean more than 50 percent and you said well, there are no numbers. Do I got -- do I have that correct as a recollection?

MR. WARD KEITH: I -- I said I wouldn't be comfortable giving you a percent.

MR. ROBERT DAWSON: Well, let's shortcut this down short. Is it just that you don't know what the number is, but if you had time you could find out what it is, or is it that the number doesn't exist?

(BRIEF PAUSE)

MR. WARD KEITH: I would say the number doesn't exist.

MR. ROBERT DAWSON: And why, Mr. Keith, have we been talking about the standards and the numbers that you set?

You've -- you've just gone on at fairly great length telling me that there are measurements and that you listen to the calls and, presumably, someone's tracking this on -- in your words on a case-by-case basis?

Was there just a misunderstanding or -- I don't understand why you were telling me this then.

MR. WARD KEITH: Mr. Dawson, what I was referring to was the -- was a broader -- a broader assessment of the question: Were customers given the information that they required when they reported the claim, not specific with respect to, did they have restrictions and were they alerted to the fact that restrictions may impact their right to present a claim or to have a claim paid and with respect to whether or not they were satisfying those restrictions.

So the service standards that are measured are -- are broader and not as specific as to get to the specific questions that you referred to and that we discussed when we first started this exchange.

MR. ROBERT DAWSON: All right.

MS. MARILYN MCLAREN: And if I might interject again to bring that to --

MR. ROBERT DAWSON: I was going to bring it to an end, but you've been --

MS. MARILYN MCLAREN: That's okay. This is important and I think I'd like to bring it to a somewhat different level of detail as well.

The rolled-up question is exactly as Mr. Keith said, but he also talked to you about internal measures and external measures. And the internal measures are established -- the -- the measures themselves are established within the customer service standard framework. The measurement of staff performance against those standards happens at a very detailed level by the supervisors in the call centre and we -- with no exception, do they -- they go through a statistically meaningful number of phone calls and track performance against the standard in every single aspect of the call.

And if someone neglected to provide the context of someone who was or was not wearing glasses, it would be the same, failure to comply with expectations as it would be if it was a wildlife claim and they were going to be expected to pay their five hundred dollar ($500) deductible, if that was the case.

It is a -- a measurable assessment of compliance to the standard at a -- at a detailed phone call by phone call, question by question in each phone-call process.

So we don't place any more or any less importance on different aspects of that staff or we invest an awful lot of -- of time and resources training staff, we expect them to comply with the expectations. We have a statistically meaningful way of measuring their compliance against those expectations. Those who fail to comply, even if it is in two (2) cases out of a hundred

(100) and generally they do a good job, the two (2) cases are brought to their attention.

So when there is not compliance, I have a very high level of confidence through that process that it's followed up and dealt with on an employee-by-employee basis. The fact that we can't pull out a number that says, here's the number of times somebody didn't talk about the correctives-lenses restriction doesn't mean that it's not measured and tracked and dealt with and -- and efforts made to have no exceptions.

MR. ROBERT DAWSON: Let me ask you, Ms. McLaren, arising from your comment, you'd agree with me that it's important that the way in which claims intake operates, well, function according to the standards of -- that Mr. Keith, for example, is describing, namely, that people are given the information, in his words, it was information needed by those who are filing claims.

You'd agree with that, wouldn't you?

MS. MARILYN MCLAREN: Certainly it's important.

MR. ROBERT DAWSON: And you'd agree with me -- well, let's go on to the next stage, the reason why it's important, I'll suggest to you, is because most of the claimants who are contacted in the claims centre probably have an unfamiliarity, if not more, with the process that's involved.

In short, they're relying upon you to guide them through the claims process, am I correct?

MS. MARILYN MCLAREN: Yes, that's fair.

MR. ROBERT DAWSON: And where a claimant has filed a claim or is trying to file a claim and presumably relies upon MPI as part of that claim, where MPI's call centre employee doesn't comply with your standards and follow your instructions, that puts the claimant at a disadvantage, is -- would you agree with that?

MS. MARILYN MCLAREN: It could.

MR. ROBERT DAWSON: So I'll leave this. I just want to confirm just by way of summary here. I got to make sure that I've got this correct.

Mr. -- Mr. Keith, your preference, the way in which you would like to see call -- the call centre operators operating is as follows: When they're faced with one (1) of these sorts of questions or, indeed, whenever they're trying to -- well, let's go beyond that, whenever they're trying to extract information from the individual, you'd like them to provide the information that that customer needs before they give that information, is that correct?

Do I have that right?

MR. WARD KEITH: Yes, the context for which the question is being asked.

MR. ROBERT DAWSON: Okay. Thank you very much.

Mr. Keith, some quick-snapper questions, to use Mr. Saranchuk's friend -- or my -- my learned friend, Mr. Saranchuk's phrase.

In the Information Requests there was reference to presentations made to health care workers, and I see Mr. McCulloch already getting his binder out, and that's at the first round, question 12 of the MBA questions.

You're familiar that the -- that MPI sponsors or hires, contracts out presenters to give such presentations on health care topics; am I right?

MR. WARD KEITH: Yes, the presentations are typically done by members of our health care services team.

MR. ROBERT DAWSON: And according to the answer given at the second round, question number 9 of the MBA questions, you spent twenty-seven thousand five hundred dollars ($27,500) last year on hiring people to give these presentations, is that correct?

MR. WARD KEITH: No, that's not correct. The twenty-seven five was the budget for doing the presentations. It was exclusive of the contract costs for the health care providers that actually delivered the presentations.

MR. ROBERT DAWSON: Thanks for that correction.

Does the Corpora -- well, I presume that the reason that the Corporation makes these healthcare presentations is it believes that in the end it results in an ultimate cost saving for the Corporation.

Am I correct?

MR. WARD KEITH: Yes, that's -- I think that's fair.

MR. ROBERT DAWSON: And without going into too much detail, could you just give a couple of examples of the way in which these healthcare presentations might result in these kinds of cost savings for the Corporation?

MR. WARD KEITH: This falls under the category of practitioner liaison and it gives an opportunity for members of our healthcare services team to speak with other members of the medical profession, with respect to injuries, with respect to emerging treatments, with respect to disability timeframes, and with respect to opportunities for rehabilitation. And -- and so all of this information collectively we believe provides more information -- information sharing opportunities within the medical community.

MR. ROBERT DAWSON: So in my lay view, the theory is, is that if you, shall we say, convey to medical practitioners the latest developments in how to treat condition "X," that might ultimately either reduce the costs of providing care to that person or return that person to the workforce or to wherever that person wanted to be faster.

Is that an example that's possible?

MR. WARD KEITH: I think that's possible, yes. It -- there could be opportunities to introduce new treatment regimes as well as alternate methods perhaps, to help the patient to return to as close to pre-accident status as possible.

MS. MARILYN MCLAREN: Thank you, Mr. Dawson. Let me interject again. I think one (1) of the major groups that tend to be the focus of these presentations tend -- tend to be general practitioners, family doctors. The -- the -- luckily, the reality is that automobile injuries make up a very, very small percentage of the typical family doctor, or general practitioner's, caseload.

So it's not necessarily not just informing people of new and -- and emerging treatment protocols;

often it's helping general practitioners understand where -- when they may have reached -- when they may be reaching the limits of their expertise, and it's helping them to understand what -- what might reasonably be expected with respect to recovery from certain kinds of injuries. When they see claimants with those circumstances, they know earlier in the future to ask for the help and assistance of a specialist. Things like that.

So it really is -- is a way to help better patient outcomes by helping general practitioners understand more about these kinds of -- of injuries because they really do make up a small percentage of their -- of their caseload.

MR. ROBERT DAWSON: To put that in the context of a rate application hearing, essentially when you -- what you're saying is, is that better -- providing better care to a claimant effectively translates usually or hopefully into reduced claims expenses attached to that claim.

Is that right?

MS. MARILYN MCLAREN: Yes, agreed.

MR. ROBERT DAWSON: I may have missed it, but I don't see any evidence in the filing that suggests or that tracks the savings. Is -- at this point your contention that it's anecdotal and that you don't specifically track it, or is it possible to be tracked?

MS. MARILYN MCLAREN: I believe that it is highly unlikely that it would ever be able to be tracked, solely within the -- the context and the perspective of Manitoba Public Insurance. With fifteen thousand (15,000) injury claims, far, far fewer of those people injured badly enough to ever have to miss work -- you know, so I mean if you start wearing down, in terms of really where are those injuries that you really need to learn a lot about and help -- and help create the circumstances for a more positive outcome, it certainly would be anecdotal within this context.

Now we can go back to your conversation about what we believe the advantages of benchmarking within a broader community of organisations doing the same kind of work. So I think there certainly can be some measurable advantages shown, but not within a population of a million people and fifteen thousand (15,000) injury claims.

MR. ROBERT DAWSON: Thank you both for that additional information, as well as tying it into the benchmarking.

Mr. Chairman, I note the time, and I feel in many ways like the over enthusiastic child who has come late in the day for show and tell and wants to continue talking. I have approximately, I would think, ten (10) minutes left. I can wait and continue tomorrow, or I'm at the Chair's disposal and we can stop now.

THE CHAIRPERSON: I think you should continue now, if you are --

MR. ROBERT DAWSON: I'm happy to do so. Thank you, Mr. Chairman.

CONTINUED BY MR. ROBERT DAWSON:

MR. ROBERT DAWSON: These pretty much all fall into the category of quick-snappers, and I'll wait because I have a question for Ms. McLaren.

MS. MARILYN MCLAREN: I'm sorry, can you repeat that?

MR. ROBERT DAWSON: I -- I didn't -- I just was -- didn't want to ask the question. I'm now turning into the school mother.

Two (2) years ago, Ms. McLaren, you and I had a conversation about the way in which the Corporation chooses, or doesn't choose, to pursue extraterritorially licensed drivers, and also to pursue subrogation against the manufacturers of defective vehicles, in a very general sense.

And I'm not going to plague you on this;

do you -- do you have a recollection of that?

MS. MARILYN MCLAREN: Yes, limited.

MR. ROBERT DAWSON: Well, I don't want to tress be -- trespass beyond your recollection, so you'll tell me if I'm going too far.

I note in the course of this year's Information Requests, I asked a follow-up question, and the keen Mr. McCullouch's already turning to question -- Round One, Question 32, which dealt with the question of subrogated claims against extraterritorial drivers.

And the question asked essentially is: How many if any did the Corporation launch subrogated claims? And the reply comes back that MPI doesn't track that information.

You're able to confirm that answer is correct?

MS. MARILYN MCLAREN: Yes.

MR. ROBERT DAWSON: And again this may be unfairly stretching your recollections from two (2) years ago, so you'll tell me if it's unfair, but it's my recollection that in the course of talking about, among other things, the pursuit of extra torritory -- extraterritorially licensed drivers, you agreed with me that it was possible that subrogation against these drivers might in fact increase revenues. And -- well let's leave it at that.

Do you have any recollection of that, or am I going too far?

MS. MARILYN MCLAREN: No, clearly any money that was recovered from extraterritorial licensed and insured drivers that flowed back into the fund would reduce the expected incurred of those particular claims as -- compared -- if we had to pay them all ourselves.

MR. ROBERT DAWSON: I wonder if you have a comment then as to why the Corporation doesn't track how many, if any, such claims it pursued during the last fiscal year?

(BRIEF PAUSE)

MS. MARILYN MCLAREN: The department responsible for this work -- I -- I guess maybe the simple way to say it is -- is -- as I understand it, the department responsible for this work manages its case load sort of on a -- on a more global basis. It is not particularly focussed on fiscal year activities.

It will have a number of outstanding claims with it -- that it is trying to subrogate, whether they are extra-provincial, whether that is against, you know, convicted auto-thieves, whatever they are, but they don't necessarily track that on a fiscal year basis.

Much the same -- from a different perspective, but much the same conversation as some of Mr. Palmer's conversations with other members asking him questions in terms of the insurance year and ultimates, and we have a number of ways to look at things. And the subrogation department does not look at its case load on a fiscal year basis.

MR. ROBERT DAWSON: So then it's wrong to say the -- numbers doesn't exist; it's just that the number doesn't exist on a fiscal year, and that's what the question asked you to produce.

MS. MARILYN MCLAREN: I believe that to be true, yes.

MR. ROBERT DAWSON: Okay. Something for another year then.

There's reference in the course of the materials to the LEED certification, that's L-E-E-D certification, that the Corporation has pursued in connection with three (3) of its new buildings claims centres, am I correct in that summary?

MS. MARILYN MCLAREN: Yes, the Provincial Government has established a policy for all government, and including Crown Corporations, that new or -- or significant renovation or new building construction be built to silver LEED status.

MR. ROBERT DAWSON: And am I correct on this --

MS. MARILYN MCLAREN: Our intention is to go with -- to shoot for silver LEED status.

MR. ROBERT DAWSON: Am I correct to understand that the way in which LEED certification pursues -- or is -- is obtained rather, is that an engineer specifically trained in LEED, that is environmental design considerations, is specifically retained on the project? Is that the key way that it unfolds?

MS. MARILYN MCLAREN: Well, the LEED certification status is awarded or not when all is said and done. So we establish our goal of silver LEEDs in the design phase. It -- it actually has an influence on sites that -- that, you know, may or may not be suitable.

Every stage of the process, whether it's the architects, or -- or engineers, or designers, all the way through the process are working and all now are -- it would be part of the criteria actually if we were, you know, looking to award an RFP for any of those professions. We're looking for expertise in that area.

But when all is said and done, when it's built then someone from the LEEDs group in some fashion comes and audits the entire process and decides whether or not you have achieved the silver status. So it's not a done deal until it's all said and done and they come back and audit it from start to finish.

MR. ROBERT DAWSON: So that final certification process is something over which the Corporation has no control, is that right?

MS. MARILYN MCLAREN: Yes.

MR. ROBERT DAWSON: Let me turn to my penultimate topic, and this is dealing with data sharing. At the first round information requests, number 27 and following, a question had been posed as to the use by parties other than MPI of the motor vehicle and driver licensing data bases. And I note that you're turning to that now.

Have I roughly correctly summarized what you see there?

MS. MARILYN MCLAREN: Yes.

MR. ROBERT DAWSON: And I just want to make sure because I'm instructed to ask a specific question, there is such a thing as bulk information, which means the party receives a complete copy of the database, am I correct, as opposed to live interactive access?

(BRIEF PAUSE)

MS. MARILYN MCLAREN: Yes.

MR. ROBERT DAWSON: And just to highlight two (2) of the organizations on the list that received this bulk information, one (1) is CSIS, that is the Canadian Security Intelligence Service, am I correct?

MS. MARILYN MCLAREN: Yes.

MR. ROBERT DAWSON: And the other one (1) that I'm choosing to highlight is the War Amps of Canada, am I correct?

MS. MARILYN MCLAREN: Yes.

MR. ROBERT DAWSON: Turning to CSIS, are you -- or is the Corporation, rather, under any legislative obligation to share this information with CSIS?

(BRIEF PAUSE)

MS. MARILYN MCLAREN: Yes, we would be. Yes, we are.

MR. ROBERT DAWSON: And I don't want to put you on the spot so it may be something on which you may have to take an undertaking, but can you indicate the basis of your statutory obligation to produce that information to CSIS?

MS. MARILYN MCLAREN: It would be the same obligation to -- to provide information to law enforcement agencies.

MR. ROBERT DAWSON: I'm going to have to ask you, if I can, for a specific reference, and that may be unfair in the circumstance.

MS. MARILYN MCLAREN: We'll take that as an undertaking then.

MR. ROBERT DAWSON: Thank you, Ms. McLaren.

--- UNDERTAKING NO. 34: MPI to indicate the basis of their statutory obligation to produce the bulk information to CSIS

CONTINUED BY MR. ROBERT DAWSON:

MR. ROBERT DAWSON: When information is being provided by way of bulk to groups like CSIS, am I correct that among other things that they receive is the name of the person, their address, the date of birth, the height, eye colour, possibly weight?

Let's pause at that point.

MS. MARILYN MCLAREN: Well, first of all, we don't ask for or record weight; our staff don't estimate and we don't ask.

MR. ROBERT DAWSON: I, of all people, am heartened by that.

MS. MARILYN MCLAREN: Me too.

MR. ROBERT DAWSON: On the question of the driver licence photo, would that be supplied to CSIS? And I ask, even -- even though the question was posed in the course of the Interrogatory, I'm not entirely sure about the answer.

(BRIEF PAUSE)

MR. ROBERT DAWSON: And I'm open to an undertaking on that simple question if you'd prefer

MS. MARILYN MCLAREN: Maybe just a point of clarification if you want to, after this, make your request for an under -- undertaking more specific, but when we do a -- a bulk download it means that we give them -- maybe it was -- maybe they're asking for a bulk download of vehicle -- vehicle registration information.

We give them everything on the vehicle registration data base but not every single piece of data about every single record on that data base. For example, Winnipeg Parking Authority, they're looking to figure out how to mail parking tickets to vehicle owners. They don't have any interest in height and eye colour and driver licence photos or any of those things at all.

So even though it's bulk information it's still very specific in terms of what their need is and -- and we have to be -- we have to believe that the -- that the specific aspects that they're asking for are appropriate for what their need is.

So, no, I don't know that we give driver licence photos to anybody. You know, a lot of -- a lot of them, like Parking Authority, is that limited, they want to mail parking tickets to people. R.L. Polk doesn't even want names and addresses, they just want to know what kind of vehicles there are in Manitoba. So it is very situation specific to the legitimate requests that come in.

MR. ROBERT DAWSON: So let me ask you a "Yes," "No" or "I don't know" question. Does CSIS get a copy of everyone's photo that's taken for driver licensing? And if you can't answer I'm willing to take it by way of an undertaking.

MS. MARILYN MCLAREN: No, they don't.

MR. ROBERT DAWSON: Thank you. And I'd just like to confirm that when this information is released, as you've indeed indicated in your reply to 1-

30, the consent of drivers or vehicle insured is not sought, is that correct?

MS. MARILYN MCLAREN: Yes, that's right.

MR. ROBERT DAWSON: And let me move to my very last area of conversation with you today, unfortunately for me, and this should be fairly quick. It's been, it seems, a recurring concern for this Board that the way in which MPI has structured its affairs may remove extension and DVL operations from scrutiny that perhaps this Board would like to exercise. Would that be a fair summary of indications we've received over the past few years?

MS. MARILYN MCLAREN: Not quite. I don't think there's any risk of anything being removed. I don't think that oversight has ever -- I know the oversight has never been here. So I think that certainly is clearly the sense I have. The Board has written in its orders that it would like more jurisdiction than it has or has had.

MR. ROBERT DAWSON: And if I understood you correctly earlier in these particular proceedings, you had indicated in the context of releasing information in reply to a question from My Learned Friend, Mr. Saranchuk, that it might actually be harmful to the financial or economic interests of the Corporation to release some or to disclose some information in the context of extension. Do you remember that?

MS. MARILYN MCLAREN: Yes.

MR. ROBERT DAWSON: And just for the sake of confirmation, you'd agree, or at least you -- you continue to think that there was some information held by the Corporation when it comes to extension that if released would be financially or economically harmful to it in the context of competition from others, am I right?

MS. MARILYN MCLAREN: Absolutely. And I think that's when you start to get to a level of detail, you know. I mean, the -- the superintendent's report that we filed in response to an under -- request on undertaking is public information. The people who are competing with us know exactly what those reports say, follow it very closely.

So it's not like putting that information at that level of detail caused any harm to anybody. But when it comes to a level of detail, absolutely. We work very hard to continue Manitobans' practice of choosing us when they don't have to, and we want to continue to be able to work very hard at that.

MR. ROBERT DAWSON: There are two (2) arguments that often are made in reply to what you've just said and I'd like to give you the opportunity to respond to these arguments.

Now, the first one would be: So what if your extension business were harmed, you still got Basic and you've got it on a monopoly basis. You can recover through Basic.

MS. MARILYN MCLAREN: Well, I don't think it would be appropriate for the Corporation to be looking to recover anything through the Basic Compulsory Program.

The Basic Compulsory Program is specified in law; that's what the people of Manitoba believe -- the government of Manitoba believes should be -- must be purchased, and should be available on a guaranteed access basis to the motorists of Manitoba, and that does stand on its own. And the Corporation exists for the most part to operate that monopoly program.

Whether or not Manitobans are well served by having access to strong and robust competitive optional coverages and programs, they seem to think so at this point in view -- in time. I think it's -- it's our job at Manitoba Public Insurance to continue to make sure they have that kind of access, they have that kind of opportunity for -- for high quality products, well priced, readily accessible. That's very, very important to the people of Manitoba, as far as we can tell, because they're buying it from us.

So there really isn't, I don't think at all, a legitimate argument to say, Don't worry about it, you can pick it up out of Basic; that there's a legitimate balance between what is mandatory and what is not and a legitimate balance between what people have a choice over and what they don't. And the situation as it -- as it sits right now with the Corporation administering different lines of business, provides phenomenally good value to Manitobans across the spectrum, in our view.

MR. ROBERT DAWSON: And the second argument against what you're saying, and I'll again just throw it out and I think you'll be able to reference some of the things you've just said, is that you already have -- the Corporation already has a monopoly when it comes to Basic. Arguably in exchange for that, there should be complete transparency when it comes to operating extension, and even DVL.

What would be your reply on that?

MS. MARILYN MCLAREN: Well, I guess my reply, first of all, is that there's nobody in this room that really has control over that. Those are issues for the Legislature -- the duly elected representatives of the people of Manitoba.

I think there is significant transparency of the Corporation's activities, because it's a Crown corporation. And I think the fact that there should somehow be some price to be paid because we have the monopoly is -- that -- that's very -- from my perspective, a very odd view of what the Corporation has been asked by the government of Manitoba to do. It is administering a legislative program.

If it was given a charter, and said, Go away, come up with a Basic compulsory insurance program, run it as you see fit, and then you can do whatever else you want, and just generally let us know every once in a while how that works out for you, maybe there would be some basis to that kind of a perspective.But I think that -- that the critical thing is, is that even when it comes to extension, might -- those products, the coverages, are all in legislation, particularly the Basic Compulsory Program, but also extension. It's there in legislation.

The Government of Manitoba, on the DVL side of things, decides what are the criteria to pass or fail a driver test in this province; it's not the Corporation's jurisdiction.

So I think there's a significant amount of transparency. I think there's an inherent belief in most circles, clearly at this point in the government, that it is in Manitoban's best interests to have access to the kinds of extension services and products that the Corporation provides through legislation, and that the context of a Basic Compulsory Program specified in the legislation where the rates are reviewed and approved in this very public forum by the PUB, all told, and particularly, I guess, more recently as we've been talking about just a little bit, and will more in the new year, by pulling some of the services together, you can provide value that has yet -- really sort of raises the bar, in terms of what value is provided by Manitoba Public Insurance, in the context that we have.

So the fact that there is law about what exactly you have to buy to hold a driver licence, or get a vehicle registerednks for use on the road is specified in law. There's some particularly important parameters around that and that's what makes the regulatory framework so critical to the basic compulsory program.

And that's why, in my view, that's the -- the limit of where that value comes, to that specified mandatory universally available guaranteed access insurance program.

MR. ROBERT DAWSON: Now I'll take away the platform that I've given you and just ask you one (1) last question.

In the context -- I'm wondering if you're aware of that in the context of ICBC, the British Columbia Information and Privacy Commissioner issues two (2) orders numbered 1594 and 31299 that supports your position to refuse disclosure when it comes to extension and probably DVL as well.

MS. MARILYN MCLAREN: I knew that the Commissioner was involved, I knew that there was that sort of decision, and I certainly did not know the detail, that there was two (2) and that they ac -- the -- the references that you've provided, I'll take that, as you've said, but I knew the issue was there and the outcome was as you've stated.

MR. ROBERT DAWSON: I'm trying to be as irrelevant as Mr. McCulloch would like me to be. And, Mr. Chairman, I apologize for going past the promised ten (10) minutes, but that does conclude my questions, subject to the reply to the undertaking that I've requested.

Thank you, Mr. Chairman.

THE CHAIRPERSON: Thank you, Mr. Dawson. Thank you to the panel.

MR. KEVIN MCCULLOCH: Mr. Chairman.

THE CHAIRPERSON: Ms. Everard...?

MS. CANDACE EVERARD: I just had a couple of issues that I wanted to raise related to some of the undertakings given by the Corporation.

Firstly, number 3 related to advice of whether the external auditors had provided a management letter on the results of the external audit. I don't think that one (1) has been answered, and if I'm wrong, then correct me, but we were hoping to get that before tomorrow.

MR. KEVIN MCCULLOCH: You're not wrong, Ms. Everard, and -- and the -- the item that was taken under advisement was whether we would provide a copy not whether they had provided a management letter.

Obviously -- no, there was a management letter provided as part of the -- the audit and I can have Ms. McLaren speak to that tomorrow if you wish.

MS. CANDACE EVERARD: Thank you. I also just wanted to state for the record, I've noticed that the numbering that the Corporation's been using doesn't exactly jive with what the court -- court reporter has, so I've figured out what goes with what and I can read that in if that would people or people can see me. I just don't want them to be confused.

THE CHAIRPERSON: You might as well read it in then. Sure, go ahead, read it in.

MS. CANDACE EVERARD: Thank you, Mr. Chairman. It would appear that the numbering is in sync up to number 18 -- oh, pardon me, I have misspoken, up to number 14, so 1 through 14 are fine.

The one (1) with the -- or the one (1) that the Corporation has filed as number 16 is number 15 on the court -- on the court reporter's list. The one (1) that the Corporation has filed as number 18 is number 16 on the court reporter's list.

The one (1) the Corporation has filed as 19 is number 17 on the court reporter's list. Number 18 on the court reporter's list is still outstanding. Then there was one (1) that the Corporation filed as number 20, relating to the comprehensive breakdown of the BPR expenses, which is actually not on the court reporter's list but it was an undertaking.

The one (1) that the court reporter has listed as 19 has been answered by the Corporation as 23. The one (1) that the Corpora -- that the court reporter, pardon me, listed as 20 has been answered by the Corporation as 24.

The one (1) that the court reporter listed as 21 has been answered as 25 by the Corporation. The one (1) that the court reporter listed as 22 has been answered as 26(a) by the Corporation.

The one (1) that the court reporter listed as 23 has been answered as 26(b) by the Corporation. The one (1) that the court reporter listed as 24 has been answered as 27 by the Corporation.

Court reporter's 25 has been answered as 28(a). The court reporter's 26 has been answered as the Corporation's 28(b). The court reporter's 27 has been answered as 28(c) and the court reporter's 28 has been answered as 28(d).

And then from 29 through 32, which is the end of the transcript from last Tuesday, we're back in sync.

THE CHAIRPERSON: Thank you. Mr. McCulloch...?

MR. KEVIN MCCULLOCH: Mr. Chairman, I want to thank Ms. Everard for that. It -- it appears we were seeing undertakings all over the place and we were aware of the fact that we weren't in sync with the -- with the transcript but chose to -- to answer them the way we had recorded them.

On that point, and if the Chair wishes, we can do it now or we can do it tomorrow morning, but Mr. Palmer has an answer to an undertaking that we didn't accept and this was a request by Mr. Oakes with respect to the practice in SGI, and Mr. Palmer declined to give him an undertaking, has thought better of it, and is willing to provide that information on the record.

THE CHAIRPERSON: Let's have it. Mr. Palmer...?

MR. DON PALMER: Last week, Mr. Oakes and I had a conversation on wildlife claims and how they're attributed to -- for rate setting purposes.

And he produced an email from Mr. Greg Franks of -- of SGI that said that wildlife claims were coded as not at fault, and then went on to put it to me in a question, and I'll just read from 1067 of the transcript:

> "That suggests to me, Mr. Palmer, and perhaps you can confirm that it would be your understanding that SGI is not allocating the claims expense arising from a vehicle or a wildlife claim to the motorist involved because of that coding not at fault?"

And I disagreed with that statement and -- and we went back and forth. And then -- and then he asked me if I would take the undertaking as far as how exactly SGI did that and I declined on the basis that it wasn't germane to the application. I stand by that because rate methodologies of other jurisdictions are not necessarily germane to this hearing, I don't believe.

However, it certainly is most important to us that our good friends at SGI, in general, and -- and Mr. Franks specifically, that they are not misrepresented by anything that goes on in this hearing.

And certainly, I thought that Mr. Oakes' supposition that a finding of not at fault on a claim file expanding that into a rate or a claims attribution for rate setting purposes was a bit of a stretch and certainly, for instance, comprehensive claims are coded as not at fault and -- but still are attributed to a class for rate setting purposes.

So I -- I thought that in my own mind I would seek to clarify and I had a conversation with Mr. Franks, and I explained to him what happened and how his information was used by the CMMG, and put forth a more direct question basically saying, how do you attribute wildlife claims?

And his answer was that they are attributed directly to the classification involved. So that's exactly the same as MPI does it. Our treatment of wildlife claims, in all aspects, coding is not at fault. The application of deductibles on Basic and on an Extension basis and the attribution to the classification for rate setting purposes are exactly the same between MPI and SGI.

THE CHAIRPERSON: Well, thank you, Mr.

Palmer. I'm sure Mr. Oakes will appreciate that, as well.

Okay. We'll see you all tomorrow at 9:00. Thank you.

--- Upon Adjourning at 4:28 p.m.

Certified Correct

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Cheryl Lavigne, Ms.