

A STRATEGIC ANALYSIS OF A SOCIALLY
RESPONSIBLE INVESTMENT FUND
MANUFACTURING COMPANY

by

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ABSTRACT

This analysis focuses on a small investment fund manufacturing firm pursuing a differentiated focus strategy aimed at socially conscious retail and institutional investors. The firm's products and its target markets are described along with the structure of the overall investment fund manufacturing industry.

A five-factor analysis suggests that the firm seeks entry into an increasingly unattractive industry, in which slow growth and excess capacity are pushing companies to control costs and to seek greater economies of scale. Without cost-competitive scale, and with limited financial resources, the firm faces a tough challenge in taking its differentiated offering to the market, especially the institutional market.

A strategic fit exercise and a value chain exercise suggest that the firm has several important competencies and a strong brand that is a source of competitive advantage. However, it lacks sufficient access to distribution channels, which has become the industry's most important source of potential competitive advantage.

Final recommendations centre on the need to find a new strategic partner that can provide additional financial resources as well as access to major distribution channels.

DEDICATION

To my lovely wife and best friend Melissa, who endured MBA widowhood. I promise no more degrees for at least 10 years.

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Thanks to Deb Abbey at Real Assets, who taught me about being responsible. Thanks to Bob Walker at The Ethical Funds Company who introduced me to SRI.

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1 PRODUCTS / MARKETS AND OVERVIEW OF THE FIRM

Real Assets Investment Management Inc. is a Vancouver-based investment fund manufacturer. It manufactures and manages two mutual funds for the Canadian retail investing market as well as two pooled funds for the Canadian institutional investing market. Real Assets was formed in 2000 and employs 7 people.

1.1 Ownership structure

Real Assets is 45% owned by VanCity Savings Credit Union. Canada's largest credit union, VanCity has \$8.2 billion in assets under management, 297,000 members and 41 branches in Greater Vancouver, the Fraser Valley and Victoria. In addition to capital, VanCity provides Real Assets with an important distribution network for its retail investment funds. VanCity treats Real Assets as a subsidiary company and handles a variety of its administrative functions, including payroll, benefits, accounting, purchasing and website hosting and programming.

Another significant ownership stake of 33% is held by United Investment Counsel, a subsidiary of Working Enterprises, a BC-based company owned by the Canadian labour movement with operations in venture capital, investment brokerage, travel, insurance and retail sectors. United Investment Counsel's sister company, United Capital Securities, is an investment dealer with offices in Vancouver and Victoria. United Capital Securities provides Real Assets with a friendly distribution channel in British Columbia for its investment funds. As well, the affiliation with Working Enterprises gives Real Assets access to communication and sales channels that allow it to market to the 2.5 million member national union movement. Individual members of labour unions constitute one potential market for Real Assets' retail mutual funds, while labour union pension funds are a potential market for Real Assets' pooled funds.

Another minority shareholder is Renewal Partners, a seed capital fund that supports mission-based, environmentally and socially sustainable businesses in British Columbia.

Real Assets' principal, Deb Abbey, also holds a smaller ownership stake.

1.2 Company background

As an Investment Advisor in the 1990s, Deb Abbey built a thriving practice helping individuals as well as charitable foundations and other institutions build investment portfolios that addressed environmental and social concerns as well as financial goals. In 1999, Abbey met Joel Solomon of Renewal Partners, a Vancouver-based seed capital firm. Together they established a plan for opening an investment management firm that would focus exclusively on socially responsible investing (SRI).

The nascent firm attracted the interest of VanCity Savings. Canada's largest credit union, VanCity is known for its commitment to corporate social responsibility. VanCity became a major partner in order to tap what it perceived as a growing acceptance and demand for socially responsible investing products. Part of VanCity's growth strategy has been to acquire more of its clients' investment business. It saw integrating backwards into investment fund manufacturing, especially with SRI funds, as a way to differentiate itself and to make its wealth management offering more differentiated, more compelling and more profitable.

Real Assets Investment Management Inc. was formed in 2000 and commenced operations in 2001 with the launch of three pooled funds – a Canadian equity fund, an American equity fund and a bond fund – aimed at “institutional” investors such as pension funds, foundations, and wealthy individuals. Initial client investors included the Columbia Foundation, the Endswell Foundation and the VanCity Community Foundation. In addition to the pooled funds, Real Assets offered discretionary portfolio management services for clients who wanted to build socially responsible investment portfolios from customized selections of securities.

Early success and perceived growth potential attracted a new strategic partner in United Investment Counsel, a BC-based institutional investment manager tied closely to the labour-sponsored Working Enterprises organization. United Investment Counsel had created Canada's first socially screened index funds, which were pooled funds targeted at institutional investors. However, the Working Enterprises family of companies wanted to re-focus resources on providing financial planning and brokerage services through United Investment Counsel's sister company, United Capital Securities. Consequently, the parties agreed in early 2003 to transfer United Investment Counsel's pooled fund assets to Real Assets, in exchange for an ownership stake in Real Assets. At that point, Real Assets trimmed its institutional product offering from three to two pooled funds. It also decided to stop offering discretionary portfolio management services and to concentrate instead on the manufacturing and management of investment funds.

By early 2003, it was apparent that establishing a foothold in the institutional market and attaining a profitable level of assets would take longer than hoped. The firm was not yet half way towards achieving a break-even level of assets, which was estimated to be about \$150 million.

The company decided to diversify its offering. In September 2003, Real Assets launched two mutual funds aimed at the “retail” market composed of individual investors. Early plans projected quick growth and the attainment of a break-even level of assets under management of about \$80 million in the retail products by early 2004.

As of April 2004, Real Assets had approximately \$100 million in total assets under management. This included close to \$32 million in the two retail mutual funds, and about \$68

million in institutional assets. Institutional assets included about \$50 million in the pooled funds and \$18 million in discretionary accounts that were to be grandfathered, as the company was no longer seeking new business in discretionary portfolio management.

This growth was encouraging, but it fell short of targets and the company was not yet cash flow positive. Major shareholders called on the company to reduce its operating deficit by cutting costs. The company reduced staffing levels from 9 to 7 people by eliminating one position in marketing and one in research. The remaining operating staff under the President & CEO include one person in each of the following roles: operations; marketing and public relations; sales; SRI research & shareholder activism; portfolio advisory services; and administrative support. The company faces several key challenges and will need to make important strategic decisions.

1.3 Product / Service offering

Real Assets offers four investment funds. For the retail market, Real Assets offers two mutual funds. For the institutional market, Real Assets offers two pooled funds. Also for the institutional and high net-worth market, Real Assets offers a separate version, or class, of one of its mutual funds. This fund has a lower fee structure than its retail counterpart, making it more attractive to financial advisors offering fee-based financial planning for high net-worth investors.

1.3.1 Investment funds defined

Investment funds, such as pooled funds and mutual funds, are corporations or trusts that raise money by selling shares or units of the funds to many investors. The majority is a special kind of trust account, called a “unit trust.” In a document called a “trust indenture,” the trust sets out the fund’s objectives, investment policy, management team, transfer agent and custodian. Under the trust indenture, unitholders usually have voting rights and must be notified of meetings to approve, among other things, changes in the fund’s fundamental objectives.

The value of a single investment fund unit reflects a pro-rata share of the value of all the assets held in the investment fund’s trust account. This is called the net asset value per share (NAVPS). The NAVPS is calculated by adding up the values of all the investments at their market prices, subtracting amounts owed by the fund and dividing by the number of units held.

Investment funds employ professional portfolio advisors. Therefore, the funds provide investors with professional money management as well as a diversified portfolio. Investment funds allow investors to pursue some combination of several goals: growth of capital, income,

risk reduction and tax minimization. In addition, investors also enjoy a high degree of liquidity, since they can purchase or redeem (sell) units at any time, subject to certain restrictions.

1.3.2 Mutual Funds and Pooled Funds defined

1.3.2.1 Mutual funds

Mutual funds are designed for smaller investors. As “public” investments, mutual funds are available for purchase by any Canadian. Their sale is subject to rigorous information disclosure requirements designed to help investors understand the risks and costs of investing. These requirements are established and enforced by the provincial securities commissions, which generally follow the lead of the Ontario Securities Commission and the Ontario Securities Act. The Act stipulates that mutual funds must be sold by prospectus, meaning that licensed mutual fund dealers must provide investors with a copy of the prospectus at the time of sale. A prospectus is an approved offer to sell shares of a mutual fund. It contains pertinent information about the fund, including: its objectives and strategies for achieving those objectives; operating expenses and fees that may be charged to investors; the identity and track record of the fund manager(s); the risks inherent in investing in the fund, including the fact that the investment is not guaranteed and that its past performance may not be repeated. The prospectus must be approved by the provincial securities commission in each province where the funds are to be sold. Fund manufacturers incur substantial costs in order to adhere to regulatory requirements. Ultimately, these costs are passed through to investors; however, larger firms are able to spread out this cost.

Typically, the minimum initial investment required to purchase units of a mutual fund is as little as \$500. As a result of this low minimum purchase amount, a mutual fund manufacturer may have a large number of unitholders with small amounts invested. These small accounts are relatively costly to maintain, since each generates ongoing costs for transactions, record keeping, prospectuses, annual reports, account statements, and so on. These costs are passed along to investors; but again, size helps, since larger firms can spread out these costs.

The NAVPS for a mutual fund is calculated every business day after the close of North American markets.

1.3.2.2 Pooled funds

Pooled funds are designed for “institutional” investors such as pension funds, foundations and wealthy individuals. More specifically, pooled funds suit small- to medium-sized institutional investors that require professional money management but do not have enough assets to warrant engaging an investment counsellor to oversee a customized, segregated portfolio of securities.

Pooled funds are similar to mutual funds but differ in their legal status. They are not “public” investments and therefore are exempt from prospectus requirements under securities laws. Instead, pooled funds usually fall under the “private placement,” or “sophisticated investor,” clauses in the Securities Act. No prospectus is required because the investor is deemed to be sophisticated enough to ascertain the risks of investing in the pooled fund. Instead of a prospectus, investors are given either an offering memorandum, or they sign a management contract that states the investment policies of the pooled fund. The sophisticated investor accepts the risks and responsibilities for the advice part of the transaction. In most jurisdictions, a minimum initial investment of \$150,000 is required in order to qualify as a sophisticated investor.

Pooled fund manufacturers need to meet fewer regulatory requirements compared to mutual fund manufacturers. As well, the average account size is larger for pooled funds than for mutual funds. Therefore, the cost to administer pooled funds is lower than the cost to administer mutual funds. Pooled fund manufacturers can pass along these savings to their unitholders in the form of lower ongoing management fees than those charged to mutual fund unitholders.

Pooled funds can be either “closed” or “open.” Open pooled funds are more common. These allow units to be redeemed any time or at scheduled intervals, at a NAVPS that is calculated at a regular interval, for example, weekly. To accommodate the liquidity of the fund units, the open pooled fund usually hold relatively liquid investments compared to closed pooled funds. Closed pooled funds usually hold more illiquid investments, such as real estate. As a result, they allow redemptions only in specific circumstances or at termination of the trust.

1.3.3 Socially Responsible Investing

There are numerous categories and sub-categories of investment funds. Socially responsible investment funds represent a small niche within the overall investment fund market.

Socially responsible investing, or SRI, is about incorporating social, environmental and ethical (generally understood to refer to corporate governance practices) considerations into an investment strategy. Socially responsible investment managers make investment decisions based on the usual financial criteria, but they also evaluate firms’ environmental, social and ethical performance. SRI has two main distinguishing features: screening and shareholder activism.

1.3.3.1 Screening

Most SRI asset managers employ “exclusionary” or “avoidance” screens. Such screens are used to eliminate investments in industries that are deemed by the manager to be objectionable. The most commonly proscribed industries are tobacco, military weapons and nuclear power. Screens against alcohol, gambling, pornography and vivisection are also found.

Most SRI fund managers also employ “qualitative” screens. These are used to assess companies’ relative performance against peers in areas such as human rights, environment, hiring practices, community relations and corporate governance practices. Typically, qualitative screens are used to create a list of companies that are ineligible for investment. Ineligible companies are those which significantly lag their peers in a relevant performance category and which show no inclination to improve. However, qualitative screens also can be used to create a list of eligible or exemplary companies. Accordingly, qualitative screening can have a negative or a positive slant.

1.3.3.2 Shareholder activism

Shareholder activism describes a set of tactics that socially responsible investors use to proactively prompt companies to change their policies and practices. All of these tactics derive from the rights accruing to shareholders as owners of public corporations.

The most basic tactic is dialogue. Socially responsible shareholders can write letters and meet in person with corporate executives, in order to express concerns and discuss solutions.

If dialogue proves fruitless, then more sophisticated tactics can be applied, such as proxy voting and sponsoring shareholder resolutions.

Corporations need approval from shareholders for a wide variety of business decisions. Issues to be decided are set out in the “proxy circular” that is mailed to shareholders prior to the corporation’s Annual General Meeting. Most shareholders cannot attend the meeting, but they can vote by mail, or appoint someone to vote on their behalf, “by proxy.” Corporate management puts forward most of the ballot proposals. Standard items include appointment of board directors and setting of executive compensation. Shareholder proposals are also showing up on the ballot more frequently. Some of them call for changes to social, environmental, or corporate governance policies. Management usually recommends that shareholders vote against such proposals, and this recommendation usually is satisfied, since few individual shareholders read, mark and return their proxy ballots, and few institutional investors vote against management’s recommendation.

As a matter of policy, many SRI investment funds conscientiously vote all the proxies they hold on behalf of unitholders. Often, they base proxy voting decisions on formal guidelines designed to reflect the shared objectives of unitholders. Some SRI investment funds also disclose how they vote, something that virtually no mainstream investment fund manufacturers do.

A handful of SRI investment fund managers also exercise their right as shareholders to file shareholder resolutions dealing with environmental, social or ethical issues. Securities regulators in Canada and the US uphold the right of all shareholders, no matter how many shares they own, to file such resolutions and have them placed on the proxy circular that is put before all

shareholders at a company's Annual General Meeting. The act of filing a shareholder resolution sometimes prompts a company to come to the bargaining table to try to resolve the issue before it makes it on to the proxy circular. If a company demonstrates a willingness to take meaningful steps, the SRI fund manager can withdraw the shareholder resolution.

Historically, such shareholder resolutions rarely win a majority of support. Recently, however, some have achieved significant, and in some cases even majority, support. In practice, support of just 10% or 20% can be enough to prompt changes, since it shows a corporation's executive that a large portion of shareholders is concerned about a particular issue.

1.3.3.2.1 Shareholder activism at Real Assets

Shareholder activism is an important feature of Real Assets' two pooled funds as well as the Social Impact Balanced Fund. Real Assets considers its shareholder activism activities to be an important differentiating feature of its products. Real Assets frequently files shareholder resolutions on issues related to several campaign themes. Currently, there are six such themes.

1.3.3.2.1.1 Climate change

Real Assets is asking petroleum companies to tell shareholders how they are addressing the risks of climate change and how they plan to transform themselves into global energy companies with a commitment to renewable energy.

1.3.3.2.1.2 HIV/AIDS

Real Assets is asking Canadian resource companies operating in Africa to implement treatment and prevention programs to slow down the spread of HIV/AIDS in the workforce.

1.3.3.2.1.3 Glass ceiling

Real Assets is asking Canadian technology companies to establish policies designed to give women greater access to senior positions.

1.3.3.2.1.4 Responsible finance

Real Assets is asking Canadian banks to evaluate and report on the social and environmental impacts and liabilities associated with their financing and underwriting activities.

1.3.3.2.1.5 Water scarcity

Real Assets is filing shareholder resolutions calling on companies to report to shareholders on the business risks associated with growing water scarcity around the world and on how they plan to mitigate those risks.

1.3.3.2.1.6 Human rights

Efforts have focused on helping destitute coffee farmers. Real Assets, along with other concerned social investors, co-filed a shareholder resolution that prompted one of the world's leading coffee retailers to add a Fair Trade coffee to its product offering.

Most of Real Assets' shareholder campaigns follow a similar pattern, whereby it files at least one shareholder resolution with at least one company, and sometimes multiple shareholder resolutions with several companies, sometimes over several years. The resolution asks the company to: acknowledge a potential problem; assess its magnitude; issue an audited report to shareholders; develop a plan for addressing the issue that includes targets reflecting industry best practices; and issue ongoing progress reports to shareholders in a credible format, such as that set out in the Global Reporting Initiative.

The purpose of shareholder activism is to make decent companies better. Real Assets does not use shareholder activism to attack or embarrass a company. As a shareholder, Real Assets wants the companies it holds to be successful and profitable. It believes that companies become stronger when they take serious steps to address important environmental, social and ethical concerns that represent risks to shareholder value.

1.3.4 *Real Assets pooled funds*

The two pooled funds are the Real Assets Canadian Social Equity Index Fund and the Real Assets U.S. Social Equity Index Fund. The former is an equity portfolio designed to track the returns of the S&P/TSX Composite Index, a grouping of about 200 companies representing the Canadian stock market. The latter is an equity portfolio designed to track the returns of the S&P 500, a grouping of 500 companies representing the American stock market.

1.3.4.1 *Index funds defined*

Real Assets' pooled funds are index funds. The objective of an index fund is to match the returns of an underlying index, such as the S&P/TSX Composite Index, the S&P 500 or dozens of others. To accomplish this objective, the index fund portfolio advisor invests in the same securities, in the same relative proportion, as the benchmark index. For example, if XYZ stock comprises 10% of the value of the S&P/TSX Composite Index, then an index investment fund based on the S&P/TSX Composite Index should have about 10% of its assets invested in XYZ stock. If XYZ's share value drops to the point where it represents, say, 8% of the value of S&P/TSX Composite Index, then the index fund's position in XYZ should represent about 8% of the fund's total assets. If a new security is added to the benchmark index, the index fund's

portfolio advisor buys it. If a security is dropped from the index, the portfolio advisor sells it. Accordingly, indexing is a “passive” investment strategy, as compared to an “active” strategy. An active portfolio advisor assesses the investment quality of each security in the portfolio, and trades in and out of the portfolio relatively frequently, in an attempt to generate a risk/return profile that beats the benchmark. The index fund portfolio advisor does not assess the investment quality of individual securities, but passively holds whatever the benchmark index holds.

Index funds suit investors who want broad exposure to a particular asset class, and who are satisfied with the risk/return profile of an index representing a broad selection of securities. Often, they believe that markets are highly efficient, and therefore that it is difficult to beat the returns of a broad index over a given time period without assuming an unacceptable level of risk.

Index funds, as passively managed products, generally are less expensive to operate than actively managed funds. Since the portfolio advisor does not analyze individual securities, research costs are lower. And the transaction costs, largely in the form of brokerage fees and commissions, usually are lower since the passive portfolio advisor generally makes fewer trades in and out of the investment portfolio compared to an active portfolio advisor. The index fund manufacturer passes these savings along to investors in the form of lower management fees.

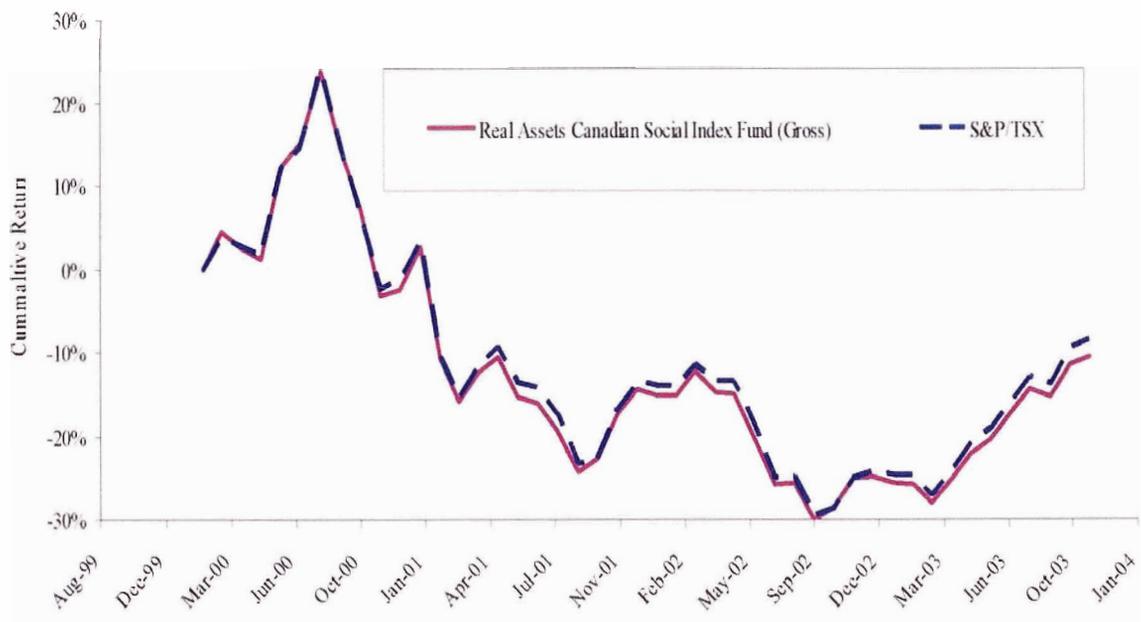
1.3.4.1.1 Socially screened indices

Real Assets’ pooled funds are not straightforward index funds. As socially responsible investment products, their underlying holdings are screened according to environmental, social and ethical (corporate governance) criteria. Real Assets maintains exclusionary screens against companies that derive significant revenue from the tobacco, military or nuclear industries. (“Significant revenue,” in the case of direct involvement by a company in a proscribed industry, is defined as greater than 1% of annual revenues; in the case of indirect involvement, the revenue tolerance is 5%.) Real Assets uses qualitative screens to assess the remaining majority of companies on seven key performance measures: business practices; employee relations; community relations; environment; workplace diversity; human rights/international operations; and products. A company’s securities are ineligible for investment when, in the judgment of Real Assets, the company significantly lags its peers and flagrantly disregards legitimate concerns.

As well, for cost control reasons, the fund manufacturer may choose to not hold securities that represent very small weightings in the benchmark index. When an investment fund is relatively new, and its total assets relatively modest, the transaction costs of holding very small positions may outweigh the benefits. As the total assets in a fund increase, the manufacturer may be in a position to justify adding some of those smaller positions to the portfolio.

The socially responsible screening, in combination with the need to avoid holding companies that represent small weightings, results in an investment fund with fewer individual securities than the benchmark index which it is supposed to track. For example, whereas the S&P/TSX Composite Index holds approximately 220 stocks, the Real Assets Canadian Social Equity Index Fund holds approximately 170 stocks. This difference creates the potential for “tracking error,” whereby the performance and volatility of the investment fund will differ significantly from that of its benchmark index.

To compensate for tracking error, Real Assets’ portfolio advisor employs a statistical modeling technique called optimization. With optimization, the weightings of certain stocks in the smaller portfolio are altered slightly compared to their weightings in the benchmark index, in order to produce a risk/return profile for the investment fund that is close to the benchmark index. Use of statistical sampling techniques is imperfect, however, and some tracking error can be expected. Tracking error decreases (increases) as the sample size increases (decreases). The number of securities included in the fund (the sample size) is a function of the amount of assets the fund has to work with. The more assets the portfolio advisor has to invest, the greater the number of issues it can buy, the greater the sample size, and the smaller the tracking error.

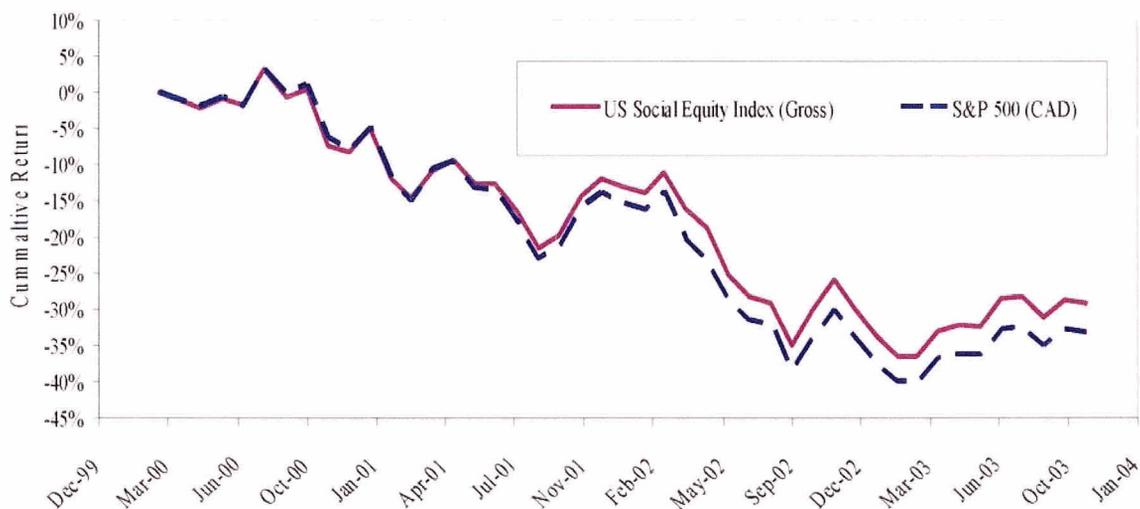


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Figure 1: Performance of the Real Assets Canadian Social Equity Index Fund vs. the S&P/TSX Composite Index

Figure 1 shows that from its inception in February 2000 until December 31, 2003 – a period of almost four years – the Real Assets Canadian Social Equity Index Fund returned (2.85%) on an annualized basis, while the benchmark S&P/TSX Composite Index returned (2.34%), a difference of 51 basis points (a basis point is 1/100 of a percentage point). This is an acceptable variance for an index-based product. For example, for the three-year period ending April 30 2004, the average Canadian equity index fund lagged the benchmark S&P/TSX Composite Index by 38 basis points (bps). During this period, Canada’s largest Canadian equity index fund, the \$4.8 billion iUnits S&P/TSX 60 Index, which is managed by Barclays Global Investors Canada Ltd., lagged its benchmark by 48 bps.¹

Figure 2 shows that from its inception in March 2000 until December 31 2003, the Real Assets U.S. Social Equity Index Fund returned (8.90%) on an annualized basis, while the benchmark S&P 500 index returned (10.43%), a difference of 153 bps. This larger gap is attributable mostly to currency fluctuation. The fund’s U.S. assets are unhedged, so a positive effect results when the value of the Canadian dollar falls vs. the U.S. dollar. A negative effect results when the value of the Canadian dollar rises against the U.S. dollar.



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Figure 2: Performance of the Real Assets U.S. Social Equity Index Fund vs. the S&P 500

¹ “Fund Profile: iUnits S&P/TSX 60 Index,” [Globefund.com](http://globefund.com), 24 May 2004
 <http://globefunddb.theglobeandmail.com/gishome/plsql/gis.fund_pro?fundname=iUnits+S%26P%2FTSX+60+Index&pi_universe=PUBLIC_FUND>.

1.3.5 Real Assets mutual funds

The two mutual funds are the Real Assets Social Leaders Fund and the Real Assets Social Impact Balanced Fund.

Real Assets had sufficient resources to enter the retail investment fund market with two products. The offering was designed for maximum appeal to and utility for the target market. The Real Assets Social Impact Balanced Fund is a robust, utilitarian portfolio designed to play a major or “core” role in an investment portfolio. The Real Assets Social Leaders Fund is a more exciting, “sexier” specialty product, suited for a smaller role as speculative holding. Together, the two products provide about as much depth as possible in a two-product offering.

Generally, a mutual fund manufacturer strives to offer the broadest possible fund line-up, so that investors can construct a well diversified portfolio using the company’s products, without needing to select competing mutual funds. The larger, well established companies offer dozens or hundreds of products in order to meet the needs of as many investors as possible. CI Funds offers more than 600 products – more by far than any other Canadian investment fund manufacturer.

1.3.5.1 Real Assets Social Leaders Fund

This actively managed global equity portfolio held \$3.46 million as of April 30, 2004. The fund holds 25 to 100 companies from Canada, the U.S. and abroad. To be selected by the portfolio advisor, a company must demonstrate outstanding leadership with regard to environmental and/or social issues, along with the potential to generate good financial returns as a result of that leadership and its overall business model. It may have a product or service that significantly mitigates human impact on the environment. It may have an exemplary approach to employee relations or outstanding community programs. It may be a pioneer in the area of human rights. As of April 30 2004, the top 15 names in the portfolio were: Novo Nordisk; Medtronic; Swiss Re; Electrolux; Church & Dwight; Zenon; Barclays; UBS; Canon; Vestas Wind Systems; Timberland; Wainwright Bank; United Natural Foods; Cisco Systems; and Trojan Technologies.

Although there are over 100 global equity mutual funds on the market, the Social Leaders Fund is unique within the overall Canadian investment fund industry as well as within the SRI niche. Whereas most SRI funds practice “negative” qualitative screening, *i.e.*, they screen out the worst environmental, social and ethical performers, the Real Assets product features “positive” qualitative screening, *i.e.*, the portfolio advisor chooses the best social and environmental performers.

Shareholder activism is not a feature of this product, since each company in the portfolio is deemed to be setting high a standard for environmental, social and ethical performance.

1.3.5.2 Real Assets Social Impact Balanced Fund

This fund held \$28.13 million in assets as of April 30, 2004.

Balanced funds spread their investments among stocks and bonds. Essentially, a balanced fund is a middle-of-the-road fund designed to achieve both moderate income and moderate capital growth with relatively low volatility. They suit the needs of conservative investors who want the convenience of holding diverse asset classes in a single fund.

The Real Assets Social Impact Balanced Fund invests in Canadian and U.S. stocks as well as Canadian bonds. Security selection strategy for the three components is primarily passive, since it aims to track the returns of benchmark indices. The Canadian equity component tracks the S&P/TSX Composite Index; the U.S. equity component tracks the S&P 500, and the Canadian fixed-income component tracks the Scotia McLeod Universe Bond Index.

However, there is an active aspect to the management of the fund: the portfolio advisor has discretion to adjust the proportions of the three asset classes relative to each other. It makes these decisions based on its opinion of the relative attractiveness of each component. This is called a “tactical asset allocation” strategy. However, the portfolio advisor’s freedom is limited, since fixed income or equities must always constitute 40% to 60% of the portfolio.

Real Assets applies exclusionary and quantitative environmental and social screens to the companies in the underlying indices. These screens are the same described above in 1.3.4.1.1. As well, the portfolio advisor may avoid taking positions in a company’s securities if that security represents a very small weighting in the benchmark index. Tracking error is therefore a potential problem, since each of the three individual components of the mutual fund will hold fewer positions than its benchmark index. The difference is most pronounced in the fixed-income component: while the Scotia McLeod Bond Universe Index represents approximately 950 issues from 150 issuers in the Canadian universe of debt instruments, the mutual fund’s fixed-income portion holds approximately 50 issues from 27 issuers. To compensate, the portfolio advisor employs the optimization techniques described in 1.3.4.1.1.

The Real Assets Social Impact Balanced Fund is offered in two versions, or classes: a regular class for retail (smaller) investors, and an “M” class. The ‘M’ stands for ‘managed accounts.’ The M class fund has a minimum investment amount of \$500,000. It also has a lower fee structure that suits the needs of financial advisors who serve wealthier clients and who have a fee-based rather than commission-based sales model. That is, they charge their clients a single fee for investment account management services, rather than receiving commissions for every transaction conducted inside their clients’ accounts. So the M class funds are a retail product design with a fee structure aimed at an institutional target market.

As of April 30, 2004, the retail class of the fund held \$12.39 million in assets, and the M class version held \$15.75 million, for a total of \$28.13 million.

1.3.6 Impact of social screening on fund performance

Opponents of SRI often claim that socially responsible investments deliver lower returns than those that can be expected from conventional investment funds. This critique is widespread and it represents a serious impediment to the growth of the SRI investment fund niche. Opponents of SRI generally make two arguments. One is that socially responsible screening hurts returns by limiting the universe of available investments. The other is that SRI tactics, such as screening and shareholder activism, create additional costs not incurred by manufacturers of conventional funds, and that these costs hurt investment returns.

A typical example of the first argument appeared in a *Financial Post* editorial column:

On average, the share prices of the 46 ethical funds tracked by investment banker Thomson Financial (www.trustnet.com) have dropped by 24% over the past five years. The managers of Ethical Funds (www.ethicalfunds.com) state that 'socially responsible investors are redefining the bottom line'; indeed, their Balanced Fund price has dropped 3.6% over the past five years.

One would think that either SRI has a cost, or else it is just like an ordinary investment. Professor Michael Knoll of Wharton writes: 'Either some investments that would be acceptable on purely financial terms must be rejected for ethical reasons, or some that would be rejected on financial terms must be accepted for ethical reasons.' *Theoretically, one would expect effective SRI to earn lower returns than non-constrained investment.*

However, this cost may be low, depending on how one accommodates one's ethics. Knoll convincingly argues that ethical investing can be nearly as profitable as unconstrained investing, provided that the cardinal rule of portfolio diversification is followed. *A constrained portfolio cannot be as diversified as an unconstrained one, but the difference needs only generate a small cost . . .*

In a nutshell, the more ethical investing differs from greedy investing, the higher the cost.² [emphasis added]

As this example demonstrates, opponents of SRI often suggest that socially responsible screening hurts investment returns because it "constrains" portfolio advisors, either by preventing them from selecting potentially good investments in proscribed industries, or by compelling them to select stocks on the basis of good social, environmental or ethical performance, even when their financial merits are questionable.

SRI proponents locate the source of this critique in Modern Portfolio Theory (MPT), which is the dominant theory of portfolio management. MPT contains the fundamental investing principal that diversification can produce the same total returns for less risk. Crudely stated, MPT predicts that combining many financial assets in a portfolio is less risky than holding fewer assets.³ However, SRI proponents accuse SRI opponents of faulty reasoning for deducing from this principal of MPT that any limitation on the universe of available investments due to socially responsible screening necessarily will harm a portfolio's risk/return profile. KLD Analytics, a supplier of social investment research, provides the orthodox SRI perspective on this debate:

The Modern Portfolio Theory holds that, in general, diversification reduces risk and maximizes long-term returns. Therefore, anything that limits an investor's ability to diversify increases investment risks unnecessarily. To eliminate, say, tobacco company securities limits a manager's ability to diversify into an industry that may outperform the rest of the stock market. This argument ignores the fact that one hires a manager because s/he is good at narrowing the universe of investable options. And, Modern Portfolio Theory is just that: a theory.⁴

Amy Domini, the founder of Domini Social Investments, states the argument succinctly:

"The rap [*i.e.*, that SRI investments under-perform conventional investments] comes from theory, rather than fact . . . Every manager promises to enhance your returns by limiting your universe. But when I do it [*i.e.*, SRI screening], it is somehow different."⁵

SRI opponents also point to the additional costs associated with screening and shareholder activism. Since the cost of running an investment fund is a drag on net returns to investors, it follows, they argue, that the additional costs of SRI should hurt investment returns.

In the long run, Real Assets believes that the additional costs of socially responsible research and screening will be rendered inconsequential through scale economies. In the short term, Real Assets counters the critics by claiming that any potential negative impacts on performance that result from the additional costs associated with socially responsible tactics

² Pierre Lemieux, "Does Vice Pay?," Financial Post 4 April 2003, Subversive Liberty: pierrelemieux.org 25 May 2004 <<http://www.pierrelemieux.org/artvice.html>>.

³ "Economics A-Z: Modern Portfolio Theory," glossary entry, Economist.com, 2 June 2004 <<http://www.economist.com/research/Economics/alphabetic.cfm?TERM=MONETARISM>>.

⁴ "Frequently Asked Questions," KLD Research & Analytics Inc., 13 June 2004 <<http://www.kld.com/resources/performance.html>>.

⁵ Amy Baldwin, "Of Mutual Interest," The Eagle Tribune Online 15 May 2001, 11 June 2004 <http://www.eagletribune.com/news/stories/20010515/BU_003.htm>.

should be more than offset by the positive effect that socially responsible screening can have on the risk/return profile of an investment portfolio.

To support this counter-argument, advocates of SRI argue that environmental and social screening eliminates companies that may be expected to perform worse than average over the long run. This is because when companies create negative environmental and social externalities, they also create liabilities that can damage shareholder value. Conversely, the more socially responsible companies should be better managed as well as more efficient and productive. Blair Feltmate, former V.P. of sustainable development at Bank of Montreal subsidiary Jones Heward Investment Counsel, provides the rationale for this claim:

Socially and environmentally responsible companies tend to be better managed. They generate less waste, use energy and resources more efficiently and, in the process, increase savings. They also tend to be well accepted in the communities in which they do business, making expansion efforts easier, and they tend to have fewer legal liabilities, earning them greater favour with lending institutions when they need capital. Turning that paradigm on its head, an environmentally or socially irresponsible company would be hard pressed to turn a profit with legal fines, clean-up costs and consumer boycotts as a result of bad publicity.⁶

For Real Assets, and for other companies trying to succeed in the SRI niche, the question of whether SRI hurts or enhances returns is more than academic. A research article by Vancouver-based Phillips, Hager and North Investment Management Ltd. (PH&N) explains why:

The answer to this question is central to the future of socially responsible investing. If it is the case that SRI produces lower investment returns, then SRI will never be more than a niche market, appealing solely to those individuals with strong convictions about the types of companies they want to hold and who are prepared to accept less material wealth in order to satisfy these concerns. If, however, it can be shown that SRI produces superior investment returns, then SRI will not only move into the mainstream but traditional investment managers increasingly will integrate SRI principles into their investment processes in order to boost investment returns. Finally, if research shows that there is no material difference between the investment performance of SRI funds and traditional investment funds, then SRI will establish itself as a legitimate investment alternative for those investors who believe companies should be held accountable for their social and environmental practices.⁷

⁶ Anne Pappmehl, "Investing with a Conscience," CAIFA Forum Magazine Sept. 2002, 7 May 2004 <<http://www.advisor.ca/caifa/article.jsp?content=21549>>.

⁷ "Does Socially Responsible Investing Hurt Investment Returns?," Phillips, Hager & North, 2003, 4 May 2004 <http://www.phn.com/pdfs/SRI%20Articles/does_sri_hurt.pdf>.

As PH&N points out in the same article, the “performance question” can be settled only by empirical research. There are three main research approaches: (1) comparing the performance of socially responsible indices with traditional indices; (2) comparing performance of SRI funds with conventional investment funds; and (3) comparing the financial performance of companies that rate highly on corporate social responsibility (CSR) measures with those that do not. While few claim that the research has produced firm conclusions, a preponderance of evidence suggests that socially responsible strategies neither hurt nor enhance investment returns.

1.3.6.1 Index comparisons

The most influential data pertaining to index comparisons come from the KLD Domini 400 Social Index (DS 400). The DS 400 is the first index created to measure the performance of a broad universe of socially responsible stocks in the United States. KLD Research & Analytics Inc. launched the index in May 1990. To create it, KLD first surveyed the various screens used by most socially responsible investors. These include the avoidance of tobacco, military weapons and nuclear power as well as gambling, alcohol and pornography. They also included evaluation of factors such as environmental impact, employee relations and workforce diversity. About half the S&P 500 companies qualified for the DS 400 Index in KLD's initial screening process. KLD then added about 150 companies from outside the S&P 500 in order to get a broad representation of industries, and to add in companies that were particularly strong models of corporate behaviour.⁸ KLD maintains an ongoing comparison of the performance of the DS 400 Index to the performance of the S&P 500 as well as the Russell 1000.⁹

Over its history, the DS 400 has consistently held its own against the S&P 500 and the Russell 1000. For the 10-year period ending April 30 2004, the DS 400 returned 12.22% on an annualized basis while the S&P 500 returned 11.37% and the Russell 1000 returned 11.32%.¹⁰

The success of the DS 400 inspired the creation of a similar index designed to generate data on the effects of social screening on a representative portfolio of Canadian stocks. In January 2000, Michael Jantzi Research Associates Inc. launched the Jantzi Social Index (JSI), a socially screened, market capitalization-weighted common stock index modeled on the S&P/TSX 60 (then

⁸ “Frequently Asked Questions,” KLD Research & Analytics Inc., May 2004, 22 May 2004 <<http://www.kld.com/benchmarks/dsifaq.html>>.

⁹ “The Domini 400 Social Index,” KLD Research & Analytics Inc., May 2004, 22 May 2004 <<http://www.kld.com/benchmarks/dsi.html>>.

¹⁰ “The Domini 400 Social Index: Comparative Performance Since Inception in May 1990,” chart, KLD Research & Analytics Inc., May 2004, 22 May 2004 <<http://www.kld.com/benchmarks/dsi-ccp.html>>.

the S&P/TSE 60). The JSI consists of 60 Canadian companies that pass a set of broadly based social and environmental screens.¹¹

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The JSI has outperformed the S&P/TSX 60. In January 2004, Michael Jantzi Research Associates reported that from its launch in January 2000 through December 31 2003, the JSI increased in value by 6.68%, while the S&P/TSX 60 decreased in value by 1.75%.¹³

Other socially responsible indices recently have been created, including the FTSE4Good Index for global portfolios.

After surveying these various SRI indices, PH&N found no resolution to the question of whether social screening improves or impairs investment returns:

A simple comparison of the performance of an SRI index with a comparable traditional investment index, while intuitively appealing, is not sufficient to determine if SRI performs better, the same, or worse than traditional investing. Differences in performance could, for instance, be due to style biases or industry biases that have material impacts on performance during the comparison period. For instance, SRI indices are widely acknowledged to have a growth bias relative to traditional indices and performance differences between these two indices over any given period could be caused by this factor.¹⁴

1.3.6.2 Performance of SRI funds compared with conventional investment funds

A number of studies have attempted to compare the returns of SRI mutual funds with conventional mutual funds. A seminal Canadian study was conducted by Paul Asmundson and Stephen Foerster of the University of Western Ontario's Ivey School of Business. The study,

¹¹ "About the JSI," Michael Jantzi Research Associates Inc., May 2004, 24 May 2004 <http://www.mjra-jsi.com/jsi/about.asp?section=1&level_2=0&level_3=0>.

¹² *Ibid.*

¹³ "Jantzi Social Index Outperforms S&P/TSX 60 And S&P/TSX Composite Indices In 2003 And Since Inception," press release, Michael Jantzi Research Associates Inc., 23 Jan. 2004, 24 May 2004 <http://www.mjra-jsi.com/current_issues.asp?section=4&level_2=13&level_3=0&pr_id=66>.

¹⁴ "Does Socially Responsible Investing Hurt Investment Returns?," *op. cit.*

entitled “Socially Responsible Investing: Better for Your Soul or Your Bottom Line?” was published in the Winter 2001 edition of *Canadian Investment Review*.

The researchers looked at the financial returns of socially screened mutual funds invested in Canadian equities with five- and 10-year performance histories. They compared the performance of these funds with returns from the Toronto Stock Exchange 300 index.

The study found that the fund returns underperformed the benchmark but that this underperformance was not statistically significant. The researchers concluded: “the results suggest that those who engage in SRI through investing in Canadian SRI mutual funds, on average, are neither giving up anything nor gaining anything in terms of financial returns.”¹⁵

Another oft-cited study was conducted by Bauer, Koedijk and Otten (2001), winners of the 2002 annual Moskowitz Prize for outstanding research in the field of socially responsible investing. They studied 103 SRI mutual funds and 4,384 conventional funds from Germany, the U.S. and the U.K. over the period from 1990 to 2001. In conclusion, they found “little evidence of significant differences in risk-adjusted returns between ethical and conventional funds.”¹⁶

In its analysis, PH&N reviewed 10 studies, including the two mentioned above. The reviewers raised serious methodological concerns with the entire body of research. In particular, they noted the small sample size of SRI mutual funds and the difficulty in constructing an appropriate control group of traditional funds. However, PH&N also observed that in all but one study where differences were found (higher or lower), the studies’ authors concluded that the differences were small or statistically insignificant. This evidence argues against the idea that SRI mutual funds systematically under-perform traditional mutual funds.¹⁷

1.3.6.3 Correlation between corporate financial performance & CSR measures

Proponents of SRI argue that companies that embrace the principles of corporate social responsibility (CSR) should financially outperform those that do not over the long term. Some of the drivers of this financial outperformance might include: better workforce productivity, stronger brands, stronger consumer support and lower litigation costs.

¹⁵ Paul Asmundson and Stephen R. Foerster, “Socially Responsible Investing: Better for Your Soul or Your Bottom Line?” *Investment Review* Winter (2001), 9 May 2004 <<http://www.investmentreview.com/archives/2001/winter/social.html>>.

¹⁶ Rob Bauer, Kees Koedijk and Rog r Otten, “International Evidence on Ethical Mutual Fund Performance and Investment Style,” *Social Investment Forum*, 2001, 19 May 2004 <http://www.socialinvest.org/areas/research/Moskowitz/2002_full.pdf>.

¹⁷ “Does Socially Responsible Investing Hurt Investment Returns?,” *op. cit.*

A large number of empirical studies have attempted to describe the relationship between CSR and financial performance. For example, Russo and Fouts (1997) won the 1998 Moskowitz Prize for investigating the relationship between environmental and financial performance. Studying 243 firms over two years and using independently developed environmental ratings, they found a positive link between environmental and economic performance. They also found higher returns to environmental performance in high-growth industries.¹⁸

Dowell, Hart, and Yeung (2000) won the 2001 Moskowitz Prize for a study linking environmental performance with investor sentiment. They studied 89 U.S.-based multinational companies that were listed on the S&P 500 and that were involved in manufacturing or extractive operations between 1994 and 1997. The researchers found that the corporations with high global environmental standards tended to have higher price/book ratios than companies adopting local (usually lower) environmental standards.¹⁹

Gompers, Ishii, and Metrick (2001) demonstrated that firms with corporate governance practices favoring management (at the expense of shareholders' rights) had lower price/book ratios, and that firms in the bottom quartile of their corporate governance ratings had significantly below-average risk-adjusted returns over the period 1990 to 1999 time period.²⁰

PH&N's analysts express reservations about the reliability of this entire body of research, citing serious methodological concerns. First, they say that many CSR variables have a strong qualitative element that is difficult to convert to numerical values. Second, many of the studies use simple linear regressions to describe a relationship between CSR variables and financial performance, without taking into account other important variables that could impact financial performance. Third, they caution that correlation does not mean causation:

Establishing a positive linkage between CSR and financial performance does not mean that CSR caused this to happen. In fact, the opposite could be true. Perhaps CSR is a 'luxury good' that is pursued by companies that are already highly profitable? According to this view, companies with weak financial performance cannot afford to be 'socially responsible' but are instead focused on core production activities designed to improve short-term financial performance.²¹

¹⁸ Michael V. Russo and Paul A. Fouts, "A Resource-Based Perspective on Corporate Environmental Performance and Profitability," Academy of Management Journal 40.3 (1997): 534-559.

¹⁹ Glen Dowell, Stuart Hart, and Bernard Yeung, "Do Corporate Environmental Standards Create or Destroy Market Value?," Management Science 46 (2000): 1059-1074.

²⁰ Paul A. Gompers, Joy L. Ishii and Andrew Metrick, "Corporate Governance and Equity Prices," Quarterly Journal of Economics 118.1 (Feb. 2003): 107-155.

²¹ "Does Socially Responsible Investing Hurt Investment Returns?," *op. cit.*

Despite the lack of definitive evidence, PH&N concludes that the entire body of research:

“provides support to individual investors and trustees of institutional funds that they can pursue a program of socially responsible investing with the expectation that investment returns will be similar to traditional investment options.”²²

1.4 Target market

Real Assets serves two market segments: retail investors and institutional investors. Investment funds are enormously popular in the retail segment, and SRI funds have carved out a small niche. Investment funds play only a small role in the institutional segment, where SRI has not gained much acceptance. However, the size of the institutional market makes it an attractive arena for investment fund manufacturers to explore and there may be opportunities for socially responsible fund manufacturers to gain a foothold.

1.4.1 The retail investor market

1.4.1.1 Demographics

The retail market is composed of individual investors. Nearly half (49%) of Canadian adults own mutual funds, according to IFIC.²³ Statistics Canada reports that there are 24.6 million Canadians age 18 or older as of the end of 2003.²⁴ Based on these figures, we can calculate that approximately 12 million Canadians own mutual funds (49% of 24.6 million). IFIC also reports that Canadians have \$471 billion invested in 52 million separate mutual fund accounts.²⁵ Therefore, we can estimate that the average mutual fund investor has \$39,250 (\$471 billion invested / 12 million investors) spread among four separate accounts (52 million accounts / 12 million investors).

Of the total mutual fund assets held by Canadians, a large share – \$359 billion in 2000²⁶ – is held by employees in employer-sponsored pension accounts and Group RRSPs. Defined

²² *Ibid.*

²³ “Industry Statistics,” Investment Funds Institute of Canada, 2 June 2004 <<http://www.ific.ca/eng/home/index.asp>>.

²⁴ “Estimates of Population, by Age Group and Sex, Canada, Provinces and Territories, Computed Annual Total, Table 051-0001, Statistics Canada,” 2 June 2004 <<http://www.statcan.ca/english/Pgdb/demo10a.htm>>.

²⁵ “Industry Statistics,” Investment Funds Institute of Canada, 4 June 2004 <<http://www.ific.ca/eng/home/index.asp>>.

²⁶ Kevin Press, “The Top 40 Money Managers of 2000,” *Benefits Canada Magazine* Nov. 2000, 4 June 2004 <<http://www.benefitscanada.com/content/legacy/Content/2000/11-00/top0.html>>.

contribution pension plans and Group RRSPs usually allow employees to select from a range of different mutual funds for their individual accounts. The employer determines which funds are offered, through an arrangement with an investment product supplier such as an insurance, mutual fund, or trust company. Depending on this arrangement, the selection of mutual funds available to employees may be very broad or quite narrow. Since product selection is mostly in the hands of employers, the pension fund market is discussed in further detail below in the context of the institutional investor target market.

Men are somewhat more likely to own mutual funds than women. IFIC reports that 53% of men and 47% of women own mutual funds.²⁷

Not surprisingly, the likelihood that a person will invest in mutual funds, and the amount of savings that a person is likely to have invested in mutual funds, increases with age, education and household income. Age is a key factor. From roughly 25 to 45 years old, people tend to accumulate debt as they purchase homes and raise families. From about 45 to 69 years old, people are concerned primarily with saving for their retirement.

According to David Foot, co-author of the *Boom Bust & Echo* books, the investor life cycle has five stages. The stages are summarized in an article in *Investment Executive*:

(1) Canadians usually make their first investments while in their 20s. The common investment for this group is stocks . . . At this point in a typical Canadian's life cycle, investing has nothing to do with retirement; the money is likely to be used for the down payment on a house.

(2) The house – and, often, the kids – come when people are in their 30s. Starting a family takes money, however, and that's why investing might slow down during this family-growth period . . .

(3) Canadians finally see the light at the end of the tunnel in their 40s, when they start to climb out from under this debt load [accumulated in their 30s]. And, from 45 or so onward, they start stashing money away for retirement in earnest. *And what's the surest way to get a diversified portfolio with minimal cash? Mutual funds. In fact, according to Foot, that's what led to the huge growth in mutual funds as, over the past several years, the first boomers were coming into their late 40s [emphasis added].*

(4) The 50s are the peak years for maxing out retirement savings, according to Foot. During these years, the mortgage is paid off, the kids leave home and workers have generally reached their top level of salary. In addition, the 50s are also the inheritance years, when people tend to come into some extra cash from a deceased parent. This is when Canadians move back to the stock market . . .

²⁷ Jim MacDonald, "Women Embrace Investing in Dramatic Fashion," *Advisor.ca News* 9 Aug. 2001, 10 May 2004 <<http://www.advisor.ca/news/today/article.jsp?content=17425>>.

(5) Once retirement is on the horizon, investors tend to back away from risk, slowly adjusting their portfolios over time away from capital gains and toward dividends and interest payments. The key, by the time one retires, is to use the portfolio to generate a steady income.²⁸

Canada's "Baby Boom" is the investment industry's biggest and most lucrative segment. Foot describes the "Boomers" as the largest and most influential demographic group, or cohort, in Canadian society. There are 9.9 million of them, born between 1947 and 1966.²⁹ The cohort's leading edge is about eight years away from the retirement age of 65 and is therefore in the stage of life where the focus is on saving for retirement. The trailing edge is still in the stage of life where debt is accumulated in order to buy homes, raise children, *etc.*

1.4.1.2 Psychographics

Research suggests that men are more aggressive as investors than women. For example, in a TD Waterhouse survey published in January 2004, 28% of men said they plan to make stock-based mutual funds the largest share of their RSP contribution in 2004 versus 16% for women. (Of the three main asset classes of stocks, bonds and cash, stocks are the riskiest.) In addition, 54% of female respondents classified themselves as low-risk investors vs. 45% for men. According to a TD Waterhouse spokesperson, the research demonstrates that "while women have come a long way in planning their financial futures, many still lack confidence, feel that they lack investment knowledge and consider themselves low-risk investors."³⁰

An interesting psychographic characteristic of the Baby Boomers, according to Michael Adams, the co-founder of Environics and author of *Better Happy Than Rich: Canadians, Money and the Meaning of Life*, is that they are less likely to choose delayed gratification than their parents' generation was. Adams says Boomers are defined by the desire to "have it all":

In their quest for fulfillment, they are cramming their jobs, their families, their aging parents, their leisure activities into increasingly hectic lives. They are unwilling to put off living for today to save for tomorrow. They take two to three vacations a year; they have season's tickets to sports events or the theatre; they seldom put off an expense for their home or their children. They accept and are

²⁸ Wendy Cuthbert, "Talking About their Generation: Demographics are More Important Than Ever," *Investment Executive* Mar. 2001, 6 May 2004 <<http://www.investmentexecutive.com/client/en/News/DetailNews.asp?IdPub=45&Id=9746&cat=30&IdSection=30&PageMem=&nbNews=>>>.

²⁹ David Foot, *Boom Bust & Echo 2000: Profiting from the Demographic Shift in the New Millennium* (Toronto: Stoddart, 1999).

³⁰ "Women Avoid Risk, Have Lower Expectations for RSPs, Says TD Waterhouse RSP poll," press release, TD Waterhouse, 12 Jan. 2004 <<http://www.newswire.ca/en/releases/archive/January2004/12/c8834.html>>.

comfortable with the changes that have accompanied their passage through life – the sexual revolution, women's liberation, multiculturalism, gay liberation, and new technology. Two incomes give them lots of money, but they are perennially time-crunched as they try to fit it all in.³¹

In the same vein, but in reference to mutual fund investors in general rather than to Baby Boomers in particular, Investment Funds Institute of Canada president Tom Hockin observed:

The reality is that most people don't have the time or confidence to choose individual stocks and bonds. Even when people do have time, they want to spend it on other more enjoyable past-times than reading annual reports or even business newspapers. Mutual funds give them the long-term benefits of the stock market without the headaches.³²

1.4.1.3 Investor behaviour

A survey commissioned by IFIC found that Canadians gave the following reasons for investing in mutual funds: professional management (90%); diversification (89%); the ability to invest small amounts regularly (75%); the reasonable cost of advice, management, reporting, etc. (71%); liquidity (67%); the ability to know the value of the investments every day (48%).³³

Investors often have more than one mutual fund account. This situation is explained partly by the fact that different kinds of accounts are treated differently for tax purposes. Canadians saving for retirement can hold mutual funds within a Registered Retirement Savings Plan (RRSP) or within an employer-sponsored pension account. Retired Canadians can protect and grow their wealth by holding mutual funds within a Registered Retirement Income Fund (RRIF). Parents can save for their children's education by holding mutual funds within a Registered Education Savings Plan (RESP). And Canadians can also hold mutual funds in non-registered investment accounts.

And, for a variety of reasons, investors often have more than one RRSP account or investment account and they often maintain accounts with more than one investment dealer. For example, an investor may own mutual funds in a Group RRSP account through an arrangement with his or her employer, while also holding mutual funds in a separate RRSP account with another dealer. He or she may maintain an account that is overseen by a financial advisor, while also holding mutual fund in a separate "self-directed" account accessible through the internet.

³¹ Susan Noakes, "Boomers: The Trend Setting Generation," *CAIFA Forum Magazine* Nov. 2001, 7 June 2004 <<http://www.advisor.ca/caifa/article.jsp?content=19305>>.

³² "Canadians See Advantages of Mutual Funds Says Survey," press release, Investment Funds Institute of Canada, 23 Jan. 2004 <<http://www.ific.ca/eng/frames.asp?11=Media>>.

³³ *Ibid.*

The Boomers' purported desire for instant gratification may partly explain an interesting dynamic in the investment fund industry: whereas fund manufacturers and distributors as well as financial advisors continually exhort investors to follow a patient, "buy and hold," strategy, investors exhibit relatively impatient behaviour. Conventional wisdom holds that equity and most fixed-income funds are "long-term investments" (as distinguished from money market funds, which are "short-term investments" suited to short-term investment goals) that should be held for at least five to seven years, which is roughly the duration of a complete market cycle. But the average investor redeems or switches mutual funds more frequently. In 2000, Dalbar Inc. published data showing that the average holding period for Canadian equity funds was 2.9 years.³⁴ The same trend obtains in the U.S., where, according to Financial Research Corp., the average holding period for broad-based mutual funds was 5.5 years in 1996 but 2.9 years by 2000.³⁵

Investor fickleness likely is exacerbated by several more tangible factors. One is that investor knowledge is improving. In the 1980s and early to mid 1990s, most mutual fund investors were novices. Today, most investors have at least a basic familiarity with mutual funds, either from personal experience or from the information that is widely available from mutual fund companies and distributors as well as the financial press. Many investors feel they have sufficient expertise to know when to make a change.

Investors are empowered by readily available data comparing the short- and long-term performance of all mutual funds. In fact, it is an industry requirement for mutual funds to report this data. Based on this information, commentators in the financial media generate ongoing coverage of which funds are hot and which are not. This coverage helps make investors increasingly intolerant of mediocre performance and encourages them to chase the "hot" funds.

Another factor is the proliferation of competing products. Morningstar Canada reports that as of February 2004, there were 4,960 mutual funds and segregated funds (a hybrid product composed of an investment fund bundled with an insurance product to protect investment principal; "seg funds" can be sold only by insurance dealers) available to Canadian investors.³⁶

³⁴ Ian Davidson, "Numeracy and the stock market," CA Magazine June/July 2001, 12 June 2004 <http://www.camagazine.com/index.cfm/ci_id/6535/la_id/1.htm>.

³⁵ Lee Barney, "Chasing Hot Funds Translates to Diminished Returns, Study Finds," TheStreet.com, 17 Jan. 2001, 9 June 2004 <<http://www.thestreet.com/funds/funds/1260879.html>>.

³⁶ Geoff Kirbyson, "Some Fund Companies Slimming Product Lines," Investment Executive 14 April 2004 <<http://www.investmentexecutive.com/client/en/News/DetailNews.asp?IdPub=98&Id=23902 &cat=22& IdSection=22&PageMem=&nbNews= Canada>>.

For any given mutual fund, at any given time, there is likely to be at least one similar product that is outperforming it. It is tempting for investors to switch into one of those funds.

Investment fund distributors sometimes contribute to fickle investor behaviour. Some dealers and brokers may be motivated to advise their clients to switch funds more often than is necessary. This is because the purchase of new funds can generate for the distributor an up-front commission from the fund manufacturer worth up to 5% of the amount invested. Such unnecessary buying and selling is called “churning.”

Fund manufacturers also play a role by periodically promoting their current best performing products in order to entice investors. However, this tactic is a zero-sum game, since today’s hot product is tomorrow’s laggard; the performance of every investment fund fluctuates over time in response to market conditions that may be more or less favourable to its strategy.

In order to prevent loss of assets, fund manufacturers have dismantled barriers preventing investors from switching between funds manufactured by the same company. Thus, for example, an investor who is dissatisfied with the performance of a Canadian equity fund manufactured by AIM/Trimark may pay a penalty for the privilege of selling units of that fund in order to purchase units of a fund offered by Fidelity. But there may be no cost to transfer assets into another AIM/Trimark fund. While the costs of internal switching need to be absorbed, this is preferable, from the point of view of the fund manufacturer, to losing the assets to competing products.

As a result of all these factors, investors are increasingly willing to switch funds.

However, there is evidence that investors should be more patient. Dalbar found that while the TSE 300 Composite Index returned 11.53% per year from March 1990 to December 1999, Canadian equity fund investors earned real returns of only 7.15% per year over the same period. The researchers attributed the gap to investors’ propensity to try to time the market by jumping in and out of mutual funds.³⁷ A study of U.S. investor behaviour by Financial Research Corp. produced similar findings: from 1990 to 1999, the average U.S. mutual fund investor underperformed the average broad based mutual fund by 20%. Investors who switched less frequently did better. Again, the researchers attributed the performance gap to the tendency for investors to chase hot funds at peak prices while dumping their underperforming funds at low prices.³⁸ This behaviour is the opposite of the “buy low, sell high” formula for investing success.

³⁷ “Market Timing: Staying Invested,” fact sheet, Investment Funds Institute of Canada, 17 Jan 2002, 3 June 2004 <http://www.ific.ca/eng/frames.asp?11=Investor_Education>.

³⁸ Lee Barney, *op. cit.*

Investment fund purchasing behaviour is sensitive to broad market and economic conditions. In general, investors react exuberantly in bull markets by investing new money in riskier, long-term equity mutual funds. They react fearfully in bear markets by reducing the rate of new investments in equity mutual funds and by shifting new and existing assets into short-term (money market) funds as well as into conservative, long-term funds such as income funds and dividend funds. These reactions lag changes in economic and market conditions. For example, in 1998, the year that followed the Asian currency crisis in the fall of 1997, net new sales (gross sales less redemptions) of long-term mutual funds fell 30% year over year.³⁹ In 2001, the year following the tech stock meltdown of 2000, net new sales of long-term mutual funds fell 47.5% year over year.⁴⁰ The ongoing economic uncertainty and stock market volatility of 2002 caused investors to seek more conservative investments: net new sales of Canadian and foreign equity mutual funds fell 96% year over year, while net new sales of Canadian bond funds, Canadian dividend funds and foreign bond funds increased by 29%, 73% and 352% respectively.⁴¹

The fees levied by mutual fund manufacturers for their ongoing investment management services also influence purchase decisions. These fees, known as the Management Expense Ratio, or MER, are set as a fixed percentage of the fund's assets. A lower MER is no guarantee of a higher return, just as a higher MER is no guarantee of a lower return. However, many investors are wary of funds with higher than average MERs, since to some degree they understand that these charges are a drag on fund performance. Ultimately, the fund's performance track record compared to similar products will speak for itself. New investment funds are restricted from reporting investment returns until they have been operating for one year. Consequently, Real Assets will not be able to report returns for its mutual funds until the fall of 2004. Many investors will hold off until they see a track record, and some will want to see a track record of more than a year before investing, especially if the performance numbers after a year are mediocre or worse.

³⁹ "IFIC Statistical Overview at December 31, 1998," Investment Funds Institute of Canada, 8 June 2004 <<http://www.ific.ca/eng/frames.asp?I1=Statistics>>.

⁴⁰ "IFIC Statistical Overview at December 31, 2001," Investment Funds Institute of Canada, 8 June 2004 <<http://www.ific.ca/eng/frames.asp?I1=Statistics>>.

⁴¹ *Ibid.*

1.4.2 The socially responsible investor segment

1.4.2.1 Demographics

The number of individual socially responsible investors in Canada is small. The Social Investment Organization counts only about 300,000 of them. However, it estimates that many more Canadian investors – as many as 11% – are interested in SRI. It says most are simply not getting their needs addressed by the investment industry.⁴²

The 11% figure comes from a widely cited survey of 2,900 Canadians conducted in 1999 by Ideation Research. Ideation found that 53% of respondents were interested in SRI, with 11% being ‘very interested’ and 42% being ‘somewhat interested.’⁴³ The research did not ascertain how many people owned socially responsible investments.

Of the respondents who expressed interest in SRI, 62% had a university education; 59% had a household income over \$60,000; and 59% were in professional or technical occupations.⁴⁴ Fifty-seven per cent were between 35 to 44 years old and 55% were female. The study also found that their average net worth was \$250,000.⁴⁵

These data suggest that those interested in SRI tend to be well educated. By comparison, the 2001 Canadian census found that 20% of Canadian adults (defined as those age 25 or older) had university credentials.⁴⁶

The data also suggest that while household income among those interested in SRI may not be especially high – the average Canadian family household earned \$69,100 in 1999⁴⁷ – their reported average net worth is relatively high. By comparison, the median net worth for Canada’s 12.2 million family units was \$81,000 in 1999. At that time, net worth of \$250,000 placed a household within the top 20% of all Canadian households. Families with primary wage earners

⁴² Jennifer McLaughlin, “Ethical Wealth,” *Advisor’s Edge* March 2002, 6 May 2004
<http://www.advisor.ca/edge/article.jsp?content=20020309_000000_0000>.

⁴³ Gail Vaz-Oxlade, “The Greening of Canadian Investors,” *Globe and Mail* 26 May 2001, 27 May 2004
<<http://www.globeinvestor.com/servlet/ArticleNews/story/GAM/20010526/STMAIN6>>.

⁴⁴ *Ibid.*

⁴⁵ Anne Papmehl, *op. cit.*

⁴⁶ “Overview: Canadians Better Educated Than Ever,” analysis series, Statistics Canada, 4 June 2004
<<http://www12.statcan.ca/english/census01/products/analytic/companion/educ/canada.cfm>>.

⁴⁷ “Average Total Income By Economic Family Types,” CANSIM Table 202-0403, Statistics Canada, 2 June 2004 <<http://www.statcan.ca/english/Pgdb/famil05a.htm>>

between the ages of 35 to 44 had a median net worth of \$96,600. Families with primary wage earners between the ages of 45 to 54 had a median net worth of \$165,800.⁴⁸

Also noteworthy in the Ideation Research study is the finding that 55% of those who expressed an interest in SRI were women. As noted in 1.4.1.1 above, of all Canadian mutual fund investor, 53% are men and 47% are women.

An EKOS Research survey for the Canada Pension Plan Investment Board in 2002 augmented Ideation's earlier findings. EKOS found that 26% of investors had instructed an investment company or advisor to use ethical screening or criteria on at least one occasion. The greatest interest in SRI was among people between the ages of 45 to 54 (approximately one third of people in that age group had invested in SRI on at least one occasion). Higher education and higher incomes increased the likelihood that someone had tried SRI: approximately one third of people with household incomes above \$60,000 had invested in SRI on at least one occasion and nearly one third of university educated people had invested in SRI on at least one occasion.⁴⁹

Ekos also found that women were more likely to choose SRI. Of those who had invested in SRI on at least one occasion, nearly 57% were women. As well, 30% of women had invested in SRI on at least one occasion, compared to 23% of men.

1.4.2.2 Psychographics

Referring to the Baby Boomer demographic segment, and quoting pollster Michael Adams, author of *Better Happy Than Rich: Canadians, Money and the Meaning of Life*, finance journalist Susan Noakes advises financial planners that:

Greed and self-interest are not the only or the main motivators among boomers – and financial services firms that appeal only to greed will ignore a significant part of the market. 'The boomer doesn't only want the good life, but to live well and meaningfully,' says Adams. Many investors will insist on ethical or environmentally sound planning.⁵⁰

Various surveys and polls suggest that investors increasingly are willing to take social, environmental and ethical considerations into account when making investment decisions. Ethical

⁴⁸ "The Assets and Debts of Canadians: An Overview of the Results of the Survey of Financial Security," Catalogue no. 13-595-XIE, Statistics Canada, Published by the Ministry of Industry, 2001, 5 June 2004 <<http://www.statcan.ca/english/freepub/13-595-XIE/9900113-595-XIE.pdf>>.

⁴⁹ "Public Opinion, Confidence, and the CPP Investment Board: Benchmark Survey Report," Ekos Research Associates Inc., submitted to Canada Pension Plan Investment Board, 2002, 6 June 2004 <http://www.cppib.ca/info/articles/Public_Survey_Report.pdf>.

⁵⁰ Susan Noakes, op. cit.

Funds Inc. participated in an Ipsos Reid omnibus survey of 1,000 Canadians in 2002. Nearly half (48%) of respondents said that recent corporate accounting scandals (for example at Enron) made them more likely to invest in mutual funds that engaged in shareholder action to encourage companies to adopt positive social, ethical and environmental policies. Reportedly, 73% said they believe mutual fund companies should use their influence as large investors to encourage companies to adopt positive social, ethical and environmental policies.⁵¹

A Vector Research poll of 2,000 Canadians, conducted for the Canadian Democracy and Corporate Accountability Commission in 2001, found that 72% (and 74% of shareholders) 'expect business to pursue social responsibilities, not just profits.' Fifty-one percent of respondents (and 54% of shareholders) said they would prefer a pension plan that invested in companies with a good record of social responsibility, even if it resulted in somewhat lower benefits to themselves.⁵²

Enviroics International (now GlobeScan Inc.) released a study in 2001 showing that 26% of Canadian shareholders said they had bought or sold shares on the basis of a company's social performance.⁵³

Clearly, many Canadians support the general ideas of SRI and corporate social responsibility. However, SRI means different things to different people. Because of these subjective perceptions, the SRI niche is not cohesive in terms of psychographics. It sub-divides into micro-niches, including: religious investors who want to avoid "sin" stocks such as pornography, alcohol and gambling; Catholic investors who want to avoid investments in companies involved in the provision of birth control or abortion; Islamic investors who wish to avoid investments with financial lending institutions; animal rights activists who refuse to invest in companies involved in vivisection; environmentalists who refuse to invest in resource extraction enterprises; trade union members who want to avoid investing in companies that are hostile to organized labour. Some investors have strong views about certain issues, yet are indifferent to others. For example, an investor might not mind investing in the nuclear or military weapons industries, but might be concerned about human rights and sweatshop labour issues.

⁵¹ "Ethical Funds Inc. Launches 7 New Socially Responsible Funds," press release, Ethical Funds Inc., 25 Sept. 2002, 8 June 2004 <http://www.ethicalfunds.com/do_the_right_thing/about_ef/newsroom/2002_articles/09_25_02.asp>.

⁵² "Analysis of the Public Opinion Poll Conducted for the Canadian Democracy and Corporate Accountability Commission," Canadian Democracy and Corporate Accountability Commission, 2001, 12 June 2004 <<http://www.corporate-accountability.ca/pdfs/PollReport.pdf>>.

⁵³ "Corporate Social Responsibility Monitor," [BSDglobal.com](http://www.bsdglobal.com), International Institute for Sustainable Development, 3 June 2004 <http://www.bsdglobal.com/issues/sr_csr.asp>.

Moreover, among a group of people sharing similar views about a particular issue, there may be differing degrees of intensity of feeling and differing degrees of willingness to compromise.

However, the reality of dealing with a psychographically and demographically fragmented market is not unusual in the context of the broader investment fund industry, where investment approaches proliferate in order to address diverse needs and opinions.

1.4.2.3 Investor behaviour

The Ekos Research finding that 26% of Canadian investors have at one time selected “ethical” investments indicates a high degree of awareness of the availability of socially responsible investment choices. Anecdotal evidence suggests that corporate governance scandals at Enron, WorldCom and elsewhere have increased acceptance among investors of the need to consider non-financial criteria when making investment selections. Sucheta Rajagopal, a Toronto-based financial advisor who specializes in SRI, observed that:

Three years ago [*i.e.*, 2000], when I said I do socially responsible investing, I would have to explain what it is. Today when I tell people, everybody nods because they know what it is. It's perceived as a legitimate investment option.⁵⁴

It is also worth mentioning a supposition, widely held among SRI fund manufacturers, that SRI investors tend to hold their SRI investment funds longer than mainstream investors tend to hold their non-SRI funds. Supposedly, investors who base decisions on environmental, social and ethical criteria as well as financial criteria tend to be more committed to their choices and therefore less likely to switch. Such commitment is a virtue from the perspective of fund manufacturers and financial advisors. A typical expression of this idea comes from Reggie Stanley of Calvert Group, a U.S. SRI fund manager with US\$9 billion under management:

... socially responsible investors tend to be loyal, long-term investors, who are ‘in it for the long haul.’ What we’re seeing is that the social investor is a committed investor.⁵⁵

The Globe and Mail reported that Meritas’ redemptions in 2002 were only 4.3% of average assets, far below the investment fund industry’s average redemption rate of 27.6%.⁵⁶

⁵⁴ Madhavi Tom-Yew Acharya, “Ethical Investing Gaining Momentum,” *Toronto Star* 20 Feb. 2003, 18 May 2004 <<http://www.corporateknights.ca/resources/media/star2.asp>>.

⁵⁵ Martin Wolk, “Socially Responsible Mutual Funds Expand,” *MSNBC News*, 31 Oct. 2003, 25 May 2004 <<http://www.msnbc.com/news/987527.asp>>.

⁵⁶ Jeff Buckstein, “Ethical fund interest rises in wake of scandals,” *Globe and Mail* 5 Feb. 2003, 20 May 2004 <<http://www.globefund.com/servlet/ArticleNews/story/GFFAM/20030205/GIETHIY>>.

Beyond this anecdotal evidence, the only empirical evidence to support this supposition comes from the 1999 Ideation Research poll (cited above in 1.4.2.1). Among its findings was that socially responsible investors “tend . . . to invest for the long term.”⁵⁷ As far as this assessment is accurate, it may be a function of the small number of SRI funds. If they had more choices, committed socially responsible investors might prove to be as fickle as mainstream investors.

1.4.3 Financial advisors

Financial advisors (FAs – here used as a generic term to denote anyone who sells investment products, including investment advisors, investment specialists, investment counselors, securities brokers, *etc.*) are an important target market for investment fund manufacturers. Consumers, overwhelmed by the range of available products, often look to their FA for advice and for recommendations about which funds to choose. For this reason, it often is said that investment funds are *sold* rather than *bought*. To a large extent, FAs determine which funds enjoy prominent “shelf space” in distribution channels. Accordingly, many investment fund manufacturers compete for the attention of FAs at least as much as they compete for consumer mindshare.

There are roughly 30,000⁵⁸ to 35,000 mutual fund-licensed FAs in Canada. The Financial Advisors Association of Canada has about 17,000 members, of whom 62% are licensed to sell mutual funds.⁵⁹ A further 23,000 people are licensed to trade mutual funds as well as other securities, according to the Investment Dealers Association of Canada.⁶⁰

FAs are employed and licensed by investment fund dealerships or brokerage firms that specialize in the advice portion of the investing value chain. Dealers provide the infrastructure that FAs need to acquire and serve clients, such as office space, transaction processing and record keeping. They also provide support in areas such as training and marketing. However, FAs own the client relationship (as long as they remain with the dealer; if they resign and move to another dealer, they are prohibited from taking clients). FAs enjoy a high degree of autonomy in how they serve clients and build their “book” of business, *i.e.*, the total value of the assets held in their clients’ portfolios. Their compensation is largely variable (incentive based) rather than salary

⁵⁷ Anne Pappmehl, *op. cit.*

⁵⁸ *Ibid.*

⁵⁹ “Membership Stats,” Advocis – the Financial Advisors Association of Canada, 27 June 2004 <http://www.advocis.ca/display_document.htm?token=public&id=2013&isdoc=1&catid=151>.

⁶⁰ “Canadian Securities Industry Profile,” Investment Dealers Association of Canada, 27 June 2004 <http://www.ida.ca/IndIssues/IndProfile_en.asp>.

based. Highly productive FAs receive larger payouts and greater support from their dealer. FAs that fail to meet minimum productivity targets are dismissed.

FAs also enjoy – and insist on – autonomy with regard to which investment funds they recommend. Most dealers and brokers have an “open architecture” structure, meaning they provide investors with access to a wide range of funds from various manufacturers. This is the case, for example, with the big five banks, each of which has integrated backwards to become an investment fund manufacturer as well as a dealer. Although these manufacturer/dealers may attempt to coax assets into proprietary products through promotional tactics and staff sales incentives, they permit their full-service FAs to recommend and sell whichever brand of mutual funds they feel are appropriate for their clients. For example, RBC Dominion Securities’ COO estimated that RBC funds make up only about 8% of their clients’ total assets.⁶¹

Investors Group is a counter-example to the open architecture distribution strategy. IG became Canada’s largest investment fund manufacturer with a proprietary-only model. Recently, however, in addition to purchasing the Mackenzie investment fund company, IG has given its FAs and clients limited access to products from third party managers such as AGF and Fidelity.

1.4.3.1 Financial advisor demographics

It is helpful to distinguish between two kinds of FAs. “Planners” work for investment fund dealers and are licensed to sell mutual funds but are not licensed to sell individual securities such as stocks and bonds. “Brokers” are full-service FAs who work for brokerages and who are licensed to sell mutual funds as well as individual stocks, bonds and other securities.

New data from 2004 show that the average *planner* is 47 years old. He or she has been in the business for 11 years and with his or her current firm for 7.5 years. He or she has 332 clients and a book of assets worth \$18 million – an average of \$70,000 per client. But the average is misleading, since the 80/20 rule applies with regard to planner productivity. About 22% of planners are big producers with average assets per client of \$159,000 and an average book worth \$32.5 million. The rest are small producers with average assets per client of just \$43,000 and an average book worth \$14 million.⁶² Naturally, investment fund manufacturers want to focus most of their sales and support efforts on the bigger producers.

⁶¹ Aileen Corr, “Push to Promote is Building: Survey Shows Freedom to Deal Independently with Clients has Dropped,” *Investment Executive* May 2004, 25 June 2004 <<http://www.investmentexecutive.com/client/en/News/DetailNews.asp?IdPub=99&Id=24167&cat=29&IdSection=29&PageMem=&nbNews=>>

⁶² James Langton, “Planners Building Books but not Assets,” *Investment Executive* June 2004, 25 June 2004 <<http://www.investmentexecutive.com/client/en/News/DetailNews.asp?IdPub=100&Id=24481&cat=29&IdSection=29&PageMem=&nbNews=>>

Data from 2002 show that the average *broker* was 44.5 years old. He had been in the business for 10 years and with his current firm for 7.5 years. He had 348 clients and a book worth \$49 million – about \$142,000 per client. Of those total assets, 35% was in “managed” products such as mutual funds. Use of the masculine pronoun is appropriate since male brokers outnumber females by a ratio of seven to one.⁶³

1.4.3.2 *Financial advisor behaviour*

Financial advisors, like retail investors, are overwhelmed by the number of products on the market. While they pay attention to which brands, which portfolio advisors and which funds are doing especially well or poorly, in the interest of efficiency they tend to recommend and sell a circumscribed number of favorite brands and funds. They develop deep expertise in the products that best allow them to meet the needs of their clientele. Performance, service and support are the factors that determine if a fund manufacturer, or a manufacturer’s product group, or a particular investment fund, gets included on an FA’s list of preferred products. FAs look for funds with portfolio advisors who have track records of producing solid returns. They also want smooth, error-free transaction processing and administrative support from the fund manufacturer’s back office. Value-added support is another important factor: fund manufacturers offer FAs business-building advice, productivity tools, sales and marketing tools, market intelligence, and co-operative advertising dollars. Fund companies deliver this support via online and telephone channels as well as through “wholesalers” – sales representatives who personally visit or call FAs. FAs appreciate support that helps them operate more efficiently and productively, and to grow their business.

FAs want to be perceived as dispensing independent advice, and to be making recommendations in the client’s best interest, rather than the interest of the FA. Many FAs who work for integrated manufacturer/dealers are reluctant to recommend their firms’ in-house products (regardless of extra incentives to do so), out of concern that the client will wonder if the FA is “pushing” proprietary products in order to earn better commissions. Explained RBC Dominion Securities’ national director:

Our RBC funds have a lot of top-quartile performers, but the investment advisors have resisted selling them because they don’t want the clients to think they’re selling in-house product because they’re getting paid more for it.⁶⁴

⁶³ *Ibid.*

⁶⁴ Aileen Corr, *op. cit.*

Similarly, National Bank Financial's national sales manager commented:

Our challenge is simply to make the in-house product good enough to earn the IAs' support. Actually, what we find is that an in-house NBF product has to be at least one notch better than the closest competitor for IAs to endorse it.⁶⁵

1.4.3.3 Financial advisors with expertise in SRI

Many FAs try to differentiate themselves by specializing in certain market segments and becoming efficient in meeting the needs of those segments. For example, an FA may specialize in serving women investors, or members of a certain profession. Some FAs differentiate by offering service and advice in complementary areas such as tax advice, insurance, and estate planning.

A small number of FAs are seeking to differentiate their service by developing expertise in SRI. About 80 FAs across Canada are members of the Social Investment Organization (SIO), a national non-profit industry association that works to raise the profile of SRI. They see an opportunity to tap in to what looks like a potentially attractive investor demographic (see 1.4.2.1. above). And they see their ability to discuss non-financial investment criteria as a way to connect with clients on a deeper level, and to build credibility and trust. SRI fund manufacturers try to sell FAs on this value proposition, and to provide them with as much SRI-related support as possible.

Anecdotally, some FAs have told Real Assets that they are not interested in developing expertise in SRI because there are too few SRI investment funds in the market to choose from.

1.4.4 The institutional investor market

The institutional market is composed of investment funds, insurance companies and pension plans, as well as organizations that oversee endowments or operate foundations. Wealthy or "high net-worth" private individuals usually are included in the institutional category as well. These entities require the services of professional money managers who exercise discretion with respect to investing their financial assets. Small- to medium-size pension plans, along with endowments, foundations and wealthy private individuals often outsource this capability, while large pension plans, investment fund companies and insurance companies often maintain it in-house. However, even investment fund and insurance companies sometimes hire third-party asset managers to oversee part or even all of the assets belonging to their unitholders or policyholders.

The largest institutional investors, which control tens of billions of dollars, usually hire in-house experts to manage it. About 28% of all pension fund assets is managed in-house and the

⁶⁵ Kate McCaffery, "Too Much Product to Handle: Advisors Complain the Product Shelf is Full," *Investment Executive* Sept. 2003, 28 June 2004 <<http://www.investmentexecutive.com/client/en/News/DetailNews.asp?IdPub=87&Id=21127&cat=27&IdSection=27&PageMem=&nbNews=>>>.

rest is outsourced to external managers.⁶⁶ The bulk of externally managed money belongs to larger institutions and is placed in customized, discretionary accounts managed by specialist investment counsellors. Small- to medium-size institutional investors sometimes utilize pooled funds since they offer cost-effective diversification and professional money management. Occasionally, larger institutions place a portion of their assets in pooled funds. However, the institutional market for pooled fund is small compared to the institutional market for mutual funds, which are popular choices for employer-sponsored pension plans and Group RRSPs.

1.4.4.1 Pension plans

For many Canadians nearing retirement, their employer pension is one of their most important assets. Private pension plans (as distinguished from the Canada Pension Plan and other public programs) provide an important source of retirement income for about 40% of Canadian workers and their families.⁶⁷ Statistics Canada reports that about 5.5 million Canadian workers in all sectors of the economy belong to registered pension plans and that the value of pension plan assets is approximately \$584 billion.⁶⁸ Of this amount, as much as \$359 billion was invested in mutual funds as of 2000.⁶⁹ Pension plans held a further \$31 billion in pooled funds in 2002.⁷⁰

Private pension plans are sponsored by employers or by unions and are set up voluntarily or through collective bargaining.⁷¹ Most of these plans are registered with a federal or provincial pension regulatory authority, and are governed by the various Pensions Benefits Acts.

Defined Benefit pension plans provide members with a defined income when they retire. The amount that the employer must contribute may fluctuate, according to how much the benefit

⁶⁶ Kevin Press, "The Top 100 Pension Funds of 2002" *Benefits Canada Magazine* April 2002, 29 June 2004 <<http://www.benefitscanada.com/content/legacy/Content/2002/04-02/top100.html>>.

⁶⁷ Canada, Dept. of Social Development, "Private Pensions and Savings," 6 July 2004 <<http://www.dsc.gc.ca/asp/gateway.asp?hr=/en/isp/common/ris/privpension.shtml&hs=cpr#pps1>>.

⁶⁸ "The Daily" Statistics Canada, 19 March 2004, 7 July 2004 <<http://www.statcan.ca/Daily/English/040319/d040319b.htm>>.

⁶⁹ Kevin Press, "The Top 40 Money Managers of 2000," *op. cit.*

⁷⁰ Scot Blythe, "Small Investors Provide Steady Inflows for Pooled Funds," *Advisor.ca*, Dec. 2002, 9 July 2004 <http://www.advisor.ca/product/current/article.jsp?content=20021202_140927_3660>.

⁷¹ "Pension Guide for Members of Federally Regulated Private Pension Plans," Office of the Superintendent of Financial Institutions, Oct. 2000, 8 July 2004 <<http://www.osfi-bsif.gc.ca/eng/documents/consultation/docs/penguide.pdf>>.

is predicted to cost. Actuaries are engaged to estimate the cost on the basis of assumptions about future salary levels, investment returns, when members will retire and when they will die.⁷²

In Defined Contribution plans, the employer contributions and employee contributions are defined, while the eventual pension benefit is not defined. The contributions often are a fixed percentage of each year's earnings and are deposited in an individual account in the member's name. Interest and investment earnings are credited to this account. Upon the beneficiary's retirement, the money in the account is used to buy an annuity from an insurance company. Defined Contribution plans typically allow members to select from a circumscribed range of investments, including, in many cases, a selection of mutual funds.⁷³

Another important plan category is Multi-Employer Pension Plans (MEPPs). These are established for employees in industries, such as construction, where employees tend to move among employers, or are employed by a variety of small- to medium-size businesses. MEPPs allow two or more unrelated employers, usually in a particular industry or trade, to contribute to a single pension fund. Since there is usually a labour union representing workers in these industries, most MEPPs are sponsored by the union through a collective agreement that describes what the employer contributions are, as well as the benefit level.⁷⁴

The assets contributed by employers and members usually are held in trust by a trust or insurance company. In this way, the assets are held separate and apart from the assets of the employer, and are therefore protected should the business fail.⁷⁵

Defined contribution pension plans often allow employees to select from a range of mutual funds for their individual accounts. The employer determines which funds are offered, through an arrangement with an investment product supplier such as a mutual fund company, investment dealer, bank, credit union, insurance company or trust company. Depending on this arrangement, the selection of mutual funds available to employees may be broad or quite narrow.

1.4.4.2 Group RRSPs

A group RRSP is a collection of individual Registered Retirement Savings Plan accounts set up for employees through an employer. The employer may or may not contribute to it. Group

⁷² *Ibid.*

⁷³ *Ibid.*

⁷⁴ *Ibid.*

⁷⁵ *Ibid.*

RRSPs are popular with employers because their administrative costs are relatively low.⁷⁶ Some 2 million private sector employees participate in Group RRSPs.⁷⁷ Often, the investments available to participants include a selection of mutual funds. The employer determines which funds are offered, through an arrangement with an investment product supplier such as a mutual fund company, investment dealer, bank, credit union, insurance company or trust company. Depending on this arrangement, the selection of mutual funds available to employees may be broad or quite narrow. As of 2000, Group RRSP assets in Canada totalled \$28 billion, and 24% of the plan providers were mutual fund manufacturers or mutual fund dealers.⁷⁸

1.4.4.2.1 Pension plan administration

In private sector organizations, including not-for-profits, the organization's Board of Directors ultimately is responsible to plan members for all statutory, contractual and fiduciary aspects of the pension plan. Board committees often are struck to oversee pension governance matters. In the public sector, and for multi-employer (usually union) sponsored plans and funds, a Board of Trustees, separate from the sponsor, has ultimate responsibility.⁷⁹ The directors or trustees must ensure that the pension plan meets the plan sponsor's objectives. To fulfill this responsibility, they must discharge various duties, including: providing information to members; responding to members' questions about the plan; and prudently managing the pension fund.⁸⁰

1.4.4.2.2 The pension plan client

Pension plan administrators often outsource the management of the plan members' assets. Investment fund managers such as Real Assets compete for a share of this business. Sometimes, administrators employ more than one investment manager. The investment manager's client ultimately is the pension plan's legally responsible administrative body – usually the sponsoring organization's board of directors. However, the *de facto* client often is a third-party pension

⁷⁶ Kate McCaffery, "Selling Group RRSPs has Limited Appeal," *Investment Executive* mid-Nov. 2003, 10 July 2004 <<http://www.investmentexecutive.com/client/en/News/DetailNews.asp?IdPub=91&Id=22260&cat=30&IdSection=30&PageMem=&nbNews=>>.

⁷⁷ "Employees Reporting a Retirement Plan in their Job," table, Statistics Canada, 3 Feb. 2004, 10 July 2004 <http://www.statcan.ca/english/ads/11-002-XIE/2004/02/03404/03404_03tbl.htm>.

⁷⁸ Doug Burn, "Group Mentality," *Benefits Canada Magazine* May 2001, 8 July 2004 <<http://www.benefitscanada.com/content/legacy/Content/2001/05-01/a43.html>>.

⁷⁹ "Twenty Questions Directors Should Ask About Their Role in Pension Governance," Canadian Institute of Chartered Accountants, 2003, 17 June 2004 <http://www.cica.ca/multimedia/Download_Library/Research_Guidance/Risk_Management_Governance/Recent_Publications/CICA_20Qs_PensionsENG.pdf>.

⁸⁰ "Pension Guide for Members of Federally Regulated Private Pension Plans," *op. cit.*

consultant hired to oversee administration of the plan.

Pension plan consultants (“consultants”) help administrators select a plan type, design features of the plan, draft investment policy statements and other governance documents, select investment managers and other third-party service providers, handle employee communications, and monitor various aspects of the plan’s operations, while providing the rigorous reporting that administrators need to discharge their responsibilities. Large players such as William M. Mercer, Watson Wyatt, Hewitt, PriceWaterhouseCoopers, and Towers Perrin dominate the market. The top 10 consulting firms own over 90% of the pension, benefits and administration market.⁸¹

Normally, “rank and file” pension plan members and beneficiaries are far removed from the decision processes that affect the administration of their pension assets. They rarely are heard from unless they believe their assets have been badly mismanaged. Accordingly, when pursuing pension fund business, investment managers’ business development tactics generally do not include attempts to influence plan members. Instead, they pursue relationships with directors, trustees, or consultants, and hope to be invited by those administrators to submit a proposal.

1.4.4.2.3 Factors influencing pension plan administrators and consultants with respect to selecting an investment management supplier

Recent high profile corporate failures have revealed directors’ deficiencies in protecting the interests of pension plan members. Directors increasingly have become the target of lawsuits related to such areas as failure to educate plan members, or selection and retention of poor investments or managers.⁸² They are aware that failure to discharge their responsibilities can expose them to significant liability risk. As a result, they tend to be conservative and risk averse in the fulfilment of their duties, and wary of pursuing any course of action that could lead plan members or shareholders to accuse them of failing to fulfil their responsibilities. Understandably, pension consultants tend to reflect this conservative approach.

Pension administrators and consultants consider it risky to award business to smaller investment management firms that lack significant track records. The idea that “nobody gets fired for choosing IBM” applies; they find it safer to select suppliers with well-established records, and significant market share. At the end of 2003, each of Canada’s top 10 pension money managers

⁸¹ Kathryn Dorrell, “25th Annual Pension & Benefits Consultants Report,” Benefits Canada Magazine Aug. 2001, 9 July 2004 <<http://www.benefitscanada.com/content/legacy/Content/2001/08-01/feature1.html>>.

⁸² “Twenty Questions Directors Should Ask About Their Role in Pension Governance,” *op. cit.*

had more than \$12 billion of pension assets under management. The top 40, which together control an 80% market share, each had more than \$3 billion under management.⁸³

Pension plan administrators also consider it risky to include socially responsible investment criteria in their investment policies. They fear that if investment performance turns out to be sub-par, whether or not the SRI features of the investments are to blame, they will be accused of not sticking to safe, tried and true investments.

Among pension administrators, there is a lot of confusion as to how socially responsible investing fits with their fiduciary responsibilities as they relate to the established legal principal of prudence. This principal includes the duty to obtain a reasonable rate of return on investments and the duty to obtain an adequate diversity of investments.⁸⁴ Gil Yaron of the Shareholder Association for Research and Education (SHARE) explains:

Existing judicial commentary has been read narrowly to require that pension trustees maximize returns on investment and maintain sufficient diversity within the pension plan's investment portfolio. Socially responsible institutional investment has been discouraged [by investment managers and their legal counsels] on the grounds that it violates this interpretation of the duties.⁸⁵

The problem lies primarily in the notion (discussed in 1.3.6) that SRI tactics may harm investment returns by constraining the choices available to portfolio advisors. Although empirical evidence may not support this notion, pension fund administrators seem afraid to consider including socially responsible investment criteria in their investment policies until the courts rule that it is okay to do so. But so far such a case has not been brought before the courts.

Yaron's extensive analysis of Canadian legislation, common law and academic authorities leads him to conclude that:

Canadian law does not prohibit pension trustees from investing plan assets in a socially responsible manner. Rather, there is significant legal and empirical support for viewing socially responsible investment practices as a requisite element of prudent and loyal trusteeship.⁸⁶

⁸³ Anna Sharrat, "Making the Call," Benefits Canada Magazine April 2004: 49-59.

⁸⁴ Gil Yaron, "The Responsible Investment Trustee: Reinterpreting the Principles of Prudence and Loyalty in the Context of Socially Responsible Institutional Investing," Canadian Shareholder Assoc. for Research and Education, 18 May 2001, 12 May 2004 <http://www.share.ca/files/pdfs/Trustee%20_final.pdf>.

⁸⁵ *Ibid.*

⁸⁶ *Ibid.*

Unfortunately for socially responsible investment managers like Real Assets, few pension administrators are eager to test Yaron's assertion.

The challenges involved in communicating with plan members may also reduce the likelihood that pension plan administrators will consider including SRI criteria in their investment policies. Directors and trustees need to inform and educate plan members about their pension arrangements. This includes information about investment selections and service providers. Administrators may worry that adding SRI policies may increase the communication burden.

Plan administrators also may worry that it may be difficult to achieve a consensus among a relatively heterogeneous group of employees as to what constitutes an acceptable set of socially responsible investment policies. This particular concern is nicely encapsulated in a letter submitted by a retired school principal to the editors of *Benefits Canada* magazine in 1999:

As a pensioner with the Ontario Teachers' Pension Plan (OTPP), I was disturbed to learn recently that the teachers' unions, who negotiate improvements to the plan, want the managers of the plan to invest more 'ethically' . . .

. . . The job of finding acceptable ethical criteria would be enormous since there are approximately 175,000 teachers involved in the plan, either as contributors or recipients. Canada has been involved in the bombing of Yugoslavia. Would this mean the fund could not invest in Government of Canada bonds? Would the recent strike at Bell Canada result in both Bell Canada and sister company Nortel Networks being excluded from the list of possible investments? Would human rights violations in China exclude investment in one of the fastest growing markets in the world? Since teachers involved in Catholic education are members of the plan, would investments in pharmaceutical firms that manufacture birth control products be prohibited?

. . . Ethical investing does have its place and is best suited for individual investors. There are several ethical mutual funds on the market. Ethical investing may also be desirable for smaller plans with a very clear set of ethical objectives that all members can support.

The decision to adopt ethical guidelines for the OTPP, fortunately, does not lie entirely with the teachers' unions, since the government of Ontario must agree to the unions' proposals. Hopefully, the government of Ontario will see the wisdom in avoiding this potential minefield.⁸⁷

The Canada Pension Plan Investment Board has acknowledged this concern:

Social investing is easily applied by individuals and small groups of like-minded people . . . It is extremely difficult, if not impossible, to implement for an

⁸⁷ B. Mayne, "Ethical Investing Unveiled: Restricting Investment Would Impact Returns," *Benefits Canada Magazine* July 1999: 9.

institutional investor representing more than 16 million contributors and beneficiaries with a wide cross-section of personal beliefs.⁸⁸

Cost is another factor affecting administrators' choice of investment managers. Directors feel pressure to control costs by reducing administrative expenses, including fees to actuaries, investment managers, consultants, custodians, trustees, lawyers and auditors. Especially in the case of Defined Contribution Pension Plans, administrative expenses can significantly impair the growth of assets in an individual's account over time.⁸⁹ Plan administrators may worry that the inclusion of socially responsible investment policies may increase the plan's administrative costs. In this regard, larger investment fund managers, who can offer lower fees thanks to scale economies, have an advantage over smaller, higher-cost investment managers. Pension plan sponsors also are seeking to consolidate their financial assets among fewer money managers so as to negotiate the best possible deals on management fees.

A final consideration is that many pension fund administrators feel pressure to grow assets eroded during the bear market following the tech stock meltdown of 2000. They are attracted to the diversification and growth potential of foreign investments. Pension legislation allows up to 30% of a plan's assets to be invested in foreign securities. As a result, an increasing amount of Canadian pension business is going to foreign investment managers who offer experience with investing in foreign markets.⁹⁰ Increasingly, domestic investment managers that cannot provide broad access to global markets are at a disadvantage.

1.4.4.2.3.1 Labour union-sponsored pension plans

Two and a half million Canadians belong to labour unions. The Canadian Labour Congress, which represents the majority of Canadian unions, stated that a "reasonable guess" for the amount of pension assets belonging to union members would be half of all trustee pension assets in Canada.⁹¹ Based on this guess, union pension plan assets would amount to nearly \$300 billion, or one half of what Statistics Canada estimates to be \$584 billion now held in all trustee

⁸⁸ Monica Townson, "Pension Managers, Advisors Don't Give SRI its Due," *Investment Executive* mid-Feb. 2003, 10 July 2004 <<http://www.investmentexecutive.com/client/en/News/DetailNews.asp?IdPub=80&Id=19036&cat=23&IdSection=23&PageMem=&nbNews=>>.

⁸⁹ "Twenty Questions Directors Should Ask About Their Role in Pension Governance," *op. cit.*

⁹⁰ Kevin Press, "The Top 40 Money Managers of 2000," *op. cit.*

⁹¹ "Union and Pension Fund Investments," Canadian Labour Congress, Feb. 1998, 11 July 2004 <http://action.web.ca/home/clcpolcy/en_issues.shtml?sh_itm=0826bf6e753cc59992c10f1b71bf562e&AA_EX_Session=dc5468dd71463b58e7d567a7431d26e>.

pension plans.⁹² Most of these assets are managed in-house or placed in customized, discretionary accounts managed by specialist investment counselling firms. However, a small amount is invested in mutual funds and an even smaller amount in pooled funds.

Initially, Real Assets viewed union-sponsored pension plans and their administrators as an attractive target market. One reason is that Real Assets is partly union-owned (see 1.1) and unions generally prefer suppliers with union affiliations. But more importantly for Real Assets, and for socially responsible investment managers in general, is the apparent increasing interest that union members are taking in how their pension money is managed. Unions have been among the first organizations to challenge the restrictive notion that fiduciary responsibility cannot include non-financial considerations. They are beginning to explore ways to incorporate SRI criteria in their pension policies, in order to make sure that their pension money promotes activity that is congruent with union values. An article in the left-leaning *Columbia Journal* quotes Joe Barrett, a researcher with the BC and Yukon Territory Building and Construction Trades Council:

‘It seems up until recently people’s pension money was under the total control of investment managers who made all the decisions and just told the trustees what was best.’

He said there is a growing trend, especially among union workers, to gain more of a say in how their pension money is used, especially after years of repeated corporate scandals where large sums of pension money was lost on bad investment decisions and nefarious activity by corporate executives, or simply being invested in ways that are not beneficial to working people’s general interests. Quite often, he says, workers learn that employers that engage in union-busting, mass down-sizing or child labour; or violate human rights and labour or environmental standards, are using workers’ pension money.

‘For years, pension trustees have been told by investment managers that they can’t question their decisions or act in a socially responsible way because it would violate their fiduciary responsibility to their shareholders,’ he said. ‘Well we have learned that the shareholders are the union members we represent and that we should question their decisions and demand social responsibility.’⁹³

The Canadian Labour Congress has taken the position that pension fund investments should be used to pursue financial as well as non-financial objectives:

The Canadian trade union movement has the opportunity to exercise its influence and control over pension fund investments to pursue several important objectives:

- creating good, unionized jobs;

⁹² “The Daily,” *op. cit.*

⁹³ Marco Procaccini, “Power to the People Via ‘Pension Sense,’” *Columbia Journal* 9.1 (March 2004).

- investing in ways that combine good returns with targeted social, economic and environmental objectives, e.g. creating affordable housing;
- promoting recognized norms of good corporate behaviour such as those set out in the ILO Declaration on Fundamental Principles and Rights at Work and the OECD Guidelines on Multinational Enterprises;
- limiting the excesses of corporate executives and insider shareholders in areas such as: executive pay and benefits; the absence of independent directors; and, stock option plans for senior executives and directors; and,
- curbing anti-social corporate behaviour such as: environmental pollution; promoting a privatized, neo-liberal world; and exploiting child and sweatshop labour.

In short, as pension shareholders, the trade union movement will press the corporate world to take high roads to profitability that recognize the long term interests of pension shareholders and that respond to the needs of workers, retirees, communities and the environment.⁹⁴

However, despite these promising signs, Real Assets has not won significant business from the union pension plan market. The reality is that most union pension plan administrators share the same concerns discussed above (1.4.4.2.3) in the context of all pension plan administrators. If anything, union pension plan administrators are even more risk averse and wary of choosing smaller, unproven investment managers, because they have more to lose. This is because union pension plans usually are administered by union officials – presidents and secretary treasurers – who have been elected to their office in the union administration by rank-and-file union members. Non-union pension plans are administered by appointed senior corporate executives. If the non-union pension plan delivers sub-par performance (assuming there has been no breach of duty) the non-union pension plan trustee may be replaced on the pension committee, but in all likelihood he or she will return to his or her executive job. If the union pension plan delivers sub-par performance, the union trustee easily could find that the resulting damage to his or her credibility makes it impossible to win the next election and to keep his or her union office.

As well, with limited resources for business development, Real Assets has a hard time competing for union business. Union pension plan administrators can take a long time to make a decision on a new investment manager. The sales cycle can be as long as two years.

1.4.4.3 Endowments and Foundations

Endowments are permanent asset pools that are set aside to generate income for continued support of an organization. These exist within the structure of the organization.

⁹⁴ “A Trade Union Approach to Pension Fund Investing,” Canadian Labour Congress, Feb. 2004, 8 July 2004 <<http://action.web.ca/home/clcpolicy/attach/TradeUnionApproachToPensionFundInvesting-EN.pdf>>.

Foundations are established by organizations as parallel but separate entities, with separate incorporations, and with separate (though often overlapping) boards of directors. A foundation's purpose is to raise funds, to manage the endowment's assets and to oversee the distribution of grants provided to support particular, usually charitable, goals.⁹⁵

Endowments typically belong to charities and not-for-profit organizations. Foundations can be established by any organization, including charities, religious organizations, companies, families, individuals, and public institutions such as hospitals and universities. Often their asset amounts, and their need to safeguard and even to grow their asset pools, compel them to engage the services of professional money managers. Investment fund managers such as Real Assets compete for a share of this business. The market is small. The Tides Canada Foundation, which advises donors on issues related to values- or mission-based philanthropy, estimates that the total value all endowed Canadian foundation assets is just \$8 billion.⁹⁶

1.4.4.3.1 The Endowment and Foundation administration and client

Foundations and endowment funds normally are overseen by boards of directors. Boards commonly appoint investment committees to oversee and administer their investment portfolios. Committee members may or may not also be board members. Accordingly, in this market, the client of the investment manager usually is a board or an investment committee.

1.4.4.3.1.1 Factors influencing Endowment and Foundation administrators with respect to selecting an investment management supplier

Safety of principle is the primary financial goal of endowments and foundations. Growth, income and liquidity are secondary goals. Administrators take a conservative and risk-averse approach to investing. Often, these entities' policies limit investments to money market products or to fixed income and money market products. In those cases, Real Assets' equity-based pooled funds would not be considered. Administrators of endowment and foundation assets also are cost-conscious, since administration costs reduce the amount of funds available for other purposes.

Real Assets has had some success winning business from this institutional segment. What makes endowments and foundations attractive to socially responsible investment managers is that often these asset pools are established by people who share a narrowly defined set of values and goals, which often are related to pursuing social missions. The administrators often are interested in SRI options, which they may view as an extension of their values and missions.

⁹⁵ Tim Draimin and Jim Morrissey, "Thinking Long Term: Why, When and How to Start an Endowment," Tides Canada Foundation, July 2003, 28 June 2004 <<http://www.tidescanada.org/files/ACF5BB3.pdf>>.

⁹⁶ *Ibid.*

1.4.4.4 *Wealthy private individuals*

Conventionally, a “high net-worth” investor is defined as a person with \$1 million or more to invest. There are about 300,000 such individuals in Canada, many with more than \$1 million to invest. Some observers expect their ranks to double in the next decade as Baby Boomers pass on inheritances. The high net-worth market controls over \$700 billion.⁹⁷

High net-worth clients typically work with financial advisors who provide discretionary investment management services. These services involve customized portfolios, complete with investment policy statements spelling out relevant goals and criteria. Preservation of capital is often a high priority. A small subset of high net-worth investors may ask their FAs to help them create portfolios that reflect environmental, social and ethical concerns.

Increasingly, these services are fee based rather than commission based. That is, the advisor charges the investor an annual service fee, instead of collecting a commission on every transaction. The fee is a fixed percentage of the total assets in the portfolio, in the range of 100 to 125 bps.⁹⁸ Fund manufacturers, such as Real Assets, offer pooled funds and/or investor-class mutual funds to meet the needs of high net-worth investors and their fee-based advisors. Pooled funds and investor-class mutual funds require large initial investments – typically at least \$150,000 up to \$1,000,000 or more – but charge lower management fees than mutual funds.

Most high net-worth investors are in the stage of life where they are focused on saving money, from roughly 45 to 69 years old. The Investment Dealers Association says these increasingly sophisticated and empowered investors want high quality service and more choice as well as better transparency when it comes to fee structures and advice.⁹⁹

1.5 Revenue streams and profitability

1.5.1 *Mutual funds*

1.5.1.1 *MERs*

1.5.1.1.1 Retail-class funds

⁹⁷ Ian Davidson, “Rich Offerings,” *CAMagazine.com*, May 2003, 26 June 2004
<http://www.camagazine.com/index.cfm/ci_id/14508/la_id/1.htm>.

⁹⁸ James Langton, “Are Mutual Funds Past their Prime?,” *Investment Executive* Jan. 2004, 25 June 2004
<<http://investmentexecutive.com/client/en/News/DetailNews.asp?IdPub=93&Id=22625&cat=27&IdSection=27&PageMem=&nbNews=>>>.

⁹⁹ “IDA Wealth Watch,” Investment Dealers Assoc. of Canada, *IDA Wealth Watch* 1.1 (April 2004), 20 June 2004 <http://www.ida.ca/Files/IndIssues/PubResearch/IDAWealthWatch/IDAWW200404_en.pdf>.

Mutual fund managers collect cash from investors, operate that cash by investing it in various financial assets, and earn revenue by skimming off some of those assets every month or every quarter in the form of a portfolio management fee along with operating expenses. Operating expenses that are incurred and paid by the fund typically include expenses for audit and accounting, trusteeship, taxes, legal, regulatory filing, custody and marketing. All these expenses are detailed in the simplified prospectus provided to unitholders at the time of sale.

The total amount charged (management fee plus operating expenses) is the “Management Expense Ratio,” or “MER.” It is calculated as a percentage of the mutual fund’s average net asset value for the financial year. Mutual funds that are more costly to operate have higher MERs. For example, money market funds typically have an MER of about 1%, while global equity funds typically have an MER closer to 3%. The MER is paid out of the fund’s earnings (whether positive or negative) before the fund’s unit price is calculated. So, if two mutual funds have exactly the same earnings as a result of investment activities, the one with the higher MER will have a lower net return. From the perspective of the unitholder, the MER is not a direct cost, since investment performance is reported to unitholders net of the MER.

The MER on the Real Assets Social Leaders Fund is 3%. The MER for the Real Assets Social Impact Balanced Fund is 2.75%. The MER on the M class of the latter fund is 1%, but a minimum investment of \$500,000 is required to purchase M-class units. From these management fee revenues, Real Assets pays its variable and fixed costs. Real Assets’ MERs are significantly higher than the largest funds in the industry, and somewhat higher than the industry average.

Top 5 balanced funds in Canada	MER	AUM (millions)
RBC Balanced	2.35%	6,982
Mackenzie Ivy Growth & Income	2.25%	3,984
London Life Diversified	2.69%	2,739
Trimark Select Balanced	2.35%	2,658
Investors Mutual A	2.75%	2,202
Average	2.48%	
Average of all Canadian Balanced	2.59%	
Median of all Canadian Balanced	2.72%	
Real Assets Social Impact	2.75%	29
<i>RA Social Impact Balanced less category avg =</i>	<i>0.16%</i>	

Used by permission of Real Assets Investment Management Inc.

Table 1: Real Assets balanced fund MER compared to category Top 5, average and median

Table 1 compares the MER for the Real Assets Social Impact Balanced Fund to MERs in the Canadian balanced fund category, using widely available data as of December 31, 2003. Compared to the average MER for the 5 largest funds, Real Assets charges a premium of 27 bps. Compared to the average MER for the entire universe of Canadian balanced funds, Real Assets charges a premium of 16 bps. Compared to the median, Real Assets charges a premium of 3 bps.

Top 5 global equity funds in Canada	MER	AUM (millions)
Templeton Growth	2.37%	7,230
Trimark Select Growth	2.37%	6,143
AGF International Value	2.88%	5,211
Fidelity International Portfolio Sr A	2.52%	3,947
Mackenzie Ivy Foreign Equity	2.55%	3,353
Average	2.54%	
Average of all Global Equity	2.94%	
Median of all Global Equity	2.93%	
Real Assets Social Leaders	3.00%	3
RA Social Leaders less category avg =	0.06%	

Used by permission of Real Assets Investment Management Inc.

Table 2 Real Assets global equity fund MER compared to category Top 5, average and median

Table 2 compares the MER for the Real Assets Social Leaders Fund to MERs in the global equity fund category, using widely available data as of December 31, 2003. Compared to the average MER for the top 5 largest global equity funds, Real Assets charges a fairly large premium of 46 bps. Compared to the average MER for the entire universe of global equity funds, Real Assets charges a premium of 6 bps. Compared to the median MER for all global equity funds, Real Assets charges a premium of 7 bps.

Although MERs are a drag on performance, a low MER does not guarantee a higher return, just as a high MER does not guarantee a lower return. Returns depend on several factors including the fund's objectives, market conditions, and the skill of the portfolio advisor. Although many investors are wary of high MERs, ultimately, the fund's performance record compared to similar products will speak for itself.

1.5.1.2 Commissions and Trailer Fees

As a service provider, a fund manufacturer requires no physical inputs to "produce" mutual fund units. Nor does it maintain physical inventories. Commissions are the only cost that meets a strict definition of a variable cost as a cost that is directly related to production and sales.

However, a number of costs might be considered “quasi-variable” since they vary with production and sales, but also with other factors, such as market conditions, that are unrelated to production and sales. Trailer (or “trailing”) fees are one such quasi-variable cost. Trailer fees and commissions are the two most important costs that impact on the profitability of mutual funds.

A commission is a one-time payment from the fund manufacturer to the distributor (dealership or brokerage) that sells the fund units. The commission compensates the distributor for the work of completing the transaction. It is payable immediately after completion of the sale.

A trailer fee is a regular payment made by the fund manufacturer to the distributor as long as its client remains invested in units of the fund. It compensates the distributor for the ongoing monitoring of the fund units held in the client’s account. Trailer fees are calculated on an annualized basis as a percentage of assets under management. Real Assets makes trailer fee payments weekly. While the trailer fee percentage is fixed, the amount paid fluctuates as the assets under management fluctuate. Assets increase with cash inflows from new sales, decrease with outflows from redemptions, and either increase or decrease due to market conditions.

1.5.1.2.1 Load options

The percentages used to calculate commissions and trailer fees vary according to the arrangement made between the distributor and the investor at the time of sale (see Table 3). Real Assets offers its mutual funds with a choice of two industry-standard fee structures: “front load” (or “front-end load”) or “low load.” The option chosen is up to the discretion of the distributor.

	{ Real Assets }		
	Front load	Low load	Back end load
Investor pays commission to distributor	0% to 5%	0%	0%
Investor pays redemption penalty to fund co.	0%	2% first two years	Approx. 6% to 3% over seven years
Fund co. pays commission to distributor	0%	1%	5%
Fund co. pays trailer fee to distributor	1.25%	1%	0.5%

Used by permission of Real Assets Investment Management Inc.

Table 3: Real Assets mutual fund commission and fee schedules

1.5.1.2.1.1 Front load

If the distributor sells on a front-load basis, it charges the investor a commission of between 0 - 5% of the invested amount. Real Assets pays the distributor 0% commission, but pays an ongoing annual trailer fee worth 1.25% of the value of the mutual fund units belonging to the distributor’s client. The investor can redeem the units any time without penalty.

The front-load arrangement favors mutual fund companies since no up-front commission is payable to the distributor before revenues can be collected from the assets. It benefits investors since they can redeem fund units any time without paying a penalty to the fund company. Some distributors prefer to charge clients a direct commission, since it signals to the client the value of the advice. The distributor has flexibility to negotiate the commission amount. A drawback of front-load for the investor is that the commission is deducted from the investment amount, and so less money is put to work generating a return. A drawback for the distributor is that its client may not be amenable to the idea of paying a direct commission. For this reason, some distributors prefer an arrangement, such as low load, where their commission is paid by the fund company.

1.5.1.2.1.2 Low load

If the distributor sells the funds on a low-load schedule, it does not charge its client an up-front commission. However, the client agrees to pay Real Assets a penalty of 2% of the value of the fund assets should he or she redeem the fund units within two years of purchase. Real Assets pays the distributor a commission worth 1% of the investment amount, plus an ongoing annual trailer fee worth 1% of the value of the fund units belonging to the distributor's client.

The low-load arrangement means the fund company has to finance an up-front cost – the distributor's commission – before it collects revenue from the invested assets. The benefit is that the redemption penalty helps “lock in” the investor for at least two years. If the investor divests before two years, a fee is generated for the fund company. The benefit of low load for the investor is that all of his or her assets are put to work generating a return and, if he or she stays invested for at least two years, no commission or penalty is charged. The benefit to the distributor is that it does not have to risk harming the client relationship by asking the investor for an up-front fee, but it still receives a modest up-front commission from the fund company. And, the trailer fee generates a healthy annuity for the distributor while the client remains invested.

1.5.1.2.1.3 Back-end load

Real Assets does not offer another common sales arrangement, called “back-end load.” In this arrangement, the investor pays no commission to the distributor. The fund company pays the distributor a large commission worth 5% of the investment amount, plus a small annual trailer of 0.5%. To help the fund company recover the up-front commission, the investor agrees to pay a penalty, known as a “deferred sales charge,” or “DSC,” for redeeming fund units within five to seven years of purchase. The amount of the penalty declines each year until it reaches zero. This

arrangement made up the lion's share of fund sales as recently as four years ago, but its popularity is declining, to the point where it makes up approximately 50% of sales today.¹⁰⁰

The back-end load arrangement favors distributors, who receive a rich commission in addition to a small trailer fee. It also favors investors who are sure of remaining invested until the DSC schedule expires. However, investors pay a significant penalty if they need to divest before the DSC schedule expires. The back-end load arrangement benefits a fund company by making the assets more "sticky," since the money is likely to stay invested for six or more years. But back-end load sales are unfavorable to a start-up mutual fund company, since significant up-front commissions must be funded before revenues can be collected from the invested assets. For this reason, Real Assets decided not to offer a back-end load sales option for its mutual funds.

1.5.1.2.2 Institutional class fund

Real Assets charges an MER of 1% for the M-class version of its Social Impact Balanced Fund, based on a minimum initial investment of \$500,000. That is a competitive fee for a smaller institutional-size account. By comparison, institutional investors with hundreds of millions to invest can source segregated balanced fund managers for fees in the range of 16 bps.¹⁰¹

1.5.1.3 Scale economies

Because they have no capital assets, fund companies grow more profitable as their assets under management (AUM) increase. Table 4 shows a 2004 sales projection for the Real Assets Social Impact Balanced Fund. New sales, normally somewhat cyclical (with a spike during RRSP season), are artificially spread out over the year to highlight scale economies. To further simplify the illustration, all sales are assumed to be for the retail class fund. Noteworthy in the scenario is that while AUM increase by 140% over the year, costs increase by just 92%. As a result, margins improve steadily. These economies improve further at higher asset levels, since suppliers such as custodians and transfer agents charge lower percentage fees on higher assets.

Table 4 also calls attention to the fact that an investment fund manufacturer has two ways to grow its AUM: net inflows of new cash from customers and organic growth of existing assets. Thanks to these growth drivers, as well as the aforementioned scalability, a manufacturer often can grow earnings faster than it grows revenue from new net sales. In good years, the two drivers produce steady, long-term revenue growth. Even in lean years, at least one of the drivers usually

¹⁰⁰ Kate McCaffery, "Are DSCs Finally on their Way Out?: Fund Firms See Advisors Change Compensation," *Investment Executive* May 2004, May 15 2004 <<http://investmentexecutive.com/client/en/News/DetailNews.asp?IdPub=99&Id=24101&cat=27&IdSection=27&PageMem=&nbNews=>>.

¹⁰¹ Kevin Press, "The Top 100 Pension Funds of 2002," *op. cit.*

will contribute to growth. However, in the event of a major market downturn, investors can delay new investments, asset valuations can fall precipitately, and revenues can decline relative to costs.

1.5.2 Pooled funds

Pooled fund fees, as a percentage of assets under management, are lower than mutual fund fees. However, the costs to operate pooled funds are lower than for mutual funds since there are fewer regulatory filings and financial reports, and fewer individual accounts to administer.

Pooled fund investors typically pay between 20 to 50 bps for operating expenses such as custody and audit. These costs are charged directly inside the fund. Normally, portfolio management fees are an additional charge outside the fund and performance is reported gross of these fees. This arrangement differs from mutual funds, where both operating expenses and management fees are charged “all in” inside the fund, and performance is reported net of fees.

In order to attract business, Real Assets charges an attractive all-in (operating expenses plus management fee) fee of 30 bps for its two pooled funds. This fee is charged inside the funds.

Few fund manufacturers make their pooled fund fees publicly available. However, Real Assets' pooled fund fees seem competitive. For example, McLean Budden, which is one of several fund companies identified as having low average management fees,¹⁰² advertises its fees for all its pooled funds at 1% on the first \$2 million, then 45 bps on the next \$8 million, then 35 bps on amounts over \$10 million.¹⁰³ Sceptre Investment Counsel, one of Canada's larger institutional fund managers, lists fees for its Canadian equity pooled funds at 1% for the first \$1 million, 50 bps for the next \$4 million, and then 25 bps for amounts above \$5 million. For its U.S. equity pooled funds, Sceptre charge 75 bps for the first \$25 million and then 60 bps for the next \$25 million.¹⁰⁴

¹⁰² Rob Carrick, “Fund Industry is Unreasonable When it Comes to Fees,” *Globe and Mail* 12 June 2003, 19 June 2004 <http://www.globefund.com/servlet/ArticleNews/story/GFGAM/20030612/RCARI_3>.

¹⁰³ “Fee Schedules,” McLean Budden Ltd., 8 July 2004 <<http://www.mcleanbudden.com/english/privateclient/feeschedule.php>>.

¹⁰⁴ “Institutional Fees and Minimum Investment,” Sceptre Investment Counsel Ltd., 8 July 2004 <<http://www.sceptre.ca/sceptre/wmsceptre.nsf/Public/FEESInstitute>>.

Real Assets Social Impact Balanced Fund

	Dec-03	Jan-04	Feb-04	Mar-04	Apr-04	May-04	Jun-04	Jul-04	Aug-04	Sep-04	Oct-04	Nov-04	Dec-04	Total
New net sales from investors	\$4,000,000	\$4,000,000	\$4,000,000	\$4,000,000	\$4,000,000	\$4,000,000	\$4,000,000	\$4,000,000	\$4,000,000	\$4,000,000	\$4,000,000	\$4,000,000	\$4,000,000	\$48,000,000
Organic asset growth (assume 8% annually)	\$200,000	\$228,000	\$228,000	\$256,187	\$284,561	\$313,125	\$341,879	\$370,825	\$399,964	\$429,297	\$458,826	\$488,551	\$518,475	\$4,289,689
Assumed Assets Under Management	\$30,000,000	\$34,200,000	\$38,428,000	\$42,684,187	\$46,968,748	\$51,281,873	\$55,623,752	\$59,994,577	\$64,394,541	\$68,823,838	\$73,262,663	\$77,771,215	\$82,268,689	
Fund revenue (MIER)														
Management fee 2.5%	\$71,250	\$80,058	\$88,925	\$98,925	\$97,852	\$106,837	\$115,883	\$124,989	\$134,155	\$143,383	\$152,672	\$162,023	\$171,437	\$1,449,465
Operating expenses 25%	\$7,125	\$8,006	\$8,883	\$9,765	\$9,765	\$10,684	\$11,588	\$12,499	\$13,416	\$14,338	\$15,267	\$16,202	\$17,144	\$144,946
Total fund revenue	\$78,375	\$88,064	\$97,818	\$107,537	\$107,537	\$117,521	\$127,471	\$137,488	\$147,571	\$157,721	\$167,939	\$178,226	\$188,581	\$1,594,411
Fund variable costs (estimated)														
Commission	\$20,000	\$20,000	\$20,000	\$20,000	\$20,000	\$20,000	\$20,000	\$20,000	\$20,000	\$20,000	\$20,000	\$20,000	\$20,000	\$240,000
Trailer fees	\$18,000	\$21,964	\$25,954	\$29,971	\$29,971	\$34,014	\$38,085	\$42,182	\$46,307	\$50,460	\$54,640	\$58,848	\$63,084	\$483,509
Prospectus and other printing / mailing														\$15,000
Custodial fees (.05 - .025 bps)	\$2,098	\$2,239	\$2,381	\$2,524	\$2,524	\$2,668	\$2,812	\$2,958	\$3,105	\$3,252	\$3,397	\$3,544	\$3,691	\$35,122
Registrar fees	\$11,083	\$11,083	\$11,083	\$11,917	\$11,917	\$11,917	\$11,917	\$13,375	\$13,375	\$13,375	\$14,000	\$14,000	\$14,000	\$151,125
Prospectus - filing fees (.03 bps)	\$1,000	\$1,000	\$1,000	\$1,000	\$1,000	\$1,000	\$1,000	\$1,000	\$1,000	\$1,000	\$1,000	\$1,000	\$1,000	\$10,280
Transaction fees	\$52,181	\$56,286	\$60,418	\$64,541	\$68,664	\$72,787	\$76,910	\$81,033	\$85,156	\$89,279	\$93,402	\$97,525	\$101,648	\$947,016
Total fund variable costs	\$26,194	\$31,778	\$37,400	\$43,022	\$48,644	\$54,266	\$59,888	\$65,510	\$71,132	\$76,754	\$82,376	\$88,000	\$93,622	\$847,395
Gross profit	\$52,181	\$56,286	\$60,418	\$64,541	\$68,664	\$72,787	\$76,910	\$81,033	\$85,156	\$89,279	\$93,402	\$97,525	\$101,648	\$947,016
As percentage of revenue (gross margin)	33%	36%	38%	39%	39%	41%	42%	42%	43%	44%	44%	45%	46%	
Fund fixed costs														
FundData	\$1,250	\$1,250	\$1,250	\$1,250	\$1,250	\$1,250	\$1,250	\$1,250	\$1,250	\$1,250	\$1,250	\$1,250	\$1,250	\$1,095
FundServ	\$417	\$417	\$417	\$417	\$417	\$417	\$417	\$417	\$417	\$417	\$417	\$417	\$417	\$15,000
Regulatory filings	\$417	\$417	\$417	\$417	\$417	\$417	\$417	\$417	\$417	\$417	\$417	\$417	\$417	\$14,050
Trustee review of legal documents	\$417	\$417	\$417	\$417	\$417	\$417	\$417	\$417	\$417	\$417	\$417	\$417	\$417	\$3,000
Audits / Financial statements	\$417	\$417	\$417	\$417	\$417	\$417	\$417	\$417	\$417	\$417	\$417	\$417	\$417	\$10,000
Legals	\$2,500	\$2,500	\$2,500	\$2,500	\$2,500	\$2,500	\$2,500	\$2,500	\$2,500	\$2,500	\$2,500	\$2,500	\$2,500	\$5,000
Trustee record keeping (using Jewelstone)	\$3,906	\$3,906	\$3,906	\$3,906	\$3,906	\$3,906	\$3,906	\$3,906	\$3,906	\$3,906	\$3,906	\$3,906	\$3,906	\$30,000
Trustee valuation services	\$314	\$314	\$314	\$314	\$314	\$314	\$314	\$314	\$314	\$314	\$314	\$314	\$314	\$46,875
Secur	\$314	\$314	\$314	\$314	\$314	\$314	\$314	\$314	\$314	\$314	\$314	\$314	\$314	\$3,766
Secur utilization by trustee														\$400
Distribution														\$750
Portfolio Mgr tactical asset allocation	\$1,995	\$2,242	\$2,489	\$2,736	\$2,983	\$3,230	\$3,477	\$3,724	\$3,971	\$4,218	\$4,465	\$4,712	\$4,959	\$40,585
(TAA) additional fee (min \$25 mm)	\$2,500	\$2,500	\$2,500	\$2,500	\$2,500	\$2,500	\$2,500	\$2,500	\$2,500	\$2,500	\$2,500	\$2,500	\$2,500	\$64,988
Portfolio Manager TAA fees	\$13,298	\$13,545	\$13,793	\$14,041	\$14,289	\$14,537	\$14,785	\$15,033	\$15,281	\$15,529	\$15,777	\$16,025	\$16,273	\$237,519
Total fund fixed costs	\$65,480	\$69,831	\$74,182	\$78,533	\$82,884	\$87,235	\$91,586	\$95,937	\$100,288	\$104,639	\$108,990	\$113,341	\$117,692	\$1,184,535
Total fund costs	\$91,688	\$93,556	\$97,352	\$100,144	\$102,934	\$105,726	\$108,518	\$111,310	\$114,102	\$116,894	\$119,686	\$122,478	\$125,270	
Portion of corp. overhead assigned to operation of this fund NOT SHOWN														
Fund contribution to corp. overhead	\$12,895	\$18,233	\$23,671	\$29,109	\$34,547	\$39,985	\$45,423	\$50,861	\$56,299	\$61,737	\$67,175	\$72,613	\$78,051	\$62,908
As percentage of revenue	16%	21%	24%	24%	17%	29%	31%	27%	29%	6%	32%	33%	33%	

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Table 4: Sample 2004 sales projection for Real Assets mutual fund showing improving scale economies

While pooled fund managers may publish fee schedules or otherwise provide them to FAs and investors, in practice these fees often are negotiable. A distributor who does a lot of business with a pooled fund manager may be able to negotiate lower fees from the manager.

Pooled fund managers can grow assets from net inflows of cash from investors as well as from the organic growth of existing assets. Pooled fund management is subject to scale economies, whereby the company grows more profitable as its pooled fund asset base increases.

2 INDUSTRY ANALYSIS

2.1 Size and global/local dimensions

2.1.1 Retail investment funds

The Investment Funds Institute of Canada (IFIC) reports that Canadians have about \$471 billion invested in mutual funds.¹⁰⁵ The universe of assets invested by life insurance companies, segregated funds, trusted pension funds, mutual funds as well as direct investment by individuals via brokerage accounts, amounted to an estimated \$1.38 trillion as of March 2003.¹⁰⁶ In other words, mutual funds account for over one third of all the invested assets of Canadians.

IFIC reports that fourteen investment fund manufacturers have assets under management greater than \$10 billion.¹⁰⁷ *Investment Executive* reported that the top 21 investment fund companies collectively own about 75% of the market.¹⁰⁸

In fact, the industry is more concentrated, given that some of those top 21 firms have the same ownership. For example, Investors Group owns Mackenzie, National Bank owns Altamira, and GGOF is owned by Bank of Montreal. These companies' combined assets are ranked in Table 5, a view that produces a list of 18 firms that together own 75% of the market.

¹⁰⁵ "Industry Statistics," Investment Funds Institute of Canada, 2 June 2004, *op. cit.*

¹⁰⁶ "Occasional Report #41: Canadian Asset Mix Benchmark," CIBC World Markets, 28 May 2003, 10 May 2004 <http://research.cibcwm.com/economic_public/download/or41.pdf>.

¹⁰⁷ "Relative Position of Members: Investment Funds Report," table, Investment Funds Institute of Canada, March 2004, 14 June 2004 <<https://statistics.ificmembers.ca/English/reports/2004/03/public/pooledfunds.xls>>.

¹⁰⁸ "How the Fund Companies Performed According to Assets in Each Quartile," table, *Investment Executive* (Toronto) May 2004: 19.

Rank	Fund company	Assets at March 30, 2004 (millions)
1	Investors Group & Mackenzie	\$71.6
2	<i>AIM Trimark</i>	\$34.3
3	RBC Asset Mgmt	\$33.6
4	CI Mutual Funds	\$32.2
5	<i>Fidelity</i>	\$25.8
6	AGF Funds	\$23.1
7	TD Asset Mgmt	\$21.5
8	CIBC Asset Mgmt	\$20.6
9	<i>Franklin Templeton</i>	\$19.7
10	BMO Investments & GGF	\$14.5
11	AIC	\$11.6
12	PH&N	\$10.7
13	Scotia Securities	\$8.5
14	Dynamic	\$8.3
15	National Bank & Altamira	\$6.9
16	Fiducie Desjardins	\$4.8
17	Clarington Funds	\$3.5
18	Manulife Investments	\$1.6
	Total	\$352.8

Data compiled by the author

Table 5: Canada's 18 largest mutual fund companies, showing parent firms together with subsidiaries

Investment funds offered for sale in Canada must be manufactured in Canada by Canadian companies. However, Canadian manufacturers may be subsidiaries of international companies. For example, AIM Trimark is a subsidiary of U.K.-based AMVESCAP PLC. Fidelity Investments Canada and Franklin Templeton Investments both are subsidiaries of U.S. firms. Together, these three Canadian subsidiaries own about 17% of Canada's mutual fund market. In Table 5, names of foreign owned firms are shown in italics.

2.1.1.1 Socially responsible mutual funds

As of June 2002, the Social Investment Organization (SIO) estimated that Canadians had \$4.32 billion in socially responsible mutual funds, down from 5.77 billion in 2000. The SIO attributed the decline to general market conditions.¹⁰⁹ Assets in SRI funds represent just 1% of all

¹⁰⁹ "Canadian Social Investment Review 2002," Social Investment Organization, March 2003, 5 May 2004 <<http://www.socialinvestment.ca/CSIR.pdf>>.

mutual fund assets in Canada. By comparison, Americans have US\$151 billion invested in SRI funds,¹¹⁰ out of total mutual fund assets of US\$7.48 trillion,¹¹¹ representing a 3% market share.

Table 6 ranks Canadian manufacturers of SRI mutual funds by socially responsible assets under management as of the end of 2002.

Socially responsible mutual fund manufacturers' assets	
	\$(000,000)
Investors Group	\$1,902.7
Ethical Funds	\$1,609.5
PH&N	\$724.6
Acuity	\$189.6
Desjardins	\$98.3
Real Assets	\$31.6
Meritas	\$19.8
Mackenzie	\$11.8
Manulife	\$5.3
Canada Life	\$5.1
Sentry Select	\$2.1
Dynamic	\$1.6
Mavrix	\$0.7
Great Western Life	\$0.6
Quadrus	\$0.6
Lutheran Life	\$0.1
TOTAL	\$4,604.0

Data compiled by the author

Table 6: Assets of Canada's socially responsible mutual fund manufacturers

Investors Group, with its single socially screened product (“Summa”) manages more socially screened mutual fund assets than any other company. IG launched Summa in 1987, just a year after VanCity Savings Credit Union launched Canada’s first socially responsible mutual fund, the Ethical Growth Fund. Summa grew to become Canada’s largest SRI fund by far, with over \$2 billion in assets. Yet from an SRI perspective, the product has little to recommend it. IG makes its living from non-SRI products and the Investors Group brand is not associated with SRI. IG is not a member of the Social Investment Organization – the industry association for socially responsible financial service providers. IG has no competencies in socially responsible screening

¹¹⁰ “2003 Report on Socially Responsible Investing Trends in the United States,” Social Investment Forum, Dec. 2003, 7 May 2004 <http://www.socialinvest.org/areas/research/trends/sri_trends_report_2003.pdf>.

¹¹¹ “Trends in Mutual Fund Investing,” Investment Company Institute, April 2004, 7 May 2004 <http://www.ici.org/stats/mf/trends_04_04.html#TopOfPage>.

and shareholder activism; Summa is the kind of product that some in the industry call “SRI lite”; that is, it features negative screening based on the recommendations of third-party research and information providers, but does not engage in shareholder activism. From a financial perspective, the fund’s MER is on the high side, at 2.95% for the back-end load version. The fund’s investment returns since inception are decent, but not outstanding. However, in the 1990s, its returns were quite good. As a result, it caught the attention and become a favourite of IG’s huge sales force, who promoted it. This is an example how important it is for products to gain high profile and widespread distribution.

The Ethical Funds Company was formed in 1992 as a joint initiative of Canada’s credit unions. It brought together under one roof several credit union-run mutual funds, most notably VanCity’s Ethical Growth Fund. In addition to fund manufacturing, Ethical Funds integrated into back-office transaction processing, to support credit unions that ran front-office sales operations. In the late 1990s, Ethical Funds was brought together with two other credit union-owned companies: a mutual fund dealership and a full-service securities brokerage. Those businesses provide back-office transaction processing infrastructure for credit unions that sell third-party mutual funds and other securities. Today, although they are legally distinct corporate entities, these businesses operate as divisions under the umbrella of Credential Financial Inc. Credential Financial is also involved in the provision of insurance products and services for credit unions through Credential Insurance Services. Credential Financial’s ability to control distribution of insurance and investment products in credit union channels was enhanced with the January 2004 merger with MemberCARE Financial Services, formerly part of the CUMIS Group.

After its launch in 1992, Ethical Funds carved out an ownable position as the leader in a new niche category and its brand awareness grew quickly. By 1996, it had \$500 million in assets. It had \$1 billion by 1997 and it reached the \$2 billion mark in 1998. Since then, its assets under management have declined steadily. Today, Ethical Funds manages about \$1.6 billion.

There are several possible explanations for this decline, beyond the general maturing of the investment fund industry. One is that the investment performance of the funds has been mediocre. Another is that the credit union channels, which sold Ethical Funds exclusively in the mid-1990s, began in the late 1990s to sell third-party mutual funds distributed by Credential. Sales volumes for the Ethical Funds products fell as flows into third-party funds increased.

As well, credit unions represent only a tiny portion of distribution bandwidth in English-speaking Canada (in Quebec, the credit union system is more powerful). Ethical Funds has had only limited success in bringing its value proposition into non-credit union sales channels. It also largely has been unsuccessful in winning institutional business.

In the late 1990s, Ethical Funds' brand equity was damaged when media stories revealed that its flagship Ethical Growth Fund held a derivative security called Toronto 35 Index Participation Units and that those units held shares of companies that did not meet Ethical Funds' screening criteria. The ineligible holdings included firms with poor environmental records and firms making military equipment. Subsequently, Ethical Funds overhauled its policies to make them more clear and transparent. It became the first SRI fund manufacturer to publish its screening criteria, the first to publish proxy voting guidelines and the first to disclose how its votes its proxies.

In 2000, Ethical Funds launched "fund-of-funds" products (bundles of several mutual funds), under the Credential brand, that contain non-screened third-party funds. It could be argued that its introduction of these non-SRI products has diluted and compromised Ethical Funds' original differentiated focus strategy. So although Ethical Funds offers the country's broadest SRI product line-up, with 14 funds, strictly speaking, Ethical Funds is not the country's largest *dedicated* SRI fund company. Only Real Assets and Meritas can claim that distinction.

It seems reasonable to contemplate possible strategic fit issues arising from the operation of Ethical Funds as a division of Credential Financial, with centralized decision making for all operating units. As a niche investment fund manufacturer, Ethical Funds needs to pursue a differentiation strategy. However, Credential's other divisions – especially the transaction processing operations – need to be operated with cost-based strategies.

Strategic fit issues may help explain why, although Ethical Funds has deep expertise in the SRI market, its brand has not accrued as much credibility and trust as might be expected. Ethical Funds seems to derive little advantage from its culture, which gives the impression of being more bureaucratic than communitarian.¹¹² It has struggled to communicate its value proposition to the market, and to frame its activities in a way that is compelling to socially conscious consumers and to the media. In general, despite its history of breaking new ground on many issues, Ethical Funds' reputation as a thought leader is not as strong as it might be.

Meritas is backed by Ontario's Mennonite Credit Union and by other Mennonite interests. With just \$20 million under management, Meritas is stretching itself thin by offering a suite of five products, and it is not yet cash flow positive. Real Assets and Meritas are similar in their strategic approach to the market and they face similar challenges in controlling costs and in accessing distribution channels. A key difference is that Real Assets' underlying philosophy is

¹¹² See Mark Wexler, "The Four Faces of Capitalism: Structure and Change in Organizations," lecture notes, MBA 603 – Structure and Change in Organizations, Simon Fraser University, Vancouver, Fall 2003.

based on secular humanism while religious values guide Meritas. For example, for religious-based reasons, Meritas screens out companies involved with gambling and pornography. Another difference is that, so far at least, Meritas has not lead shareholder activism campaigns, although it has supported campaigns led by others. Among SRI investment fund manufacturers, only Real Assets and Ethical Funds frequently take a lead role in shareholder activism campaigns.

Acuity has a strong reputation for expertise in promoting environmental sustainability, with its family of four “Clean Environment” funds. Recently, it launched two “Social Values” products, which apply wider social criteria to the investment selection process. The privately held firm manages over \$3 billion in assets in mutual funds, pooled funds and discretionary investment accounts. The majority of these assets are not managed according to SRI criteria: Acuity manufactures 10 non-SRI mutual funds and 15 non-SRI pooled funds.

Desjardins is a Quebec-based co-operative organization. It is a major fund manufacturer that competes in a broad product market. In 1990 it launched a fund focused on environmental sustainability. After 14 years, the fund has \$90 million in assets.¹¹³ In 2000, Desjardins entered into an agreement to resell Ethical Funds products. The Desjardins SRI offering now includes a fund-of-funds product – the Desjardins Ethical Canadian Balanced Fund – that blends three separate underlying Ethical Funds products. This product has gathered just \$11.25 million.¹¹⁴

Ethical Funds, IG, Acuity and Desjardins have more than 10 years’ experience offering SRI funds. PH&N, Meritas and Mackenzie have fewer than five years’ experience.

2.1.2 Institutional investment funds

The entire Canadian institutional money management market is worth \$1.2 trillion¹¹⁵ and the trading of securities in institutional accounts is responsible for a major portion of the Toronto Stock Exchange’s trading volume.¹¹⁶ Investment fund manufacturers share a small piece of this market. Institutional accounts – mostly pension funds – held \$80 billion in mutual funds as of

¹¹³ “Fund Profile: Desjardins Environment Fund,” [Globefund.com](http://globefund.com), 30 July 2004 <http://globefunddb.theglobeandmail.com/gishome/plsql/gis.fund_pro?fundname=Desjardins+Environment>.

¹¹⁴ “Fund Profile: Desjardins Ethical Canadian Balanced Fund,” [Globefund.com](http://globefund.com), 30 July 2004 <http://globefunddb.theglobeandmail.com/gishome/plsql/gis.fund_pro?fundname=Desjardins+Ethical+Can+Balanced&pi_universe=PUBLIC_FUND&product_id=>>.

¹¹⁵ Jim MacDonald, “Top 40 Money Managers of 2003,” [Benefits Canada Magazine](#) Nov. 2003: 42-54.

¹¹⁶ “Account Management: Buy-side Account managers,” TSX Group, 10 July 2004 <<http://www.tse.com/en/productsAndServices/tradingServices/tse/accountManagement/#buy>>.

2000. A further \$31 billion was invested in pooled funds.¹¹⁷ Of the pooled fund assets, about \$7 billion, or 22%, was in products manufactured by dedicated investment fund companies.¹¹⁸

Each of Canada's top 40 institutional money managers oversees more than \$3 billion. Each of the top 12 manages more than \$10 billion. With \$97 billion under management, first place Caisse de dépôt et placement du Québec is triple the size of the nation's number two firm. Most of the top 40 are specialist money managers, not investment fund manufacturers. A couple of insurance companies make the list. Fund manufacturers that make the list include: PH&N in third place; TD Asset Management in fourth; McLean Budden in sixth; Beutel Goodman at number 17; Franklin Templeton at number 21; Sceptre at number 31, and Brandes at number 32.¹¹⁹ However, these companies make the Top 40 list primarily by virtue of assets that they manage in segregated, customized accounts, rather than assets held in pooled or mutual funds.

Investment fund companies are relinquishing the business of administering institutional accounts, such as pension funds and Group RRSPs, to insurance companies. Although such accounts may represent a large amount of total assets, they are aggregates of many small accounts. Account administration increasingly is the domain of insurance companies, which have a competency in processing huge numbers of small accounts.¹²⁰ The big insurance companies are involved in investment fund manufacturing, but they are willing to sell third-party funds and to put their own brand on white-label funds manufactured by third-party fund companies.

The biggest opportunity for investment fund manufacturers is not in servicing institutional accounts, but in getting onto the insurance companies' platforms of fund options. In these arrangements, margins are low for fund manufacturers. But they can still make money since the insurance companies cover the marketing and administrative costs.¹²¹ AIM/Trimark, Elliot & Page and Franklin Templeton have successfully pursued this business. AIM/Trimark owns about 46% of the investment fund offerings and the other two own about 14% each.¹²²

¹¹⁷ Kevin Press, "The Top 40 Money Managers of 2000," *op. cit.*

¹¹⁸ Scot Blythe, *op. cit.*

¹¹⁹ Anna Sharrat, *op. cit.*

¹²⁰ Scot Blythe, *op. cit.*

¹²¹ *Ibid.*

¹²² *Ibid.*

2.1.2.1 *Socially responsible institutional assets*

The Social Investment Organization estimates that Canadian institutions have about \$41 billion under management according to SRI guidelines. Virtually none is held in investment funds. Third-party, specialist asset managers oversee \$17 billion in customized portfolios. Another \$24 billion is overseen by institutional investors who manage their assets primarily or wholly in-house using SRI criteria. These institutional investors include pension plans as well as religious and public institutions such as universities, hospitals and foundations.¹²³

2.2 **Five-factor analysis**

Figure 3 maps the five-factor analysis for the investment fund manufacturing industry.

2.2.1 *Threat of entry*

In the investment fund manufacturing industry, threat of entry by new firms is low. By now, most of the domestic and foreign firms with the financial, distribution and marketing muscle to make a strong entry have entered or invested elsewhere. These include firms operating in related areas of financial services, such as banks and insurance companies. Today, slow industry growth, flat demand, excess capacity and falling margins make new entry, whether on a large or a small scale, much less probable. This situation is unlikely to change. Cost is a prohibitive entry barrier. In the current environment, it is hard to justify the significant investment that is required to get up and running and to attract enough customers to achieve minimum efficient scale.

In the 1980s and 1990s, the industry grew exponentially and dozens of new fund manufacturers sprang up to meet burgeoning demand. The market was worth \$27 billion in 1987, \$40 billion in 1994, \$340 billion in 1999, and nearly \$400 billion by 2001. Industry veterans recall, only half joking, that in the 1990s all you had to do was put a bucket labelled 'mutual fund' outside your door, and watch it fill up with money. But those days are over. The industry has matured. Perhaps the most bullish industry outlook, provided by Investment Funds Institute of Canada (IFIC) President & CEO Thomas Hockin, is for 7% to 10% per year until 2010¹²⁴ – good, but nothing like the growth rates of the 90s.

¹²³ Social Investment Organization, *op. cit.*

¹²⁴ Thomas A Hockin, speech, 10 Sept. 2003, Investment Funds Institute of Canada, 11 July 2004 <<http://www.ific.ca/eng/frames.asp?11=Media>>.

Canadian Investment Fund Manufacturing Industry

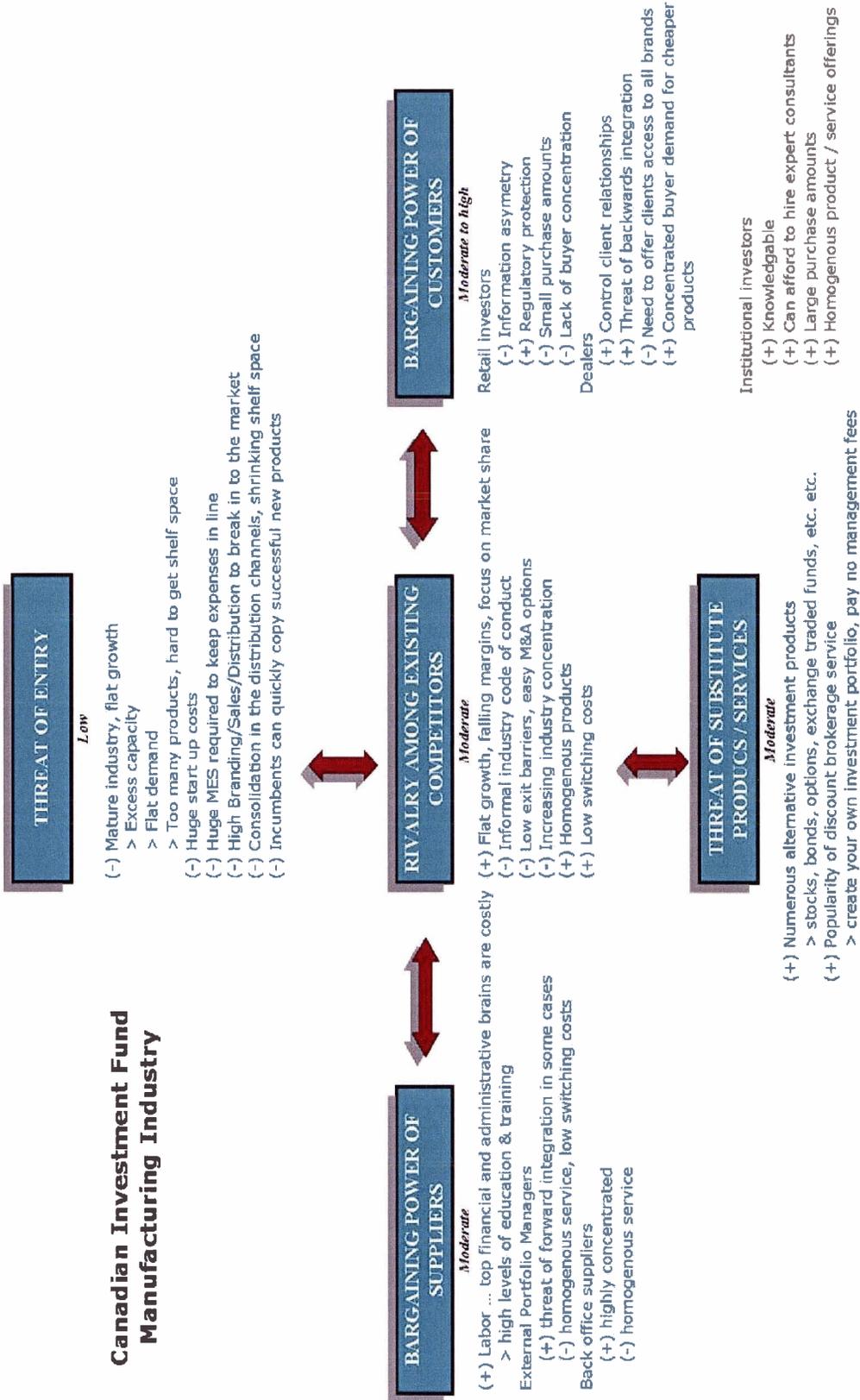


Figure 3: Five-factor analysis¹²⁵ of Canadian investment fund manufacturing industry

125 Adapted from Michael E Porter, "How Competitive Forces Shape Strategy," *Harvard Business Review* Reprint 79208 March-April 1979: 1-10.

Industry capacity is highly scalable and is already more than sufficient to meet demand in the foreseeable future. Many industry analysts agree that there are too many firms and too many products. IFIC's Thomas Hockin recently suggested that there are about 20 to 30% too many funds in the marketplace.¹²⁶ There are approximately 4,500 investment funds available in Canada – far more than the number of stocks listed on Canadian stock exchanges. Financial advisors and investors cannot keep track of them, and the distribution channels are crammed with products.

The rate of new product launches has slowed and many overlapping or unprofitable investment funds are being closed or consolidated. Some of these consolidations are fuelled by recent mergers and acquisitions among investment fund manufacturers. For example, following its 2000 merger with Trimark, AIM cuts its line-up from 85 to 70 funds.

Start-up costs are a significant barrier to entry. Every new investment fund must be seeded with enough start-up capital to create an investment portfolio that is sufficiently diversified to meet its objectives. High legal costs must be incurred in order to meet regulatory requirements. Key personnel and suppliers have to be engaged to begin investing the money and managing transactions. As well, initial losses must be funded, while the firm strives to attain the volume and scale required to achieve cost competitiveness. New fund manufacturers cannot simply pass along all costs to investors without pricing themselves out of the market. They must deliver competitive rates of return to investors. Operating costs create a drag on a fund's performance. Large scale, scope and volume are required to reduce the drag as much as possible.

For entrants that lack their own distribution network, branding and marketing costs are high. A new independent manufacturer needs to spend heavily to create awareness and trust and to promote some kind of value proposition that will allow it to earn support from distributors and acceptance from investors. Costs to integrate into direct distribution are significant, even with a purely virtual model. Costs to set up bricks and mortar distribution systems are enormous.

And in fact, consolidation within the distribution channels has made it harder to gain access to shelf space. The banks and insurance companies now control the majority of investment fund distribution.

Furthermore, should a new entrant manage to introduce a successful value proposition based on some unique product design or delivery model, the first-mover advantage likely would be short-lived. Innovations are transparent and competitors can copy them quickly.

In the SRI niche, the threat of new entry is low. The market share for SRI is low, at just 1%, and growth of the segment is low, in keeping with trends in the overall investment fund

¹²⁶ Geoff Kirbyson, *op. cit.*

industry. SRI advocates argue that there is significant untapped growth potential in the SRI segment, despite its small share and flat growth rate. To back up this claim, they point to evidence that many more Canadians are interested in SRI than currently hold SRI investments (see 1.4.2.1). The problem, SRI advocates say, is that the market is not addressing the interest in SRI. They say that with the addition of more SRI products, and increasing knowledge of SRI among financial advisors, that more investors will switch to SRI products, and that the segment will reach critical mass, or a “tipping point.”

Large players such as Investors Group, Mackenzie, and Phillips, Hager & North have tested the waters by introducing SRI products. Notably, these products employ socially responsible screening but not shareholder activism. In some circles this product strategy is called “SRI lite.” It seems reasonable to speculate that these companies are reluctant to engage in shareholder activism because it would entangle them in difficult questions about conflicting strategies and interests. It would be difficult for the fund manufacturer to allow its SRI fund manager to engage in shareholder activism with a certain company, when much larger positions in that company’s stock likely are held in one or more of the manufacturer’s non-SRI products. Issues like these create a barrier that buys time for Real Assets to grow and learn. However, given a sufficient spike in market demand for more ‘activist’ funds, large companies would seek to reconcile their strategic issues in order to introduce products to meet the demand.

2.2.2 Rivalry among existing competitors

Rivalry among competitors is moderately intense and likely will remain moderate or even increase. Several factors are putting pressure on margins and decreasing the ability of fund manufacturers to differentiate. However, recent M&A activity has taken off some of the competitive pressures.

Margin pressures, and some degree of cost competition, are relatively new dynamics in the industry. The main factor is the flattening of industry growth in the last three years. As growth stalls, firms began to fight for market share. Turbulent market conditions have played a role. Following the bursting of the high-tech bubble in 2000, investors have seen mostly disappointing fund performance and as a result they have become aware that high MERs, and high operating costs in general, are a drag on performance. Therefore, investment fund manufacturers need to seek efficiencies on the supply side in order to keep MERs in check while delivering competitive performance. Margins are under pressure as a result.

However, the largest firms are still profitable and so far none have resorted to aggressive price cutting strategy to gain market share.

One way to protect margins is to get bigger and spread costs over a larger asset base. Cash is the raw material of the fund manufacturing industry. Manufacturers have low fixed costs and no significant fixed assets. These factors soften industry competition because they make exit easy. Manufacturers' assets can be merged relatively easily and the merged entity stands a good chance of being more efficient and profitable than the sum of its parts. This explains why flat growth and falling margins have led to a flurry of M&A activity rather than a bloody shakeout. In fact, no Canadian investment fund manufacturer has ever gone bankrupt.

M&A activity has increased industry concentration, which now is moderate. The top 18 firms control about 75% of the market (see 2.1.1 above). Increased industry concentration tends to reduce rivalry between firms.

Rivalry is fuelled by the difficulty of differentiating product offerings. Investment funds have become commoditized, with major manufacturers offering similar product lines and major distributors acting as investment fund emporiums. Investors and financial advisors have trouble distinguishing between brands, and between the dozens of similar products in every category.

Moreover, it is increasingly difficult for manufacturers to differentiate on investment performance. Every portfolio manager has access to similar information and tools. There are few "star" managers remaining who can consistently outperform their peers.

Companies still spend heavily on advertising, promotion and channel support in order to maintain brand awareness and preference and to hold on to market share. Competitors are forced to follow suit or risk losing market share. Behaviour that forces competitors to respond is a signal of strong competitive rivalry.

Low switching costs increase competition. It is easy for investors to switch between competing investment funds and firms must work hard to acquire and keep customers.

Distribution channel consolidation also increases competition. The banks have a huge share: each has its own fund dealer and brokerage in-house. This channel consolidation creates fierce competition for shelf space.

2.2.3 *Threat of substitute products/services*

The threat of substitute products is moderate for the retail market and high for the institutional market. While the investment fund firms' existing asset base should remain stable, clients increasingly will consider alternatives before putting new money into investment funds. Therefore, a growing threat of substitutes characterizes this factor.

Investors want some combination of growth of capital, safety of principal (*i.e.*, risk minimization), income, liquidity and tax minimization, for a reasonable cost and reasonable

convenience. Investment fund manufacturing meets those needs nicely – especially for smaller investors – by creating pools of assets that bring together thousands of investors with similar goals. However, there are numerous alternative ways that investors can meet their individual objectives without tying their fortunes with thousands of others within the structure of an investment fund. Essentially, alternatives to investment funds allow investors to ‘go it alone’ and keep their financial assets within discrete, more customized portfolios. These alternatives limit the pricing power of investment fund manufacturers.

For example, institutional and high net-worth investors can afford investment portfolios managed by investment counsellors. These services can be more customized than what investment funds can provide, at a cost that is comparable or even cheaper, given a sufficiently large amount of investable assets.

Investors, even smaller ones, who have a higher threshold for risk and volatility, and a do-it-yourself orientation, can self-manage a customized portfolio of individual securities such as stocks and bonds within ‘self-directed’ investment accounts. Highly risk-averse investors can choose term deposits.

New investment products and services are being introduced continually and many are designed to steal assets from investment funds. For example, investors who are satisfied with a passive approach to investing can purchase exchange traded funds and index participation units, which deliver many of the same benefits of investment funds, but which can be bought or sold just like stocks and which have a lower cost of ownership.

2.2.4 Bargaining power of customers

The bargaining power of customers is moderate to high. While low to moderate customer power characterizes retail investors, the situation is different with dealers and institutional investors. The latter two customer groups wield moderate to high bargaining power.

2.2.4.1 Retail investors

There remains a high degree of information asymmetry between individual retail investors and fund manufacturers. However, the balance is shifting in favour of investors. Financial literacy is increasing and individual investors possess a more sophisticated understanding of investment funds than ever before. Many have a good idea as to what constitutes reasonable expenses for an investment fund, reasonable returns, and reasonable compensation for dealers who sell the funds.

The regulatory regime favours retail investors. Manufacturers face rigorous disclosure and transparency requirements. And the financial media benefit from fulfilling a strong demand for content related to financial matters. These factors give investors more information and power.

However, these points should not be overstated. Investing is a complex area and manufacturers and distributors still have much more knowledge than typical retail investors.

As well, the bargaining power of individual retail investors is severely limited by the small amounts they have to invest and also by their lack of buyer concentration.

2.2.4.2 Dealers

The power of the dealers that sell and distribute investment funds is moderate to strong.

Investment fund dealers enjoy a high degree of bargaining power since they control the all-important client relationships. Their recommendations have enormous influence over which investment funds the client selects. Productive dealers can demand preferential fees and service from investment fund manufacturers.

Large dealers also represent a credible threat of backwards integration into investment fund manufacturing, and this gives them additional power. In recent years, major distributors such as banks and insurance companies have purchased several fund manufacturers. A distributor that can sell its own products is more profitable than a pure dealer or a pure manufacturer.

However, the bargaining power of dealers is kept in check by their competitive need to offer their clients and sales reps access to the widest possible array of investment funds from various manufacturers. They believe that investors value having choices, and therefore they cannot easily refuse to offer a brand that is available on the shelves of competing dealers.

Although dealer concentration is relatively low (over 100 firms deal investment funds), increasingly they are calling with a single voice for cheaper products. This development is driven by the transition in dealer channels from the transaction-based to the fee-based revenue model. In the transaction-based model, investment fund dealers generate revenues primarily from commissions and trailer fees. These fees are wholly or partly invisible to the investor, since they are part of the MER charged by the investment fund manufacturer against the mutual fund's assets. In the fee-based model, the dealer foregoes commissions but charges the client an annual fee for advice and service. This fee is based on a percentage of the client's assets, typically around 100 to 125 basis points. For dealers, this fee revenue is more reliable than commissions. As well, the fee-based arrangement helps to define the value of advice and service and to align the interests of investors and dealers.

For investment fund manufacturers, the problem in the fee-based dealer revenue model is that investors do not want to pay a 1% fee to the dealer on top of the typical investment fund MERs of 2 to 3% for actively managed funds. As a result, dealers are demanding products that are better suited for fee-based accounts. These demands place pressure on investment fund manufacturers to find ways to deliver all the benefits of investment funds for a lower cost.

For financial advisors and dealers, fee-based accounts become attractive only once the client has about \$100,000 to invest. For this reason, Jim Rogers, chairman of Rogers Group Financial, predicts that mutual funds will be relegated to the role of the “poor man’s product” – good for accounts that are within the vicinity of \$25,000 but with little appeal for accounts of more than \$100,000.¹²⁷ But even if this prediction turns out to be true, the large number of small accounts still adds up to a very large market for mutual funds.

2.2.4.3 Institutional investors

Trustees of institutional assets are increasingly knowledgeable and empowered. As well, they can afford to engage the services of expert consultants. The large amounts of money under their control give them enormous bargaining power when it comes to negotiating fees from specialized asset managers or from investment fund manufacturers.

As well, the product and service offering throughout the asset management industry as a whole, as well as the investment fund industry, is increasingly homogeneous, and the industry is increasingly competitive. These factors give institutional investors power to demand extra service, added features, and lower costs.

2.2.5 Bargaining power of suppliers

The bargaining power of key suppliers is moderate and holding steady. They have power to maintain or increase the prices they can charge for their inputs.

Intellectual capital is the primary input in the industry. Key personnel are highly educated and trained and they command top dollar. Portfolio advisors, in particular, enjoy bargaining power, especially if they are seasoned by experience through several market cycles. However, their power is limited by the fact that their outputs are somewhat homogenous, given that they all have access to similar information and employ similar analytical tools for setting asset allocations and for deciding which securities to buy or sell and when to buy or sell them.

Manufacturers can keep some, all or none of the portfolio advisory function in-house. The larger external asset management firms are powerful since their huge size creates a threat of

¹²⁷ James Langton, “Are Mutual Funds Past their Prime?,” *op. cit.*

forward integration. However, this supplier power is mitigated since investment fund manufacturers have a number of external portfolio advisors to choose from. Should a third-party portfolio advisor not perform to expectations, the manufacturers' switching costs are high but not prohibitively so. Therefore, third-party portfolio advisors have a moderate amount of power.

Back-office service providers have a moderate amount of power. In particular, with the important custodial function, suppliers are concentrated, with the top three custodians controlling a 97% market share.¹²⁸ Custodians and transfer agents, which provide transaction processing, record keeping and reporting, have invested heavily in expensive technology platforms and specialized personnel and processes. However, their services are relatively homogeneous.

2.2.6 Overall assessment of the attractiveness of the investment fund industry

The five-factor analysis suggests that the Canadian investment fund manufacturing industry is becoming less attractive for existing competitors as well as for new entrants. The industry's growth rate has slowed and there is excess capacity. These factors, in addition to low exit barriers, have led to a period of industry consolidation through mergers and acquisitions, as firms seek to gain greater scope and scale.

At the same time, significant customer and supplier power checks companies' ability to maintain prices and control costs. As a result, margins are under pressure. Companies need to control costs. Being bigger is better, since costs can be spread out over a larger asset base. Again, the quickest way to become bigger is to acquire or merge with a competing firm.

There are several barriers to entry. One is the cost of launching and marketing products. Another is the need to attain scale in order to achieve a competitive cost structure. Another is the difficulty in accessing distribution. These forces will dominate the industry for the foreseeable future. Growth will be moderate, in part due to the proliferation of substitute products. Pressure to reduce costs and increase scale will lead to further industry consolidation. Life will get harder for independent investment fund manufacturers that lack integrated distribution networks.

2.2.6.1 Key issues

2.2.6.1.1 Access to distribution channels

The bargaining power of customers is a key issue. More specifically, the power of investment fund distributors is the top issue facing investment fund manufacturers.

¹²⁸ Andrea Davis, "Seventh Annual Special Report on Custodial Services," Benefits Canada Magazine Feb. 2001, 13 July 2004 <<http://www.benefitscanada.com/content/legacy/Content/2001/02-01/a76.html>>.

For an investment fund manufacturer's products simply to be included on a distributor's list of available products is not enough, since it does not guarantee a sufficiently high profile for the products. Ideally, fund manufacturers want distributors and their retail sales personnel to recommend the manufacturer's products to clients whenever appropriate. For new as well as for existing independent investment fund manufacturers, one of the biggest challenges is building and maintaining trust and preference for the products among distributor channels.

Investors Group's integrated distribution channel helped it become the country's biggest fund manufacturer. Several independent manufacturers, such as Mackenzie, which depended on third-party distribution, have been acquired by other firms. Several manufacturers that sold directly to investors through the internet and the telephone, such as Altamira, likewise have faltered. Full-service financial institutions, such as banks and insurance companies, take advantage of their retail distribution networks. As investment fund emporiums, the bulk of their distribution business is in third-party funds. However, they have integrated backwards into investment fund manufacturing, since distributing proprietary product is more profitable than distribution alone. They can promote the "house" products, and control client relationships, whether clients choose house or third-party funds. A CIBC World Markets analyst estimated in March 2004 that banks now control 50% of net fund flows, up from just 20% in 1997.¹²⁹

2.2.6.1.2 Need to attain economies of scale

The second top issue facing the industry is the slowing of growth and the subsequent need to gain scale (and scope) in order to remain cost competitive and protect market share. From 1980 to 2001, industry sales grew exponentially, and assets increased from \$3.6 billion to \$426 billion. But in 2002, assets decreased on a year-over-year basis for the first time since 1981.¹³⁰ Although this downturn coincided with a period of cyclical market volatility, analysts expect that secular factors will limit the industry to relatively modest growth rates in the foreseeable future.

Slow growth, in an industry with excess capacity, has led to increased competition and pressure to reduce costs. Companies need to achieve scale in order to spread administrative costs over larger asset bases and to remain competitive. This imperative has led to a flurry of recent M&A activity. Smaller companies, whether new or established, need to innovate and find some source of sustainable competitive advantage, or else be driven to merge with bigger firms.

¹²⁹ David Berman, "Fund Firms Back on Many Wish Lists: Shares of Publicly Traded Trio up 44% on Average in Year," National Post (Toronto) 24 March 2004: F1.

¹³⁰ Canada. Dept. of Finance. "Canada's Mutual Fund Industry." Aug. 2003, 20 May 2004 <http://www.fin.gc.ca/toce/2003/cmfi_e.html>.

3 INTERNAL ANALYSIS

3.1 Generic strategy

Real Assets is pursuing a differentiated focus strategy, by concentrating on a particular market niche. With around \$100 million in AUM, the company cannot compete on cost in the broader product market against multi-billion dollar firms. Instead, it has focused its limited resources, its strategy, its products, and its culture towards serving socially conscious investors. Socially responsible investment screening and shareholder activism are special features of Real Assets' investment funds that add actual value for investors who want to have their social, environmental and ethical considerations reflected in their investment portfolios. This focus has enabled Real Assets quickly to carve out an ownable position, and to build credibility and a strong reputation within its target market. Though the payoff of this strategy may be small, at least in the short term, the company has time to build its competencies and its assets without too much worry about larger competitors making aggressive attempts to take over the SRI niche.

	Cost based Low cost / adequate quality	Differentiation High quality / adequate cost										
	←—————→											
	0	1	2	3	4	5	6	7	8	9	10	
Product Strategy	Rapid Follower						6.5	Innovative				
R & D Expenses	Low R & D						High R & D					
Structure	Centralized						6	Decentralized				
Decision Making	Less Autonomy						6	Autonomy				
Manufacturing	Economies of Scale				5	Economies of Scope / Flexible						
Labour	Mass Production						6.5	Highly Skilled / Flexible				
Marketing	Comparative / Push							7	High Cost / Pull			
Risk Profile	Low Risk								9	High -Risk		
Capital Structure	Leveraged					5	Conservative					

Strategic fit chart adapted from Bukszar, 2004¹³¹

Figure 4: Strategic fit chart for Real Assets

¹³¹ Adapted from Ed Bukszar, lecture notes, EMBA Strategy Seminar, Simon Fraser University, Vancouver, Spring 2004.

3.2 Strategic fit

Figure 4 shows a strategic fit chart for Real Assets. The chart shows that some organizational competencies and capacities suit a differentiation strategy. However, there are dimensions that receive a mid-range score. A couple of these mid-range scores are attributable to the small size of the company. Other mid-range scores are cause for concern as they suggest an uncomfortable blending of cost- and differentiation-based strategies.

3.2.1 *Product strategy*

The product strategy is differentiated by socially responsible screening and shareholder activism. However, the underlying structures of the two pooled funds and of the Real Assets Social Impact Balanced Fund are conventional. The underlying structure of the Real Assets Social Leaders Fund is more unique. But overall, the dimension gets a mid-range score of 6.5.

Similarly, the Real Assets Social Impact Balanced Fund is a conventional balanced mandate. Socially responsible screening and shareholder activism are value-added features. A sub-advisor applies proprietary optimization techniques. Much of the research into the social, environmental and ethical performance of companies is purchased from third parties, but some is conducted in-house. Research for shareholder activism campaigns, which generally target companies that are held in at least one of the pooled funds as well as the Real Assets Social Impact Balanced Fund, largely is conducted in-house.

While the underlying structures of these three products are not highly differentiated, the socially responsible screening that Real Assets carries out is matched in only in a handful of other products. The shareholder activism campaigns are highly unique, and Real Assets is more aggressive than the competition in the SRI niche when it comes to conducting shareholder activism campaigns (and to communicating the value of this activity to the market).

The Real Assets Social Leaders Fund is a differentiated global equity mandate. As the only example of true “positive” screening, it is unique in the Canadian investment fund industry. The portfolio holds only companies that are outstanding leaders when it comes to social and/or environmental sustainability. As well, the portfolio’s blend of big, established companies with small, emerging companies, in many industry sectors, is unusual among equity funds. Real Assets manages the fund in-house and conducts most of the research that goes into stock selection. Selections are informed by leading-edge metrics and thinking related to the evaluation of the social, environmental and ethical performance of companies. Other firms could launch similar products, but it would be difficult (expensive) to put together a team with the necessary expertise.

3.2.2 R & D Expenses

This strategic fit variable rates a 7 on the chart. About one quarter of the company's operating budget is allocated to research related to the products. Research activities are directed towards evaluating companies' financial as well as social, environmental and ethical performance. As well, ongoing research is being carried out to support new shareholder action initiatives.

A higher rating is withheld for two reasons. First, Real Assets recently eliminated a staff role in R&D, following ownership's direction to reduce operating expenses. Second, R&D expenses tend to be fairly high as a rule in the investment fund manufacturing industry. Manufacturers conduct continuous research related to assessing the prospects for individual firms as well as micro-and macro-economic factors that could impact investment portfolios.

3.2.3 Structure and decision making

The mid-range score assigned for these variables is a function of the company's size and its position in its growth cycle. It is essentially still in the start-up phase. Cash flow is negative and not projected to be positive for some time. Shareholders are watching closely; expenditures need to be carefully monitored. Teams and departments have yet to form; functions like sales and marketing are handled by just one person who reports directly to the CEO. Processes have yet to be created; tactics often are ad hoc and opportunistic. Therefore, structure and decision-making needs to be more centralized and controlled than might be typical in a larger, more mature organization pursuing a differentiation strategy.

A value of six is awarded, however, because individuals are expected to demonstrate a high degree of responsibility, adaptability and flexibility. They have to react quickly to take advantage of opportunities to express Real Assets' unique value proposition. They also are expected to take the lead in setting the agenda for their functional areas.

3.2.4 Manufacturing

The differentiated screening and shareholder action aspects of the products require the production and application of specialized knowledge assets, including brand, reputation and expertise in socially responsible screening. These knowledge assets are applied across the product line-up and could be applied equally to new products and services. Therefore, Real Assets is generating economies of scope.

However, a mid-range value is assigned for this strategic fit variable, since Real Assets must contend with the industry imperative to achieve economies of scale and to control costs.

Accordingly, three of Real Assets' four products are built on generic, low-cost platforms, although the socially responsible features add expense as well as value to the generic platforms.

Generally, the investment fund manufacturing industry seeks both economies of scope and scale. Size counts because it allows a firm to enjoy a lower cost structure, but also to take advantage of economies of scope and to be more flexible. Big firms easily can introduce new products using the cash and the knowledge generated from manufacturing other products. Initial operating losses can be subsidized with the earnings of established products. New products that do not flourish can be shut down and their assets absorbed or transferred into other products.

Despite its ability to generate economies of scope, Real Assets' ability to launch new products and services is severely limited by its small size. However, it seems reasonable to propose that even large, low-cost firms would find it difficult (*i.e.*, expensive) to match the knowledge assets that Real Assets creates, should they attempt to take a leading role in the SRI niche. Especially, it would be expensive to find people with the requisite expertise in socially responsible screening and shareholder activism.

3.2.5 Labour

A rating of 6.5 is assigned for this variable. Real Assets' staff is skilled, talented, and flexible. However, Real Assets does not have the resources to pay top dollar for the most experienced and capable labour.

Although many of the functions such as operations, marketing and sales are well understood within the investment fund industry, Real Assets' requires specialized knowledge and experience with social, environmental and ethical issues and corporate social responsibility. Two of Real Assets' staff members – the CEO as well as the Vice President in charge of socially responsible research and shareholder campaigns – are former senior staffers with the David Suzuki Foundation, a high-profile environmental conservation organization.

A higher rating is prevented by the fact that the fund manufacturing industry as a whole relies heavily on intellectual capital for product development as well as sales and marketing functions. Therefore, all manufacturers should have a high rating along this dimension.

3.2.6 Marketing

A rating of 7 is assigned for this variable. As the investment fund manufacturing industry has grown and matured, marketing strategy has trended from pull to push. Early in the industry's growth cycle, investment know-how was king and companies built consumer brands around investment expertise (and they learned to process transactions efficiently to control costs).

Eventually it became difficult to differentiate on the skill and expertise of portfolio managers. Today, it is a rare fund manager who can outperform benchmark indices over the long term. Portfolio advising, though it is a highly skilled role, is more of a commodity. Indeed, it is fairly common for investment fund companies to outsource the day-to-day management of the assets (as well as the back office transaction processing) to specialist organizations that oversee billions of dollars and routinely work for several competing fund companies at the same time.

Later, investment fund manufacturers tried to differentiate and built consumer brands on the basis of product design. Instead of plain vanilla, chocolate and strawberry investment funds, companies packaged every conceivable mixture of assets in order to entice investors. For example, for a time, the Altamira brand was strongly identified with index-based mutual funds.

But since successful new offerings are quickly copied, the value of product design as a differentiator evaporated. Investors became confused and overwhelmed by the proliferation of different products. Today there are more Canadian mutual funds than there are listed companies on Canadian stock exchanges. Every major fund company offers a similarly broad and relatively homogeneous mix of products and no single company is strongly differentiated in this regard.

Distribution is a key to success for investment fund manufacturers today. Companies compete vigorously for shelf space in distribution channels. Big manufacturers like Investors Group are integrated forward into distribution, and big distributors such as banks are integrated backwards into fund manufacturing. The majority of today's most successful manufacturers rely heavily on push strategies – pushing the product out to the consumer – as distinguished from pull strategies – building brand preference that pulls the consumer to the product.

Apart from VanCity and United Capital, Real Assets does not have its own distribution system. It is too small to build its own distribution system and too small to pursue a push strategy based either on price/commission incentives or value added service to distributors. Therefore, Real Assets has no choice but to market the old fashioned way (for the investment fund industry): by differentiating its products, by branding, by personal selling of its value proposition to financial advisors, and by trying to motivate consumers to ask their distributors for the products.

Real Assets' differentiated strategy calls for an above-average allocation of resources towards sales and marketing. Resources are required to build brand awareness and preference as well as to educate investors and financial advisors about Real Assets' value proposition. However, the company's major shareholders have not furnished above-average resources for sales and marketing. In fact, they have asked management to minimize those expenditures.

Despite being under-resourced in sales and marketing, Real Assets has achieved remarkable success in bringing its differentiated message and its brand to the market. Without the

big marketing dollars required to engage in mass advertising and to send a sales force out to promote directly to financial advisors, Real Assets has instead resorted to guerrilla tactics. It has focused on low-cost publicity and word-of-mouth. In fact, the firm's competency in executing public relations marketing tactics gives it an important edge.

3.2.7 Risk profile

A rating of 9 is assigned to this variable. Real Assets is a high-risk venture. Growth in the overall investment fund industry has reached a plateau. The demand for SRI funds is small and growth prospects are uncertain. And, it will be difficult for Real Assets to deliver the basic feature of competitive returns, which is a market requirement. Economies of scale shape the industry, and small companies must cope with a higher cost structure that creates a drag on fund performance.

3.2.8 Capital structure

Real Assets is a 5 on this variable. With a high-risk, differentiated start-up enterprise, pure equity financing is the general rule. Real Assets has private equity financing, but it would like more in order to finance the sales and marketing efforts required to take its differentiated value proposition to market. Real Assets also has a significant amount of debt in its capital structure (see 3.5.1 below), in relation to the size of the firm. Debt financing is contra-indicated for Real Assets because it has no positive cash flow to pay interest and no collateral. Debt servicing reduces the amount of resources available to ramp up sales and marketing efforts.

3.2.9 Culture

Culture is not included in the strategic fit chart, but it warrants discussion under its own heading in the context of strategic fit. Real Assets singular focus on serving socially conscious investors unites its staff. The company's values support the mission of using invested capital to make a positive social difference. These values help create shared norms of behaviour, such as taking time to ensure that business decisions meet the same stringent environmental, social and ethical standards that the company advocates for public corporations. This commitment extends even to the level of selecting the most environmentally sustainable carpets for the office. The staff feels a high level of intrinsic motivation because they appreciate and believe in the authenticity of the company's social mission. They feel a sense of making a social contribution that goes beyond their jobs and beyond the interests of the firm. A communitarian sense of mission informs the culture, with CEO Deb Abbey as its guiding force. Every staff member would be willing and able to deliver an "elevator pitch" on the good things Real Assets is doing. This culture is quite

unusual for the financial industry, where profits, cost control and bureaucracy tend to be the main concerns. Therefore, its culture must be counted among the firm's most important assets.

3.2.10 Strategic fit assessment

Real Assets' strategic fit is sound in some areas but out of tune in other areas.

Areas that support differentiation are the design of innovative products, R&D, labour and marketing. However, efforts in these areas are compromised by the capital structure, which is an area of concern. Ownership's emphasis on cost control, and the presence of debt in the capital structure, are more in line with a cost-based strategy than with a differentiation strategy. A larger commitment of resources could support more innovative product design, more R&D and more experienced and capable labour. Especially, more resources are needed in sales and marketing so that Real Assets' can take its differentiated value proposition to market more aggressively.

The company needs to adjust its capital structure to better support a differentiation strategy. This theme will be addressed further in chapters three and four. The challenge for the company is to acquire new equity financing while maintaining its focus, its decision-making power in areas of competence, and the integrity of its brand.

Mid-range scores in structure and decision making reflect the firm's small size and do not detract from differentiation at this stage. As the firm grows, it will need to tune these areas to allow a more decentralized structure and to support autonomous decision making. The mid-range score in manufacturing is consistent with the firm's size. As it grows, it will have more resources to leverage its knowledge assets across more products to achieve greater economies of scope.

3.3 Value chain

The fund manufacturing industry breaks down into six main areas of value. Table 7 shows a value chain that identifies the six areas.

CONCISE INVESTMENT FUND MANUFACTURING INDUSTRY VALUE CHAIN*					
Sponsorship aka: "manufacturing"	Sales & Marketing	Sales / service / distribution	Inbound Logistics	Operations	Outbound Logistics
*Adapted from Porter (1985)					

Table 7: Concise fund manufacturing industry value chain¹³²

¹³² Adapted from Michael E. Porter, Competitive Advantage: Creating and Sustaining Superior Performance. (New York: The Free Press, 1985).

Table 8 shows a concise list of key value-added functions within the six areas. Real Assets' basic footprint within the industry value chain is shown in table 9. A more comprehensive view of Real Assets' footprint is shown in table 10.

CONCISE INVESTMENT FUND MANUFACTURING INDUSTRY VALUE CHAIN* SHOWING KEY VALUE ADDED FUNCTIONS						
Key value added	<ul style="list-style-type: none"> ● Establish investment objectives ● Establish cost-effective mix of in-house & out-sourced resources to support the objectives 	Communicate product benefits to create brand awareness and preference among dealer channels and investors	Assess investor needs & recommend suitable investment products	Process purchase orders efficiently and manage costs	Employ investment research and analysis skills to achieve investment objectives (target returns within given risk profile)	Process purchase orders efficiently and manage costs
	Sponsorship aka: "manufacturing"	Sales & Marketing	Sales / service / distribution	Inbound Logistics	Operations	Outbound Logistics

*Adapted from Porter (1985)

Table 8: Concise industry value chain¹³³ showing key value added functions

CONCISE INVESTMENT FUND MANUFACTURING INDUSTRY VALUE CHAIN* SHOWING REAL ASSETS INC. FOOTPRINT					
	Real Assets 90%				
Real Assets 60%				Real Assets 55%	
			Real Assets 15%		Real Assets 15%
	Real Assets 10%				
Sponsorship aka: "manufacturing"	Sales & Marketing	Sales / service / distribution	Inbound Logistics	Operations	Outbound Logistics

*Adapted from Porter (1985)

Table 9: Real Assets' footprint within industry value chain¹³⁴

¹³³ Ibid.

¹³⁴ Ibid.

COMPREHENSIVE INDUSTRY VALUE CHAIN * SHOWING FIRM FOOTPRINT

KEY: highlighted — Real Assets Inc. footprint * Adapted from Porter (1985)

Infrastructure & HR	<p>Fund co.</p> <ul style="list-style-type: none"> Establish corporate structure & board Acquire office space and basic equipment <p>Fund co.</p> <ul style="list-style-type: none"> Hire sales & marketing staff Set up retail offices (possibly call centre and online access) 	<p>Dealership/Brokerage</p> <ul style="list-style-type: none"> Hire operations staff Install sophisticated IT for transaction processing & database management <p>Fund co.</p> <ul style="list-style-type: none"> Manage 3rd party dealer relations Monitor Custodian / Registrar and Trustee Accounting 	<p>Portfolio Advisor</p> <ul style="list-style-type: none"> Hire research staff <p>Fund co.</p> <ul style="list-style-type: none"> Assess Portfolio Advisor Monitor Custodian / Registrar Pay dealer commission & trailer fees Pay mgmt fees to Fund co. Fund data to dealers 	<p>Fund co.</p> <ul style="list-style-type: none"> Manage 3rd party dealer relations Monitor Custodian / Registrar and Trustee Accounting <p>Dealership / Brokerage</p> <ul style="list-style-type: none"> Mail trade confirmation to investor <p>Dealership / Brokerage</p> <ul style="list-style-type: none"> Produce annual report Audit (accounting & compliance) Produce client statements Compliance audit 	<p>Fund co.</p> <ul style="list-style-type: none"> Manage 3rd party dealer relations Monitor Custodian / Registrar and Trustee Accounting <p>Dealership / Brokerage</p> <ul style="list-style-type: none"> Mail trade confirmation to investor <p>Dealership / Brokerage</p> <ul style="list-style-type: none"> Receive investor's redemption order Send redemption request to Registrar Receive money from Custodian for deposit in investor account <p>Custodial:</p> <ul style="list-style-type: none"> Send info to Registrar Send cash to Dealer, less any back-end fees Notify Portfolio Advisor of cash requirement <p>Portfolio Advisor:</p> <ul style="list-style-type: none"> If necessary, issue sell order to raise cash <p>Registrar:</p> <ul style="list-style-type: none"> Process transactions Remove fund units from participant account <p>Outbound Logistics</p> <p>Output: investment returns</p>	
Administrative	<p>Mutual Fund co.</p> <ul style="list-style-type: none"> Engage lawyers Oversee legal activities <p>Fund co.</p> <ul style="list-style-type: none"> Manage 3rd party dealer relations 	<p>Fund co.</p> <ul style="list-style-type: none"> Manage 3rd party dealer relations Monitor Custodian / Registrar and Trustee Accounting 	<p>Fund co.</p> <ul style="list-style-type: none"> Manage 3rd party dealer relations Monitor Custodian / Registrar and Trustee Accounting 	<p>Fund co.</p> <ul style="list-style-type: none"> Manage 3rd party dealer relations Monitor Custodian / Registrar and Trustee Accounting 	<p>Fund co.</p> <ul style="list-style-type: none"> Manage 3rd party dealer relations Monitor Custodian / Registrar and Trustee Accounting 	<p>Fund co.</p> <ul style="list-style-type: none"> Manage 3rd party dealer relations Monitor Custodian / Registrar and Trustee Accounting
Legal / regulatory compliance	<p>Fund co.</p> <ul style="list-style-type: none"> Create trust deeds for mutual fund trusts Create preliminary prospectus & annual information form; submit to regulators for approval 	<p>Fund co.</p> <ul style="list-style-type: none"> Compliance review of sales communications 	<p>Dealership/Brokerage</p> <ul style="list-style-type: none"> Register as dealer Ensure sales staffs licensed Capture "Know your client" information Review suitability of client transactions 	<p>Dealership / Brokerage</p> <ul style="list-style-type: none"> Mail trade confirmation to investor 	<p>Dealership / Brokerage</p> <ul style="list-style-type: none"> Receive investor's money, less any commission Open investor account Send p.o. to registrar and money to Custodian <p>Custodial:</p> <ul style="list-style-type: none"> Send info to Registrar Send fund units to Dealer Notify Portfolio Advisor that \$ available to invest Store data <p>Registrar:</p> <ul style="list-style-type: none"> Process transaction corresponding to the dealer's investor accounts Create participant data <p>Portfolio Advisor:</p> <ul style="list-style-type: none"> Acquire secondary market research 	<p>Dealership / Brokerage</p> <ul style="list-style-type: none"> Receive investor's money, less any commission Open investor account Send p.o. to registrar and money to Custodian <p>Custodial:</p> <ul style="list-style-type: none"> Send info to Registrar Send fund units to Dealer Notify Portfolio Advisor that \$ available to invest Store data <p>Registrar:</p> <ul style="list-style-type: none"> Process transaction corresponding to the dealer's investor accounts Create participant data <p>Portfolio Advisor:</p> <ul style="list-style-type: none"> Acquire secondary market research
Primary activities	<p>Fund co.</p> <ul style="list-style-type: none"> Raise min \$150k seed capital Establish investment objectives Appoint Trustee to maintain fund trust accounts Appoint Custodian to open fund custody account & safekeep securities held in fund trusts Appoint Registrar to maintain client records Appoint Portfolio Advisor(s) to execute the fund's investment objectives <p>Sponsorship</p> <p>aka: "manufacturing"</p>	<p>Fund co.</p> <ul style="list-style-type: none"> Set up dealer agreements to access 3rd party distribution channels "Wholesaling" — personal selling to dealers/advisors Branding Create sales collateral Publicity & media relations Events, presentations Advertising 	<p>Dealership/Brokerage</p> <ul style="list-style-type: none"> Assess investor's needs (growth, income, capital preservation, liquidity, etc.) and risk tolerance Provide advice Write purchase, redemption, or switch orders 	<p>Dealership / Brokerage</p> <ul style="list-style-type: none"> Process secondary research and conduct primary research Decide securities to buy, sell, hold Decide portfolio asset allocations Issue trade (buy/sell) orders to broker Proxy voting and shareholder advocacy <p>Brokerage:</p> <ul style="list-style-type: none"> Execute trade orders <p>Custodial:</p> <ul style="list-style-type: none"> Safekeeping of securities held in fund portfolio Calculate & distribute fund valuations daily Store data <p>Registrar:</p> <ul style="list-style-type: none"> Store / track participant account data 	<p>Dealership / Brokerage</p> <ul style="list-style-type: none"> Produce annual report Audit (accounting & compliance) Produce client statements Compliance audit 	<p>Dealership / Brokerage</p> <ul style="list-style-type: none"> Receive investor's redemption order Send redemption request to Registrar Receive money from Custodian for deposit in investor account <p>Custodial:</p> <ul style="list-style-type: none"> Send info to Registrar Send cash to Dealer, less any back-end fees Notify Portfolio Advisor of cash requirement <p>Portfolio Advisor:</p> <ul style="list-style-type: none"> If necessary, issue sell order to raise cash <p>Registrar:</p> <ul style="list-style-type: none"> Process transactions Remove fund units from participant account <p>Outbound Logistics</p> <p>Output: investment returns</p>
	<p>Sales & Marketing</p> <p>(to dealers & investors)</p>	<p>Sales / service / distribution</p>	<p>Operations</p>	<p>Operations</p>	<p>Operations</p>	
	<p>Inbound Logistics</p> <p>Inputs: (1) cash (2) data</p>					

Table 10: Comprehensive investment fund manufacturing industry value chain¹³⁵ showing Real Assets footprint

3.3.1 Sponsorship

Real Assets' role in sponsoring, or "manufacturing," in the industry terminology, involves: designing investment objectives for the funds; fulfilling legal and regulatory requirements; and setting up the infrastructure required to introduce the funds to the market.

Most investment fund manufacturing companies maintain a large footprint in this part of the value chain and Real Assets is no exception. The 40% portion shown in table 9 that is not covered relates to the significant role of legal expertise in sponsoring a new investment fund offering. As a small company, and since legal activities are not among its competencies,¹³⁶ Real Assets finds it cost effective to outsource legal services. Lawyers are required to draw up trust deeds for the investment funds, as well as the disclosure documentation that is submitted for approval to the securities regulators. In addition, lawyers are employed to help design contracts for such third-party suppliers as trustees and portfolio sub-advisors.

The 60% footprint in sponsorship covers the competencies of designing the investment fund's mandate and objectives, and setting up the corporate structure in terms of the mix of in-house and outsourced resources.

The ability to design an investment fund that will be attractive to the market is a threshold competency of every manufacturer. The possible fund designs are virtually limitless, but all manufacturers seek to achieve some particular combination of fundamental investment objectives: growth of capital; safety of principal; income; liquidity; and tax minimization. Real Assets, as a socially responsible fund manufacturer, also seeks to address non-financial criteria in its product designs, namely, investors' social, environmental and ethical concerns.

The need to control costs has a large influence on decisions regarding the mix between in-house and outsourced resources. Fixed costs and operating expenses must be paid out of the investment funds' assets under management. These costs are therefore a drag on the funds' ability to generate competitive returns for investors. Competitive performance is a market requirement, so it is essential to minimize costs until sufficient scale economies are achieved.

A large number of provincial securities regulations govern the formation and operation of investment funds. For its mutual funds, Real Assets had to: ensure that each of its corporate officers meets certain requirements for experience and education; raise seed capital of \$150,000 per fund; establish itself as a trustee legally permitted to hold title to the assets on behalf of investors; search for

¹³⁶ Adapted from C.K. Prahalad and Gary Hamel, "The Core Competence of the Corporation," Harvard Business Review Reprint 90311 May 1990.

and appoint a custodian to hold the funds' cash and securities on behalf of the funds; search for and appoint a transfer agent to keep a register of the owners of units of each fund as well as to process orders and issue account statements within specified time frames; and appoint auditors to audit the funds' financial statements in accordance with Canadian GAAP.

Real Assets engaged as its custodian National Bank Trust Inc. It appointed the same company as its registrar, or transfer agent. As its auditor it appointed Grant Thornton LLP. Real Assets also engaged third-party legal expertise to create the required disclosure documentation and to seek the necessary approvals from the provincial securities regulators in provinces where the investment funds are sold. In addition, Real Assets engaged State Street Global Advisors as sub advisors for the Real Assets Social Impact Balanced Fund and for the pooled funds.

The ability to set up this network of services, and to decide which to keep in-house and which to outsource, in order to support the company's overall strategy, is a threshold competency of a fund manufacturer.

3.3.2 Sales & Marketing

Table 9 shows that Real Assets largely has kept sales and marketing functions in-house.

The fund manufacturer executes a plan for promoting the products within the chosen distribution channels and also possibly to individual investors. Real Assets chose to pursue an intensive distribution strategy. Accordingly, a key marketing function was to approach as many third-party mutual investment fund dealers as possible and ask them to enter into agreements whereby the dealer adds the Real Assets products to its list of available products. At the same time, Real Assets' VP of sales engages in wholesaling activity, which involves contacting as many third-party dealers and individual financial advisors as possible, speaking to them about product features and benefits, and encouraging them to recommend the products to their clients.

Using in-house resources, and relying on its industry expertise and on word-of-mouth, Real Assets had a relatively easy time identifying and contacting the small number of successful advisors who already were committed to serving the SRI niche.

It has proven harder for Real Assets to identify and reach advisors who may potentially be interested in selling SRI investment funds but who are not doing so yet. These advisors are scattered across the country, and reaching them using in-house resources is difficult because of the imperative to keep overhead low. Real Assets has experimented with engaging freelance, commission-based sales agents to assist in these efforts. However, they have not proven able to properly represent Real Assets' differentiated message, perhaps because they are not as

committed to the company's mission. This experience suggests that wholesaling is a threshold competency that should be maintained in-house.

Since the Real Assets product offering is differentiated, marketing is also focused on branding and on creating awareness and interest among investors, so that they will be motivated to search for the products. Real Assets created a strong brand identity as well as a website and sales collateral, largely using in-house resources with the exception of graphic and web design services, which are outsourced.

Real Assets' CEO and its VP of public relations are skilled at executing low-cost guerrilla tactics designed to generate valuable publicity and media coverage. For example, CEO Deb Abbey wrote a book on how investors and consumers can use their "money power" to make a positive impact on society. The publication of this book provided an opportunity to conduct a substantial publicity campaign including book launch events, news releases, and numerous print and broadcast media appearances. All these events in turn provided opportunities to promote Real Assets and its products. Real Assets' shareholder campaigns with high profile companies like PepsiCo, Sears and BMO have attracted a good deal of media attention. Deb Abbey often makes presentations at events that attract people who may be interested in SRI. These include union events, public policy events, and so on. Deb Abbey has earned a reputation as a credible expert on the subjects of SRI and corporate social responsibility, and journalists often ask her to comment on related topics. Her ability to be a public role model, spokesperson and advocate for Real Assets and its style of "social impact investing" is a key asset of the firm which is supported by staff working in public relations, research and sales.

3.3.3 Sales / Service / Distribution

As the investment fund industry has evolved, direct control of distribution has become a key success factor. As mentioned, Canada's big banks, which have competencies in distribution, now control 50% of mutual fund cash flows. They enjoy a competitive advantage from their extensive networks of physical branches and their robust virtual channels. Large insurance companies also have extensive reach and are major players in the investment fund industry.

Without a captive sales distribution system, it is hard for a fund manufacturer, especially a small one, to gain the attention of advisors and investors. It helps that Real Assets is differentiated, and that a small number of investors may be motivated to seek out the products. However, the lack of distribution increases potential investors' search costs. An interested investor has to ask her advisor for information about the products. The advisor is unlikely to be familiar with the products, and may be disinclined to take the time to learn about them.

Selecting a distribution strategy is a key decision for an investment fund manufacturer. Distribution entails two separate functions. One is the dealer or “back office” that maintains client accounts and processes transactions. The other is the retail sales function or “front office” that is the point of sale for investors. Front office functions can be provided through physical retail locations as well as through telephone and internet channels.

There are several possibilities. The investment fund company can establish itself as a dealer with its own back office to maintain accounts and process transactions and maintain its own front-office sales channel. The front office may sell its own products exclusively, and may not allow other dealers to sell its products. This model was successful for Investors Group.

The investment fund company might have its own back office and its own front office, allowing its front office to sell third-party products along with the “house” funds, but not allowing distribution of its own funds through other dealers. This “open architecture” model has been successful for the big banks.

The investment fund company might maintain its own back office and a limited front-office sales capacity, but encourage sales through third-party dealers. This strategy has been successful for Phillips, Hager & North.

The investment fund company might maintain its own front office, but outsource the back office function to a third-party.

The investment fund company might not maintain any back- or front-office capacity, but rely entirely on third-party dealer and sales channels. One variation on this strategy is for the investment fund company to “white label” its products, by selling them at wholesale rates to another fund company (typically one that is more focused on distribution than manufacturing) that repackages them for sale to its clients.

Real Assets has no competencies either in the back-office processing functions or the advice and distribution functions of the front office. Back-office functions are outsourced to National Bank Trust through a service contract. Real Assets’ VP of operations monitors this supplier to ensure that it fulfills the terms of the service agreement.

Table 9 indicates a 10% footprint since one of Real Assets’ equity partners – VanCity – and the sister company – United Capital Securities – of another equity partner run front-office sales operations. VanCity distributes mutual funds through its network of 41 branches throughout the Lower Mainland of British Columbia. United Capital distributes mutual funds through advisors operating in offices in Vancouver and Victoria. Real Assets expects its products to receive preferential billing from these dealer channels.

As distribution channels, United Investment Counsel and VanCity are small and regional in the context of the Canadian market. Furthermore, Real Assets has no direct say in how their sales operations are conducted. It is therefore appropriate to describe Real Assets as a pure manufacturer, with no integration into and no competency in distribution.

3.3.4 *Inbound logistics*

The 15% footprint shown in table 9 (both for inbound as well as outbound logistics) represents the resources allocated by Real Assets towards monitoring the performance of the custodian and registrar, through analysis and verification of various reports. It is a regulatory requirement that the main custodial function – the safekeeping of the investment fund’s underlying securities – be carried out by a third party.

Back-office transaction processing functions require major investment in I.T. infrastructure and skilled resources and generally are not taken in-house by small fund manufacturers.

Inbound logistics involve money flowing in from investors in exchange for investment fund units. Real Assets’ portfolio advisors invest the money. As well, market intelligence (information) comes in to help the portfolio advisors decide how to invest the money. But money is the key input. This simple overview abbreviates an exceptionally complex system for moving money as well as data pertaining to the money, in a stringently regulated industry. Figure 5 describes the system in more detail, though the illustration is simplified.

In a typical transaction, an investor works with a financial advisor. The advisor is licensed to sell investment funds as an agent of a third-party dealer. The dealer, in turn, is licensed by securities regulators. A dealer agreement between Real Assets and the dealer enables the dealer to sell the funds and process the transactions through Real Assets’ back-office service supplier; the dealer is a “participating dealer” of Real Assets. The advisor and the investor agree to purchase a certain dollar value of Real Assets fund units. The advisor submits paperwork to his or her dealer, and the investor makes a payment to the dealer for the amount specified on the paperwork. The dealer opens a client account for the investor, and makes a purchase order to the investment fund’s registrar, or transfer agent (usually through a fund industry electronic data transfer utility firm called FundServ). The registrar receives the purchase order, and opens a “participant account” corresponding to the dealer’s client account. The registrar credits the participant account with the value of the fund units as of the close of that business day. Real Assets’ custodian collects the investor’s payment electronically from the dealer, and issues to the dealer the correct number of fund units. The dealer then credits its client account with the correct number of investment fund units and the transaction is said to have “settled.” Settlement must

occur within three business days after the placement of the purchase order. At that point, the dealer and the registrar both have a record of those investment fund units and both have client information. However, the investment fund company cannot use that client information to solicit business from the client without the dealer's permission. It can only use the client information to send statements and legal documents (e.g., annual reports) to the client.

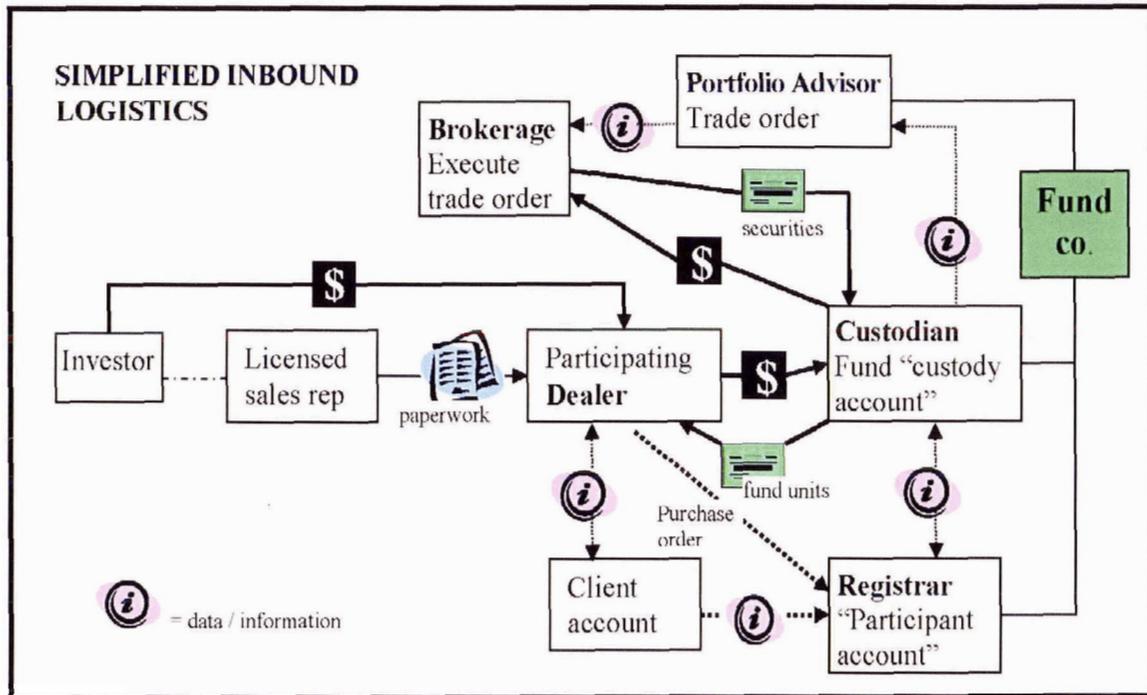


Figure by the author

Figure 5: Simplified inbound logistics

Once the transaction settles, the custodian notifies the portfolio advisor that money is available to be invested. The portfolio advisor issues trade orders to a brokerage to purchase securities for the investment fund. A large, vertically integrated, company such as a bank may include a brokerage operation. Real Assets uses third-party brokers. The brokerage “executes” the trade immediately. Within three business days, the trade settles when the money moves from the custodian to the brokerage as the securities move from the brokerage to the custodian.

A few days after settlement, Real Assets pays a commission to the dealer (see 1.5.1.2 above).

On a regular, even weekly or daily basis, Real Assets’ operations staff reviews reports from the registrar and custodian in order to ensure that transactions are processed efficiently and smoothly. They also review data that tracks sales and redemptions (inflows and outflows), and in general, they evaluate on an ongoing basis whether these key suppliers are providing adequate

service to Real Assets as well as to the third-party dealers that submit purchase and redemption orders for Real Assets' products.

3.3.5 Operations

Operations in the investment fund industry pertain mainly to the work of the fund manufacturer's portfolio advisor(s) in operating the assets under management. At Real Assets, operating the assets entails financial operations as well as socially responsible investment activities, including screening and shareholder activism. Table 9 shows a 55% footprint for Real Assets in this part of the value chain.

Real Assets CEO Deb Abbey is the nominal portfolio advisor for all the investment funds. In practice, the firm's associate portfolio advisor conducts most of the day-to-day tasks related to portfolio advising. Real Assets has no competencies in the portfolio advisory functions related to the underlying financial structure of its investment funds. An external sub-advisor, State Street, is engaged to fulfill complex functions related to maintaining the indices that underlie the pooled funds and the Real Assets Social Impact Balanced Funds, and in setting the asset allocation (the relative proportion of asset classes, *i.e.*, cash, stocks, bonds) in the latter product. Notably, the optimization techniques used to bring the socially screened indices in line with the risk/return profiles of the unscreened benchmark indices are proprietary to State Street.

Real Assets manages the Real Assets Social Leaders Funds in-house. The associate portfolio advisor carries out day-to-day advisory tasks, including assessing the financial health of current and potential holdings. The VP in charge of socially responsible research assesses the social, environmental and ethical performance of current and potential holdings. Final buy and sell decisions for the portfolio are made by a committee composed of the CEO, the associate portfolio advisor, the VP sales and a financial advisor from United Capital Securities who specializes in socially responsible investing.

In order to make decisions related to the portfolios, Real Assets' associate portfolio advisor as well as its third-party sub-advisory team constantly monitor and analyze economic, market and firm data. Some of this information is purchased from vendors such as Bloomberg. Some is gathered through primary research and data analysis.

As the senior portfolio advisor for all the funds, Real Assets CEO Deb Abbey is responsible for continually analyzing and monitoring the performance of the associate portfolio advisor and the sub-advisor. The key metric is the performance of the Real Assets portfolios against the established benchmarks. Sustained underperformance would be a critical problem requiring immediate action, since competitive fund performance is a market requirement.

Decisions about which companies are eligible or ineligible on social, environmental and ethical grounds are made in-house and communicated to the associate portfolio advisor and the sub-advisor. The VP responsible for SRI research and shareholder activism makes these decisions in conjunction with the CEO.

Although it is not the norm among investment fund manufacturers, Real Assets' often exercises its right to participate in the governance of the corporation whose shares it owns on behalf of unitholders. It votes proxies on behalf of unitholders, files shareholder resolutions, and enters discussions with corporate executives. The purpose of these activities is to encourage corporations to address potential liabilities related to environmental, social and ethical issues.

Shareholder activism campaigns require careful preparation. Staff members undertake research into possible focus areas, such as water scarcity and climate change, in order to understand how these issues put corporations and their shareholders at risk. Then they conduct research into and select a number of corporations that may be impacted by the risks identified. The VP SRI crafts a shareholder resolution and files it with the companies in accordance with securities laws and regulations. Companies may attempt to delay or resist the action, on various legal grounds, in order to prevent the issue from being raised before shareholders. In response, Real Assets may have to assert its legal rights, using its knowledge and perhaps drawing on wider legal expertise from within the SRI community. Often, discussions with corporate executives ensue. These discussions may lead to negotiations during which the corporation offers to take specific actions to address the issue, in exchange for having Real Assets rescind its shareholder resolution. Real Assets staff must conduct due diligence on these offers, and may go back to the corporation with a counter offer. Occasionally, successful negotiations lead to a "win-win" whereby the corporation can present itself as a good corporate citizen, and Real Assets can present itself as a catalyst for positive change on behalf of its unitholders. In these cases, Real Assets' VP of public relations may produce a joint press release. Or, the negotiations may not lead to any agreement. In that case, the resolution will be placed on the proxy ballot sent to all shareholders for the company's annual general meeting (AGM). The VP SRI may attend the AGM in order to speak to the resolution. The VP of public relations issues press releases and background information to introduce shareholder action campaigns and to report on the outcomes following AGM votes. Real Assets' CEO Deb Abbey fields media inquiries, armed with key messages constructed with input from the VP SRI and the VP of public relations.

As noted above, support operations pertaining to the registrar and custodian functions are outsourced. These functions involve maintaining, constantly updating and safeguarding data and records pertaining to the various participant and client accounts. On a daily basis, the custodian

must calculate the value of the mutual fund units based on the value of the underlying securities at the close of the markets, and then distribute that information to various sources, such as the financial media. The registrar produces and distributes regular monthly client statements. Real Assets' VP of operations continually reviews various reports from the custodian and registrar in order to ensure that these important responsibilities are carried out properly.

Hiring is conducted in-house, since it is important for Real Assets to recruit the right people, but administrative functions related to areas such as benefits and payroll are handled through VanCity. Information systems maintenance is outsourced to a third-party vendor.

3.3.6 *Outbound logistics*

For Real Assets, outbound logistics are essentially the reverse of the inbound logistics portrayed in 3.3.4. An investor places a sell or "redemption" order through her financial advisor. The advisor submits paperwork to her dealer. The dealer places an order with Real Assets' registrar to redeem the fund units. The registrar instructs Real Assets' custodian to "sell" the units at that day's unit valuation (total value of the fund's assets divided by total units issued). The custodian sends back to the dealer an amount of money equal to the investor's original investment, net of any investment gains or losses. The dealer sends the cash to the investor. The registrar's participant account and the dealer's client accounts are adjusted accordingly.

If net flows out of the investment fund materially exceed net flows in, then Real Assets' portfolio advisors are forced to liquidate assets of the fund, through a brokerage, in order to remit cash to investors.

The main output of the value chain is investment returns (whether positive or negative).

3.4 Competencies and competitive advantages

Investment fund manufacturers can achieve an edge or a competitive advantage in four main areas. One is sponsorship, and in particular in the design of products that incorporate innovative ways to meet investors' objectives. Another is in marketing, and in particular in building a brand that signals excellence in achieving the investment objectives that are important to the target market. Another is in distribution, in reaching as many investors as possible, and in efficient provision of the services that facilitate investors' purchase decisions. The last is in operations, in operating the assets under management more productively, and in achieving better than average outcomes in comparison to an appropriate set of competing products or benchmarks.

COMPREHENSIVE FIRM VALUE CHAIN* OMITTING OUTSOURCED FUNCTIONS

KEY: highlighted=Real Assets area of competency *Adapted from Porter (1985)

Infrastructure and HR	<ul style="list-style-type: none"> Establish corp. structure & board Hire operations staff Acquire office space and basic equipment 	Hire sales & marketing staff	Hire SRI research and shareholder campaign staff			
Administrative	<ul style="list-style-type: none"> Engage lawyers Oversee legal activities 	Manage 3 rd party dealer relations	<ul style="list-style-type: none"> Manage 3rd party dealer relations Monitor Custodian / Registrar and Trustee Accounting 	<ul style="list-style-type: none"> Assess Portfolio Advisor Monitor Custodian / Registrar 	<ul style="list-style-type: none"> Manage 3rd party dealer relations Monitor Custodian / Registrar and Trustee Accounting 	<ul style="list-style-type: none"> Manage 3rd party dealer relations Monitor Custodian / Registrar and Trustee Accounting
Legal / regulatory compliance	<ul style="list-style-type: none"> Create trust deeds for mutual fund trusts Create preliminary prospectus & annual information form; submit to regulators for approval 	Compliance review of sales communications		Produce annual report and distribute to unitholders		
Primary activities	<ul style="list-style-type: none"> Raise minimum \$150,000 to seed fund Establish investment objectives Appoint Trustee Appoint Custodian Appoint Registrar Appoint Portfolio Advisor(s) 	<ul style="list-style-type: none"> Set up dealer agreements "Wholesaling" personal selling to dealers / advisors Branding and creation of sales collateral Communications & media relations Events, presentations Advertising 	[Equity partner front office sales channels]	<ul style="list-style-type: none"> Process secondary research and conduct primary research Decide securities to buy, sell or hold Decide portfolio asset allocations Issue trade (buy/sell) orders to broker Proxy voting Shareholder advocacy campaigns 	Acquire secondary market research	If necessary, issue sell order to raise cash
	Sponsorship aka: "manufacturing"	Sales & Marketing (to dealers & investors)	Sales / service / distribution	Operations	Inbound Logistics Inputs: (1) \$ (2) data	Outbound Logistics Output: investment returns

Table 11: Real Assets value chain¹³⁷, omitting outsourced functions, showing sources of competitive advantage

¹³⁷ Adapted from Michael E. Porter, *Competitive Advantage: Creating and Sustaining Superior Performance*, op. cit.

Table 11 shows a comprehensive firm value chain for Real Assets, omitting outsourced functions. Highlighted areas indicate where Real Assets has competencies that give it an edge. Noteworthy is that Real Assets has competencies in three of the four areas. The area missing is distribution, which today is probably the key area in which firms can build core competencies and achieve sustainable competitive advantage.

It is harder to develop core competencies in the three remaining areas. Competitors quickly will copy innovative products that stimulate investor demand. Building brands is getting more difficult because investment funds have become commodified to a large extent. And, since all portfolio advisors have access to similar information, and since markets are efficient, it is hard for portfolio advisors who operate assets to produce above average returns for sustained periods.

Nevertheless, in the context of a niche market, and a differentiated focus strategy that targets a particular, socially motivated, segment of the market, it makes sense to talk about Real Assets' competencies in sponsorship, marketing and operations. Real Assets' has a strong and credible brand that is a source of competitive advantage.

3.4.1 Competency in sponsorship

Product design, a key function of fund sponsorship, is a competency that gives Real Assets an edge. While the company cannot excel at designing the underlying financial structure of investment funds, it excels at designing products and product features that appeal to and are valued by SRI investors. Real Assets knows the SRI market segment as well as anyone. And it knows as much or more than anyone about how to meet SRI objectives through screening and shareholder activism. Furthermore, its focus on SRI products helps Real Assets avoid strategy dilution or distraction with regard to product design. Except for Meritas, most of the other manufacturers of SRI investment funds also offer non-SRI funds, including Investors Group, Ethical Funds, Acuity, Phillips Hager & North, and Desjardins.

3.4.2 Competencies and competitive advantage in marketing

With marketing in general, and promotions and public relations in particular, Real Assets has competencies that give it an edge. The return on investment for these functions is high and it makes sense to keep them in-house. No third party could understand the message and communicate it with as much conviction, or understand the audience, as well as Real Assets' staff. These competencies have helped Real Assets create a strong brand.

Although its brand is not widely recognized, it is reasonable to propose that Real Assets generates a competitive advantage from it. In a short time, the Real Assets brand has accrued a high degree of credibility and trust among socially conscious investors. Authenticity,

competence, trustworthiness and excitement are aspects of the brand's personality that distinguish it from the competition and that are valued by SRI investors. Real Assets is associated with social justice, leadership and making a positive social impact.

It would be hard for a competitor to replicate the set of cues encompassed in the Real Assets brand. Mainstream fund manufacturers, such as Investors Group, which reach into the SRI segment, cannot hope to earn this kind of credibility and reputation among SRI investors because of the obvious conflict of interest created by mixing SRI with non-SRI products. The same problem dilutes the branding efforts of manufacturers, such as The Ethical Funds Company and Acuity, that are committed to the SRI segment but which also manufacture non-SRI products.

Key assets that support this advantage are people with specialized expertise and a culture that is committed to making a positive social impact. Competencies that support this advantage are: the ability to make sound judgments about which companies to screen out and screen in on social, environmental and ethical grounds; deep knowledge of issues related to SRI and corporate social responsibility; the ability to frame issues in a way that is compelling to stakeholders; the ability to communicate issues and a value proposition in a way that demonstrates expertise and thought leadership; and skill in pushing the company's story out through public relations tactics.

Real Assets has a strong competency in understanding and in framing social, environmental and ethical issues. Two of Real Assets personnel – the CEO and the Vice President in charge of SRI research and shareholder activism – are former senior staffers with the David Suzuki Foundation. There, they polished their skills in presenting issues in a compelling way to the public. This background is rare, if not unique, among leaders in the investment fund manufacturing industry. It has helped Real Assets to generate a tremendous amount of valuable media coverage, which in turn strengthens the firm's reputation and credibility within the SRI community as well as the broader investment market.

Real Assets has been more successful than other firms competing in the SRI niche in leveraging its screening and shareholder activism initiatives to build credibility and a reputation for "walking the talk." Its skill in executing promotional and public relations tactics has created a virtuous circle. As the firm's reputation has grown, it has attracted more positive media coverage. The more positive media coverage it attracts, the stronger its reputation and its brand grows.

3.4.3 Competencies in operations

While it does not have the capacities and competencies to excel at the purely financial aspects of portfolio construction, Real Assets does have assets and competencies that allow it to excel against the competition in managing the socially responsible features of the products.

There are important competencies at work in Real Assets' ability to assess companies' social, environmental and ethical performance and to conduct shareholder action initiatives. These activities meet the expectations of and add value for socially conscious investors.

Real Assets has a competency in screening out poor performers ("negative screening") from the two pooled funds and from the Real Assets Social Impact Balanced Fund. This competency involves experience and skill in assessing primary and third-party research into companies' activities. It also involves being connected to NGOs, community groups and labour organizations which possess information that helps Real Assets cut through corporate PR spin.

Part of this competency lies in making sensitive judgement calls about which holdings will or will not be palatable to socially conscious investors. It takes experience and a good feel for the market to make those kinds of judgements. At times, other SRI fund manufacturers have been accused of making screening decisions that violate the spirit, if not the letter, of their stated approach to responsible investing. For example, other SRI fund companies may hold Wal-Mart in their portfolios. Wal-Mart scores well on certain social criteria, but poorly on others. It is possible only to speculate why an SRI investment fund company might hold Wal-Mart. It may feel that it can use shareholder activism to push Wal-Mart to be more progressive. It may worry that dropping the world's largest retailer from its portfolios will egregiously harm the financial performance of its funds. Regardless, SRI fund companies that hold Wal Mart have faced criticism from thought leaders in the SRI community. Real Assets has decided for the time being to exclude Wal-Mart from its portfolios and it has not been reticent to describe why it has made this decision. This decision, and others like it, has contributed to Real Assets' reputation and credibility within the SRI community as a firm that stands behind its principles and demonstrates leadership on issues of concern to socially responsible investors.

Real Assets' competency in assessing corporate social, environmental and ethical performance is applied in the selection ("positive screening") of companies for the Real Assets Social Leaders Fund. Competitors easily could copy the product's underlying structure. However, they would find it difficult to hire people with the skills, experience and credibility to select companies from around the world that are ahead of the curve on social, environmental and ethical performance, and to put them together in a portfolio to achieve a target risk/return profile. This product and the competency that enable it give Real Assets an edge, since they are unmatched in the Canadian SRI niche, let alone the wider investment fund manufacturing industry.

With regard to shareholder activism, Real Assets has the people and the expertise required to design and conduct shareholder campaigns that are compelling to socially responsible investors and that produce positive results that investors appreciate. This competency

differentiates Real Assets (especially given that only two fund manufacturers regularly lead shareholder campaigns) and it matters to SRI investors who like the idea of putting their money to work towards making a positive social impact. It also contributes greatly to Real Assets' reputation as an SRI leader. Real Assets has demonstrated more success in campaign design and execution than the competition, measured by more media coverage generated.

An important aspect of this competency is the ability to select shareholder activism focus areas that will resonate with socially conscious investors and with the wider public. For example, the high-tech industry's glass ceiling was not on anyone's radar screen before Real Assets made it a shareholder campaign issue, but the campaign has generated a lot of positive media attention.

From its ongoing research and from its experience in running shareholder campaigns, Real Assets continually augments the competencies that allow it to identify and frame the social, environmental and ethical issues that can impair shareholder value and to effectively apply pressure to firms in order to prompt them to address those issues.

3.5 Financial analysis

3.5.1 Capital structure

Share capitalization is shown in table 12. Real Assets has authorized an unlimited number of common shares, class A preferred shares and class B preferred shares, at no par value. There are 2.7 million common shares outstanding, no class A preferred shares outstanding, and 933,000 class B shares outstanding. In addition, the company has two outstanding subordinated promissory notes totalling \$1,125,000. VanCity holds a note for \$900,000 and United Investment Counsel holds a note for \$225,000.

Share Capitalization of Real Assets

Shareholder	Common Shares	% of vote	Preferred B Shares
VanCity	1,034,000	45.5	840,000
United Investment Counsel*	807,429	33.2	560,000
Renewal Partners	411,250	10	
Deb Abbey	382,500	9.9	25,000
Minority shareholder	56,250	1.4	

*Share capitalization for United Investment Counsel includes investment by the affiliated organizations United Capital Group and Working Enterprises

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Table 12: Real Assets' capitalization

3.5.2 Financial statements

Table 13 shows Real Assets' 2003 statement of loss and deficit. The table shows proforma numbers for 2004. These proforma numbers are based on the projected investment fund assets under management for 2004, which are shown in table 14. A balance sheet is shown in table 15 and a statement of cash flows in shown in table 16.

Real Assets Investment Management Inc.			
Statements of Loss & Deficit			
for fiscal years ending December 31	proforma	actual	acutal
	2004	2003	2002
Fees & other income			
Management fees	\$ 1,282,246	\$ 454,079	\$ 242,352
Other income		\$ 26,734	\$ 4,021
	<u>\$ 1,282,246</u>	<u>\$ 480,813</u>	<u>\$ 246,373</u>
Expenses			
Salaries & benefits	\$ 711,995	\$ 539,983	\$ 503,424
Occupancy & equipment	\$ 76,862	\$ 94,121	\$ 92,128
General operating	\$ 1,328,714	\$ 941,395	\$ 397,095
	<u>\$ 2,117,571</u>	<u>\$ 1,575,499</u>	<u>\$ 992,647</u>
Loss before income taxes	<u>\$ (835,325)</u>	<u>\$ (1,094,686)</u>	<u>\$ (746,274)</u>
Provision for income taxes (recoveries)			
Current		\$ 386	\$ 1,502
Future		\$ (8,064)	\$ (20,826)
		<u>\$ (7,678)</u>	<u>\$ (20,826)</u>
Net loss		<u>\$ (1,087,008)</u>	<u>\$ (725,448)</u>
<hr/>			
Deficit, beginning of year		\$ (1,969,454)	\$ (1,244,006)
Net loss		<u>\$ (1,087,008)</u>	<u>\$ (725,448)</u>
Deficit, end of year		<u>\$ (3,056,462)</u>	<u>\$ (1,969,454)</u>

Used by permission of Real Assets Investment Management Inc.

Table 13: Real Assets 2003 statement of loss & deficit showing proforma for 2004

Assets Under Management (000,000's)	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec
Market Value - AUM - Mutual Funds	29.0	30.7	32.0	33.5	35.5	37.5	39.5	41.5	46.5	53.5	60.0	65.0
Market Value - AUM - Institutional clients	45.0	45.0	45.0	50.0	50.0	50.0	70.0	70.5	80.0	100.0	100.0	100.0
Total Market Value - AUM	\$74.0	\$75.7	\$77.0	\$83.5	\$85.5	\$87.5	\$109.5	\$112.0	\$126.5	\$153.5	\$160.0	\$165.0

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Table 14: Projected 2004 assets under management in retail and institutional products

Real Assets Investment Management Inc.
 Balance Sheet
 as at December 31, 2003

2003

2002

Assets

Current

Cash and cash equivalents	\$ 7,919	\$ 7,436
Cash held by VanCity Credit Union	\$ 283,172	\$ 309,107
Accounts receivable	\$ 134,695	\$ 79,471
Prepaid expenses	\$ 4,472	\$ 4,472
	<u>\$ 430,258</u>	<u>\$ 400,486</u>
Future income taxes	\$ 33,194	\$ 25,130
Capital assets	\$ 52,250	\$ 78,807
Intangible assets	\$ 112,500	\$ -
	<u>\$ 628,202</u>	<u>\$ 504,423</u>

Liabilities

Current

Accounts payable & accrued liabilities	\$ 187,977	\$ 130,205
Obligations under capital leases	\$ 1,470	\$ 9,463
	<u>\$ 189,447</u>	<u>\$ 139,698</u>

Promissory notes

VanCity Credit Union	\$ 942,152	\$ 939,450
United Investment Counsel Inc.	\$ 225,000	\$ -
	<u>\$ 1,356,599</u>	<u>\$ 1,079,148</u>

Shareholders' deficiency

Capital stock	\$ 2,328,065	\$ 1,394,729
Deficit	<u>\$(3,056,462)</u>	<u>\$(1,969,454)</u>
	<u>\$ (728,397)</u>	<u>\$ (574,725)</u>
	<u>\$ 628,202</u>	<u>\$ 504,423</u>

Used by permission of Real Assets Investment Management Inc.

Table 15: Real Assets 2003 balance sheet

Real Assets Investment Management Inc.
Statement of Cash Flows
as at December 31, 2003

	2003	2002
Cash flows provided by (used in)		
Operating Activities		
Net loss	\$ (1,087,008)	\$ (725,448)
Adjustments to determine cash flows:		
Amortization of capital assets	\$ 26,557	\$ 26,556
Amortization of intangible assets	\$ 112,500	\$ -
Future income taxes	\$ (8,064)	\$ (22,328)
Change in non-cash working capital	\$ 2,548	\$ 77,402
	<u>\$ (953,467)</u>	<u>\$ (643,818)</u>
Financing Activities		
Issuance of common shares for cash	\$ 2	\$ 200,000
Issuance of preferred shares for cash	\$ 933,334	\$ 150,000
Repayment of obligation under capital leases	\$ (8,023)	\$ (7,033)
Interest on promissary note	\$ 2,702	\$ 39,450
Proceeds from issuance of promissary note	\$ -	\$ 450,000
	<u>\$ 928,015</u>	<u>\$ 832,417</u>
(Decrease) increase in cash & cash equivalents	\$ (25,452)	\$ 188,599
Cash & cash equivalents, beginning of year	\$ 316,543	\$ 127,944
Cash & cash equivalents, end of year	<u>\$ 291,091</u>	<u>\$ 316,543</u>
Cash & cash equivalents are composed of:		
Cash & cash equivalents	\$ 7,919	\$ 7,436
Cash held by VanCity Savings Credit Union	\$ 283,172	\$ 309,107
	<u>\$ 291,091</u>	<u>\$ 316,543</u>
Change in non-cash working capital		
Accounts receivable	\$ (55,224)	\$ (13,799)
Prepaid expenses	\$ -	\$ 202
Accounts payable and accrued liabilities	\$ 57,772	\$ 90,999
	<u>\$ 2,548</u>	<u>\$ 77,402</u>
Supplementary cash flow information:		
Interest paid	\$ 1,652	\$ 2,635
Taxes paid	\$ 764	\$ 558
Acquisition of intangible assets	\$ (225,000)	\$ -
Issuance of promissary note	\$ 225,000	\$ -

Used by permission of Real Assets Investment Management Inc.

Table 16: Real Assets 2003 statement of cash flows

The statement of loss and deficit shown in table 13 covers a period of rapid change as Real Assets transitioned away from managing discretionary investment accounts and focused more on manufacturing pooled funds for the institutional market (especially pensions). It then added mutual funds targeting the retail investor market in late 2003. General operating expenses have increased significantly with the addition of new products. Encouragingly, however, revenues increased by 87% from 2002 to 2003 while expenses increased by approximately 59%. This reflects the effect of scale in the fund manufacturing industry whereby revenue grows faster than expenses. Table 4 demonstrates this scale effect at a product level; in that projection, margins improve as the assets increase in the Real Assets Social Impact Balanced Fund.

For its complete suite of products, Real Assets is projecting revenue growth of 182% in 2004, against a 34% increase in expenses. This growth projection depends on a 123% increase in assets under management from \$74 million to \$165 million.

Real Assets' future depends on its ability to significantly increase the asset base. An internal analysis estimates that a realistic break-even point will be achieved once pooled fund assets reach \$150 million and mutual fund assets reach \$80 million. However, the exact break-even point depends on the mix between mutual fund and pooled fund assets, since each produces different revenue streams. The break-even point may be as much as two years away. The statement of loss & deficit shows the company incurring operating losses since incorporation. In 2003, the need for cash was satisfied by the issuance of 933,334 preferred shares to existing shareholders in exchange for \$933,000. United Investment Counsel and VanCity also have negotiated friendly terms on promissory notes they hold from Real Assets.

The balance sheet shows that Real Assets' cash position is tenuous, and that it lacks a comfortable buffer to meet short-term obligations. Clearly, additional cash injections will be required in the short to medium term.

Real Assets' major shareholders are committed to providing sufficient resources to finance basic, no-frills operations. This commitment is secure as long as Real Assets maintains its current growth trajectory. It is possible that they may purchase more preferred shares in 2004. For now, major shareholders have asked management to reduce costs as much as possible.

The balance sheet shows that there would be virtually no capital assets to sell in the event of liquidation. Liquidation is unlikely, however, since the existing asset base has value to another asset manager. An interested buyer would calculate its offer based on the discounted value of the revenue stream generated by those assets, plus an amount for goodwill, less an allowance for attrition – or erosion of the asset base – due to the transition of ownership. In a buyout scenario, Real Assets' shareholders are unlikely to recover their investments.

4 ISSUES

Real Assets faces three major issues. First, its product distribution is ineffective. Gaining better access to distribution is the top priority since new sales are required to grow the asset base, from which revenue can be generated. Second, it has insufficient financial capital to execute its go-to-market strategy, to offer a broader product line-up, and to fully leverage its competencies in socially responsible screening and shareholder activism. Third, it lacks sufficient scale to be cost competitive. These issues are intertwined, but solving the first is the key to solving the second, and solving the first two is the key to solving the third.

4.1 Ineffective product distribution

Real Assets expected to build sales momentum primarily in British Columbia through its relationships with VanCity and United Capital Securities. It expected its products to receive preferential billing from those two dealers. It dedicated a significant portion of its marketing resources towards supporting these channels, with the lion's share going towards the much larger VanCity channel. Sales through United Capital have been reasonably strong. However, VanCity's sales volume so far has fallen short of expectations.

Several factors have contributed to VanCity's low sales volumes. One is that VanCity undertook major changes to its mutual funds sales model over the past year. Formerly, a large number of front-line staff was licensed to sell mutual funds. VanCity decided that it could deliver better member service and improve sales volumes by shifting responsibility for mutual funds sales from front-line staff to a new team of full-time mutual funds specialists. This was a significant and disruptive organizational change and it has taken some time to get the new team integrated into VanCity's overall service model. During this period of adjustment, overall mutual funds sales have been low. This situation is expected gradually to improve as the new sales team becomes more efficient and productive.

Another factor is that VanCity's mutual funds specialists and financial advisors have expressed concern about "pushing" the house product on credit union members. As discussed in 1.4.3.2 above, this concern is endemic to the investment fund industry. However, the concern is especially important in the context of VanCity. As a cooperative credit union association, VanCity has a strong "member-centred" culture and one where decision making is consensus based rather than top down. Despite the obvious fit between VanCity's image and the Real Assets products, if the VanCity sales people do not believe that it is in the members' best interests to invest in the products, they will not recommend them. And it would be completely antithetical to VanCity's cooperative culture if management unilaterally was to compel them to recommend the

products. Many of VanCity's sales personnel do not yet believe in Real Assets' products, since the products have no track record, somewhat high MERs, and a resemblance to the Ethical Funds products that historically have delivered mediocre returns. Real Assets has taken pains to work with VanCity's sales staff in order to educate them about the products' value proposition and to assuage their concerns and doubts. However, building their trust and earning their backing will be a long-term project because many of them are taking a 'wait and see' approach.

Perhaps because its sales organization is not yet tuned to represent the products, VanCity so far has not made its foray into socially responsible investment fund manufacturing a major focus of corporate-wide promotional and branding activity. Going forward, Real Assets likely will get more profile in VanCity's marketing and promotional plans.

Outside of the VanCity and United Capital channels, Real Assets has dealer agreements set up with most of the major investment fund distributors across Canada (outside of Quebec). However, its products have a very low profile. There is little awareness of the products among the financial advisors. As mentioned in the industry analysis (2.2.4.2) distributors and their financial advisors control the client relationships and they strongly influence investors' choices. There are too few financial advisors who will proactively recommend Real Assets' products.

An investor who had heard about the Real Assets investment funds (perhaps through a newspaper story), and who was interested in buying in, would have a hard time finding a financial advisor who was enthusiastic about selling them. Unless the investor was prepared to make a very large purchase, or unless she or he was one of many investors inquiring about Real Assets, an advisor might well be reluctant to take the time to learn about the products as well as the finer points of SRI. Instead, the advisor might dissuade the investor from investing in Real Assets, and instead steer him or her towards one of the advisor's preferred products.

Occasionally, investors contact Real Assets by telephone or email to inquire about where they can purchase its funds. Real Assets can direct the investor to a financial advisor who is known to specialize in SRI. But these SRI specialists are few and far between. Most investors want a financial advisor who is based close to where they live and with whom they feel some affinity on a personal level. So there is only a slim likelihood of Real Assets successfully facilitating a new advisor/client relationship. Alternatively, Real Assets can simply direct the investor to their preferred investment dealer, assuming there is a dealer agreement set up with that dealer. But then, as mentioned, the sale can be lost if the particular advisor is reluctant to help the client invest in Real Assets' funds.

Two examples illustrate the importance of gaining high profile distribution. One is the Summa product from Investors Group, which gathered more than \$2 billion as a result of gaining

profile within the company's large captive sales force. Another is The Ethical Funds Company, which achieved a \$2 billion asset base through credit union distribution, even though credit unions in English-speaking Canada account for only a tiny fraction of the country's mutual fund distribution capacity. These two examples were discussed in more detail in 2.1.1.1 above.

4.2 Insufficient resources

Although the company has not met its growth targets, major shareholders are prepared to support Real Assets as long as it maintains its current growth trajectory. VanCity and United Investment Counsel are committed to providing Real Assets with sufficient resources to continue basic operations, although they have asked management to reduce costs wherever possible.

But additional resources are required to help ensure that Real Assets can maintain its current growth trajectory. And ideally, Real Assets' differentiated positioning requires an above-average allocation of resources for sales and marketing. Generally, a new investment fund manufacturer needs a heavy up-front spend on sales and promotions. It is essential to build sales momentum as soon as possible. Early success breeds more, and the opposite is equally true. If financial advisors and investors see that a new entry is attracting sales, they are more motivated to proactively seek information about the products. Conversely, if a new entry's sales are weak for a sustained period, financial advisors and investors will be sceptical that it has anything to offer.

Without integrated distribution, Real Assets' strategy counts on reaching out to third-party distributors and investors in order to build awareness and interest in a differentiated value proposition. Real Assets needs more resources to execute this go-to-market strategy.

Third-party financial advisors are not motivated to seek out new products on their own. Winning their attention and interest is the role of wholesalers – the fund manufacturer's "feet on the street." They network to find advisors who might be interested in their products. They phone advisors and set up meetings in order to explain how the products can help them build their business. Real Assets' differentiated value proposition involves ideas that need to be explained. Most advisors do not know what SRI entails, who the target market is, how to position the products, or how to talk to clients about the products. Furthermore, some advisors who have heard of SRI may be prejudiced against it; for example, they may have heard that socially responsible screening necessarily reduces investment performance. A experienced wholesaler can neutralize those prejudices. Every advisor who takes an interest and "buys in" to the products' value proposition is a potential source of new assets for the manufacturer.

Real Assets has enough resources to sustain one person in a wholesaling role. However, more is needed. The company needs to support several wholesalers who can concentrate on and cover key territories and aggressively build relationships with advisors.

Real Assets' go-to-market strategy also depends on reaching out to investors and "pulling" them to the products. Substantial efforts over a sustained period are needed to build awareness, generate interest, educate, convince and drive action. It is necessary to employ mass tactics, since investors are spread out and cannot easily be targeted. While big advertising spends may never be part of Real Assets' marketing plan, even guerrilla tactics that seek to exploit publicity and word-of-mouth channels require substantial resources to execute effectively. Real Assets has just one person dedicated to public relations, with assistance from the CEO and the VP Sales. This team has achieved remarkable success in getting its message out through public relations tactics. However, a dedicated marketing communications role was eliminated in budget cutbacks, and Real Assets needs more resources to engage in a richer ongoing dialogue with investors through such tools as newsletters, direct mail, and its web site.

Use of mass communication techniques also would be valuable in "softening" the advisor community and making it more receptive to overtures from wholesalers.

Real Assets also needs more resources to address the institutional market. In order to win significant pieces of business in the institutional market, business development resources are needed to network with the trustees and consultants who administer institutional assets. It can take a great deal of time and effort to build awareness and interest among them. Such efforts are aimed at winning invitations to submit proposals to manage institutional assets. Additional resources are needed to submit lengthy, detailed, and customized proposals. Real Assets' slim resources allow it to pursue institutional opportunities only opportunistically, rather than systematically. And to do so, it must turn its attention temporarily from the retail market.

Lack of resources also impacts the company's product line-up. Ideally, an investment fund manufacturer wants to offer the broadest possible range of products, so that the target investor can meet most of his or her objectives with the company's products. Real Assets retail product offering is about as broad as possible with just two products. However, it could be much broader. Lack of resources prevents the launch of additional products.

Lack of resources also could impair Real Assets' ability to execute socially responsible tactics such as screening and shareholder activism within the products. Recent cutbacks eliminated a research position that supported screening and shareholder activism campaigns. As a result, the company may have to reduce the number of shareholder campaigns that it engages in. As well, its positive and negative screening may be less comprehensive. As a result, opportunities

to select social leaders for its global equity portfolio may be missed, and the risk of damage to brand and reputation may increase as a result of failing to do sufficient due diligence on socially, environmentally or ethically questionable companies in its balanced fund and its pooled funds.

4.3 Lack of scale

Real Assets is too small to achieve an adequately competitive cost structure. The fund manufacturing industry is subject to scale economies, whereby administrative expenses such as custodial, record-keeping, transaction, unitholder communication and marketing grow at a slower rate than assets under management. For example, custodians and transfer agents charge lower fees per dollar of assets on larger asset bases. As a result, large fund manufacturers benefit from a lower cost structure than smaller manufacturers. Lack of industry growth and excess capacity in the industry is eroding margins and forcing companies to focus on reducing costs. The best way to reduce costs is to get bigger in order to achieve greater scale economies.

In this increasingly competitive environment, large manufacturers can pass along cost savings to investors in the form of lower Management Expense Ratios (MERs). Since MERs reduce net returns to investors, it is easier for larger investment fund manufacturers with lower MERs to deliver the competitive rates of return that investors require. Conversely, smaller companies with higher MERs have a harder time delivering competitive rates of return.

A new, small mutual fund manufacturer like Real Assets has a high cost structure. But it cannot pass along all costs to unitholders, because doing so would impair the company's ability to deliver the performance results that investors need to see. Real Assets therefore needs to subsidize its expenses for a period of time – perhaps for two more years. At the same time, it needs to execute a marketing and distribution plan that will allow it to grow its asset base to the point where operating losses cease and positive cash flows is achieved. Real Assets needs to get even larger to generate the kind of scale economies that will allow it to be cost competitive in the industry and to generate an acceptable return on investment.

Lack of scale is a major barrier to winning business in the institutional market. The trustees and consultants who administer institutional assets are reluctant to award business to small firms. Real Assets is caught in a "Catch-22" situation: it needs to be bigger to attract business, but it cannot get bigger without winning some business.

5 RECOMMENDATIONS

Real Assets' major shareholders are unhappy that Real Assets' growth has been slower than expected. Although they are prepared to finance a continued 'bare-bones' operation, they are

reluctant to commit the additional resources that would allow Real Assets to take its differentiated value proposition to the market more aggressively. Clearly, Real Assets needs more cash.

But more importantly, it needs better distribution, since that is how sales will be generated. With additional resources and better distribution, Real Assets will be on its way towards achieving its ultimate goal, which is to get big enough to attain the economies of scale required to be cost competitive and profitable, and to compete for institutional assets.

5.1 Increased support from current partners

The most obvious solution would be for the two largest shareholders to commit additional resources to allow Real Assets to execute more aggressive sales and marketing tactics. At the same time, VanCity can take steps to help increase sales in its branches. While VanCity's head office may not have much leverage to compel sales staff to proactively recommend and sell the products, it still could give the Real Assets products much more profile in its corporate marketing and promotional programs. Doing so would increase awareness and interest among members and would begin to motivate them to ask about the products. It is likely that sales staff would feel more comfortable with and confident about recommending the products if they saw them promoted at the corporate level and if they sensed more interest among members.

The time for VanCity to begin to give the Real Assets products a good promotional push would be in the fall of 2004, ahead of the RRSP season in January and February. By the fall of 2004, Real Assets will be able to publish its funds' performance over the previous year. Decent looking numbers will go a long way towards gaining trust among sales representatives and building interest among members. Also by the fall of 2004, VanCity should have most of the wrinkles ironed out of its new mutual funds sales model, as it gears up for the busy winter investing season. At the same time, Real Assets can work alongside VanCity management in ongoing education and training for the sales staff, to ensure that staff understands the products' value and that they have opportunities to work through their concerns or doubts.

5.2 New equity partner (cash)

Real Assets could seek a new equity partner that is willing to buy a share of the company and its future earnings. Current equity partners likely will make room for a new partner who can inject enough cash to ease the burden of operating losses on the existing partners and to finance more aggressive sales and marketing efforts.

To pursue this course of action, Real Assets' major shareholders need to increase their support to the same degree described in 5.1. Doing so will buy time to look for a new partner.

Moreover, it will send an important signal to a potential new investor that the current partners strongly believe in Real Assets' potential and are committed to seeing the company succeed.

More tangibly, increased support from the current partners through the fall of 2004 and winter of 2005 will maximize the inflow of new assets over the course of the busiest season for investing. Ideally, by the spring of 2005, Real Assets' asset base and its income statement will look more attractive to potential investors.

5.2.1 Benefits

With more cash, Real Assets can hope to maintain a slow but steady growth trajectory and perhaps to become cash flow positive within a couple of years.

5.2.2 Drawbacks

In this scenario, it may be a long time before Real Assets acquires sufficient scale to be cost-competitive by industry standards. And it may be a long time before the company builds sufficient size and a sufficient track record to make a breakthrough in the institutional market.

This course of action may only be a temporary fix if the primary issue of distribution is not sufficiently addressed within the VanCity channel as well as third-party channels.

5.3 New strategic partner (access to distribution)

Whether Real Assets remains with its current ownership structure or seeks another equity partner, it should also look for a strategic partner that can provide it with high-profile access to a major, national distribution channel.

Real Assets' products already are available for sale in major distribution channels. But availability by itself does not generate sales. What is required is that the products be given a high profile and strong promotion within the channel, and that front-line sales staff receive education on the products and encouragement to recommend them to clients.

One way for Real Assets to achieve this kind of profile within a major, national distribution channel is to enter an exclusive portfolio advisory agreement with a large, well-established, well-financed, vertically integrated manufacturer/dealer, such as one of the big banks, one of the large insurance companies, or one of the large mutual fund companies.

In this scenario, Real Assets becomes a supplier of portfolio advisory services for funds manufactured by "BigCo." Real Assets assists BigCo in product design and also plays a key role in promoting the products to investors and to BigCo's sales force.

Unfortunately, the possible scope of such an arrangement may be limited by BigCo's reluctance to involve itself with shareholder activism. As mentioned (2.2.1), up until now, all of

the SRI funds manufactured by large institutions are “SRI-lite” products. That is, they engage in negative screening but not in shareholder activism. Shareholder activism looks like an awkward fit for the large investment fund manufacturer/dealers, because it seems to lead to possible conflicts of interest. Banks, for example, provide securities underwriting and other services to commercial clients. A bank may not like to see one of its mutual fund managers engaging in a shareholder campaign with a company that was, or could potentially be, a major corporate banking client. It is hard to conceive of a contractual arrangement that would allow Real Assets to carry out shareholder activism but that would give BigCo the power to veto any shareholder campaign that could put it at risk. The bank’s definition of a potential commercial client would be quite broad. As well, such an arrangement would seriously erode Real Assets’ credibility.

The same issues obtain if BigCo is an insurance company: it might see shareholder activism as a possible threat to some of its commercial client relationships. A big investment fund company might share the same concerns, since it makes part of its living by managing assets for institutional clients.

Because of these possible conflict-of-interest issues, BigCo may not be open to the idea of engaging Real Assets to manage products that involve shareholder activism. However, BigCo should be interested in engaging Real Assets in an exclusive portfolio advisory agreement for a product that features screening alone. Third-party suppliers can provide BigCo with the resources that it requires to carry out basic negative screening. So there is little incentive for BigCo to engage Real Assets to manage a typical “SRI lite” product, although the possibility still exists. But BigCo should be interested in engaging Real Assets to manage a BigCo version of a product similar to the Real Assets Social Leaders Fund. The positive screening and portfolio design of such a product is a Real Assets specialty. There is no potential conflict of interest because the product does not feature shareholder activism; all the companies held in the portfolio are deemed to be leading by example when it comes to social, environmental and ethical performance.

Ideally, BigCo would manufacture at least one SRI product that featured true positive screening. Conceivably, there could be more than one product. For example, the Real Assets “Social Leaders” concept, which is a global equity portfolio, could be split into Canadian equity, U.S. equity and global equity versions. BigCo would engage Real Assets as the portfolio advisor, and give it complete responsibility for the financial as well as the socially responsible aspects of operating the portfolio. BigCo would look after all other parts of the investment fund value chain, from sales and promotions, to transaction processing, to record keeping and client communication – all things that BigCo can do more efficiently and cost-effectively than Real Assets can.

In such an arrangement, the product should be co-branded to leverage the specialty skills of Real Assets and the strength of BigCo. For example, the new product could be called the 'BigCo Real Assets Fund.' BigCo would give the product a high profile in its distribution channel, and it would promote its offering of a "best-of-breed," "cutting edge" socially responsible investment fund, sub-advised by Canada's most respected SRI management firm.

Real Assets should take steps to ensure that BigCo is prepared to give the products a high profile and a strong promotional push in its sales channel. Assuming this requirement is satisfied, Real Assets should negotiate for a long-term agreement and for favourable compensation based on a percentage of assets under management. Any such agreement would restrict Real Assets from entering similar arrangements with BigCo's major competitors.

Such an arrangement should leave Real Assets free to continue to manufacture and promote its own products, since these would be completely separate from the product manufactured by BigCo and advised by Real Assets. BigCo should understand that it benefits from leveraging the increasing strength and credibility of Real Assets' independent status.

These kinds of arrangements exist today in the investment fund industry. For example, Investors Group has a number of "asset management partners." One is Beutel Goodman, an independent money manager that specializes in institutional markets, but that also manufactures a suite of mutual funds for the retail market. Investors Group offers four co-branded products – the "IG Beutel Goodman" funds – that are manufactured by Investors Group but advised by Beutel Goodman. The IG Beutel Goodman suite comprises Canadian Balanced, Canadian Equity and Canadian Small Cap mandates. Beutel Goodman covers these same mandates in its own mutual fund offering. In less than two years, the funds have gathered over \$500 million in assets.

Another paradigm is RBC's "O'Shaughnessy Funds." This suite of three products from RBC Mutual Funds is named after James P. O'Shaughnessy, a high-profile investment guru and author. O'Shaughnessy is a portfolio advisor with Bear Stearns Asset Management, a U.S. asset manager with \$20 billion under management. Bear Stearns Asset Management is a subsidiary of The Bear Stearns Companies Inc., one of the world's largest investment banking and brokerage firms. Since 1997, RBC has had the exclusive right to distribute O'Shaughnessy funds in Canada. RBC handles all aspects of distribution, promotion and client services. Bear Stearns concentrates on operating the asset in the portfolios. The three funds have gathered over \$1.2 billion in assets.

5.3.1 Benefits for Real Assets

Given BigCo's massive distribution network, huge client base, and its marketing muscle, the product has the potential to grow at a satisfactory rate. Real Assets' management fee revenue

would increase at the same time. It could use that revenue to invigorate the sales and marketing initiatives needed to promote its own products and to grow its assets under management.

The agreement would provide Real Assets with a high profile in a major distribution channel, and bring Real Assets to the attention of a great many potential new investors.

To some extent, the additional credibility that would accrue to Real Assets as a result of having been chosen as a strategic partner by BigCo would help Real Assets to be taken seriously by institutional clients. Real Assets could claim the assets in the BigCo products as part of its total assets under management and could also point to BigCo as a major client. It is even possible that Real Assets and BigCo's institutional asset management division could co-bid on proposals from institutions willing to consider adding social screening to the management of their assets.

This scenario allows Real Assets to leverage some of the areas in which it has competencies, while dropping responsibility (with regard to a BigCo/Real Assets fund) for aspects of manufacturing for which it has no competency.

The arrangement would contribute to economies of scope for Real Assets, since knowledge assets generated from socially responsible research activities could be leveraged across all the BigCo and Real Assets products.

5.3.2 Benefits for BigCo

If BigCo currently has no product coverage for the SRI segment, an exclusive portfolio advisory agreement with Real Assets allows it to make a major entry into the segment, with a product that is differentiated, exciting and compelling.

BigCo can do this with a lower level of investment and commitment than would be required in order to bring the SRI fund manufacturing capacity completely in-house. BigCo gets to offer cutting-edge SRI products without needing to develop competencies that would represent an awkward fit with its current fund manufacturing activities.

By entering the segment, BigCo can offer its clients more choice. It also can derive benefits to its brand equity by promoting the deal as an example of its commitment to corporate social responsibility.

High profile co-branding allows BigCo to gain by associating itself with a specialist firm that enjoys a solid reputation in the SRI niche. And the exclusive portfolio advisory agreement would pre-empt competitors. Competitors wishing to emulate the BigCo/Real Assets deal would have trouble finding an external advisor with SRI-related competencies on par with Real Assets.

High profile co-branding will help BigCo's financial advisors overcome any reluctance to recommend and sell 'house' funds (see 1.4.3.2). The association, suggested by the co-branded

name of the products, with an outside investment manager would give the funds some of the cachet of third-party products, even though the products would be manufactured by BigCo.

5.3.3 Concerns

The co-branded product may have limited growth potential. The “Social Leaders” concept is a specialty fund suitable as a speculative holding in a diversified investment portfolio. It is not designed to play a major or “core” role in a portfolio. Consequently, it may gather only a modest amount of assets, and the revenues generated from advising it may be correspondingly modest. The revenues may be insufficient to fuel Real Assets’ growth plans. Modest growth potential may dampen BigCo’s enthusiasm for the deal. However, if enough investors buy in, even with small amounts, their combined investments could add up to an amount that makes the deal worthwhile for both parties.

While the RBC O’Shaughnessy Funds and the IG Beutel Goodman Funds have produced excellent results, BigCo undoubtedly would consider the disappointing results for the Desjardins Ethical products. In 2000, Ethical Funds entered into an agreement with Desjardins, a dominant investment fund manufacturer/dealer in Quebec. As part of the deal, Desjardins began selling three Ethical Funds products, re-branded as “Desjardins Ethical” funds. To date, the funds have gathered just \$11 million in assets. Desjardins recently moved to merge the three separate funds into a single fund-of-funds product in order to reduce the administrative costs to operate them. The reasons for this poor outcome are unclear, but Real Assets will need to build a convincing case for BigCo that their co-branded product will be much more successful.

It is essential that the co-branded product be given a high profile in the channel, and that BigCo initiates a program to educate its sales force about the product and to encourage them to recommend the product. Without this sort of push, the product is unlikely to generate satisfactory sales volumes. However, it will be difficult for Real Assets to define the required promotional support and to negotiate assurance that BigCo will provide it.

In order to maintain the integrity of its brand and its reputation for leadership in the SRI niche, Real Assets should negotiate complete control over decisions about which companies to screen in or out. BigCo is likely to allow this, since it creates no risks to its business.

If Real Assets partners with a bank, some socially conscious investors will complain about Real Assets’ ‘getting into bed’ with a bank. Socially conscious investors sometimes criticize banks for underwriting enterprises that may not be socially, environmentally or ethically progressive. An alliance with an insurance company or with a large mutual fund manufacturer may draw similar criticism, based on the fact that the BigCo partner may invest in or underwrite

enterprises that are questionable in the minds of socially conscious investors. However, as long as Real Assets can maintain the integrity of its decisions in socially responsible screening within the context of the BigCo/Real Assets product, then the benefits of the BigCo alliance will far outweigh the drawback of potential dissatisfaction among some socially conscious investors; the BigCo/Real Assets offering would introduce far more new investors to SRI than the number of existing socially conscious investors who would be turned off by the strategic alliance.

It is unclear how Real Assets' major shareholders would view the possibility of an exclusive portfolio advisory arrangement with BigCo. However, it would seem to be an extension of, rather than a deviation from, the current situation, whereby Real Assets is free to solicit business from any dealer channel, some of which compete in the Lower Mainland of British Columbia against VanCity and United Capital Securities.

There may be some concern at BigCo about entering into such an arrangement with a firm partly owned by Canada's largest credit union. However, this concern is surmountable, since VanCity's regional market would overlap with only a tiny portion of BigCo's total market.

5.3.4 Potential strategic partners

Real Assets should identify a list of potential strategic partners. Some of the large fund manufacturers already manufacture their own 'SRI-lite' products. Some of the large insurance companies already re-sell SRI funds from another SRI fund manufacturer by combining them with an insurance wrapper to create a segregated fund product. These companies would move to the bottom of the priority list.

The big banks are likely targets. A couple of them are more likely partners than the others because they have demonstrated a keener interest in building a reputation for corporate social responsibility. One or two of the large fund manufacturers are likely targets as well, as they have a gap in the SRI product segment.

5.3.5 Real Assets' source of bargaining power

Real Assets should be prepared to paint the most attractive picture possible of the size and growth potential of the market, based on the discussion in chapter one. In particular, it should call attention to the gap between the number of Canadians who say they are interested in SRI, and the number of Canadians who own SRI investments. It can also accentuate the attractive demographic profile of the typical SRI investor. It should emphasize the opportunity for BigCo to fill a gap in its product line and to pre-empt competitors by offering a cutting-edge product that would be hard for competitors to match. And it should emphasize that BigCo will have an easier

time filling that gap by partnering with a small, differentiated, specialist firm, than it would by trying to build the capacity from scratch when it does not possess the necessary competencies.

Real Assets can sell the deal on the competencies and competitive advantages discussed in chapter three. Primarily, it can offer a solid and untainted reputation in the SRI niche, industry-leading expertise in positive screening, and excellent communication and promotional skills. No other SRI fund manufacturer matches Real Assets in all of those important competencies. If BigCo is interested in launching a high-profile SRI offering through an exclusive portfolio advisory agreement, then Real Assets clearly is the best choice for strategic partnership.

5.4 New strategic partner (cash and access to distribution)

If Real Assets cannot find a strategic partner willing and able to provide high profile access to a major distribution channel, perhaps through an exclusive portfolio advisory agreement, then it may be able to find a strategic partner that could provide cash *as well as* high profile access to a major distribution channel. This approach is more drastic since it likely will involve a change of ownership through a buyout or a merger. A joint venture is an unlikely scenario since Real Assets has no financial capital or human resources to contribute towards a new entity under joint control. Again, the ideal strategic partner is a well established, vertically integrated manufacturer/dealer.

5.4.1 Longshot scenario: buyout by a major financial institution

It would be difficult to convince one of the big banks, insurance companies or investment fund manufacturers to invest in the capacity to manufacture SRI products that feature shareholder activism, for the same reasons discussed in 5.3: the potential conflicts of interest with BigCo's commercial lines of business.

Difficult, but perhaps not impossible. Some large financial institutions are beginning to see the value of assessing social, environmental and ethical risks before entering into business with commercial clients. Some of these institutions are on the verge of establishing transparent environmental, social and ethical policies to guide their commercial finance activities.

For example, in February 2004, Bank of Montreal (BMO) shareholders voted 90.9% in favour of a shareholder resolution, filed by Real Assets, asking the bank to disclose how it evaluates and manages environmental risks to its business. Specifically, the resolution called on the bank to report on the environmental criteria it uses and the precautions it takes to ensure that it provides credit only to companies that meet its environmental standards.

The tally was one of the strongest majorities ever recorded in Canada for a shareholder resolution dealing with social or environmental issues. This vote was also distinguished by the fact that BMO's directors had recommended that its shareholders vote *for* the resolution. This was the first such executive endorsement for a social or environmental shareholder resolution in the history of corporate Canada.

This example suggests a potential paradigm shift among major financial institutions, where they begin to acknowledge the financial risks of doing business with corporations that have serious environmental, social and ethical liabilities and they begin to discuss those risks with the same level of comfort as they discuss financial considerations today. From there, it may be a short step towards endorsing constructive shareholder activism as a means of prompting corporations to address those liabilities.

Although it must be considered a longshot, it is conceivable that a major financial institution might be interested in buying Real Assets in order to fill out its product line and to make a bold, pre-emptive entry into socially responsible investing, with cutting-edge products that involve shareholder activism.

To begin exploring this possibility, Real Assets can draw on its expertise to ascertain which of Canada's big financial institutions are the most progressive when it comes to integrating the principles of corporate social responsibility throughout all aspects of their business.

While this scenario is worth mentioning, at least as a thought experiment, it is a distinct longshot. Therefore, an exhaustive inventory of the possible benefits and the many challenges and drawbacks of a BigCo buyout is not provided.

5.4.2 Buyout or merger with another SRI investment fund manufacturer

Still a longshot scenario, but one within the realm of possibility, is a buyout or a merger with another SRI investment fund manufacturer. This scenario has certain inherent advantages. One is the likelihood of a reasonably good strategic fit. Another is that there would be no concerns about conflicts of interest around shareholder action initiatives.

As the industry analysis reveals (2.1.1.1), there is only one possible merger partner that could offer the resources and the access to distribution that Real Assets requires: The Ethical Funds Company. Though small by industry standards, with \$1.6 billion in investment fund assets, Ethical Funds generates positive cash flow. It has widespread distribution through credit unions across English-speaking Canada as well as a widely recognized brand. Real Assets should explore the possibility of a merger with The Ethical Funds Company, though the scenario is problematic.

To discuss merging with The Ethical Funds Company is really to discuss merging with Credential Financial. Although it is a distinct legal entity, Ethical Funds is run as a division of Credential Financial Inc. (see 2.1.1.1). Most of the senior executives responsible for Ethical Funds also have responsibilities for Credential Financial's other operating divisions. The other operating divisions are run with cost-based rather than differentiation-based strategies. This structure impairs Ethical Funds' ability to pursue a differentiation strategy. In a merger, Real Assets' management team would be grafted onto Ethical Funds' operations and distribution infrastructure, thereby giving the Ethical Funds operation within Credential Financial a distinct management team responsible for making decisions in the best interests of Ethical Funds.

Ideally, Credential Financial's leadership would agree to allow the organizational changes necessary to separate Ethical Funds from Credential Financial's other operations, so that Ethical Funds could tune its strategic fit to better suit a differentiation strategy.

The Ethical Funds name would be retained because of its greater equity and awareness among investors. The Real Assets name could survive in product titles.

Real Assets' current shareholders should be willing to accept a reasonable amount of compensation in exchange for the future benefit of operating Real Assets' small asset base, plus a reasonable amount for goodwill. Mostly, they will be satisfied with eliminating the burden of financing Real Assets' continuing operating losses.

5.4.3 Benefits

A merger between Real Assets and The Ethical Funds Company is worth considering for several reasons.

First, the two companies share a similar philosophy about and approach to SRI. Both believe in the need to provide investors with products that allow them to achieve their financial goals and to address their environmental, social and ethical concerns. Both seek to fulfill this need with products that can deliver competitive returns and that feature socially responsible screening as well as proactive shareholder action.

Second, both companies have needs that the other could fulfil. Real Assets needs resources and access to distribution. The Ethical Funds Company has an asset base that generates financial resources and it has a strong presence in credit union distribution channels.

Ethical Funds needs to improve its ability to design compelling shareholder campaigns, to communicate and promote its value proposition to investors and to the media, to demonstrate integrity, and to demonstrate dynamic leadership in the category. It needs to build a culture that is more motivated and more passionate about the company's mission. Fulfilling these needs will

help Ethical Funds to stop the erosion of its asset base, which has been continuous for several years. Real Assets can offer a management team with proven abilities in all of those areas. All of Real Assets' competencies either augment or add to Ethical Funds' strengths.

By grafting Real Assets' leadership team onto Ethical Funds' operations and distribution infrastructure, the result could be stronger than the sum of its parts. The newly merged company certainly would be the country's strongest SRI fund manufacturer.

Both firms are based in Vancouver, so head office location does not pose a problem.

5.4.4 Drawbacks

Real Assets does not bring much financial clout to the table. Credential Financial's leadership may not see the value in the knowledge assets that Real Assets can contribute.

The two organizations have different cultures. The Ethical Funds culture is strongly influenced by the overall culture of Credential Financial, which tends to be bureaucratic rather than values-driven, due to the focus on cost-control in its transaction-processing businesses. The Real Assets' culture is more communitarian and values driven, in keeping with the firm's focus on making a positive social impact. The Credential Financial leadership may see the different cultures as a problem, rather than as an opportunity. This merger idea suggests that Real Assets' culture should supplant Ethical Funds' culture, since the former is a better fit with the differentiated focus strategy that Ethical Funds needs to follow.

The merged entity has the best chance of success if Credential Financial allows the organizational changes necessary to separate Ethical Funds from Credential Financial's other operating divisions. This way, Ethical Funds can adjust its strategic fit so that it is more in tune with a differentiated focus strategy. But Credential Financial, over the last several years, has expended a great deal of effort in bringing its operations close together, in order to achieve cost efficiencies. Its leadership may not see the wisdom in reversing these efforts in order to allow autonomy for Ethical Funds. Unfortunately, the merger will be successful only if the Real Assets management team is given a wide scope and mandate to run Ethical Funds as a distinct entity, and to make the decisions that it feels will best allow Ethical Funds to exploit its market opportunity. Credential Financial may be willing to allow these changes, if it believes they are required to reverse the steady erosion of the Ethical Funds' asset base over the last several years.

At \$1.6 billion in assets, Ethical Funds is a small fund manufacturer by industry standards. Unless it can grow its asset base it will not remain cost competitive. Furthermore, the credit union distribution channels that it occupies represent only a tiny fraction of investment fund distribution bandwidth in Canada. So although Ethical Funds is far stronger than Real Assets

in terms of resources, distribution and scale, it ultimately may not be strong enough to remain viable in an increasingly competitive industry. From Real Assets' perspective, nothing much can be done about this concern except to work hard to execute the best strategy and tactics possible.

Real Assets' management team will need to be compensated adequately for the risk that the merger will not work out. At the same time, they will need to be provided with adequate incentives to make every possible effort to ensure that the merger succeeds. Generous severance packages could be combined with non-compete agreements to deal with the contingency that Real Assets' staff members do not remain with Ethical Funds.

5.5 Conclusions

Real Assets has several competencies that should allow it become a leader in the socially responsible investment fund niche. However, the firm lacks the resources and the access to distribution channels that are required to reach out to that market with its differentiated value proposition. If the firm remain on its current organic growth trajectory, it should break even eventually. However, the industry's minimum efficient scale is increasing, and Real Assets needs to get bigger quickly in order to achieve an adequate cost structure.

The fit between Real Assets, VanCity and United Investment Counsel ostensibly is good, and the partnership stands a good chance of success. Ideally, however, Real Assets' major shareholders should furnish additional resources to allow Real Assets to carry out a more aggressive sales and marketing campaign during the fall of 2004 and winter of 2005.

Even if Real Assets wishes to take on a new equity partner that can inject some cash, the current shareholders should increase their support in order to buy some time and to signal to a potential new investor that they believe in and remain committed to Real Assets.

However, acquiring additional cash really is a secondary concern behind the need to attain better distribution. Beginning in the fall of 2004 and leading up to the winter RRSP season, VanCity should use its corporate marketing and promotional programs to give Real Assets a healthy push in its retail branches.

At the same time, Real Assets can seek to gain profile in a major, national distribution channel by proposing an exclusive portfolio advisory agreement with a big fund manufacturer/distributor, such as a bank, insurance company or investment fund company. However, the scope of any potential arrangement, as well as the revenue potential, may be limited, due to concerns at BigCo about potential conflicts of interest arising from shareholder activism.

A merger with or buyout by a major financial institution is worth exploring, although it is a distinct longshot. A more likely scenario to consider is a merger with The Ethical Funds

Company. There are a number of compelling reasons to think that synergies could result from this merger. Ethical Funds may be the only strategic partner that is focused on SRI and that can provide financial resources as well as high-profile access to a significant distribution channel. Real Assets may be the only strategic partner that can provide Ethical Funds with the leadership capacities that it needs in order to halt the steady erosion of its asset base. However, in order for the merger to be workable, Credential Financial would have to agree to allow major changes to its organizational structure. These changes would be necessary to give the merged entity the autonomy it requires to succeed with a differentiated focus strategy. It is not clear that Credential Financial would be willing to make these changes.

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