# ICPP Total Index Overview

## Philosophy

Three main philosophies underpin the construction of the ICPP Total Index and therefore the construction of the ICPP Accumulation Fund:

1. The accumulation phase requires a long-term strategy;
2. Equities are the most suitable asset choice over the long-term; and
3. Markets are chaotic.

The accumulation phase, defined as the part of the member's career that is more than ten years before the ICPP pays out any expected target benefit, is typically somewhere around 30-40 years. Thus, the primary goal of the ICPP Accumulation Fund is to provide the best possible outcome over this long-term.

Research shows that equities form the asset class that provides the highest expected returns over the long-term. The equity risk premium is compensation for short-term volatility. Since the ICPP Accumulation Fund is not concerned with short-term results, the equity risk premium becomes an equity premium the ICPP Accumulation Fund collects over the long-term for enduring the short-term volatility. Further, exposure to asset classes with lower expected long-term returns (compared to equities) creates an unjustifiable opportunity cost in a long-term strategy. Therefore, the ICPP Accumulation fund invests only in equities.

Over the long-term, ICPP Funds Ltd. believes that markets are best described as chaotic and that short-term strategies suggested by Financial Economic Theory (i.e. markets are random, instantaneous and memoryless) are an insufficient foundation for the ICPP Accumulation Fund's long-term strategy. Chaotic systems appear random on the surface but in fact have underlying structure. Thus, ICPP Funds Ltd. expects current conditions, previous outcomes, constant monitoring and rules-based management of the investment process all to matter when it comes to structuring an appropriate long-term fund.

## Construction

Since ICPP Funds Ltd. believes long-term investment outcomes are chaotic, the long-term investment process must focus on:

1. Selecting a diversified set of investments that represent the best long-term opportunities within the economy (i.e. market leaders in industries with positive long-term outlooks);
2. Ensuring the portfolio never becomes unbalanced in any particular equity or industry;
3. Ensuring recognition of past experience by establishing rules that force the sale of equities that have exceeded relative growth targets and the purchase of equities that have lagged targets;
4. Constant monitoring of the set of market leaders and selected industries to ensure they continue to have a strong long-term outlook; and
5. Establishing procedures to buy and hold the portfolio in order to avoid expenses.

It is crucial for the ICPP Total Index to have an objective benchmark that is able to measure these goals. Typical benchmarks for the Canadian pension industry are the S&P/TSX Composite Total Return Index or the S&P 500 Total Return Index for US equities. Although these are widely used indexes, they do not necessarily provide an objective measure for the goals stated above. First, the goal is to invest in leaders in the Canadian economy or multinational companies available through US markets with a substantial presence in Canada. Second, the S&P/TSX Composite Index has high concentration in a few industries, which might not provide a properly diversified benchmark. Thus, ICPP Funds Ltd. created the ICPP Total Index to provide a suitable benchmark for the ICPP Accumulation Fund.

Research conducted led to the following construction for the ICPP Total Index:

1. The ICPP Total Index contains 20 pairs of Canadian market leaders and 20 pairs of multinational market leaders traded in the US markets that are in industries expected to have a strong and sustainable long-term outlook.
    a. Multinational companies were included to complement the Canadian companies and to provide exposure to industries not represented well in the Canadian stock exchanges and to avoid overexposure in any area of the economy.
    b. Research concluded that 20 pairs of companies was enough to provide proper diversification.
    c. Companies that rely heavily on government funding to support their business as well as companies in selected industries such as airlines, gold miners, property and casualty insurers and tobacco companies should be excluded.
2. Rebalanced quarterly.
    a. Balancing costs monthly is too costly and annually allows for too much drift.
3. Sell portion of a specific equity on rebalancing held above a rules-based threshold and buy equities that have lagged.
    a. Sell equities in 20% blocks of the equal weighting that are more than 40% above the equal weighting.
    b. Buy equities that have the lowest allocation in 20% blocks of the equal weighting.
4. Oversight committee monitors the investments quarterly to ensure equities remain market leaders and industries continue to have strong long-term outlook.
5. Minimal turnover via optimizing the rebalancing rules-based thresholds.

Finally, ICPP Funds Ltd. believes that there are instances when a professional investment manager can use short-term investment management techniques to provide excess returns against the ICPP Total Index. The portfolio manager of the ICPP Accumulation Fund can do this by occasionally shifting the weights in the pairs of companies to ones that the manager expects to perform better in the short-term (this is the active part of the rules-based active management approach). Although there is no guarantee that the active weight adjustments will consistently provide excess returns (and in some cases, underperform the benchmark) over the long run, ICPP Funds Ltd. believes the additional risk is worth the reward.