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MERCER CANADIAN ENDOWMENTS, FOUNDATIONS, AND NOT-FOR-PROFITS SURVEY

MAY 2013

MARSH & McLENNAN COMPANIES

CONTENTS

ACKNOWLEDGEMENTS 1

THE ENDOWMENTS, FOUNDATIONS, AND NOT-FOR-PROFITS TEAM 1

WELCOME MESSAGE 2

INTRODUCTION 3

KEY FINDINGS 4

INVESTMENT POLICY ASSET ALLOCATION 6

INVESTMENT PERFORMANCE 14

SPENDING POLICY 19

INVESTMENT POLICY REVIEW 21

POLICY FOR RESPONSIBLE INVESTMENTS AND ENVIRONMENTAL, SOCIAL, AND CORPORATE GOVERNANCE (ESG) 22

INVESTMENT IMPLEMENTATION 23

CURRENT ISSUES AND OPPORTUNITIES 24

IMPORTANT NOTICES 25

ACKNOWLEDGEMENTS

This survey was produced by Mercer's Investments business. Mercer is a leading global provider of consulting, outsourcing, and investment services that traces its roots back to 1937. Mercer is a wholly owned subsidiary of Marsh & McLennan Companies, Inc. Mercer's investment consulting business offers customized guidance at every stage of the investment, risk management, and monitoring process.

It has been dedicated to meeting the needs of clients for more than 30 years, and works with the fiduciaries of pension funds, foundations, endowments, and other institutional investors in some 35 countries.

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WELCOME MESSAGE

WELCOME TO THE MERCER 2013 CANADIAN ENDOWMENTS, FOUNDATIONS, AND NOT-FOR-PROFITS SURVEY

Mercer is pleased to present findings from its first annual Canadian endowments, foundations, and not-for-profits survey. The survey covers 27 endowments and foundations with total assets of $4 billion and funds ranging in size from $5 million to over $1.1 billion. The average fund size in the survey is $146 million. Results were compiled as of September 30, 2012.

The charts and tables that follow are intended to give you an overview of the types and size of respondents' funds. Throughout the survey, respondents' funds are categorized as follows:

By assets:

- Small funds (less than $100 million in assets).
- Medium-sized funds (between $100 million and $250 million in assets).
- Large funds (more than $250 million in assets).

By endowment, foundation, and not-for-profit sector (number of respondents):

- Education (12).
- Health (7).
- Public (4).
- Community (4).

Chart 1. Split of Respondents' Funds by Size

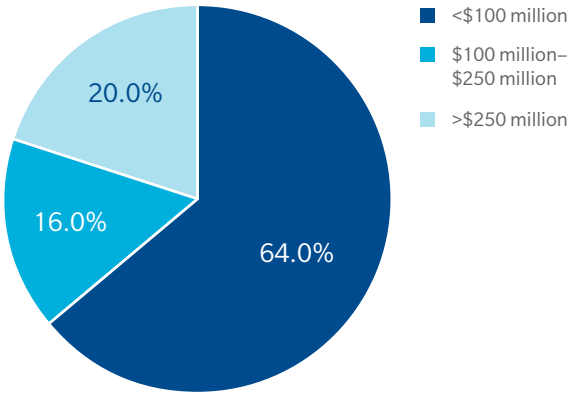
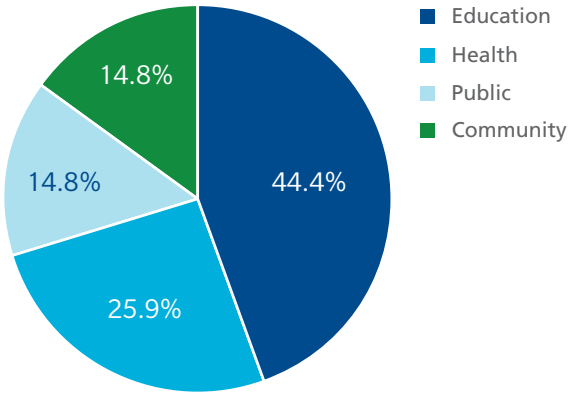


Chart 2. Split of Respondents' Funds by Sector



INTRODUCTION

Endowments and foundations are playing a critical role in Canadian society by providing financial support and assistance to their beneficiaries in a period when the global economy and financial markets are increasingly volatile. Endowment boards and administrators are facing many challenges in order to meet the expectations of donors and beneficiaries. Their ability to do so depends heavily on the investment of the donor contributions and the results achieved thereon.

Mercer views endowments and foundations as an important and unique institutional investor segment. For this reason, we have decided to institute an annual survey of investment and spending policies, investment performance and emerging trends, practices, and philosophies. We hope that you find the survey results useful.

Our survey findings indicate that respondents are concerned with their ability to maintain spending, as they feel challenged to earn the investment returns required to do so. In fact, their concerns are justified by returns achieved over the past decade — these fell short of being able to meet typical objectives for spending, inflation protection, and provision for their operating expenses. We were, however, heartened to discover that many respondents have reviewed their investment policies and that many more are planning to do so.

A survey of this nature always yields some interesting results. First, alternative investments seem firmly entrenched and poised to continue growing. Second, there is a significant minority of respondents that reflect responsible investment and environmental, social, and corporate governance (ESG) considerations in manager and security selection. Those who don't reflect such considerations, however, weren't sure if they would do so in the future. In the area of governance, a significant proportion weren't sure if they had proxy voting and shareholder rights policies.

Many respondents indicated that they have already taken some steps to mitigate equity volatility. Perhaps related to this is that tactical and discretionary asset allocation seem to have been alive and well over the past several years, even with a vast majority of respondents having automatic asset-mix rebalancing procedures.

We note several interesting results by sector in the survey, primarily in the use of alternative investments and investment performance during the market crash of 2008. As our survey grows in size in the future, we will build out sector-specific results in more detail.

We wish to thank this year's participants. We invite those who did not participate this year to do so next year in order to enhance the value for all readers.

SECTION 1

KEY FINDINGS

We summarize below some of the key findings of our survey, classified by topic.

INVESTMENT POLICY TIME HORIZON

- Respondents generally distinguish between short- and long-term investment policies.
- Close to half of respondents consider the short-term time horizon to be five years or less, with 8% using a five- to 10-year time frame.
- Long-term policy generally applies to a time horizon exceeding 10 years (50% of respondents), though 23% indicated a five- to 10-year horizon, and the remaining 27% have an unspecified long-term time horizon.

INVESTMENT POLICY ALLOCATION

- Equities remain the dominant asset class for long-term or endowed funds, with an average allocation of 57%, followed by bonds at 33%, and real estate and other alternative investments totalling 10%.
- Larger funds exceeding $250 million have a higher allocation to alternative investments at the expense of a lower bond allocation than do other funds. This difference primarily occurred in the public and education sectors.
- Equities are dominated by large cap developed market allocations with Canadian equity at 44% of total equity, while bonds are heavily weighted to universe bonds (70% of total bonds).
- As one would expect, short-term asset allocation is dominated by bonds at 83% of total assets, with the remaining assets in equity and alternative investments.
- Almost two-thirds of all respondents don't hedge foreign currency. The key reason cited for changing the currency hedge ratio was an increased allocation to non-domestic assets.

INVESTMENT IMPLEMENTATION AND OBJECTIVES

- Approximately two-thirds of respondents review their investment policy every one to three years and all use external investment consultants for advice.
- Not surprisingly, 81% of respondents use external managers and the vast majority (92%) have no plans to change this practice.
- Investment objectives are generally expressed as a target real return or nominal return over rolling periods.

TACTICAL ASSET ALLOCATION

- A significant minority (23%) of respondents have a defined process for opportunistic or tactical asset allocation shifts. However, 46% have actually undertaken discretionary changes to their asset allocation over the past three years, even though 76% have a defined process for asset-mix rebalancing to policy targets.

SPENDING POLICY

- Three-quarters of respondents reported having a formal spending policy, but surprisingly, only 56% relate their spending policy, either directly or indirectly, to their investment policy asset allocation.
- Over half of participants have a spending rate of at least 4%, but only a minority (9%) are at 5% or more, while just under 10% are at 3% or less. We believe there has been a trend to reduce spending rates and that this trend will continue.

RESPONSIBLE INVESTMENTS AND ENVIRONMENTAL, SOCIAL, AND CORPORATE GOVERNANCE (ESG)

- Although only 31% of respondents have a policy regarding the integration of ESG issues into their investment process, we view this as meaningful and reflective of an emerging trend that we expect will continue. Similarly, 35% ask their managers to report on ESG risks in their portfolio.
- Regarding intentions to integrate ESG issues, 46% had no plans to do so and 46% don't know if they will do so, while 8% did have plans to do so. The results suggest that this is an area that requires further education and review.

ALTERNATIVE INVESTMENTS

- Alternative assets are mostly in real estate, infrastructure, hedge funds, and private equity.
- Survey results indicate that alternative investment allocations are meaningful regardless of fund size, though higher with larger funds. However, 40% of respondents still do not invest in alternative asset classes.
- The primary reasons cited for investing in alternatives were diversification, return enhancement, and downside (tail risk) protection.
- The most common vehicles used are open-ended and closed-ended funds, followed by funds-of-funds and multi-strategy funds.
- In terms of expected changes in alternative allocations over the next 12 months, hedge funds, real estate, and infrastructure were to be increased by several funds.

CURRENT ISSUES, CHALLENGES, AND EXPECTED CHANGES

- Insufficient fund returns to meet objectives was cited by 50% of the respondents as the greatest risk or challenge facing funds over the next several years, followed by the ability to maintain spending, which was cited by 35%. Clearly, the two are directly linked to a dominant concern about being unable to fulfill the objectives currently outlined in respondents' investment and spending policies.
- Quite significantly, one-third of respondents have recently revised or are expected to amend their investment and spending policy over the next 12 months. However, 73% intend to review this policy in light of the current market environment.
- Also noteworthy is that 61.5% of respondents have implemented strategies to protect against downside equity market volatility.
- Besides the previously noted intended increase in some alternative assets, there are also intentions to reduce universe bonds and increase corporate bonds.

INVESTMENT PERFORMANCE

- Respondents' median investment return for the 10 years to December 31, 2011, was 4.3%, with 10-year returns ranging from 3.6% to 6.2%. In comparison, the Mercer Balanced Pooled Fund Universe median return was 5.5%, and the corresponding passive benchmark return was 4.7% over the same period.
- Respondents' median returns (-13.1%) were better than the Mercer balance fund universe benchmark in 2008 (-14.1%). Respondents' 2008 returns ranged widely, with a survey high return of 6.7% and minimum of -20.3%.
- Health care and community foundations led the way in 2008, with median returns of 1.1% and -3.5%, respectively, both well above the median returns of all funds.

SECTION 2

INVESTMENT POLICY ASSET ALLOCATION

TIME HORIZON FOR INVESTMENT POLICY

Mercer believes that it is important to distinguish between short- and long-term funds in establishing investment policy. In our survey, 36% of respondents have separate policies for short- and long-term or endowed plan assets, while 48% use the same policy for both.

Close to a third of respondents set their investment policy for short-term funds with a time horizon of less than three years. For the health sector, this proportion doubles.

Chart 3. Investment Time Horizon for Short-term Funds

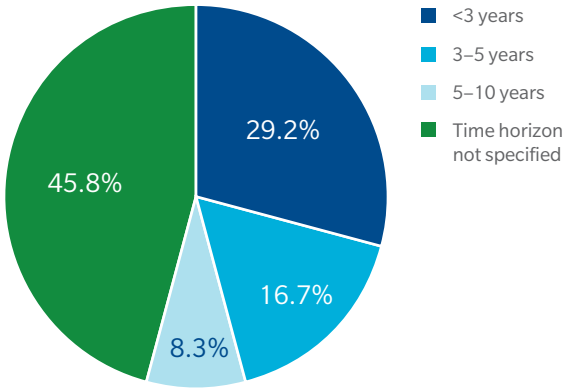
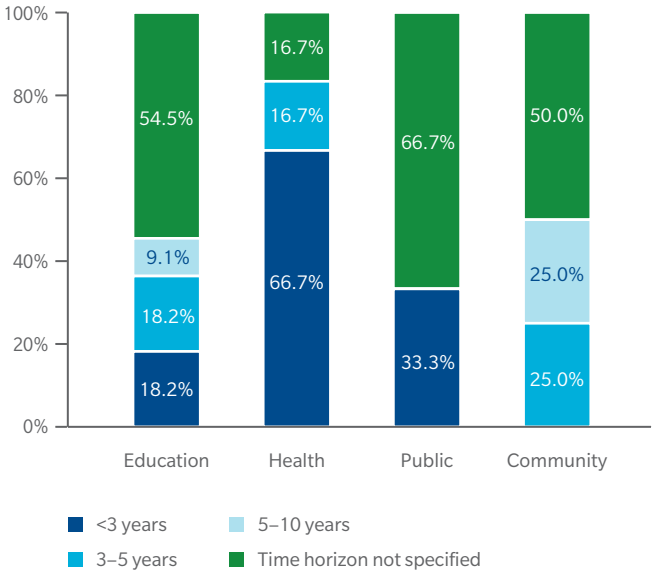


Chart 4. Investment Time Horizon for Short-term Funds by Sector



Half of respondents set their investment policy for long-term funds with a time horizon of more than 10 years, although this proportion is significantly lower for the public sector.

Chart 5. Average Investment Horizon for Long-term Funds

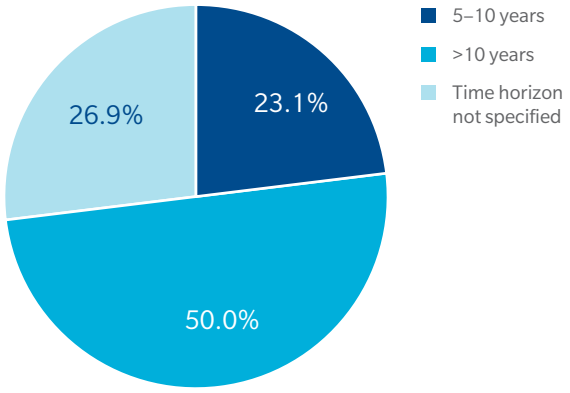
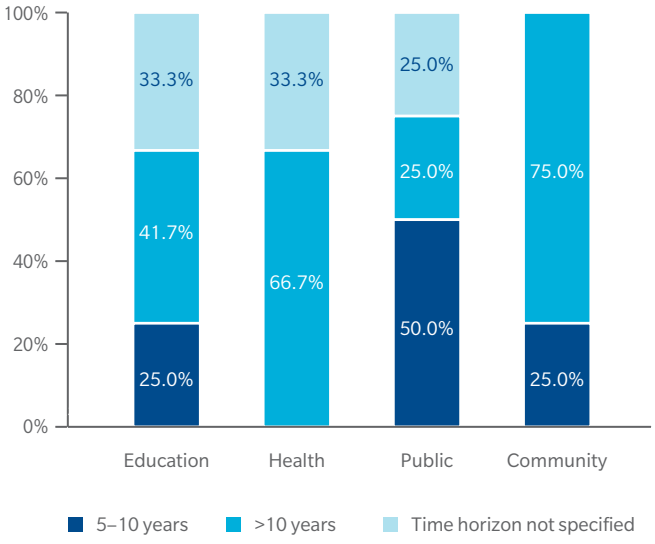


Chart 6. Average Investment Horizon for Long-term Funds by Sector



ASSET ALLOCATION FOR LONG-TERM OR ENDOWED FUNDS

Most funds seem to be close to a 60/40 structure for the long-term or endowed funds. Allocation to real estate and other alternatives makes up about 10% of the average long-term strategic asset allocation, with this proportion increasing to 15%–20% for the larger funds. These asset classes are all the more present in the education and public sectors.

Chart 7. Long-term Asset Allocation

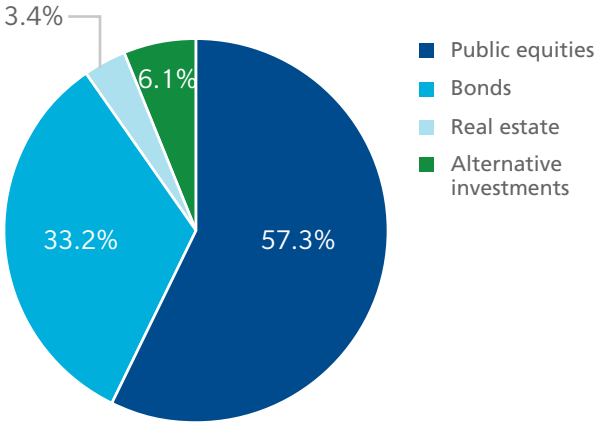


Chart 8. Long-term Asset Allocation by Fund Size (Millions)

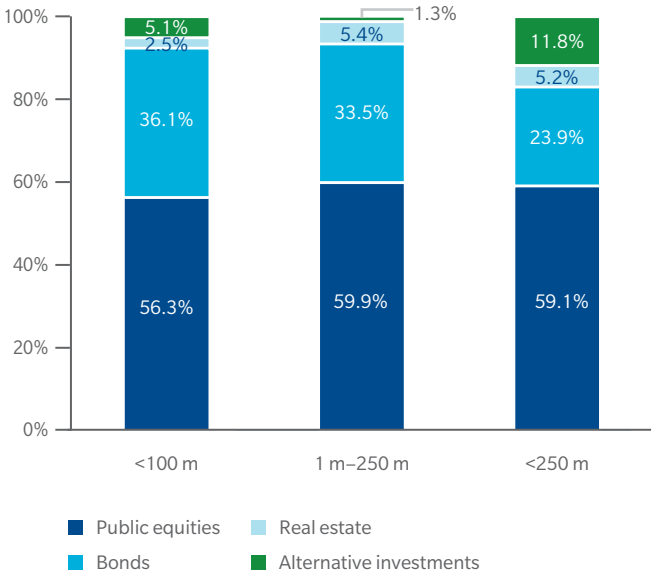
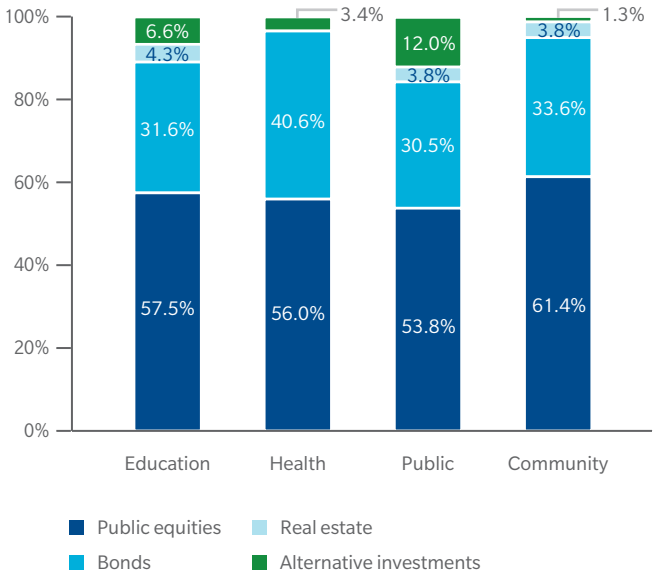


Chart 9. Long-term Asset Allocation by Sector



The charts below show the breakdown of the strategic asset allocation for long-term or endowed funds for each of the major asset classes.

Chart 10. Long-term Asset Allocation by Equity Category

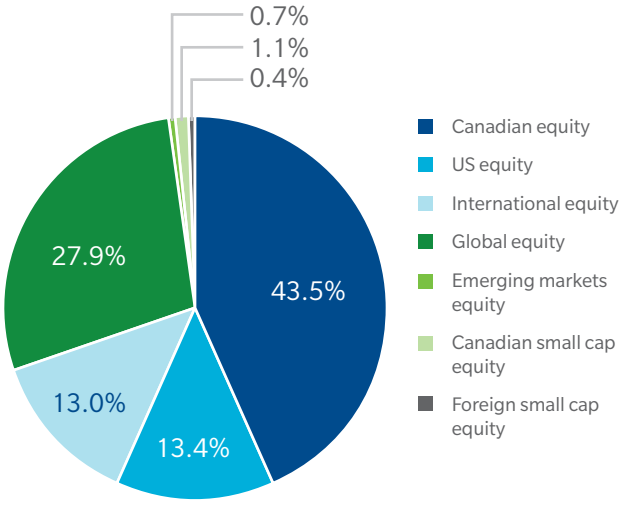


Chart 11. Long-term Asset Allocation by Bond Category

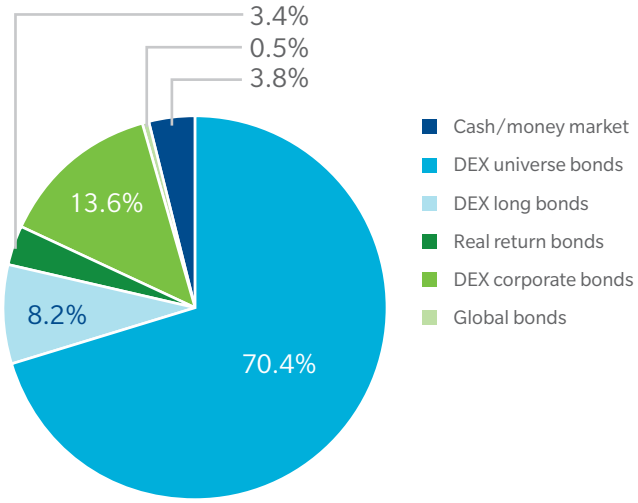
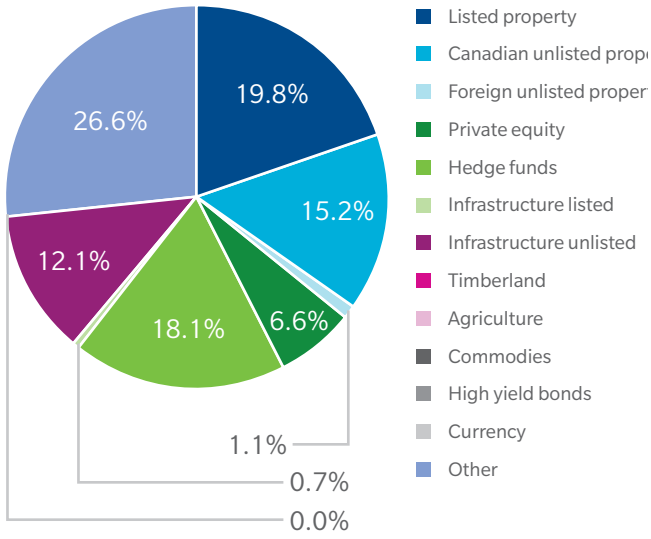


Chart 12. Long-term Asset Allocation by Real Estate and Alternative Investments Category



INTENDED CHANGES IN LONG-TERM ASSET ALLOCATION

The following charts indicate intended changes in each of the key asset classes included in investment policy for long-term funds.

Chart 13. Expected Change Over the Next 12 Months: Public Equities

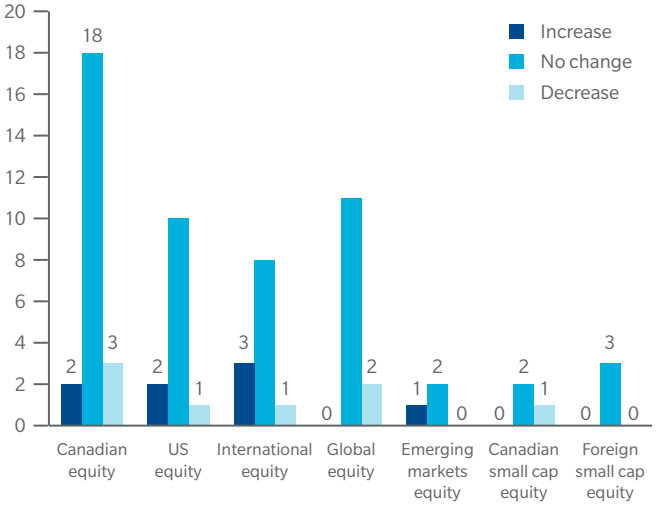


Chart 14. Expected Change Over the Next 12 Months: Bonds

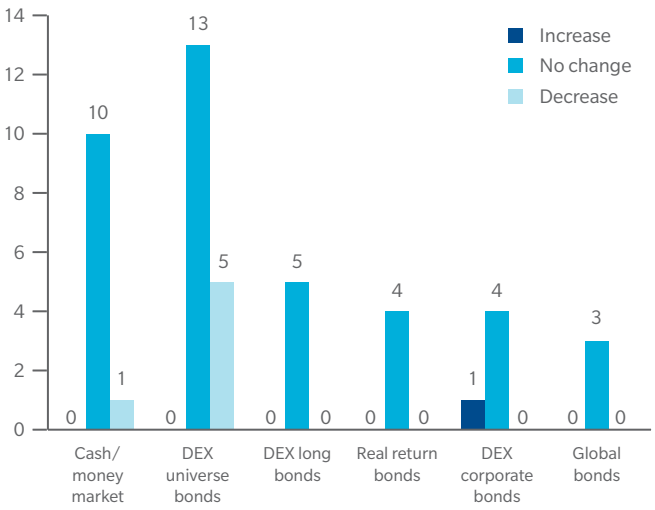
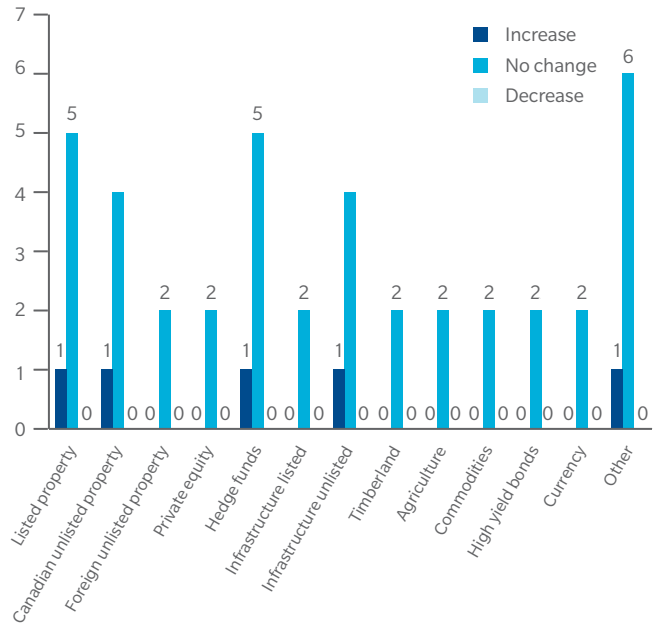


Chart 15. Expected Change Over the Next 12 Months: Real Estate and Alternative Investments



ASSET ALLOCATION FOR SHORT-TERM POLICY

For funds that have indicated that their short-term or non-endowed fund asset policy is different from their long-term policy, we have set out a breakdown of their asset allocation below.

Chart 16. Short-term Asset Allocation

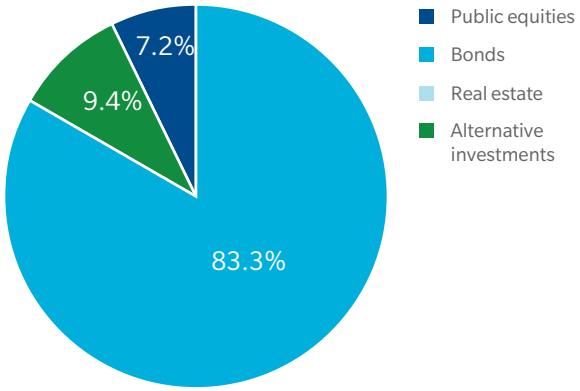


Chart 17. Short-term Asset Allocation by Public Equities Asset Category

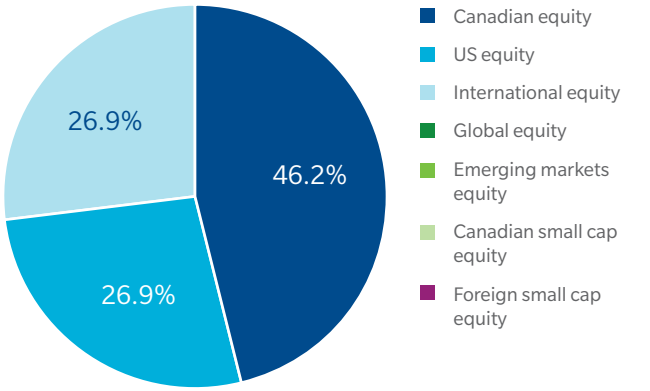


Chart 18. Short-term Asset Allocation by Bonds Asset Category

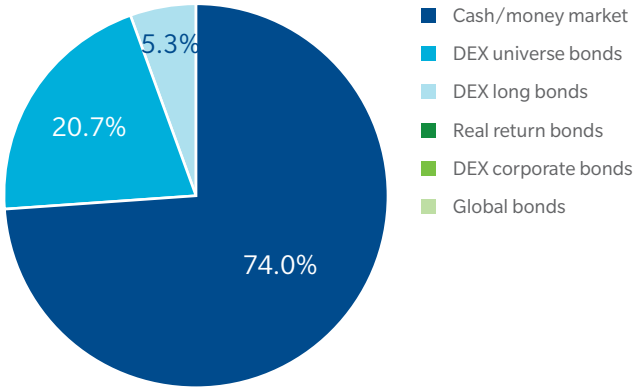
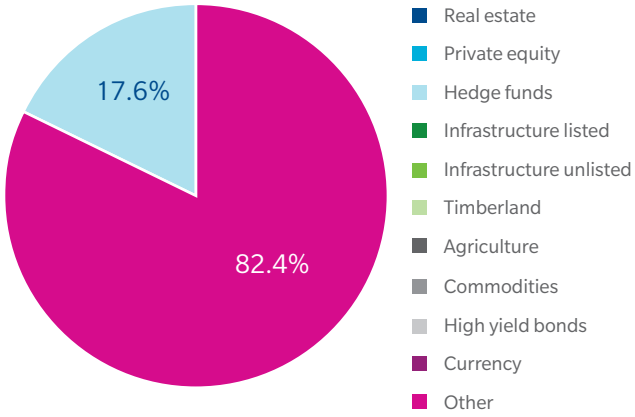


Chart 19. Short-term Asset Allocation by Real Estate and Alternative Investments Asset Category



MOTIVATION FOR INVESTING IN ALTERNATIVE ASSET CLASSES AND CURRENCY HEDGING

We asked respondents what are or would be the primary objectives of their organization when investing in alternative assets. The chart below shows the number of times each of the answers was selected (respondents were allowed to select as many as they liked). Diversification benefits and return enhancement were the most common answers, followed closely by tail risk protection (see Chart 20).

We asked respondents what vehicles they would use for investing in alternative investments. The most popular answers were closed-ended funds and open-ended funds (see Chart 21).

Chart 20. Alternative Assets' Objectives

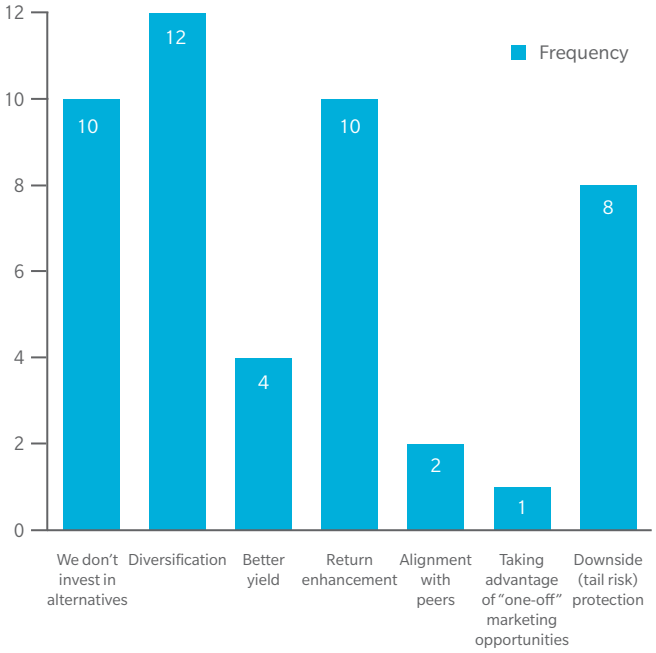
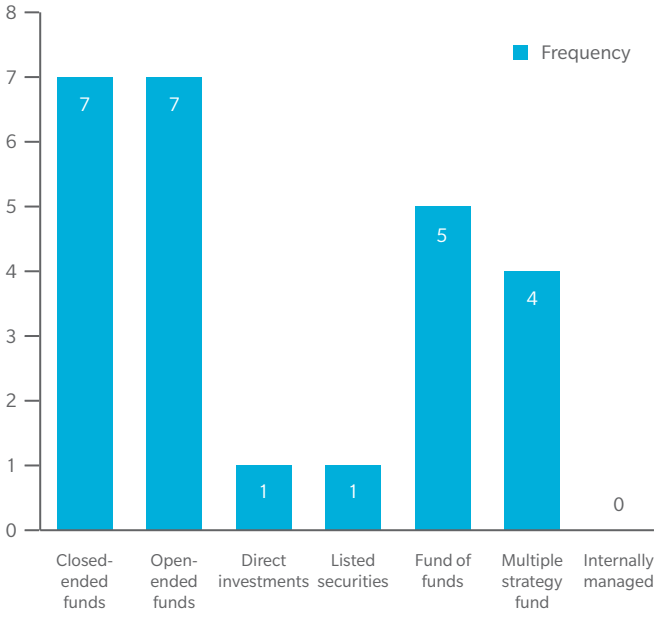


Chart 21. Alternative Assets' Vehicles



We asked respondents what proportion of foreign currency exposure is hedged to their local currency. Almost two-thirds do not hedge currency at all (see Chart 22).

We asked respondents what would cause a change to their stated foreign currency hedge ratio. The main reason given was an increased allocation to non-domestic assets (see Chart 23).

Chart 22. Currency Hedging

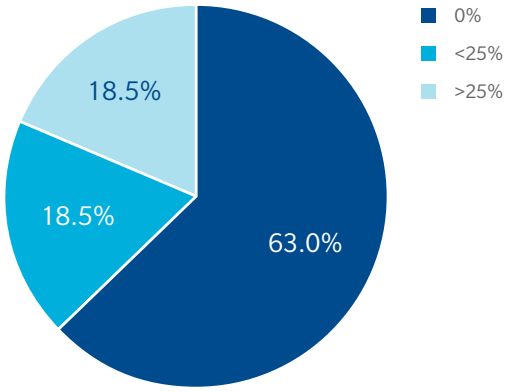
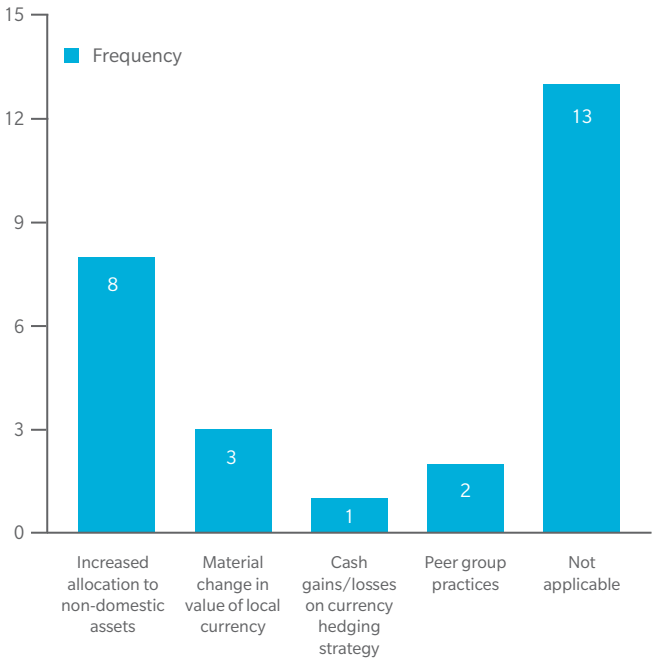


Chart 23. Potential Reasons to Change Foreign Currency Hedge Ratio



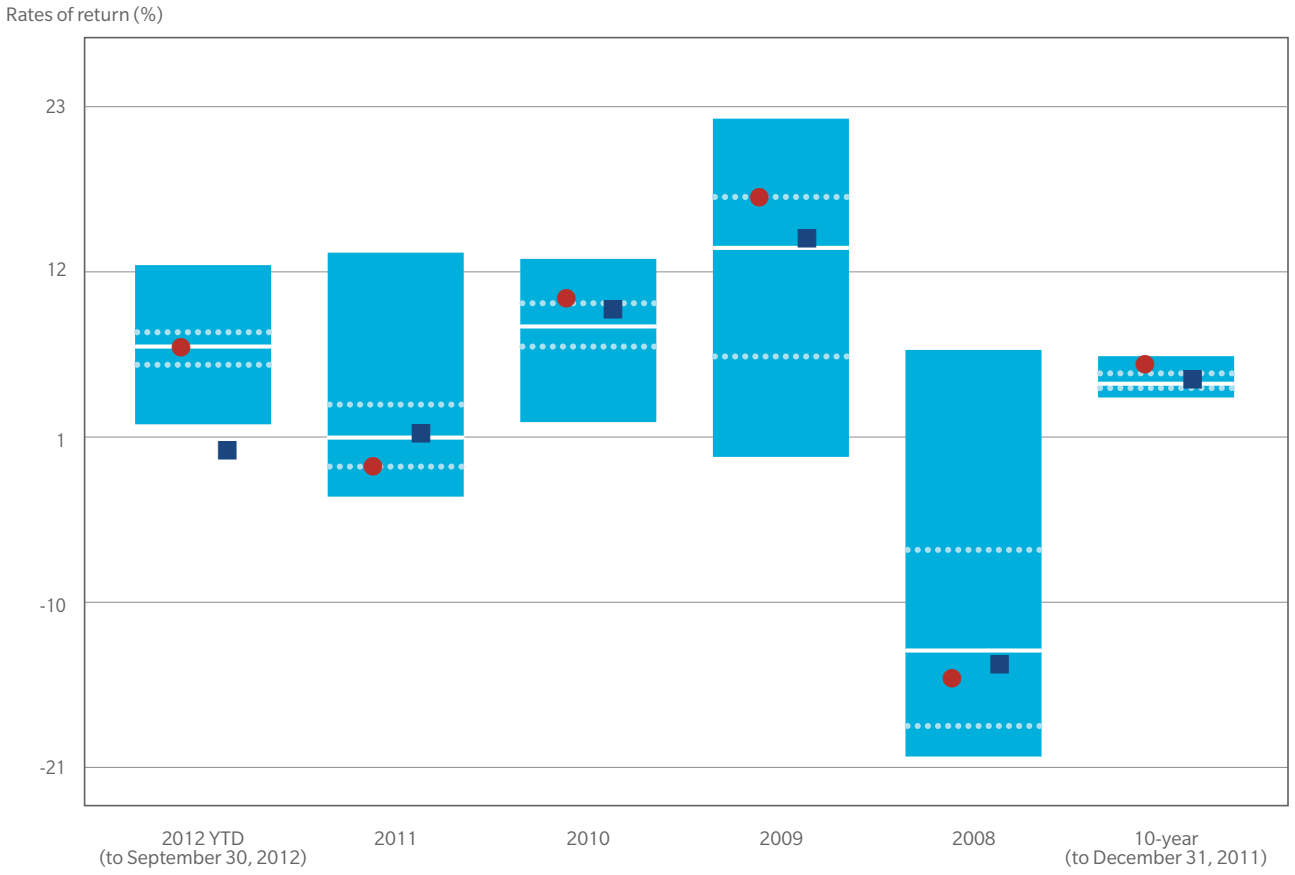
SECTION 3

INVESTMENT PERFORMANCE

We asked respondents to submit the investment performance of their long-term or endowed fund assets annually since 2008, and for the last 10 years to December 31, 2011. Returns are reported on a nominal annualized basis (except year-to-date performance, which is the actual return), net of transaction costs but before deducting investment management fees.

It was somewhat surprising that over the last 10 years, respondents underperformed the benchmark and median in the Mercer Balanced Pooled Fund Universe.

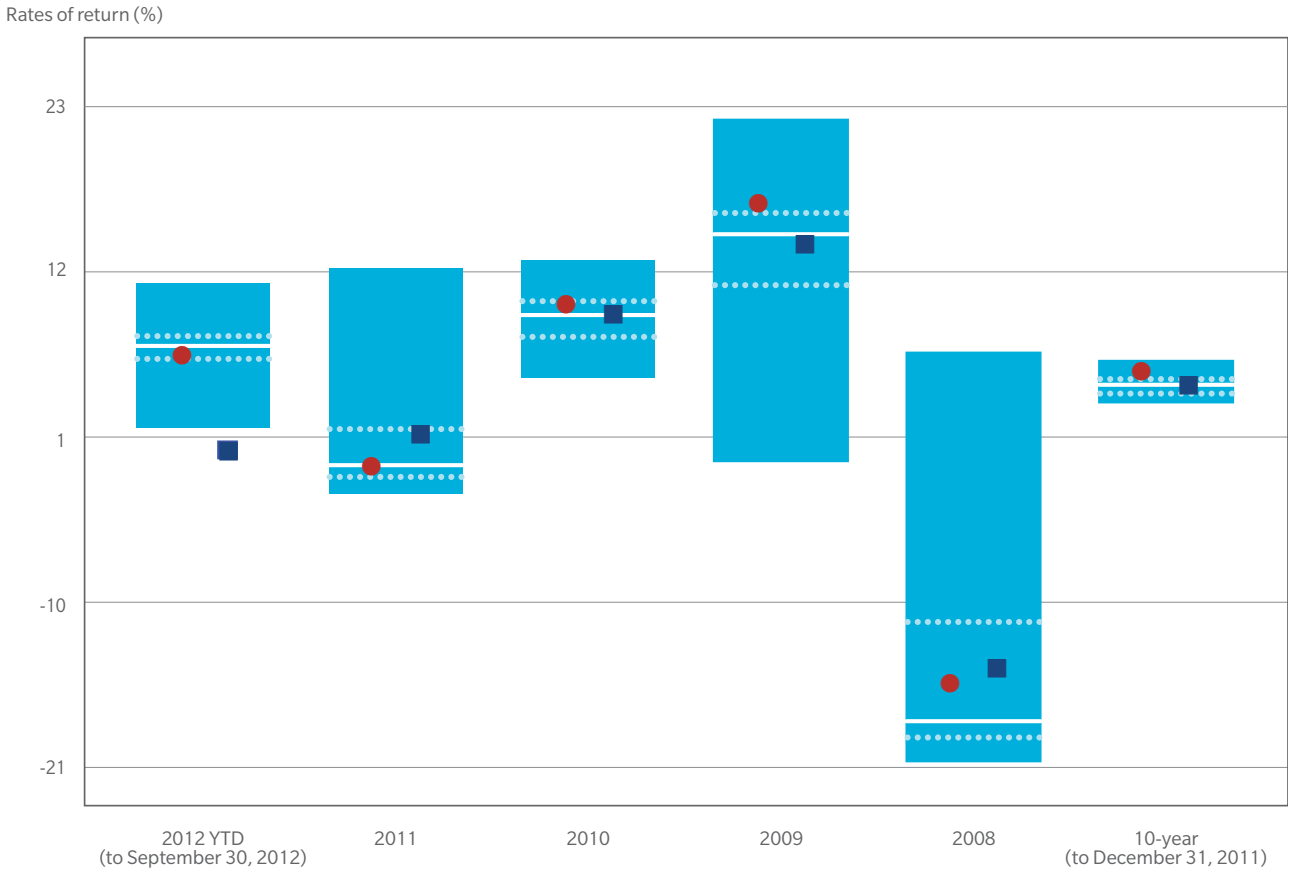
Chart 24. Comparison With the Mercer Balanced Pooled Fund Universe



	2012 YTD (to September 30, 2012)	2011	2010	2009	2008	10-year (to December 31, 2011)
Mercer median	6.6	-0.9	10.0	16.5	-14.9	5.5
Mercer benchmark	0.1	1.1	9.2	14.0	-14.1	4.7
Maximum	12.2	13.1	12.7	22.1	6.7	6.2
Upper quartile	7.9	3.1	9.8	16.5	-6.6	5.2
Median	6.9	0.9	8.1	13.3	-13.1	4.3
Lower quartile	5.5	-1.1	7.0	6.2	-18.0	4.1
Minimum	1.8	-3.0	2.0	-0.3	-20.3	3.6
Number of respondents	24	25	24	24	22	12

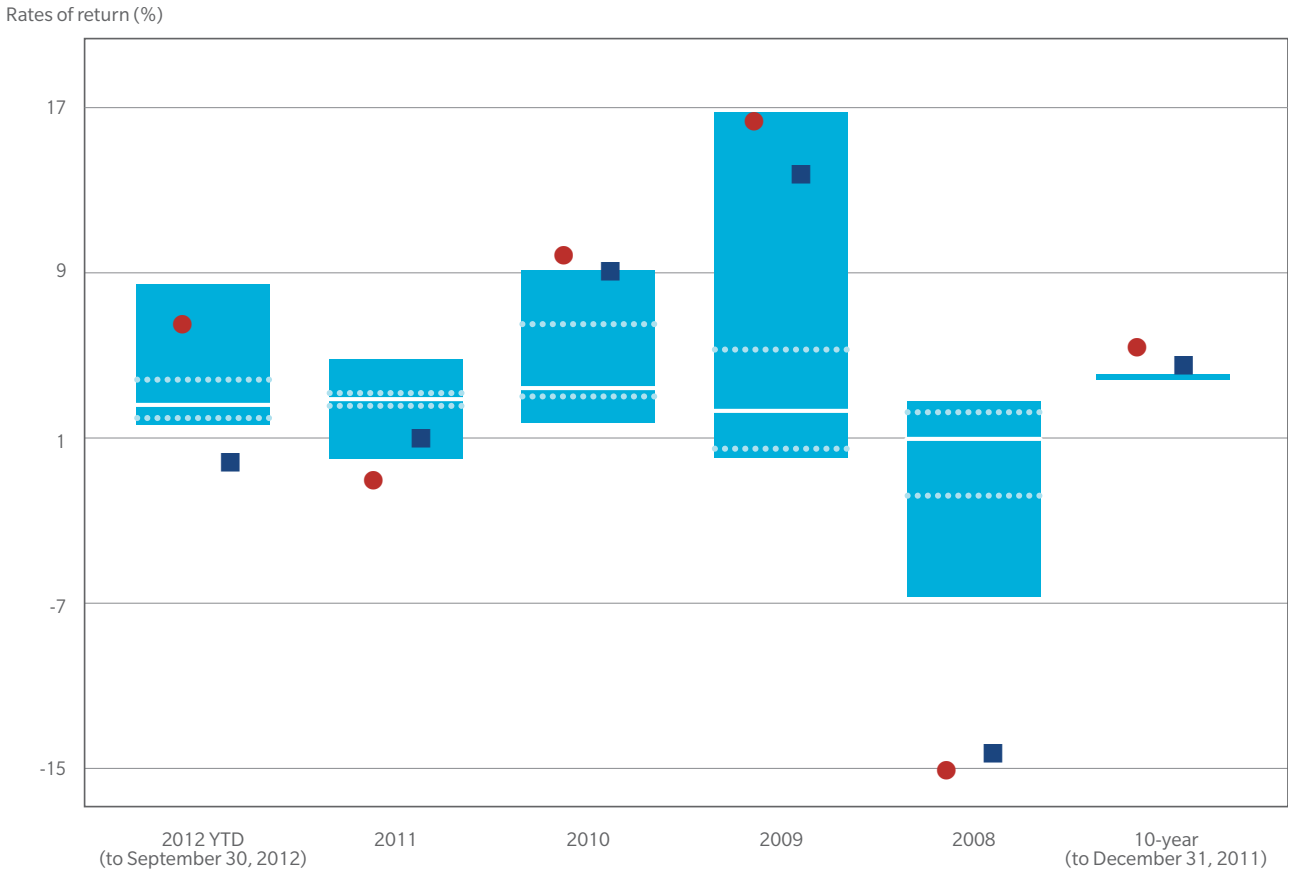
The Mercer passive portfolio comprises 42.5% DEX Universe Bond, 25% S&P/TSX, 15% S&P 500 (CAD),15% MSCI EAFE (CAD), and 2.5% DEX 91 Day T-Bills.

Chart 25. Comparison With the Mercer Balanced Pooled Fund Universe (Education)



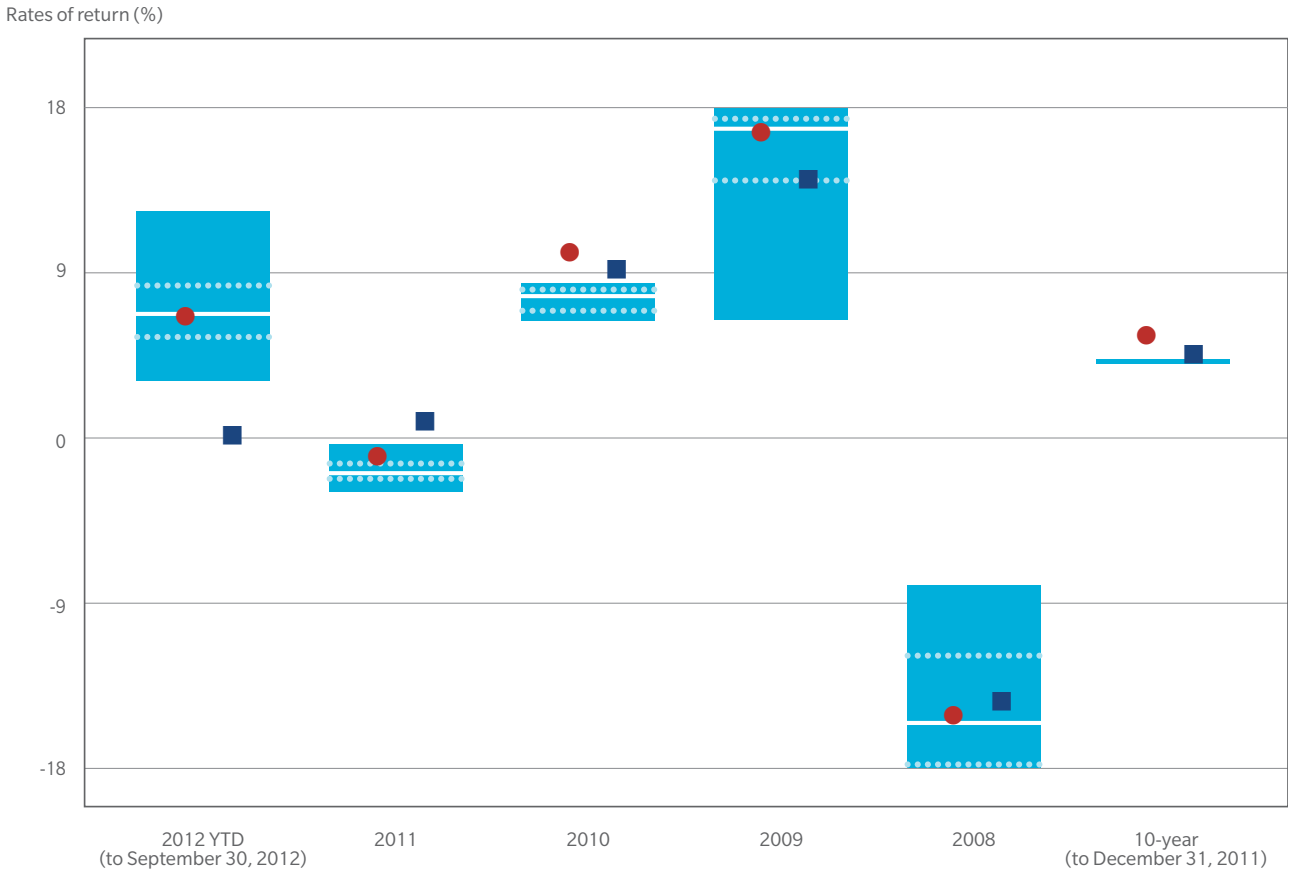
	2012 YTD (to September 30, 2012)	2011	2010	2009	2008	10-year (to December 31, 2011)
Mercer median	6.6	-0.9	10.0	16.5	-14.9	5.5
Mercer benchmark	0.1	1.1	9.2	14.0	-14.1	4.7
Maximum	11.3	12.1	12.7	22.1	6.7	6.2
Upper quartile	7.9	1.8	10.2	16.2	-10.8	5.2
Median	7.2	-0.7	9.3	14.6	-17.4	4.8
Lower quartile	6.4	-1.4	7.7	11.3	-18.7	4.1
Minimum	1.9	-2.5	5.3	-0.3	-20.3	3.6
Number of respondents	12	12	12	12	12	8

Chart 26. Comparison With the Mercer Balanced Pooled Fund Universe (Health)



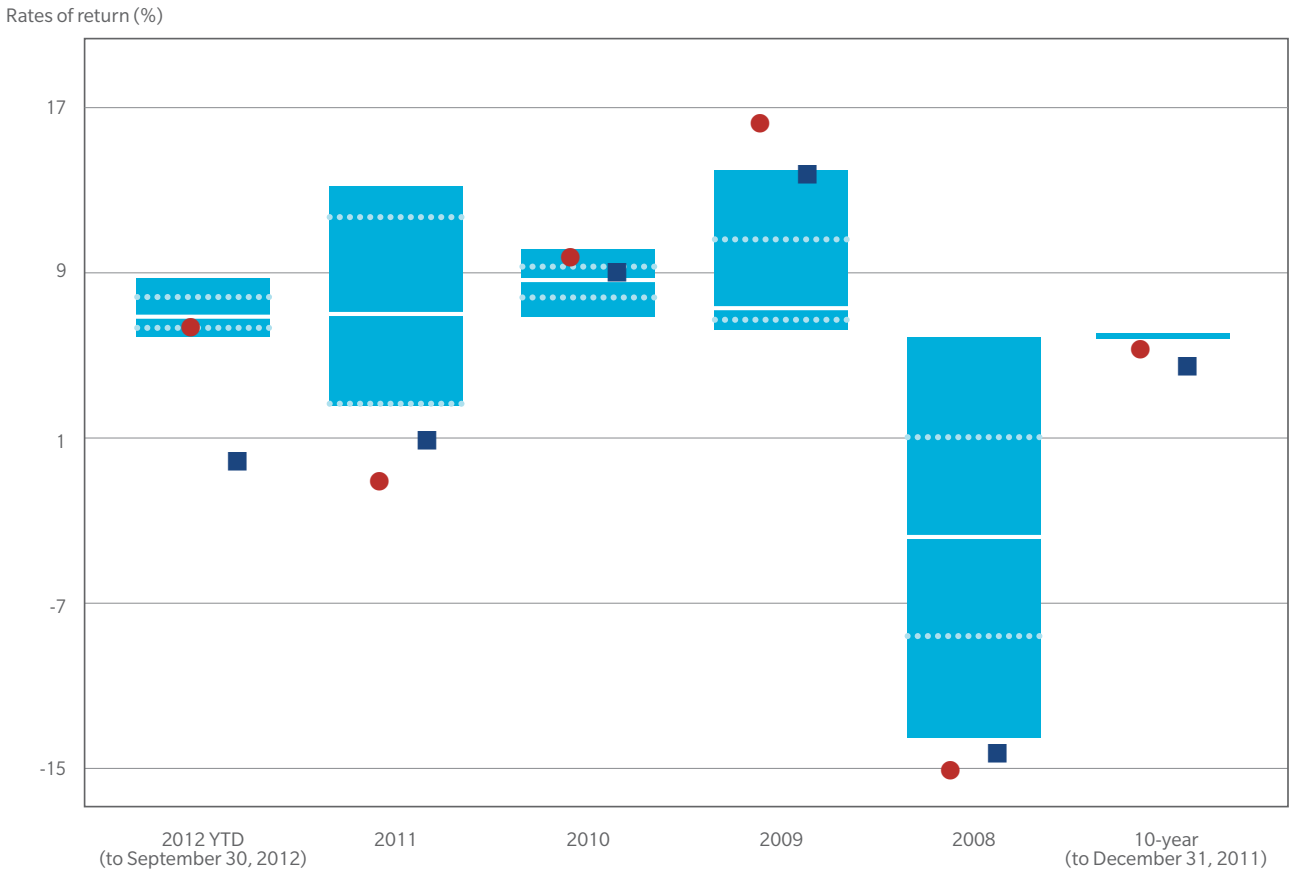
	2012 YTD (to September 30, 2012)	2011	2010	2009	2008	10-year (to December 31, 2011)
Mercer median ●	6.6	-0.9	10.0	16.5	-14.9	5.5
Mercer benchmark ■	0.1	1.1	9.2	14.0	-14.1	4.7
Maximum	8.5	4.9	9.3	16.7	2.9	4.1
Upper quartile	4.0	3.1	6.6	5.4	2.4	4.1
Median	2.8	3.0	3.6	2.5	1.1	4.1
Lower quartile	1.9	2.7	3.1	0.6	-1.6	4.1
Minimum	1.8	0.2	2.0	0.0	-6.5	4.1
Number of respondents	5	5	5	5	12	1

Chart 27. Comparison With the Mercer Balanced Pooled Fund Universe (Public)



	2012 YTD (to September 30, 2012)	2011	2010	2009	2008	10-year (to December 31, 2011)
Mercer median	6.6	-0.9	10.0	16.5	-14.9	5.5
Mercer benchmark	0.1	1.1	9.2	14.0	-14.1	4.7
Maximum	12.2	-0.5	8.3	17.9	-7.8	4.2
Upper quartile	8.3	-1.4	8.1	17.2	-11.7	4.2
Median	6.8	-1.8	7.6	16.8	-15.3	4.2
Lower quartile	5.6	-2.1	7.0	14.0	-17.5	4.1
Minimum	3.0	-3.0	6.3	6.5	-17.6	4.1
Number of respondents	4	4	4	4	4	2

Chart 28. Comparison With the Mercer Balanced Pooled Fund Universe (Community)



	2012 YTD (to September 30, 2012)	2011	2010	2009	2008	10-year (to December 31, 2011)
Mercer median ●	6.6	-0.9	10.0	16.5	-14.9	5.5
Mercer benchmark ■	0.1	1.1	9.2	14.0	-14.1	4.7
Maximum	9.0	13.1	10.3	14.2	6.1	6.2
Upper quartile	8.1	11.9	9.6	10.9	1.3	6.2
Median	7.1	7.3	8.9	7.6	-3.5	6.2
Lower quartile	6.6	3.0	8.1	7.0	-8.3	6.2
Minimum	6.1	2.9	7.2	6.5	-13.2	6.2
Number of respondents	3	4	3	3	2	1

SECTION 4

SPENDING POLICY

Nearly three-quarters of respondents have a formal spending policy. In nearly half the cases, there is no direct or indirect relationship between the spending policy and the investment policy asset allocation. A third of respondents have a spending policy that is directly related to the investment policy asset allocation.

We also asked respondents about their current spending policy rate, excluding their organization's operating expenses. For over half the respondents, this corresponds to more than 4%.

Chart 29. Spending Policy Rate

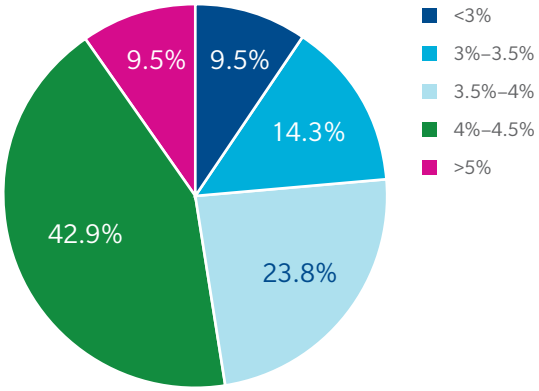
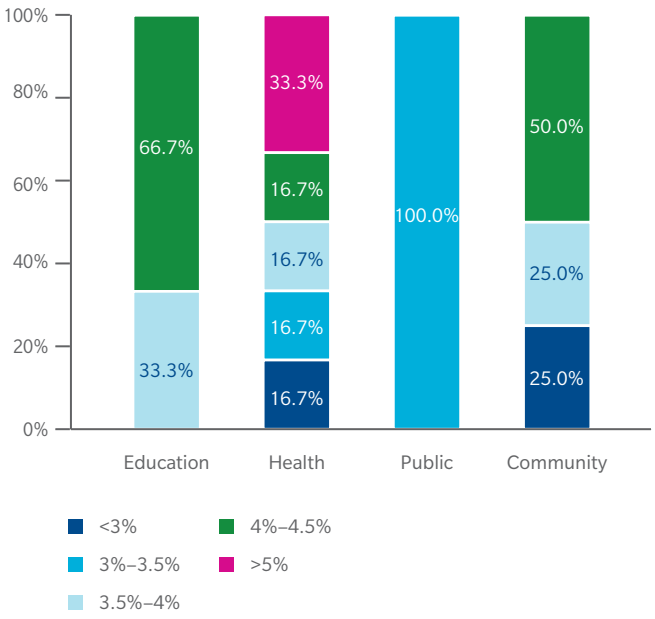


Chart 30. Spending Policy Rate by Sector



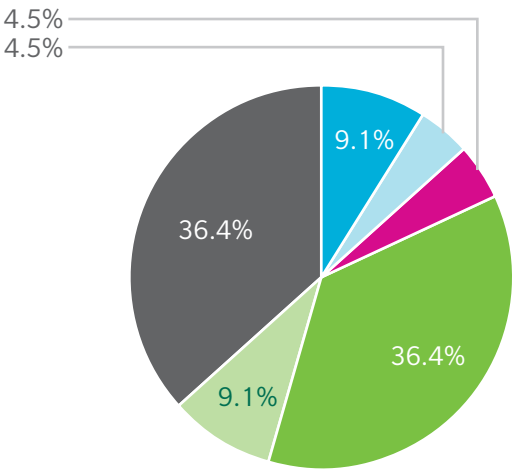
SPENDING POLICY METHODOLOGY

We asked respondents how their spending policy rate is calculated:

- Over a third of respondents' spending policy rate is a fixed percentage of a moving average of market values. A similar proportion use "other methodologies."
- Almost a tenth of respondents use the cash income received, including realized profits.
- Almost a tenth of respondents use a combination of inflation indexed, past distribution, and a percentage of latest market value.

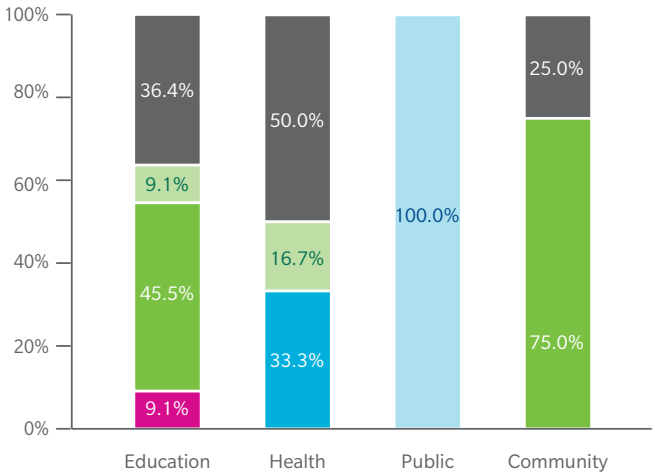
A third of respondents recently revised or are considering revising their policy in the near future. The main stated motivation is the inadequacy of fund returns. In fact, 85% of survey respondents considered the possibility of insufficient returns to meet their objectives or maintain their spending at the current level as being the greatest risk faced by their funds. But some were also concerned about the volatility of equity markets and the low yield on cash and fixed income investments.

Chart 31. Spending Policy Methodology



- Cash income received, excluding realized profits
- Cash income received, including realized profits
- Fixed percentage of latest market value of portfolio
- Fixed percentage of initial or past portfolio value, indexed for inflation
- Fixed percentage of moving average of market values
- Combination of inflation indexed, past distribution, and a percentage of latest market value (e.g., Yale-type formula)
- Other methodologies

Chart 32. Spending Policy Methodology by Sector



- Cash income received, excluding realized profits
- Cash income received, including realized profits
- Fixed percentage of latest market value of portfolio
- Fixed percentage of initial or past portfolio value, indexed for inflation
- Fixed percentage of moving average of market values
- Combination of inflation indexed, past distribution, and a percentage of latest market value (e.g., Yale-type formula)
- Other methodologies

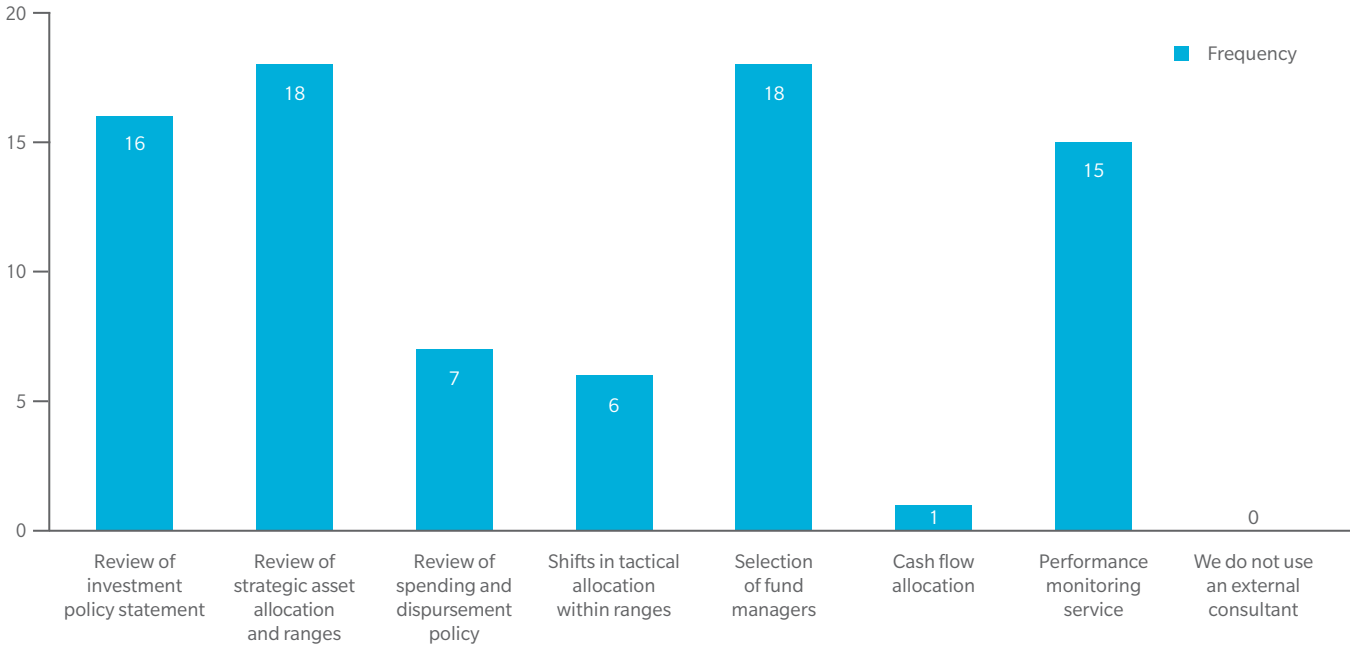
SECTION 5

INVESTMENT POLICY REVIEW

About two-thirds of respondents review their investment policy target percentage allocation every one to three years and a tenth review it every four to five years. A quarter of respondents do not review their policy systematically.

Roughly two-thirds of respondents use investment consultants to review their investment policy statement, their strategic asset allocation and ranges, and selection of investment managers. A quarter of respondents obtain external advice for tactical asset allocation shifts. All use consultants.

Chart 33. Use of External Investment Consultant



SECTION 6

POLICY FOR RESPONSIBLE INVESTMENTS AND ENVIRONMENTAL, SOCIAL, AND CORPORATE GOVERNANCE (ESG)

Only 31% of respondents have a policy regarding the integration of ESG issues into the investment process. However, two-thirds ask their investment managers to report on ESG risks in their portfolio and ESG-related investment opportunities. Finally, 62% never use ESG ratings or research when reviewing or appointing external managers. Only a small percentage indicated that they had the intention to integrate ESG issues into their decision-making process.

When asked if their organization had a policy on corporate governance, including proxy voting and shareholder engagement, 42.3% replied that they do. Surprisingly, 46.2% replied that they don't, and 11.5% responded that they don't know.

Chart 34. Policy for ESG

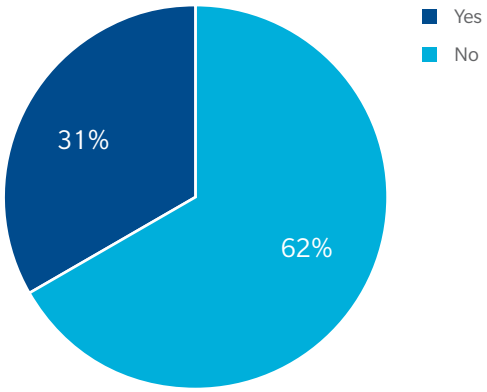
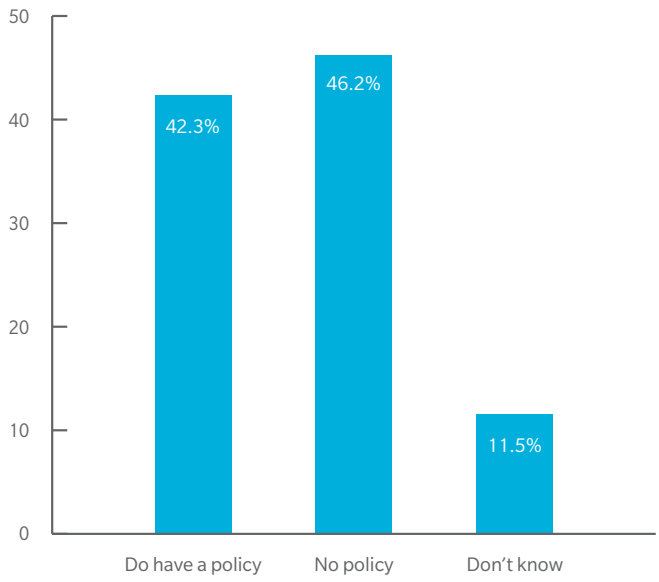


Chart 35. Corporate Governance



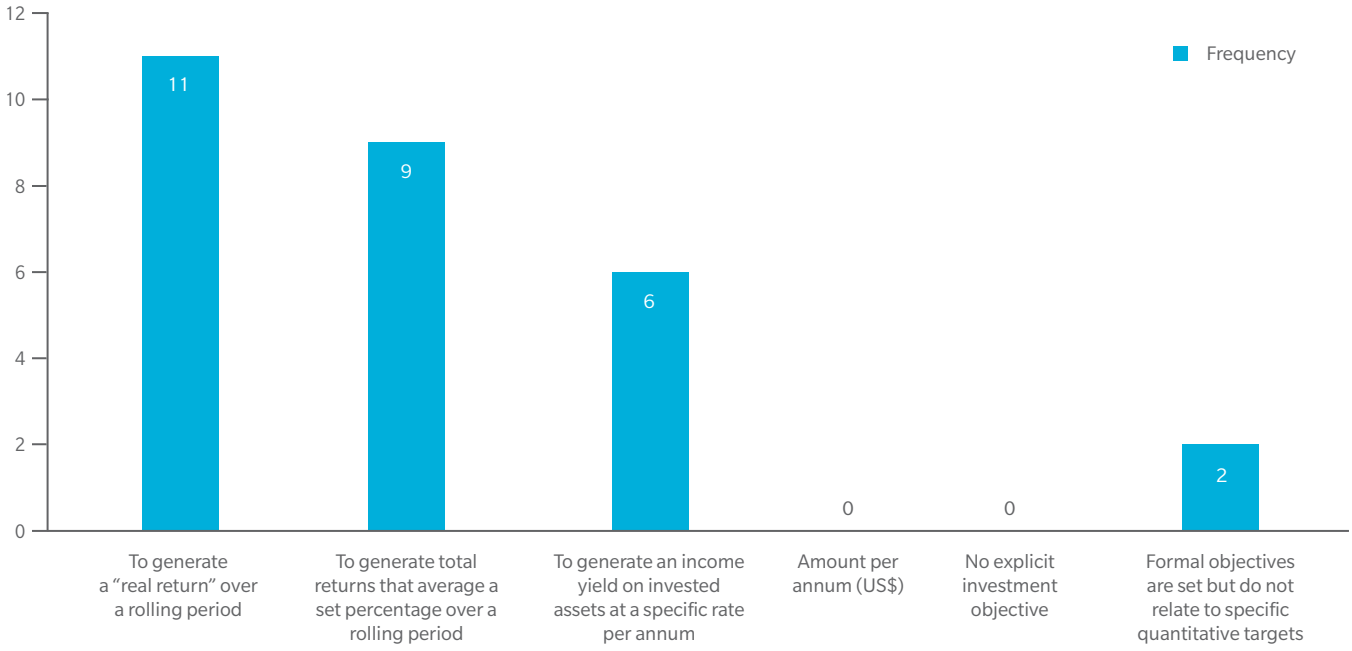
SECTION 7

INVESTMENT IMPLEMENTATION

Most respondents (80%) use external investment managers to manage their assets and an overwhelming majority (92%) plan to continue.

The most common investment objectives are to generate a real return or total returns that average a set percentage over a rolling period.

Chart 36. Investment Objectives



Although more than three-quarters of respondents don't have a defined systematic process for managing discretionary changes to the strategic asset allocation, close to 45% have made such changes in the past several years. Close to three-quarters of respondents have a defined process for rebalancing assets back to the policy target asset allocation.

SECTION 8

CURRENT ISSUES AND OPPORTUNITIES

In this section, respondents were asked for their opinions on the greatest challenge they will face in the years ahead and what steps they have taken or plan to take to tackle that challenge. Many indicated that their biggest concern is the ability to earn adequate returns and maintain spending, and said that they plan to undertake investment and spending policy reviews.

The following charts show the motivations for reviewing spending policy, the greatest future challenges, and the planned activities for tackling these challenges.

Chart 37. Motivation for Spending Policy Review

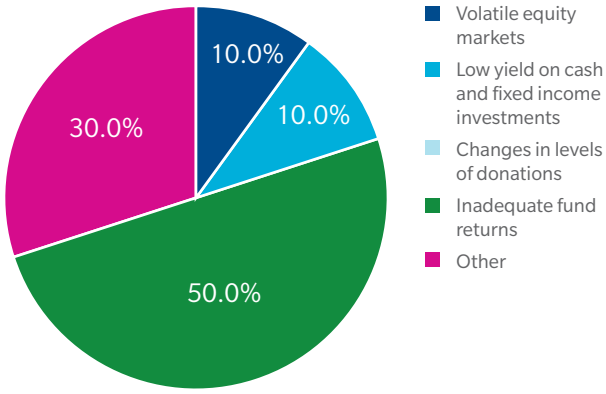


Chart 38. Greatest Challenge Over the Next Several Years

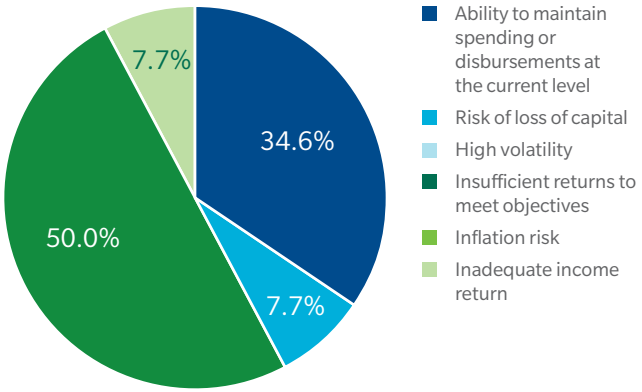
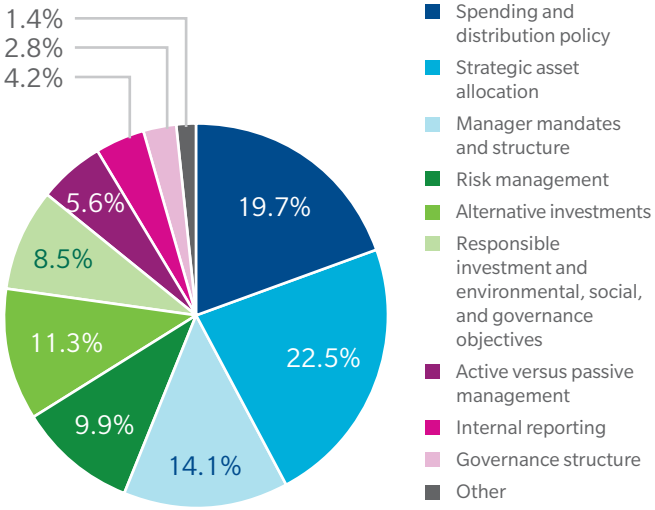


Chart 39. Issues to Review Over the Next Year



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