

Developing Investments

Montreal-based IFPT offers a new, secure and very attractive investment asset class

BY TOD HOFFMAN

If you can succeed in convincing Revenue Canada to amend the Tax Act to accommodate an investment proposal you've devised, chances are that you're on to something quite interesting.

By the mid-1990s, Carl Otto recognized that pension funds needed fresh, high quality domestic fixed income investment options to enhance their returns, while meeting their predisposition for security. Over the course of the decade, their assets had grown from \$190 billion to \$500 billion and inflows currently exceed outflows by \$9 billion annually. At the same time, both the federal and provincial governments reduced their issuance of bonds, thus limiting the pension funds' selection.

In 1999 he prevailed upon the federal government to permit investment in a Canadian trust that would purchase the component loans that make up World Bank and regional development bank investments and have those investments exempted from the foreign property definition. Therefore, by not falling into the 30% foreign property basket, they give investors more flexibility and, thus, become a more attractive asset.

Ottawa perceived a benefit, in that the trust's participation in loan financing promises to raise the profile of Canada's exporters in the developing world. Presumably, this will manifest in greater economic opportunities for them. Following from this will be more jobs in Canada, as well as all the other benefits that accompany participation in major international projects.

Otto created International Finance Participation Trust (IFPT) as an opportunity for fund assets to extend the breadth of their invest-



David Creighton
Executive Vice President and COO
IFPT

ment prospects. It invests in loans issued by international financial institutions (IFIs) to finance development projects in countries with emerging economies. Among these IFIs are the World Bank; Asian Development Bank; European Bank for Reconstruction and Development; Inter-American Development Bank; Development, and the International Finance Corporation; and Export Development Canada.

"Investing pension fund money through IFIs in emerging market private sector loans, makes sense to the government,"

explains Executive Vice President and COO David Creighton. "Canada, and its very competent exporters, will benefit from an increased exposure and understanding of their abilities by the international institutions and therefore have a greater chance of participating in the growth of the developing world."



Establishing the IFPT took a two-pronged effort. It had to entice the pension funds to invest and the IFIs to offer access to the loans.

"An investment vehicle of this type is very new, not just in Canada but in the world," Creighton points out. "As a result, we

have had a very steep learning curve for everyone involved."

Canadian pension funds are generally conservative in their choice of investments and, at first blush, this smacks of something risky. But, in fact, it isn't particularly so. The IFIs with whom the trust co-finances projects are all AAA institutions. The financing is constructed on an A/B loan syndication structure, whereby the IFI funds the A portion as the lender of record, while the IFPT purchases the B portion. Since the loan is not separated, those who take on B loans share in the "Preferred Creditor Status" of the IFI. Because they understand the repercussions of defaulting on these loans, host governments are motivated to ensure these loans perform.

Taking all these factors into account supports the argument that, contrary to appearances, this form of investment is comparatively secure.

Creighton elaborates, "Over the last ten years, less than 1% of

THE FIRST TRANCHE

The International Finance Participation Trust issued its first tranche last December. It raised US\$360,000,000 from a selection of Canada's largest pension funds. The Trust intends, over the next eighteen months, to filter through available loan offerings and conduct extensive due diligence to determine exactly which fit into its matrix of diversity, ethical investing, and sustainable return.

From the pool of potential investments under consideration, it is expected that approximately thirty will make up the portfolio.

Executive Vice President and COO David Creighton anticipates that the next twelve months will be crucial in establishing the Trust's bonafides and demonstrating the viability of the class of asset it is offering. □

Carl Otto, Founder
IFPT



IFI loans have been written off. This is largely because the development banks are committed to the success of the projects they invest in, and if there is a default they expend a huge amount of effort to work things out. A commercial bank, when faced with a problem loan, might be more prone to throw in the towel.

“As a result, based on the low yield degradation due to defaults, you’d have an investment grade rating from Moody’s or Standard & Poors, while at the same time yields equivalent to what would usually be generated from a lower rating. So, you end up getting a higher pay-off for the risk taken.”

On the issue of investing in developing countries, Creighton says, “There will always be blow-ups, both in the emerging markets and the developed world. In 1994 Mexico experienced a crisis, in 1997 it was Asia. And last year, both before and after September 11, the United States experienced a crisis.”

Given that there are no risk-free investments, the time honoured strategy of building a portfolio that is well diversified by region, sector, and obligor holds. IFPT is rigorous in ensuring this quality in its fund. Its philosophy is to focus more on the nature of the project than on the country where it’s being implemented, while still taking care to spread itself around the globe. The point is that if a project promises to bring social and economic benefit, it will engender widespread support from the government and populace.

“As long as a project itself is performing, just because there may be some financial crisis in the country, the access to U.S. dollars to service the loan will be assured,” says Creighton. He cites the August 1998 situation in Russia, when the government announced a debt moratorium. They were quick, however, to exempt those with Preferred Creditor Status. This happened for a number of reasons, but most significantly because countries consider IFI investments essential for their social and economic progress. Relationships extend beyond the loans to technical assistance. A failure to repay could jeopardize committed but undispersed funds, not to mention access to future project financing.

“Recent events, including the stock market crunch and the September 11 attacks, reveal that the need for improving lesser developed regions is at its greatest right now,” says Creighton. “The

developing world holds great prospects for growth. We need to foster a middle class in more countries if they are to be successful and emerge.”

IFPT is conscious of the responsibility to promote ethical investing. It factors in environmental, societal, and sustainability considerations. A project’s longer term prospects are very much affected by whether or not it brings tangible benefits to the community in which it is implemented. These are often the determining factors in its ultimate success.

“We are putting together something in which investors will see a return,” says Creighton, “and they can also feel good about it.” □

THE TRUST

Carl Otto, with twenty-five years of experience in dealing with the Canadian pension fund market, is a true innovator. The idea to establish a Trust investing in emerging market debt instruments has never before been tried. Otto is a graduate of the University of Freiburg, the London Institute of Bankers, and he also did post graduate work at Oxford. Otto has co-founded a number of leading investment firms over the course of his career, including AMI Partners, Penreal Advisors, Fleming Canada Partners, and Quantitative Capital. Through Carl Otto Associates he serves as an investment strategy advisor to universities, large family trusts, governments, and pension plans.

He approached David Creighton almost three years ago and intrigued him with the concept underlying the IFPT. At the time, Creighton was in London with BMO Nesbitt Burns, where he developed its international fixed income sales team. He had a number of years experience dealing with multilateral banks and quickly understood the potential of Otto’s concept. A native Montrealer, Creighton is a member of the Securities Institute (UK) and the Securities Exchange Commission (US).

The third senior executive of the IFPT is Tony Iskarpatyoti, Vice President Portfolio Manager. He has been a senior officer with both the World Bank and International Finance Corporation, as well as CoreStates Securities. Most of his career has been spent structuring projects in developing countries to mobilize outside investors. He leads a diverse, international team of analysts.

The Trust is overseen by a venerable Board of Directors, chaired by J. Anthony Boeckh, the editor-in-chief of *Bank Credit Analyst*. The other members are Christiane Bergevin of SNC-Lavelin Capital; Germaine Gibara of Avvio Management; Erik Richer La Flèche of Stikeman Elliott; Clive Minchom, Brian L. Neysmith of Standard & Poors; Allison D. O’Brien, a fellow at the University of Alberta; as well as representation from the Ontario Teachers Pension Plan Board, along with Otto and Creighton. □