Q. Evidence of Ms. McShane Page 45-7

(a) If only 47% of Canadian outward portfolio investment is to the US why should sole reliance be placed on historic US equity risk premiums?

(b) If US interest rates are expected to be 0.20% higher than in Canada why would the expected equity rates of return to be the same?

(c) In Ms. McShane's judgement is the US treasury yield a correct indicator of a US risk free rate in view of the US$ position as the world's reserve currency? If Ms. McShane believes it to be unaffected by liquidity considerations please provide the evidentiary basis for such an assumption.

(d) On page 46 Ms. McShane estimates the realized arithmetic market risk premium in Canada at 4.6%, but in her estimates she uses 6.75% (page 55) please provide the evidentiary basis for assuming that Canadian investors will earn an average 2.15% more going forward than they have earned for the last 60 years. In other words how are they going to earn this extra risk premium?

A. (a) Ms. McShane does not place sole reliance on the U.S. historic equity risk premiums. (See page 47, lines 1162-1166, page 49, lines 1222-1226 and lines 1239-1241) The U.S. is by far the most important recipient of Canadian portfolio and direct investment abroad. In terms of portfolio investment, portfolio investment in the U.S. exceeds the next largest recipient (the U.K.) by over 5 to 1. The two economies are highly integrated. The U.S. accounts for approximately three-quarters of the exports of Canada and the U.S. provides approximately 50% of Canadian imports. There has been a high degree of correlation between the equity markets in the two countries. In terms of relative risk, the equity markets have exhibited similar levels of volatility in returns.

(b) While, in principle, all other things equal, a higher interest rate environment would translate into higher expected returns, a differential in long-term interest rate forecasts (which are subject to forecast error) of 0.2% is not a material difference.

(c) The U.S. Treasury yield may understate the "true" U.S. risk-free rate inasmuch as the U.S. dollar is the reserve currency and Treasuries are valued for their liquidity. Factors such as a flight to quality or a Treasury buy back of securities may increase the price investors are willing to pay (lowering the yield) for the liquidity value of U.S. Treasuries.

(d) As explained in Ms. McShane's testimony, the historic risk premium (the difference between returns on stocks and bonds) in Canada reflects a significantly higher return on bonds than is impounded in current and expected bond yields. The higher risk premium relative to history primarily reflects an expected value of equity returns similar to history but lower bond returns.