

# 100% RSP Funds

TAX & ESTATE BULLETIN



100% RSP funds can help you gain access to 96 per cent of the world's capital markets you would otherwise miss out on in your registered (RRSP or RRIF) retirement portfolio. Through the use of derivatives, these funds can increase foreign exposure in a registered plan, while staying within the foreign content limit imposed by the Canada Customs & Revenue Agency (CCRA, formerly Revenue Canada). This bulletin explains how 100% RSP funds work.

## Why buy a 100% RSP fund?

These funds are suitable for investors who want to invest more of their registered money in foreign securities than the allowable percentage. Normally, doing so would subject the plan to excess foreign content penalties. Instead, if the investor opts to buy a 100% RSP fund the fund will attempt to mirror the performance of a foreign security, and avoid being subject to excess foreign content penalties. To do this, the fund will use a type of *derivative* called a *forward contract* to establish a link to a foreign security.

## What is a derivative?

A derivative is a special type of financial instrument that usually takes the form of a contract between two parties. It is called a derivative because the value of the contract is derived from the value of an underlying asset or an indicator such as stock, stock indices, bonds, currencies or interest rates. Basic derivatives include forwards, futures and options.

## What is a forward contract?

A forward contract is a simple derivative security. It is an agreement to buy or sell an asset at a certain future time for a certain price.

The contract is usually between two financial institutions or between a financial institution and one of its corporate clients. It is not normally traded on an exchange.

## How does a 100% RSP fund work?

The following is a summary of how one of these funds works. These 10 steps are also presented in an easy-to-follow diagram on page 3.

### INITIAL INVESTMENT IN A 100% RSP FUND (STEP 1)

The investor invests a lump sum in a 100% RSP fund. The fund will attempt to mimic the performance of a foreign security, such as a global or foreign equity fund, for example. In our scenario, the client's money will not be invested in forward contracts or other derivative instruments, or in the foreign security that the 100% RSP fund itself is attempting to mimic in performance. Rather, the fund will invest the client's money in Canadian money market-type instruments, such as T-bills, banker's acceptances or bank deposits. The bulk of the portfolio of the 100% RSP fund will be made up of these Canadian investments. This is why a 100% RSP-eligible fund counts as Canadian content for registered plans.

Some managers may invest up to the maximum allowable percentage of the cost of a 100% RSP fund in the underlying foreign security that the RSP fund is attempting to mimic. But the RSP fund itself will still qualify as Canadian content as long as at least the minimum per cent of the book value of the RSP fund's investments is invested in Canada. In our example, if the underlying foreign security the RSP fund is attempting to mimic in performance is a global or foreign equity fund, the RSP fund may invest up to the maximum allowable foreign content limit of its portfolio's book value in units of the underlying mutual fund itself. This example only follows those steps involved with that portion of a 100% RSP fund that is not invested in the actual underlying foreign security.

#### ESTABLISHING A LINK TO THE FOREIGN SECURITY (STEP 2)

To establish a "link" between this 100% RSP fund in which our client has invested and the foreign security, the managers of the RSP fund will approach an outside counterparty, such as a chartered bank or a similar financial institution. The RSP fund will enter into a forward contract with the counterparty. The terms of the forward contract state that if, after a set period of time the underlying foreign security has increased in value, the counterparty will pay to the RSP fund the equivalent amount of growth on the client's money, as if the client's money had been invested in that foreign security all along. Similarly, if the underlying foreign security has decreased in value, the RSP fund instead must make a payment to the counterparty.

#### THE ROLE OF THE COUNTERPARTY (STEP 3)

To hedge their obligation, most counterparties will take their own money and invest it in the underlying foreign security that the RSP fund is attempting to mimic. The counterparty is not, however, obligated to do so, but it is generally the simplest and most prudent way for the counterparty to hedge its obligation under the forward contract.

It's important to understand that this investment in the foreign security has come from the counterparty and not the client. The client's original money will stay invested in the RSP fund in money market-type instruments.

#### SETTLEMENT OF THE FORWARD CONTRACT (STEPS 4 & 5)

Under the terms of the forward contract, an increase in the value of the foreign security means that the counterparty must make an equivalent payment to the RSP fund, as if the client's money had been invested all along in the foreign security. So, for example, if the foreign security has risen by the equivalent of eight per cent compounded annually during the length of the forward contract, then the counterparty owes the RSP fund the equivalent growth on the amount originally invested by the client in the fund. This payment by the counterparty is a credit to the RSP fund.

Similarly, if the value of the underlying security decreased, the RSP fund would make a payment to the counterparty.

#### COUNTERPARTY'S FEE (STEP 6)

In exchange for entering into the forward contracts with the RSP fund, the counterparty levies a fee against the RSP fund for the length of the forward contract. This fee is often based on the going market rate for different types of money market instruments plus a small premium. For example, a common fee may be the market rate for banker's acceptances (*B/A rate*) at the time the forward contract was signed, plus a premium of 40 basis points. (A basis point is one one-hundredth of one percent).

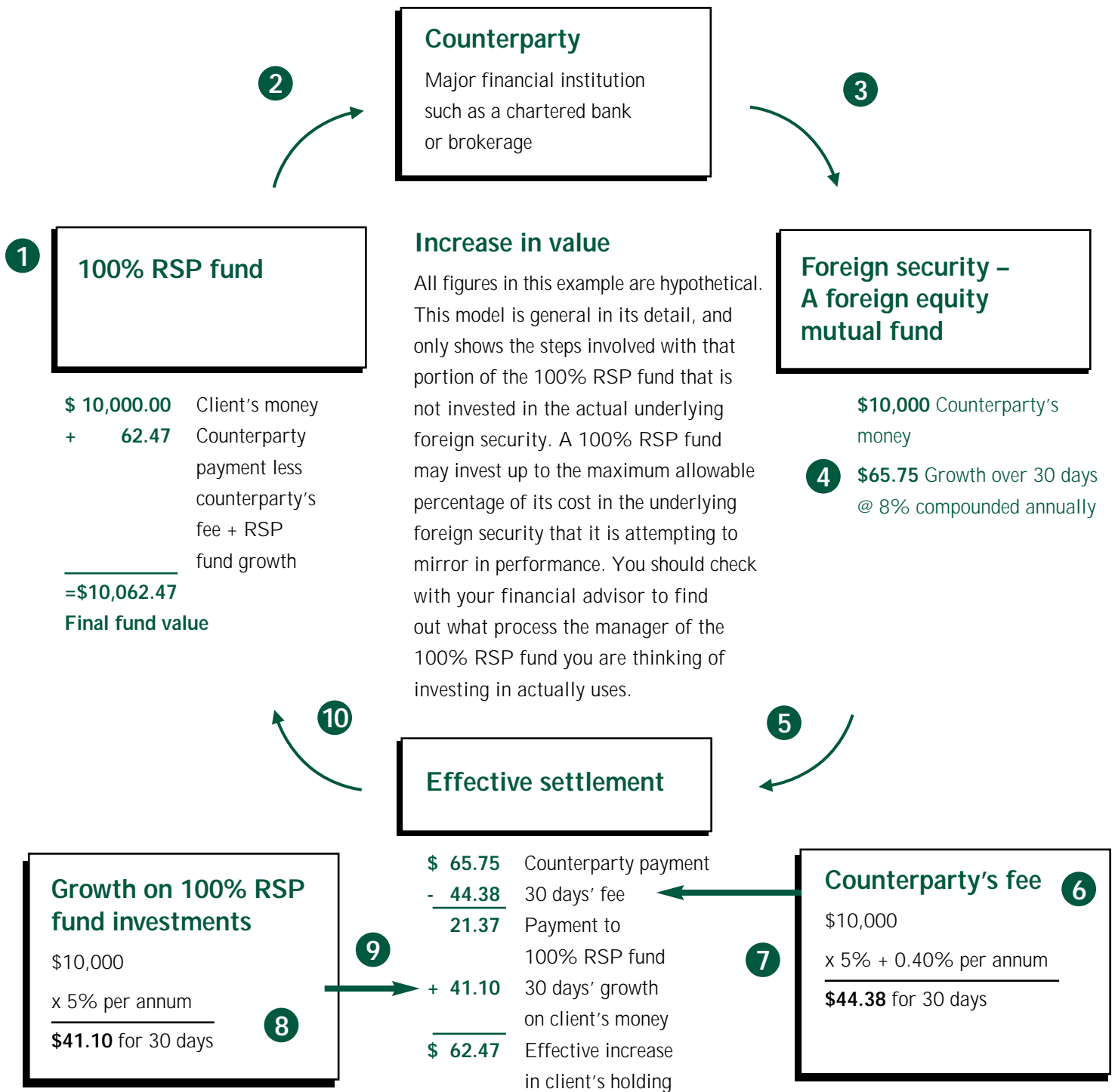
#### THE EFFECT OF THE COUNTERPARTY'S FEE (STEP 7)

Upon settlement of the forward contract, the counterparty's fee is deducted from the payment that will be made by it to the RSP fund if the value of the underlying foreign security increases (or added to the payment the RSP fund must make to the counterparty if the value of the underlying foreign security decreases).

#### THE GROWTH IN THE RSP FUND'S PORTFOLIO (STEP 8)

The client's original money has been invested all this time in the actual RSP fund in money market-type instruments. Because of this, the return on the money market investments in the RSP fund may potentially be very close to the amount of the counterparty's fee, helping to largely but not completely offset it.

# How a 100% RSP fund works



## An increase in value

- Step 1** A client invests \$10,000 in a 100% RSP fund.
- Step 2** The managers of the RSP fund approach a counterparty and enter the RSP fund into a forward contract.
- Step 3** The counterparty may invest a similar amount of money in the underlying security on which the forward contract is based to hedge its obligation.
- Step 4** In this example, the underlying foreign security increases the equivalent of eight per cent compounded annually, or \$65.75, over the 30 days of the forward contract.
- Step 5** With an increase in value of the underlying security, the counterparty must make a payment of \$65.75 to the RSP fund.

- Step 6** The counterparty charges a fee for the length of time of the forward contract. In this example, the rate was agreed to be the banker's acceptance rate (5%) plus a premium of 40 basis points per annum. The fee for 30 days on \$10,000 at this rate is \$44.38.
- Step 7** The counterparty's fee effectively reduces the counterparty's payment to the RSP fund.
- Step 8** The client's original investment in the RSP fund may have earned a rate of growth similar to the counterparty's fee. The difference is largely due to the premium charged by the counterparty.
- Step 9** The growth on the client's investment in the RSP fund effectively reduces the counterparty's fee.
- Step 10** The net amount is paid into the 100% RSP fund.

## A decrease in value

The steps that occur when the underlying foreign security has decreased in value by the settlement date of the forward contract are very similar to the previous example.

Rather than the counterparty having to make payment to the RSP fund, the RSP fund instead must make payment to the counterparty. The RSP fund must also pay the counterparty's fee.

## USING THE GROWTH IN THE RSP FUND'S PORTFOLIO TO REDUCE THE COUNTERPARTY FEE (STEP 9)

Any growth in the underlying investments in the RSP fund will help to reduce the effect of the counterparty's fee. So, for example, if the counterparty owed the RSP fund money, this payment would first be reduced by the counterparty's fee. However, this fee will now be largely offset by the growth in the money market securities in which the RSP fund itself has been invested.

## PAYING THE GROWTH TO THE 100% RSP FUND (STEP 10)

The final settlement amount, if positive, is paid into the RSP fund and increases the value of the client's investment in that fund.

The client's investment in the 100% RSP fund now has a return on it very similar to the return on the underlying foreign security on which the forward contract was based. If the client's money had been invested directly in the underlying foreign security, it would have had almost the same return as the RSP fund but could have been subject to excess foreign content penalties.

## DIFFERENCE IN PERFORMANCE

There will always be a slight difference in performance between the foreign security and the RSP fund that is attempting to match the performance of this underlying security. This is due to the difference between the total counterparty's fee, including the counterparty's premium, and what the client's money earned as a result of the RSP fund having invested in instruments similar to those on which the counterparty based its financing charge. The difference in performance is also partially attributable to the amount of time it may take for new purchases to be settled into the RSP fund, and the subsequent entering into of new forward contracts based on the new settled purchases.

The 10 steps outlined here are illustrated in a numerical example in the accompanying diagram on page 3. We have used a simple scenario to help you understand the general process behind 100% RSP funds.

**Q** What am I getting when I buy a 100% RSP fund?

**A** You're buying units of a mutual fund like any other, but one that uses derivatives to provide the return potential of a corresponding international fund.

**Q** Doesn't this violate the government's foreign content rule?

**A** No. An RSP fund mirrors the performance of international investments with a Canadian investment when held in a registered retirement plan. It's basically a mirror of the international fund. Most of an RSP fund's assets will actually be invested in bank deposits and Canadian money market investments such as treasury bills or banker's acceptances, which will provide backing for the forward contracts. This approach complies with the foreign content rules and makes the RSP fund a wholly Canadian content holding in your RRSP.

**Q** Why aren't these funds considered part of my foreign content?

**A** The assets held by an RSP fund are Canadian assets. Any foreign content it owns is within the permitted foreign property limit.

**Q** What does a 100% RSP fund actually own?

**A** For the most part, a 100% RSP fund will own short-term Canadian money market investments (T-bills, banker's acceptances) and bank deposits, though it can hold up to the maximum allowable percentage of its investments in international content like any other fund. It uses the income they generate to finance the counterparty's fee on forward contracts. The contracts require the counterparty to pay a return that mirrors the return of a corresponding foreign mutual fund.

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**Q** Does a 100% RSP fund generate capital gains?

**A** Generally no. Most income it receives is treated as income rather than capital gains, but because it's held in an RRSP, taxes on that income are deferred. If the RSP fund invests directly in units of the underlying fund or its portfolio securities, it may have some opportunity to generate capital gains on those investments.

**Q** So there's no advantage to holding one of these funds in an open account?

**A** No. RSP funds were created specifically to provide the potential for greater long-term growth that has historically come from tapping into foreign investments. Because they earn mostly income instead of capital gains, 100% RSP funds would not enjoy the preferential tax treatment applied to capital gains to any great extent.

**Q** Won't the MER for a 100% RSP fund be much higher than an ordinary international equity fund?

**A** No, the MER should be similar. While an RSP fund may absorb some limited extra cost associated with the forward contracts, most of that cost will be reflected in the performance of the fund, rather than the MER. Keep in mind that you are getting extra value – the value derived from having greater international exposure for your registered retirement plan. The interest revenue earned on the money market assets in the fund will partially offset some of the counterparty fees of the forward contracts. The fees minus this extra interest revenue will represent the difference in return from the underlying fund. This is why the performance of these funds will mirror that of the corresponding international equity fund, but won't have quite the same returns.

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