



# CHANGING THE FOREIGN PROPERTY RULE

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As announced in the federal government’s 2005–2006 budget speech, the repeal of the foreign property rule could have a substantial impact on the Canadian investment universe, particularly on pension plans. Will investors, used to allocating a maximum of 30% of their assets to non-Canadian issuers, change their behaviour now that the limit is on its way out and if so, how?

We would like to provide our thoughts regarding the impact of this decision on the investment environment in general and on the bond market in particular.

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## The Foreign Property Rule

First, a reminder. The foreign property rule was introduced in 1971 to foster the development of Canada’s capital markets and to facilitate investment in domestic issuers. At the time, the rule put a 10% ceiling on the investments of Canadian entities in foreign securities. This limit was then raised to 20% during the 1990s and has been at its current level of 30% since 2001. Non-compliance with this ceiling results in a monthly penalty tax of 1%.

The federal government now feels that the time has come to repeal this measure that protects Canada’s financial markets, concluding that these markets have sufficiently evolved. In fact, the country’s corporate and government sectors increasingly use international markets to satisfy their funding requirements. In addition, note that the Canadian economy’s indebtedness has changed since 1971, in that the fiscal balance of governments and the economy’s current account are no longer in a chronic deficit position. Accordingly, the supply of federal government bonds has been reduced, despite the ever-growing needs of investors, notably pension funds. Under such conditions, the foreign property rule is no longer necessary.

*In Latin, Addenda means “addition”; this perfectly summarizes our mission, which is to generate added value for our clients’ portfolios.*



**ADDENDA** CAPITAL INC.

# 1/ Impacts of the Foreign Property Rule

The ceiling has forced most investors to comply with the authorized limit, as evidenced by the investment policies of many pension funds and the foreign content limits of private retirement savings accounts. However, some investors have turned to synthetic products, such as structured notes and exchange traded derivatives, in order to gain exposure above and beyond the 30% foreign investment limit.

Restricted by legislation and by investment policies, non-Canadian investments have historically been directed toward equities. How will investors' asset allocation react to the removal of this constraint?

Investors can be broken down into three categories based on their foreign property investments: those who have not invested up to 30%, those who, as described above, have exceeded the limit, and those who have taken full advantage of the authorized limit. In almost every case, investments in non-Canadian securities have been in international equities, without much regard for foreign exchange risk.

## Investors with foreign investments below the 30% limit

Note from the outset that some investors, even though they were given an opportunity to invest up to 30% of their portfolios in international assets, did not reach the limit. Removing the ceiling will probably not make such assets more attractive to those investors.

## Investors with foreign investments over 30% of their assets

Investors holding non-resident securities accounting for over 30% of their portfolios, but still complying with the foreign property rule, are among the only ones to hedge against foreign exchange risk, at least insofar as the derivatives portion is concerned. Once the rule is repealed, it will no longer be necessary to use synthetic instruments, since it will now be possible to invest directly in international markets. Because their exposure to foreign securities already exceeds the limit, one can assume that repealing the rule will have little impact on these investors.

## Investors who have matched the 30% limit for non-resident securities

Investors who have brought their international investments up to the 30% limit will be tempted to take advantage of the increased freedom provided by the repeal of the foreign property rule. However, they will look at foreign investment under a new light, given the appreciation of the Canadian dollar from 2002 to 2004. These investors will be the most likely to react to the repeal of the foreign property rule by increasing their non-Canadian investments.



In almost every case, investments in non-Canadian securities have been in international equities, without much regard for foreign exchange risk.



## RETURN ON INTERNATIONAL EQUITIES

Will foreign investment be primarily carried out through international equities? This section will analyze past returns on international assets.

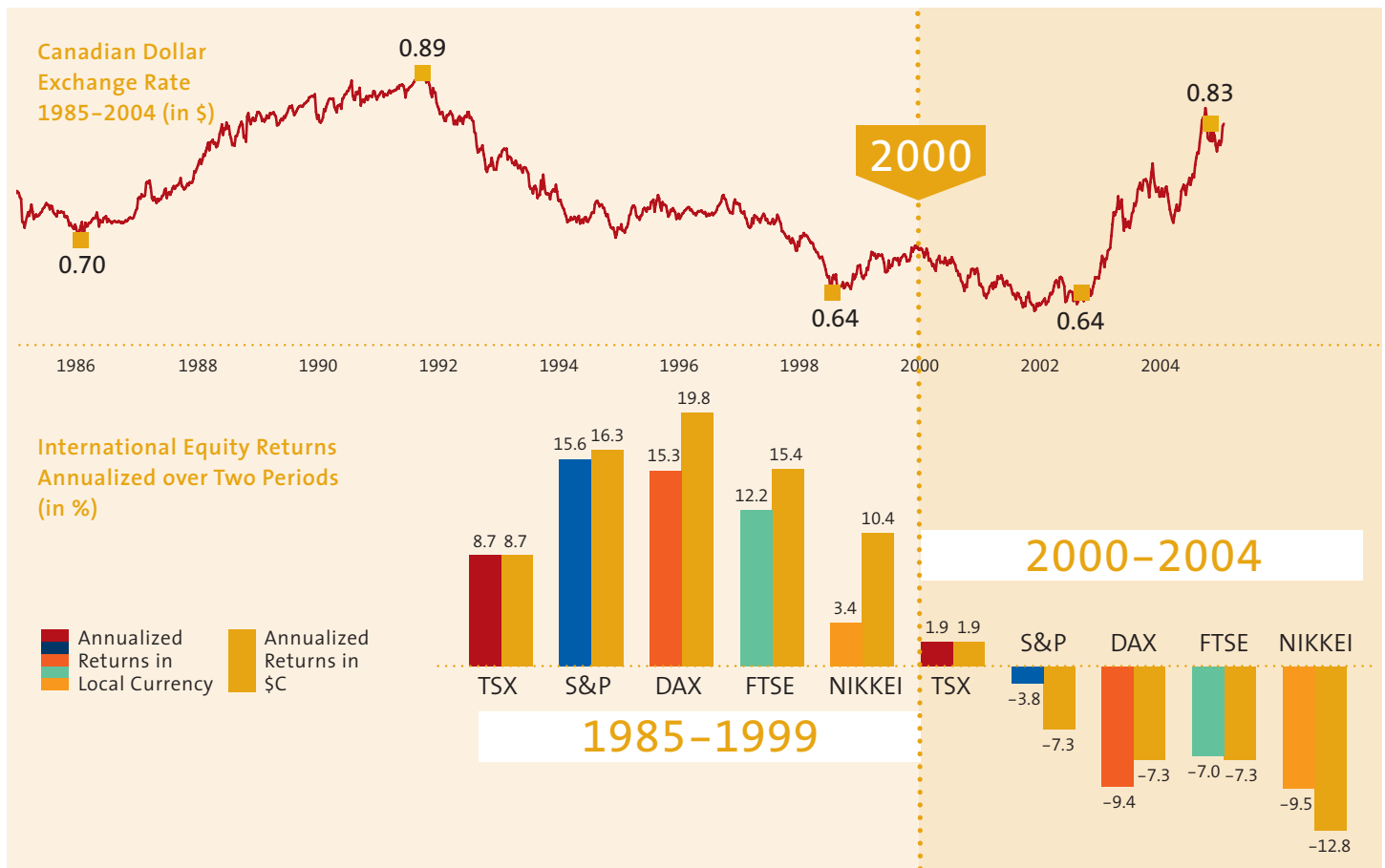
The chart on the following page shows international equity returns annualized over two periods, from 1985 to 1999 and from 2000 to 2004. Each index is represented by two bars. The first bar refers to local currency returns while the second bar refers to returns in Canadian dollars. Note that throughout the period from 1985 to 1999, returns on the U.S. (S&P) and European markets (German DAX and British FTSE indices) outperformed their Canadian counterpart by 3.5% to 7.0%. Only the Japanese market (Nikkei) underperformed the Canadian market during this period.

Note that the Canadian dollar depreciated against the currencies of all other countries during this period. Annualized depreciation ranged from 0.7% against the U.S. dollar to 7% against the yen. The loonie's lacklustre performance during this period therefore enhanced the return on foreign assets.

However, history has not repeated itself since the foreign content limit was raised to 30%. In fact, as shown on the right-hand side of the dotted line in the chart on the next page, local currency returns on foreign equities fell while the TSX recorded positive growth. In addition, given that the Canadian dollar greatly appreciated for the period from 2000 to 2004, the Canadian stock market outperformed international equities markets by 9.2% to 14.7% on an annualized unhedged basis!

Therefore, diversification into foreign equities did not contribute positively to the total return of portfolios during this period, despite a recent history in which returns on international equities were very appealing. Those returns were greatly influenced by the currency risk hedging decision. Accordingly, we refer the reader to the box on page 4 to demystify foreign currency hedging mechanisms.

## Canadian Dollar Exchange Rate and International Equity Returns



## RETURN ON INTERNATIONAL BONDS

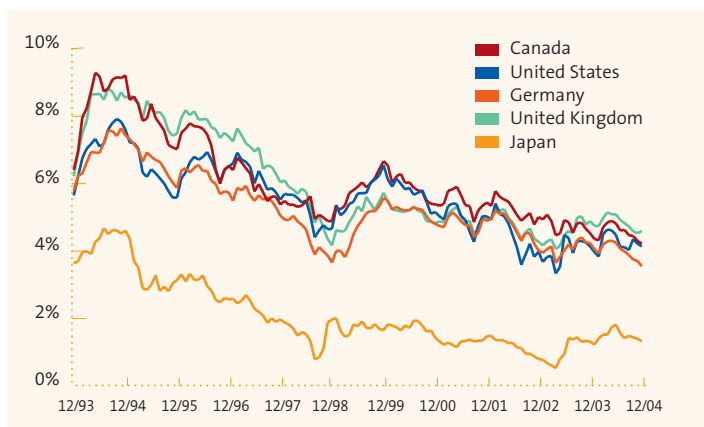
After the foreign property limit was increased from 20% to 30%, Canadian investors felt justified in investing more in international equities than in international bonds. In fact, foreign stock markets historically outperformed their Canadian counterparts, whereas the reverse was true for bonds: the Canadian bond market was historically more rewarding than international bond markets.

However, the risk premium for Canadian bonds was drastically reduced when the federal government achieved fiscal balance in the mid-1990s. This reduced the potential increase in value of domestic bonds compared to those of other countries, which made international bonds relatively more attractive.

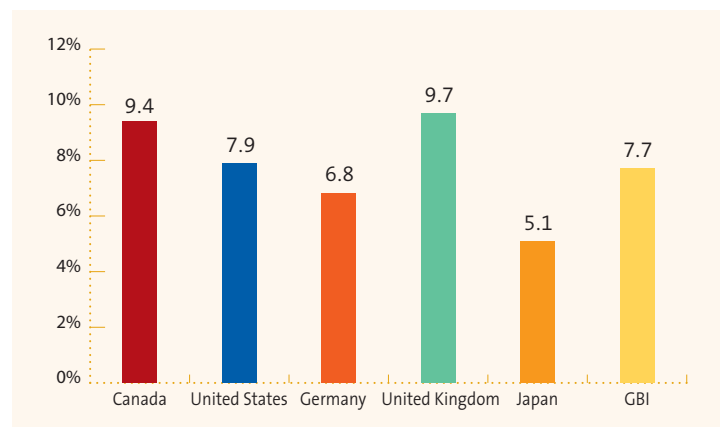
» The risk premium for Canadian bonds has drastically declined.



### International Bond Yields 1993-2004



### International Bond Market Returns 1985-2004



## Foreign Exchange Risk: TO HEDGE OR NOT TO HEDGE?

The impact of currency fluctuations on international returns warrants special attention. This section illustrates the differences between a local currency return, an unhedged return and a hedged return, to help the reader understand the underlying mechanisms of currency hedging and the significance of such a decision. The table below shows bond yields for Canada, Japan and the United Kingdom in 2004.

A **local currency** return is available only to an investor in his home country. Thus, a local currency return of 6.60% for the U.K. bond market in 2004 or of 1.29% for the Japanese market represents an actual return only for a British or Japanese investor who invested bonds within their own market. Canadian investors will obtain a different return, depending on whether or not they decided to hedge their returns in Canadian dollars.

Should an investor **not hedge** foreign currency risk, international returns will be increased (decreased) if the currency in which the investment is denominated appreciates

(depreciates) against the dollar during the holding period. In 2004, the pound sterling's slight depreciation (0.60%) against the loonie reduced the British market's return from 6.60% to 6.00%. Meanwhile, the yen's value fell 2.89% in 2004, also reducing the return of Japanese bonds from 1.29% in local currency terms to -1.78% in Canadian dollars.

Investors may also choose to **hedge** their investment against foreign currency risk, i.e. to immunize their return against a potential depreciation of the foreign currency against the Canadian dollar. To do so, they purchase foreign securities and immediately agree to resell the foreign currency amount at an agreed price at a later date. A premium will be paid or a discount received to purchase the currency at its current rate and to resell it at the agreed-upon price. This premium (or discount) will be primarily determined by the difference between the overnight interest rate in Canada and its counterpart in the country of investment.

### Bond Market Returns in 2004 (in %)

	Local Currency	Change in Local Currency vs \$C	Unhedged \$C	Average Overnight Rate	Hedged \$C
Canada	7.16	N/A	7.16	2.25	7.16
Japan	1.29	-2.89	-1.78	0.00	3.45
United Kingdom	6.60	-0.58	6.00	4.50	4.33

### Underlying Hedging Mechanism

For instance, since the overnight rate in Japan was lower than in Canada in 2004 (0.00% vs 2.25%), a Canadian investor could hedge against changes in the value of the yen and benefit from a discount that was roughly equal to the difference between the respective overnight rate, i.e. 2.25%. This brings the hedged Japanese return from 1.29% to 3.45%<sup>1</sup>.

Moreover, Canada's overnight rate ranged between 2.75% and 2.00% for an average of 2.25%, whereas the Bank of England maintained its rate between 3.75% and 4.75%, for an average of 4.50%. Since rates were higher in the country of investment (the U.K.), a Canadian investor would have had to pay a premium to hedge against foreign currency risk. This premium was approximately equal to the difference between the average overnight rates in the two countries, i.e. 2.25% (4.50% - 2.25%).

In the absence of such premium and because markets are efficient, investments in Canadian fixed income securities could be sold to be invested in the U.K. in order to earn an additional

return of 2.25%. After hedging for foreign exchange risk, the return on the British market is therefore reduced from 6.60% to 4.33%.

Accordingly, foreign exchange risk does not necessarily increase returns. On the other hand, due to the abrupt changes in foreign exchange rates, foreign currency hedging limits the volatility of returns on international assets that have been converted into an investor's local currency.

<sup>1</sup> To determine the premium or discount, we use the following equation:

$$\text{Forward Rate} = \text{Spot Rate} \times \left[ 1 + \frac{3 \text{ month rate}_{\text{Canada}} - 3 \text{ month rate}_{\text{foreign country}}}{4} \right]$$

## 2 / International Bond Management

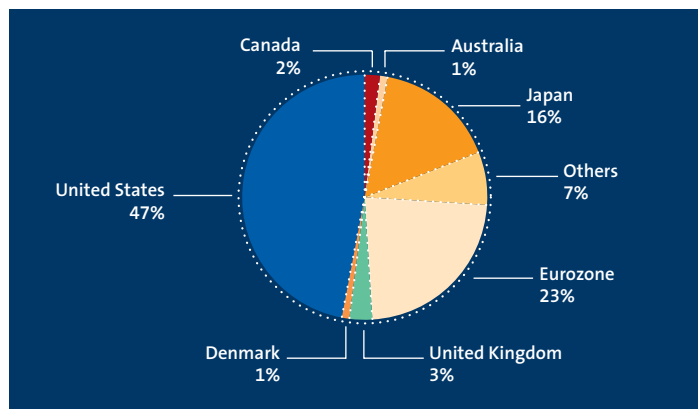
To begin with, note that the Canadian bond market accounts for only 2% of the world's total outstanding bonds.

Canadian interest rates are sometimes more attractive than their global counterparts, and sometimes the reverse is true.

Why should an investor limit himself to Government of Canada bonds if they are expensive compared with liquid government debt of other highly rated industrialized nations? Let's have a closer look at the role that international bonds can play in a Canadian portfolio.

### Bonds Outstanding on Global Markets

December 2004



Source: Merrill Lynch, *Size and Structure of the World Bond Market*, May 2004.

## INTERNATIONAL BONDS: A TACTICAL INVESTMENT

At Addenda, we determine a relative value for domestic bonds compared to other markets. For us, this represents an opportunity to add value, an opportunity we have seized on a few occasions.

Although we are neighbours and economically related to the United States, bond market returns on Canadian markets are different from those on U.S. markets, as can be seen from the table below. Thus, the ability to choose between government bonds of these two countries provides an additional opportunity to add value by making it possible to assess a country's high cost in relative terms.

Over a 10-year period, the average return difference between Canada and U.S. government bonds was 2.82% (local currency).

Access to the U.S. bond market enables managers to take advantage of the most attractive interest rates (and therefore of the largest potential return), whether it be in Canada or in the United States.

### Canada and United States Bond Market Returns (in %)

	Canada	United States	Difference
1994	-4.49	-2.90	-1.60
1995	19.80	17.34	2.46
1996	11.81	2.94	8.87
1997	9.39	10.00	-0.61
1998	9.58	10.25	-0.67
1999	-1.44	-2.88	1.43
2000	10.43	13.93	-3.50
2001	7.48	6.55	0.93
2002	8.31	12.21	-3.90
2003	6.04	2.44	3.60
2004	7.16	3.75	3.42
<b>Average difference (in absolute terms)</b>			<b>2.82</b>

When we determine that the U.S. rate structure is more interesting than Canada's, we underweight the exposure to Canadian bonds in favour of U.S. bonds while hedging the currency risk.

Furthermore, when we operate under Canadian content restrictions, we invest in Government of Québec or Ontario issues denominated in U.S. dollars (Yankee bonds)<sup>2</sup>. This Canadian content instrument provides us with access to the U.S. market, while remaining compliant with our portfolios' foreign security allocation.

However, Canada – U.S. yield spread trades using Yankee bonds were carried out in small sizes, infrequently, because such products offer less liquidity. In addition, the use of provincial Yankee bonds is subject to an additional risk premium related to the provincial credit, which increases the overall risk level of such a transaction.

Where such a transaction is designed to take advantage of an under performance in Canadian yields relative to U.S. yields, U.S. Treasury bonds ("Treasuries") are the securities of choice to express this market's greater return potential compared to the Canadian market. Firstly, they provide greater liquidity and secondly, unlike provincial Yankee bonds, they entail no credit risk.



The proposed legislative change will make it possible to express the relative value of Canadian government bonds.

<sup>2</sup> This type of trade was performed for mandates that allow the purchase of Canadian issues in foreign currencies on a hedged basis. The most recent episode occurred during the second quarter of 2004 and generated more value added due to the higher relative return of the U.S. market during this period.

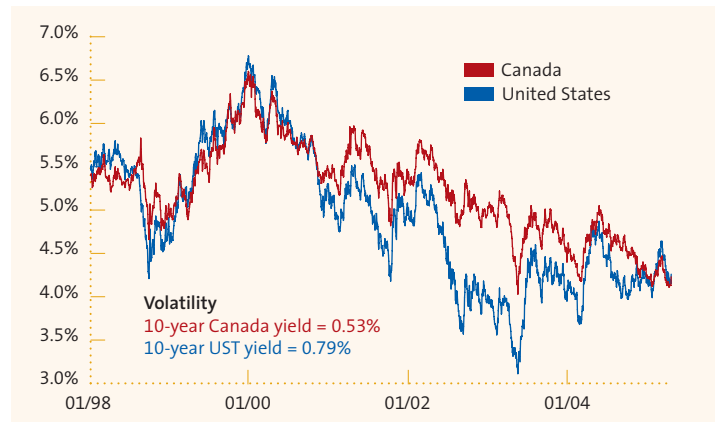
The proposed legislative change will make it possible to express the relative high cost of Canadian government bonds as they relate to their U.S. counterpart by using U.S. government bonds, which efficiently reflect the relative value of Canadian interest rates. This is what we refer to as the tactical use of international bonds.

In addition, one will notice that changes in U.S. interest rates have been greater than those in Canada over the past few years (since 1998). Added value from Addenda’s management process depends on the volatility of interest rates.

Thus, an investment policy authorizing access to U.S. Treasuries would enable us to increase such added value opportunities. To enhance its returns, a pension fund should provide more flexibility while controlling the risks relating to access to international bond markets.

## 10-year Canada and U.S. Bonds

January 1998 – March 2005



## INTERNATIONAL BONDS: A STRATEGIC INVESTMENT

Pension funds generally use bonds to “match” their liabilities: these products provide them with a solid base that enables them to pay out the benefits defined under the pension plan. As illustrated in the previous section, a tactical use of international bonds (with “Treasuries”) makes it possible to achieve this objective more efficiently.

Moreover, international bonds, as an asset class, also make it possible to maximize the return/risk profile of an overall portfolio. This section shows how international bonds provide a portfolio with enhanced diversification (Beta) and how the **Addenda International Bond Pooled Fund** has added value since its inception (Alpha).

The table below compares returns on the Canadian bond market with those of markets of other industrialized countries. To illustrate the returns of the global government bond universe, we use the JP Morgan Government Bond Index excluding Canada (GBI Global ex-Canada)<sup>3</sup>.

From this table we note that investing on international markets, while allowing the investment currency to fluctuate against the

### International Returns and Volatilities 1994–2004

(in % except for return/risk ratio)

	Canada	GBI ex-Canada Unhedged	GBI ex-Canada Hedged
1994	-4.5	7.7	-3.2
1995	19.8	15.9	19.1
1996	11.8	4.7	7.6
1997	9.4	5.8	8.4
1998	9.6	24.2	10.9
1999	-1.4	-10.5	0.3
2000	10.4	5.8	9.9
2001	7.5	5.4	6.4
2002	8.3	18.4	9.1
2003	6.0	-6.6	3.5
2004	7.2	2.0	5.6
<b>Average</b>	<b>7.6</b>	<b>6.6</b>	<b>7.1</b>
<b>Volatility</b>	<b>4.8</b>	<b>7.5</b>	<b>3.2</b>
<b>Return/Risk</b>	<b>1.6</b>	<b>0.9</b>	<b>2.2</b>

Canadian dollar (GBI Global ex-Canada, unhedged), generated a 6.6% return, compared to 7.6% for the Canadian market, all the while increasing volatility. In fact, volatility was 7.5% and 4.8% for those respective markets for the period under observation.

Moreover, the hedged return of 7.1% on global bonds generated a volatility of 3.2%, which was lower than the 4.8% volatility of returns on the Canadian market.

After hedging for foreign currency risk (GBI Global ex-Canada hedged), international bonds have a return/risk ratio of 2.2, compared to 1.6 for Canadian bonds.

When this asset class is added to a portfolio, we observe an improvement in the return/risk ratio. While this improvement doesn’t replace the matching function performed by Canadian bonds, it does merit consideration as an instrument of diversification within a portfolio’s total asset allocation.

As for Addenda’s experience with foreign bonds, management of the Addenda International Bond Pooled Fund began in 2002<sup>4</sup>. Our active management style has enabled us to enhance returns on this asset class by over- or under-weighting countries in the GBI Global ex-Canada.

Based on interest rate fluctuations, our active duration management process capitalizes on the increase or decrease in bond prices: we apply the same process to government bond yields in all industrialized countries. Therefore, just as we do to determine our Canadian bond management strategy, we determine a target yield based on an inflation forecast, as well as volatility ranges for industrialized nations. In other words, the Addenda style can be exported!

After hedging for foreign currency risk (GBI Global ex-Canada hedged), international bonds have a return/risk ratio of 2.2, compared to 1.6 for Canada bonds.



<sup>3</sup> The horizon for this analysis begins in 1994, as hedged returns for the index are available only from that year on.

<sup>4</sup> We use the GBI Global ex-Canada hedged into Canadian dollars as our benchmark index to restrict currency-related volatility. You will find the Fund’s returns on page 8.

## Annualized Returns

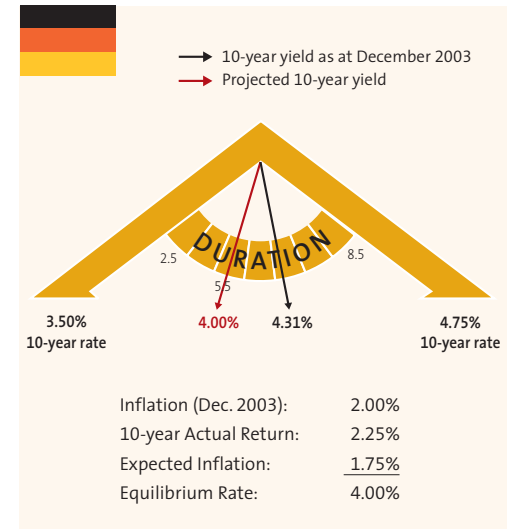
From January 1, 1994 to March 31, 2005 – in \$C (in % except for return/risk ratio)

	TSX	S&P500	MSCI EAFE	GBI ex-Canada	SCU
Return	7.3	9.6	5.1	6.9	7.6
Standard Deviation	16.0	14.1	13.6	3.1	4.8

## Asset Mix Scenarios

Portfolio	1	2	3	4	5	6
TSX	30.0	30.0	30.0	30.0	<b>25.0</b>	<b>27.5</b>
S&P500	15.0	15.0	15.0	<b>10.0</b>	15.0	15.0
MSCI EAFE	15.0	15.0	<b>10.0</b>	15.0	15.0	<b>12.5</b>
GBI ex-Canada	0.0	<b>5.0</b>	<b>5.0</b>	<b>5.0</b>	<b>5.0</b>	5.0
SCU	40.0	<b>35.0</b>	40.0	40.0	40.0	40.0
<b>Return</b>	<b>7.2</b>	<b>7.2</b>	<b>7.3</b>	<b>7.1</b>	<b>7.2</b>	<b>7.3</b>
<b>Standard Deviation</b>	<b>8.6</b>	<b>8.5</b>	<b>8.1</b>	<b>8.0</b>	<b>7.9</b>	<b>8.0</b>
<b>Return/Risk</b>	<b>0.84</b>	<b>0.84</b>	<b>0.90</b>	<b>0.88</b>	<b>0.92</b>	<b>0.91</b>

## Germany 2004 Duration Guide



# 3 / Implications of the Repeal of the Foreign Property Rule

## Opening up the Canadian Market to Foreign Issuers

Federal government debt has been contracting for some years now. This, combined with pension funds' appetite for return, has made corporate bonds increasingly popular. From 15% of the Scotia Capital Universe Index in 1998, the share represented by corporate bonds now exceeds 27% (March 31, 2005). As a result, corporate bonds now account for a larger share of Canadian fixed income portfolios.

Foreign issuers that pick up on Canadian investors' voracious appetite for corporate instruments and on attractive risk premiums could create some pressure on spreads by issuing their products in Canadian dollars. Indeed, with the repeal of the foreign property rule, investors will be able to obtain securities from foreign issuers denominated in Canadian currency. Even though these securities will not be included as part of the Universe index, Scotia Capital will set up a separate index for foreign corporate issuers on the same basis as indices for real return bonds and commercial mortgage-backed securities.

We have already noted a major presence of these firms on the Canadian market since the announcement February 23, 2005 as shown in the following table.

## Issues by Non-Canadian Firms from January 1 to March 31, 2005

Issuer	S&P Credit Rating	Moody's Credit Rating	Amount \$C M	Coupon	Date of Issue
Landwirtschaftliche Rentenbank	AAA	Aaa	250	4.875	2005-02-14
Bank Nederlandse Gemeenten NV	AAA	Aaa	200	5.150	2005-02-23
Kommunalbanken AS	AAA	Aaa	200	4.750	2005-03-07
Rabobank Nederland	AAA	Aaa	500	4.000	2005-03-09
DEPFA ACS Bank	AA-	Aa3	300	5.250	2005-03-11
Instituto de Credito Oficial	AAA	Aaa	250	5.000	2005-03-14
Nederlandse Waterschapsbank NV	AAA	Aaa	200	5.200	2005-03-15
Royal Bank of Scotland LT II	AA-	Aa2	700	4.250	2005-03-15
<b>Total</b>			<b>2,600</b>		

Source: TD Securities

To the extent that an investment policy authorizes the use of non-Canadian corporate issuers in Canadian dollars, an investment in such securities could be attractive if it provides a greater yield spread for a level of risk consistent with Addenda's strategy. Thus, we will add value while increasing the diversification of portfolios through the "maple" or "canuck" market (market for foreign issues denominated in Canadian currency).

## The Canadian Bond Market and Global Interest Rates

With this change in legislation, investors who wish to express the relative high cost of the Canadian market will be able to meet their management objectives, but with a larger universe of available products and, more importantly, one fewer substantial constraint: their investment in fixed-income products will no longer be directed solely at securities of Canadian issuers.

Accordingly, the risk premium for Canadian bonds may increase somewhat to reflect the growing universe of available bond products.

## Using Synthetic Products

To counter the effect of the foreign property rule and increase the exposure of their funds to foreign products, some investors have resorted to synthetic products designed to replicate the performance of international indices. One can assume that demand for this type of product will decrease in favour of direct investment in non-resident financial markets. In fact, once the repeal has become law, such products will provide no particular advantage apart from the elimination of foreign exchange risk. Some organizations have already reduced the fees of these products to retain a customer base that will be regaining its investment freedom!

## Changing Investment Policies

Since investments in foreign property will be authorized on an unrestricted basis, investors will set their own limits within their investment policies. It is likely that asset classes will no longer be defined by place of residence (Canadian or foreign), but rather by large categories, primarily equities and bonds. It is within these categories that any limits to investments in foreign securities would be determined.

## Conclusion

The government's intention to repeal the foreign property rule, announced in its budget speech of February 23, 2005, undoubtedly surprised observers who had been expecting that the limit would be raised, but not eliminated. Investor reaction should therefore be gradual. Recall that several investors do not take full advantage of the current 30% maximum authorized for investments in foreign property. For pension funds and most investors, liabilities (i.e. payment of pensions at retirement) are denominated in Canadian dollars. Accordingly, asset structure will be largely determined by this criterion.

The Canadian market may also undergo a number of changes following the repeal of the foreign property rule, especially in terms of its composition. The foreign property rule restricted the access of foreign issuers to the Canadian market. Its repeal will enable foreign issuers to solicit the savings of Canadians more actively, which will heat up the competition for domestic issuers.

International bond markets may provide a return potential that complements that of Canadian assets both tactically and

strategically. On a tactical level, both investors and managers will, in the near term, have access to markets that offer a greater potential return, e.g. the U.S. bond market when bond yields there are more appealing than those in Canada.

From a strategic perspective, international bonds as a whole provide risk and return diversification and should be considered for inclusion in an investor's asset mix. However, as the recent rise in the value of the Canadian dollar has shown, the impact of exchange rates on the return of international assets must be taken into account. In fact, Addenda has been managing a pooled fund of international bonds for three years now, in which the benchmark index is hedged against foreign currency risk.

The repeal of the foreign property limit is, in and of itself, an invitation to increase the share of non-Canadian securities in a fund's portfolio. However, pension committees and their advisers must remain vigilant to ensure that an investment in non-resident assets is more beneficial than a strictly Canadian investment.

## Summary Table of Returns

Return AFTER trust costs and transactions (net)

For the period ended December 31, 2004	Annualized		
	1 year	2 years	3 years
<b>Addenda International Bond Pooled Fund</b>	<b>6.74%</b>	<b>6.01%</b>	<b>8.23%*</b>
J.P. Morgan Government Bond Index Global ex-Canada hedged (\$C)	5.58%	4.52%	6.04%
<b>Value Added</b>	<b>115</b>	<b>149</b>	<b>219</b>
As at December 31	2004	2003	2002
<b>Addenda International Bond Pooled Fund</b>	<b>6.74%</b>	<b>5.28%</b>	<b>12.83%</b>
J.P. Morgan Government Bond Index Global ex-Canada hedged (\$C)	5.58%	3.47%	9.14%
<b>Value Added</b>	<b>115</b>	<b>182</b>	<b>368</b>

\*Return since the beginning of the Addenda International Bond Pooled Fund management in January 2002.

»»» Our active management style has enabled us to enhance returns on this asset class: *the Addenda style can be exported!*

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