What it means to be a Long-Term Investor

Notes for remarks by:

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Thank you for that kind introduction and thanks as well to the conference organizers, Towers Watson and the Conference Board of Canada, for the invitation to participate in this impressive program.

My remarks today will primarily be focused on the concept of long-term investing, but I would also initially like to touch upon the subject of pension reform in Canada, a topic whose importance is confirmed by its prominence on this conference's agenda.

It's not my intent to discuss at any length the various alternatives being considered - other speakers are doing an excellent job in that regard - but I would like to highlight the fact that among those alternatives are various proposals to expand the role of the Canada Pension Plan in the overall mix of retirement savings and income in Canada.

If we go back 15 years, the thought that an expanded Canada Pension Plan could seriously be considered as part of a solution would not have remotely crossed anyone's mind. Indeed, at that time, the Canada Pension Plan was regarded as a primary component of the problem. However, the extensive reform measures implemented at that time have resulted in a sound, sustainable Canada Pension Plan that is clearly a viable option for consideration.

Over and above its sustainability, which is of course critical, some of the other features that make the Canada Pension Plan especially valuable in the overall retirement income mix within Canada include:

- the fact that it is actually a pension, not just a pool of tax assisted savings, that provides a stream of payments indexed to inflation throughout a participant's entire life span.

- the plan takes advantage of a large pooling of risks, there are currently 17 million participants and that number is growing, with no concerns about sponsor solvency.

- there is very clear risk sharing between contributors and beneficiaries reflected in a pre-defined adjustment mechanism that ensures that the plan remains sound and sustainable as actual results inevitably play out differently than actuarial projections.

Regardless of what direction any further reforms to the retirement savings system may take, Canadians do have the assurance that the second pillar of that system, the Canada Pension Plan, will provide them a reliable, sustainable stream of income throughout their retirement years.

Now let me move on to the main topic of my comments today and that is to address the question **"What does it mean to be a long-term investor?"** This is a particularly important question for us at the CPP Investment Board given that our

mandate is to generate investment returns literally over multi-generational time frames in order to help ensure the ongoing sustainability of the Canada Pension Plan. However, it's an important question more broadly for a number of reasons that I will cover in my remarks today.

The phrases "long-term investor" or "investing for the long-term", like many others in the world of investing, tend to be used often and in many contexts but without a common understanding of what they actually mean. Certainly over the last couple of years there has been considerable discussion about the role that long-term investors should play as stabilizing forces in times of market crisis or dislocation, and their enhanced responsibilities with respect to the governance of companies they own as two examples. Conversely, there has been much rhetoric about the evils of "speculators" with respect to currencies, sovereign and corporate debt, the practices of "shorting" or "renting" equity capital, their "short-termism" and undue influence on companies and boards of directors. They clearly have been assigned the black hats of the investing world by many observers with the long-term investors being given the virtuous white hats.

So if there is this distinction between short and long-term investors, we've asked ourselves the questions – who are these long-term investors, what does it take to be one, and do we at the Canada Pension Plan Investment Board actually operate as a long-term investor? I'll fast forward to our answers and then spend some time explaining how we came to them; we've concluded that there are actually a set of very challenging preconditions that must be in place in order to enable long-term

investing, consequently there are relatively few investors that actually operate that way, and we think the Canada Pension Plan Investment Board is one of them.

Although this is not intended to be an exhaustive list, in our view the set of preconditions that enable long-term investing include the following:

- an appropriate business model
- a tolerance for volatility
- rigour around portfolio construction
- an enabling governance model
- the design of the investment process

Now at the risk of oversimplifying this concept, I do think a useful descriptor of the long-term investor is someone who is never obliged to sell assets because of prevailing market conditions, with the decided emphasis on **obliged** to sell. Somebody once asked Warren Buffett to describe the ideal holding period for stocks in his portfolio, and his simple reply was "forever". In the Berkshire Hathaway corporate model and investing philosophy, this is actually possible, although even Mr. Buffett does have a practice of selling holdings from time to time. In this vein, the first of my preconditions is an appropriate underlying business model that provides sufficient stability of the investors' asset base to allow them to operate with a long horizon. What has become very evident over the past 24 months is that the majority of market participants do not enjoy that certainty. If you are a mutual fund or institutional manager facing a redemption notice, you have to sell. If your

model requires high use of leverage, when volatility spikes or financing markets dry up, you have to sell. If you are subject to capital requirements and markets become dislocated or regulators become nervous, you have to sell. If you are a private equity, real estate or infrastructure fund manager and your carried interest is triggered by realized value, you need to sell in order to get paid.

The tolerance for volatility precondition refers to an investor's ability to endure market cycles. Looking back at the decade of the 2000's, we have lived through a few extraordinary cycles; while we might hope for more benign conditions in the future, our view is that we shouldn't count on that. In this most recent financial crisis we have seen many market participants decide or be compelled to alter their investment approach, in some cases due to absolute volatility limits inherent in their investment programs, in others where they effectively hit stop loss pain point levels with respect to potential funding requirements, and in others just plain visceral tolerance limits – in that respect, I am reminded of a comment by my former Fidelity Investments colleague, Peter Lynch, that the most important organ for investors is the stomach rather than the brain.

If the importance of being very careful about the liquidity dimensions of portfolio construction wasn't clear to investors 24 months ago, I think I can safely say it certainly is now. There are of course a number of aspects to this issue; one of these is the implication of having fixed or tight bands of allocations to asset classes. We became the fortunate buyers of a number of secondary sales of private equity interests from investors who suddenly found themselves over-allocated to private

equity in the past 18 months. Another factor in portfolio construction was the failure to factor in future capital requirements; we have also been a beneficiary in some real estate vehicles for instance, where other parties weren't able to meet capital calls and consequently forfeited a portion of their invested equity. And we have all certainly seen a number of investors who hadn't preserved enough underlying liquidity in their portfolios to accommodate margin or collateral requirements and consequently had to prematurely unwind swaps and similar arrangements. These and similar issues run contrary to the essence of long-term investing.

Appropriate governance is another requirement to be able to act as a long-term investor. Irrespective of an investor's business model, if its governance regime is focused on short-term profits or performance, is nervous about reporting results that may be different than the mainstream, is unable or unwilling to grasp the principles of long horizon valuations and risk, or has relatively short tenure for directors or trustees, then it won't likely succeed in operating as a long-term investor or at least it won't do so for very long. As an aside, I'm always struck by the importance here in Canada given to comparisons of the annual performance of the average balanced fund with the performance of funds with significant holdings of long duration private market real estate, infrastructure and equity. Apart from the overriding principle that for funds with different liabilities and risk preferences direct comparisons don't make particular sense, of course short-term performance will be different. If a board of directors or trustees is fixated on such comparisons, uncomfortable with differences or unable to analyze risk and return streams over

sufficiently long periods, the organization will inevitably be driven to short-term investing.

My last precondition for acting as a long-term investor perhaps states the obvious, and that is that your investment process actually has to incorporate long horizon valuation factors. As obvious as this may sound, relatively few investment processes actually operate this way. In addition to the points already noted, another simple reason is that investment managers who are measured, rewarded, and can be hired/fired over increasingly short periods are not likely to build investment processes that identify valuation anomalies that may take 5 years to materialize. In practice it means that those managers aren't likely to buy real estate in a falling market with the expectation that they will have to mark it down in the near term even though its risk adjusted returns over a ten-year timeframe may be compelling – it's also worth pointing out of course that those real estate assets are not necessarily for sale when times are good. It means investors won't likely defer receipt of current dividends from an infrastructure asset for example in order to instead re-invest to improve the efficiency or capacity of the asset to generate future returns. And it means that such managers are not likely to invest resources into researching and identifying long horizon factor models that are different from most standard investment programs.

In response to the question, who are these long-term investors, as noted previously we actually think it's a relatively small group. Within that group, there are certainly a number of pension funds, indeed some located here in Canada, some sovereign

wealth funds, some foundations, some family offices, a small subset of investment managers, and of course investors like Warren Buffett. In fact, if you assessed Berkshire Hathaway relative to the five preconditions I have cited, I think you would readily conclude that the organization not only meets those conditions but is ideally positioned to act as a long-term investor. However, even in the aggregate, it's our conclusion that this group is still a relatively small proportion of the investor universe and overall investment capital.

As to my final question, do we at the Canada Pension Plan Investment Board actually act like a long-term investor, we think we're very fortunate that the nature of the CPP Fund meets some of these pre-conditions I have described and we have made some key operating decisions that allow us to address the others, specifically:

- given the design of the Canada Pension Plan, not only do we have a stable asset base to work with, but we also have relative certainty of the timing and amounts of excess contributions into the fund over the next ten years.

- the triennial valuations of the Canada Pension Plan are done over a 75-year time horizon on a steady state versus full funding basis and the fund isn't required to meet any solvency tests; consequently from an investment perspective we have much greater flexibility to deal with the volatility of market returns than almost any other pension fund or pool of capital.

- we are blessed with a very strong governance structure featuring an experienced, professional and sophisticated board of directors who understand the nature of our investment mandate and mission and are appropriately engaged in ratifying and monitoring the execution of our investment strategy.

Those all come our way by virtue of the nature of our mandate. With respect to our operating decisions, one of the most important with respect to long horizon investing is our Total Portfolio Approach to portfolio construction whereby we essentially ignore asset labels in our investment decisions and instead focus on underlying economic and risk/return attributes. This focus on economic exposures versus asset classes allows us considerable flexibility in constructing and managing our portfolios and avoids some of the perils of fixed weights. We have also been careful to maintain a liquidity buffer within the portfolio and conduct regular stress tests under a variety of market scenarios to ensure we can preserve our ability to meet our strategic exposures without affecting our long horizon investment programs.

- and finally, for our internal investment programs, we seek to ensure that in all cases they incorporate some elements of long horizon value drivers and that we actually make investment decisions based upon return streams that can play out over extended timeframes. In our experience, this is very hard to do and requires considerable discipline. It's hard because it's not the common way to do valuations and because the degree of uncertainty around future cash flows gets higher over longer time frames. But the very fact that

it’s hard and that fewer investors do it makes it inherently more valuable from our perspective.

So let me close by posing and answering one final question:

Apart from being perhaps an interesting intellectual exercise, why does this examination of long-term investing actually matter?

From our perspective, there are a number of practical conclusions that we at the Canada Pension Plan Investment Board have derived from this exercise.

Perhaps most importantly, from an investment perspective it emphasizes to us just how crowded the short horizon investment playing field is. Our view is that the vast majority of the considerable intellectual capital devoted to the investment industry is actually focused on a 0 - 24 month time horizon. Rather than us joining this hyper competitive universe, we quite simply believe there is a better opportunity for us to capture value added returns by focusing on the long horizon end of the spectrum where there are far fewer participants and far less competition because of the effective barriers to arbitrage I have described earlier.

From an overall functioning of the capital markets perspective, there is a clear benefit to having a set of long-term investors who would quite naturally act in a counter cyclical way both from liquidity and valuation dimensions to other investors. We certainly saw examples of this during the financial crisis when

investors like the Canada Pension Plan Investment Board were liquidity providers as others backed away from the markets, and earned very attractive returns for doing so. The high profile Berkshire Hathaway investments into Goldman Sachs and General Electric were other examples. The reality, however, is that there are too few such market participants to effectively balance the preponderance of shorter term actors; we have pointed this fact out in our conversations with regulators who were definitely hoping that there would be an overall natural equilibrium within the markets.

A similar point could be made about the potential benefits of the corporate governance orientation of long-term investors versus short horizon market participants. Our conclusion is that we, along with other like-minded investors, need to be prepared to devote considerable resources to encouraging and monitoring proper governance practices in the companies we own. We're not doing this solely for the sake of governance itself; we're doing it because we want to ensure that the long-term value creation that we are interested in is not sacrificed for short-term goals or expediency that may be advocated by other players.

In summary then, we think that there are some important characteristics that enable organizations to act as long-term investors, some of which are structural and some operating choices; there are actually relatively few investors that operate this way; consequently we believe that there are potential advantages to be gained by doing so; and we at the Canada Pension Plan Investment Board are very focused

on capturing those advantages for the benefit of the 17 million Canadians whose money we manage.

Thank you for your attention and I would be happy to respond to questions now.