Canadian pension funds as “Maple Revolutionaries” - lessons from our success

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CHECK AGAINST DELIVERY

INTRODUCTION

Good afternoon everyone and thanks Bill for that kind introduction.

It is a real pleasure to address the C.D. Howe Institute again. David Dodge was right when he said that the Institute is “the best common room in the country.” I have spoken at Institute events in the past and I am happy to have been invited back one last time before the end of my tenure with the CPP Investment Board. In that respect, I’ve always found the C.D. Howe organization to be very responsive to news and issues, but I was really impressed that almost immediately after the announcement of my retirement I received forms to convert my membership from corporate to individual – yes Bill, the paperwork and most importantly the cheque will be in the mail soon.

There are two related topics I would like to address today

- first some brief comments about the need to reform Canada’s retirement system which was given additional prominence and momentum by Prime Minister Harper’s speech at Davos earlier this year and subsequent government proposals.
- and then I would like to discuss the attributes that make Canada’s large pension fund investment organizations successful and recognized internationally including by The Economist magazine which published an article in March titled “Maple Revolutionaries: Canada’s public pension funds are changing the deal-making landscape”.

CANADA’S RETIREMENT SYSTEM

Both Prime Minister Harper and Finance Minister Flaherty in recent months have noted that there is considerable urgency to proceeding with reforms of Canada’s retirement system. Now this might strike some international observers as odd since Canada’s system was ranked fifth best in the world in the Mercer Global Pension Index study for 2011. In truth, Canada’s high ranking has more to do with the woeful state of many other countries’ retirement systems than the robustness of our own. There is little doubt that reforms are indeed needed as numerous studies have pointed out that the current system will not lead to adequate and affordable retirement income for all Canadians.

So perhaps I can start by describing the “Retirement System” that Messrs Harper and Flaherty have referred to and then consider which elements do require “urgent” reforms.

I would describe Canada’s retirement system as having four elements:

One of these is private individual savings, through tax assisted vehicles like RRSPs and Tax-Free Savings Accounts.

The second is workplace savings plans, typically in the form of either defined benefit or defined contribution pension schemes.

The Canada Pension Plan, along with the QPP in Quebec, is another. CPP is of course a universal savings program with compulsory contributions by all workers and employers. Benefits received are directly proportional to contributions made and thus there is no income redistribution or benefit claw back through the tax system involved in this plan.

The fourth is the Old Age Security program including the Guaranteed Income Supplement (OAS/GIS). These are in effect means tested programs with benefits reduced as income levels increase. Unlike CPP/QPP, these aren't contributory programs, but are financed out of general tax revenues.

So which of these four elements require urgent reforms?

Looking at the Federal Government's program announcements over the past few months it is clear that they are focusing their efforts on two areas.

On the OAS/GIS front, they are proceeding to raise the eligibility age to 67 from 65 over a phase in period. Given that those benefits are funded out of general tax revenues, that they already represent the federal government's largest single expenditure program, as well as the increased ageing of Canada's population along with longevity trends, one can certainly appreciate the rationale for this change.

One obvious insight from the projections of the future costs of OAS/GIS is that failure to improve the effectiveness of the other pillars of the retirement system will only increase the strain on OAS/GIS.

And so another clear focus for the Federal Government is to increase the coverage and effectiveness of workplace retirement savings programs. Here there is much scope for improvement, as fully two thirds of workers in Canada do not participate in a workplace assisted retirement program. To address this gap, the Federal Government has introduced the concept of the Pooled Retirement Pension Plan or PRPP. Anything that facilitates convenient and systematic retirement savings through payroll deductions can have a powerful impact on eventual levels of retirement income in Canada. But while the concept is good, I would also say that unless some significant decisions are made as to how PRPPs are implemented, I fear that they will not increase coverage to the degree required to result in a material increase in levels of retirement savings among Canadian workers.

These important decisions in my mind include:

- making participation mandatory, with an opt out provision.
- defining a simple, age appropriate default investment option within these plans which automatically evolves over time.

- ensuring participants get the benefit of wholesale rather than retail fee levels; every 1% of fees charged for investment management and administration can reduce accumulated retirement savings over a working life by approximately 20%, so this is a big benefit.
- ensuring portability so participants don't end up with a multiplicity of small and potentially orphaned accounts as has been the experience in Australia for instance.
- assisting participants to convert PRPP assets into a pension-like stream of payments through annuitization or other means. It is one thing to accumulate assets; it is just as challenging to draw them down strategically over a period that can extend up to 35 years or more.

The ultimate outcomes of the PRPP initiative will depend upon policy makers' willingness to address these key decisions – I hope they don't leave this as unfinished business.

With respect to the private retirement savings pillar, while I know that C.D. Howe and others have argued for increases in RRSP contribution limits to achieve fairness with the level of benefits provided by defined benefit pension arrangements, given the significant unutilized RRSP and TFSA contribution room that currently exists I wouldn't put this in the category of a "burning platform" and hence isn't a near term priority for urgent reforms.

Which then brings us to the final element, the Canada Pension Plan, which both Prime Minister Harper and Finance Minister Flaherty have emphasized requires no reform measures. In fact, the CPP stands out as a bastion of stability and sustainability compared to its national counterparts in other countries around the world, including notably, Social Security in the U.S.. The Chief Actuary of Canada has recently confirmed the CPP's sustainability, as currently constituted, throughout the 75 year period of his report while taking into account Canada's changing demographics and increasing life spans. And even if that status changes at some point in the future, the plan provides for an automatic adjustment of benefits and contributions to bring it back on side without requiring action by its political stewards.

The reforms of the CPP enacted in 1997, including the role that CPPIB has played since its inception in 1999, were well designed and have operated as planned. In the course of 15 years, the CPP has gone from perhaps the weakest of the four elements to the strongest today, so much so that policy makers can legitimately consider an expanded CPP as an option to shore up those other elements. Quite a remarkable turnaround.

In summary, pension reform has become a hot topic in Canada moving beyond the Cabinet table to the kitchen table across the country. Some of the elements of Canada's retirement system are now on track to achieve what they are designed to do – on a sustainable basis. There is no silver bullet that will instantly increase the levels of retirement income among Canadians. Delay only makes the issue worse, so I urge Canada's policy makers to implement additional changes that will lead to that outcome as soon as possible.

'**MAPLE REVOLUTIONARIES' – A DISTINCT CANADIAN APPROACH**

Let me now turn to my second subject, the distinct Canadian approach to pension fund management that was labeled "Maple Revolutionaries" by The Economist. Now we in Canada have grown used to how our large public funds like CPPIB, OTPP, OMERS, HOOP, CDPQ, PSP, AIMCo and BCIMC operate and perhaps consider them as the norm globally.

The reality is quite the opposite – there are very few pension funds anywhere in the world that operate like these Canadian plans. Indeed, here I would note McKinsey's observation that "there are few industries globally where Canadians dominate, pension funds are one".

The Economist found the Canadian approach to pension fund management "intriguing" – beyond intriguing, I believe it provides significant advantages to Canadian pension plan beneficiaries and ancillary benefits to other sectors in Canada as well.

There are a number of reasons why Canadian pension funds operate differently than their counterparts in other countries. I will touch on four of them today:

- scale
- governance
- internal capabilities
- investment horizon

I will illustrate my remarks by references to CPP Investment Board but my comments apply generally to all the funds I have mentioned.

First, I would say that size definitely matters when it comes to pension fund management. The CPP Fund at $162 billion is the largest in Canada but all the plans I have mentioned have significant pools of assets under management. In contrast, I have recently been in the U.K., Australia and Hong Kong. The U.K. has over 100 individual council plans as they call them within the public sector all of which are all subscale with average assets of under £1.5 billion. The Superannuation system in Australia has also fostered a proliferation of almost 150 relatively small funds over the last 10 years. The mandatory Provident Fund system in Hong Kong similarly has 40 schemes with almost 450 underlying funds.

There are many advantages to the greater size of Canadian plans; certainly one is the broader diversification it permits. Using CPPIB as an example, in addition to investing in public markets we also invest in private equity, private debt, intellectual property, infrastructure, real estate and most recently agriland. Size also permits a more global orientation to investing versus the typical home country bias evident in small plans. For instance, our most recent infrastructure and real estate investments have been in Chile and China respectively.

As one quantification of the benefits of size, a recent study by Alexander Dyck and Lukasz Pomorski from the University of Toronto found that larger plans outperform smaller ones by half a percent annually on average, and that difference is much larger for high performing large funds such as those in Canada. Compounding that difference over many years makes an enormous impact upon accumulated fund assets.

Now, some observers have asked if size at some point could be a disadvantage, if, for instance, the CPP Fund could get too big. While a $162 billion fund is certainly large, it pales somewhat in comparison to the size of Japan's $1.4 trillion national plan, the Sovereign Wealth Funds of Abu Dhabi, Norway, China, commercial money management organizations like Blackrock, BNY Mellon, Fidelity all with assets well in excess of $1 trillion, or indeed our 3 largest insurance companies here in Canada which combined have over $1.2 trillion in assets under administration. From CPPIB's perspective, we believe we can manage a considerably larger fund and don't see the prospect of diseconomies of scale in what we do for the foreseeable future.

One absolutely critical aspect of the Canadian model of pension fund management is its governance structure; this is really the Achilles heel for most other organizations around the world. In CPPIB's case, we have a professional board of 12 directors chosen solely for their experience and capabilities to guide and oversee the CPPIB organization. They are not political appointees and are meant to ensure that CPPIB operates without any political involvement or influence. They understand what it takes to build and operate a sophisticated investment management organization and have adopted policies, including our compensation system, to enable and promote a high performance culture. The Canadian plans certainly aren't homogeneous with respect to governance structures but they are all vastly superior to the typical highly politicized structures we see elsewhere around the world.   For instance, Joe Dear, the CIO of CalPERS which is the largest pension plan in the U.S., has stated that implementing policies consistent with the Canadian model is simply "not politically feasible" in the state of California.

One other thing common to the Canadian plans is that they all have sizable, professional internal teams conducting direct investing programs across the public and private markets; I would say that the scale and governance factors I just mentioned are preconditions to building effective internal capabilities.

In CPPIB's case, we currently have 830 people within our Toronto, London and Hong Kong offices implementing a variety of direct public market strategies as well as the private market programs I mentioned previously. Now we don't do all our investing directly. We focus our internal direct activities on areas where we have a comparative advantage as an investor and where we are convinced we can hire the experienced talent required to be successful, and then engage external managers in other areas that align with their advantages and skills. Apart from allowing us to exploit our scale, time horizon and asset certainty advantages there is also a significant cost benefit to investing directly. As an example, we estimate that it would cost approximately $250 million annually in fees to have our existing infrastructure portfolio managed externally, which is approximately 10 times more than our actual internal costs to do so.

The final common attribute of the Canadian pension funds I will mention is their long investment horizon. All these plans are defined benefit schemes with associated long duration liabilities. Now while this doesn't guarantee that these funds will operate with a long-term investment mindset, it certainly both enables and encourages such a mindset. Long-term investing has many benefits. It permits such investors to capture liquidity and long-term value premia for example. In contrast, it is very hard, if not impossible, for a defined contribution plan to invest in a long dated, illiquid asset class like infrastructure.

The primary beneficiaries of the Maple Revolutionary approach to pension fund investing are the participants in each of these plans; in our case, some 18 million workers and retirees in Canada. To do our part to keep the CPP sustainable at its current contribution rate, CPPIB needs to earn a 4.0% real rate of return over the long-term. This is no easy task in the environment we are likely to face in the decades ahead, and so our goal is to exploit every possible investment advantage we have to benefit those 18 million Canadians.

ANCILLARY BENEFITS

But we also think there are considerable additional ancillary benefits created by the Canadian pension fund investing model, and I will briefly cite a few of these:

- these funds with their long investment horizons can act as countervailing forces to the increasing short-term orientation of most market participants; this is especially valuable in times of market stress.
- they are important sources of long-term capital for much needed infrastructure investments which are critical to economies and societies globally. They are also good owners of these assets since they have the

incentive to reinvest in them to maintain their cash flow generative capabilities over many years.

- they pay attention to Environmental, Social and Governance factors that matter greatly over the long-term whereas short-term investors may not consider them as relevant.
- they have created thousands of highly skilled jobs and have attracted experienced talent from around the world to Canada.
- they have also created beneficial "cluster" effects within this country. In 2011 alone, pension funds in Canada were involved in financial transactions totaling some $189 billion and in the process engaged many Canadian partners such as banks, law and accounting firms, and other advisors. Given the leadership role Canadian funds play in global infrastructure investing for example, there is every reason to think that Toronto can rival London and Sydney as a centre of expertise in this sector in the years ahead.

While these may not be express objectives of the pension funds that operate in Canada, they are nonetheless significant benefits of how they operate and important ones to consider when discussing the role of public pension plans in this country.

CONCLUSION

Let me conclude with a brief summary of the two topics I have covered today.

- while Canada's retirement income system is better than most other countries around the world, it still needs improvements to provide adequate levels of retirement income for many Canadians. For PRPP 's to make a significant positive impact in this regard, policy makers will need to make some important design and implementation decisions.
- the model for Canadian pension funds, dubbed "Maple Revolutionaries" by The Economist, is quite unique globally and provides significant direct and ancillary benefits. It is broadly admired outside Canada, and hopefully is both appreciated and encouraged within this country.

With that, I would now turn it back to you, Bill, to moderate the question period.