Achieving Success in Pension Fund Management:

Innovations in Process, Governance, and Strategy

An address by

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Thank you ________ and good afternoon everyone. It's always a pleasure to visit New York, one of my favourite cities in the world. We do a lot of business here and have many partners and friends here. In fact, I had breakfast this morning with my good friend Larry Schloss, Chief Investment Officer for the city's pension fund… I don't know if I enjoy my time with Larry because he makes my job seem so much easier or just because he's such a smart guy ……..

In any event. I am glad to be here to discuss success from a few perspectives with you…. I am especially looking forward to taking your questions at the end my prepared remarks.

Achieving Success in Pension Fund Management: Innovations in Process, Governance, and Strategy. With a topic this big I could keep you here all day, but I'll try to be succinct... I'm going to change the order of these points, however, so you can better follow my logic…

- Governance is really this pension plan’s sweet spot, so I will address it first. Our founding chair showed great foresight in establishing our governance model and it really is the root of our ongoing success.
- From a process perspective, I will discuss our investment beliefs.
- And finally, as we are in the first year of our five-year strat plan – what we call our strategic roadmap -- I will close with an overview of it and its role in our long term view.

First, a snapshot of our organization. We are Canada’s largest single profession pension plan and we are jointly sponsored by the teachers’ unions – the Ontario Teachers’ Federation - and the Ontario government. We’re an independent organization, and our 900 employees invest the pension fund's assets and administer the defined benefit pensions of 303,000 active and retired teachers in Ontario.

As you may know, we released our 2012 rate of return results earlier this month. I am glad to say that we had a very successful year – it might have been a bit awkward delivering this speech, otherwise!!

In a nutshell, our 2012 rate of return was 13%, which equates to $14.7 billion in investment income. We were about $2 billion ahead of our benchmark, and our 10-year annualized rate of return is $9.6 billion. Our net assets as of year-end were $129.5 billion (believe me, I tried to find that extra $500 million to push us over the $130 billion mark…)

And as of January 1, 2103, we are 97% funded. That is to say we have a deficit – or gap between our projected assets and liabilities -- of $5.7 billion.

As an aside, that is why it is important to understand the discount rate assumption when people are throwing around numbers about pension surpluses or deficits. At Teachers', we are using a rate of about 3% real or around 5.05%. Other Ontario plans use 4% real. And most US plans use over 6% real (or *unreal*, as I like to say!).

Some of those differences are explained by plan maturity – but some are just plain kidding themselves – and putting future generations at great jeopardy. Why is this? Maybe it's optimism. Maybe it's cowardice. Maybe it is political interference. But I'll tell you one thing it *isn't*, and that's *realistic*.

Teachers' is what is considered a "mature pension plan." We have a declining number of active members *contributing* to the fund compared to the number of members who are *collecting* pensions from the fund. We currently have a 1.5-to-1 ratio of active-to-retired members and are moving towards a 1.1-to-1 ratio over the next decade or so. To put that into perspective, that ratio was 10-to-1 in 1970 and 4-to-1 in 1990.

Our maturity affects our risk tolerance. We simply do not have enough active members amongst whom to share material losses should they occur… So, for example we have had to reduce our allocation to equities, the highest risk/reward asset class, to 45%. This is lower than most other pension plans.

As I said, we have more than 300,000 members. And let me stress the fact that our individual members are scheduled to contribute an average of 13% of their salary annually to the plan. That is matched by the government, bringing total saving for retirement to 26% of salary. We administer one of Canada's largest annual payrolls, at $4.9 billion.

We receive only $2.9 billion in contributions annually, however. That's a considerable gap, and it means the first $2 billion we earn every year is automatically earmarked for paying the difference between what is *contributed* and what is *distributed*. But more importantly, it means that the investment growth of that nearly $2 billion must be foregone. And it is the investment returns on those contributions that fund the pension plan.

The average age for our new retirees today is 59. Each will have worked about 26 years at retirement. They are expected to receive their pension for 31 years, and a survivor pension may be paid for an additional three or so years. The average starting pension in 2012 was $48,000. And as I said, it is a Defined Benefit. It is jointly sponsored by the Ontario Teachers' Federation and the Ontario government, who together determine contribution rates and benefit levels.

Now a little pension history…..

Pension plans - public and private – were devised when "retirement longevity" was an oxymoron. Pensions were meant to bridge the gap between work cessation and death … a short distance, given life expectancies at the time.

According to demographer Professor David Foot, Canada chose a retirement age of 70 in the 1920s … when life expectancy was 61. So, on average, you were dead for nine years before you could receive your pension! In 1951, a means-tested pension was made available at age 65 … when average life expectancy was 68 and a half. When the Canada Pension Plan was introduced in 1966, life expectancy was 72.

That was then. Today's life expectancy rates are very different. Think of it this way: World life expectancy has more than doubled over the past two centuries. According to the World Health Rankings, a Canadian woman who is 60 years old in 2012 can expect to live to age 86, while today's 80-year-old woman can expect to celebrate her 90th birthday.

In the case of Teachers', we now have 2,800 pensioners in our membership who are over the age of 90. And that includes 107 who are over *100* years of age … our oldest collecting member is 110 years old. I checked, and Hallmark doesn't even make a card for that! …. But in all seriousness, it highlights the issues of benefit sustainability and intergenerational equity – making sure that pension funds are there for today's younger teachers … and those who haven't even been born yet … when they retire.

Let me give you an eye opening example. *The Economist* told the story of the late Gertrude Janeway, of the United States. Mrs. Janeway died in 2003. Until then, she had been receiving a $70 a month Veterans' Administration pension. Not much, you say. Well maybe not…. Until you take into consideration the fact that her late husband was a soldier in the American Civil War … which ended in 1865! She married him in 1927, when he was 81… and she was 18. So, as *The Economist* reported, that particular pension entitlement actually spanned *three centuries*…….

An extreme case, for sure. But it makes an important point, of which our actuaries and investment managers are acutely aware: we must consider the plan's long term *liabilities*, not just its assets.

So, as you can see the first cause of rising pension costs is demographics: that is, increasingly higher life expectancy, coupled with retirement periods that exceed careers, as well as the reduced ratio of working to retired members.

The second cause is low interest rates: today, a 1% change in the interest rate assumption has a $25 to $30 billion impact on the cost of teachers' pensions. Pension finances are no different than consumer finances in this regard: you have to save more to pay for pensions when investment returns are lower. At 4.0% interest rates, you need

$650,000 to pay for a typical $40,000 pension. When that rate drops to 1.0%, the cost spikes to almost $1 million.

Given that our liabilities are growing faster than our assets, our sponsors have been faced with making the tough decisions that shortfalls demand. Ordinarily they could:

- reduce benefits, or
- raise contribution rates, or
- both.

Because contribution rates have been frozen by government mandate for the next five years, however, their only option for the time bring is to reduce benefits. They recently removed the guarantee of inflation protection on years of credit earned from January 1, 2014, onward, for example, and are now actively considering what other measures they can take to further reduce costs.

That background gives you the context for our investment mandate and the rest of my remarks.

Socrates said "Well begun is half done."

And such is the case at Teachers'.

The governance model that our founding chair, former Bank of Canada Governor Gerald Bouey, began with must indeed be credited as the foundation of our initial and ongoing success.

Let me explain.

When tasked with becoming the Ontario Teachers' Pension Plan's inaugural chair, it was Gerry's vision that the organization be jointly sponsored by the two contributing parties, that it be an independent organization, and that its board members would not be hands-on managers of the fund. As co-sponsors, the teachers and the provincial government agreed to share the benefits, that is potential surpluses … and the risk, that is potential shortfalls … and to jointly decide what action to take in the event of either.

The first brainwave was ensuring the organization was independent – a model for which my friend Larry Schloss would give his eye teeth … The board members are appointed by the two sponsors – four by each, and the chair is jointly appointed. And everyone on the board is a professional – think actuaries, investment managers, economist, CPAs, governance experts…. They in turn delegate the operational decision making of the fund to the CEO… to me … and the executive team and I do so accordingly.

Board members are required to act independently of both the plan sponsors and management, and to make decisions in the best interests of all beneficiaries of the pension plan. They are highly engaged in plan oversight, but they do not make investment or other management decisions.

So as you can see, we are in fact, built for success. Our governance model gives us the latitude for making the right investment decisions for the right reasons … and to adopt and apply the investment innovation we've come to be known for.

And that really is the genesis of our direct investment track record … sometimes called "the Canadian model" … which we have followed virtually since the outset of this plan in 1990.

Another indicator of success? Until 1990, there was no investment program per se for the teachers' pensions. It was guaranteed by provincial debentures. When the investment program was launched, it was done with a series of provincial bonds that were non-negotiable, non-transferrable and non-marketable.

With a lot of innovation and even more determination, our founding CIO and his team created derivatives – the first in Canada – and the fund has now grown to be one of the most diverse and largest of its kind … all with the humble beginnings of $18 billion in government IOUs. In fact, the last of those bonds was "retired" last summer and so we had some fun with a "debenture burning" ceremony for staff.

Our direct investing program dates back to 1991 – just one year after our very first investment professional was hired. The inaugural Chief Investment Officer had determined that the fund should be in Private Equity. However, at that time, there were no Canadian Private Equity funds. In Canada, Private Equity had become the purview of the banks and rich families. By contrast, in the US, the Glass-Steagall Act had prevented US banks from making private investments – as a result firms such as Forstmann Little & Company and KKR were spawned to act as conduits for institutional monies into private investments.

Since there were no Canadian funds to invest through, Teachers' decided, by default, that we better do it ourselves – it was as simple as that and it sounded easy – NOT!.

The first deal was really exciting until the company, White Rose, ultimately went bankrupt and we lost our entire investment. What a debut – it is amazing that our board did not insist that we fold up our direct investment tent and stay home. They allowed us to continue … to learn from our mistakes … and the rest, as they say, is history….

But that history did not happen overnight.

Perhaps due to the White Rose lesson, we took our time – more than 10 years – in building the talent and infrastructure to prudently invest directly, first in Canada, then the US and now globally. Subsequently, when new asset classes were introduced, such as infrastructure, we already had the formula to go direct as opposed to through third parties.

Beside better risk control, one of the key benefits of "going direct" is lower cost. Think about it, a successful private equity investment via a fund will cost the investor 6% per annum. Our private equity costs are way below that and yet our net returns are in the top quartile.

Assuming that the differential is 5%, that means that our $20 billion Private Capital portfolio will, on average, earn an extra billion dollars per annum compared to investing through the best performing funds – enough to pay over 25,000 pensions each year.

Our Internal rate of return on our Teachers' Private Capital direct investment department, for example, is nearly 20%. Why? Because we have our own internal investment deal teams – we have about 50 investment professionals. This means we don't have to rely on high cost, third party fund managers.

We pay our people competitively – keeping in mind that they do not have to fund raise … and we do not have to part with anywhere near as much cash as other funds who do not have the authority to hire … and compensate … internal deal teams. We now use third party managers only to access markets or expertise that we do not believe we can develop economically on our own.

All this to say: We started slowly and learned to walk before we broke into the run we're now known for. We blazed that trail, and now most of the large Canadian plans have followed suit – a strategy that I'm proud to say distinguishes the Canadian plans from others around the world.

While our investment culture truly is unique and well-recognized internally, we had not articulated it as a unified set of operating principles until last year. But as we prepared to review our overall corporate strategy and our five-year destination, as we call it, the executive team was wise enough to look around the organization and say “let’s get these smart people involved in the process – there’s no sense going this alone.”

And that’s when a group from senior team investment sat down together and framed our “Investment Beliefs”.

These tenets define our philosophy for earning superior returns and managing related risks … all to ensure the long term sustainability of the pension plan. The “beliefs” define “Who We Are” and “How We Invest”. I’ll resist the urge to read to them to you, but will say that the précis in today’s program is a pretty succinct outline. I’ve already covered active management and good governance thoroughly, so I’ll just touch on a couple of others to help you see why they’re so important to us…

Let’s take “risk” as an example. Neil Petroff, our Chief Investment Officer likes to say that we are in the “risk business” … that our fund gets paid according to the amount of risk we take. As such, the first point you will see in how we invest is:

”Taking risk is necessary to earn the returns required to meet our pension obligations. In so doing, we accept that we will experience periodic investment losses.”

Well, you certainly saw that exemplified in the White Rose example … and yes, there have been others since…. Which brings me to the importance of diversification… and this Investment Belief:

> “Total fund diversification, through effective portfolio construction, is fundamental to our success. Diversification allows us to spread risk across key factors such as time periods, geography, and economic outcomes, which reduces the adverse impact of any one investment loss on the fund overall.”

Today our investment portfolio covers the gambit, but all fit within the broad asset classes of Public and Private Equities, traditional and not-so-traditional Fixed Income, what we refer to as “Real Assets” – which includes Infrastructure, Real Estate, and Tactical Asset Allocation and Natural Resources. We make direct investments in all asset classes.

A large part of our investment success is due to the diverse asset mix that we’ve been able to design and execute against over the years. In fact, our asset mix is one of the most diverse in the pension industry….

Our best known <u>direct investment portfolios</u> are found in:

- Private Capital
- Real Estate
- Relationship Investing
- Infrastructure, and
- Long Term Equities

Here's a sample of our holdings:

- Four North American marine container terminals,
- the British lottery operator,
- Canada's finest commercial real estate portfolio,
- several major international airports,
- The high-speed rail line linking the city of London with the Chunnel,
- Australia's desalination plant,
- A major stake in South Korea's third largest life insurance company,
- Modern new Chilean water treatment and distribution utilities, and
- Munchkin Inc. the world's largest manufacture of sippy cups and potty seats.

One last Investment Belief that I would like to cite has to do with the relationships we cultivate. It says:

> "Strong relationships support our success. We identify and cultivate relationships with like-minded partners globally to broaden our investment reach. We must be flexible and disciplined as we adapt to business cycles and shifting investment environments."

What this really says is we are stronger together. Our team and our partners can help each other identify deals and opportunities and we can benefit jointly from them. This calls for a certain degree of humility, as well as patience … character traits we look for in our team.

And that brings me to our five-year strategic roadmap, which we developed last fall, and which brings all of this thinking together.

In fact, this roadmap represents the confluence of our key business and operational strategies - it does not reflect new concepts, but rather brings them together logically and into alignment towards common, long term goals. And it does so in a five-year increment that is measurable, but aspirational.

It integrates our Mission, Vision and Values with our key business drivers – everything from the global economic downturn to the fact that our members' longevity rates are among the highest in the country. It allows us to mold our objectives into one, two or three-year milestones, so we can see what we need to achieve along the way to ensure our success at the end of our five-year plan.

And it is overlaid with our core strategies – which are the "how" in our approach to our work. Innovation, Engagement and Partnership are among those strategies, so you can see they are well aligned to our investment beliefs and our fundamental commitment to our members.

The most striking feature of our roadmap is the integration of the organization's businesses, functions and individuals into one, cohesive, progressive and over-arching strategy that can be expressed vertically and horizontally. Every employee in the organization, from the very top down, is aligned towards that destination and their performance is measured accordingly. As I tell staff, if you are working on a project, and you cannot see how it's going to help get us to where we're headed, stop doing it and start doing something that will.

So, in conclusion, let me say that it is my firm belief that we are living up to Socrates' spirit. Our success can be tracked back to being "well begun," that is to our governance principles. They are appropriate to our mandate and aspirations, and they are the foundation of our culture.

In Teachers' case, our governance is the foundation of our independence from our sponsors, and of the empowerment of our people to make decisions for which they are accountable. Our governance has allowed us to become the organization that we are today.

It led us to our vision and strategy and attracted the talent that delivers our success. I personally feel honoured to lead a team that respects these principles, and am grateful for the opportunity to share them with you today.

Now I look forward to your questions….

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