"Direct Investing for Direct Results"

Remarks by

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Thank you, Craig, and good afternoon, everyone.

It’s a pleasure to join you today to talk about Teachers’ direct investing program… Since my invitation arrived from the treasurer of one of our most prized investee companies, GCT Terminals, it was an offer I couldn’t refuse. I also should add that it’s not unusual for me to be telling our story to an audience of financial professionals…although I am more accustomed to a one-person audience, given that I’m married to a Chief Financial Officer

So what is the head of a pension fund doing concerning himself with the fortunes of, for example:

- Four North American marine container terminals,
- the British lottery operator,
- North America’s most valuable professional sport and entertainment conglomerate,
- Canada’s finest commercial real estate portfolio,
- several major international airports,
- The high-speed rail line linking the city of London with the Chunnel,
- Modern new Chilean water treatment and distribution utilities,
- The largest global specialty retailer of health and wellness products, and
- The largest manufacturer of Serta brand mattresses in North Americaor
- Munchkin Inc. The world’s largest manufacture of sippy cups and potty seats?,

Well, those are just a few of the companies we at Teachers’ have acquired directly, wholly or in part, in recent years. And they are helping us to keep our pension promise to the 295,000 active and retired teachers of Ontario who are counting on us for their retirement security.

As you can see from this partial list, there is considerable diversification among our direct investments. And although, as a pension fund we are long term investors by nature, let me say that there is long term, and there is longgggggg term …. depending on which of our portfolios is doing the investing.

I'll explain what I mean by that, but first, let me give you a bit of detail about Teachers' in general, and our direct investing program in particular……..

First, Teachers'.

At the risk of sounding like an excerpt from an old TV show episode, it all started 21 years ago, with a small, under-funded pension fund…. . You see, from 1917 until 1990, Ontario's pension fund for teachers was under the auspices of the Teachers' Superannuation Commission. Allegedly the commission had sufficient assets to back the pension promise. In 1990 when the plan was privatized, the government transferred $18.5 billion of non marketable, non negotiable, provincial government bonds to the newly created Ontario Teachers' Pension Plan. So we started life 100% invested in a single asset – crumby government bonds - a $5 or 6 billion deficit, and not one investment professional. Our mandate was to manage the plan's investments, as well as administer the pensions, under the joint sponsorship of the government and the teacher unions. We weren't exactly set up for success!!!

Well so far it has been a happy story. Our assets are now $107.5 billion, we've added $23.2 billion above market benchmark returns – that's $4.7 billion more than the original total value of the fund - during those 21 years, and we are recognized worldwide as one of the most sophisticated institutional investors.

Our investments cover the gambit, but all fit within the broad asset classes of Public and Private Equities, traditional and not-so-traditional Fixed Income, Commodities, and what we refer to as "Real Assets" – which includes Infrastructure, Timberlands and Real Estate. We make direct investments in all asset classes.

Up until 2003, we were in surplus – that is our assets outweighed our liabilities. Unfortunately, as you may have read, we had a preliminary funding shortfall this year, which was just resolved last week by our plan sponsors. That initial shortfall was not because of our investment programs – rather, it's largely because of low real interest rates and the economic outlook they foretell – rates are at their lowest levels since the 1950s and 60s - coupled with our demographics (teachers live a long time….). I'll be addressing those root causes in a moment, as I am sure you are wondering how we could possibly be in deficit given the strong investment success that we've had … a 14.3% return last year and 13 % in 2009.

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… and when I say diverse, I mean by asset class, by industry and by geography, as my opening list of "latest hits" illustrates.

Our success also is largely thanks to our "homegrown" direct investment capability. While the vast majority of the world's pension funds hand their money over to third party managers to invest on their behalf, Teachers' has had a direct investment program since the outset. We started slowly and learned to walk before we broke into a run. We now only use third party managers to access markets or expertise that we believe would be uneconomic for us to develop internally. Teachers' blazed that trail, but now most of the large Canadian plans have followed suit – a strategy that I am proud to say distinguishes the Canadian plans from all others in the rest of the world.

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 a company called White Rose Crafts and Nurseries. Our purchase of that company, in partnership with a Canadian bank, marked our debut as a direct private equity investor. It was really exciting until 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 over night.

Perhaps due to the White Rose lesson, we took our time – more than ten 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 best known direct investment portfolios are found in:

- Private Capital
- Real Estate

- Relationship Investing
- Infrastructure, and
- Long Term Equities.

Let’s look at our Infrastructure portfolio. It’s relatively new, having been launched in 2001. It holds the container terminals and airports and utilities I mentioned. Since launch, its assets have grown from $300,000 to $7.07 billion at year-end 2010. Last year alone its assets returned 13%, compared to the industry benchmark of 4% - or $600 million more than market.

Our private capital portfolio, as inauspicious as its debut may have been, has been especially successful, with an average IRR of 20% net in the 20 years since its inception. It’s now valued at $12 billion. It returned $1.1 billion more than its benchmark last year.

Nowhere is the value of our direct investment program more evident than in our real estate program. In fact, one of our earliest forays into direct investing was in real estate – in 1991, we partnered with Cadillac Fairview to purchase three major Canadian malls.

We took full ownership of Cadillac Fairview in the year 2000. Instead of purchasing properties one at a time, this purchase of an operating real estate company that owned prime properties, instantly brought the real estate portfolio up to the target asset-mix we had been trying to achieve. And, to my knowledge, was a “first” in the pension industry anywhere in the world.

Getting to that 100% ownership is an interesting story in itself…….

We first became involved with Cadillac when it went into bankruptcy in the mid ‘90’s. While the company was in bankruptcy protection, we began a dialogue with Blackstone to put together a restructuring plan to exit Cadillac from bankruptcy protection. As we worked through the deal with Blackstone, there was one debt holder, Goldman Sachs, who was trying to structure its own plan for Cadillac. We ultimately teamed up with them and the three of us ended up owning Cadillac as a private company. A few years later, we took Cadillac public through an IPO, which provided some liquidity to each of the original partners. In 1999, Blackstone and Goldman both had expressed an interest in liquidating their entire position in Cadillac. They started a disposition process, of their intents.

We initially teamed up with two public companies to "re-privatize" Cadillac. The plan was to split up the company, by selling the office portfolio to one of these public companies and the retail portfolio would be joint ventured with the other public company. At the 11th hour, both partners got cold feet and decided not to participate in the purchase of Cadillac.

Where did that leave us?

Well, it left us with the biggest investment decision in our brief history:

- Do we forgo this gem of an investment, in which we believed so strongly? … or
- Do we go all in - $1.8 billion of equity ($6 billion gross assets) – the largest investment the fund had ever made until that point?

It was gut wrenching, but we decided "in for a penny, in for a pound". And we couldn't be happier with our decision. It may be the one and only time that Goldman was bested at its own game and I constantly remind them of the 10 times return we have made so far.

…….

Real estate, like our other real assets, Infrastructure and Timberland, is a good fit for a pension fund for two key reasons:

- Unlike many other asset classes, real estate produces cash flow year in, year out, which helps to pay pensions, and
- Over a longer period it tends to be a good hedge against inflation.

Cadillac Fairview was one of the first foreign landlords to enter Brazil in early 2006, with our investment in Multiplan. This investment has proven to be an excellent one. It now is publicly listed and is the largest public equity holding in our fund, with a value of more than $1.15 billion.

That Brazilian investment in Multiplan coincided with our Project Atlantis program, which Teachers' launched in 2004. As part of that project, we decided, as an organization, to target key emerging economies for our own diversification and growth across all asset classes. We chose Brazil, and our research began. We visited then there in 2006 as an executive investment management group. We met as many people as we could and learned as much about the market, the economy, the prospects, etc. as we could. As I said, we pride ourselves on innovation, so we did not want to just follow the pack. We needed to do our own research and find the right fit for our strategies, culture and risk tolerance.

As a result of Project Atlantis, in addition to major real estate investments, we also now have significant public equity holdings in Brazil. Well-known entrepreneur Eike Batiste is an important partner there, and we have backed several of his resource-focused companies. This includes nearly $680 million in oil company OGX, $160 million in their mining company, MMX, and about $350 million in his logistics company. We also have taken a position in the largest indigenous investment bank there. These all are direct investments, made by our public equities Relationship Investing team.

The newest of our direct investment portfolios is Long Term Equities, launched just two years ago. And this brings me back to my earlier comment about long term and *longggggg* term. In our private equity portfolio, a 5 – 7 year hold is considered average. That generally gives us the time we need to build the value of the enterprise we're investing in before either selling to another investor, or taking it public.

Because they have a lower risk profile, our Long Term Equities team doesn't expect to earn the large returns that the higher risk private capital team receives. They are focused on direct investments that have steady cash flow and growth potential over a longer-term time horizon. When you ask Lee Sienna, who leads that team, just how long that might be, he says: "Forever should be long enough. But no less than 10 years." They look for investments that can provide a stream of income, while holding and growing their value relative to inflation.

Their first acquisition in this portfolio, in 2010, was 100% of Camelot, a global lottery operator that holds the exclusive license to operate the UK National Lottery.
They are also actively building a portfolio of seniors housing through our wholly-owned subsidiary, BayBridge Seniors Housing. Talk about correlation….

So that's a snapshot of Teachers' direct investing evolution.

Now let me talk about the pension reality that is driving our need for these investments now more than ever.

Of course, the best way to understand the present is to understand the past. So let's start with a little Canadian pension history.

Pension plans – both 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 David Foot, when Canada chose a retirement age of 70 in the 1920s, life expectancy was 61.

Understand what they had in mind: on average, you would be dead nine years before you started to receive any 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 have continued that upward trend. According to Statistics Canada's data, life expectancy at birth in 2007 was an average 80.7 years. But that increases to 85, if you make it to age 65. That is, if you were born in 2007 and you have not died before you are age 65, your life expectancy increases to over 85 years of age.

A recent issue of *The Economist* tells 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 alike are acutely aware: we must consider the plan's long term liabilities, not just the assets.

In Teachers' case, we now have 2,500 pensioners in our membership who are over the age of 90. And that includes 95 who are over *100* years of age … our oldest collecting member recently celebrated her 109th birthday and has been collecting a pension since 1967. We jokingly call ourselves the Century Club. …. But in all seriousness, it highlights the issues of benefit sustainability and intergenerational equity – making sure that pension funds are there for today's young people … and those who haven't even been born yet… when they retire.

Initially, pensions were designed to allow workers to live decently for the short gap between ceasing work and death. However, longevity and "Freedom 55" have changed all that. At Teachers', our members now generally collect pensions for longer than they contributed to the plan. In 1990, the average member retired with 29 years of service. By 2010 that was down to 26 years. To further exacerbate the problem, with increased longevity, today's retiree can expect to enjoy 30 years on pension, compared to the 1990 retiree, who only had 25 years on pension to look forward to.

Given that our liabilities are growing faster than our assets, our sponsors have been faced with making the decisions that shortfalls demand in recent years. They can:

- reduce benefits, or
- raise contribution rates, or
- adopt a combination of both.

Because we are at the front end of the pension maturity curve, our sponsors have had to make some difficult decisions sooner than some other plans. That is what being a leader is all about - much the same way we made the decision to invest directly long before other plans even thought about it. Both the right decisions, made in our members' best interest.

The sponsors' task is not an easy one. With the latest preliminary $17 billion gap between assets and liabilities, they looked for solutions in an environment that is very different from the 1990s and early 2000s – when markets were flourishing and potential seemed limitless. For example, in 1990, real rate bond yields were 4.5%. In 2010 they were 1.2%. In 1990, the 10-year outlook for GDP was 3.1%. Now it's 2.0%. Our 10-year real returns outlook then was 6.4%. Today it is 4.2%.

And when rates are low, it costs a lot more to pay pensions. At a real interest rate of 4.0%, you need $650,000 to pay for a typical $40,000 pension. When that rate drops to 1.5%, the cost spikes to $900,000.

And here's an added conundrum: just when we most need to be able to grow the size of our fund, our ratio of working to retired teachers has plummeted to 1.5:1 from the 1990 level of 4:1. This reflects the slowing in the rate of growth in Ontario's school-age population, which ultimately causes a relative slowing in the rate of growth in the teaching profession.

Why does this matter? Simply because, with fewer active members among whom to share the risk in the event of another market tsunami, we have to limit our higher risk – and higher yielding – investments. Let me give you an example. In 1990, if our assets were to lose 10% of their value, members would have needed to increase their contribute rate by 1.9%. If the same thing occurred in 2010, the rate would have to jump by twice as much, to an additional 3.9%. And remember, they're already contributing between 11 and 12%.

That is why we have capped equities, for example, at 45% of our total asset mix. In 1996, we had 73% in equities.

We have learned in recent years that concepts of unlimited growth are illusory. Markets crash, taking past growth with them. Witness 2008: three years of good growth was obliterated from our fund.

Just last Friday, our sponsors told members that their contribution rates would be increasing by 1.1% and that their cost of living increases would equal only 40% instead of 100% of inflation for at least the next three years. They made the right decisions on our members' behalf. As such, I am not as concerned for our members as I am for the 75% of the Canadian private sector workforce reported to have *no* employment-based pension plans whatsoever. And RRSPs have not proven to be the solution – average RRSP balances are woefully short of the levels they need to be in order to fund retirement.

It is our view at Teachers' that there will never be a better time than *right now* for Canada to undertake visionary pension reform. The Dutch have done it. The British are doing it. It's time we did so, too. And I mean "reform", not the slash and burn tactics that some US states have employed. The economic storm clouds that started in 2007, turned to recession in 2008/9 and whose impact will be felt for years to come, have made discussions like this possible. Governments, corporations, labour – everyone has seen the damage wrought on so many pensions and other investment accounts.

There was a silver lining to these economic storm clouds: they helped move the pension issue to the front pages. They have given rise to a pension debate that is gaining volume and that people are finally listening to. It has taken an economic crisis for people to accept that the concern is a real one. But that's OK. At least the debate has an engaged audience. As David Florida said recently, "A crisis is a terrible thing to waste."

Canada's pension funds are well-regarded internationally for their innovation – the same reason they have become such an important force in the investment industry.

And that is why, as gut wrenching as the recent period in the markets was, I have to say that I feel fortunate to be where I am. Pension plans now represent a new brand of financial institution –- we have the power to combine a large capital pool with a long term investment horizon, something that is extremely novel – and valuable - today.

We now are looking at the confluence of two major forces: boomers who are retiring … and are used to getting their way … with the fallout from the worst economic crisis in the lifetime of the majority of Canadians. As such, pension funds offer not just a measure of *market* stability, but a respected voice for pension reform … which could in turn lead to national *retirement* stability.

This situation has been brewing for years. Peter Drucker warned about it in the '60s. He said then that the current generation was postponing chaos for the future generations. And in his book While America Aged, Roger Lowenstein recounts the horror stories of US politicians passing the buck (or lack thereof) to future generations.

The fact is, Canada has done the same.

Canada’s retirement system has many strengths. But there are opportunities for improvement, especially for those individuals without workplace pensions. All Canadian workers should have the opportunity to maintain their desired post-work standard of living. They should be able to participate in low-cost, well-managed, collective pension arrangements. Canada’s current public pension structure – Old Age Security, CPP, QPP – is a good start. But supplementary pension arrangements are needed.

A number of possible solutions have emerged. Some focus on expanding CPP/QPP, others on enrolling non-covered workers in a low-cost, well-managed personal account-based plan. Such a plan could be delivered by the private sector, by pension plans, or through a new national structure that is directly supplementary to the CPP/QPP.

To-date the changes to pension legislation have been at the margins – the length of time sponsors have to make up shortfalls, posting letters of credit to back deficits, changing some investment rules, and even amalgamating several funds to reduce costs and gain scale. These are all good ideas and will help those who are currently members of a pension plan. But they do nothing for the millions of Canadians who have *no* pensions.

With that in mind, the federal and provincial ministers of finance jointly announced a framework for Pooled Registered Pension Plans at the end of last year. This new defined contribution concept is designed to improve the range of retirement savings options for Canadians. From what we have seen so far, it is a start, but we don’t know the details – for example, will it be voluntary like RRSPs (which have not worked), or mandatory like CPP? And since defined contribution plans place the investment risk on individual investors, will there be any level of guarantee? Are there tax implications?

As a society, we have an opportunity right now to lead the way in delivering innovative and practical retirement financing solutions, as long as:

- Legislators clear the way with practical, current pension rules and restrictions, and also launch a new mechanism for non-covered workers

- Pension plan sponsors make tough decisions about contribution rates and benefits
- Citizens take responsibility for saving for themselves, and
- The pension industry sharpens its focus on innovation

As a nation, we in Canada have led the world in healthcare, free trade and energy distribution.

Now it's time to lead the world once again … this time in pension funding and retirement financing. Doing so will only follow considerable debate, discussion and of course, differences of opinion. But that is how good decisions are made and consensus is reached … It's how the public is educated and engaged.

In the meantime, knowing that our members are in good hands, I sleep very soundly on my Serta mattress most nights…. did I mention that we own Serta mattress?? ….

I thank you for the opportunity to talk you today about our direct investing program and its role in our pension promise, and now I look forward to taking your questions.

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