Canadian Pension Leadership

A speech by

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Thank you, Sam (Belzberg), and good afternoon everyone.

It is a pleasure to be here today with a group that understands Canada's leadership position and ongoing potential and is so passionate about promoting it.

At Teachers' we have had the good fortune of introducing many firsts to our industry, both on the investment and the pension service side of the business. We probably are best known for introducing a direct investing program to our fund – something unheard of when we did so in the early '90s.

Let me start with a little history.

In 1990 I came to Toronto from Edmonton for a job interview to become Teachers' first Chief Investment Officer. It was before a panel of 10 or so people – board members, government officials and newly appointed CEO Claude Lamoureux.

During the interview someone asked me what I would do with the $16 billion of non-marketable Ontario debentures that were the pension plan's only assets. I'd thought about this on my way to Toronto and had written my answer down on an airline napkin. So I said with great confidence: We'll have to get into the derivatives business.

It was at that moment that I learned the meaning of the expression: The silence was deafening.

Running a pension plan like a business was not a new idea. But it had never been tested. I had read the 1986 book by Keith Ambachtsheer entitled "Pension Funds and the Bottom Line: Managing the Corporate Pension Fund as a

Financial Business." I knew it was possible and I was up to the challenge of building the team that could make it happen.

The problem was the exposure of the debentures to interest rate volatility and the lack of asset diversification. As I mentioned, we inherited a $16 billion bond portfolio. I called them the triple "nons" – non- marketable, non-tradable and non-negotiable. I think everyone here realizes that one big stack of vanilla, one issuer, below market rate, non-marketable, bonds could not earn the returns necessary to support the inflation-indexed, defined benefit pensions of a growing number of pensioners. To diversify, derivatives were the only answer.

I guess they believed me, because I got the job.

Until then, few pension funds had invested in equity swaps or futures. Within three months, we had invested $805 million in S&P 500 futures.

There was no capital at risk because we retained ownership of the underlying debentures. Fast expansion into equities through derivatives would enhance the fund's long-term returns, increasing the security of teachers' pension benefits. As a result, Teachers' was the first pension plan to use derivatives – in fact, we sought and won the federal rulings that gave all pension plans the right to use them.

The impact was dramatic. By the end of 1993, for example, we had increased our equity exposure to 44% of total assets. The debentures comprised 47% of the total, with the remaining assets mostly bonds, mortgages, and money market securities. We were well on our way to a number of firsts

We introduced the swap market to Canada. We were the first to bring managed index funds inhouse and to use hedge funds. We also were the first pension plan to buy a major operating real estate company … and we were early to invest in commodities, infrastructure and timber … and to build our own private capital team.

Our vision was one born of necessity. It also allowed is to lead the way in how pension plans the world over now invest their funds.

Any discussion about the importance of global opportunities to our investment program needs to be put into the context of today's markets. And let me just say that, in the 91 years since the Ontario government established a pension plan for the province's teachers, the market has seen – and done – it all.

For those who have never experienced a downturn like the one caused by subprime and asset backed commercial paper, the sky may seem to be lower than it was last year at this time. Those veterans among us know that the end is not nigh, however.

Let me talk about that for a moment.

Every major financial crisis has followed the same pattern. Just look at them: Depression. Recession. Inflation. Stagflation. Tech boom. Tech bust. Bull market. Bear market. REITS. Savings and Loans. Asian crises. Long Term Capital. October '87: First the markets were good. Then the markets were bad. Then the markets were good again.

The same indicators warned us of every looming crisis. And the same refrain was heard every time: "This time it's different."

Harvard's Kenneth Rogoff and the University of Maryland's Carmen Reinhart say the main indicators in large financial crises are the run-up of four key elements: asset prices, debt accumulation, growth patterns and current account deficits.

At Davos this year, the head of the European Central Bank reminded everyone he had said last year that risk was under-priced, and had cautioned of the US housing market bubble and the worrying proliferation of complex credit derivatives. I'm sure others said the same thing, but as we all know now, the louder claims were that "this time it's different."

Of course we all know it wasn't. Every financial/market crisis we've endured since the 1929 crash started the same way: with over-exuberance. First - Smart people borrowing short and lending long. And second – over leverage, with a cavalier lack of concern about when the money-fairy was going to stop making deliveries.

All this to say that the subprime crisis and its aftershocks are seeing history repeat itself yet again: There have been losses and there will be more. But there will be opportunities created, which will lead to a recovery. And there will once again be gains. The phase we're in right now is what I would characterize as a 'crisis of confidence.' I think of the credit crisis that the subprime situation ignited as a massive margin call. It is like a tsunami wave surging through the markets. Damage in low lying areas will be extensive.

In Canada, this "margin call" in turn caused the ABCP crisis, whose economic fallout was further compounded by its stunning collision with the soaring Canadian dollar and its subsequent impact on the value of foreign investments. What a year it has been. It has proved that, no matter how clever or prepared our investment professionals might be, we can never know all of the surprises the market can have in store. Wells Fargo CEO John Stumpf put it well when he said: "It is interesting that the industry has invented new ways to lose money, when the old ways seemed to work just fine."

I will note here that Teachers' did not invest directly in the types of investments that gave rise to the subprime crisis. However, we had invested in banksponsored asset-backed commercial paper and commercial mortgage-backed securities, whose trading values were materially impacted by the global credit crisis. In short, like so many other institutional investors, the subprime mortgage crisis reverberated through our halls, too. There is the general malaise that it caused and there are some specific direct hits. For example, one of our private capital portfolio companies filed for protection this spring because it relies on the U.S. new home and renovated home market.

But as I said, our senior investment team and executives have been there before. We've experienced and survived similar investment pain in the past. Cool heads are in charge. We're confident in our geographically and asset-diverse portfolio, our attention to market condition details, and our ability to act and react.

In times of market turmoil, especially, there are few better responses than to focus on the basics, and to concentrate on doing what we do well. We have been able to take advantage of opportunities already. Our public equity team is part of the investment consortium that recently recapitalized National City Bank in the US, for example.

We must continue to innovate and develop creative investment programs. We have 278,000 why we must: our pension plan members – 108,000 of whom are retired, and 170,000 are working teachers. Our average member works for 26 years, then collects a pension for 31 years, and their survivor then collects for another five years, on average. We've pioneered in the past and we'll continue to do so. And we'll do so within our long term parameters. We continue to comb the world for appropriate investments. The Canadian market is simply not big enough to satisfy our investment appetite.

As of the end of last year, for example, nearly 80% of our private capital investments were outside of Canada. If you look at our total equities portfolio – private and public – only one-third of our investments are in Canada. And our inflation sensitive assets can be found in Chile, Brazil, the UK, the US, and New Zealand, as well as other countries. And we co-invest with partners around the world – South Africa, Turkey, Hong Kong….

Now back to that pension payment timeline I just mentioned. Because of the 60 or 70 years from the start of a teacher's career to the end of their survivor payments – we have the luxury of being able to hold investments for the long term.

We don't have to worry about cash calls and we are not like a private equity fund that has to divest itself and pay out returns to a group of limited partners. Our partners are our members, and they share our patience. One of the benefits that holding for the long term brings us is that, with our capital profitably at work, we don't have to take on the cost and effort … and risk …. of finding new investments.

A lot of people have asked me lately if the glory days of private equity deals are over. The answer is No. They will be back – maybe not to the same degree, given the former amount of leverage and the current cost of capital, but there will be very large deals again. The National City Bank re-cap I referred to earlier was a $7 billion deal led by a private equity fund. That's a start. More and larger deals will follow. One of the realities is that sluggish markets offer opportunities. And that, of course, spurs recoveries

I am not in any way trying to minimize the importance, the impact or the pain of the current credit crisis. The International Monetary Fund noted in its biannual report that falling US housing prices and rising residential mortgage delinquencies could result in losses of $565 billion. Couple that with commercial real estate and other consumer loans, and they say the losses could be $945 billion – or the equivalent of $142 per person *worldwide.* What I *am* trying to do is to put it into historical perspective. Yes, it caused intense and widespread pain.

But it has not brought the world to an end. Investors will regain their confidence and growth will return to slow economies.

Let's just hope that it does so with improved credit rating systems, more comprehensive due diligence and compensation packages that better mirror successes *and* failures.

To conclude, then, the Ontario Teachers' Pension Plan will continue to strive to be a world leader in pension investment. We will continue to innovate and to cultivate the talent necessary for our success. We will go wherever in the world the opportunities lead us, but we will go there with a well-considered, well-researched strategy that meets our risk parameters; we'll go with partners, if appropriate; and most important, we'll go with one constant, guiding light: long-term investment success for our members' retirement security.

Thank you.