Government of Ontario Consultation Regarding the Creation of a Single Asset Manager for Pension Plans in the University and Broader Public Sector

OCUFA's Submission to Mr. Bill Morneau

Ontario Confederation of University Faculty Associations
Union des Associations des Professeurs des Universités de l'Ontario

Ontario Confederation of University Faculty Associations

INTRODUCTION

The Ontario Confederation of University Faculty Associations (“OCUFA”) represents 17,000 faculty and academic librarians in 27 faculty associations across Ontario.
The quality and security of the pensions of University faculty members depends, in part, on the quality of investments made with the pension assets that are set aside to provide their pensions. Accordingly, OCUFA and its constituent Faculty Associations have a vital interest in any proposals that would affect the manner in which pension assets in the University sector are invested.

OCUFA notes first and foremost that the time frame for consultation and for the introduction of legislation to create a new pension investment entity (already announced for the fall of 2012) is perilously and needlessly short. The process now underway does not allow sufficient time to properly consider and construct an investment fund that will have a very significant impact on the pensions of persons who work in the University sector and the BPS. Further, the process does not provide a future opportunity for input from stakeholders once the consultation is complete. It is imperative that any advice provided to the Minister of Finance be publicly available prior to the introduction of legislation.

In addition to the question of scale economies and diseconomies – which has been broached but not yet thoroughly examined – there are a number of other issues to resolve before embarking on the proposed course. Among those readily identifiable issues are questions of personnel composition, selection and mandate at the Board level, and of management, accountability and execution at the staff level. These are not easy issues, and many pension investment funds have failed to answer them well.

There are a number of principles OCUFA believes should underlie any degree of consolidation of assets, either in the University sector specifically or in the BPS more generally:

1. The interests of plan members and our pension plans must be of paramount consideration. For example, other types of funds should only be considered for inclusion to the extent that their asset allocation requirements are aligned with those of our pension plans;

2. The ultimate scope of the entity (which plans or funds are included or excluded) should flow from the empirical evidence on best practices in pension plan investment, management and governance. Bigger is not necessarily better; growing the scale of the pool to facilitate participation in particular asset classes should not be a goal in and of itself;

3. Risk bearing parties should have representation in the governance structure of any new investment entity. There is no doubt that controlling costs and maximizing (risk

adjusted) returns are important goals for every pension plan. However, equal weight must be given to the creation of a governance structure that remains ultimately accountable to pension plan members, and is properly constituted and resourced to enable effective oversight of professional staff and best of class decision-making;

4. Any consolidated investment fund should be established as a not for profit entity to ensure that costs to the plans are controlled;

5. The fund must provide a sufficient range of cost-effective investment options to accommodate the asset allocation requirements that flow from the different demographic and risk tolerance characteristics of the participating pension plans;

6. Participation in the consolidated investment fund must be voluntary and exit from the fund in the future must be possible; and

7. Transition timelines should be long enough to ensure that any necessary changes to collective agreements can be made through the normal course of bargaining, and no existing asset positions need to be wound up to the disadvantage of the pension plan.

While the amount of "assets under management" ("AUM") undoubtedly makes a difference as to opportunities for efficiencies and access to alternative investment classes, there are also recognized diseconomies of scale in the asset management business, and a number of studies have identified many variables other than scale that are quite important in determining the success of an investment fund. In their study for the World Bank - "Managing Public Pension Reserves Part I: Evidence from the International Experience"[1], - the authors concluded, after surveying public pension plan annual returns from 22 countries over significant measurement periods, that the average compound rate of return for the group of plans considered in the study was *negative* 6.7%. The variation between plans and countries was very significant, and the authors generally point to governance structures as being particularly significant to the variation. Others have noted that large funds may not be as nimble as their smaller rivals.[2] Accordingly, while the amount of AUM may create possibilities for efficiencies and alternative investments, there is no assurance that those opportunities will be properly developed, and there are many other factors and risks that jeopardize the viability of large public funds.

As well, and as the variation in investment performance between different investment funds within and outside of Canada amply demonstrates, there are significant risks to the concentration of assets. Mistakes made by large funds are much more serious than mistakes at small funds, as they will cause much greater losses and affect many more people. While a thorough study of the risks attendant to asset concentration in a public sector investment vehicle is required, certain risks are immediately apparent. Generically, concerns have been

[1] Managing Public Pension Reserves, Part I: Evidence from the International Experience, Augusto Iglesias and Robert J. Palacios, January 2000, Annex 1, p.38

[2] http://www.bloomberg.com/news/2012-06-06/texas-teachers-taking-alternative-investing-to-new-risks.html

expressed about political interference in investment decisions, and about the management of compensation expectations and demands from professional staff[3]. Some large public pension funds have been first movers, and reaped corresponding rewards; others have been slower and earned lower returns. Board composition, selection and mandate vary among funds, as do management mandates, accountability and compensation arrangements. Getting the governance "right" at a large investment fund is critically important, and requires that these, and other, issues be carefully considered and addressed.

The single study[4] referenced by Ontario (from the International Centre for Pension Management) (the "Rotman Study") is not an adequate basis, by itself, upon which to base public policy. The study relies on a private data base maintained by CEM Benchmarking, Inc. ("CEM"), which cannot be independently assessed. The CEM data base relies on self-reporting by pension funds, with limited verification by CEM, and is not generally accessible. The results of the study are not amenable to independent verification. The Rotman Study sets out to examine scale economies and diseconomies[5] in pension fund investing, but does not purport to consider other factors integral to successful investing, even though it acknowledges the multiplicity of factors that bear upon pension investment outcomes. In general, but especially in this multivariate environment, it is not appropriate to rely on a single study to inform a complex public policy issue.

As indicated, and for the reasons set out above, OCUFA does not believe that the timeframe indicated in the Budget for the introduction of legislation to create a single investment fund for the University and BPS is realistic. OCUFA expects that other critical examinations of the economies and diseconomies of scale in pension investing will be considered, and that the creation of the proposed investment management entity would follow only after considerable study of other investment funds and their strengths and weaknesses. OCUFA would expect a thorough and careful review of governance alternatives, as well as a further opportunity for stakeholders to respond to the proposed management structure for any such fund. Too much is at stake to rush the creation of this important entity.

In response to the specific consultation questions proposed by the Minister of Finance, OCUFA submits as follows:

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[3] Is Bigger Better? Size and Performance in Pension Plan Management, Alexander Dyck and Lukasz Pomorski, February 2011, p.5

[4] Is Bigger Better? Size and Performance in Pension Plan Management, Alexander Dyck and Lukasz Pomorski, February 2011

[5] The Rotman Study notes both theoretical and observed diseconomies of scale in the mutual fund industry, due to the "more severe impact of trades, increased capital inflows leading managers to puruse poorer investment ideas, and/or growing hierarchies in an organization that slow down decision making and dampen incentives." (see p.2)

APPROPROATE MECHANISMS FOR POOLING INVESTMENTS OF PENSION PLANS

The Rotman Study examines the effects of scale on the asset allocations, external/internal asset management and the costs of investments by pension plans. It does not examine the economies or diseconomies of investment funds that must accommodate a significant number of different pension plans. Yet, the investment challenges inherent in creating a single multi-plan investment fund are very different from the challenges faced by individual pension plans. Most obviously, a single plan, of whatever size, has a single asset allocation, reflecting the single plan's underlying demographics, investment expectations and risk appetites. An investment fund that invests on behalf of a number of different plans, on the other hand, must reflect each plan's potentially very different demographics, investment expectations and risk appetites. This is a completely different challenge.

A single investment fund that serves a number of different plans will be challenged, on the one hand, to accommodate each plan's particular investment allocations and strategies, and, on the other hand, to deliver investment services on a cost effective basis. These will not be easy challenges to reconcile. Accommodating different plans' investment strategies may entail a large number of different asset class pools, with different risk and liquidity characteristics, while the imperative to be efficient and low cost suggests a restricted number of offerings. This will be an important threshold issue for the proposed investment fund.

The Rotman Study suggests that "… the most significant contributor to economies of scale comes from larger plans shifting towards asset classes for which scale and negotiating power matter and obtaining superior performance in these 'overweighted' asset classes."[6] In particular, the study finds that investments by large plans in private equity and real estate[7] were substantial contributors to the largest funds' outperformance of their smallest counterparts. This suggests that a potential focus for any new investment fund may be on the alternative asset classes, and on providing University sector and BPS pension funds with low cost access to these asset classes from a not-for-profit best of class asset manager.

Navigating the alternative asset class environment, however, has proven to be an overwhelming challenge for many plans. In recent years, the 'first mover' advantage has been lost, as pension funds across North America and the world have already crowded into these areas.[8] Fees for investing in these asset classes are notoriously high, often at the '2 and 20' level (2% of assets under management and 20% of returns above a threshold). Given the crowding of

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[6] Rotman Study, p.4
[7] Rotman Study, p.4
[8]Texas Teachers Taking Alternative Investing to New Risks, http://www.bloomberg.com/news/2012-06-06/texas-teachers-taking-alternative-investing-to-new-risks.html; South Carolina's pension push into high octane investments, http://www.nytimes.com/2012/06/10/business/south-carolinas-pension-push-into-high-octane-investments.html?_r=1&hpw

the field, and the exorbitant fee and salary levels in these areas, it is no longer clear that they represent attractive investment opportunities. Moreover, the private equity area has spawned its own controversies that threaten to undermine confidence in the pension sector generally. Private equity funds can spend lavishly to entice new pension fund clients, leading to difficult ethical issues and conflicts of interest.[9] Controversies have erupted in Canada as to the legal obligations of alternative investment managers to their pension fund clients[10], and controversies over the internal management of highly compensated private equity employees have recently erupted into public view at one of Canada's mid-size public sector pension plans.[11]

In addition, the Rotman Study notes that the largest pension funds utilize internal rather than external asset management much more than small funds, for all asset classes[12]. Internal management realizes substantial economies and accounts for substantial savings: "Costs of internal management are on average 3 times cheaper in public equities and fixed income and 5 times cheaper in alternatives."[13] Similarly, internal management develops internal expertise and allows for a closer safeguarding of confidentiality. This result similarly implies that the proposed University sector and BPS asset manager should manage its assets internally, and that economies may be realized not only in respect of alternative assets but also in the traditional equities and fixed income asset categories. On the other hand, the governance of internally managed pension investment funds is not without its significant challenges.[14]

The most obvious ways to provide access to these asset classes is through pooled funds or segregated accounts. The proposed asset manager should offer unitized pooled funds that will allow the participating pension funds to invest in one or other pool in accordance with the pension fund's own investment strategy and risk tolerance. Consideration should be given to establishing pools for distinct asset classes, and, as well, for different risk tolerances within each asset class. Overall, the number of pools that are sensibly provided by the proposed fund will depend on the size of the proposed fund, the costs of providing multiple pools and the range of investment strategies and risk tolerances among the client pension funds. To the extent that the proposed fund does not provide a full range of offerings, consideration should be given to permitting client pension funds to invest only a part of their assets with the proposed investment fund, so that the balance of their assets may be invested in a manner that reflects their preferences.

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[9] For example, South Carolina's pension push into high octane investments http://www.nytimes.com/2012/06/10/business/south-carolinas-pension-push-into-high-octane-investments.html?_r=1&hpw

[10] Mackinnon v Ontario Municipal Employees Retirement Board, http://www.canlii.org/en/on/onca/doc/2008/2008onca120/2008onca120.html

[11] OPTrust's Former CEO Files Suit for Wrongful Dismissal, http://www.theglobeandmail.com/report-on-business/optrusts-former-ceo-files-suit-for-wrongful-dismissal/article4240742/

[12] Rotman Study, p.20

[13] Rotman Study, p.21

[14] Wysocka, supra.

Segregated accounts raise the risk of preferences (for example, preferences in investment opportunities in the real estate or alternative asset classes) being given to large segregated fund investors over smaller pooled fund participants, and so should not be offered by the proposed investment fund.

VOLUNTARY VS. MANDATORY PARTICIPATION

OCUFA submits that participation should certainly be voluntary. The possibility of exit, and market discipline, are essential to the efficiency and efficacy of the proposed investment vehicle. For example, in British Columbia, the *Public Sector Pension Plans Act* required a number of public sector pension funds in that Province to place their assets with the British Columbia Investment Management Corporation ("BCIMC"), but then allowed each pension fund to move some or all of its assets to another investment manager after one year. This mitigates the captivity of the pension funds as clients, and maintains market pressure on BCIMC to perform strongly. An exit option provides a counterbalance to the recognized risks that public pension assets are used to support specific firms with political influence[15], or are compulsorily loaned to sponsoring governments[16], or are invested in accordance in accordance with a public mandate rather than in the best interests of the funds' members.[17] Without an exit option, and to the extent that pension funds are captive clients of the proposed investment manager, the proposed manager will be insulated from competition, and the market-based imperative to maintain competitive pricing and practices will be absent.

EFFECTIVE LEADERSHIP AND REPRESENTATIVE DECISION-MAKING

OCUFA believes that risk bearing parties should have representation in the governance structure of any new investment entity. If employees bear the risk of investment losses, either by way of future increased contributions or future reductions in benefits, then it is essential that they have representation on the Board of Governors of the proposed entity. We believe that, as a risk bearing stakeholder, employees have the most significant interest in the performance of the investment fund, and can therefore be relied upon as highly motivated participants in the governance structure. However, OCUFA is not advocating a Board of Governors that consists exclusively of representatives of risk bearing parties. In OCUFA's view,

[15] Managing Public Pension Reserves, supra. p.18
[16] Managing Public Pension Reserves, supra. p.16
[17] Managing Public Pension Reserves, supra. p.12-15

individuals with a strong asset allocation and investment background should also be named to the Board of Governors. OCUFA wishes to underline, however, that implementing these two objectives has proven complex in other investment fund arrangements and reiterates that it expects a thorough and comprehensive process to test alternative governance and appointment models before any legislation is introduced.

It should also be underlined that the composition of a governing board for the proposed investment fund is only one (important) element in creating effective leadership for the proposed organization. One commentator has stressed that governance arrangements should support thoroughgoing risk management, an appropriate investment time horizon, the capacity to innovate and be a 'first mover', the clarity of the fund's mission and the capacity to effectively manage agents.[18] Others have stressed conflict and conflict of interest identification and management and outside oversight (by auditors or other qualified external reviewers) as critical elements to build into a governance framework.[19]

PLAN SPECIFIC INVESTMENT NEEDS

In OCUFA's view, it is essential that a single investment entity accommodate the different asset allocation requirements of the different participating pension plans. Each pension plan will have its own demographic characteristics, its own funding policy and its own level of risk tolerance. Imposing a single asset allocation on all participating pension plans would impose an intolerable strain on those plans, and undo any advantage that could conceivably be extracted from a large, efficient and effective investment entity.

As noted, the most obvious way to accommodate these interests is through pooled funds that are established for discrete asset classes and risk levels. Segregated accounts may better accommodate specific funds' needs or risk appetites, but segregated accounts raise conflicts and fairness concerns and so should not be offered by the proposed investment fund.

[18] Roger Unwin, Lessons for Pension Funds on the Governance of Investments, in Governance and Investment of Public Pension Assets, World Bank 2011, at p.35-36
[19] Anne Maher, Policies and Procedures needed to Implement Good Governance, in Governance and Investment of Public Pension Assets, World Bank 2011, at p.83

ROLE OF PENSION PLAN DESIGN, ASSET ALLOCATION MODELS AND PLAN SIZE IN DETERMINING PARTICIPATION

Each of these characteristics is relevant to the participation, or form or level of participation, of any pension fund in the proposed new investment fund.

In regard to plan design, OCUFA is particularly concerned about hybrid plans, which are not uncommon in the University sector. Hybrid plans have group defined contribution characteristics as well as a defined benefit minimum guarantee. Asset allocation and investment selection functions are performed at the administrator level, not by individuals, in hybrid plan arrangements. However, hybrid plans do require individual account record keeping, and may also require annual benefit amount recalculations. The mechanics of efficiently fulfilling both of these functions must be developed prior to the establishment of the proposed investment fund.

Asset allocations may also affect participation in the proposed fund, as discussed above. Much depends on the eventual size and quality of the proposed fund's investment offerings, and on the variety of the asset allocations of the participating pension funds.

TRANSITION PERIOD AND TRANSITION COSTS

OCUFA recognizes that the government has established as a public policy objective to rationalize the pension investment function of a number of BPS plans, and to seek efficiencies for members and taxpayers. In practical terms, there is little alternative but for government to provide the initial seed money to properly study and then establish the proposed investment entity.

DEFINED CONTRIBUTION PENSION PLANS

OCUFA does not believe that it would be appropriate for a single investment fund to provide investment services to both defined benefit and defined contribution plans. Defined contribution plans entail substantially different member reporting obligations than defined benefit plans, and defined contribution plans also typically provide members with investment choice. These incremental responsibilities and costs are materially different from those involved with the investment of defined benefit assets, such that it would not be appropriate to combine defined benefit and defined contribution investment mandates within a single entity. If any such combination were contemplated, it would be essential that defined contribution plans pay the full amount of all costs related to the incremental investment and reporting activities that are required in respect of defined contribution plans.

Additional questions would arise with respect to defined contribution plan member participation in alternative investments. Alternative investments tend to be illiquid, and to have time horizons that are incompatible with the time horizons of individual defined contribution plan members. Combining long horizon defined benefit assets with shorter term defined contribution assets is neither practical nor desirable.

OTHER BPS INVESTMENT FUNDS

This is a difficult question to consider in the absence of information about the type of BPS funds under consideration. In principle, the proposed investment entity should not structure its investment options, to accommodate non-pension fund investment requirements. If non-pension BPS investment funds wish to invest their assets in offerings tailored to pension fund requirements, this may be acceptable. However, creating investment options for non-pension funds will entail costs and could distract the proposed fund from their main challenge – investment of pension fund assets.

CONCLUDING REMARKS

OCUFA recognizes that, in the short time frame available for this consultation, and for the preparation of submissions, it is not possible to thoroughly canvass the many issues that must be carefully reviewed and analyzed before the proposed investment fund is established. In order to have the confidence of participating funds and their members, such a thoroughgoing analysis must be conducted, and OCUFA takes this opportunity to reiterate the importance of such a review before the proposed investment fund is established.