Canadian Investment Management: After Crisis, Institutions Adjust Portfolio Strategies

The market downturn of 2008–2009 reduced the value of assets in Canadian institutional portfolios to levels below those last seen in 2006. A 17% year-to-year reduction in valuations reduced institutional portfolios to $915 billion in assets as of the third quarter of 2009. Asset value declines were less severe among endowments and foundations, which traditionally have maintained more conservative portfolio strategies than those of Canadian pension funds.

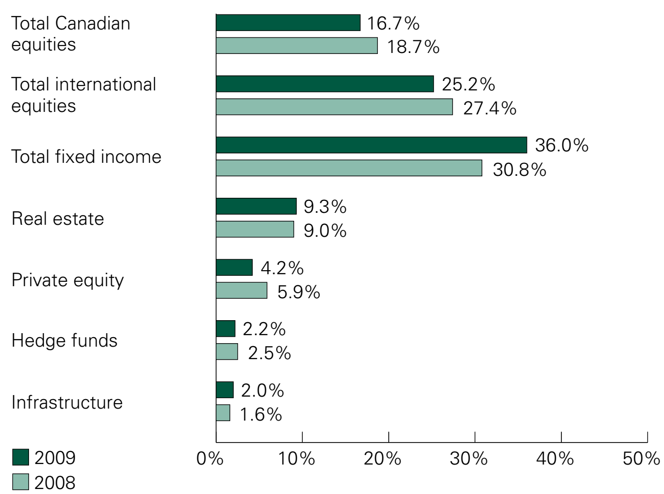
Declines in asset values — coupled with low interest rates that serve to increase the value of pension funds' long-term liabilities — had severe consequences on pension funding ratios, which declined to an average of just 90% in 2009 from 99% in 2008. Among the country's largest pension funds, funding ratios declined to 82% from 94%. Corporate funds saw their funding levels decline from 102% in 2008 to 89% in 2009, while funding levels for public sector/provincial plans fell to 90% from 95%. Actual funding ratios for all Canadian funds could be significantly lower, since, in keeping with normal reporting schedules, only some funds reported valuations in 2009.

Deteriorating funding ratios in defined benefit pension funds are particularly problematic in Canada, where plan sponsors remain firmly committed to DB plans over defined contribution or other hybrid alternatives. Fewer than half of Canadian plan sponsors have established defined contribution plans, and almost 94% of Canadian institutional assets reside in DB plans, with only about 5% in DC and 2% in hybrid plan structures. That mix is weighted even more heavily toward DB when the analysis excludes Canadian subsidiaries of U.S. companies, which have relatively large shares of assets in DC plans. Among Canadian corporate plan sponsors, 26% of DB funds have been closed to new employees and 2% anticipate closing their funds in the next 2–3 years. By contrast, 38% of Canadian subsidiaries of U.S. companies have closed their DB funds to new employees and another 8% have plans to do so. "Projecting to 2019, Canadian corporate plan sponsors still expect DB plans to house 88% of all institutional assets, with DC growing to only 8%," says Greenwich Associates consultant Dev Clifford. "Canadian subsidiaries of U.S. companies expect to reduce DB to just 77% of assets in that time, bringing DC up to 23%."

Canadian Funds Shift to Defensive Stance

Canadian pension funds adopted an increasingly conservative strategy amid the turbulent markets in 2008 and 2009. A combination of declining equity valuations and proactive shifts in portfolio asset mixes brought down institutional allocations and domestic equity allocations to 16.7% of total assets in 2009 from 18.7% in 2008. International equity allocations fell to 25.2% from 27.4% over the period. At the same time, fixed-income allocations increased to 36.0% of assets from 30.8%. Allocations to private equity declined to 4.2% of assets in 2009 from 5.9% in 2008. A more modest reduction was seen in hedge fund allocations, which decreased to 2.2% from 2.5%.

Proportion of Assets in Specific Investment Types
Percent of Assets



Note: Projected to the Greenwich Associates universe. Based on interviews with 277 participants in 2008 and 251 in 2009.
Source: 2009 Canadian Investment Management Study

"Rather than reaching for higher levels of investment returns to close the gap in funding ratios, Canadian funds are shifting to a more defensive posture and diversifying their portfolios," says Dev Clifford.

One group of funds did take a slightly more aggressive approach: Canadian public sector and provincial funds. Although these funds had the market's lowest average allocation to domestic equities at just 14.1%, they also

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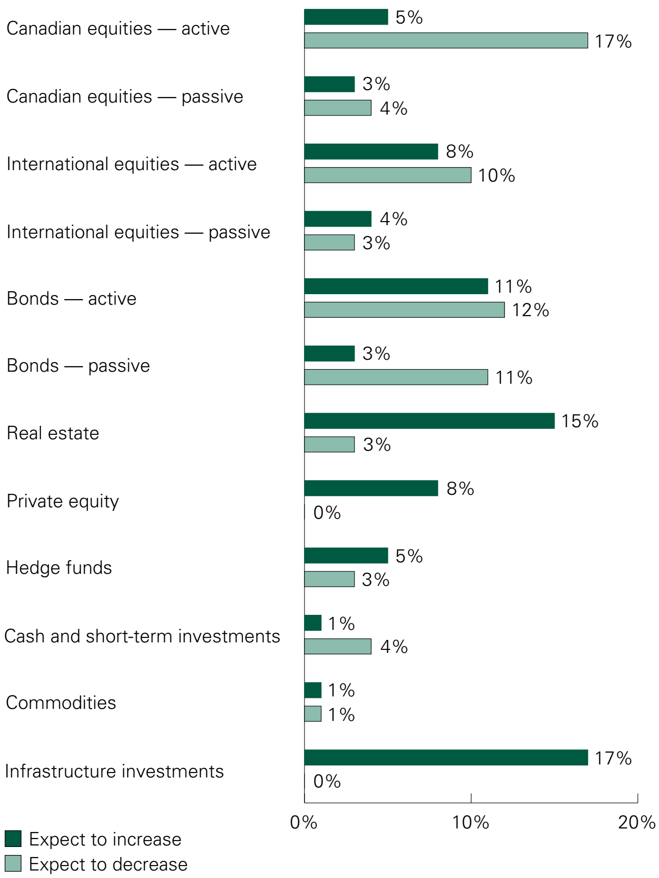
Number of Current or Expected Investors Planning to Make a Significant Shift in Asset Mix
Total Funds



Note: Based on interviews with 251 participants.
Source: 2009 Canadian Investment Management Study

had lower allocations to fixed income than those of corporate funds and higher allocations to alternatives. Public sector/provincial funds had allocations of 5.8% of total assets to private equity in 2009, compared to allocations of only 0.7% among Canadian corporate funds. Public/provincial funds also had higher allocations to real estate, hedge funds and infrastructure.

Across the board, funds appear to have additional changes in store. Forty percent of Canadian plan sponsors last year said they were planning to make substantive changes in their asset mixes in the coming 12 months, up from 31% the prior year. Endowments and foundations were most likely to report plans for major changes in allocation, with 58% reporting such intentions. Fifty-one percent of public sector/provincial plans said they were planning to make meaningful alterations to their asset mixes, as did 34% of Canadian corporations and 26% of Canadian subsidiaries of U.S. companies.

If implemented, the changes planned by these institutions will result in additional reductions to domestic equity allocations. Seventeen percent of Canadian funds plan to significantly reduce allocations to active Canadian stocks; only 5% plan to increase them. It appears much of the cash moved out of domestic equities will be invested in alternative asset classes, particularly in infrastructure. Seventeen percent of funds plan to make a meaningful increase in their currently modest allocations to infrastructure investments. “Almost all the funds planning to increase infrastructure are public sector/provincials,” says Greenwich Associates consultant Andrew McCollum.

Also poised for an increase are real estate allocations, of which 15% of funds say they are planning to increase and only 3% say they are planning to reduce; private equity, of which 8% are planning increases and no cuts; and, finally, hedge funds, which 5% of funds plan to increase and 3% plan to reduce. Funds are more evenly divided between those planning increases or cuts to fixed income allocations.

Institutions Embrace International Equities and Alternatives

Although decreases in equity valuations held down average allocations to international stocks from 2008–2009, the global market crisis did not stop the flow of Canadian funds making their first forays into international equities. The proportion of Canadian institutions using a manager for EAFE/international equities increased to 76% in 2009 from 68% in 2008, and the share of funds using U.S. equities increased to 72% from 69%. “Although there is no strong trend toward significant increases in allocations among institutions that already invest in international equities, 6% of Canadian funds as a whole say they plan to hire a manager for EAFE/international equities, the highest share reported for any traditional asset class in 2009,” says Dev Clifford.

A growing share of Canadian institutions are also investing in alternative asset classes. In private equity, hedge funds and infrastructure, the share of funds investing is on the

The Turnover Begins?

The closing months of 2009 brought what appears to be the beginning of an anticipated uptick in manager turnover. In the wake of the worst of the global market crisis, institutions the world over put manager searches on hold as they sorted out the crash’s impact on their portfolios, assessed the performance of their investment strategies and charted a course for both the immediate and long-term future. Thirty-four percent of Canadian funds conducted a review or changed their investment policies from 2008–2009 — a process that consumed significant amounts of time through the first half of last year. As institutions moved into the third and fourth quarters of 2009, however, that period of reflection was coming to an end. As such, the pace of both manager hirings and terminations began to accelerate. The proportion of Canadian funds reporting that they had hired a new manager in the prior 12-month period increased to 39% at the start of the fourth quarter of 2009 from 34% at the same point in 2008. Meanwhile, the share of funds reporting that they had terminated a manager during that period increased to 26% from 23%.

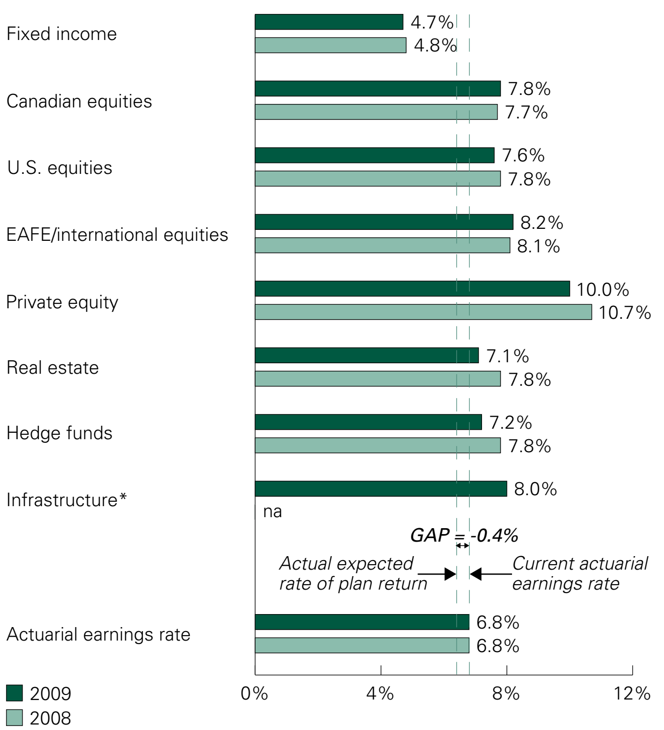
rise. While real estate usage was unchanged from year-to-year at 36% of Canadian funds, 8% of funds say they plan to hire a real estate manager in the next 12 months. Those expectations are topped by the 12% of Canadian funds planning to hire a manager for infrastructure. Four percent of funds plan to hire in hedge funds and private equity, the latter share representing a decrease from the 6% of funds that reported plans to hire a private equity manager in 2008.

Expectations: Investment Returns and Outperformance

Canadian institutions' expectations for returns on their investment portfolios have remained remarkably consistent throughout the crisis. Average expectations for fixed income dipped to 4.7% in 2009 from 4.8% in 2008, while expected returns on Canadian equities inched to 7.8% from 7.7%. Expectations for U.S. equities fell to 7.6% in 2009 from 7.8% the prior year, while expectations for EAFE/international equities increased to 8.2% from 8.1%.

Only in alternative asset classes did Canadian plan sponsors report significant movement in return expectations from year-to-year, with expectations for private equity dropping to 10.0% from 10.7%, real estate expectations falling to 7.1% from 7.8% and expected returns on hedge funds declining to an annual 7.2% from 7.8%. In line with their higher allocations to fixed income and more modest

Mean Rate-of-Return Expectations Over the Next Five Years and Actuarial Assumptions



Note: Means exclude "None." Based on interviews with 277 participants in 2008 and 251 in 2009. *New question in 2009.
Source: 2009 Canadian Investment Management Study

Management Fees on the Rise

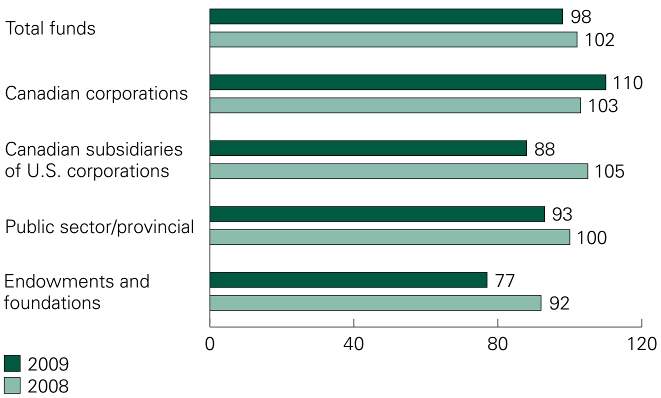
Average fees paid to external investment managers by Canadian institutions increased in all the major classes from 2008 to 2009, despite historically poor performance levels. Two factors pushed up average fee levels last year. First, institutions continued to move into international equities. In addition to the fact that international equity fees are higher on average than those in domestic stocks, as funds make their initial investments in EAFE and other non-domestic equities, they generally start with relatively modest mandates, which incur higher fee levels than those of larger allotments. Second, the dramatic declines in overall asset valuations in 2008 and early 2009 reduced the size of the average institutional mandate. In many cases, these reductions moved institutions across the threshold from one asset size break to another, smaller category for which managers charge higher fees. Because investment management contracts prohibit managers from providing individual clients with fee discounts within specified mandate size categories, these reductions in asset valuations have triggered increases in average fee levels. "As is often the case in periods of poor performance, institutions expressed a growing interest in performance fees across a range of asset classes last year," says Dev Clifford.

exposure to equities, Canadian endowments and foundations report lower expected returns on their portfolios overall. "As for pension funds, because the average actuarial earnings rate was unchanged from 2008 to 2009 at 6.8%, Canadian pension funds face a gap of 0.4% between that rate and their expected overall portfolio returns," says Andrew McCollum.

Canadian plan sponsors did reduce expectations about the levels of alpha that will be generated by their portfolios in coming years. In 2008, Canadian funds expected their managers to outperform the market by 102 basis points annually. In 2009, funds reduced that expectation to 98 bps. Alpha expectations are highest among Canadian corporations, which actually increased outperformance goals to 110 bps in 2009 from 103 bps in 2008. Canadian subsidiaries of U.S. corporations reported the biggest drop in alpha expectations, which they took down to 88 bps from 105 bps. Canadian endowments and foundations have the most conservative alpha projections after reducing expected levels to 77 bps in 2009 from 92 bps in 2008. Public sector/provincial funds reduced alpha expectations to an annual 93 bps from 100 bps.

While quite aggressive, these alpha expectations are actually more conservative than those reported by U.S. institutions this year. U.S. endowments and foundations, which maintain relatively low allocations to fixed income and large allocations to alternative asset classes such as private equity and hedge funds, predictably expect to achieve the highest levels of annual outperformance, at 145 basis points. U.S. corporate funds, which are in the process of taking down risk levels and emphasizing fixed income in their portfolios, have the lowest stated expectations for alpha among U.S. funds at 116 bps. Alpha

Anticipated Annual Outperformance in Basis Points



Note: Number of basis points. Based on interviews with 277 participants in 2008 and 251 in 2009. Source: 2009 Canadian Investment Management Study

expectations among U.S. public funds are more in line with those of endowments and foundations, at an annual 140 bps.

"For institutions in any market, expecting your portfolio to outperform benchmarks by more than 100 bps on an annual basis is not realistic over an extended time horizon," says Dev Clifford. "It is rare for any investment manager to consistently generate double or triple-digit levels of alpha; it would be rarer still for an entire portfolio to achieve that level of outperformance for any number of years."

Consultants Dev Clifford and Andrew McCollum advise on the investment management market in North America.

Methodology

From July to October, 2009, Greenwich Associates conducted in-person interviews with fund professionals at 152 corporate funds, 80 public funds, and 19 endowments and foundations in Canada. Interview participants were asked about their investment-service providers, their business practices and philosophy, and their future expectations.

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