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CUPE Pension Trustee Training

Implementation and Monitoring – Trustee Education

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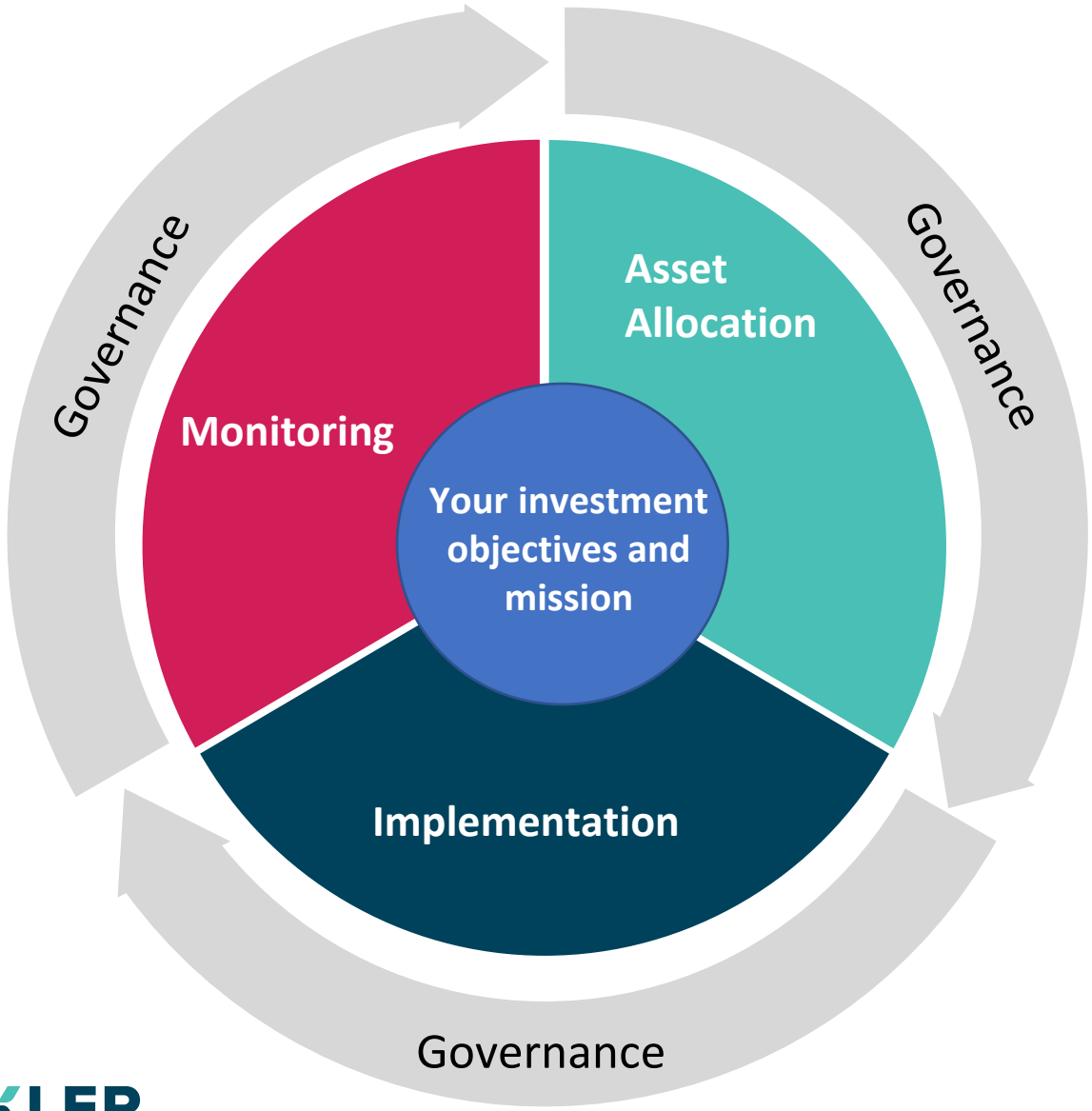
May 18, 2022

Investment strategy governance



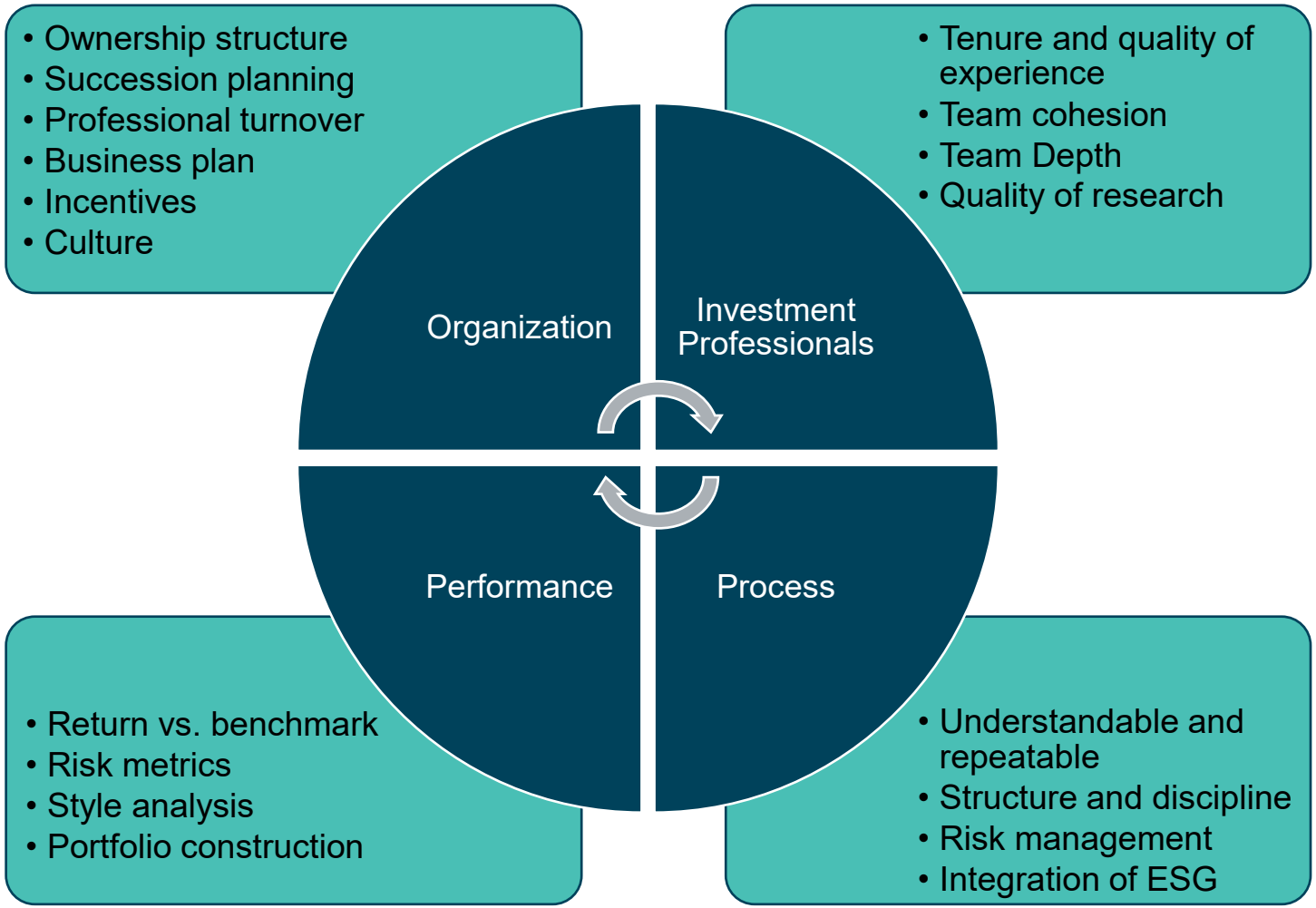
- Today's presentation will focus on implementation (i.e. manager selection) and monitoring.

Manager selection background

- Manager selection is a core component of a successful investment strategy. Selection requires thorough due diligence of the investment manager's approach and performance, investment process and portfolio construction decisions.

- Challenges related to manager selection:
  - Finding managers that has the capability and resources to outperform the benchmark – avoid chasing last year's performance or the "hot style"
  - Maintaining exposures to strong managers during period of underperformance but not holding a poor manager for longer than necessary – avoid compounding underperformance with poor market timing
  - Recognizing that the time and governance required to oversee managers can in some ways have no limit – we must be able to make key decisions in a timely manner
  - Understanding total portfolio diversification and recognition that no manager can outperform all of the time.

Investment manager assessment



Sample Checklist - Organization

Category/Factor	Example of how assessed	Things we favour	Things we dislike
Ownership and incentive structure	Do the key professionals have equity in the firm? Is compensation aligned with investment performance?	• Broad ownership amongst senior leaders and employees • Asset management only business • Compensation structures that promote retention • Compensation structures that promote collaboration and team work	• Listed organizations driven by shareholders • Parent acquisition strategy which is not driven by asset management • Investment professionals' compensation structures tied to profitability and asset growth
Succession plan	Is there a clear plan in place to replace key individuals?	• Good signs of back up for key positions • Effective plans for retirement • Laddered experience	• Key man risk • Lack of transparency on plans
Leadership turnover	Number and proportion of investment team departed in each of the last five years.	• Healthy turnover which supports progression and preserves culture and continuity	• Abrupt departures with no clear planning

Sample Checklist – Investment Professionals

Category/Factor	Example of how assessed	Things we favour	Things we dislike
Tenure and quality of experience	What is the total experience level relevant to the product being evaluated; how long have the professionals been at this firm?	• At least 5-10 team members share experience • Recruitment processes which build diversity without destroying culture • Individuals with relevant experiences and backgrounds	• Significant change and rapid growth
Turnover of investment professionals	How many members of the teams have recently left the team? What were the reasons for the departures?	• Healthy turnover which supports progression and preserves culture and continuity	• High turnover of investment professionals • Rapid growth of team
Team depth	Does the investment team have adequate resources to research and support all of the products being managed?	• Resources aligned with breadth and depth of mandate • Cultural diversity to match the universe of investment opportunities – e.g. language and local knowledge	• Insufficient resource to cover universe in the way the mandate requires

Sample Checklist - Process

Category/Factor	Example of how assessed	Things we favour	Things we dislike
Understandable and repeatable	Is the investment process understandable and repeatable?	• Clear process which demonstrates a competitive advantage to sustain outperformance over time	• Process is hard for clients to understand
Structure and discipline	Is the team able to demonstrate a clear structure to the investment process and how it is adhered to?	• Clear buy/sell discipline • Well defined metrics for building portfolios	• Portfolios that hold names that are inconsistent with the process

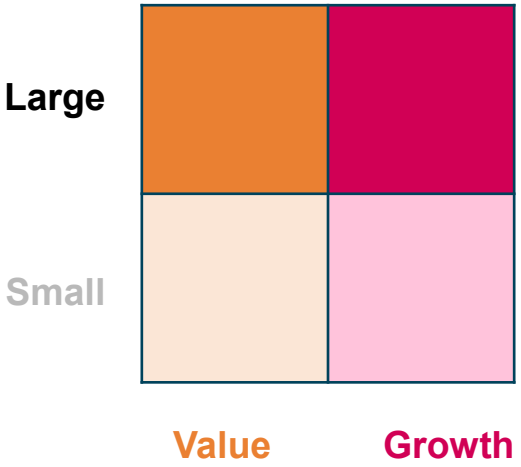
Manager Checklist - Performance

Category/Factor	Example of how assessed	Things we favour	Things we dislike
Return versus benchmark	Annual, annualized, and rolling 4-year periods	• Sustained outperformance over rolling 4 years	• Volatile performance which is inconsistent with manager's style
Risk metrics	Volatility, information ratio, beta, upside/downside market capture	• Competitive information ratio • UMC/DMC which is consistent with stated style	• Significant variation in IR over time
Style analysis	value/growth and capitalization biases and trends, concentration, and active share	• Performance consistent with style • Adherence to process and style	• Style drift • Unexplained changes in style or concentration, especially resulting from lack of capacity discipline

What are equity styles?

Active equity managers analyze myriad company characteristics and financial factors in their attempt to add value. Most active managers end up focusing more on either growth or value metrics. Along with value versus growth, the other most common distinction used in understanding a manager's style is the size of the companies they tend to focus on. These two dimensions – value vs. growth and small vs. large are explained further and depicted below

1. **Value vs growth:** these two styles contrast each other but can be constructed in a portfolio to complement one another.
   - The **Value** equity style focuses on picking stocks that appear to be trading for less than their intrinsic value.
   - In other words, Value managers analyze and select stocks that are priced lower than they believe they should be based on the underlying fundamentals. They are long-term investors of quality firms.
   - The **Growth** equity style focuses on firms that are expected to grow. Growth investors typically invest in younger firms whose earnings are expected to increase at an above average rate compared to others in their sector / the wider market.
   - In other words, they tend to favor younger companies poised to expand and increase profitability potential in the future.
2. **Size:** meaning the size (or market capitalization) of the firm, this ranges from small, to large.
   - In the global equity market, large cap stocks range in size from $(US) 2.4 billion to $194 billion
   - Small cap stocks range in size from $9.8 million to $9.5 billion.



Other equity styles

There are many other equity styles that build on those key equity styles, such as:

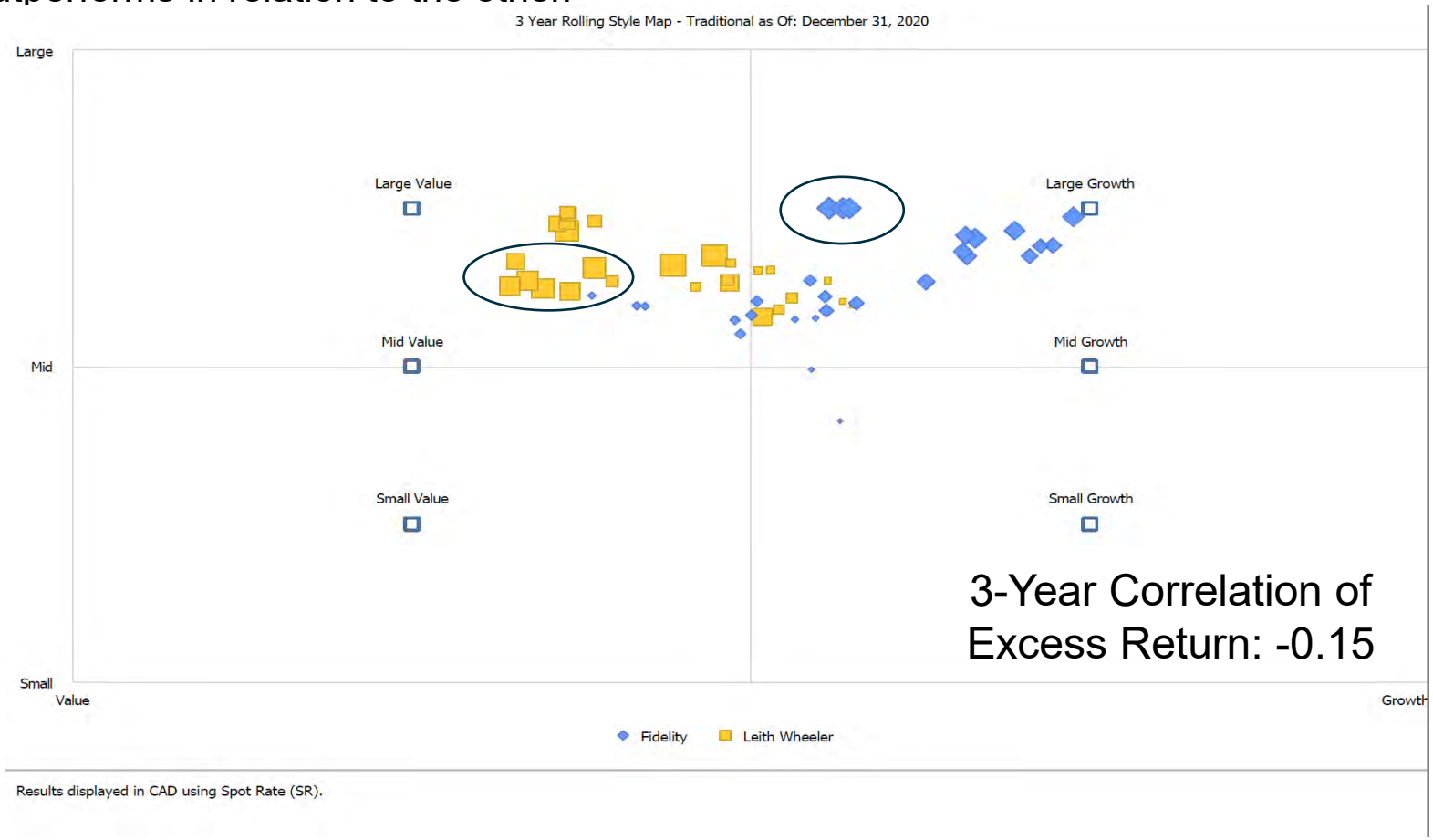
The **core style** seeks to balance the approaches of both growth and value styles by roughly equalizing the emphasis on both growth and valuation characteristics and may have more risk controls around sector allocations vs. the benchmark.

The **momentum style** is a strategy that aims to capitalize on the continuance of an existing trends in the market.

A **low volatility** strategy is designed to minimize the standard deviation of returns without a specific return target. Academic research suggests that low volatility strategies can achieve index-like returns over the long-term, albeit the asset class has struggled to do so in recent times.
The strategy is designed to perform well in down markets and lag in strong bull markets. The strategy will underweight more volatile sectors like Energy while overweighting more steady sectors like Consumer Staples.

Style Analysis – Canadian Equity

- Style analysis looks at the drivers of each manager's performance and their historical allocations. Correlation of Excess Return considers when each manager outperforms in relation to the other.



How to monitor your managers

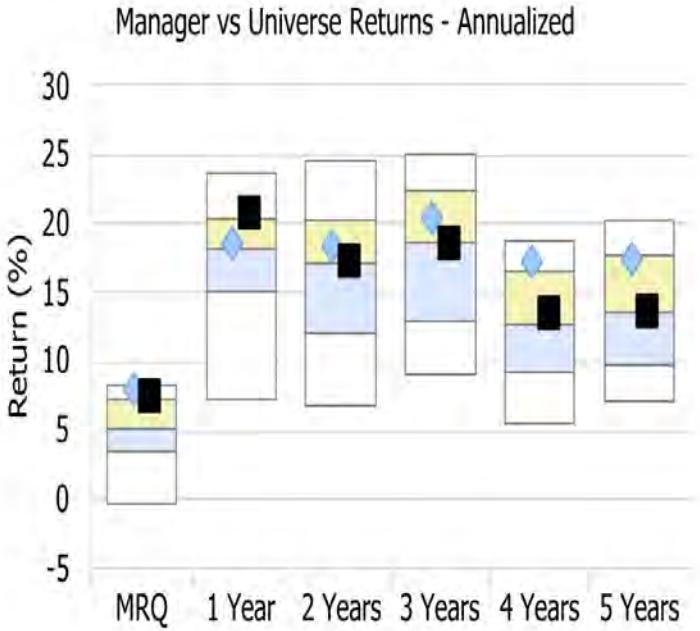
Your investment consultant's reports will most likely vary based on the size of the plan, # of managers utilized and your budget (which impacts frequency). Regardless of these factors, there are several key elements for Trustees to monitor:

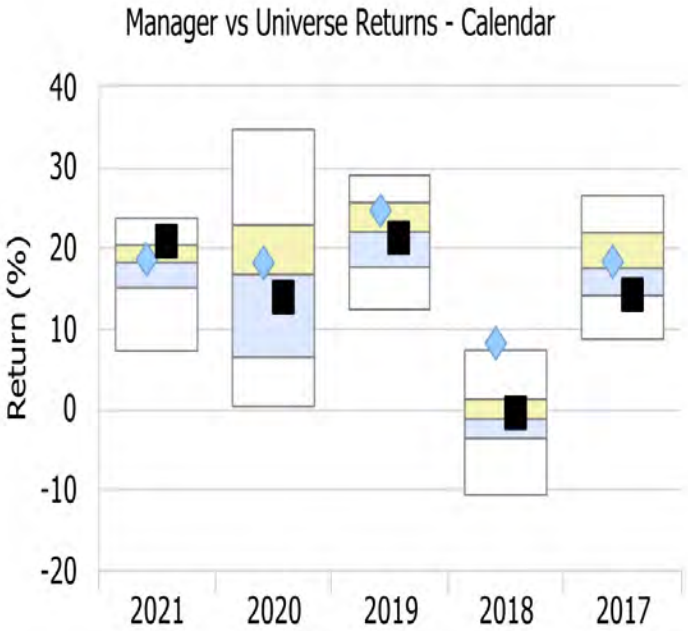
- Organizational
  - You can't "buy" historical returns but can monitor your managers to ensure the conditions for prior success remain in place. This includes organization structure and investment team
- Performance
  - Analysis against an appropriate index (for example, the S&P/TSX Composite in Canada)
  - Analysis against a peer group of similar strategies (easy for public markets, much more challenging for alternative investments)
- Risk
  - Even when performance is strong, you want to ensure that the investment manager is doing so without taking too much risk. Consider various risk metrics that measure volatility, efficiency and market conditions.
- Portfolio construction
  - Is the manager's portfolio generally aligned with your expectations?
  - Sector diversification, # of holdings, etc.

Sample performance and risk monitoring

What is a “universe”?

A collection of other managers in which to compare your manager against their competitors

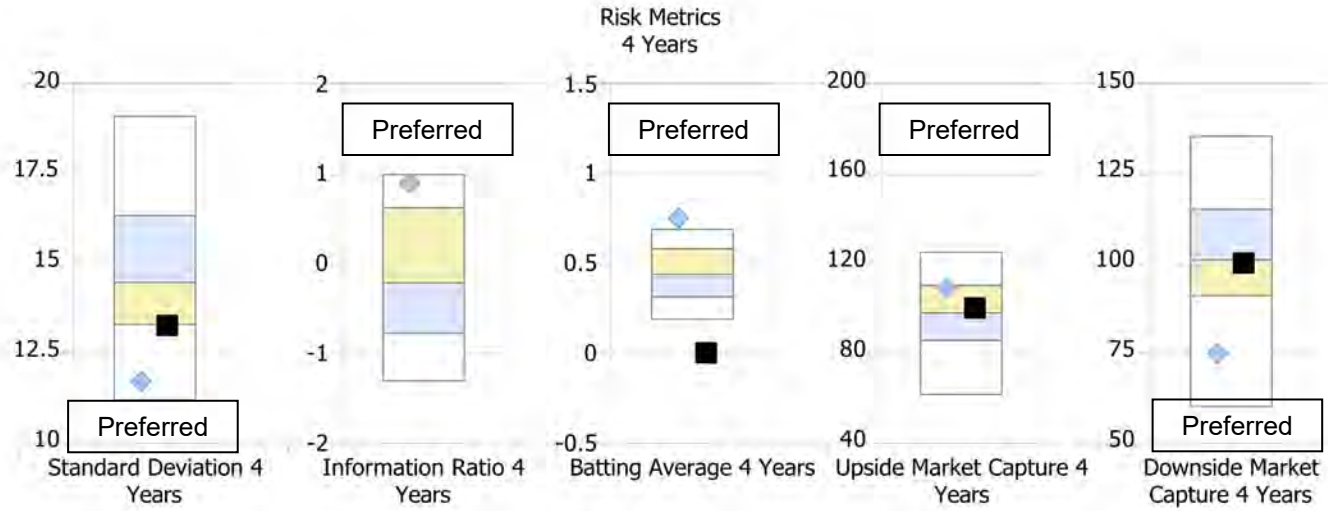


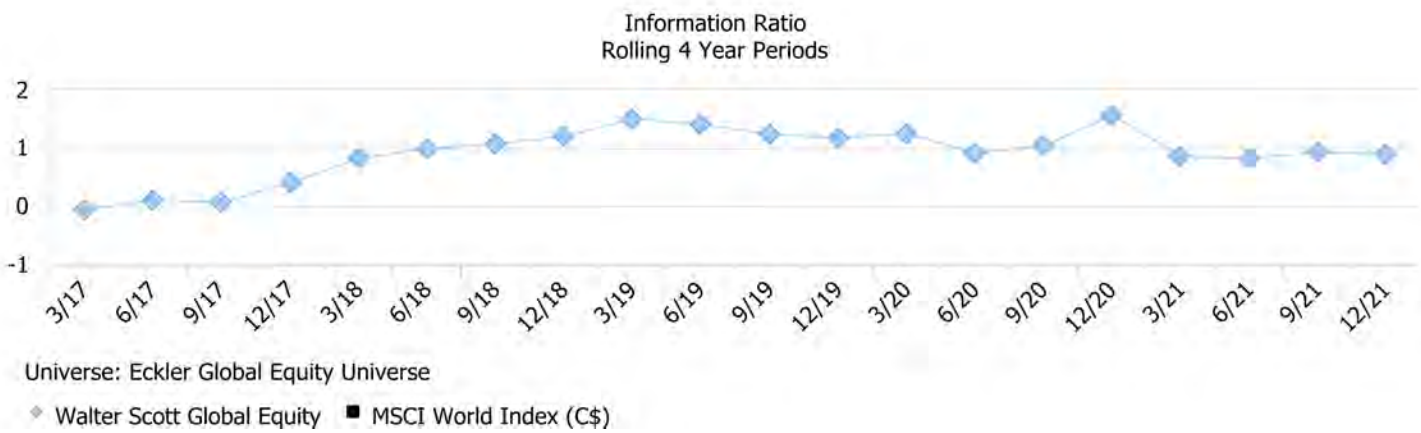


Universe: Eckler Global Equity Universe

◆ Walter Scott Global Equity ■ MSCI World Index (C$)

Sample performance and risk monitoring





Standard deviation is a "volatility metric"

Info Ratio, Batting Avg. are "efficiency metrics"

UMC, DMC are "market condition metrics"

When to consider terminating a manager?

Manager terminations are generally related to one of two issues:

1. Manager Specific Issues (i.e. replacement of the manager)

- Weak performance results or risk metrics.
- Changes in personnel, firm structure or investment philosophy which might adversely affect the potential return and/or risk level of the portfolio;
- Compliance issues
- Poor client service / communications

2. Plan Specific Issues (i.e. your strategy / objectives have changed)

- As your strategy changes, not all of your existing managers may be needed going forward
  - If you reduce equities to fund other asset classes (real estate, etc.), your plan may not need as many equity managers
  - Eliminating certain allocations due to an updated asset liability study

Would you fire this manager?

Example 1: Poor 2021 – Should we be concerned or make a change?

Background:

- Very large global investment manager with one of the largest research teams in Canada
- While the strategy has performed well, 2021 was challenging years and the strategy was one of the worst performers in the universe.

	Gross Annualized Performance and Percentile Ranks as of December 31, 2021													
	Quarter	Rank	YTD	Rank	1 Year	Rank	2 Years	Rank	3 Years	Rank	4 Years	Rank	5 Years	Rank
Core Canadian Equity Manager	7.1	32	21.6	98	21.6	98	17.1	16	20.1	7	13.2	4	12.4	2
S&P / TSX Composite Index	6.5	54	25.1	73	25.1	73	14.9	52	17.5	36	10.3	35	10.0	32

Questions:

- What are other information do you need to assess this manager?
- What would you do with this manager? Put them “on-watch” or terminate?

Would you fire this manager?

Example 1: Poor 2021

Eckler Recommendation:

- We have no concerns with this manager despite a weak 2021
- All key investment staff remain intact with the same lead Portfolio Manager since mid-2000s
- We reviewed the key investments which lead to the underperformance to assess if they were consistent with the approach used by the manager (generally higher quality companies that don't keep up in the stock market is up significantly).
- The manager tends to perform best in down markets (Down Market Capture was 83 while Up Market Capture is historically around 100). A better test for this manager would be how they perform when markets are down.

Would you fire this manager?

Example 2: Longer-term underperformance

Background:

- Well established Canadian equity manager utilizing a “value” investment strategy
- The strategy underperformed over all annualized periods as of June 30, 2020 and generally ranked below median.

	Gross Annualized Performance and Percentile Ranks as of June 30, 2020													
	Quarter	Rank	YTD	Rank	1 Year	Rank	2 Years	Rank	3 Years	Rank	4 Years	Rank	5 Years	Rank
Value Manager A	12.7	61	-13.0	66	-6.7	56	-4.2	70	0.7	69	4.7	45	3.6	59
S&P / TSX Composite Index	17.0	23	-7.5	28	-2.2	29	0.8	18	3.9	19	5.6	23	4.5	35

Questions:

- What are other information do you need to assess this manager?
- Would you replace this manager due to underperformance?

Would you fire this manager?

Example 2: Longer-term underperformance

Eckler Recommendation:

- We recommended that the manager be retained and clients have agreed.
- The firm remained stable and the investment team, which had strong results over many other time periods, remained in tact.
- During this period, most “Value managers” underperformed due to not holding expensive technology companies and instead owned cheaper energy and banking companies which is consistent with expectations for their strategy.
- Versus a peer group of 8 other leading Canadian equity value managers, this manager ranked either 1st or 2nd in terms of performance.

Would you fire this manager?

Example 3: Great performance – why did the pension plan terminate this manager?

Background:

- Bank-owned investment manager focused on retail and high net worth clients. Some small institutional clients.
- The balanced strategy (blends bonds, Canadian equity and global equity) was a strong performer since inception. Performance as of June 30, 2020

Rate Of Return (%) as of December 31, 2015 and Percentile Rank						
Manager	MRQ	YTD	1 Year	2 Years	3 Years	4 Years
Balanced Fund Manager	3.2	10.4	10.4	9.6	9.5	8.4
Benchmark	1.8	3.7	3.7	6.6	6.4	6.2

Questions:

- What are other information do you need to assess this manager?

Would you fire this manager?

Example 3: Great performance – why did the pension plan terminate this manager?

Eckler recommendation:

- Eckler was hired to monitor the manager and we noted that there were at least 4 compliance violations over a 30-month span. These compliance violations were not always caught by the firm's compliance department. To date, the violations had not cost the Plan any money but could have.
- The Trustees put the firm "on-watch" and asked by the Trustees to confirm explain the issue and what steps would be taken by the compliance department to correct the issue.
- "While returns of our mandate have been strong, strong returns do not excuse a failure to comply with the terms of the SIPP. Individual investors may turn a blind eye to compliance problems. However, that is a luxury that the Trustees of the plan cannot afford given their fiduciary obligations to Plan beneficiaries"
- Ultimately, the firm was unable to put in place adequate compliance controls and was terminated.

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Appendix A: Definitions

Definitions

- Below are some key definitions when assessing managers from quantitative perspective

  - **Alpha (value-added):** A measure of incremental return that a manager has earned due to non-market factors. A positive alpha indicates that the manager has been able to add value above expectations based on the level of market risk taken.

  - **Information Ratio:** A measure of the value added over an index per unit of active risk. As such, we can view it as a measure of performance "efficiency" (i.e., are we getting enough excess return for the active risk being taken?).

  - **Batting Average:** A measure of the frequency in which the manager's return exceeds the benchmark. Measured on a quarterly basis, we look for managers that have exceeded the benchmark more than 50% of the time.

  - **Market Capture Ratio:** A measure of the manager's performance in up (or down) markets relative to the market itself. A value of 110 suggests the manager performs ten percent better (worse) than the market when the market is up (down) during the selected time period. The return for the market for each quarter is considered an up (down) market if it is greater than or equal to (less than) zero. The ideal position in a market capture chart is toward the upper left or NW corner (higher upside capture – lower downside capture).

  - **Standard Deviation**: A measure of how widely dispersed or tightly bunched a set of returns are around their average return. The higher the standard deviation, the higher the dispersion over time and hence it is used to gauge performance volatility. Generally, equity performance has higher standard deviation than fixed income performance. The ideal position in a risk vs. returns chart is toward the upper left or NW corner (higher return – lower risk or volatility).

  - **Correlation:** A statistical measure of how strongly two variables are related. Asset classes with a high correlation (close to 1) will perform in a similar fashion in different market environments. Assets with a low or negative correlation are likely to perform differently and will therefore contribute to the diversification of the portfolio. Correlations range from +1 (perfectly correlated) to 0 (no correlation) to -1 (negatively correlated).

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Appendix B: Manager Assessment Checklist

Sample Checklist - Organization

Category/Factor	Example of how assessed	Things we favour	Things we dislike
Ownership and incentive structure	Do the key professionals have equity in the firm? Is compensation aligned with investment performance?	• Broad ownership amongst senior leaders of the firm Broad ownership amongst individuals at various levels and functions • Asset management only business • Compensation structures that promote retention, are aligned with clients' interests and long-term goals • Compensation structures that promote collaboration and team work	• Listed organizations driven by shareholders • Parent acquisition strategy which is not driven by asset management • Investment professionals' compensation structures tied to profitability and asset growth
Business plan	Does the business strategy clearly support the investment product being evaluated, or is this firm distracted by a proliferation of different investment products?	• Growth targets which are consistent with capacity • Reasonable focus • Clear strategy for future growth • Firm's commitment to the strategy – adequate resources	• Asset gatherers • No sign of capacity limits • Product proliferation • Concentration risk by product or by client type/size
Succession plan	Is there a clear plan in place to replace key individuals?	• Clear career paths for different categories on employee • Good signs of back up for key positions • Effective plans for retirement • Laddered experience	• Key man risk • Lack of transparency on plans
Leadership turnover	Number and proportion of investment team departed in each of the last five years.	• Healthy turnover which supports progression and preserves culture and continuity	• Abrupt departures with no clear planning • Inability to retain strong talent in various departments and roles

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Turnover of investment professionals	How many members of the teams have recently left the team? What were the reasons for the departures?	• Healthy turnover which supports progression and preserves culture and continuity	• High turnover of investment professionals • Rapid growth of team
Team cohesion	How long have the members of the investment team been working together?	• Demonstrated ability to work as a team through good markets and bad • Team based goals • Open environments and regular communication • Compensation structure that promotes collaboration	• Very individual goals
Team depth	Does the investment team have adequate resources to research and support all of the products being managed?	• Resources aligned with breadth and depth of mandate • Cultural diversity to match the universe of investment opportunities – e.g. language and local knowledge	• Insufficient resource to cover universe in the way the mandate requires

Sample Checklist - Process

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Structure and discipline	Is the team able to demonstrate a clear structure to the investment process and how it is adhered to?	• Clear buy/sell discipline • Well defined metrics for building portfolios	• Portfolios that hold names that are inconsistent with the process
Team-based	Through observation of interaction between team members, is there an open flow of information and opinion?	• Good degree of challenge and debate • Shared ownership of decisions	• Dominance of a single individual
Quality of research	Is the team able to demonstrate the quality and usefulness of their research?	• Relevant knowledge of companies which surpasses similar competitors • Depth and breadth of research which is consistent with the process they employ	

Manager Checklist - Performance

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