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RISKY BUSINESS

Are Canada's largest pensions putting your retirement at risk? A growing chorus of experts say they are

As more Canadians retire, pressure is mounting on our largest public-sector pensions to take on more risk to beat the market. Billions have been poured into leveraged alternative investments, such as airports and toll roads. But just how safe is that?

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Part 1 of the Star's Risky Business series

An opulent new neighbourhood has emerged over the past decade on the west side of midtown Manhattan, where angular glass office towers, condos and a luxury mall now perch above an old rail yard.

Anchored by an Instagram-baiting steel and concrete sculpture known as the Vessel, with winding, jagged staircases visitors can climb up for a view (you can take an elevator if you're tired), the $25-billion (U.S.) Hudson Yards development was dreamed up after the financial crisis and meant to lure marquee tenants from the business, media and tech worlds to New York City.

It may surprise you to learn that this international spectacle was backed, in part, by a Canadian pension fund. Oxford Properties, the real estate arm of the Ontario Municipal Employees Retirement System (OMERS), one of the province's largest funds, is a key joint-venture partner for the glitzy development.

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But these days, that's not at all unusual.

Canada's largest public-sector pension funds have become global financial players and they routinely spend billions on such ventures around the world. The Economist dubbed them the Maple Revolutionaries in 2012 while Fortune magazine informed readers three years later, "These Canadians Own Your Town."

The so-called "Maple Eight" pension funds (topped by the investing arm of the Canada Pension Plan) now hold a dizzying array of investments in businesses that range from a Chilean power transmission company to the London City Airport, lab services company LifeLabs, a major logistics park in the United Kingdom, and the Confederation Bridge linking New Brunswick and Prince Edward Island.

It's an exciting new way to invest and, so far, it has been wildly successful.

Thirty years ago, Canada's biggest public-sector pension funds and investment managers either didn't exist or invested in little more than government bonds. Since then, despite an era of persistently low interest rates, the big eight have parlayed their

diversified and active investing approach into impressive market-beating annualized 10-year returns that range between eight and 11 per cent.

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There's just one problem: As any seasoned investor knows, higher than average returns always come with higher than average risk. And a major part of the strategy of the big eight funds is based on buying alternative assets, pursuing complex investing and risk-hedging strategies, and using debt leverage to finance deals.

Those tactics have worked well in recent years, when markets have been steadily trending up and borrowed money has been dirt cheap. But the market may be turning, and while using debt to leverage larger and larger investments juices returns — it can also amplify losses if investments go sour.

That becomes especially worrisome when leveraged money is used to buy into airports, highways, power plants, office buildings and other exotic investments that can't be easily unloaded when things go bad. Especially when many of those investments are overseas, in places like China.

How risky is it? It's hard to say. Mainly because such an investing approach has not yet had to weather an era of steadily rising rates, or a devastating market downturn that lasts for years.

Malcolm Hamilton, for one, has been warning for close to a decade that the big public-sector plans are able to consistently deliver enviable pensions to members, in part because of the "completely invisible" risks inherent in the model.

"We've now gone 13 years since we had a really bad investment year. Taking a lot of risk during this period was hugely profitable," says Hamilton, a senior fellow at the C.D. Howe Institute and retired pension actuary who spent more than 30 years at Mercer Canada advising public and private sector pensions.

But how long will this run last?

He admits it would take a bad decade, not just a bad year, to really rock any of the major pension funds. But while we haven't seen such a period since the 1970s, eventually, inevitably, we will have a bad decade.

"When the bad years come, they're going to take a beating."

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Many argue that the pension funds first fell in love with real estate and other hard assets back in the 1990s, when the Ontario Teachers' Pension Plan went shopping at the mall — and bought it.

Teachers' took a major stake in Cadillac Fairview, owner of Toronto's Eaton Centre and other malls, in 1995, and by 2000 it bought the commercial property company outright, becoming the owner of the Eaton Centre and Toronto-Dominion Centre, among dozens of other big-name malls and office towers that now include the Deloitte Tower in Montreal, Maple Leaf Square in downtown Toronto and White City Place in London, England.

This real estate bet came within years of Teachers' evolution to becoming an arm's-length institution from the provincial government. Its leaders — professional investment managers — would become the pioneers of a whole new approach to investing retirement savings in Canada.

Real estate was a crucial pillar of that. Reliable rent revenue that increases with inflation is seen as an ideal counterpoint to the benefits the funds must pay to their pensioners.

Before that time, most pensions operated on a pay-as-you-go approach, where employers and current workers made contributions that paid for the retirement benefits of current pensioners and so on. Any extra money on hand was typically invested in government bonds.

That worked well in times of steady economic growth and an expanding population, but when those trends slowed in the 1970s and 1980s, concerns about shortfalls, slashed benefits and higher contributions mounted.

Beginning largely in the 1990s, federal and provincial governments changed the rules around public-sector plans, letting them invest in the broader market and eventually even scrapping limits on investments outside of Canada.

"People forget we were created because the Canada Pension Plan was going bankrupt," says Michel Leduc, senior managing director and global head of public affairs and communications at CPP Investments. "So there were a number of reforms and one of them was to expose the fund to capital markets."

(Out of the big eight funds — CPP, the Caisse de dépôt et placement du Québec, Ontario Teachers' Pension Plan, Public Sector Pension Investment Board, B.C. Investment Management Corporation, Alberta Investment Management Corporation, OMERS and Healthcare of Ontario Pension Plan — CPP was the only one that agreed to an interview for this story, while the others provided written comments.)

In 1993, according to Statistics Canada, Canadian public-sector pension plans (the data doesn't include CPP) had assets worth a combined $161 billion, and 58 per cent of that money was in ultrasafe, fixed-income investments such as bonds, mortgages and

guaranteed investment certificates.

By the end of 2020, however, the public-sector plans had $1.6 trillion invested in assets and fixed income accounted for just 32 per cent of that, down by almost half since the early 1990s.

To be sure, the big eight still invest in public stocks — as of March 2021, for example, CPP owned $1.4-billion worth of shares in Facebook and almost $2.8 billion in Chinese e-commerce giant Alibaba — but the area of growth has definitely been alternative investments in buildings, property, infrastructure and private companies.

With private assets that don't trade on public markets — a piece of land in Asia, a pipeline in Alberta, or an office tower in Australia — the funds rely on periodic appraisals to determine their value. Those values are not verifiable by outsiders and can suggest a stability the investments may not actually possess.

Alexander Dyck, professor of finance at University of Toronto's Rotman School of Management and board member for Rotman's International Centre for Pension Management, says he's concerned about how difficult it is to value such investments over the short term.

A pension fund could invest in a bridge or power dam, but "we'll only be able to find out in 20 years whether it was a good investment or not," he says. "There has been appetite at places like CPP to invest in assets for a longer period of time."

"I'm going to tell you that makes me nervous because I think it's a lot harder to provide accountability that people aren't just investing for the fun of it."

For the investment managers working at the funds, Dyck says, it can be "more fun to do things actively than passively."

"You get to meet everyone around the world, you're a player in every single investment," he says, adding, "I'm worried there could be an overinvestment in doing these things when the returns don't merit the costs."

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Making big bets on interesting assets around the world is undoubtedly fun. But it's also getting expensive.

When CPP began its active investing approach in earnest in 2006, it had 164 employees. Last year, it had almost 2,000 working in nine offices around the world.

Expenses have climbed to $4.4 billion in fiscal 2021 from less than a billion dollars a decade ago.

"We're fighting — for assets, for partners, for talent, for favourable policy decisions around the world — with hundreds of big plans, and some of them are trillion-dollar behemoths," Leduc says, explaining the rationale for CPP's spending.

The fund spends 98 cents on expenses for every $100 in net investments it manages. And while CPP has the highest ratio of costs to investments, the rest of the big eight pension funds and asset managers have also added to their staff and expenses over the years.

In responses to the Star, the funds emphasize that — on top of the value for pension plan members from benchmark-beating returns over the years — they save money by using internal investment managers for the majority of their assets.

The funds also say they have different business models, and most told the Star they object to direct comparisons on their returns and expenses.

In other words, they say, it may be pricey to invest like one of Canada's big pension funds, but so far at least, even after factoring in the higher cost, it has paid off.

Sebastien Betermier, associate professor of finance at McGill University's Desautels Faculty of Management, says his research shows that Canadian pension funds got better returns than their international peers from 2004 to 2018, after taking costs into account.

When they do turn to outside advisers, which come with expensive performance fees, it's like a well-earned splurge, he says: "The Canadian funds are cooking at home a lot with good ingredients and then they can afford to go to a high-end restaurant."

"I think it's fair to ask about cost," says Leduc, but he argues that conversation should come with a solid understanding of what goes into those expenses and how they support the fund's goals.

Part of the problem is the unrelenting demand for higher and higher returns as more Canadians retire, leaving fewer working contributors to support them.

When it comes to the majority of the money CPP manages, benefits owed to retirees are starting to outstrip contributions, so the fund has set an increasingly aggressive benchmark to evaluate its performance.

Its reference portfolio — approved by its board — now includes an eye-popping weighting of 85 per cent in global equities and 15 per cent in government bonds. That's up from 65 per cent in a mix of global and Canadian equities in 2015.

The other large funds have different business models and through statements of investing policies or benchmark portfolios they generally call for less risk than the CPP (none state their risk appetites quite as clearly as CPP), they still tend to take more risk than the classic 60/40 split between equities and fixed income.

The three Ontario funds (OMERS, HOOPP and Ontario Teachers') manage defined-benefit pensions and must invest according to the specific needs of their members — largely an aging demographic — and funding status of their plans.

The Caisse, PSP, BCI and AIMCo invest money on behalf of multiple different clients — pensions, insurance plans, government funds and more — and all have different mandates and risk profiles that can depend on the client.

Even CPP doesn't invest 85 per cent of its money in public stocks — in fact, more than half of its investments are in private markets around the world — but the mandate means it invests in assets with a similar risk profile.

Leduc says some of CPP's assets straddle the characteristics of equities and fixed income, pointing to the example of a toll road, which offers a steady income stream resistant to interest rate fluctuations. (For a local example of such an asset, CPP is a major investor in the tolled Highway 407 ETR.)

But the risk of investing in a toll road is that a lot of things — including rising interest rates and new government policies or regulations — can impact what it's worth.

Now that central banks, including the Bank of Canada, are raising interest rates and paring back other monetary stimulus, Philip Cross says alternative assets like the toll road could be hit.

"We'll see what happens to those asset prices as we start to normalize," says Cross, former chief economic analyst at Statistics Canada who has written about the cost of the pension funds for the Fraser Institute and co-authored a paper on risk with the C.D. Howe Institute's Hamilton.

He's not convinced the pension funds have cracked the code for how to beat the market in the long run, noting that such an accomplishment is basically the Holy Grail of the investing world.

"I don't think this country ... questions this industry enough about what is going on," he says. "The one thing we're sure of is you people (at the funds) are making a lot of money on this."

One big question some influential organizations *have* been quietly asking is this: What would happen to the pension funds if markets took a drastic change for the worse?

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Because they've been quietly successful and don't invite a lot of scrutiny, Canada's big pension funds don't get a lot of bad press. That's why it was notable when, in a 2016 publication, the Bank of Canada pointed to the potential for trouble.

In a few lines — and in language as dry as you'd expect from the country's central bank — the paper noted that the funds were bulking up on "more illiquid assets, combined with the greater use of short-term leverage."

"If not properly managed," it said, "these trends may lead in the future to a vulnerability that could create challenges in a severely stressed financial environment."

Three years later, in a report on the stability of Canada's financial system, the International Monetary Fund pointed to "rising risk-taking" by the country's pension funds, noting the increased use of complex financial strategies, increased leverage and exposure to illiquid asset classes, among other concerns.

"In the event of market stress, rising liquidity and valuation risks could magnify losses and market volatility," the IMF report said.

Here in Ontario, the Financial Services Regulatory Authority of Ontario (FSRA), which regulates employer-sponsored plans registered in the province, has also flagged the issue.

The FSRA said in a report last year that it is monitoring risk-management practices related to alternative assets, noting that while such investments are attractive for their potential returns, they "come with complexities that introduce additional risks to plans."

And in fact, the recent market turmoil of March 2020, the first month of the pandemic, put significant pressure on the big eight funds to suddenly increase liquidity, according to another Bank of Canada report.

It found the funds were generally able to meet increased demands for cash by borrowing against equities, using other short-term borrowing strategies and selling bankers' acceptances (securities based on short-term bank loans taken out by businesses).

But what if that difficult month had become a sustained financial downturn that spanned years or even a decade?

Asked about that scenario, the funds all told they Star they have prepared for market stress by diversifying their investments across the world and in different asset classes.

The Caisse also says it limits the use of leverage to no more than 10 per cent of investment value, while OMERS says it deploys leverage "prudently" to improve investment returns.

"Active management becomes even more important," when it comes to the prospect of an extended downturn, says CPP's Leduc, adding that the fund runs hundreds of scenarios as part of a stress-testing approach to evaluate potential risks.

"Are we completely immune to a very severe, long period of downturn? No, of course the fund would be impacted by that," he says. "However, we believe we would hold up much stronger than without active management and diversification."

Hamilton, who has written papers on the topic for both the C.D. Howe and Fraser Institutes, is not convinced.

"You can hide anything in a pension plan for a decade," he says, noting that periodic funding valuations and smoothed estimates of asset values could help pensions delay the disclosure of something disastrous for several years. "But at the end of the bad decade they'd have to admit they lost just a ton of money."

With half or more of their investments in private markets, many of the biggest funds have made a huge commitment to illiquid assets, Hamilton says. If those values plummet, if the assets can't be sold, or both, pension plan members would be hard-pressed to make up for a large shortfall just by upping their contributions.

That's in part because of the sheer size of the funds.

Take Ontario Teachers', for example. It's worth about $240 billion, and while members and their employers' contributed $3.4 billion in 2021, the fund paid out $6.9 billion in benefits.

If it were faced with a very large loss on investments, the fund's sponsors (unions and employers) have three basic options they could use alone or in combination: increase member and employer contributions, slash benefits for retirees, or cut inflation indexing on some retirement benefits (the latter being a contingency policy the fund introduced in 2008).

In its annual report, Teachers' says indexing alone can be a powerful "risk management tool." In a hypothetical extreme scenario where it was facing $104 billion in asset losses, Teachers' says that by 2031 it could absorb that shortfall entirely by cutting inflation indexing to 50 per cent on retirement benefits earned between 2010 to 2013 and permanently eliminating indexing on benefits earned after that time.

That step is unlikely to be used in isolation — the permanent loss of inflation-indexed retirement benefits would no doubt be a major blow to plan members — and Dan Madge, a Teachers' spokesperson, says that in practice, the fund's sponsors view the policy as much more likely to be used in a temporary fashion to address smaller funding shortfalls. (Madge also notes Teachers' has been fully funded for nine consecutive years.)

Still, if some painful combination of benefit cuts and contribution hikes turns out not to be enough for any public-sector plan facing a large investing loss, Hamilton says it could be taxpayers who are called on to bail out the funds (except for CPP, he says).

Which leads one to wonder: Is there another way? Could Canada's pension funds continue to stay solvent without resorting to short-term leverage and exotic investments?

In fact, there are other ways of approaching the management of vast sums of pension and public money, says Dyck, pointing to Norges Bank Investment Management, a Norwegian sovereign wealth and pension fund manager with about $1.8 trillion (Canadian) in assets.

The fund uses a largely passive investing approach (with low limits set for leverage on equities and fixed income), and in 2021 it reported a 10-year annualized return on investment of 9.65 per cent.

Just 2.5 per cent of its assets are in real estate, 0.1 per cent of the fund is invested in renewable infrastructure and it has no private equity stakes. More than 70 per cent of its money is in equities with the balance in fixed income, and NBIM's costs are extremely low — its expense ratio in 2021 was just 4 cents per $100 invested.

"The question is," Dyck says, coming back to the Canadian approach, "by having more than 50 per cent in private markets ... are they generating a risk-adjusted return that compensates for the additional risk that we're taking on?"

There's nothing inherently wrong with a riskier approach, he says — after all, the higher returns help keep contributions lower — but stakeholders don't always have a clear understanding of what could be at stake.

"There's a hidden risk," Dyck says. "There's an assumption that these returns are guaranteed, which of course, they're not."

Friday: *Why OMERS CEO Blake Hutcheson isn't dwelling on the past.*

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