CIBC MELLON

CHAPTER 2

In Search of New Value

IN-HOUSE CAPABILITIES ARE ON THE RISE AMONG CANADIAN PENSION FUNDS, BUT OUTSOURCING REMAINS VITAL

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Foreward

Canada's pension plans enjoy a well-deserved global reputation for strong management and resilient performance, but they are not immune to shocks in the markets in which they operate. The COVID-19 pandemic has been testing pension plans and their asset managers, prompting significant volatility in financial markets and reshaping the global economy.

This is the backdrop against which we surveyed 50 of Canada's leading pension plans, seeking insights into how they have coped with the crisis, the challenges and opportunities that now lie ahead, and how they are positioning themselves accordingly.

Our **first chapter** explored how pension funds are adapting their investment strategies. In this second chapter, we present insights, opportunities and challenges with which Canadian pension funds are grappling as they seek to position their organizations for the future. In particular, we explore how Canadian pension plans are significantly advancing their in-house teams and capabilities with respect to investment and technology operations, even as they look to strategically outsource key functions to achieve scale and capture opportunity.

Over the months ahead, we will invite you to join us as we explore other dimensions of Canada's innovative pension and investment landscape.

In-house capabilities are on the rise, but outsourcing remains vital

64% of pension managers believe that **clearer alignment of strategies** to long-term objectives is one of the key benefits of in-house asset management.

66% of pensions report that bringing asset management in-house has **generated cost savings,** with 91% of those achieving savings of more than 10%.

Pension funds say the leading barriers to in-house management:

- **Internal expertise**
- **Technology**

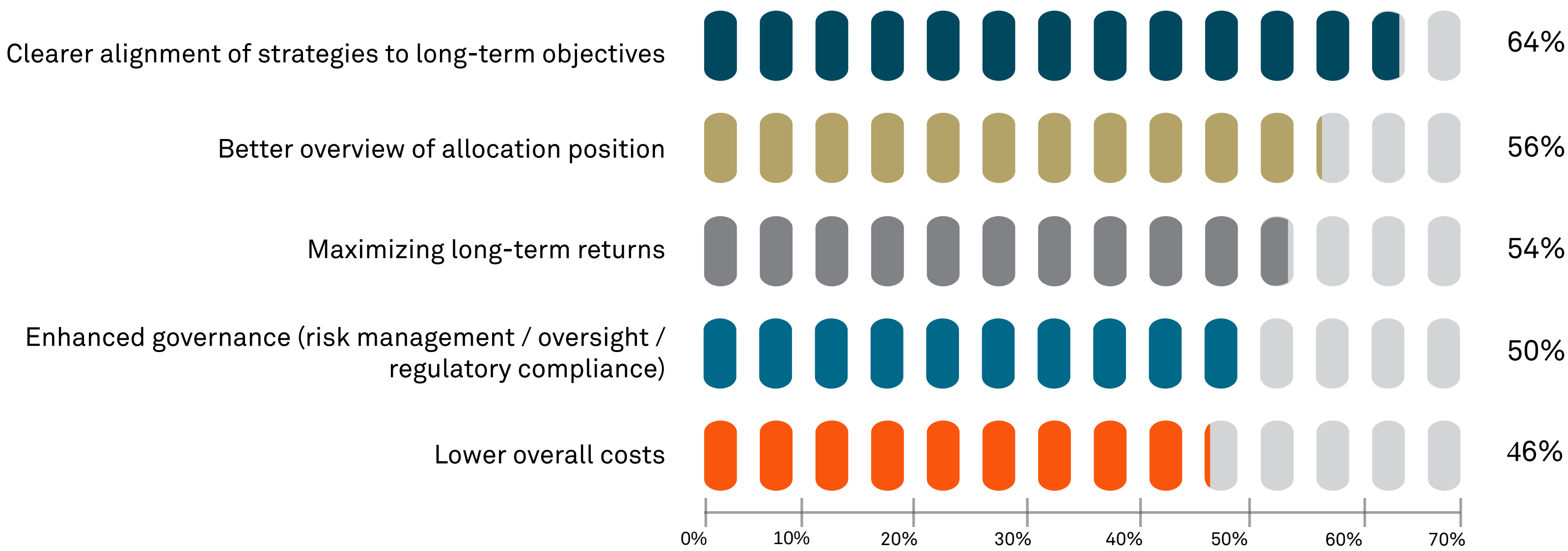
86% of pensions using external managers intend to **look for lower fees** over the next 12 months.

Many Canadian pension funds anticipate an increasing proportion of their assets being managed in-house over the coming months and years and there are good reasons for this. Many view in-house management as the best way to understand the context in which portfolio choices must be made.

Almost two-thirds (64%) of pension managers say one of the most important advantages of in-house management is a clear strategic alignment of the long-term objectives for the fund. Just over half (56%) point out that in-house teams have a better understanding of the plans overall asset allocation.

The question of governance is also particularly important. With pension plan sponsors and managers coming under increased scrutiny from regulators, plan members, employers, counterparties and other stakeholder groups, the fact that an in-house team can potentially enhance governance may become even more crucial. Complexity rises further for multi-employer plans operating on behalf of a larger set of underlying organizational public and private sector stakeholders. Half of the respondents see stronger governance as a key benefit of operating with an in-house team.

What are the top benefits of in-house asset management / insourcing? (Select top three)



64%

of pension funds believe that clearer alignment of strategies to long-term objectives is one of the key benefits of in-house asset management.

Pension funds say the leading barriers to increased use of in-house asset management are their **internal expertise** (70%) and their **technology capabilities** (60%).

86%

of pensions using external managers intend to look for lower fees over the next 12 months.

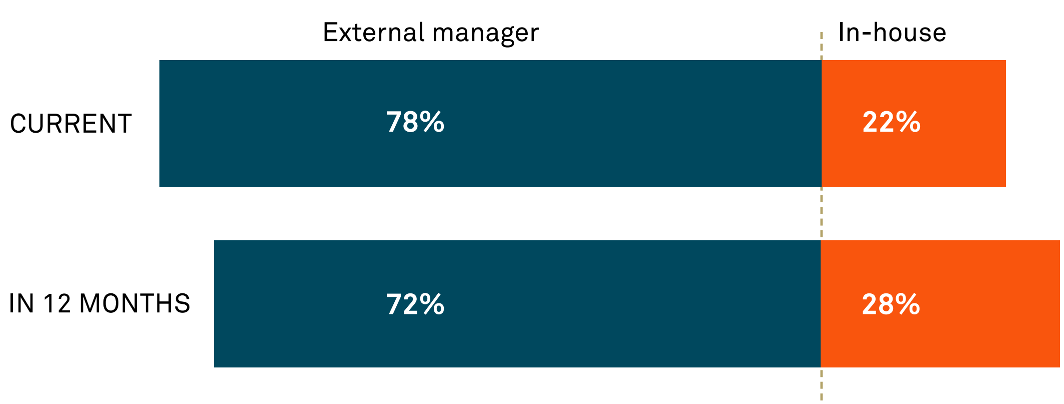
Pension funds are moving in-house

As we **explored in Chapter 1,** many Canadian pension funds are preparing to bring assets and investment activities in-house. Currently, the funds in our survey manage an average of 22% of assets in-house, but this is expected to rise to 28% over the next year.

This may indicate a desire to bring costs down, with in-house teams often cheaper to manage than external mandates, but it also reflects the strong record of the Canadian pension fund sector in managing assets in-house. Studies have shown that the industry's strong performance compared to international peers is at least partly explained by its greater use of in-house management teams.[1]

At the same time, as the managing director of one fund points out, some funds simply want more control: "The investment and risk environment has been rapidly changing. We want better control of decisions and closer involvement will ensure that performance increases each year. We are aiming at a 10% increase in in-house management in the next 12 months, but this depends on how fast teams can adapt and recognize the opportunities and various risks attached to investing."

What percentage of your total portfolio is managed by in-house teams versus by external managers?



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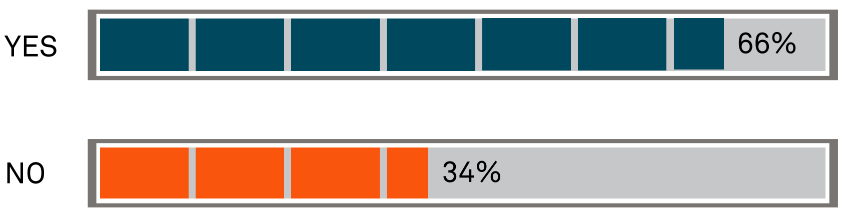
Managing Director,
Pension fund organization

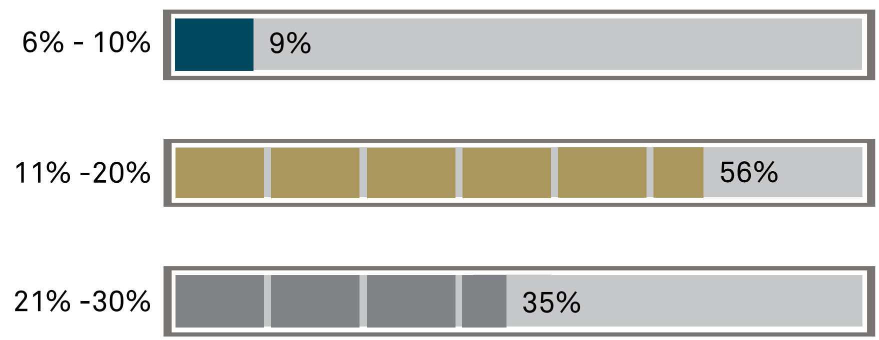
There is the question of cost: 46% of pension funds point to the lower costs of operating in-house management teams. In an era of low interest rates and low returns, this will be crucial – and some studies suggest that Canadian pensions are reducing their costs by as much as a third by favoring an in-house approach.[2]

Our research supports this finding. Of the pension funds that have taken asset management in-house, two-thirds (66%) say they have enjoyed savings as a result, with 91% of those reporting savings of more than 10% – including 35% who claim to have saved more than 20%.

Have you seen a cost saving since taking asset management in-house?



What has been the average percentage saving compared with outsourcing asset management?



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“Our plan operates a robust external manager program, and we have achieved strong results by outsourcing rather than building in-house. We appreciate the flexibility to seek out best-of-breed managers across Canada and around the world. For example, we are able to achieve a very competitive cost profile for the external management of our fixed income assets. It is also easier to replace underperforming external managers than in-house teams.”

Pension Plan Chief Financial Officer

Talent and technology are a challenge for in-house management

Given that in-house asset management appears to offer both superior alignment of investment strategy and lower costs, why are pension managers not embracing in-sourcing in even greater numbers? First and foremost, the move to in-house management is not straightforward, from the technology required to the talent involved.

"Maintaining in-house technology capabilities and in-house expertise are challenging," says the chief financial officer of one fund. "Addressing skill gaps is difficult at a time when the economic situation is changing and most companies are looking to adapt. Increasing technology capabilities is challenging because of the significant downtime that is involved."

Talent is indeed a key challenge and a focus area for many plans. Almost three-quarters (70%) of pension managers regard in-house expertise as one of the top three issues they have to confront in any shift to in-house asset management. As we have seen, Canadian pension funds are pursing investment strategies founded on portfolios with diverse assets, including significant holdings of alternative assets. Securing sufficient expertise in such a broad range of areas is naturally difficult.

It is also notable that 60% of pension fund respondents also cited concerns related to insufficient investment management experience on their Boards.

As for the question of technology, "with the asset management sector relying on a process of near constant renewal of its IT competencies, many pension funds worry about their ability to keep up in this arms race."

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The top quartile returns delivered by the Trans-Canada Capital Inc. (TCC) investment team have been a major factor in the financial turnaround of Air Canada's Canadian pension plans, in which a $4.2 billion solvency deficit was eliminated and replaced by a surplus of over $2 billion. Over the years, TCC has developed unique skills in managing pension assets with a specific expertise covering Canadian fixed income, absolute return hedge funds and alternative investments. Building on this valuable experience, TCC is now proud to offer its unique expertise to third-party institutional investors, including pension plans, foundations and endowment funds.

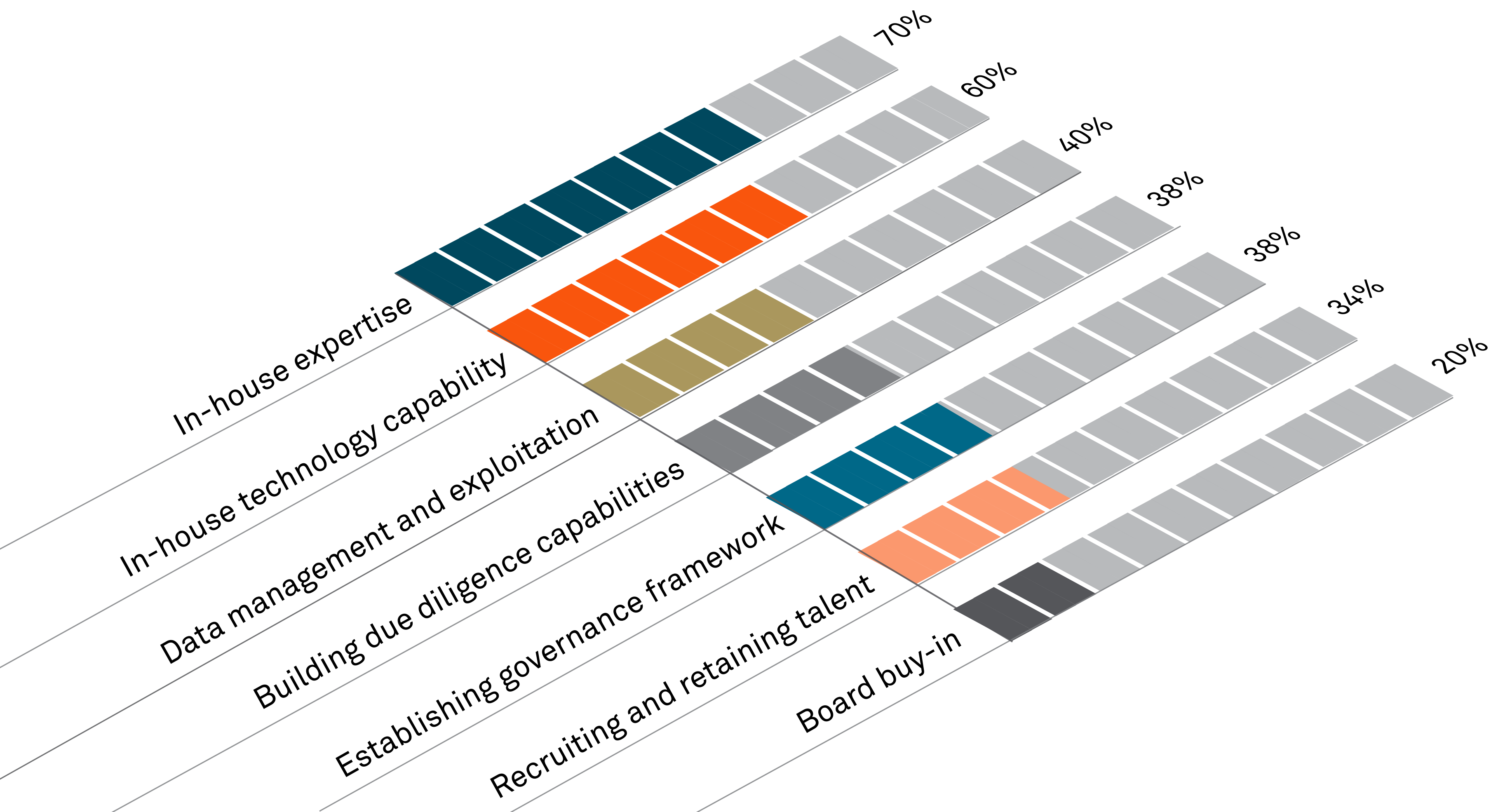
While innovation and sophistication are key elements of our ongoing success in these challenging markets, teamwork and the quality of our people provides us with a competitive edge."

Julie Pominville
Chief Operating Officer
Trans-Canada Capital Inc.

Some 60% point to in-house technology capabilities as standing in the way of in-house asset management. That bar is only likely to move higher as tools and technologies such as data analytics, data science, machine learning and artificial intelligence become more embedded in the asset management sector. Data is increasingly the lifeblood of the investment process, with rapidly rising complexity across asset classes, global markets and information sources. Many asset owners, like many other institutional investors, have evolved technology environments over time through iteration, and are facing challenges as their goals and needs outstrip the capabilities available from their legacy technology platforms. Already, 40% of funds say they worry about their abilities in data management and exploitation.

The challenges of in-house management are further multiplied when plans move into private market investments, with cross-border complexities, data inconsistencies, transparency barriers and an intense and relationship-driven competition for deals. Given these challenges, the intense competition for talent that can deliver outsized results is no surprise.

What are the main challenges to in-house asset management? (Select top three)



> **With the asset management sector relying on a process of near constant renewal of its IT competencies, many pension managers worry about their ability to keep up in this arms race.**

Darcie James Maxwell
Lead Architect, Client Data Solutions

Top three challenges to in-house asset management

70%
In-house expertise

60%
In-house technology capability

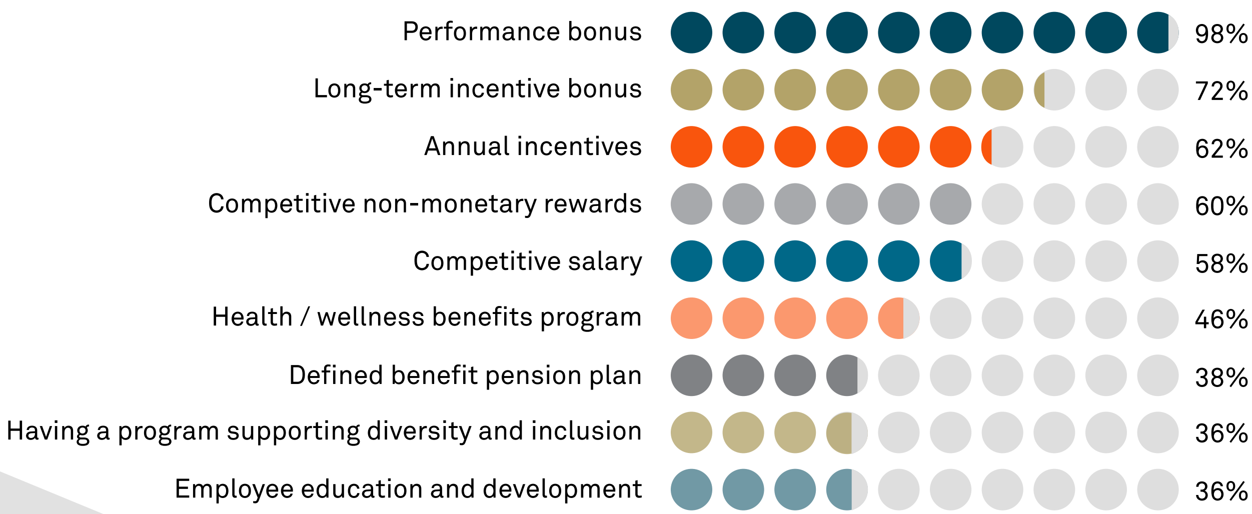
40%
Data management and exploitation

Pension funds are working hard to address these issues, with a significant number drafting in large teams of asset management professionals. A fifth of pension funds (20%) now have more than 100 members of staff employed directly in asset management. A further 10% employ between 51 and 100 asset management professionals, though in most cases the numbers are smaller.

With 34% of pension funds citing recruitment and retention as a significant challenge to in-house asset management, many funds are now focusing on incentives to address this issue. Almost all pension funds offer staff performance bonuses, but many are also looking at a wider range of broader benefits. Some 60% point to the non-monetary rewards they offer; 46% offer health and wellness programs; and 36% point to employee education and development initiatives.

Casting the net for talent more broadly may also be a crucial driver of success in recruiting and retaining the teams required. Already, more than a third of pension funds (36%) say they operate a program that supports diversity and inclusion. **With substantive research suggesting more diverse asset management teams deliver superior performance, this will no doubt be an area of increased investment in the years ahead.**[3]

What incentives do you have to recruit and retain appropriate talent? (Select all that apply)



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Pension Fund Chief Financial Officer

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Successful outsourcing: pension funds demand more

Despite their plans to manage more assets in-house, it is also clear that outsourced asset management remains important for Canadian pension funds. This makes sense given some of the barriers standing in the way of in-house asset management functions, but also because of the specialist expertise that external managers can offer.

“The majority of our assets are managed externally,” says the director of investments at one pension fund. “It limits the risk and liability for our organization, with an assurance of returns as well. We collaborate with managers on a regular basis to improve our understanding of the investment strategies employed and to gauge their suitability overall.”

Such pension funds will need to choose these managers carefully, with rigorous selection processes and performance and compliance measurement under-pinning their outsourcing programs.

Better returns are one of the top three drivers for those appointing external managers, cited by 58% of pension funds. This goes hand in hand with a desire to secure broader expertise and specialist services, which 56% of funds cite as important.

Many pension funds are identifying asset classes or investment specialties where they believe exposure is desirable and then appointing the managers they believe can deliver in these areas.

What are the key drivers for using external asset managers / outsourcing over in-house management? (Select top three)

Top three key drivers for using external asset managers / outsourcing over in-house management:

58%

Better projected returns

55%

Broader expertise / specialist services

52%

Complexity of funds

Canadian pension funds are determined to hold their external managers to account. Pensions know they will face rising reporting needs from their boards and trustees, which includes demonstrating strong oversight over their external manager or OCIO programs. Pension sponsors have taken the Canadian regulatory position to heart: they can outsource an activity or its execution but they cannot outsource the ultimate responsibility or duty.

Many funds are not only looking for more from their external managers, they are also seeking to pay less for their services. According to our findings, 86% of pension funds say they intend to drive a harder bargain on investment fees over the next 12 months. As we have seen, in-sourcing asset management often secures considerable savings, but many funds are also keen to bring down on costs on outsourced contracts. The demand for greater transparency – highlighted by 80% of pension funds – is part of the same strategy.

It is also significant that 80% of pension funds intend to be more vocal about investment strategies over the next 12 months. Many funds recognize the benefits of in-house management but do not feel this is appropriate for them. Some may wish to focus in-house teams on specific asset classes, while leveraging external managers for other arenas. Others may lack the scale or organizational commitment to undertake the substantial investments into talent, technology and data systems necessary to support an in-house management program. However, where they are continuing to work with external managers, they intend to be more hands-on than in the past. This not only relates to performance, but to broader issues such as governance and – for some – the consideration of non-financial or values-driven factors such as ESG.

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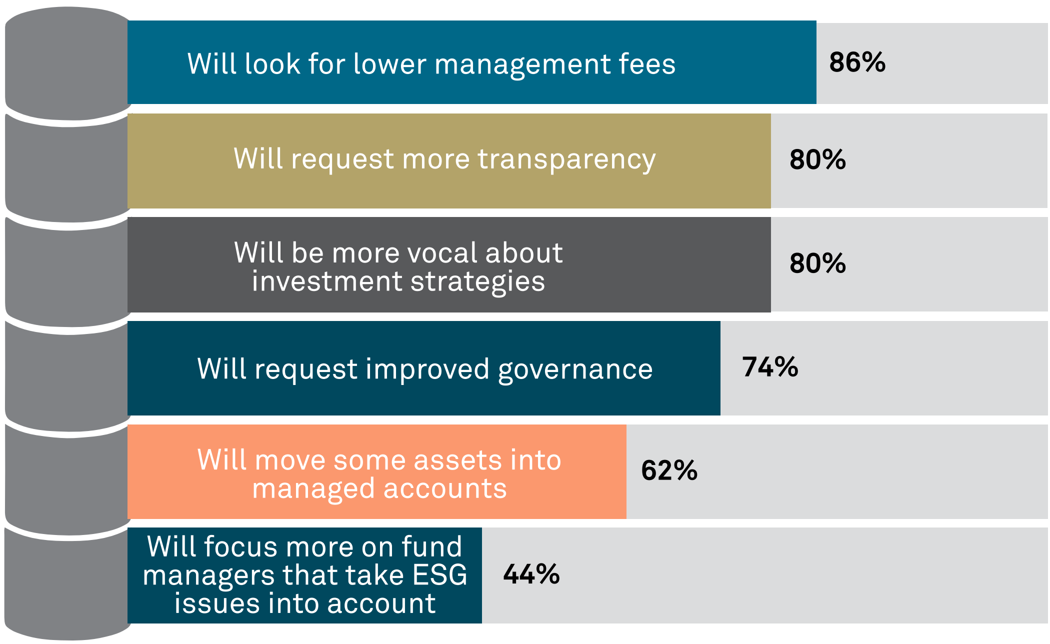
In what ways do you expect your approach to investing in fund managers to change in the next 12 months? (Select all that apply)



"The majority of our assets are managed externally. It limits the risk and liability for our organization, with an assurance of returns as well. We collaborate with managers on a regular basis to improve our understanding of the investment strategies employed and to gauge their suitability overall."

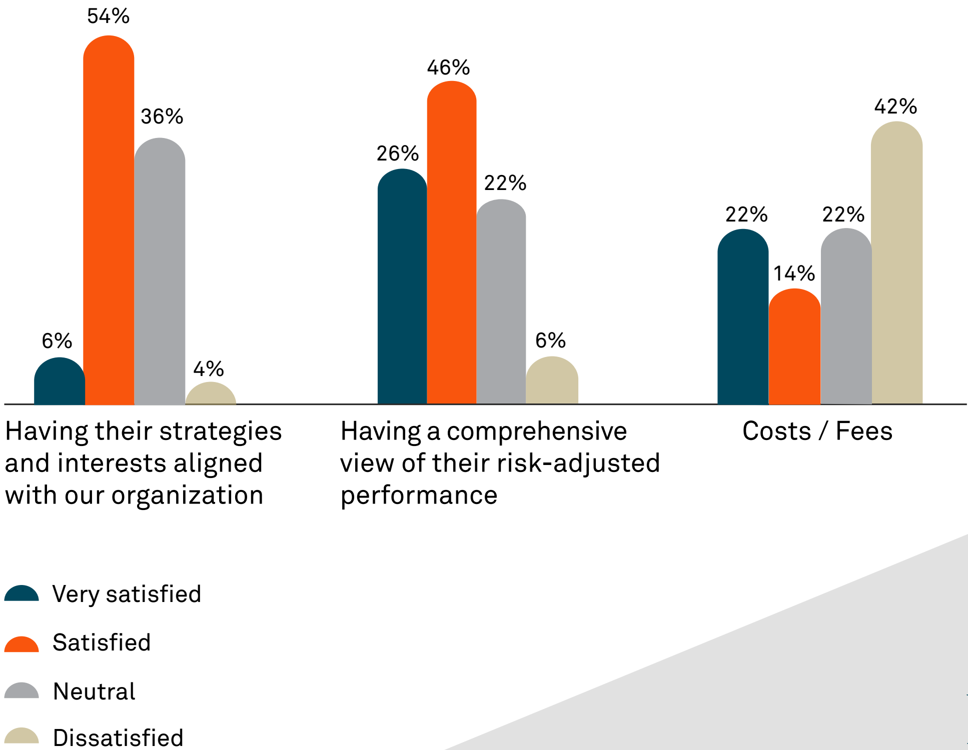
Pension Fund Director of Investments

External asset managers will need to be prepared to rise to the challenge – while many pension funds say they are satisfied with the performance of their external managers in key areas, there is plenty of room for improvement.

On cost, 42% of pension funds say they are not happy with the current fees involved. This focus on cost is likely to feed through into charging models. Already, more than half of pension funds (54%) expect to increase fixed hurdles in performance fees over the next 12 months, including 34% who expect use to increase significantly. Similarly, two-thirds (66%) of funds expect the use of indexed hurdles to increase.

On aligning strategy with investment goals – a key driver for a move to in-house – only 60% of pension funds say they are satisfied or very satisfied with their managers' performance. The number rises to 72% on the extent to which managers have a comprehensive view of funds' risk-adjusted performance, but here too there is room to go further.

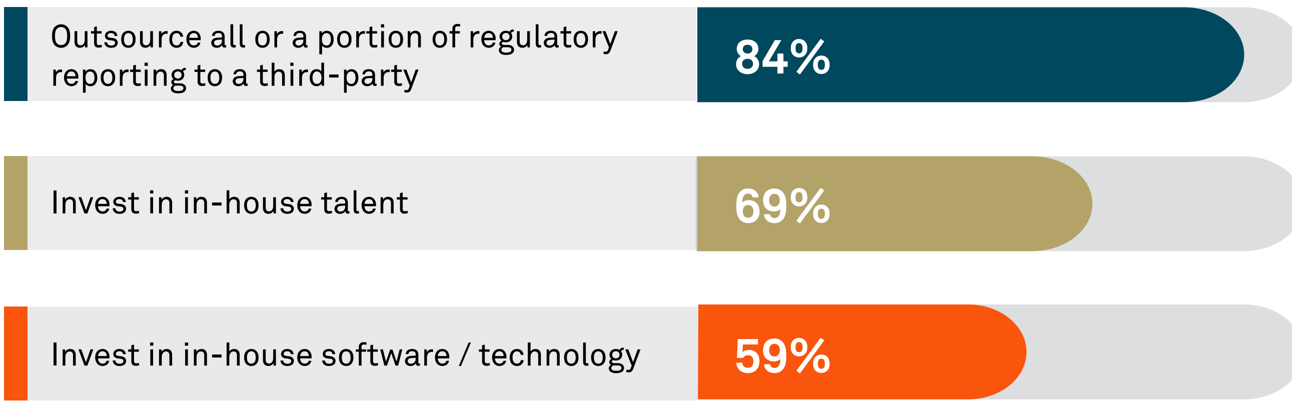
How satisfied are you with your external managers in the following areas?



> Only 60% of pension funds say they are satisfied or very satisfied with their managers' performance. As pension plans reposition their investments, this may create opportunities for leading external managers to capture new mandates based on outperformance, cost containment or their ability to demonstrate closer strategic alignment to pension funds' goals."

Finally, it is important to recognize that pension plan sponsors and pension fund managers are looking across the board at the in-house versus outsourcing debate - from operations to technology to investment management. While 84% of funds say they will outsource at least some of their regulatory reporting work over the next 12 months, it is notable that this is also an area prioritized for in-house investment. Some 69% and 59% of pension funds respectively report they will invest in talent and technology in this regard.

How do you expect your organization to meet its legal and regulatory requirements over the next 12 months? (Select all that apply)



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Shilpa Savla
Assistant Vice President, Institutional and Pension Accounting

“Pension plan administrators are under tremendous and rising pressure to exercise good governance - from regulators, boards, trustees, governments and individual members. Governance audits or reviews should be regularly undertaken to review compliance, best practices and areas for potential improvement.”

“Canadian pension plan sponsors and fund managers remain relentless in their pursuit of stronger outcomes for stakeholders. Boards and Trustees demand sustainable returns, dependable operations and attentive service to plan members - all while reinforcing sharp focus on compliance and sound governance. Even the largest plans increasingly recognize they lack the scale and resources to be the very best at everything for which they are ultimately accountable. As a result, they continue turning to strong and specialized providers for support as they focus their time and resources on the areas where they can drive greatest value for plan members.”

Ian Fulton
Assistant Vice President, Institutional and Pension Accounting

“As we have seen, Canadian pension funds are pursuing investment strategies founded on portfolios with diverse assets, including significant holdings of alternative assets. Securing sufficient expertise in such a broad range of areas is naturally difficult.”

Alistair Almeida
Segment Lead
Asset Owners

Methodology

In 2020, CIBC Mellon's research provider interviewed senior executives, including directors of investment, CEOs and managing directors, from 50 pension funds headquartered in Canada to assess their asset management trends, including their response to the impact of COVID-19. The funds being managed were split evenly between those with AUM of C$600million -C$1.2 billion to those with AUM over C$1.2 billion. The average AUM of funds in the study was $C31 billion. Respondents were located across Canada; 26% of respondents were private plans, and 74% public.

Watch for Chapter 3 of our research, which explores how Canadian pension plans are seeking scale via consolidation, and in some cases transforming into asset managers who compete for external mandates.

To learn more, please visit www.cibcmellon.com or contact your Relationship Manager.

1 "The World's Best Pension Funds Are Canadian. Sorry." Institutional Investor. Christine Idzelis. 6 Aug, 2020.
https://www.institutionalinvestor.com/article/b1mtnmnvkzwn2j/The-World-s-Best-Pension-Funds-Are-Canadian-Sorry

2 "Yes, Canadian pension plans really do outperform their global peers: study". Canadian Investment Review. 12 Aug 2020.
https://www.benefitscanada.com/news/bencan/yes-canadian-pension-plans-actually-do-outperform-their-global-peers-study/#:~:-text=While%20Canadian%20pension%20plans%20hold,McGill%20University%20and%20CEM%20Benchmarking.
https://www.mcgill.ca/delve/article/article/canadas-pension-plan-envy-world-and-now-we-know-why

3 "Diverse asset managers continue to beat benchmarks, says NAIC performance study". Private Equity Wire. 30 March 2020.
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