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In Search of New Value

CANADIAN PENSION FUNDS ARE ADAPTING THEIR INVESTMENT STRATEGIES FOR A POST-COVID-19 ENVIRONMENT

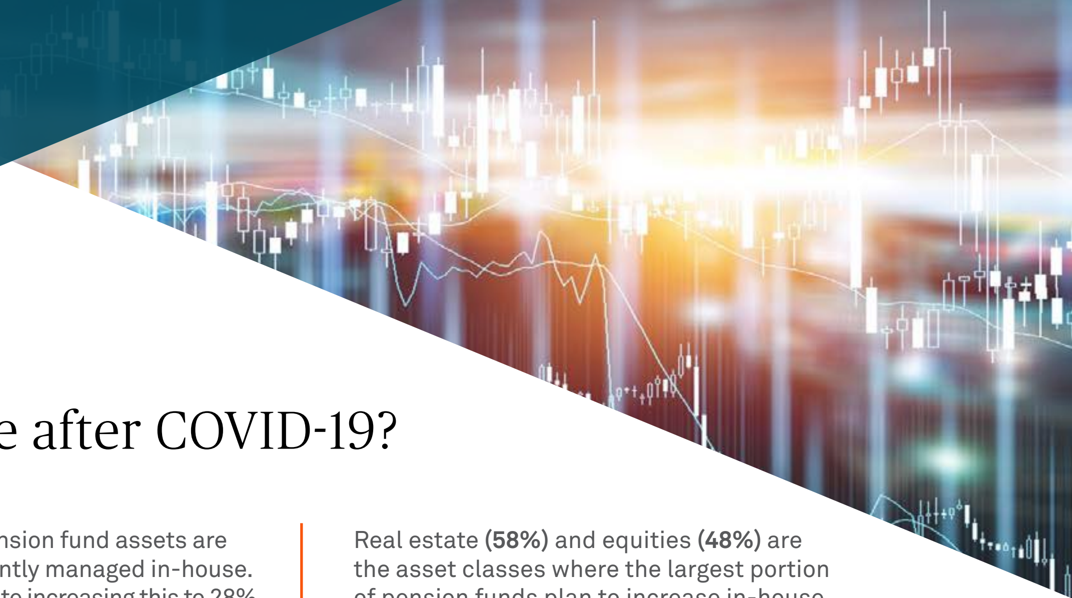
Foreward

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.

In the first chapter of our report, we present our findings with respect to how pension funds are adapting their investment strategies. Over the months ahead, we will invite you to join us as we explore other dimensions of Canada's innovative pension and investment landscape.

Investment strategy



What will life look like after COVID-19?

86% of pension funds expect to reduce investment in infrastructure over the next 12 to 24 months;

- 90% expect to increase investment in private equity.
- 86% say the same of fixed income.

22% of pension fund assets are currently managed in-house. Sponsors anticipate increasing this to 28% in the next 12 months.

Real estate **(58%)** and equities **(48%)** are the asset classes where the largest portion of pension funds plan to increase in-house management over the next 12 to 24 months.

Canadian pension funds have demonstrated their resilience through the COVID-19 pandemic, even after their performance was hit by market volatility caused by the crisis during the first half of the year.

With long-term investment horizons and, typically, a strong credit profile, most pension funds have the time and flexibility they need to work through the negative impacts of COVID-19. One factor may be the governance model: many Canadian pension plans also operate in the "Canadian Model", as independent organizations overseen by boards of directors on behalf of their employee and employer stakeholders.[1] These groups focus on meeting long-term pension obligations on behalf of members – a model the World Bank recognized[2] as enabling longer-term decision making. Long-termism is, of course, not exclusive to jointly-sponsored plans, with many large Canadian single-employer pensions, endowments and foundations taking a similar perspective.

Nevertheless, uncertainties remain, providing potential for further volatility in asset classes worldwide. The investment outlook for 2021 is clouded by many unknowns, including the trajectory of vaccination deployment, the emergence of new strains of the virus, pivots in U.S. policy brought about by the Biden administration, and to the post-Brexit evolution of Europe. In this context, pension funds continue to review their asset allocations, investment strategies and their investment operations models.

Ash Tahbazian
Chief Client Officer

> "Asset owners and asset managers require timely insights, effective solutions and responsive execution as they work to position their organizations to succeed in today's rapidly shifting environment. Canadian asset owners continue to reinforce their position as global leaders with the strategy and the resources to succeed and win on the global stage."

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of pension fund assets are currently managed in-house. Pension managers anticipate increasing this to 28% in the next 12 months.

Real estate (58%) and equities (48%) are the asset classes where the largest portion of pension funds are planning to increase in-house management over the next 12 to 24 months.

A shift by 86% of Canadian pension asset manager respondents to decrease their allocations to infrastructure represented an unexpected departure from anecdotal global trends. It also represents a departure from the pre-pandemic expectations of Canadian alternative asset managers.

This suggests further discussion may be warranted; our enterprise will explore this further in the year ahead, and we look forward to conversations with clients navigating both sides of the trend.

Alistair Almeida
Segment Lead
Asset Owners

Private equity on the rise, and a clear shift away from infrastructure

Investment decisions made by individual funds (or the outsourcing of those decisions) will inevitably reflect their specific circumstances – in particular, the maturity of their plans and their appetite for risk. Nevertheless, in several areas, large numbers of the Canadian pension funds surveyed have significant plans to alter the mix of their portfolios.

Notably, 86 per cent of funds expect to reduce their exposure to infrastructure over the next 12 to 24 months. This may be surprising given the way many funds have sought such assets out in recent years, with falling interest rates encouraging managers to cast their nets more widely for returns. However, while the defensive characteristics of infrastructure remain attractive – including the offer of stable, long-term yields – some have warned of the dangers of over-exposure to illiquid assets.[3]

The COVID-19 crisis has underlined the importance of diversification as well as the vulnerabilities of illiquid assets and Canadian pension fund managers appear now to be rethinking their appetite for infrastructure.

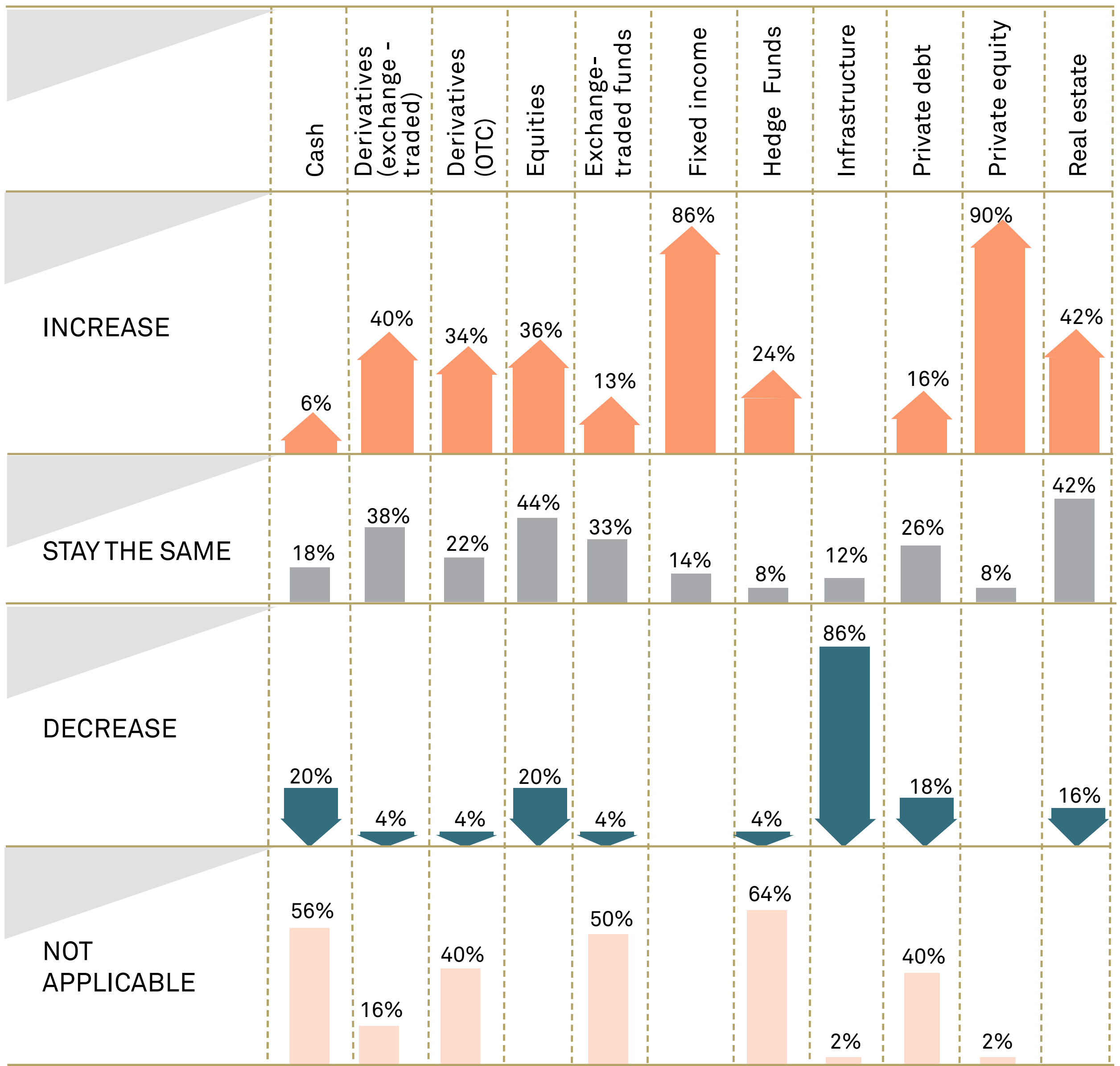
This is not to suggest such exposures will necessarily be redeployed in the public markets. In fact, according to our survey, the asset class most likely to see a rise in allocations is private equity, where 90% of respondents say they intend to increase allocations over the next 12 to 24 months. Almost half of funds (42%) expect to raise their exposures to real estate.

As for more liquid investments, the dominant trend in the wake of this year's volatility is towards "risk-off" asset classes. Almost nine in 10 pension funds (86%) expect to invest more in fixed-income assets in the short term. However, not all funds are taking a defensive stance: 36% plan to increase their allocations to equities, almost twice as many as plan to trim allocations, while 20% anticipate a reduction in the size of their cash holdings.

Infrastructure: Canadians running counter to global consensus?

The shift by 86% of Canadian pension asset manager respondents to decrease their allocations to infrastructure represented an unexpected departure from anecdotal global trends. It also represents a departure from the pre-pandemic expectations of Canadian alternative asset managers, who anticipated maintaining their infrastructure allocations.[4] This shift could indicate repositioning to achieve liquidity goals, portfolio re-balancing to capture gains, or even a strategic departure by Canadian plans relative to their global peers. This suggests further discussion may be warranted; our enterprise will explore this further in the year ahead, and we look forward to conversations with clients navigating both sides of the trend.

How do you expect your level of investment to change in the following asset classes over the next 12 to 24 months?



Many investors are still interested in investing in private debt and with the retrenchment of bank lending this is an asset class that we believe will continue to grow.

Anecdotal evidence suggests Canadian managers are diverging from global peers in reducing allocations to infrastructure.

Megan Gentilesco

Global Head of Private Equity and Credit Fund Services

“The impact of the pandemic continues to be felt and the final outcomes are yet to be known.

As cashflow issues persist in certain sectors, some firms have become challenged. This has resulted in a rise in distressed loans and debt, and in turn to dislocation or distressed credit funds as an area of particular fundraising appeal.

Many asset owners seem to be focusing on known entities, and concentrating investment with asset managers where they have established relationships - both through the launch of new separately managed accounts or investment into newly launched comingled funds. In some cases these relationships have allowed asset managers to quickly launch targeted funds designed to take advantage of current market turbulence.

The challenge for many managers is the ability to originate well today, with more limited capability to undertake detailed due diligence on borrowers. Diligence processes have historically been reliant on a lot of paper and in-person meetings, which have not been possible in the remote pandemic environment. The large volumes of dry powder seeking opportunity, the disruption to paper-based business models, and indeed the rising allocations to classes like private equity mean we will likely see competition continue to rise aggressively across global markets.”

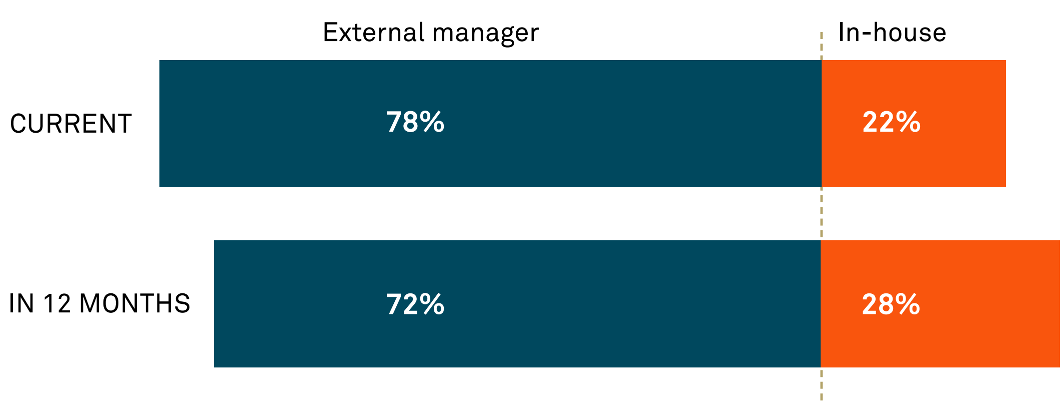
Pension funds are moving in-house

There is also evidence that pension funds are preparing to bring assets and investment activities back 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 (look for more on this in the forthcoming second chapter of our research, 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.[5]

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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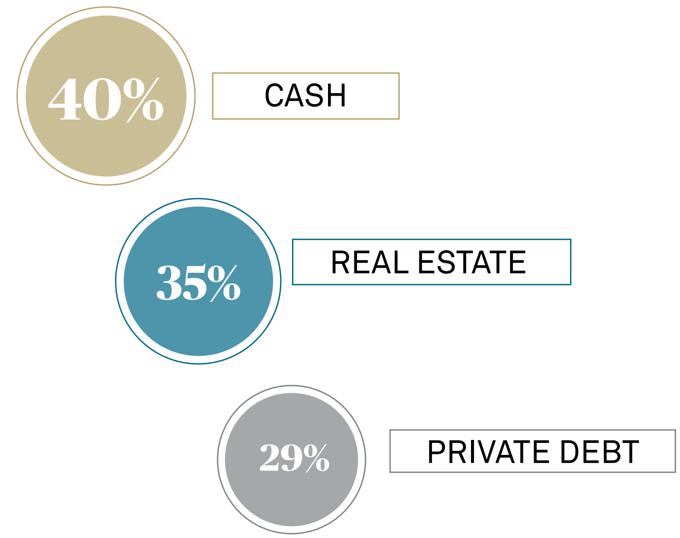
Managing Director,
Pension fund organization

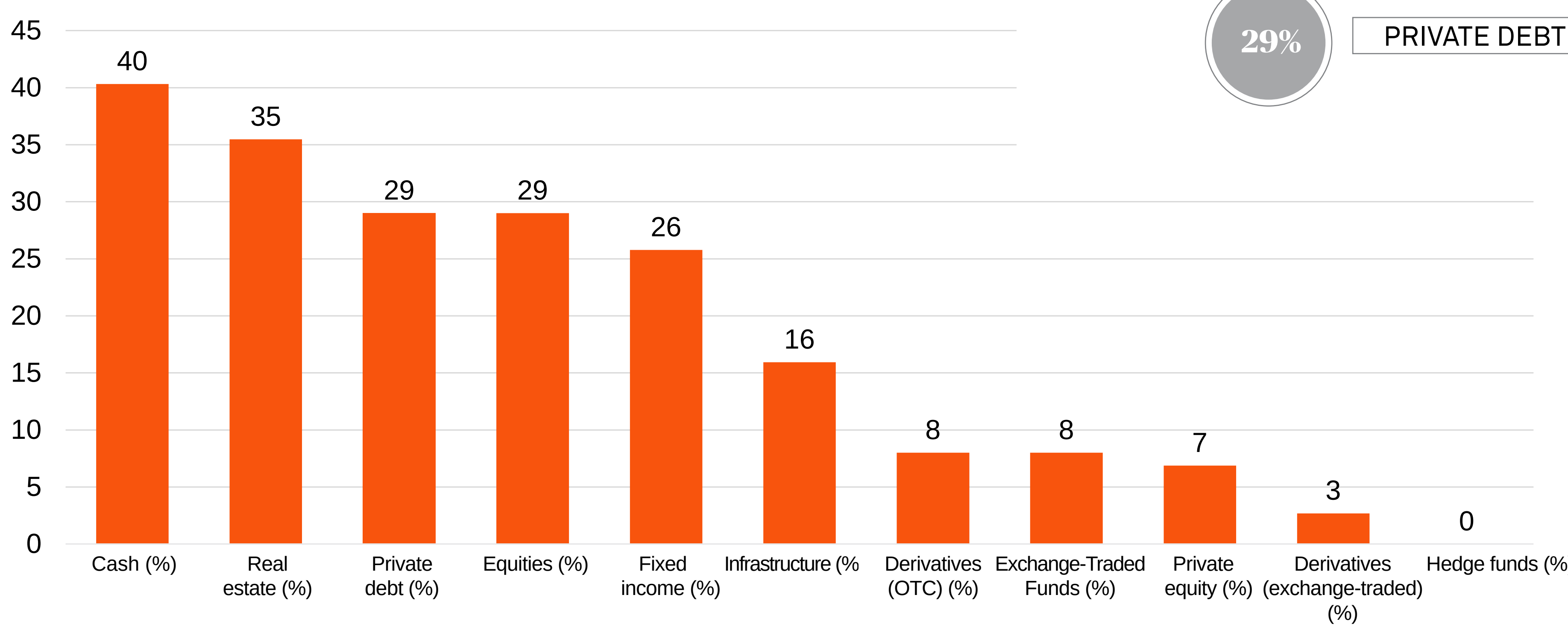
Some asset classes are more obvious candidates for in-house management than others. For example, pension funds are more likely to be managing real estate, private debt, equity and fixed-income investments in-house at the moment. By contrast, in more specialist areas, such as infrastructure and derivative contracts, the dependency on external managers is significantly higher.

Pension funds indicating an increased preference for in-house asset management are most likely to focus on those areas best suited to in-house management. This may be a matter of recognition that few organizations can be great at everything, and to achieve target investment results takes substantial investment in technology, talent and time.

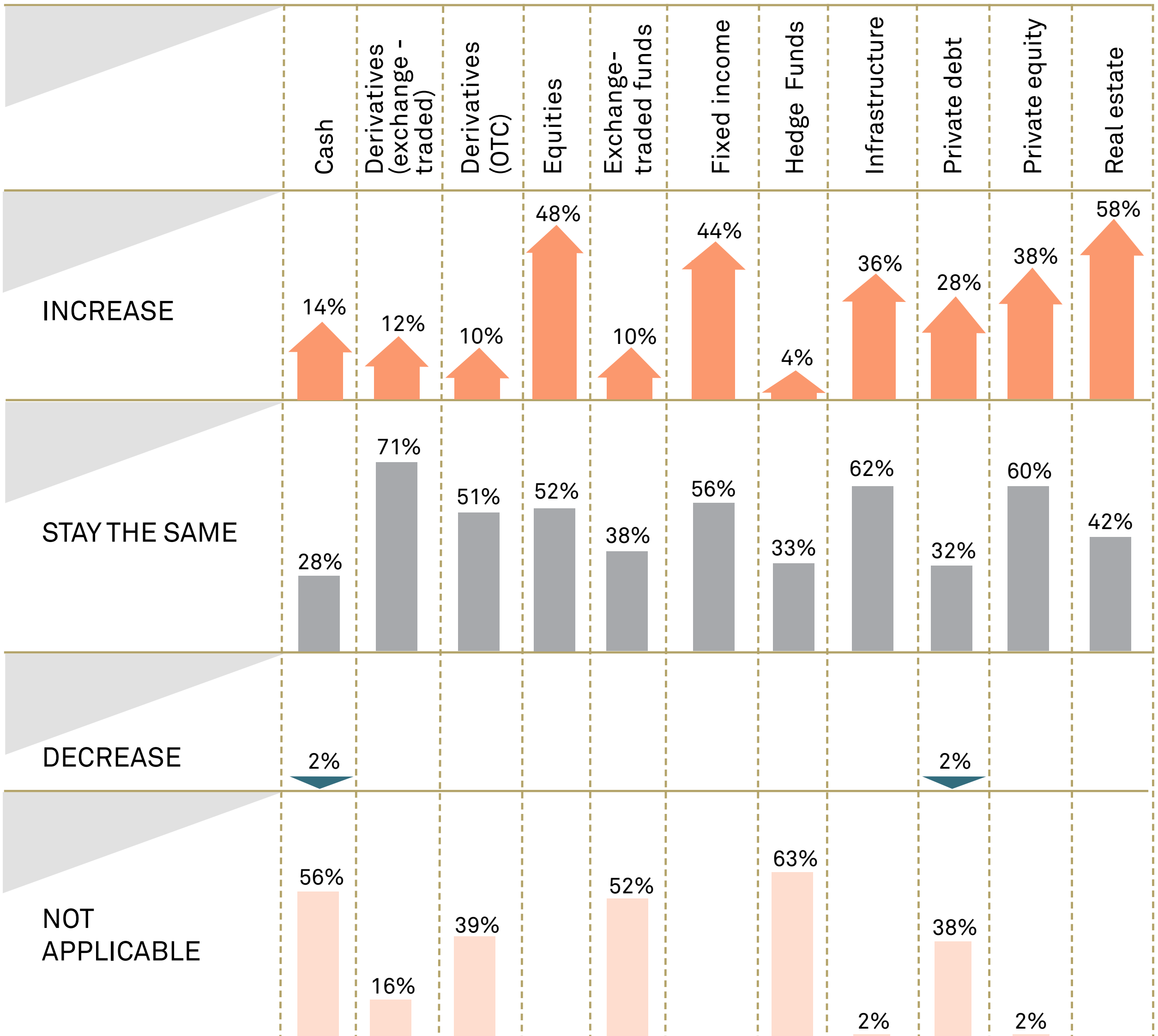
Asset classes with the highest ratios of in-house asset management



What average percentage of asset allocations are managed in-house, by asset class? (percentage)



For each of the following assets held by your organization, how do you expect the proportion managed in-house to have changed in 12 to 24 months' time?



In-house asset management dramatically impacts a pension organization's requirements around talent, technology, governance and many other areas.

Canadian pension asset managers continue to show a lower appetite for hedge funds than many global peers.

Ash Tahbazian
Chief Client Officer

"As the Canadian investment industry works through the market turbulence, early indications are that investors may see this as an inflection point to secure increased transparency. From gathering information to assist in various risk and performance scenarios, to launching separately-managed accounts with trusted asset managers, initial feedback is that investors are keen to further the gains they have made in enhancing control in recent years.

The months ahead will be a test for asset owners and asset managers alike. Recent market pressures will undoubtedly change the relationship between asset owners and asset managers. Although the exact evolution of those relationships is unclear, initial feedback indicates that the desire for increased transparency and control will help define some of the changes ahead."

Alistair Almeida
Segment Lead
Asset Owners

“Many Canadian pension funds take a nuanced approach to asset management. Where appropriate, they operate with in-house teams and this appears to be increasing. Elsewhere, they are pursuing partnerships and collaborations, as well as full-scale outsourcing arrangements. There is no one-size-fits-all arrangement.”

Innovation rather than one-size-fits-all solution

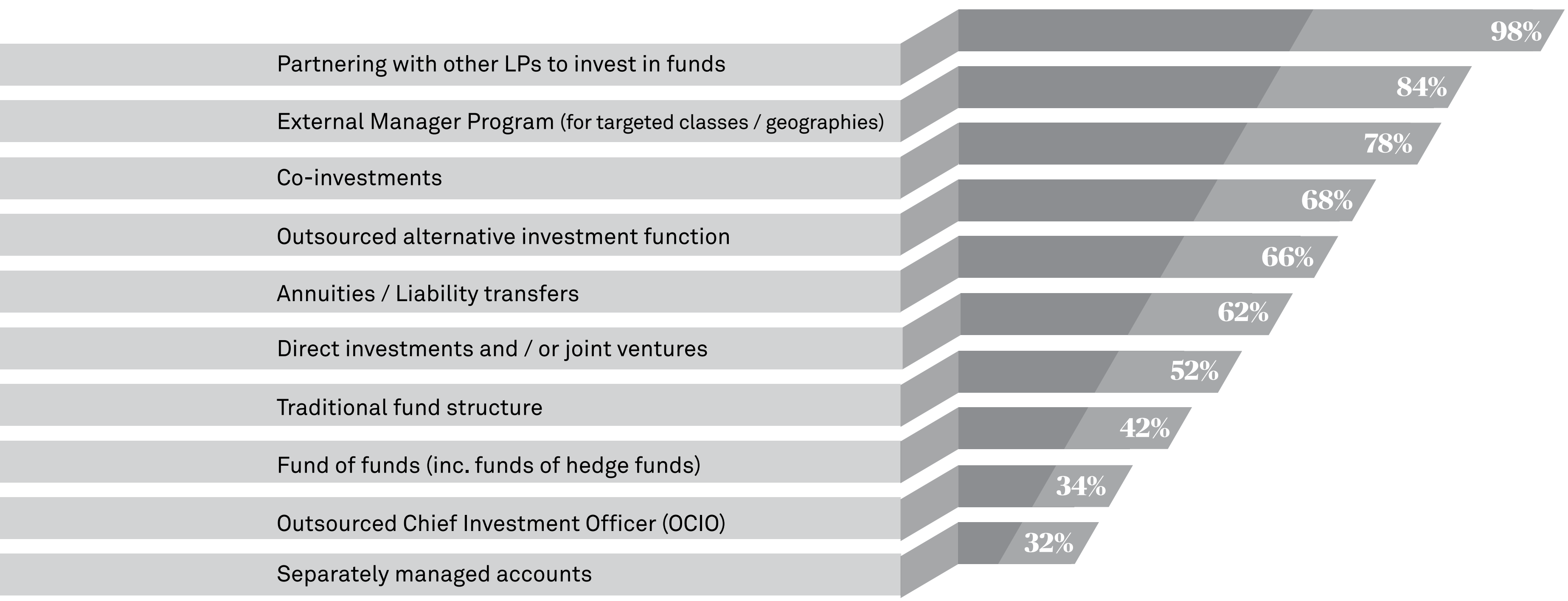
It would be a mistake to think of the debate between in-house and outsourced asset management as black and white. Our survey confirms that Canadian pension funds take a nuanced approach to investment models, employing a broad range of different operational strategies.

Some 98% of pension plans currently work alongside other limited partners (LPs) to invest in funds, for example, while 78% hold co-investments. Joint ventures (62%), external manager programs for specific asset classes or geographies (84%), direct investments (62%) and funds of funds (42%) are all popular options. It's also notable that, while many funds continue to outsource significant chunks of their portfolios, only a third (34%) have an outsourced chief investment officer (OCIO).

The picture is one of pension funds taking an imaginative approach to asset management. Where appropriate, they operate with in-house teams and this appears to be increasing. Elsewhere, they are pursuing partnerships and collaborations, as well as full-scale outsourcing arrangements. There is no one-size-fits-all arrangement.

We anticipate innovation and change will continue as Canadian pension fund managers focus on agility and responsiveness in the context of a fast-moving investment environment.

Which investment model(s) does your organization currently employ?



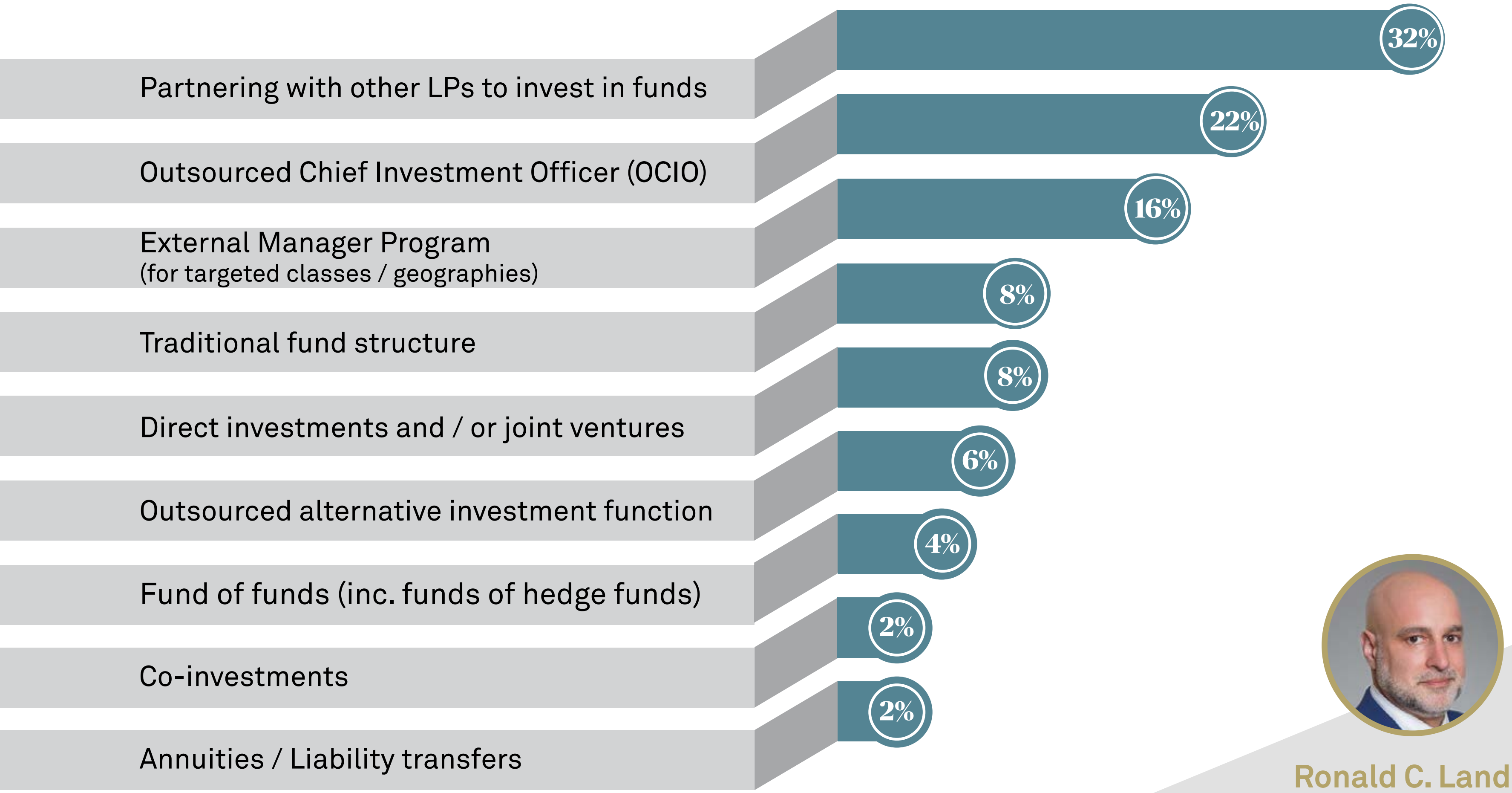
Top three most common investment models:

98% Partnering with other LPs

External manager program for targeted classes / geographies **84%**

78% Co-investments

What is the primary investment model your firm employs?



Ronald C. Landry
Head of Product

In recent years, there has been a trend of increasing sophistication among asset owners, and they are changing the way they work with fund managers. Canadian pension managers are keen to play a greater role in their private market investments, but there is no one-size-fits-all approach. Direct and co-investment by sophisticated in-house asset management teams can operate alongside robust external manager programs."

Cynthia Shaw-Pereira
Vice President
Client Solutions & Business Development

"The majority of asset owners wish to enhance transparency to meet the rising demands of Boards, trustees, regulators and others - and are structuring their investments and operations to help them achieve this. Many Canadian asset owners have invested in alternatives for decades, having built internal teams knowledgeable about asset class nuances and equipped them with the necessary talent and technology to succeed. In some cases, pension managers are transforming into asset managers themselves, building robust investment operations, and consolidating in or taking on outside assets as they seek to build scale and generate return. Others are working to further refine their robust external manager programs designed to deliver results without the substantial costs associated with building in-house while achieving the necessary oversight."

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.

Watch for Chapter 2 of our research, which explores how in-house capabilities are on the rise among Canadian pension plans, even as outsourcing remains vital.

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

1 "Canadian Pension Fund Returns Pressured, Long-Term Strategy Intact". Fitch Ratings. 31 Aug, 2020. **https://www.fitchratings.com/research/fund-asset-managers/canadian-pension-fund-returns-pressured-long-term-strategy-intact-31-08-2020**

2 The Evolution of the Canadian Pension Model Practical Lessons for Building World-class Pension Organizations. International Bank for Reconstruction and Development / The World Bank. 2017.**http://documents1.worldbank.org/curated/en/780721510639698502/pdf/121375-The-Evolution-of-the-Canadian-Pension-Model-All-Pages-Final-Low-Res-9-10-2018.pdf**

3 "Head of Canada's biggest pension fund warns on rush to illiquid assets". Financial Post. 20 Jan, 2020. Paula Sambo. **https://financialpost.com/news/fp-street/head-of-canada-pension-fund-warns-on-rush-to-iliquid-assets**

4 Race for assets 2019, p. 14 **https://www.cibcmellon.com/en/_locale-assets/pdf/our-thinking/2019/the-cibc-mellon-race-for-assets-canada-vs-world-may-2019.pdf#page=14**

5 "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**

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