PIAC 2016 Spring Conference

INNOVATION, OPPORTUNISM, AGILITY:
RETOOLING TO OPTIMIZE PERFORMANCE IN A LOW-GROWTH LANDSCAPE

Keynote address by André Bourbonnais
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—Check against delivery—

Thank you, Mr. Janusauskas, for that kind introduction. Good evening ladies and gentlemen.

I'm delighted with the opportunity to address this gathering of our Canadian peers tonight. Looking over this sea of faces reminds me of the title of a song written by fellow Montrealer Leonard Cohen: "*First we take Manhattan*…" So clearly the Canadians have arrived on Wall Street.

I would like to begin by thanking PIAC Chair Lisa Jankov, Executive Director Peter Waite, and the entire PIAC conference committee for putting together an excellent conference program—and for the great work they do year round as the national voice of Canadian pension investment managers.

Over the next few minutes, I intend to take stock of some industry trends that are likely to impact the global investment picture going forward, and share some insights into the strategies and tactics being deployed by PSP Investments to capture value and maximize long-term returns.

I'd like to set the stage by providing a brief overview of PSP Investments for the benefit of those who may not be familiar with our organization.

PSP Investments commenced operations on April 1, 2000. It concluded its first fiscal year with a relatively modest $2.5 billion of assets under management, almost entirely invested in bonds and public securities. Flash forward to 2016 and we find PSP Investments ranked *fourth* in Canada in terms of pension assets under management and in the top 30 globally,[1] with approximately $115 billion of assets.

Some 400,000 members of the federal public service, the Canadian Forces, the Royal Canadian Mounted Police and the Reserve Force are reliant on PSP Investments to fund their retirement benefits for post-2000 service.

PSP Investments' mandate is twofold: to manage the funds transferred to it by the Canadian Government in the best interests of the plans' contributors and beneficiaries; and to invest its assets with a view to achieving a maximum rate of return without undue risk of loss.

To that end, our team of over 600 professionals manages a diversified global portfolio composed of investments in public markets, private equity, real estate, infrastructure, natural resources and private debt.

Over the past decade, PSP Investments managed to deliver on what might well be termed the *real* measure of its success by exceeding the targeted long-term investment 'return objective', currently 4.1% after inflation, required to fund the Plans' Post-2000 liabilities. Over the past 10 years, PSP Investments has outperformed the return objective by 1.6% per year on average, which translates into a cumulative $16.3 billion of net investment gains.

As most of you are painfully aware, though, sustaining the sort of high-level performance has become a lot tougher of late.

Consider this: In April 1996, 10-year Government of Canada bonds offered a risk-free, real rate of return of 6.3%. Today, the same 10-year bonds offer a real return of between 0 to 0.5%. Contrast those anemic yields with PSP Investments' long-term target of a 4.1% real return and you can see the magnitude of the challenge we face.

Unfortunately, based on our view of the current picture, the situation is not about to change for the better. Unfavourable demographics, continued low market interest rates, rock-bottom policy rates by various central banks, 'quant' easing in the Eurozone and Japan and negative risk-free rates across part of the yield curve in certain countries are only some of the challenges we will continue to be facing.

Along with low returns on traditional public asset classes, today's new reality forces us to grapple with a high degree of volatility and uncertainty in global markets.

These days, it seems, even highly respected experts in finance and investment have widely divergent views on what the future holds. For instance, some say the Federal Reserve Board will raise rates in the

[1] Based on net pension assets under management. *Measuring Impact of Canadian Pension Funds*, The Boston Consulting Group, October 2015.

near future. Others, arguably as smart, contend that the rates will remain where they are. Some warn that inflation will soon be on the rise; others suggest that deflation is imminent.

All this to say that, as 2016 unfolds, picking winning investments in an ever-shifting global marketplace can be quite a challenge. As history has taught us, what might appear to be a sure bet today won't always play out as envisioned. For instance, if we look back five years or so, 'BRICs' were the talk of the town. Regretfully, many of those economies are no longer doing so well or delivering on their promises.

Despite emerging markets' significant contribution to the global economy, they remain fragile. High levels of uncertainty make investments in these markets riskier and more complex, underscoring the need for high-grade market intelligence, strong, knowledgeable local partners, and in some cases, a local presence.

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At any rate, volatile times like these add truth to that old adage about market analysis: "The less you say, the less you have to retract!" Perhaps we should all take our cue from storied New York banker and financier J.P Morgan. When asked what the stock market was likely to do, Morgan retorted "It will fluctuate!"

Okay, so let's cut to the chase. Given today's new normal of lower growth and high volatility—not to mention views that range from bear to bullish—how *does* one go about retooling to optimize performance? Overarching themes and trends identified by leading institutional investors surveyed recently by McKinsey include: Portfolio construction; Balancing risk taking and returns; Flexibility; Capability building to capture value; Innovation; and, finally, Disintermediation.

My colleagues and I at PSP Investments recently put together a new five-year strategic plan. This plan provides a blueprint as we transition from today's $100-billion-plus entity to a global investment manager projected to have $200 billion of AUM within a decade, and to exceed $350 billion of AUM within the next 20 years.

In the process, it quickly became clear that we needed to adapt how we manage our portfolio.

I would like to share my views on some of those emerging trends identified by McKinsey that we believe have merit and briefly discuss the tactics PSP Investments has deployed to ensure they are reflected in our strategic planning and evolving portfolio architecture.

First, portfolio construction. PSP Investments' primary focus recently has been on 'total portfolio management' which, as the term implies, entails focusing on the absolute return of the total portfolio, rather than on individual asset classes. This approach facilitates a more dynamic and fluid strategic asset allocation.

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At PSP Investments, we accomplish this through our 'CIO Office', headed by my colleague Daniel Garant. Daniel's team plays a leadership role in asset allocation at the total-fund level, and ensures a common vision of the macro trends influencing the performance of the organization. Its focus encompasses economics, research and market strategy.

I should note, too, that this total portfolio approach is not limited to investment activities. It's also reflected in our commitment to the development of a common corporate culture—an initiative we call "One PSP", which is designed to maintain a strong alignment of our measures of success between stakeholders, our Board and the management.

Now let's turn to flexibility, something that we really take to heart at PSP Investments.

Indeed, we've been implementing changes designed to giving ourselves increased flexibility and room to maneuver, not only with respect to portfolio architecture, but also with respect to how we approach investments and, more generally, our entire decision-making process.

In terms of being more flexible in our approach to investing, we believe that the very concept of what constitutes 'long term investing' has become muddied in recent years.

It is true that, as pension fund managers, our obligations are long-term by nature. But having a long-term horizon does not mean we need to—or ought to—give up short-term flexibility.

For instance, toll roads generally have a long service life—very long if they are properly maintained. However, that does not mean those who invest in toll roads must forever renounce questioning the continuing relevance of such investments in their strategy.

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So, should we continue to think long-term? Yes, by all means. But does this mean that we need to be inflexible? Certainly not.

I alluded earlier to the establishment of our CIO Office. To be more flexible in our approach to new investments, we also created a separate CIO portfolio, which gives us the leeway to undertake investments that make business sense at the total portfolio level, but are too large for, or do not fit well, in a single asset class.

Last but not least as regards flexibility, my colleagues and I are striving to be significantly leaner and more streamlined in terms of our decision-making process with, I'm pleased to note, the full support from our Board.

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The notion of building capability to capture value is another trend that particularly resonates with us at PSP Investments. To quote my colleague Guthrie Stewart, our Global Head of Private Investments, we see ourselves as being "in the business of *capturing*, not necessarily *creating* value". This approach implies a certain degree of humility. Some might regard this as weakness… I view it as strength.

To our way of thinking, *creating* value entails being very actively involved in operations, which is not among our core strengths. Of course, we rely on the expertise of our diverse PSP Investments teams with regard to their respective sectors. But, basically, we are financial investors and generalists with little operational know-how.

In light of that reality, a strategy PSP Investments and some of our peers have deployed to good effect, involves the creation of specialized investment 'platforms'. This approach essentially entails partnering with leading operators who have extensive knowledge and demonstrated expertise in their particular fields of endeavour.

For example, to take advantage of opportunities in farmland in the U.S., we could conceivably have hired, say, 30 specialists and sent them off in search of attractive parcels of land. But such an approach would prove cumbersome in terms of structure—especially if we were to repeat the same scenario in other areas where we invest.

So rather than going that route, we hold jointly with Ontario Teachers' a real estate investment fund called U.S. Farm Trust, which has an excellent management team and extensive expertise of the U.S. agricultural sector.

Another example is our AviAlliance platform, a German-based entity wholly-owned by PSP Investments, which ranks among the world's leading private industrial airport investors and managers. The portfolio includes interests in various European airports, which together handle almost 70 million passengers a year.

The salient point here is that PSP Investments does not have experience in agricultural land or airport management. However, via our platforms—which are astutely managed by operators with the know-how and networks required to create significant value added—we are able to *capture* the value they generate.

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Innovating in search of new investment opportunities is arguably the single most important of those current industry trends identified by McKinsey—and one we fully embrace. On balance, I think it would be fair to say that, in terms of distinguishing ourselves from the pack going forward, it will probably come down more to *how* we are doing things rather than *what* we are doing.

A good illustration of this is the way we entered into the private debt asset class.

Private debt represents a one trillion-plus investment landscape that is currently in transition as a result of reforms to international banking regulations.

Our entry into this space in November, through a newly created U.S. affiliate led by industry veteran David Scudellari, created a lot of buzz at the official inauguration of PSP Investments' U.S. office here in New York last month.

In fairness, we were not alone in seeing opportunity knocking in the form of private debt, nor were we first in. However, we made the deliberate decision to take a different approach in terms of how we would develop our presence in this asset class.

Simply put, our strategy involved opening an office here in the 'Big Apple', where you find the best talent in the sector—and the networks that go with it—then leveraging the new team's relationships to expand PSP Investments' own network.

We moved fast, because we sensed the market was evolving in our favor.

Although it has been only a few months since the opening of our New York office, we've already committed some $3 billion in private-debt transactions, alongside renowned names in this field such as Barclays, Deustche Bank, Credit Suisse and Apollo.

Among the transactions in which we've been involved are the financings behind the acquisition of ADT Corporation by Apollo, and of Mills Fleet Farm, a retailer based in the Midwest that was purchased by KKR.

In terms of further expanding PSP Investments' footprint in key global markets, I should note that we are currently setting up shop in London, where our office will focus primarily on private equity, real estate, infrastructure and private debt.

As well, we plan to open an office in Asia in the next year or so, provided we are able to find quality on-site leaders capable of marrying the mission and culture of PSP Investments in a manner that will enable us to seize opportunities in the region.

Finally, although not specifically included among the industry trends and themes identified earlier, I would like to say a few words on responsible investing.

These days, we are seeing increasing importance attached to the identification and mitigation of environmental, social and governance (ESG) issues that are, or could become, material to the long-term performance of investments—and rightly so.

Here again, there are widely differing views as to potential impacts, particularly with respect to climate change, from some very high-profile people.

For instance, current Bank of England and former Bank of Canada Governor, Mark Carney, believes climate change is likely to have a major impact on the financial stability and industry over the longer term.[2] On the other hand, value-investing guru Warren Buffet recently wrote in his letter to shareholders that, "as shareholder[s] of a major insurer, climate change should not be on [their] list of worries."[3]

[2] *Breaking the Tragedy of the Horizon – climate change and financial stability*, speech given by Mark Carney, Governor of the Bank of England, Chairman of the Financial Stability Board, Lloyd's of London, September 29, 2015.
[3] *Letter to shareholders 2015*, Berkshire Hathaway Inc., February 27, 2016.

While we do not see ourselves as a trailblazer with respect to ESG, we are committed to exercising leadership in the responsible investing area through a *pragmatic* approach.

Before making an investment, we measure how the value of the asset could be affected positively or negatively by ESG factors. Then, through the life of the investment, we engage in dialogue with stakeholders, including external managers, boards of directors, and senior management teams of the companies in which we invest, with a view of monitoring ESG risks and improving ESG performance.

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We believe an approach that combines this sort of active engagement with a thorough ESG risk analysis, is preferable to the screening and blacklisting of stocks or investments.

To sum up, in today's increasingly competitive and highly volatile global investment marketplace, status quo is not an option.

Accordingly, my colleagues and I are determined to do things differently. That's why we are striving hard to be more *innovative*, more *opportunistic*, and more *agile*.

Just to be clear, I do not wish to imply that PSP Investments fancies itself as having any sort of monopoly on innovative ways to maximize investment performance.

Au contraire, as evidenced in a recent study of Canada's 10 largest public pension funds carried out by The Boston Consulting Group[4], many of us are pursuing similar strategies, essentially focused on increased portfolio diversification to maximize long-term returns.

BCG further notes that Canadian managers distinguish themselves not only by their investment approach, but also by the "impressive returns" they generate, earning the 'Maple Revolutionaries' a reputation for being "among the most successful public pension funds in the world". That is something we can all be proud of.

Of course, with more and more of our peers chasing essentially the same opportunities, the competition for quality assets has become even more intense. So we are challenging our entire team to come up with novel ideas that could give our organization a comparative edge, which admittedly is not easy.

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At the same time, I truly believe, however, that there should be more collaboration and less competition among leading Canadian

[4] *Measuring Impact of Canadian Pension Funds*, The Boston Consulting Group, October 2015.

pension plans.

That leads nicely to the final point I wish to make here this evening: the critical importance of ensuring that we are able to attract, develop and retain a new generation of high-caliber talent to successfully manage the growth of our organization.

You can appreciate this might seem like a daunting task for a 'Boomer' who is painfully aware we are living in an era distinguished by the reverse accumulation of knowledge—that is, the younger you are, the more you know!

As I have remarked to friends and colleagues, only half joking, I sometimes feel that I could greatly benefit from a sort of 'reverse mentor', who could school me in the ways of the tech-savvy 'Millennials' for whom the entire world is only a click away.

The portrait of Millennials assembled in a recent study on generational change carried out by Deloitte[5] is impressive. Among their key attributes, Millennials:

- Work well on teams;
- Are collaborative, resourceful and innovative thinkers;
- Love a challenge;
- Are comfortable with speed and change;
- Thrive on flexibility and being given space to explore; and
- Partner well with mentors.

What's not to like?

As I see it, the challenge for my generation is to provide the sort of stimulating environment and incentives that will help us attract and retain the best and brightest members of that generation.

On that note, I'd like to thank you for being such an attentive audience and wish everyone a productive and enjoyable conference.

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[5] *The Deloitte Millennial Survey*, Deloitte.