Opportunities for managers, as Canadian pensions adapt

Alana Johnston Gould of Scotiabank Prime Services discusses the new opportunities arising for managers in a changing marketplace for Canadian pensions

Canada is home to some of the largest and most sophisticated investors in the world. The most prominent of these investors are Canada's pensions, with the top 10 collectively managing over CAD$1.5trn in assets.

There is much discussion of the 'maple' model of Canadian pension investing, the pillars of which include sophisticated global investing teams, extensive use of alternative investments, political independence, and comprehensive due diligence and risk management.

Canadian pensions are facing a raft of new opportunities and challenges, including growing geopolitical risk, expanding external manager programmes, increasing emerging market exposure, enhanced risk management, and commitment to sustainable investing. As these much-admired investors consider those emerging themes, we see considerable opportunities for managers to create partnerships with Canada's pensions.

Growing geopolitical risk

"As an organisation nearly 85% invested outside of Canada, we... pay close attention to the geopolitical environment. In fiscal 2019, this theme loomed especially large, with the growth of protectionism, trade uncertainty and growing trade tensions – particularly between the United States and China." *(CPPIB Fiscal 2019 Annual Report, pg. 5)*

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Canadian pensions have been key beneficiaries of globalisation, capitalising on their ability to access investments on a global scale – specifically via direct investment in infrastructure and real estate. However, their significant global investment programmes, most of which are in long-term assets, have also increased their exposure to geopolitical risk. These risks involve developed and developing markets and are expected to be the biggest challenge for Canadian pensions.

Rising political instability, including policy uncertainty, has come to the forefront recently. Contributors to this rise in geopolitical risk include: the US/China trade dispute, Brexit, international sanctions and growing sovereign debt. While Canadian pensions operate at arm's length from governments within Canada, their investments could be materially impacted by foreign and domestic government policy.

To mitigate the risk, it is crucial for Canadian pensions to understand the challenges in each market where they invest and their potential impact on returns and future opportunity sets. One of the ways they are doing this is by hiring on-the-ground expertise, including external fund managers. Managers who can demonstrate their expertise in specific jurisdictions, and emerging markets in particular, are better positioned to develop long-term investment and co-investment relationships with Canadian pensions.

Expanding external manager programmes

"Ontario Teachers' selectively allocates capital to key external managers in order to access specialised talent and investment opportunities where it is not efficient or practical to maintain the equivalent in-house." *(Ontario Teachers' Pension Plan 2018 Annual Report, pg. 23)*

"[Healthcare of Ontario Pension Plan] is growing our derivatives and fixed income department and we have added an external managers programme to the group. The programme will provide HOOPP with an attractive and diversifying return-to-risk profile that complements our internal trading programme. The mandate involves making long-term direct investments and investments on a managed account platform." *(HOOPP job posting – PM, External Managers Programme, Derivatives and Fixed Income)*

One of the pillars of the Canadian pension model has been hiring in-house investing teams to develop sophisticated global investment programmes. These internal teams have helped keep costs down, while also developing best-in-class investing expertise. To supplement their in-house teams, most of Canada's largest pensions have also established external manager programmes. These programmes are always looking for alpha-generating external managers with capabilities that complement their internally managed portfolio.

When managers frame their conversations with Canadian pensions, they should keep in mind how they add value. Canadian pensions are very interested in managers and strategies that add additional coverage for large markets and provide 'on the ground' experts in geographies where pension funds do not have a physical presence. They are also attracted by managers who cover niche sectors where the individual investments are too small on an individual basis to be covered in-house but, once aggregated, are meaningful enough for portfolio allocation. Finally, Canadian pensions seek managers who cover specialised markets and strategies where significant experience is required.

Once managers are identified, Canadian pensions conduct extensive investment and operational due diligence. In our experience, this process can be intensive and lengthy, but the end result is aimed at creating long-term partnerships with sizeable investment and co-investment potential. Managers should be prepared for a significant up-front time commitment along with annual on-site due diligence reviews and ongoing investment monitoring.

Increasing emerging market exposure

"Pillars of our 2025 plan include investing up to one-third of the fund in emerging markets such as China, India and Latin America, increasing our opportunity set and pursuing the most attractive risk-adjusted returns." *(CPPIB F2019 Annual Report, pg. 9)*

Canada's pensions are not immune to the search for attractive risk-adjusted returns in the current low interest rate environment. Emerging markets are a growing economic power that can provide yield and growth opportunities in public securities, private markets, infrastructure and real assets.

One of the largest opportunities as developing economies advance and modernise, is the need for significant investment in infrastructure and real assets. Canadian pensions find these investments attractive due to their long-term nature, risk/return potential, diversification, and the lack of correlation to the global equity markets. Increasing sovereign debt loads have also made these private/public partnerships attractive to governments for projects where they may not have considered private investment in the past.

Canadian pensions are using in-house and local resources to understand the potential in each specific emerging market, and the risks that must be managed before, during and after investment. We believe there is considerable opportunity for partnerships with managers who have a strong local presence or have significant expertise in these markets.

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Enhanced risk management

"La Caisse attaches great importance to risk management, which is an integral part of its activities in both its portfolio management and business processes... In managing its risks, la Caisse takes into account factors such as global economic conditions, changes in financial markets, and sectoral and geographic concentrations in the portfolio." *(Caisse de dépôt et placement du Québec 2018 Annual Report, pg. 53)*

As Canadian pensions have evolved, so too have their risk management functions. The amount and quality of data available for analysis has increased dramatically as technology and software advancement allow for a near-infinite amount of reporting. Risk teams work with internal and external investment managers to identify and track risks at the portfolio and plan level. As a result, Canadian pensions are demanding greater transparency in their investments.

To help manage the volume of data and extract valuable reporting, several Canadian pensions have created partnerships with one or more managed account platform providers. These service providers offer comprehensive portfolio aggregation, plus risk management and reporting solutions. As a result, we have seen a shift from commingled LP investments to separately-managed accounts (SMA) and funds-of-one. These structures can provide increased transparency, additional control over fees, and the ability to more easily conduct portfolio aggregation risk assessments. Managers should be prepared for these structuring, transparency, and risk discussions when engaging with a Canadian pension.

Commitment to sustainable investing

"As a Principles for Responsible Investment (PRI) signatory since 2010, AIMCo has committed to considering environmental, social and governance (ESG) factors across investment processes, to foster sustainable, long-term growth while capturing risk-adjusted returns." *(AIMCo 2018 Annual Report, pg. 39)*

Canada's large pensions have been early adopters of environmental, social and governance (ESG) principles in their investing processes. We believe this is the result of several factors. First, sustainability is a key factor when analysing long-term investments. Second, pensions are increasingly aligning their investment philosophy with the values of their annuitants. Finally, as industry thought-leaders, we believe Canadian pensions enjoy being at the forefront of investment analysis, with ESG factors incorporated directly into investment analysis, rather than serving as a stand-alone category of investment.

Looking forward

Canadian pensions have a proven ability to innovate, whether with infrastructure and real asset partnerships, SMAs, ESG risk assessments, or on-the-ground offices in emerging economies. As they continue to adapt to current opportunities and challenges, we believe there are significant opportunities for managers to offer their expertise and create long-term, mutually beneficial partnerships. HFM