hedge?

Considerations for pension plan sponsors looking at portfolio exposure in their own sector

BY MARTHA PORADO

Canada's economy is famously reliant on its rich natural resources, with a heaping helping of financial service providers thrown in for good measure.

But when oil companies, mining outfits or Canadian banks are deciding how to invest the capital in their pension funds, does it make sense to steer clear of exposures that directly correlate to their core businesses? Or does the inherent confidence in their respective sectors drive them to include these investments even more heavily?

The short answer appears to be both. "You really do get different responses," says Janet Rabovsky, a partner at Ellement. "Some of it is the type of business and some of it is the financial position of the company and some of it is just simply belief. There's no consistency, in my experience."

Conscious conversations

Rabovsky has had conversations with pension plan sponsors in Canada's oil patch about whether they should lean away from investment exposure to crude. Often, they'll express confidence in their own sector, she says, while at other times they'll jump at the chance to hedge that risk.

The same can be true for plan sponsors that produce renewable energy and related technology, she says. "I've worked with companies where they make turbines and they're very comfortable with things like infrastructure."

Such varied answers stem largely from human bias, with changes to a plan's asset mix often accompanying the addition of new members to the investment team, says Rabovsky. "If you have a change in the committee, you just have a different bias and lens and you can see a big shift there. And that's why there's no consistency, because you've got people in this. It's not just a financial discussion; it can be an emotional discussion, too."

Meanwhile, non-corporate plans such as charities often take their overall assets into account, including what they own as part of their business operations, like real estate, she says. If a charity already owned a few buildings, it would be more likely to stay away from too many more allocations to that asset class.

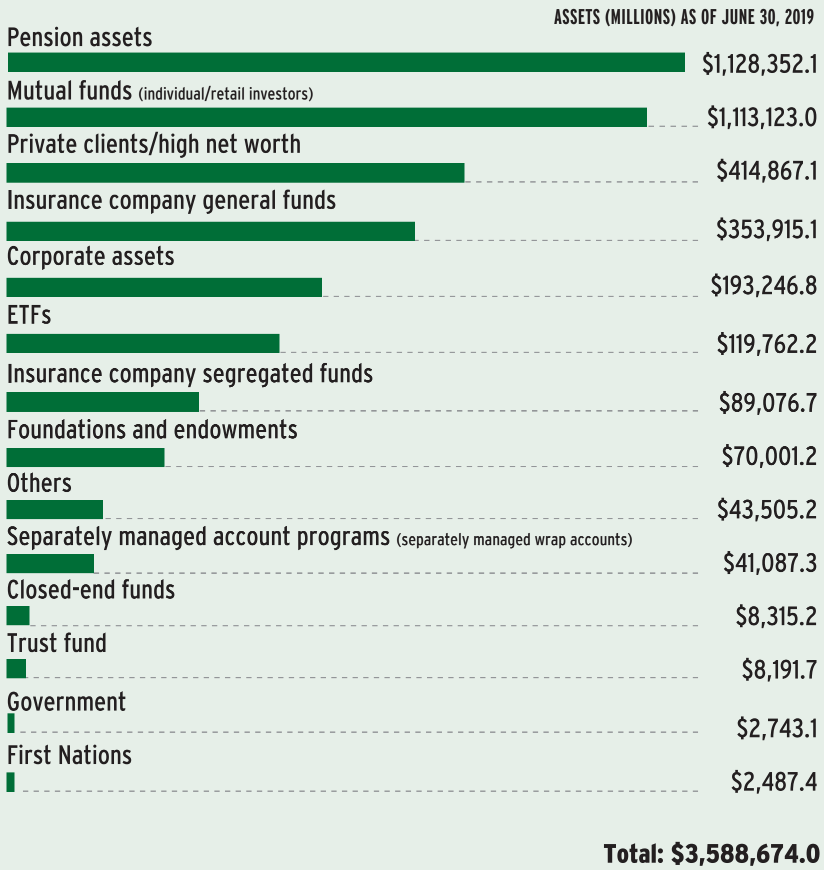
Exclusions also come purely from an optics perspective, notes Rabovsky. "Usually, when it comes to charities and endowments, it's less about the economic cycle and more about [environmental, social and governance] concerns — 'We're a children's charity, we don't want to be seen to be investing in places that have child labour practices that aren't great.'"

More broadly, Canadian pension plans' inherent exposure to the health of the domestic economy could be a reason to diversify geographically, she says, noting that concern comes up more often than overexposure to a plan's own sector.

Regardless of the scenario, Rabovsky says she raises the question of hedging in this capacity with plan sponsors whenever she has a discussion about adjusting a portfolio's asset mix.

"I will explicitly ask them if there are certain asset classes that they don't want to be in, either because of a bad experience or because they think it will compound their business situation, and I will probe on that."

BREAKDOWN | CANADIAN ASSETS UNDER MANAGEMENT



Source: Firms participating in the *Canadian Institutional Investment Network*'s fall 2019 top 40 money managers survey

Bank on it

The Canadian Imperial Bank of Commerce's core business creates a wide variety of sector, asset and geographic exposures. Its defined benefit pension plan makes a deliberate effort to diversify these exposures away from the core business, says James Ash, the plan's chief investment officer and head of pension investment management.

"As far as possible, we want to weaken the correlation between the performance of the company and the performance of our investments, such that we're not going to be impeding benefit security at a time when it would be more difficult to fund them from the pension plan."

With high correlation to the Canadian economy, CIBC looks to underweight domestic assets in its plan, he says. Getting more granular, the bank is highly conscious of the exposures generated by its lending activities; residential mortgages, for one, have a solid presence.

"We might look to avoid those areas, particularly as we move into real estate, for example. We might . . . look to under allocate to it, or completely avoid those areas altogether."

Further, Ash notes the plan's natural effort to underweight the Canadian financial sector. But it's difficult to leave the sector out altogether, especially with financial firms' high weighting on the Canadian equity market.

In maintaining its pension portfolio,

CIBC, along with many other Canadian plans, has moved away from public equity investments to private ones. "I think it's the longer-term investment horizon of those products and the muted effect of the market impact, because they're not mark-to-market," says Ash. "So that fits with us insomuch as it commits us to still generate our returns, but avoids some of the volatility associated with the businesses that would be tied to our own business."

Among other alternative assets, the bank's plan considers infrastructure to be attractive. And while real estate also has some appeal, it's aiming to avoid further exposure to the domestic market, looking further afield when sourcing investments in the asset class.

Overall, says Ash, a primary reason CIBC's plan is hedging natural exposures is to minimize the noise created by volatility in the pension fund, which could ultimately show up on the company's balance sheet.

Running from risk

While this type of risk mitigation is appealing for all plans, de-risking by shifting from DB to a defined contribution arrangement is more attractive to today's oil patch companies, says Mark Sack, vice-president and head of Canadian institutional investments at Mackenzie Investments.

"The main objective nowadays for sector-based, big resource companies, and all corporate plans in general, is to mitigate the risk of their pension plan by either converting to DC, reducing cost by indexing, increasing diversifications with alternatives, using derivatives to mitigate the drawdown, hedging currencies or other risks, annuitizing all or parts of the pension plan, closing plans to new entrants or increasing employee contributions."

However, DC plans aren't exempt from the conversation. In this context, employees should avoid investing too much of their own savings in their employer, says Steve Sproule, team lead in health, benefits and retirement at Husky Energy Inc.

He says the organization considered adding a specific option in the DC plan to allow employees to invest directly in Husky shares. "We had the discussion and it was very thoughtful and, to be honest, it wasn't something that we belaboured or studied. We asked, 'Should Husky shares be part of the [registered retirement savings plan] or the pension?' And it was a resounding no."

However, in addition to the DC plan and the RRSP, Husky offers employees a non-registered savings plan that they can use to directly purchase Husky shares, although they aren't discounted. The ease of purchasing the shares via a payroll deduction, as well as the fact that the company takes care of the investment fees and logistics, makes it an attractive option for plan members, says Sproule.

But Sproule also notes it was important to the pension committee that employees didn't feel obliged to invest in their employer. "It just didn't seem right. We wanted to diversify and we didn't want to have all their eggs in one basket all tied to one company. So we said, 'Sure, you can invest in Husky shares if you'd like, but it won't be part of your retirement plan unless Husky shares are within the assets or the funds that we've chosen in our fund lineup."

TOP 10 | TOTAL CANADIAN ASSETS UNDER MANAGEMENT

ASSETS (MILLIONS) AS OF JUNE 30, 2019

	Company	2019 CANADIAN AUM
1	Phillips, Hager & North Investment Management (RBC Global Asset Management)	$339,319.9
2	TD Asset Management Inc.	$309,374.4
3	BlackRock Asset Management Canada Ltd.	$201,657.0
4	CIBC Asset Management Inc.	$167,869.3
5	Sun Life Capital Management (Canada) Inc.	$145,461.7
6	Brookfield Asset Management	$142,229.0
7	Fidelity Canada Institutional	$137,947.4
8	Mackenzie Investments	$134,199.0
9	1832 Asset Management LP (Scotiabank)	$129,358.0
10	Manulife Investment Management	$128,709.0
Top 10 total:		**$1,836,124.7**

Source: Firms participating in the *Canadian Institutional Investment Network*'s fall 2019 top 40 money managers survey

A VERY HEAVY BASKET

For the past two years, Norway's public pension fund has been ratcheting down its exposure to investments that would be heavily impacted by a permanent drop in the price of oil.

While the fund has expressed deep concern over the environmental impact of its investments, this gradual shying away from oil companies isn't just an attempt to be green. Rather, the intention is to reduce the pension plan's exposure to oil, given the major role the commodity plays in the country's overall wealth.

In March 2019, the pension fund announced it would be divesting from oil exploration and production companies as classified by the FTSE Russell. The fund estimated it held 66 billion krone (close to $13 billion) worth of these companies at the end of 2018, comprising 1.2 per cent of its overall equity holdings.

Upper limit

A decade ago, many DC plans encouraged their members to invest in the company's own stock, notes Dave Makarchuck, wealth business leader for Western Canada at Mercer. While a stock-sharing program can work in the short term as a tool to motivate employees, investing too much of their long-term savings in their employer's stock can be risky.

In addition, some DB plans still have rules around how much of a company's own proprietary stock is allowed in the plan, he says. "So some will just exclude, so there is no apparent or real conflict of interest. Some will just limit to some function of whatever the market cap weight is of the TSX — if you're one per cent or two per cent of the TSX, you can't be more than that."

However, the move by pension plans into more sophisticated alternative investments, like real estate, infrastructure and private equity, has done a lot of the work required to spread exposures, says Makarchuck. Even in scenarios where a company's stock features heavily on the Canadian stock exchange, it will only comprise up to three per cent of the market. And as public equity becomes a smaller component of the portfolio, that exposure is further muted, he adds.

It would be a clear conflict of interest for a pension plan to instruct a money manager, for example, to make a heavy investment in the company's own stock, notes Makarchuck.

"As long as it's not over the top, I think, in today's market, there's no reason why we would advise the client to not permit an investment

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BREAKDOWN | PENSION ASSET BY CLASS

ASSETS (MILLIONS) AS OF JUNE 30, 2019

Canadian bonds	26.36%
Canadian equity	11.72%
Global equity	11.51%
Overlay strategies	6.57%
Real estate	6.46%
Balanced/asset allocation	5.57%
International equity	5.29%
U.S. equity	5.10%
Real asset/infrastructure	3.50%
Emerging markets equity	2.62%
Private equity	1.99%
Target-date/lifecycle	1.78%
Cash/money market	1.73%
Hedge funds	1.58%
Mortgage	1.22%
Global bonds	1.12%
Private debt	0.97%
Other	0.76%
Target-risk portfolio	0.74%
Other bonds	0.62%
Other equity	0.44%
Emerging markets debt	0.384%
Real return bonds	0.378%
U.S. bonds	0.33%
High yield bonds	0.26%
European equity	0.25%
Canadian small/mid cap equity	0.22%
Commodities	0.19%
Other sector equity	0.12%
Asian equity	0.09%
U.S. small/mid cap equity	0.08%
International bonds	0.06%

Source: Firms participating in the *Canadian Institutional Investment Network*'s fall 2019 top 40 money managers survey

"I will explicitly ask them if there are certain asset classes that they don't want to be in, either because of a bad experience or because they think it will compound their business situation, and I will probe on that.

TOP 10 | CAP INVESTMENT MANAGERS

CPA = CANADIAN PENSION ASSETS; ASSETS (MILLIONS) AS OF JUNE 30, 2019

	Company	2019 CAP CPA
1	BlackRock Asset Management Canada Ltd.	$48,215.1
2	GLC Asset Management Group Ltd.	$21,334.0
3	Sun Life Global Investments	$15,339.1
4	TD Asset Management Inc.	$14,835.6
5	Beutel, Goodman & Co. Ltd.	$13,076.4
6	Fidelity Canada Institutional	$9,977.4
7	MFS Investment Management Canada Ltd.	$9,911.9
8	Phillips, Hager & North Investment Management (RBC Global Asset Management)	$7,661.5
9	Fiera Capital Corp.	$7,566.7
10	Connor, Clark & Lunn Financial Group	$7,351.7
Top 10 total:		**$155,269.4**

TOP 10 | DB INVESTMENT MANAGERS

CPA = CANADIAN PENSION ASSETS; ASSETS (MILLIONS) AS OF JUNE 30, 2018

	Company	2019 DB CPA
1	TD Asset Management Inc.	$92,281.7
2	Phillips, Hager & North Investment Management (RBC Global Asset Management)	$63,204.0
3	BlackRock Asset Management Canada Ltd.	$59,552.8
4	Brookfield Asset Management	$43,384.0
5	Goldman Sachs Asset Management LP	$28,858.1
6	CIBC Asset Management Inc.	$27,671.1
7	Fiera Capital Corp.	$27,473.3
8	Manulife Investment Management	$26,010.0
9	Connor, Clark & Lunn Financial Group	$21,785.0
10	TD Greystone Asset Management	$21,542.4
Top 10 total:		**$411,762.4**

Source: Firms participating in the *Canadian Institutional Investment Network*'s fall 2019 top 40 money managers survey

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TOP 5 | FASTEST GROWING (%) — GREATER THAN $10 BILLION

CPA = CANADIAN PENSION ASSETS; ASSETS (MILLIONS) AS OF JUNE 30, 2019

	Company	2019 CPA	2018 CPA	Variance
1	Brookfield Asset Management	$43,384.0	$28,691.0	51.2%
2	Goldman Sachs Asset Management LP	$28,858.1	$24,343.8	18.5%
3	AllianceBernstein Canada Institutional Investments	$10,730.6	$9,205.1	16.6%
4	PIMCO Canada Corp.	$18,943.0	$16,820.0	12.6%
5	Sun Life Global Investments	$15,339.1	$13,671.8	12.2%

TOP 5 | FASTEST GROWING (%) — $1 BILLION TO $10 BILLION

CPA = CANADIAN PENSION ASSETS; ASSETS (MILLIONS) AS OF JUNE 30, 2019

	Company	2019 CPA	2018 CPA	Variance
1	DWS	$1,242.7	$617.4	101.3%
2	Trez Capital	$1,900.0	$1,100.0	72.7%
3	Morneau Shepell Asset & Risk Management Ltd.	$1,529.4	$938.7	62.9%
4	Setanta Asset Management Ltd.	$1,754.0	$1,372.0	27.8%
5	NISA Investment Advisors	$1,771.6	$1,442.6	22.8%

TOP 5 | FASTEST GROWING (%) — LESS THAN $1 BILLION

CPA = CANADIAN PENSION ASSETS; ASSETS (MILLIONS) AS OF JUNE 30, 2019

	Company	2019 CPA	2018 CPA	Variance
1	Pathway Capital Management LP	$444.4	$61.5	622.6%
2	Global Alpha Capital Management Ltd. (a Connor, Clark & Lunn Financial Group Co.)	$561.4	$180.1	211.7%
3	Wasatch Advisors	$668.9	$390.3	71.4%
4	CC&L Infrastructure (a Connor, Clark & Lunn Financial Group Co.)	$411.0	$308.2	33.4%
5	Wells Fargo Asset Management	$170.8	$132.0	29.4%

Source: Firms participating in the *Canadian Institutional Investment Network*'s fall 2019 top 40 money managers survey