



# meet the Allocators

CANADIAN PENSION FUND MANAGERS DISCUSS INVESTING IN CANADIAN HEDGE FUNDS

It is well known that many Canadian pension plans of all sizes have turned to alternative investment sources as a means to diversify, reduce volatility and generate 'alpha' in their portfolios. But how do plan sponsors choose external managers? What criteria are used in selecting hedge funds both domestically and abroad?

The 'Meet the Allocators' forum held in Toronto in May 2007, brought together an expert panel of Canadian pension plan managers to answer those questions. The event—conceived by TD Securities Prime Brokerage and organized by Benefits Canada—was held for two reasons: To address a growing need to inform the emerging Canadian hedge fund community looking to raise institutional capital, and to educate domestic endowment funds who have hedge funds in their own investment mandates.

The morning began with a compelling keynote address by Don Drummond, Senior Vice President and Chief Economist, TD Bank Financial Group who spoke on the strength of the Canadian economy largely fuelled by the 'boom' in the natural resource and commodity sectors.

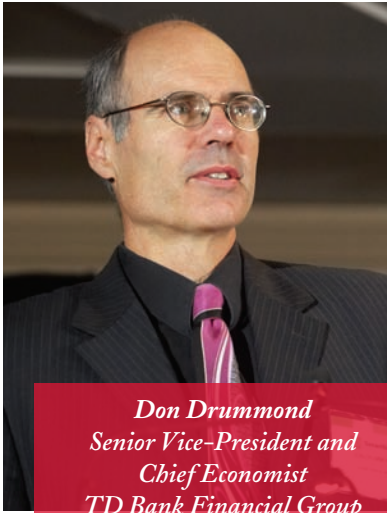
The capacity audience comprised of hedge fund and endowment managers then heard an engaging panel session from an expert group of pension plan managers. Key senior staff from Ontario Teachers' Pension Plan, Caisse de dépôt et placement du Québec, Keel Capital Management and the Toronto Transit Commission all described their own internal experiences and fielded questions from an inquisitive and enthusiastic crowd.

Panel members addressed the key components in allocating to hedge funds. The themes of transparency, operational due diligence, fee structure and returns largely dominated the discussion and question period. The panel's diverse AUM sizes and wide-ranging years investing in alternative products produced well-rounded perspectives on how Canada's largest institutional investors incorporate both single fund and fund-of-funds within their portfolios.

By all accounts 'Meet the Allocators' was an insightful event for everyone involved. The following are highlights of the comments made by all the participants.

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*Don Drummond  
Senior Vice-President and  
Chief Economist  
TD Bank Financial Group*

Today I would like to present a report card on the fundamentals of the Canadian economy to understand our prospects over the long term.

Canada has had 15 consecutive years of sustained growth—something not experienced since the 1950s. We have had the fastest employment and per capita GDP growth among G7 countries since 1997. Even though we have weak productivity growth, we're still third behind only the U.S. and UK. The most important measure is output per capita, where we've had the strongest growth

of all the countries.

Canada has been growing faster than most other G7 countries. With the exception of the U.S., Canada was on top of the growth pile in 2006. In 2007, with the exception of the UK, we'll probably have the strongest growth of the industrialized countries, and we'll probably be around the top of the pack in 2008.

Canada has been very successful on the inflation front. We went to an official reduction target of 2% in the early 1990s. Since then, the actual rate of inflation has averaged 1.9%.

On the fiscal side, we've had a remarkable turnaround. In 1992 and 1993, everyone believed we were on the precipice of a fiscal crisis. But now we're running sustained surpluses both federally and provincially. We have a

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*Patricia Muzyk  
Vice-President, Investments  
Keel Capital Management Inc.*

The NSAHO Pension Plan began investing in hedge funds in 2000. It was about the same time that the Trustees went through a process which changed how they viewed risk, and moved to a surplus-at-risk approach which considers both asset as well as liability risks. We also looked at the capital markets and felt that there were not any beta risks that could deliver the return required to keep the pension plan's assets and liabilities on an even keel.

At first we looked at hedge funds in a small way. Being a small shop, we took the direct approach as opposed to fund-of-funds because we were wary of the level of beta in many single-fund strategies. We were also wary of negative skew in some return profiles, and short volatility strategies.

Over time we allocated more to hedge funds and as we did the question became: Are they an asset class or another form of talent? We took the position that they were another form of talent and we adopted overlay strategies at that time. Currently, there is about US\$1 billion in hedge funds.

We use hedge funds now to manage the pension plan risk. In some long-only strategies, we may use hedge funds as substitutes if we're afraid of beta in a particular area, such as the U.S. equity market.

But we predominantly use the hedge funds as an alpha overlay. In the alpha overlay portfolio (fund-of-funds) we're always very concerned about the correla-

tions in the event of a disaster in any of the capital markets, so we maintain a protection program on that portfolio.

What we insist on when seeking out managers is process transparency—not individual security transparency. But as a measure of assurance in that area, we ask our managers whether, if we show up unannounced at their office, they will give us security level transparency at that time. If they agree, then we feel confident of that manager's integrity.

Another consideration is fees. There is a fee point beyond which we won't go. Above two and 20, for example, we will probably walk away. Has the program worked? Before we changed to a surplus-at-risk approach, and began including hedge fund strategies, the value added on the portfolio versus the benchmark was, on average, about 22 basis points; since 2000 it has grown to average about 150 basis points annually.

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lower federal debt burden and it is still falling. Our debt-to-GDP ratio reduced dramatically from 70% in the 1990s. The government has set a target of debt down to 25% of GDP by 2011. In an international context, we are alone in the G7 for running surpluses and we have the lowest total government debt burdens.

With regards to current account and foreign indebtedness, in 1994, we owed 44% of our GDP to foreigners—we're now down to 11%. And if that trend continues, we will be in a net asset position by 2011 or 2012.

Inward and outward foreign direct investment has soared. Contrary to current belief, since the late 1990s, Canadian companies have been placing more foreign direct investment outside Canada than foreign companies have

been placing in Canada.

Our low inflation and strong fiscal performance help keep interest rates low, so our interest rates are about 45 basis points lower than the U.S. Canada also has a corporate tax advantage over the U.S. That gap is going to grow as the federal corporate income tax rates go down, particularly since 2006 when the federal government eliminated the capital tax.

Canada is known as a resource-based economy. Globally, we only come behind Saudi Arabia, Norway and Venezuela. Since we are the third-largest producer of natural gas, ninth-largest producer of crude oil and third-largest generator of electricity among OECD countries, we are well positioned as the price of these commodities climbs higher. We're in the top two or three in the production

of virtually all the metals; and the prices of all of these will remain relatively high.

Commodity prices have boomed—we're seeing a very strong increase as depicted by the general climb of the TD commodity price index since 1998. The Canada-U.S. exchange rate is sensitive to commodity prices. People wonder why the dollar went from 62 cents to 90 cents. The answer is that commodity prices pulled it up. If commodity prices remain high, the dollar will remain strong.

The main challenge for Canada is to lift the weak productivity record so far this decade when output per hour has only been growing barely above one per cent per annum. This will require a concerted effort from both the public and private sectors.



*Ron Mock  
Vice-President,  
Alternative Investments  
Ontario Teachers' Pension Plan*

Teachers' has been investing in hedge funds since 1996. Of the \$100 billion that Teachers' has, about 40% of it is in broadly defined alternatives, including hedge funds. In our hedge fund portfolio, we have about \$7.5 billion invested in a global platform concentrating on North America, Europe and Asia. Half that \$7.5 billion we do directly ourselves.

From this program, we are looking for LIBOR plus 500 or 600 basis points, with

the volatility of a one-and-a-half-year bond. More importantly, this hedge fund portfolio can't fluctuate with the rest of the asset classes—in fact, we don't want any downturns at all. That means we have to be very careful about the beta that we take on. This portfolio is designed to deliver fairly stable and steady returns.

We execute the program through both directs and fund-of-funds; half the portfolio is directly invested—we conduct the due diligence and we choose the managers. We use fund-of-funds, however, in a very special way. Since we can't be awake 24 hours a day looking at what's going on in Asia, fund-of-funds are an excellent way to extend our staff throughout Asia. The same applies to Europe.

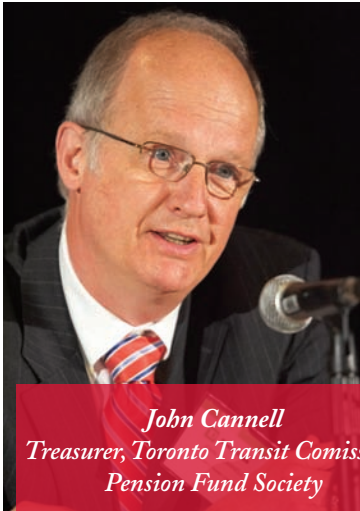
When using fund-of-funds, we hire them as advisors but all investments go on our books. That way, if we decide that the fund-of-funds manager is not working for us, we can terminate the manager without

losing the investments. So fund-of-funds and directs both have a very important role to play in the portfolio.

When it comes to fees, we know that we have to pay for correlation benefits. We're not trying to match the S&P; we're trying to deliver LIBOR plus 500. Since 1996, the portfolio has done that.

We invest in Canada—the hedge fund community here is growing by leaps and bounds. Having said that, the Canadian marketplace has been an interesting one: it has consisted of a lot of long/short equity that has come with a lot of beta. And since we've tried to keep beta out of the portfolio, it's been harder to find managers who have the alpha we need without the beta. There are some amazing hedge fund managers in Canada, but we are working to a certain investing profile. If we can find the managers who deliver that, the location is irrelevant.

**We invest** in Canada—the hedge fund community here is growing by leaps and bounds.



*John Cannell  
Treasurer, Toronto Transit Commission,  
Pension Fund Society*

We have invested with two U.S.-based hedge fund-of-fund managers, each given CDN\$50 million. We got into hedge funds

because we're being beset, as most basic defined benefit plans are, by some very difficult situations: 1) Our demographics are deteriorating fast. In effect, in 1985, we had four active members for every pensioner. As of today, we have fewer than two active members per pensioner and within 15 years, we will be down to one. 2) The market crash in the earlier part of the century made life hard for us—it peeled almost half a billion dollars off in terms of market value. We have made that back but interest rates are holding us down. 3) So now, our concern is what happens to us as the rates go down, particularly in terms of solvency, as our liabilities skyrocket? So we're moving towards hedge funds in a search for alpha.

Our experience with hedge funds has involved a huge learning curve. We found out very quickly there are thousands of

hedge funds, and that we, as a board, cannot search out the best funds. So we hired consultants to help us. We wanted an excess return of between 2%-4% after all costs; to minimize drawdowns; capital preservation; low volatility; lots of diversification; and a substantial history of outperformance of LIBOR plus cost.

We went through a long process, got down to a shortlist of six funds, and then chose two. My observations while on the six visits were: most of the people in this business are young; many are former traders; and most of them are very, very driven. We're paying them for their knowledge and expertise, specifically in due diligence and back-office processes. Once the funds have been set up, we pay them for their expertise in monitoring and assessing the reasons for over- and underperformance.



*Michel Malo  
Executive Vice-President,  
Hedge Funds  
Caisse de dépôt et  
placement du Québec*

I operate both internal and external hedge funds. On the internal side, there are commodity-based hedge funds, equity market neutral and also global macro hedge funds. We have approx. \$3 billion in internal funds, which is my responsibility, and \$5 billion in external. Our external program is made up primarily of 90% direct investments and 10% of fund-of-

fund investments. The program itself was around for several years before I arrived.

We operate three subgroups within our hedge fund group: 1) A group of analysts follow and select managers just as an analyst would select securities; 2) We have a portfolio construction group that runs a variety of quant-style analyses; 3) We also run our own operational due diligence internally. I've given the operational due diligence person full veto mandate if she doesn't think operations are well run.

We also retain the services of outside advisors to run background checks and further legal document analysis. Overall the program has been very successful.

For us, the hedge fund program is built to be less directional, so we emphasize arbitrage-type strategies. The hedge funds provide us with some downside protection—to us it's insurance.

Our board brings up issues such as transparency and fees. With regards to transparency, we ask the managers to provide us with risk reports, which we analyze. We are looking at hiring independent third

parties, who contract with the hedge fund managers to get direct links to their custodians and administrators, to provide us with a risk matrix. That gives us a certain amount of transparency.

As for fees, two and 20 seems high for any business if performance isn't there. We try to negotiate fees. If a hedge fund's mandate is to provide capital protection you don't want to pay performance-based fees because returns match money market returns. However, my board has told me that they're willing to give more money to the hedge fund space if they feel confident, they feel my analysts understand the style, and we provide more transparency.

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