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— Jim Leech, president and CEO, Ontario Teachers' Pension Plan

«*STRATEGY*»

MASTER CLASS

Jim Leech, president and CEO of the Ontario Teachers' Pension Plan, gives lessons learned on investing in an uncertain world

By Alyssa Hodder / Photography by Jaime Hogge

The past few years have tested the mettle of investors—and with continuing economic and market instability, pension investing is not a domain for the faint of heart. "We were hurt in 2008, like the average pension plan," acknowledges Jim Leech, president and CEO of the Ontario Teachers' Pension Plan (Teachers'). "That really bothered us, because we're not used to being average…and we're not used to losing money, either. So it was a double whammy." But the experience has taught Teachers' some important lessons about risk: why it's necessary, how to manage it and how to keep it in perspective.

In the Risk Business

Since 2008, *risk* has become a four-letter word. But from a pension fund investor's viewpoint, risk isn't a bad thing—in fact, it's necessary to meet future plan obligations. "We are in the business of taking risk; there are no two ways about it," says Leech. "You want to try to mitigate as much as you can, but you know you're going to lose on something. And if that upsets you, then get out of the business—because it's going to happen."

What's important is to understand the nature of the risks you're taking and plan accordingly. For example, Teachers' has a proprietary risk system that stress tests the portfolio under a number of different scenarios. "The key thing, from a risk perspective, is to be able to say, 'What's going to happen to my portfolio if we're in Scenario A, B or C?'" adds Leech. "And to make sure that you're immunized or have the ability to move quickly enough if you're going down Path B instead of Path A."

In 2008, Teachers' doubled its liquidity requirements, and, in 2010, it introduced a new investment strategy. Although these initiatives weren't implemented in response to the recession, they did help to address some of the issues arising from it. "The biggest lesson, I think, for all pension plans was liquidity," Leech remarks. "You can have all sorts of risk models that say things are going to go up or things are going to go down, but for the first time for pension plans, liquidity became an issue. Many plans were caught in circumstances where they had to sell assets at a low in order to meet collateral calls on their derivative books, as an example, or even just to meet cash requirements. And that's just about the worst position you can ever be in."

Overage and Underfunded

While liquidity hasn't been a problem for Teachers', it does face other challenges. Despite a strong track record of success (Teachers' has reported double-digit returns for the past 20 years), funding remains a significant issue. "We're facing the challenge that every single DB plan on the planet is facing, and it's largely driven by demographics," Leech explains. "Some character invented Freedom 55 a number of years ago, and we're all living it down ever since. But the fact of the matter is, working careers have gotten shorter and longevity has gotten longer." For a mature plan like Teachers', this is a particular challenge. "In our case, in 1990, people worked for around 30 years and retired for 25 or 26. Today, it's the exact opposite: they're working for 25, 26 [years], and they're retiring for 30."

Key stakeholders are working toward a long-term solution and have already taken action to address current concerns. To resolve the $17-billion deficit reported on a preliminary basis as of Jan. 1, 2011, the Ontario Teachers' Federation and the Ontario government agreed to three key plan design changes: combine the basic and special contribution to make it the new basic contribution; introduce a 1.1% contribution increase; and reduce inflation protection from 100% to 60% for service after 2009.

Introducing these changes "went very smoothly," says Leech. From its 300,000 active and retired plan members, Teachers' received only 30 emails when the changes were announced. He attributes the minimal reaction from members to a transparent communication process. "The Ontario Teachers' Federation, the four unions, the government and the plan have worked together over the last two years on a very intensive education/communication program to members," he notes, adding that the communication efforts actually started earlier, in 2007, with a survey of plan members to determine their "pain points" around plan changes.

And whether or not members agree with them, Leech says these changes are necessary to keep the plan sustainable over the long term. "The key for a DB plan is, those plans have got to show flexibility that they can change with the demographics. Because a deal that was made in 1970 doesn't hold water today."

Constantly Seeking Returns

A plan's sustainability depends, in part, on investment returns. Direct investment in infrastructure has proved lucrative for Teachers' and continues to be a focus—for instance, the recent deal (expected to close later this year) to swap its ownership position in Sydney Airport in Australia, plus approximately C$800 million in cash, for ownership positions in airports in Copenhagen and Brussels. "So here you have, at Yonge and Finch [in Toronto], the Ontario Teachers' Pension Plan, but that's the scale that we're operating on," Leech comments. "We're swapping an airport on one continent for two airports on another continent." But he adds that infrastructure investment isn't what it used to be. "Ten percent of this fund is invested in infrastructure, and we were one of the very first. The difficulty now is that the types of returns we got in the early days aren't there anymore, because everybody else has jumped into the asset class."

Emerging markets is another important investment for Teachers', with 12% of the fund invested in this area. According to Leech, China and India continue to be of interest, but future growth may lie in other developing countries. "Going into those markets, we knew that A, we had to be there, but B, it would be competitive. The challenge we gave ourselves was, Are there economies where we could go in and get the same advantage that we enjoy in Canada? And that advantage is an information advantage, where we can become a big fish in a medium-size pond instead of just one of many."

This drive to find the next new innovative idea led Teachers' to invest in Brazil starting in 2007. "When we went into Brazil, it was not investment grade," Leech explains, adding that while most investors thought it would be eight years before Brazil was sufficiently developed as an investment opportunity, Teachers' was banking on a shorter timeline. "[Our fixed income managers] took a huge position in Brazilian bonds, and it was two years," he says. "The way you're successful in the investment business is to have conviction on something that not everybody else agrees with."

Leading by Example

What investment lessons would Teachers' give to other pension funds? Leech believes that conviction is important, but so is agility. Many low-probability events have, nonetheless, occurred over the past few years—and if you can't anticipate the next crisis, you need to be able to move quickly to react to it. "Who'd have thought when you buy an airport in Bristol that you're going to have to worry about volcanoes in Iceland?" he muses. "This is an interconnected world, and it's something that you don't even think is remotely connected that will come and bite you."

Teachers' is refining the systems and processes that support its investment activities to improve agility. But for now, caution is key. "It's a tough market to have conviction in," Leech admits. "This is a time to be hedging your bets."

Alyssa Hodder is editor of *Benefits Canada*.
alyssa.hodder@rci.rogers.com

Q&A

JIM LEECH TALKS ABOUT TEACHERS' INVESTMENT PRINCIPLES AND WHY THEY MAKE THE GRADE

What differentiates Teachers' from other plans?

It really starts right at the top, with governance. The place is run like a business. It's independent of its sponsors, it has professional board members, and it's focused on only two things: investment returns and service to members. We could not do what we're doing if we didn't have the governance structure that we have now. I see, time and time again, organizations try to do it, and they run right into that.

We have Investments and Member Services under a single roof. If people ask me what the core differentiator here is, [it's that] we have one customer and we know who they are. They're very visible to us, and we're very visible to them.

Most people who work here have a teacher in their family. There is a concept of service: 'I'm proud to be working for the teachers of Ontario.' That identification with the customer is so strong.

The Maple Group (in which Teachers' is a partner) has announced a $3.7-billion bid for TMX Group Inc. What's behind this move?

What's behind it, from Teachers' perspective, is, this looks like a very good investment. We're not participating in Maple for any patriotic reasons.

What's Teachers' view on responsible investing?

To us, it is purely a risk tool. We are a leader in governance, and I think we were one of the first to recognize that was important when studying a company: to understand the risk of the governance. For example, that's why we didn't own shares in Magna [International Inc.]—because it wouldn't pass a governance test. Notwithstanding the fact that Magna was, and is, a great company, we just thought the risk was too high....And that's what we emphasize to people: it isn't done for the greater good of mankind; it's to understand risk.