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Event Coverage

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ALL EVENT PHOTOS TAKEN BY MICHELLE QUANCE

Introduction

By Gideon Scanlon
Editor, *Canadian Investment Review*

In 2022, normal was supposed to make a comeback — it didn't.

Just as supply chains began to stabilize, war broke out in Europe, China invaded Taiwan's waters, inflation skyrocketed and central banks began hiking interest rates. While investments in renewable energy infrastructure reached new highs, economies that had been moving away from fossil fuels started reopening coal plants in order to meet their energy needs.

To explore these challenges and their implications for institutional investors, a group of defined benefit pension plan sponsors, asset managers and academics gathered in Muskoka, Ont. in August for the *Canadian Investment Review*'s 2022 Risk Management Conference.

To kick the proceedings off, keynote speaker Janice Gross Stein, founding director of the Munk School of Global Affairs at the University of Toronto, argued that the lessons of the past half-century would be poor preparation for the challenges of the next one. "Most of us, in this room, started their careers in the 1970s through about 2010. Those were the golden years — there was no war between major powers. It was a long peace period, but with globalization on steroids. . . . It was a golden age — exceptional and not at all the norm."

Stein called on institutional investors and academics to come together to rethink risk in the context of the day. In the presentations that followed, the speakers took up the challenge. They noted countless examples of ways that out-of-date thinking causes problems in everything from portfolio construction to emerging market investing. They also shared new perspectives — ones better suited to long-term investing in the volatile post-pandemic era.

Understanding risk in a time of global turmoil

Janice Gross Stein
founding director of the Munk School of Global Affairs
University of Toronto

by Gideon Scanlon

Managing risk in an era defined by escalating geopolitical tension, degenerating global trade networks and unprecedented economic turmoil is no simple task – and doing so well may require adopting a new perspective.

"We aren't thinking about risk in a way that's appropriate for the world that we're moving into," said Janice Gross Stein, founding director of the Munk School of Global Affairs at the University of Toronto.

"We've, essentially, siloed the way we think about risk. That's true in your industry and that's true in my profession. The next 20 years are going to require that we get together in the same room and build the vectors of risk, so that I understand how your risk influences my estimates and you understand how my risk assessment influences yours because they're interacting. If we don't do that, we're going to get it wrong."

According to Stein, very few academics or institutional investors understand what it means to operate during periods with major European conflicts and rising inflation and interest rates. "Most of us, in this room, started their careers in the 1970s through about 2010. Those were the golden years – there was no war between major powers. It was a long peace period, but with globalization on steroids. . . . It was a golden age – exceptional and not at all the norm."

As today's investors lack experience dealing with the risks posed by global political instability, Stein said she believes they should be paying a little more attention to history. One issue that's especially important to view through a historical lens is de-globalization, she added, noting it was unknown in the latter half of the 20th century, but was a defining feature of the early 20th century and the European Dark Ages. It's even credited with ending the Bronze Age – and sparking the Iron Age.

"Global trade is in retreat – it's dropping as a proportion of the global economy. . . . Remember, global supply chains accounted for 70 per cent of the world's growth over the last 40 years, but no more. In Ottawa, I recently had a conversation with [former U.S. Treasury Secretary] Janet Yellen about friend-shoring – trading with partners you trust not to cut down supply if there's a problem."

Stein also said the next four decades will be defined by a resurgence in the strength of governments. "[Does] anybody remember when government was the problem, not the solution? That's over. Government is back and not only as a regulator but as an investor. . . . We have billions of dollars that will be invested by the United States in key strategic industries."

While the distant past may be a guide to some of the world's issues, Stein noted some challenges facing humanity in the coming decades are unprecedented. One such issue is the world's aging population. With fewer people entering the workforce than leaving it, the foundations of a productive economy are left shaken. "And, second, old people don't spend as much money as young people. . . . Frankly, my kids' spending is on an entirely different order of magnitude than my own."

The only major economy with a steady supply of young people is India, she said, whereas China's demographics challenges may be more significant than in the West. "China is racing against the clock to beat its tough demographics and build a productive economy before time runs out. . . . It's got 10 years at the most. A lot of the really alarming and worrying behaviour we're seeing from China comes from these underlying tough economic problems."

Two other issues – global warming and the transition away from fossil fuel reliance – also lack clear historical precedent. "The good news is that almost every industry and every sector, both public and private, has woken up to this and is beginning to build that risk into their assessments," said Stein. "And there are huge opportunities for countries that move ahead of the curve – in green tech, sustainable fishing and agro tech."

Assessing risk is, by its nature, an imperfect art, she concluded. While she said she's certain the Canadian government is trying to figure out how likely internal political divisions in the U.S. will lead to a civil war, she's unclear on what methodology could provide a useful answer. "The last one was in 1865, so there's not enough data points."

While Stein acknowledged the idea of a full-scale domestic conflict occurring south of the Canadian border is outlandish, she noted that, in the long run, outlandish events occur with surprising frequency. "In 2019, if you'd asked my colleagues if [Russia] was going to invade Ukraine, almost everyone would have said no, it wouldn't have seemed rational. It would be too costly and it would have led to the sanctioning of the Russian economy – so who would make that decision?"

Tactical fixed income strategies for managing risk during volatility

Jeffrey Moore
portfolio manager, fixed income division
Fidelity Investments

by Gideon Scanlon

Fixed income investing isn't known for its excitement, but in the volatile markets of the post-coronavirus pandemic period, bond specialists may be in for a wild ride.

"There's more yield in the marketplace, so bonds are becoming a better competitor to stocks. . . . You should be asking yourself, how do I get more to my portfolio's core allocation?" said Jeffrey Moore, portfolio manager in the fixed income division at Fidelity Investments. "I think there's a whole bunch of ways."

The key to understanding the U.S. Federal Reserve's responses to inflation is to think like its chairman, Jerome Powell, rather than to look at its forecasts and consumer price index reports, he noted. "Every time we come up to a monthly CPI, realize the market will be — full stop — waiting for that one number. But there are two numbers to pay attention to right now, the CPI and jobs."

Moore said fixed income investors gain a multi-sector perspective by considering employment figures. "You're probably going to have some beta rotation in your portfolio, so you're going to want to have a sense of interest rate sensitivity and where the debt markets might go, as well as what's happening with different types of risk assets. . . . I call the approach 'now casting.'"

Unlike forecasts, this dual-figure approach offers key insights about how quickly the Fed will reduce its balance sheet as quantitative easing is wound down, he added, suggesting other approaches may overestimate the central bank's sense of urgency. "I don't think they have any idea how they're going to bring it down in a big way."

To back this up, Moore pointed to the enormous number of mortgages bought by the Fed during the aftermath of the pandemic — a surge that's left almost one in three American homeowners directly indebted to it. "They're probably going to keep this at an elevated level, though the Fed has backed away from buying up new ones at auctions."

For institutional investors, the Fed's lackadaisical approach to reducing its balance sheets should encourage an increased focus on interest rate sensitivity to protect from volatility, he said. "If you go back over the last 10 years, the average daily move of a 10-year treasury note was three to four basis points. It's now going to be eight to 10. . . . What's interesting is that's really what the daily rate volatility was in the 1990s, so this isn't unprecedented. It's just that we got really used to rate repression and a central bank that was very heavy handed."

Another weapon he suggested fixed income investors keep in their arsenal during periods of high-rate volatility is the Merrill Lynch Option Volatility Estimate index. "If you're going to do something tactical and you're going to try to get more to your core allocation or more absolute returns, the first thing you have to realize is that every market has its nature.

In going through the MOVE index, Moore said his team analyzed a baker's dozen of the bond markets generating significant interest from investors. In several cases, the Fidelity team found reason to question popular sentiment, especially in regard to emerging markets. "EM is either first or worse in your portfolio, there's no middle ground. It looks like stocks, but with a third of the return, so it's hard to allocate big chunks to it. . . . The more you put in there, the more unstable your beta is at the core level."

Up close, the other 12 bond markets also present a bewildering mix of advantages and disadvantages, he said.

Rather than focusing on individual bond markets, Moore advised investors to take cues from the bond market aggregate. "If you're the chief investment officer for a big pension, you love stable beta. Allocations have a good degree of certainty about how they'll act in a portfolio. . . . So when we're building our portfolio, we decided to focus just on the aggregate. We don't want to own what's in the [bond aggregate index], we just want to wiggle the same way and to have the same tails."

Even in a high-yield environment, he said institutional investors can benefit from building a diversified bond portfolio. In the U.S., you could probably do something in Euros hedged back to the dollar."

Using renewable energy assets to manage risk in private markets

Saad Qais
head of U.S. asset management
Greencoat Capital

by Gideon Scanlon

Renewable energy assets can offer a lot to institutional investors' portfolios, serving to lower risk opportunities over the long term compared to traditional energy assets while providing similar returns, said Saad Qais, head of U.S. asset management at Greencoat Capital.

This is true as long as investors avoid making several key mistakes, including confusing real risks with fictional ones. Despite the supposed dangers related to renewable assets — such as solar farms being a cause of health issues and wind farms inspiring dread with their low-frequency sound waves — these concerns are unsubstantiated, he said.

"Some risks are just truly fake."

Real risks do exist in the renewable asset development cycle, acknowledged Qais, noting many of these risks are related to the proposed location of an asset. Some projects falter because they're built around sensitive habitats or on archaeologically important sites. These tend to be addressed in the early stages of project development.

"But then there are some more significant real risks — construction risks and operational risks that need to be adequately managed, whereas development risks may present too high of a risk profile for a typical pension plan to manage."

The developmental risks compare to those found in private equity investing, with low capital requirements, very high risk and the possibility of staggering returns, he said. "When you start developing renewable assets, typically, there's a 25 per cent chance that's actually going to make it through — and it could take anywhere from two to 10 years to materialize."

While this may make it difficult for institutional investors to get in on the ground floor, opportunities remain at later stages of the project development cycle, he noted. "The construction side historically has offered a decent entry point for investors to come in, especially pension funds and insurance companies, because wind takes roughly a year to construct. Solar is going to be even less than that."

Even late-stage investments, such as at the start of project construction, face supply chain risks, which are somewhat elevated in the post-coronavirus pandemic environment, according to Qais. "Unless contracts are very tightly structured, that risk can be borne by common equity and the overall project cost can far exceed the fair market value of the project. . . . But it all starts with making the right decision upfront. . . . This is common to all investing in general in the real asset category: you make the right decision you're going to be happy with it for the rest of your life."

To prevent buyers' remorse, Qais recommended that institutional investors develop key relationships and ensure they're buying from developers that have deep experience and understand development risks.

Once assets are in operation, investors face a slew of new risks, he said. "In wind assets, there can be bird strikes. There can be blade damage from hailstorms. As an asset manager, one advantage mitigating those risks stems from having economies of scale. With a large fleet of projects, an asset manager can form strong relationships with contractors. When something goes wrong, you know who to lean on."

There are also risks around energy prices, which have been exacerbated by the increasing sophistication of power markets. "Like any commodity market, contracts are exchanged at regional hubs. You must manage what the power price you were going to get at your specific project versus what the contract is giving you at the regional hub — the way to manage that would be to have access to power trading."

One frequently discussed issue with renewable energy assets are the related environmental concerns, said Qais, noting that endangered bird species roosting near wind assets will often fly into their spinning blades. Asset owners can be protected by consulting with relevant authorities, he suggested. "They will want to know [whether] you have followed suggested guidance in conducting the pre- and post-construction monitoring and doing what you can do to protect the environment around the asset."

Despite these risks, he said renewable assets offer advantages over traditional energy investments. "Funds are increasingly diverting allocations away from the oil and gas sector. The big oil and gas companies are feeling the need to to shift toward renewable energy. . . . We also see corporations taking charge in their own right and investing in the space with an eye towards offsetting their own carbon footprint.

"If managed properly, renewable energy investing can check all the boxes for a pension fund while delivering stable returns over the long term."

Navigating rising inflation, minimizing impact on pension plans

Eric Menzer
senior portfolio manager, global head of OCIO and fiduciary solutions, multi-asset solutions team
Manulife Investment Management

by Blake Wolfe

Alongside a potential recession and lower global economic growth looming in 2023, defined benefit pension plan sponsors have several tools to minimize the impact of rising inflation, said Eric Menzer, senior portfolio manager and global head of outsourced chief investment officer and fiduciary solutions and multi-asset solutions at Manulife Investment Management.

"We're in good [economic] shape, roughly speaking. Household balance sheets are really in good shape. Corporate balance sheets are in really good shape. . . . The focus will shift as we get into 2023 for sure."

The primary way DB plans can reduce the impact of inflation is through real return bonds, he said, noting the U.S. market is stronger than Canada. The asset class provides plan sponsors with an option to help hedge against long-run, break-even inflation rates.

"The key there is to find your inflation duration . . . and coming up with a number there in terms of measuring your sensitivities. Once you've nailed that down and you have a long-term strategy, real return bonds on a buy and hold for the long-term can help. It's just you're going to have some noise in between as you get bumps up in the consumer price index like we have right now, where break-evens don't match with what the CPI is doing."

While real estate can also provide an effective inflation hedge amid increasing rents, Menzer suggested pension plan sponsors balance these investments with other real assets including commodities like oil and gas, as well as timberland and farmland, said. He noted a diversified basket of real assets provides lower correlations and increases inflation protection within a portfolio.

"We've seen the rents go up quite a bit over the last two years. You've seen it here in Canada. We're seeing it in the States as well. It's pretty substantial. That's an inflation hedge. [But] how much longer will that train continue to run? The key is to have different types of real assets that have flexibility to pass those costs down so that the investor benefits from those rising prices."

Plan sponsors can also make use of growth assets to hedge against inflation, he said, noting this strategy has increased in popularity in recent years. "It's pretty commonplace to talk about how to allocate the capital between growth and hedging. Sometimes it's static, sometimes there's a glide path. . . . Not only [are growth assets] helping you . . . hit your target return, but it also gives you that ballast and protection against inflation.

"Because if we do get in an environment where inflation is transitory, [when] the economy starts growing back, then your allocation of growth assets are going to help offset that."

Institutional investors have a fiduciary duty to assess, mitigate climate-related risks

Patrick DeRochie
senior manager
Shift Action for Pension Wealth and Planet Health

by Lauren Bailey

The climate crisis puts the security of workers' retirements at stake, said Patrick DeRochie, senior manager at Shift Action for Pension Wealth and Planet Health.

Pension plan sponsors' investment decisions and their ability to achieve adequate returns for their members depends on a stable climate, he noted, laying out the stark choice in front of institutional investors: they can choose to invest in developing gas plants, offshore oil projects and pipelines or they can allocate their capital to electric vehicles, wind farms and zero-carbon buildings.

With significant economic power, scale and global reach, institutional investors' capital allocation decisions play a major role in whether real-world infrastructure can profitably make the required transition away from fossil fuels and be made resilient to a more extreme climate.

Pension plan sponsors have a legal obligation to minimize risks and maximize returns, said DeRochie, referring to the physical, transition, policy and regulatory, legal and reputational and systemic risks they must take into consideration as they perform their fiduciary duties.

Physical risks — such as a warming world, increased fires, floods, heatwaves, hurricanes, droughts, rising sea levels and extreme weather — damage the systems and infrastructure that underpin the global economy and threaten the value of real estate, utilities, ports, highways, bridges, energy infrastructure and other physical assets that make up a significant portion of the holdings of Canadian pension funds, he noted.

Sectors such as electric utilities, vehicle manufacturers and oil, gas and coal are facing unprecedented transition risks right now, added DeRochie, noting these companies are a large part of the global economy and are widely held by pension funds. Indeed, the energy transition could create massive disruption and fuel a carbon bubble in which the valuation of fossil fuel companies could suddenly and rapidly plummet all at once, he cautioned.

Public demand for faster methods to cut global carbon output has led world governments to set climate targets and increasingly stringent laws, policies and regulations that have massive financial implications for large parts of the world economy, said DeRochie. The industry is also facing an onslaught of litigation with more than 2,000 climate-related lawsuits filed against governments, oil and gas companies and their directors and officers for breach of fiduciary obligation, failure to disclose material financial risks to investors or tort claims as a result of losses.

"Polluting companies are losing their social licence to operate, having difficulty attracting labour and investment and facing massive financial penalties. Fossil fuel companies look a lot like tobacco companies did in the 1990s."

The entire global economy and stability of the financial system is at risk from climate disruption, said DeRochie, noting the possibility of calamities such as the collapse of the interconnected food system, wide-scale water shortages, entire parts of the planet becoming too hot for humans to inhabit and devastating sea levels that flood coastal cities and cause mass migrations.

"If Canada's largest public pension funds are serious about protecting their members' retirement savings in the face of this emergency, they must act rapidly and decisively . . . [to] fully disclose all climate-related financial risks [and bring] carbon emissions from their portfolios to net zero as soon as possible."

How institutional investors can power an investment program from strategy to implementation and oversight

Darren Spencer
director, client portfolio manager, alternative investments
Russell Investments

by Blake Wolfe

As institutional investors increasingly turn to private markets in their investment strategies, a holistic approach is required to understand the opportunity set and optimize exposure, said Darren Spencer, director and client portfolio manager of alternative investments at Russell Investments.

Over the last 20 years, the number of private equity funds has increased by 650 per cent, with the private markets asset class representing nearly a $10 trillion opportunity set, he noted. "I think one of the key reasons why investors globally are increasingly attracted to private markets is this is no longer a niche asset class. . . . This asset class is really too big to ignore and there's a lot of interesting opportunities for people to be able to tap into."

It's paramount for institutional investors to invest in private markets across both time and sector, said Spencer, citing the differences in returns between venture capital and buyouts.

"Do you want to have a lot of exposure to venture capital, which is obviously going to help your returns? That's been really one of the best performing parts of the private markets arena over the course of the last 10 years, but that hasn't always been the case. Looking at buyout, the risk profile is different and returns tend to be more consistent.

"In addition, then you've got things like infrastructure and private credit which have differing return profiles again, so just be mindful of what the underlying risk and return characteristics are of those strategies and making sure that's aligned with what your strategy is."

He also suggested investors be aware of the dispersion of returns in private markets compared to public markets. "If you look at private markets, the dispersion between the top quartile manager and the managers performing in the bottom quartile, can be in the order of 30 per cent. Contrast that to traditional equity or fixing account managers with a spread between the top performing and the bottom performing managers, it's maybe about 200 or 300 basis points. . . . It's very important that [investors conduct] appropriate levels of due diligence, so you're giving yourself the best opportunity, the best chance to invest in high performing managers."

Shifts in supply chains caused by increased geopolitical tensions will also increase investment opportunities in private markets, said Spencer. "This is going to be one of the key trends, we think, particularly over the course of the next 10 to 20 years as companies, particularly in North America, are going to want to bring their supply chains back to places like the United States, Canada and Mexico.

"That has really important implications and opportunities for specialist small- or mid-market buyout firms, particularly those focusing on [sectors such as] high-end manufacturing."

And for institutional investors considering private credit, he noted, it's important to focus on managers that are investing in sponsor-backed loans. "[If you get] a loan that starts to go wrong or there's issues, the management teams [and] the operating partners are in a much better position to take remedial action and maximize the value of those investments and protect the interests of the lenders."

How economic cycles impact global REITs

Corrado Russo

managing partner and head of global securities

Hazelview Investments

by Blake Wolfe

While publicly traded real estate investment trusts have been impacted by rising interest rates, the extent of the impact varies from market to market, said Corrado Russo, managing partner and head of global securities at Hazelview Investments.

"It's not shocking to see those [markets] that have been more open in terms of the economy coming out of COVID and have experienced more inflation – and therefore are more at risk of further rising rates – have seen a bigger impact on . . . publicly traded real estate."

While a recession hasn't been officially declared, it's already been priced into U.S. REITs, he said, adding he believes inflation has peaked and will decrease in the second half of 2022, leading to a return of normal liquidity.

"If you do get a recession, rates start to come down again and that supports real estate pricing and it supports public real estate. This tells me if you think we're in a recession or going to go into a recession, you should buy REITs, but if you don't think we are going into recession then you should buy U.S. equities. And if you have no idea, then you should probably buy REITs because they give you a typical average return of about 40 per cent cumulative in either scenario."

Russo noted REITS closely follow private real estate values and are subject to short-term variables such as fund flows. However, despite price drops, the intrinsic value of the buildings hasn't changed.

"People get scared, there's more sellers than there are buyers, it takes prices down. . . . What it means is that in the public markets, there are people that are looking for the exit to either go to cash or to find opportunities elsewhere. And that's typically when you've seen a significant outsized return, if you have the courage to buy into those environments. Typically, what we've seen is if you're buying at these levels, you're typically set up for multiple years – two to five years of double-digit returns to get back to that trend line."

And with public markets already pricing in a recession, there's an opportunity for institutional investors, said Russo, citing an exercise among publicly traded companies underwritten by Hazelview that projected annualized returns of between 13 per cent and 15 per cent over the next three years.

"Let's take our cap rates higher, let's change our growth rates and bring them down lower, let's increase our overall cost to capital for our underlying companies and then redo the exercise based on where the companies are trading today versus where they were at the beginning of the year. . . . With all that priced in, we are seeing 13 to 15 per cent expected returns. If you think we fall short of those negative assumptions and cap rates go back to where they were, then that [return] becomes more like a 15 to 25 per cent potential."

Multi-asset credit provides income, diversification amid rising volatility

Blair Reid
partner, senior portfolio manager, multi-asset and income
BlueBay (part of RBC Global Asset Management)

by Blake Wolfe

With market volatility increasing amid the convergence of multiple global events, institutional investors can turn to multi-asset credit to provide attractive levels of income and diversification as well as reposition their existing asset mix or risk budget, said Blair Reid, partner and senior portfolio manager for multi-asset at BlueBay Asset Management, part of RBC Global Asset Management.

"We have inflation, the economic aftereffects of COVID and Putin's war all happening at once. . . . The great thing about multi-asset credit is you can pivot and there are two aspects. Firstly, we can dial the risk up and down and hopefully get out of the way when markets react negatively. Secondly, there are a lot of asset classes to choose from and the best risk-adjusted returns are always moving around the market."

Multi-asset credit can help institutional investors weather the current volatility, he noted. "It's not a panacea, though there are about 40,000 bonds we can choose from and often we select just a couple of hundred in a portfolio. It means, even in difficult times, we can seek out attractive risk-adjusted opportunities and rotate across the credit market."

Reid said portfolio simplification is one reason institutional investors seek out multi-asset credit. "Investors with multiple static, single asset class portfolios can benefit from multi-asset credit. Combining multiple individual portfolios into a single multi-asset credit portfolio reduces governance time and adds to the ability to actively asset allocate."

He also noted bonds are playing a key role in funding the transition to greener energy and multi-asset credit can help investors access opportunities that aren't already in their existing portfolio.

How a four-state probability model can improve investment, risk decisions

Tom McCurdy
professor of finance and Bonham Chair in International Finance, Rotman School of Management
University of Toronto

by Blake Wolfe

The use of a four-state probability model can more accurately predict stock market phases and improve investment and risk management decisions, said Tom McCurdy, professor of finance and Bonham chair in international finance at the University of Toronto's Rotman School of Management.

The proposed model incorporates trends and sub-trends labelled bear markets and bear rallies, bull markets and bull corrections, he noted. "I think that individual models or thought processes have a limited domain. . . . What's really important is, when are we going to have a transition from [a] low interest rate to a high interest rate or from recessions or expansions . . . or bear rallies to bull markets?"

These sub-models can provide a lot of information about the aggregate distribution, including a fuller picture of risks. The four states are also linked by a transition matrix that determines the movement from bear to bull market, he added. "I'm always trying to model the full distribution if I can, rather than just the first moment, and sorting these phases based upon both the risk and the return provides very useful information."

To be fully effective, this approach requires as much data as possible, said McCurdy, adding while the model looks at how typical market corrections and rallies have played out and makes forecasts based on these past events, it's still difficult to predict the timing of market crashes.

"We'll find the sequence of transition from a bull correction back to the bull [market] can be different in different bull markets and the realized structure of the bull markets can be different over time, but we're still utilizing information about what a typical bull correction looks like to improve our forecasts for the bull market phase."

McCurdy applied the model to the market heading into the coronavirus pandemic in early 2020, which started in a bull market before quickly sliding into a bear market by the end of February. While some economists were quick to declare a return to a bull market as the market slowly improved in April 2020, McCurdy's model pointed to a bear rally, amid high levels of volatility.

"The model still thinks there was quite a bit of risk [at that time] and, although we were thinking about it as a positive trend, we weren't confident enough that we were in this long-run bull market."

Based on the model, McCurdy noted it's unlikely the bull probability state will increase to more than 50 per cent until the current market volatility settles down. "Our model would say, 'Be careful, we're still in a bear rally.' Once we get back to normal levels of volatility for the bull state, then it will give us a higher probability [of a bull market]."

How institutional investors can accept, overcome inherent risk misperception

Dan Gardner
author, journalist and senior fellow at the Graduate School of Public and International Affairs
University of Ottawa

by Lauren Bailey

Risk misperception is inherent in humans and has been since stone-aged men and women first roamed the earth, said Dan Gardner, a senior fellow at the University of Ottawa's Graduate School of Public and International Affairs.

People possess two systems that help them make decisions, he said, noting one system is quick, intuitive and rooted in one's known experiences, while the other is conscious thought, at times making use of science and statistics, while processing information in a slow and laborious manner. But no matter the statistic or logic available, humans will defer to the first system, using their experiences and senses to make judgements on risks they encounter daily, said Gardner, adding that system is usually in the driver's seat when it comes to decision-making and, routinely, it comes to incorrect conclusions.

Gardner said the first system doesn't think logically and carefully about available evidence; rather, it uses heuristics and biases, essentially little snippets of information, to develop an immediate response. He shared an example of an ancient man rustling up food on the plains of Africa. "One of the things he comes across is purple berries. . . . Bob has to decide [whether to] eat the purple berries."

Gardner explained the tools Bob uses to deduce whether the berries are a risk are familiarity — whether the berries are new to him or he sees them every day — as well as affect, the emotions that can influence our judgements; availability, the commonality of any given thing; and social heuristics.

With affect heuristic, Bob determines he's tried the purple berries many times and has yet to fall sick, therefore his brain identifies the berries as good and reduces his risk perception. Conversely, Gardner noted the opposite could also happen. "Our brains are constantly [slapping] emotional labels . . . on everything. We're not aware of it, but believe me, they're there."

With availability heuristic, Bob may recall these berries are quite common and he knows someone who tried them and got sick, leading him to label the berries as risky, he said. Similarly, social heuristic allows Bob to recall how everyone he knows eats the purple berries without getting sick and it doesn't occur to him that he could be the one exception.

However, it's possible for people to train their brains to do the opposite and defer to the second system when assessing risk, said Gardner, noting humans can habitually train their subconscious to ignore this system's impulsive snap decisions. One way investors can get in the habit of deferring to the second system is to explain their reasoning behind a decision to a colleague.

"If your analysis is pure [and] the data comes to this conclusion, you should be able to explain . . . every single step with perfect clarity. If you can't, that's a warning signal that there's something else going on, that there may be a psychological factor, which is influencing your judgement in ways that may be inappropriate."

Another mechanism that could help is to constantly ask for a second opinion, he added. "If you are a psychologically astute person who recognizes that [making mistakes] is human, [you'll ask] other psychologically astute people [to] check [your] homework."

He advised institutional investors to ask colleagues to go through their work to see whether the numbers are solid or if something else is affecting their judgement. "It's not hard to understand, to identify when other people are making . . . inappropriately psychologically influenced judgements," said Gardner, noting social media is a perfect example of a space where people are often over-committed to a viewpoint and all the various psychologically driven mistakes that lead to ridiculous conclusions are evident.

"It's not hard to spot it in somebody else, [but it's] hard as heck to spot it in yourself," he added, suggesting investors aim to develop a relationship within their offices that recognizes everyone's vulnerable to risk misperception, letting colleagues know they're in this together and are there to double-check the work.

Regulatory, stakeholder pressures moving ESG investing from fringe to centre stage

Sean Cleary
executive director, Institute for Sustainable Finance,
Smith School of Business
Queen's University

by Lauren Bailey

With close to two-thirds (62 per cent) of the market committed to investing responsibly, environmental, social and governance investing is no longer a fringe activity, said Sean Cleary, chair of the Institute for Sustainable Finance at Queen University's Smith School of Business.

A combination of factors is driving growth in ESG investing, including regulatory and reputational ethical pressures, he said. "But what's really driven this acceleration has been customers and other stakeholders."

Citing a 2021 survey by RBC Global Asset Management, Cleary noted 75 per cent of the 800 global institutional investors surveyed were integrating ESG factors into their portfolios. As well, 87 per cent said they believe doing so will mitigate the risk, while 70 per cent believe they can generate alpha through ESG investing. And more importantly, 63 per cent believe factoring in ESG is part of their fiduciary duty.

The integration of ESG into investment decisions is market driven, he said, noting legislation in Canada and the U.S. don't require institutional investors to factor in ESG considerations. However, in Canada, some important legal decisions suggest boards of directors and pension plan sponsors, in particular, should be considering climate change in their investment decisions.

The more investors integrate ESG factors in their investment decisions, the more those decisions will benefit their beneficiaries because it presents an opportunity to identify big risks, such as climate change, said Cleary. Even though ESG was gaining momentum when the coronavirus pandemic first hit, many people thought, 'It's time to batten down the hatches and tighten the ship and forget about these considerations,' he added, though the opposite happened.

"The returns during the first quarter were actually better for firms with higher ESG ratings, which is consistent with that long-term evidence that it would help you avoid those big risks. In the recovery period, . . . I saw nine or 10 that said, the performance is better."

Money continued to flow into ESG funds and the number of signatories to the United Nations' principles for responsible investment increased, he said. "In fact, the performance didn't suggest that everyone was just going to stop worrying about this for now."

While some of the recommendations after the 2022 severe acute respiratory syndrome outbreak were never put in place for the coronavirus, they should've been, noted Cleary, cautioning institutional investors to avoid making the same error by missing the implications of climate change. "We need to start preparing for it . . . [and] trying to get to that 1.5 degree [Celsius target, as set out in the Paris Agreement] or two degree warming scenario. But . . . in the interim, we need to develop some mitigation . . . and adaptations strategies. Because even if we do achieve 1.5 or two degrees, our climate is still getting worse. We're going to have more flooding and fires and heat waves."

In terms of the different approaches institutional investors can take, he suggested they use negative exclusionary screening, eliminating sin stocks such as tobacco and guns from their portfolios; ESG integration, where investors integrate these factors into their investment analysis and decision-making processes; and the integration of ESG into their wider portfolio management circles, risk management processes and attribution analyses when evaluating performance.

After ESG integration, the second most prevalent strategy used by Canadian institutional investors is engagement, said Cleary, referring to meetings with clients, filing shareholder proposals and creating proxy voting policies.

It's also about public policy and how institutional investors engage with public policy-makers, he said, noting collective actions can be an important way for investors to engage on issues like climate action. For instance, Climate Action 100+ started out with investors trying to impact the 100 largest industrial polluters globally and today the organization has grown to 167 companies and 650 signatories with $60 trillion in assets under management.

"When you get that kind of assets, you actually do have a chance to make a change."

Long-term implications of Russia's invasion of Ukraine for emerging market investors

Seth Weingram
senior vice-president, director, client advisory
Acadian Asset Management

by Lauren Bailey

For years prior to the Russia-Ukraine war, there were murmurs about deglobalization as geostrategic tensions grew, nationalism flared worldwide and the coronavirus pandemic stressed global supply chains, said Seth Weingram, senior vice-president and director of client advisory at Acadian Asset Management.

Since the invasion, that discussion has become much louder, he noted, amid speculation that the war could trigger a breakdown in globalization and, perhaps, the fragmentation of the world into strategic blocs. Although it's difficult to predict how events might play out in the long term, Weingram argued that reglobalization — in other words, a change in globalization patterns — is more likely than deglobalization.

Pointing to a chart tracking the price of Russian oil relative to Brent crude, he noted that in the weeks after the invasion, Russian oil fell to a $30 discount to Brent as Western governments and refiners stopped buying it. That led China and India, two of the thirstiest oil importers in emerging markets, to step into the gap, buying Russian oil at a discount.

"This is a [clear] demonstration of the economics that give rise to and maintain globalization. It's [also] a direct example of the crisis actually causing a change in globalization patterns — or reglobalization. Finally, if you think about it, does this example portend some kind of a strategic bloc forming between China, Russia and India? I doubt it. I think it's better understood as three countries using globalized infrastructure to further their own economic interests."

Using another chart marking the imposition of former President Donald Trump's tariffs on China, Weingram showed the impact of those tariffs was fairly modest and short-lived, due to the emergence of the coronavirus pandemic and the subsequent economic recovery. Imports rebounded quickly, he noted. "This is another example of short-term economic incentives, trumping, so to speak, strategic policy objectives.

Turning to the implications for institutional investors, Weingram said emerging markets, in aggregate, have become highly integrated with developed markets over the last several decades, a trend that reflects increasing trade integration, as well as mobility of information, capital and people. If globalization remains reasonably intact, investors may have to live with this kind of investing environment for the future, he added.

As a result, he suggested investors prioritize distinctiveness in their emerging markets investments to maximize the additivity to their opportunity set and portfolio diversification. "Think about focusing on the onshore China market, which is less well-integrated with other global markets. Think about focusing on [less well-integrated] segments of emerging markets — locally oriented companies, locally oriented stocks that tend to be less liquid, less efficiently priced than, say, high-flying mega caps — because emerging market strategies that lean into [the] large cap EM space, for example, may simply duplicate exposures and opportunities that you can get elsewhere."

As for managing geopolitical event risk, when shocks hit, unless you have specific information about the nature of the event itself, the wisest course of action may be to stay the course, said Weingram, advising investors to focus on advance preparation as opposed to response.

Specifically, he suggested they focus on portfolio diversification, incorporate geopolitical risk into alpha models and not rely solely on backwards-looking risk management frameworks. "Geopolitical event risk tends to look a lot like idiosyncratic company specific risk, which should be diversified away. We see narrow, concentrated EM types of strategies coming into vogue periodically, but when local shocks hit, they can lose their appeal pretty darn fast."

Weingram recommended institutional investors incorporate risk management guardrails into portfolio construction, starting with basic limits on individual position and country and sector exposures. They can also use scenario analysis to think holistically about how a portfolio might respond to certain triggering events, he noted. "From the standpoint of geopolitical event risk, don't panic. Instead, prepare."

Concordia University re-evaluating integrated investment policy

Marc Gauthier
university treasurer and chief investment officer
Concordia University

by Gideon Scanlon

Institutional investors' best laid plans sometimes go awry — especially following global pandemics.

Marc Gauthier, treasurer and chief investment officer at Concordia University, said the dramatic events shaping the world in the past two years have challenged the university's carefully designed investment model.

"The last time I was here was the summer of 2019. I shared some of my experiences transforming the university's pension plan — its culture, its governance, its administration and, most importantly, its investment strategy. It was a massive transformation."

Before the 2008/09 financial crisis, Concordia's defined benefit plan was split 60/40 between equities and bonds, respectively. During the crisis, the plan's funding ratio dropped from 101 per cent to 74 per cent.

Things needed to turn around, said Gauthier, noting he was dealing with a board of directors that wasn't interested in making changes. To start shifting the culture to focus on sustainability instead of headline risk, he spent five years pushing for change, inviting more than 20 specialists to educate the board.

Eventually, this led to the adoption of a new investment policy entirely driven by absolute returns and aimed at limiting drawdown without sacrificing returns. "It's what I call [liability-driven investment] 2.0," said Gauthier. "It's driven by our funding policy. And ultimately, what the funding policy seeks to accomplish is to have stable and sustainable funding costs.

Instead of dividing the plan's portfolio by asset classes, it's categorized based on funding objectives. On the defensive side, it has a capital preservation strategy. It also has a growth category that focuses on specialization, concentration and high conviction. "On a going-concern basis, the behaviour of liabilities is pretty much absolute driven."

The final part was the diversification strategy, which is aimed to be disconnected from capital markets. "I focus on capital preservation," said Gauthier. "If you do the math right, when you have capital withdrawals or capital decreases, it gets back to equilibrium."

The plan, which helped Concordia's pension plan reach its return targets and remain solvent from 2013 to 2019, continued to perform well through the rest of 2019, 2020 and most of 2021. Only as the threat posed by the coronavirus pandemic began to fade did it face significant turbulence. Its solvency ratio, which had been above 100 per cent, slipped to 94.5 per cent by May, 2022.

"From a portfolio construction perspective, each bucket had a funding objective. . . . They didn't move in the same direction. . . . In 2021 and 2022, when rates started increasing and the bond market didn't do so well, we saw the same type of returns."

Despite the hiccup, Gauthier said the plan remains effective, though he added it's in need of tweaking. "While there's no cheap beta, we could take advantage of equities being devalued and increase our exposure. . . . The idea here is to emphasize more idiosyncratic risk. Because we have very little exposure to the public equity side, we want to do so in a tactical overlay way."

The growth program, which has a North American and Asian side, has been knocking its targets out of the park. "The performance has been outstanding, but what's also good is that we have a strong alternatives portfolio."

While many investors with considerable allocations to real estate were surprised by the pandemic, which hit offices and retail real estate pretty hard, Concordia's portfolio saw double-digit returns. "We have short [real estate investment trust investments]," said Gauthier. "The capital preservation did very well throughout the post-pandemic."

One other part of the carefully crafted investment model that was exposed by the pandemic was the pension plan's exposure to the U.S. dollar, in which 40 per cent of its assets are invested. "It's a massive exposure — it's really my only risk concentration I have to manage."

Up until the pandemic, Concordia's in-house dynamic hedging program performed well, protecting the plan's assets from shocks. "It's based off the risk strength indicator model's seven indicators. All behaved in line with the model, but then, suddenly, currency risk offerings were gone. Simple as that."

While the weakness might push other DB plan sponsors away from U.S. assets, Gauthier said he isn't planning a radical departure from the land of the free. "I like the exposure to the volatility. . . . It, probably, needs to have an overlay with a lot longer-term view — that's the way to capture the benefits."

Panel: A look at two pension plan sponsors' experience with impact investing

PANELLISTS

Dawn Jia
president and chief executive officer
UBC Investment Management Trust Inc.

Karen Lockridge
director, ESG investing
Canada Post Corporation Pension Plan

MODERATOR

Les Marton
managing director
bfinance Canada Inc.

by Gideon Scanlon

Responsible investing covers a spectrum between simple exclusion practices to environmental, social and governance integration to thematic and impact investing, said Les Marton, managing director of bfinance Canada Inc., while moderating a panel discussion.

The two panellists — Karen Lockridge, director of ESG investing at the Canada Post Corp. pension plan, and Dawn Jia, president and chief executive officer at the University of British Columbia Investment Management Trust Inc. — represented organizations with well-established, though different, approaches to responsible investing.

According to its statement on responsible investing, UBC IMANT incorporates ESG considerations into its investing decisions. It also requires external asset managers to provide evidence of ESG incorporation and for them to practice corporate engagement through proxy voting and direct contact.

With the organization managing the UBC's endowment fund and working capital, as well as its pension fund, its pension plan members have different responsible investing priorities than other stakeholders, said Jia. "I find that pension plan members. . . think of financial security as a higher priority. They want you to fully evaluate ESG risk — that's all. It's part of their priority. On the endowment side, we have lots of young students involved. They put lots of pressure [on UBC IMANT] about [fossil fuel] divestment specifically."

Canada Post has a responsible investing philosophy built on four pillars: integration, engagement, advocacy and investment. "I thought we should have three — investment is only the fourth pillar when there's intentional investing in solutions and I thought we were too early for that, but a board member encouraged it," said Lockridge. "We still have a way to go to implement [the investment pillar], but I think it's an important part."

Like the UBC IMANT, Lockridge's team assesses asset managers on ESG issues and is involved in corporate engagement, including by supporting shareholder-led proxy votes asking companies to provide climate-related disclosures and emissions targets. The three-person advisory team supports these efforts throughout the organization. "We support the broader team as we integrate ESG and get to some of the specifics about how that impacts our portfolio and the world," she said.

With Canada Post's team and external managers doing the direct investing, the team developed a due diligence framework to grade new managers and existing managers. "It has six attributes and impact is one of them," said Lockridge. "It's about looking at their intentionality, their research processes and their approaches."

However, the team doesn't like to describe itself as being involved in impact

investing, she added. "While we're not looking for impact investment strategies now, it's part of our strategy going forward. We have a lot of work to do first. We need to develop mandates, guardrails and ask ourselves, 'What, specifically, are we targeting?'"

While the Canada Post pension plan's team may not be looking for impact investment strategies, it sometimes stumbles into them. "We recently invested in an affordable housing strategy. . . . It was not presented as an impact investment strategy, though everybody knew the manager had intentionality in there. But it met the real estate team's expectations and our due diligence process."

Similarly, UBC IMANT's staff don't think their work investing for UBC employees qualifies as impact investing. "There's a grey area between impact investing and an investment philosophy," said Jia. "When we talk about ESG investing and sustainable investing, we like to say, 'You don't have to sacrifice return. If you can keep your return and do something good, why not?' Whereas impact investing, I feel impact has to be your priority, superseding return."

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