

# **PRUDENCE, PATIENCE AND JOBS**

**Pension Investment in a Changing Canadian Economy**

**— Summary Report —**

*Prudence, Patience and Jobs: Pension Investment in a Changing Canadian Economy*

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The Canadian Labour Market and Productivity Centre (CLMPC) is an independent national labour-business organization whose mission is to contribute to economic growth and the betterment of society by improving business-labour relations in Canada and by providing joint advice on public policy, particularly related to labour market and productivity issues.

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## Preface

To most of us, the topic of pension funds suggests concerns of aging, retirement and long-term economic security. In other words, we think about such personal questions as: *Exactly how much money will I need to ensure comfort and a good quality of life in my senior years?* Canadian public policy and the media reflect these pre-eminent household concerns, evident in recent discussion about the challenges presented to society in an aging population and increasing calls on government treasuries to guarantee the provision of adequate health care and income security programs. In this context, the role assumed by employer-sponsored (or occupational) pension funds is a vital one for many Canadian workers, retirees and their families.

Increasingly, public policy also views pension funds from an entirely different perspective: their fast-growing importance as institutional investors in the Canadian financial system. Employer-sponsored funds are not just a principal source of retirement income to many working people, they are also large and influential financial institutions that perform a current economic function in converting national savings into productive, value-added investment that can create jobs.

To what extent do these different roles positively converge? The singular priority of pension trustees and managers is to obtain optimal revenues from investing in a prudent fashion. Legislators and governments must

be concerned about maintaining a social policy framework that accounts for trends in the Canadian retirement income system and anticipates an aging population. At the same time, there must be confidence that pension asset allocations act to facilitate national economic policy requirements. The challenge here is to find an effective and efficient way of maximizing the intersection of these distinct and occasionally conflicting imperatives.

Consideration of pension funds in this new light is long overdue. This report by the Canadian Labour Market and Productivity Centre (CLMPC) undertakes the task of examining pension funds in their second and less-well-known function as economic agents. In particular, *Prudence, Patience and Jobs: Pension Investment in a Changing Canadian Economy* looks at the role and performance of pension investment activity in fostering positive output, productivity and employment outcomes in an era of major change and restructuring. In so doing, it aims to increase appreciation of funds in this realm and help broaden and deepen public discussion.

The following is the **Summary Report** of a larger **Technical Report**, of the same title, containing much more detailed data and analysis, full complementary figures, discussion of major public policy themes, lists of consultees, endnotes, a bibliography and sources suggested for further reading. This document can be readily obtained through the CLMPC.

## Acknowledgements

*Prudence, Patience and Jobs* would not have been possible without the generous help of a great number of individuals and organizations in Canada, the United States, the United Kingdom, Australia and elsewhere internationally.

Firstly, the CLMPC acknowledges, with thanks, the financial contribution of the Labour-Management Partnerships Program of Human Resources Development Canada.

Secondly, it is important to note that the research contained in *Prudence, Patience and Jobs* has relied heavily on interviews conducted over 1997-98. Informants included representatives of academe, research and market analysis agencies, business and labour constituencies, federal and provincial governments, not to mention the community of pension trustees, money managers, advisers and regulators. The CLMPC warmly acknowledges this sharing of expertise. A comprehensive list of informants is found in Appendix 1 of the **Technical Report** (see **Preface**).

Special thanks to those who contributed extensively to CLMPC research by supplying data and analysis, advice on key issues, and/or feedback on report drafts. This includes project consultants Mary Macdonald (Macdonald & Associates), Bob Baldwin and Dick Martin (Canadian Labour Congress) and Gordon Sharwood (Sharwood and Company). Regular contributors also included such senior pension fiduciaries as

Darcie Beggs, Drew Bucknall, Bill Clark, Lynn Clark, Ian Collier, Jean-Claude Cyr, Heather Gavin, Russell Hiscock, Michael Lay, André Mayrand, Michel Nadeau, Doug Pearce and Don Walcot, as well as Keith Douglas of the Pension Investment Association of Canada (PIAC). Also included are capital market researchers Randy Barber, Tessa Hebb, Ted Jackson, Regina Markey, and Allan Riding, pension analysts Keith Ambachtsheer and Isla Carmichael and market practitioners Michael Brown, Peter Friend, Kevin McKenna, Robert Olsen, David Podmore, Hugh Rorison, Tony Stephens, Bob Tattersall, Sebastian Van Berkom and Sam Znaimer.

Thanks to PIAC and the Ontario Public Service Employees Union (OPSEU) for in-kind and other resources dedicated to the production of two surveys (see **Introduction**), as well as those PIAC members and labour trustees that participated in these.

Thanks to Jean-Guy Bourgeois for his assistance in the research, and to the staff of the Pension Section of Statistics Canada, the magazine *Benefits Canada*, and the federal Department of Finance for their regular consultative contributions.

Finally, thanks to officials and staff of Canadian and non-resident corporations, financial institutions and pension funds that gave the CLMPC very generous access to their operations and records for the purpose of case study and who, in many instances, also provided considerable input and support.

## Introduction

Canadian employer-sponsored pension funds are a cornerstone in the country's system of providing a guaranteed source of income to working people and their families in retirement. With a total asset base of over \$500 billion (i.e., the dominant fraction that is trustee-owned) in 1998, such funds now form the most sizeable portion of this system.

Employer-sponsored funds are based on the deferred wages of employees and comprise in-trust assets invested for their sole interest. This fundamental mandate cannot be ignored, bypassed or subordinated to any other goal. To provide for the "pension promise", fiduciaries are expected to govern their fund organizations with care, diligence and skill, ensuring that all decisions are transparent and consistent with the law.

At the same time, pension funds are also financial institutions. By rapidly accumulating assets, these funds have become an overwhelming presence in the capital markets of industrialized economies worldwide. In Canada, funds have expanded by seventy-five times their recorded size since the mid-1960s and today make up this country's second largest pool of capital resources, after the banks. In other words, they are also potent institutional investors with increasingly deep roots in many private and public capital markets, and a vital force in Canada's ability to convert national savings into productive investment.

During the process of maximizing financial returns, pension investment may generate "collateral benefits" or positive economic effects, such as growth, jobs and local development, and other social goods. These benefits frequently emerge incidentally. They are also obtained through strategic asset-targeting (e.g., economically-targeted investments, or ETIs, in the United States) that occurs within a prudential framework that still treats earnings as the first and overriding priority. Be they unintended or planned, collateral benefits may be more important today due to the impact of Canadian economic change and restructuring. As high

unemployment levels persevere, there remains a need to support those sectors that promise future generations of output, work and income. A key challenge here is ensuring that capital markets and financial institutions are facilitating this objective by directing resources to the economy's highest productivity potential.

*Patience, Prudence and Jobs: Pension Investment in a Changing Canadian Economy*, a report by the CLMPC, investigates the role of pension funds in this endeavour. As research literature in this area is limited in Canada, the CLMPC approached the task with a broad brush, examining past and current pension engagement in four distinct capital markets that impact markedly on a new economic and job environment. Key private (debt and equity) capital markets that serve the financing demand of small and medium-sized enterprises (SMEs) are given special attention, particularly in the report's final section on impediments to pension participation in them.

One obstacle in conducting this study has been the absence of comprehensive information — apart from the excellent data provided by Statistics Canada and *Benefits Canada* — that casts light on these funds as financial institutions. To compensate, the CLMPC conducted interviews with Canadian pension trustees, money managers, market analysts and practitioners. The CLMPC also drew on market-specific evidence and case study data pertaining to different aspects of pension participation. This material was supplemented by data on some comparative international experience.

Finally, the CLMPC performed a survey in co-operation with the Pension Investment Association of Canada on barriers to pension investment activity that may yield significant collateral economic benefits (and which forms the basis of the final section). Also in co-operation with the CLMPC, the Ontario Public Service Employees Union performed a survey on labour participation in pension investment decisions.

## **1. Constituency Views of Pension Investment in a New Economy**

### ***Views of the Business Constituency***

The top concern of many in Canada's business constituency about the investment and management of pension assets can be summed-up in one phrase: access to capital. More specifically, available financing must be more closely linked to the need to invest in economic change and, in particular, the introduction of more knowledge, technology and skills to industry. Over the years, several national business organizations have asserted that, in a new and more competitive global economy, the nation's stock of capital must be deployed strategically to reach our optimal growth prospects. To do this, the needs of small and medium-sized enterprises (SMEs) must be addressed. This is especially important to high-growth firms in knowledge-based and technology-intensive sectors.

The Canadian Chamber of Commerce, in cooperation with the CLMPC, helped to confirm the facts of this situation in a 1995 survey of the former's SME membership. This survey found that one-half of respondents believed their financing circumstances were only somewhat adequate or were not adequate. Impediments were more pronounced for the smallest, youngest and most innovative of these firms.

Business has expressed specific concern about the role of pension funds in this regard. For instance, in the late 1980s, the Chamber noted the limited engagement of funds in SME financing of all kinds, including venture financing. Considering the expansion of pension assets and influence in the Canadian financial system, it was argued that fiduciaries must adopt a longer-term perspective to investing and broaden their capital market participation to reflect greater economic relevance.

### ***Views of the Labour Constituency***

The top concern of many in the Canadian labour movement about the investment and management of pension assets can be summed-up in one phrase: employment creation and protection. To maintain the living standards of working people and their families, new or existing jobs that are primarily full-time, value-added and well-paying must be given top priority. Increasingly, unions and workers in Canada have found a vital connection between this goal and decisions about the deployment of national capital resources. Many unions and union centrals have devised collective investment strategies with job-related mandates, a trend documented by the CLMPC in its study of labour-sponsored funds (1995).

More recently, labour has turned its attention to the contribution of pension funds to this end. Where individual unions have issued policy statements, they generally have urged funds to invest with greater emphasis of the long-term interests of workers, their employment and the economy, both nationally and locally. The Canadian Labour Congress (CLC) has determined to explore pension investment issues more closely at the national level.

Part of labour's focus is on asset-targeting models capable of producing collateral benefits, such as affordable housing, community economic development, and jobs through SME growth in both traditional and non-traditional industries. Some unions promote the introduction of social responsibility criteria to pension investing and to the actions of fiduciaries as significant minority owners of equity in Canadian public securities exchanges. Above all, many unions seek establishment of a more central role for employees and other plan members in pension governance through joint trusteeship and other means.

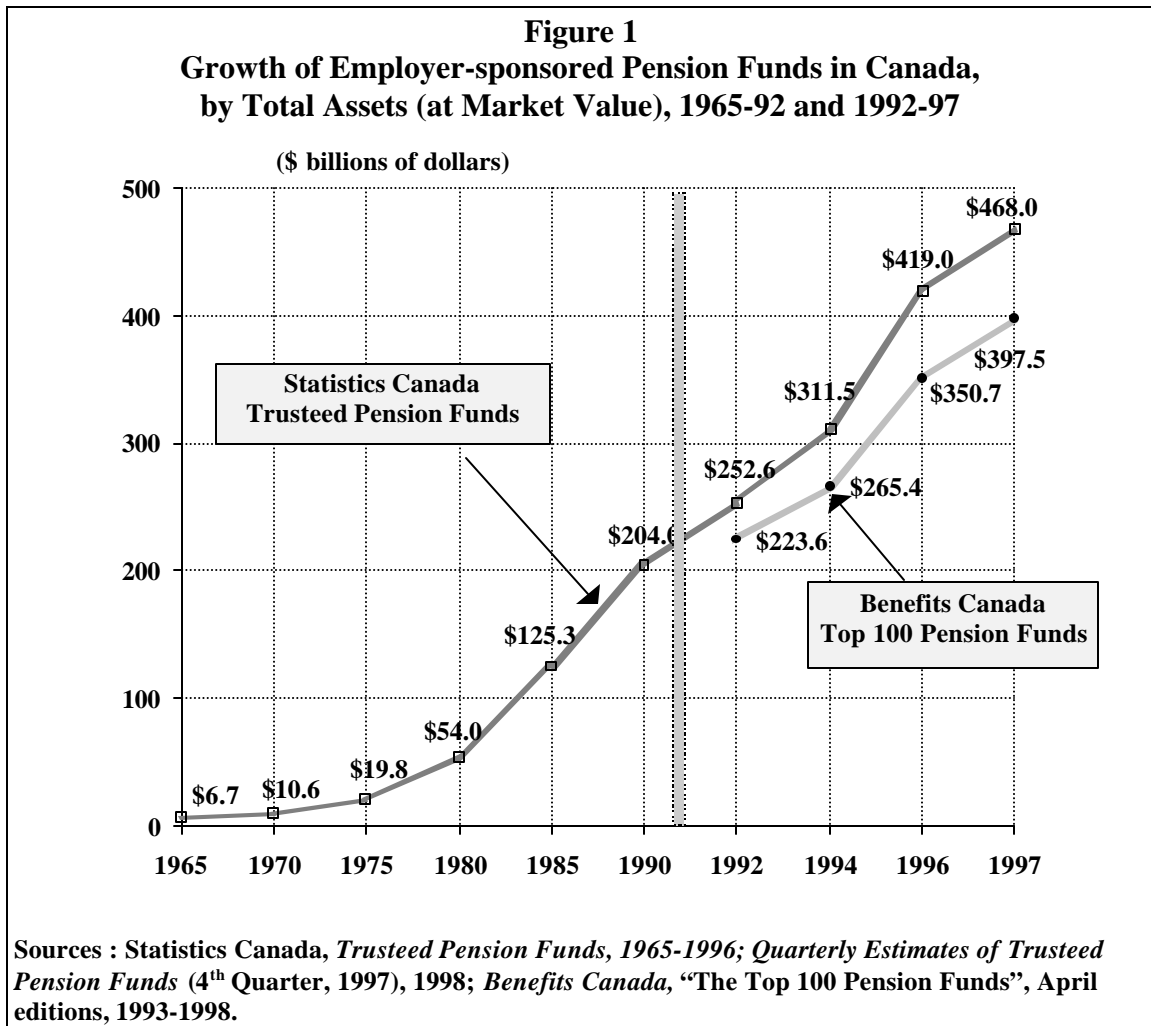
## **2. Investing and Managing Pension Assets in Canada**

Employer-sponsored pension funds can be described from different angles, but are usually discussed using the Statistics Canada database for trustee funds holding 90 percent of all legally-registered plans and two-thirds of all plan money. These also reflect the active membership of almost four million Canadian workers. Over the years, trustee funds have grown at brisk, healthy rates (currently, over 10 percent annually). Indeed, by 1998, they had expanded by seventy-five times their aggregate size in the mid-1960s and may well be 100 times larger early in the next century.

Exponential pension growth is based on several factors, including the recent re-weighting of core asset classes towards more

many public sector funds. The Ontario Teachers Pension Plan Board (PPB) illustrates this in its movement from a \$16 billion portfolio in non-marketable bonds in 1990 to a \$53 billion fund with broad debt-equity diversification in 1997.

The cumulative result of these and other events has been a better than doubling of assets held by trustee funds — from \$204 billion to over \$500 billion — from the decade's beginning to today. A significant aspect of this trend is the ascendance of the public fund category in a few short years. In 1997, *Benefits Canada* revealed that only five of the top twenty pension funds in Canada are private sector. The largest fund is Ontario Teachers, followed closely by the



public equity holdings and plan "restructuring", a common feature of which is the first-time capital market participation of

\$49 billion Government and Public Employees Retirement Plan of Quebec, the \$30 billion Ontario Municipal Employees Retirement

System (OMERS) and the \$13 billion Hospitals of Ontario Pension Plan (HOOPP). At around \$10 billion apiece, the largest in the private sector are the Bell Canada plans, managed by Bell Investment Management Corporation (BIMCOR) and Canadian National Railways Pension.

There is also growing asset concentration at the top. In a universe of over 3,500 trustee funds, the twenty largest reflect nearly 57 percent of total assets, the ten largest, 44 percent, and the top three, 28 percent. Public sector assets have been further consolidated by the rise of money management institutions, such as the \$64 billion Caisse de dépôt et placement du Québec. Similar institutions include the \$52 billion Office of the Investment Officer (OCIO) in British Columbia and the \$33 billion Investment Management Division (IMD) of the Alberta Treasury.

Asset accumulation of this magnitude betokens the coming of age of Canadian pension funds as financial institutions, at least in terms of overall supply. Today, they are the second largest pool of capital resources, after the banks. With the same variables in play, the trustee fund asset base will continue expanding in the short-term, possibly surpassing the \$600 billion mark not long after the year 2000.

### ***Aspects of Pension Governance***

Governance issues pertaining to multi-stakeholder pension funds have also come to the fore recently. In 1997, PIAC crafted guidelines for model governance principles and practices. Canadian pension analysts, such as Keith Ambachtsheer and Don Ezra, have emphasized the importance of these as fund roles and obligations expand and evolve.

For most funds, governance relationships are defined by the legally-sanctioned trust agreement. This agreement clarifies the responsibility that individual trustees or fiduciaries owe to plan beneficiaries. The former individuals are named as official plan administrators under Canadian statutes and tend to be sponsoring employers or specific

pension boards or committees of diverse compositions. There are governing, managing and operating fiduciaries who function in distinct capacities for single or multi-employer plans that can be employer-administered or administered by joint trusteeship. In most jurisdictions, trustees who are employers must set up advisory committees with employee or plan member representation, though few of these actually exist outside of Quebec.

By all accounts, there is mounting Canadian labour interest in a greater role for employees and other plan members in pension governance, including investment decision-making. Many national unions and provincial affiliates of the CLC have expressed concern about limited labour participation in governance structures, despite the growing incidence of joint trusteeship and input bodies since the 1980s. This is because joint administration remains confined to multi-employer and some public sector funds and because some existing arrangements are unsatisfactory to labour.

To address this concern, the CLMPC cooperated with the Ontario Public Service Employees Union (OPSEU) in 1998 on a first-ever survey of Canadian labour fiduciaries and labour members of advisory committees. The survey's aim was to obtain more understanding about the assorted conduits of labour influence in pension governance from representatives of the country's twenty-three largest funds. Among the key findings were:

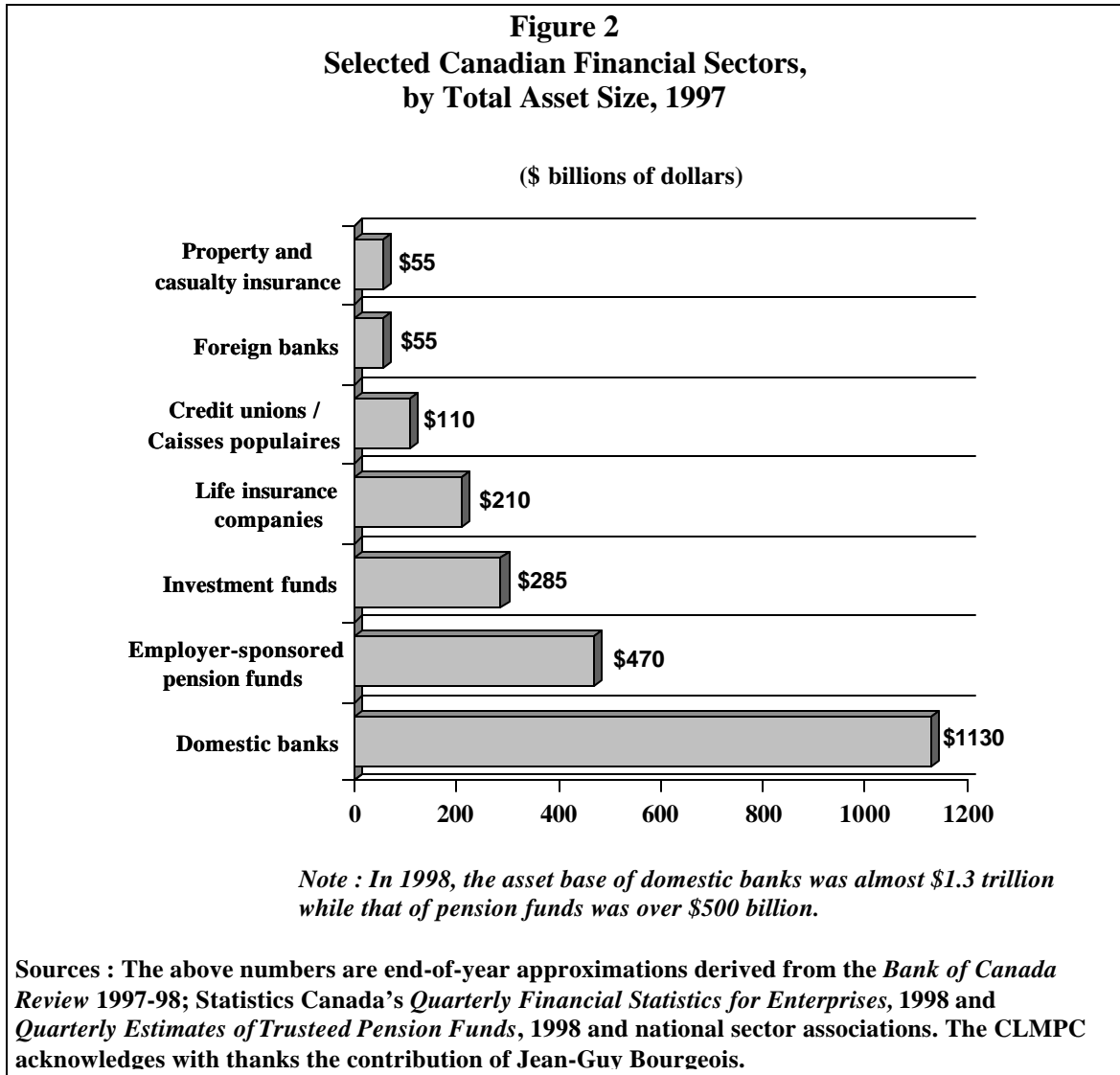
- ✓ Labour input in pension governance ranges from joint trusteeship (in the largest public sector funds) to little or no formal involvement.
- ✓ Full joint trusteeship is well-reflected in plans for the Alberta Public Service, the College of Applied Arts and Technology, HOOPP and OPSEU Pension Trust.
- ✓ Five other public sector plans also function under joint trusteeship while others may be moving in this direction.

- ✓ Most large private sector plans provide for little or no official labour representation.
- ✓ Unions select labour trustees in five plans or recommend appointees to employers in others.
- ✓ Most models featuring labour participation include some input in

Using OPSEU survey findings, the CLMPC estimates that approximately one-third of total pension assets fell under some version of jointly-trusted administration in 1998.

### *Investing for the Pension Promise*

All pension investment policies and processes originate with the benefits promise made to retiring plan members. Governing fiduciaries



- investment decisions.
- ✓ There is increasing labour interest in full involvement in pension governance and in investing that better reflects Canadian economic and social priorities.

determine the minimum level of assets (based on contributions and investment revenue) needed to render long-term benefit payouts. Based on this determination, formal investment policy states the appropriate asset mix and such imperatives as return expectations, diversification and risk

parameters. From these essential considerations, most pension investment decisions flow.

This prudential framework is re-inforced by Canadian law. Federal and provincial pension standards legislation holds individual trustees responsible for their decisions and actions as official administrators. Beginning in 1987, fiduciaries in Canada have been guided in the exercise of their duties by the “prudent person rule”, a theme from common law that requires one individual to act with care, diligence and skill in handling the assets of another. Along with this rule, statutes spell out supplementary specifications for pension investing. For instance, no more than 10 percent of a fund may be at risk in any one entity, nor may it own more than 30 percent of the voting shares in a single corporation.

Managing fiduciaries turn policy into strategy. The latter can be based on any number of investment style preferences, such as the extent to which asset allocations are actively or passively managed. Pension funds can be grouped according to how they combine these two styles or prefer one to another. It has been argued that the active approach thrives where there is relative inefficiency in capital markets and value can be added by skilled management.

For long-term investment purposes, pension funds can be organized in multiple ways. For instance, management teams may be situated internally or externally, or both. In general, the in-house approach is available only to very large funds, though there is no uniform pattern even among them. Balanced managers of assets may be utilized, or specialty managers, or both. Where there is investing in alternative or non-traditional asset classes — those that depart from the core mix of stocks, fixed income and cash —

active, highly specialized management resources are a clear prerequisite.

### ***Trends in Pension Investing***

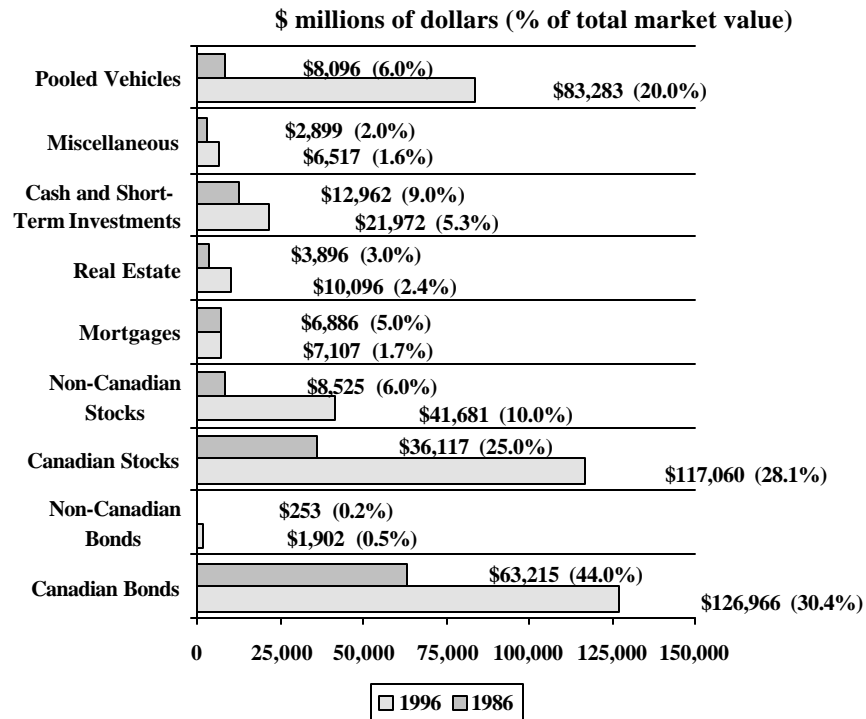
Canadian pension investment patterns have changed markedly over time. Since the mid-1980s, there have been three developments that stand out concerning sources of optimal rates of return and from a national economic perspective.

The first of these is heightened aggregate exposure of pension assets to public equity. According to Statistics Canada, bonds represented the biggest proportion of total assets (44 percent) a decade ago, but declined to 31 percent by 1996. Today, at nearly 50 percent of total assets, stocks have supplanted bonds. Among the largest pension funds, the level is closer to 54 percent. This fact notwithstanding, Canadian funds invest less in public equity than do their counterparts in the United Kingdom and the United States.

Secondly, there is greater Canadian pension investment diversification into American and global capital markets. A few years ago, funds were nowhere near reaching the 20 percent ceiling imposed by legislation on foreign holdings as a percentage of overall portfolios. However, the ceiling was hit by large funds in 1997 (and approached by others), though international asset exposure trends remain understated due to fiduciary use of derivative instruments.

Finally, high-price stock-picking and low inflation of the mid-to-late 1990s appear to have contributed to reduced pension portfolio emphasis of alternative/non-traditional asset classes, such as private equity and real estate. Data are not always precise on this topic since much of these asset allocations are typically a very modest fraction of the whole.

**Figure 3**  
**Investment by Canadian Pension Funds,**  
**by Asset Class (at Market Value), 1986 and 1996**



Source : Statistics Canada, *Trusted Pension Funds, Financial Statistics, 1996, May 1998*

***Pension Investing and the Economy***

Today, Canadian pension investment activity intersects with Canadian economic development needs as never before. In a few short years, funds have emerged as pre-eminent institutional lenders and shareholders in public securities exchanges. In particular, increasing pension asset exposure to corporate equity in the 1990s has led to unprecedented interaction with publicly-listed business and periodic offerings of the kind that can yield productive investment, growth and jobs.

However, there remain barriers to financing geared to new and developing SMEs, growing knowledge-based and technology-intensive firms and traditional firms attempting a transition in an altered economic environment. Is there a “disconnect” between demand from these sectors and pension asset allocations, perhaps illustrated in reduced exposure to alternative/non-traditional asset classes and the private capital markets in which they are chiefly situated?

If this is so, there is also evidence that some pension fiduciaries, at home and abroad, are currently charting a new and fundamentally different investment course. With characteristic patience — due to the ability of most to balance assets with liabilities over the long-term — and with prudent goals in mind (e.g., asset and portfolio diversification), some are exploring still broader capital market participation.

**3. Pension Participation in Selected Capital Markets**

CLMPC research into the link between pension investment and transition in Canada’s economy draws attention to four capital markets — venture investing, middle market investing, public equity investing (with specific reference to small-capitalization stocks) and real estate investing. The first three form a private-public continuum for financing supply to new company formations, SME growth and later-stage business development, in both traditional and non-traditional Canadian

industries, that is job-creating or job-protecting. All enjoy some measure of pension asset exposure.

Financing barriers can arise because of the intrinsic qualities of SMEs (e.g., size, age) or when specific capital markets are impaired due to size, under-development and other structural factors. Extensive research shows that barriers can have immediate ramifications for economic output and job creation, particularly in an era of change and restructuring. Moreover, the more SME demand is technically specialized or located outside of large urban centres or central regions, the greater the difficulties encountered.

The inherent inefficiency of Canadian private capital markets (e.g., information problems that induce high transaction costs and risks) make them a regular focus of improving SME financing circumstances, nationally and locally. Increasingly, there is recognition that loan markets, institutional venture capital, mezzanine financing and other markets for privately-placed debt and equity require skilled management resources, infrastructure and stable supply conditions, among other things, if their potential is to be realized. Though different in quality, challenges also exist in public securities exchanges.

As the second-largest pool of capital in the financial system, the degree of attachment of pension funds to such markets is a valid consideration. In the next sections, the nature, scope and dimensions of the four markets are discussed as well as historical and current pension investment activity, where data permit. To compensate for gaps in the latter, details of current participatory models are also provided. Each section concludes with brief examination of the local context and prospects of a greater pension presence in future.

#### **4. Pension Funds and Venture Investing**

Private equity investing can have many possible applications in a national economy. One of the most important of these is venture capital, the focus for which is new, growth-oriented SMEs at various stages of development, such as seed projects, start-ups and early or late phases of expansion, or slightly more established SMEs engaged in acquisitions, buyouts or turnarounds. As its name implies, such financing carries exceptionally high risk. Venture investment projects usually do not exceed \$7-10 million in size (in contrast with non-venture private equity available for well-established medium-sized and larger firms) and last between three and ten years.

Venture capital is a vital alternative or complement to bank loans for SMEs, and particularly those in emerging knowledge-based and technology-intensive industries that are unable to obtain more conventional forms of secured, low-risk financing.

Canada may be considered fortunate in having a growing and increasingly diverse institutional venture capital market when, by all accounts, this is not the situation in many advanced industrialized countries outside of North America. Its origins can be traced to the early 1950s, but a fully-fledged market did not appear until the 1980s. Since that time, the Canadian market has evolved despite major structural impediments, such as restricted or unstable capital supply flows, limited infrastructure and too few qualified or experienced specialists.

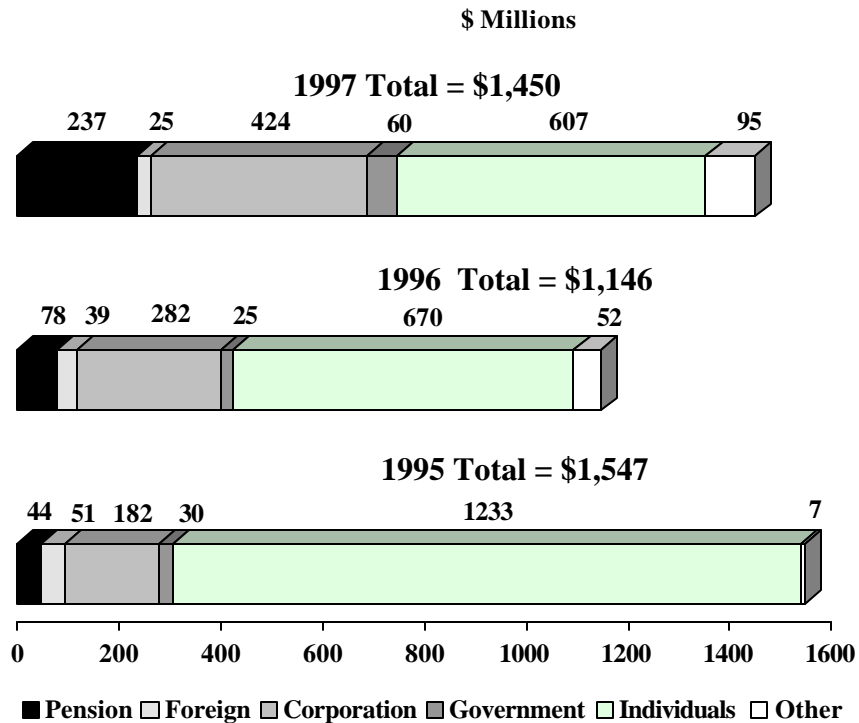
In 1998, total capital under management in the Canadian market was \$8.4 billion or a near doubling of resources since the early 1990s. Investment activity is also at record levels. In 1997, a total of \$1.8 billion was disbursed to close to 800 companies.

These trends are critical to Canada's capacity to replace old sources of economic growth and jobs with new ones. Over the years, new business formations and SMEs in high technology and other high value-added industries have increasingly been given the opportunity to grow rapidly with the backing of venture capital. Slowly but surely, this process is helping to change the face of the national economy and employment, in large part through the creation of more knowledge-based production and knowledge workers. Between 1991 and 1996, 17,000 jobs were created by 420 venture-financed companies at an annual growth rate of 26 percent — a performance that outstrips the rest of the Canadian economy by wide margins.

***Pension Funds and Venture Investing: Then and Now***

Canadian pension funds occupied a formative position in the venture capital market during the 1980s following regulatory reforms (e.g., introduction of the prudent person rule) that gave them much broader investment powers. This prominent supply role peaked in 1987, but plummeted thereafter, as did the participation of other institutional investors (e.g., life insurance companies) due to several factors. While the subsequent economic recession was one trigger, CLMPC research found that withdrawal of pension funds was chiefly linked to unexpected financial under-performance, at least in the short-term, and market structure deficiencies that reduced the confidence of fiduciaries.

**Figure 4  
Supply Sources of New Venture Capital  
in Canada, 1995-1997**



Source : Macdonald & Associates, 1998

### **Risk-taking in America**

America's venture capital market is certainly the largest and most evolved in the world and has leveraged much of the industrial growth in computer hardware and software, Internet-related products, life sciences and other technology-intensive sectors that has been apparent in that country over three decades. The Silicon Valley-based Kleiner, Perkins, Caufield and Byers (KPCB) is one of more than 370 venture capital institutions and 600 partnerships and pools that operate in a market holding in excess of \$46 billion in capital under management in 1998.

Sufficient backing of KPCB and other venture capitalists is taken for granted in a market where pension funds have historically been the major source of supply. In recent years, funds have contributed approximately 50 percent of new capital commitments annually to private equity markets of all kinds, including venture investing. While private sector funds tend to allocate proportionately more assets per plan, it is public sector funds, such as the California Public Employees Retirement System and Utah State Retirement Systems, that are collectively the top suppliers overall.

The result was a drop in aggregate pension participation to an average of \$50 million in new capital commitments per year. Only in Quebec did participation continue unabated. Finally, 1997 witnessed something of a rebound in the pension presence in venture investing, with new capital commitments from this source jumping to the unprecedented high of \$237 million. This translates into 16 percent of total new market supply in that year, or a nearly threefold increase over percentage levels of the immediate past.

Most current pension involvement is that of a handful of very large public sector funds, such as HOOPP, OMERS, Ontario Teachers PPB and plans associated with Caisse de dépôt and British Columbia's OCIO. By contrast, other private and public sector funds with holdings in venture capital pools dating from the 1980s have been liquidating these

steadily without, in the majority of cases, any subsequent follow-up in new commitments.

Using the database of Macdonald & Associates going back to 1985, the CLMPC estimates that Canadian pension supply to the venture capital market currently totals approximately \$800 million to \$1 billion.

### **The Pension Difference Down-under**

Like Canada, Australia is home to private equity markets that have occasionally had to struggle with considerable setbacks before delivering a consistent stream of returns to investors and to the economy. At the end of 1997, however, the fast-growing venture capital market had attained a pool of over \$1.6 billion, most of which has been invested in expansion projects in high technology, manufacturing and other exporting industries. Much of this relatively new investment activity has also reached New Zealand.

Providing the fuel to this market development are pension funds. Peaking at over 72 percent of total new capital commitments to venture investing in 1997, the pension share in cumulative supply over time has been 62 percent. One-half of this level has generally been contributed by jointly-trusted industry superannuation funds (at 3.5 percent of assets per fund), a recently-established supplement to the employer-sponsored system. A key vehicle for this participation has been the Development Australia Fund. Public sector funds are the second largest supply source.

In practice, pension funds can enter the market either directly or indirectly. The direct approach often entails co-investment with others on a per transaction basis (in the case of large funds). However, most engagement occurs indirectly through syndication of pension assets in a pooling vehicle situated externally, such as a limited partnership. This method is demonstrably efficient as it permits investors of all sizes to share the costs and risks of generally small deals and small investment sums and to defer management-intensive tasks to value-adding specialists. Given the finite supply of the latter, pooling

also enables multiple funds to take advantage of those available. The CLMPC found both direct and indirect systems in evidence in Canada.

### ***Examples of Pension Participation***

- ✓ **DIRECT**: Key to the success of the Quebec venture capital market over two decades, the Caisse de dépôt deploys a sophisticated, internal group of corporate subsidiaries geared to SME stages of development, industrial context, product line or locale. Such specialized subsidiaries as Sofinov, active in biotechnology, life sciences, information technology and industrial goods sectors, contributed substantially to total Caisse venture investing of up to \$500 million in 1998.
- ✓ **DIRECT**: In 1997, Ontario Teachers PPB formed an innovative partnership with Celtic House International, a corporate venturing subsidiary of Newbridge Networks Corporation. As part of its \$100 million commitment to venture capital, Ontario Teachers co-invests with Celtic House in several of the information technology spin-off projects comprising the latter's portfolio. Investee firms benefit greatly from the developmental nurturing and resources provided by Newbridge.
- ✓ **INDIRECT**: Over its history, Ventures West Management has initiated several limited partnerships in which close to 100 pension funds have invested, including British Columbia's OCIO beginning in 1993. By 1997, other public sector funds had joined OCIO in capitalizing a \$56 million pool with a mandate for investment in early stage high technology SMEs. Ventures West has been responsible for bringing such high profile Canadian firms as Ballard Power Systems from start-up to public offering.
- ✓ **INDIRECT**: Also consistently effective in syndicating pension assets since the 1980s has been the management team now administering Miralta Capital. A

corporate structure wherein funds act as shareholders (unlike a limited partnership), Miralta was established in 1992. Along with the affiliated Almasa Capital, this venture capital institution invests in such industries as communications, computer products, electronics, industrial automation and specialized manufacturing.

### ***From Acorns to Trees***

One measure of increasingly mature Canadian venture investing is the proliferation of new specialty or niche pools, many of them pension-supplied. Two good examples are the \$25 million Eastern and Western Technology Seed Investment Funds established by Ventures West and various partners in 1997. Along with initial financing of between \$100,000-\$500,000, these pools offer value-adding management resources, such as "company creators" or skilled entrepreneurs that help build a business entity around a product idea found in western Canadian universities and research centres. The goal is to generate high technology start-ups prepared for further growth.

Public sector pension plans associated with British Columbia's OCIO contributed to the capitalization of this initiative. Also in 1997, the Caisse de dépôt launched two \$30 million seed financing pools – T2C2/Bio and T2C2/Info for similar commercialization of innovation in the life science and information technology sectors, respectively. Both the western Canada and Quebec pools had initiated several seed investment projects in 1997-98.

### ***The Local Dimension***

Today, venture investing is integral to Canadian community and regional economic development, diversification and job creation of any magnitude. Nonetheless, venture capital stock is not always readily available at the local level. In fact, prior to the mid-1990s, only two in ten venture capital institutions resided in sub-markets outside of central Canada.

Where pension involvement exists, it has sometimes helped to redistribute overall venture capital flows and disbursements to regions and within them. For instance, at 37 percent in new capital commitments, public sector funds were the top supply source in British Columbia in 1997 under the auspices of the OCIO. Along with contributing around one-quarter of total new capital to the Quebec sub-market in the same year, the Caisse de dépôt has taken steps to locate venture investment opportunities to a broader range of urban and rural Quebec communities through its latest subsidiary, Accès Capital.

In the United States, pension funds are at the forefront of venture capital market supply, both nationally and locally. 1995 research conducted for the federal Small Business Administration (McNeill and Fullenbaum) found that pension-sponsored economically-targeted investment programs were effective in spreading the incidence of venture investing beyond large states. The program of the Public Employees Retirement Association of Colorado was cited as one model that facilitated new investment activity in twenty-one out of twenty-nine states. Moreover, the impact of these was greatest in small, disadvantaged states where public sector funds proved a driving force.

### ***Concluding Thoughts***

The Canadian institutional venture capital market has shown signs of maturation on both its demand and supply sides in the 1990s despite the challenges inherited from the previous decade. At present, pension funds occupy a minor position in this evolution, at least outside of the British Columbia and Quebec sub-markets and as compared to some other countries (e.g., Australia, the United States). One unfortunate outcome is less balanced, less diversified supply sources than should ideally exist.

#### ***Pension Assets at the Grassroots***

The Caisse de dépôt's aim to invest profitably with reference to local economic needs is

evident in the fact that 80 percent of all asset allocations are situated in Quebec. In 1996, the Caisse advanced this effort with initiation of an instrument for community economic development – the Accès Capital network of pools. Today, these pools are situated in twelve regions of the province and capitalized at a total of \$100 million. In its short history, seventeen investments have been made as part of an aggregate portfolio valued at \$13 million.

Accès Capital has multiple roles. Regional pools receive and evaluate local business plans and offer financing of between \$50,000-\$750,000, most of which occurs in the form of term loans. Most borrowers are established SMEs in traditional manufacturing and service industries, but start-ups are also considered for venture financing. In larger projects (up to \$1 million), pools co-invest with Capital CDPQ. Accès Capital also serves as a link between Quebec communities and Caisse products and services that extend into national and global economies.

1997 may represent a turning point given the influx of capital from large funds, directed at venture investment activity that is fuller-spectrum (including seedings, start-ups and early stage developments) than was apparent in the more conservative pension investment stance of the 1980s. Because of the long-term focus of these funds, their fiduciaries may increasingly be able to influence trends to suit pension needs — for instance, in relation to limited partnerships that remain the market's chief conduit, and in the development of complementary market infrastructure.

At the same time, funds providing the impetus behind recent heightened levels of pension participation are few in number, large and overwhelmingly from the public sector. Many are also first-time market entrants. This suggests something of the serious dissatisfaction that remains with fiduciaries whose private and public sector funds (of all sizes) permanently left the venture capital market following their 1980s experience. This

situation is unlikely to change in the immediate future unless certain barriers, such as those raised by the 1998 CLMPC-PIAC survey, are addressed comprehensively. This topic is further explored in **8. Pension Barriers to Financing New Economy Investment.**

## **5. Pension Funds and Middle Market Investing**

Despite its importance to the national economy and jobs, Canada's middle market — the financial environment for investment or merchant banking — is not well appreciated. This is unfortunate since a large volume of capital resources has recently been pouring into this market to meet demand among a range of established medium-sized and larger enterprises in traditional industries, such as manufacturing, retail and services. Furthermore, pension funds have been central to emerging middle market investing.

Despite their maturity, which gives them certain advantages over other SMEs, companies in the middle market still encounter major financing obstacles. This is due to the multi-various development needs and patterns of traditional medium-sized business in the current context of economic change. Middle market transacting has been dubbed “event-driven” because it responds to singular types of demand. Examples include:

- ✓ Private firms aiming to grow or make new investments without going public.
- ✓ Mature private firms aiming to do a first-time public offering.
- ✓ Firms seeking to acquire or merge with other business entities.
- ✓ Firms seeking changes in ownership or management (e.g., buyouts).
- ✓ Restructuring firms or firms in severe financial distress (e.g., rescues).
- ✓ Publicly-listed firms that are “orphans” or are undertaking complex or high risk deals.

- ✓ Other “events”, such as corporate divestitures, industry-specific expansions and refinancings.

The economic consequences of success or failure in the middle market are meaningful. Due to the competitive pressures felt by traditional industries in a global economy, “good” jobs can be lost if restructurings or turnarounds are not adequately financed. South-of-the-border, research by the Economic Policy Institute (1996) has found that well-established, large, as well as ascendant small American manufacturers are frequently caught in this circumstance. Succession of company ownership is another challenge, considering the very large numbers of family-owned firms begun in the postwar years that must now transfer ownership from aging founders to a next generation.

Leveraged buyouts have also been gathering steam among North American merchant bankers, although, depending on the project in question, the economic effects can be mixed. In addition, concern has been raised in the United States that the recent intensity of investment in this realm may be distortionary and wasteful of capital resources.

The financial means of the middle market are no less heterogeneous than the events they address, although Canadian medium-sized business is commonly unaware of the private placement alternatives to going public. Much long-term investing occurs through multi-layer deal structures, involving debt and equity instruments of different risk orientations. On average, deal sizes are in the order of \$5-50 million or above. Like the venture capital market, specialty managers and other advisor-agents are vital to the successful resolution of deals.

Intermediate and long-term loans, mezzanine financing (or subordinated debt) and non-venture private equity (i.e., above \$7-10 million) form the basis of middle market investing, though gaps have periodically been observed in these. For instance, mezzanine financing supply has recently been shown to be insufficient relative to demand in Canada. Macdonald & Associates recorded

\$2.5 billion in non-venture equity placements in 1997.

### ***In Debt to Pension Funds***

SME loans have little historical representation in the fixed income allocations of pension funds, however, this situation may be changing. In the United States, the Federal Reserve System has argued that funds are in a good position to improve supply of privately-placed debt (i.e., above \$10 million, US \$) to middle market borrowers. Some, such as the State of Wisconsin Investment Board (SWIB), have for years specialized in debt financing alternatives, such as SWIB's \$300 million program for making intermediate and long-term loans directly to local manufacturers, retailers and service providers.

SWIB and other state-based funds also use certificates of deposit purchases to assist in capitalizing smaller-size loans extended to SMEs by local lending institutions. In another example, the Teacher Retirement System of Texas and other public sector funds support two pools managed by the Texas Growth Fund (TGF) and mandated to invest in medium-sized firms found chiefly in traditional manufacturing industries. Most 1998 portfolio projects of TGF were leveraged by subordinated debt.

### ***Pension Funds and the Middle Market***

Pension funds have been integral to supply of the Canadian middle market as it has gained breadth and depth since the 1980s. Today, some of the biggest merchant banking operations are those of the Caisse de dépôt, OMERS and Ontario Teachers PPB, while HOOPP and the plans associated with Alberta Treasury's IMD and British Columbia's OCIO are top suppliers to pools.

Using data provided by Macdonald & Associates and individual funds, the CLMPC estimates pension supply of private debt and equity placements in the Canadian middle market to have approximated \$4-5 billion, at a minimum, in 1998. Without knowledge of the present size of the market universe, it is not possible to say what proportion of total supply this estimate represents.

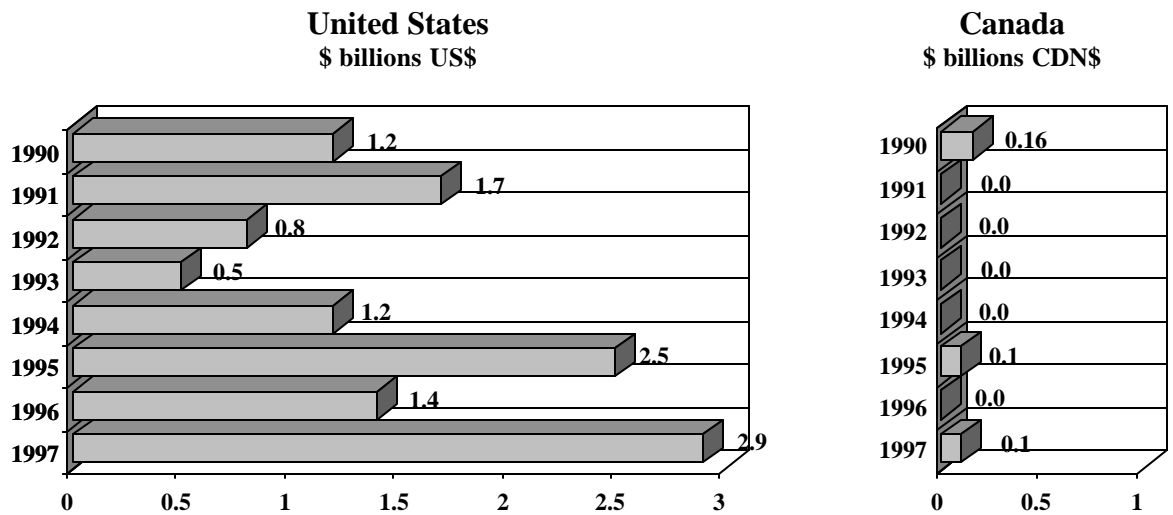
As private capital markets go, the middle market is fairly conducive to pension asset exposure since risk-adjusted returns are attainable through a few deals of high dollar value and featuring demonstrably profitable firms. These same factors may incline some funds to invest in the market's upper end (e.g., above \$50 million).

Pension funds can participate in the market either directly or indirectly. The former tends to entail co-investment between the internally-managed programs of large funds with other merchant banks on an individual project basis. Given the relatively small size of Canada's middle market, per investment syndication is efficient, particularly when the deal is large-scale. As compared with the United States, there is less use here of externally-managed pooling vehicles, such as limited partnerships, although those in existence are vital market players.

### ***Examples of Pension Participation***

✓ DIRECT: The over \$800 million Merchant Banking and Private Placement program of OMERS is one of the longest-standing among pension funds, beginning in 1981. Its mandate is to invest in a diversity of core event-driven projects, within a range of \$10-50 million, and predominantly Canadian enterprises that reflect the market's traditional industrial mix. In-house specialists rely on non-venture equity and term loans.

## Estimated Supply of Capital Raised for Mezzanine Pools, Canada-U.S. Comparison, 1990-1997



Source : Macdonald & Associates and *Private Equity Analyst*, 1998, with CLMPC thanks to CCFL.

- ✓ **DIRECT:** Ontario Teachers PPB emerged rapidly in the middle market with its 1991-incepted Merchant Banking Group. With a \$1.7 billion portfolio in 1998, Ontario Teachers prefers deal sizes of \$50 million and above, but has also targeted those of around \$25 million. The bulk of transacting has involved leveraged management buyouts, financed with non-venture equity, and in traditional sectors, two-thirds of which are domestic.
- ✓ **INDIRECT:** Penfund Management's origins are in the mid-1970s when it initiated a syndicate owned by private and public sector funds. This pool (and further co-investment by participating funds) capitalizes all investments reflecting various demand needs among medium-sized manufacturers in central and western Canada. Penfund currently has 100-120 projects in a \$700 million portfolio based primarily on term loans.
- ✓ **INDIRECT:** Since 1979, Canadian Corporate Funding Limited (CCFL) has also been a key middle market presence, frequently with pension backing. It currently offers term lending and subordinated debt to medium-sized firms undertaking mergers, acquisitions, expansions, buyouts and other events in deals of up to \$50 million. Since inception,

CCFL has leveraged \$900 million in privately-placed debt nationwide.

- ✓ **INDIRECT:** Several public sector funds are current partners in syndications featured by McKenna Gale Capital, a specialty manager of mezzanine and non-venture equity investing in assorted middle market transactions, such as expansions, mergers and acquisitions. McKenna Gale's investment projects vary in size and encompass those below \$50 million, reaching medium-sized business across the country.

### ***The Local Dimension***

Unlike close-to-home venture investing, merchant banking can entail considerable global exposure. Given the growing proportion of world exports in manufactures that comes from new and developing SMEs (Organization of Economic Development Cooperation, 1997), such exposure can benefit Canadian entrepreneurs pursuing internationalization, as has been explicitly recognized in the investment strategy of the Caisse de dépôt.

### ***Caisse de dépôt: Ways and Means***

Over thirty years, the Caisse de dépôt et placement has developed a comprehensive, long-term strategy for assisting job-creating SMEs in Quebec. Much of the estimated \$3-

4 billion dedicated to this effort is deployed by in-house corporate subsidiaries of the Caisse Private Investment Group that are positioned at all points of the SME growth financing continuum and in several capital markets. This includes Capital Communications CDPQ and Sofinov that apply a specialized focus to firms in emerging knowledge-based and technology-intensive industries.

The Caisse utilizes research and technical advice to help it anticipate Quebec economic trends and respond innovatively to relevant financing gaps. This emphasis on “smart” capital includes new methods for enhancing entrepreneurship. For instance, many start-ups and early stage projects backed by Caisse subsidiaries are first passed through independent business development centres or incubators. Hence, value is added to Caisse investing, a quality that has proved effective in multi-stage sponsorship of such leading Quebec firms as Telesystem International Wireless.

This said, most pension asset allocations tend to support medium-sized and larger companies in national and provincial middle markets. This is significant as much community and regional economic development in Canada is rooted in transitions taking place within traditional manufacturing and resource extraction industries. Public sector funds, such as those associated with British Columbia’s OCIO and the Caisse de dépôt, have been especially active in private placements that foster provincial sub-markets, the former by participating in external syndicates and the latter through the in-house corporate subsidiary Capital d’Amerique CDPQ. The New Brunswick Investment Management Corporation similarly targets traditional business projects in that province.

In the United States, pension-sponsored economically-targeted investment programs exist with middle sub-market mandates. In 1995, the Union Labor Life Insurance Company initiated its \$100 million Private Capital Fund for extending loans, equity and mezzanine financing to mature firms that aid, where feasible, the jobs of unionized workers, nationally and locally.

## ***Concluding Thoughts***

In Canada’s financial system, the middle market occupies crucial ground between SME term lending and venture investing, on one side, and public securities exchanges, on the other. Though smaller and less developed, Canada’s middle market appears to be following a similar path to that in the United States. Being small, investment patterns in the Canadian market are set by a few dominant institutional investors, including increasingly influential pension funds. As in the venture capital market, fund participants are predominantly large and from the public sector.

There is probably still space for more, and more diversified, pension participation, especially through limited partnerships, and favouring niche activity (e.g., mezzanine financing) and small dollar investment deals (i.e., below \$50 million). Over time, funds are likely to enhance their already major supply role with regard to non-venture equity and perhaps turn more attention to intermediate and long-term lending. These are directions that have been taken by their American counterparts.

Due to the absence of research attesting to the nature and scope of the Canadian middle market, it is not clear how trends in private debt and equity placements are facilitating the event-driven investment requirements of medium-sized and larger clients across the country. Neither is it clear what all this activity adds up to with regard to economic growth and jobs. Questions about how pension funds may specifically help address merchant banking challenges in future also remain unanswered for now. This topic is discussed further under **8. Pension Barriers to Financing New Economy Investment.**

## **6. Pension Funds and Public Equity Investing**

Canadian public securities exchanges underwent astonishing changes in the 1990s. According to the market analysis firm SEI, total capitalization of the four major

exchanges exceeded \$800 billion in early 1998. This represents a near doubling in size since the beginning of the decade. The composition of investors has also altered. The Toronto Stock Exchange (TSE) has reported that in the period between the mid-1980s and the mid-1990s, pension funds replaced individuals as the top investor and shareholder group in Canada. Total equity ownership of funds on the TSE is estimated to have risen to 40 percent by 1996.

There have also been developments in the buying and selling of listed securities. One of these is the enhanced attention given to public equity investing based on size or market capitalization. Generally speaking, large-capitalization (large-cap) stocks, also known as blue chips, exist above a threshold of \$1-2 billion, while small-capitalization (small-cap) stocks are usually said to be below \$1 billion.

One of Canada's most frequently quoted small-cap indices — Nesbitt Burns — recently estimated the small-cap universe to be within a range of \$65-700 million. In 1997, this translated into total capitalization of \$94 billion, as compared to the \$651 billion TSE 300 for larger companies.

### **Stock-picking, Ethically**

In 1997, the American Social Investment Forum reported that well over \$500 billion flowing through public securities exchanges was screened according to "ethical" criteria that acts to exclude certain investing. Like Canada's \$2 billion-plus ethical mutual funds, such criteria can range from "sin" activities to environmental protection, gender equity and human rights, among others. A growing number of American pension funds are apparently adopting formal and informal investment screens, recently with the aim of excluding tobacco company stocks.

Canadian pension funds have also shown interest in this practice. For instance, the United Church of Canada Pension Fund is currently modernizing its long-term guidelines pertaining to global human rights and

sustainable development. In 1992, HOOPP introduced four standards to its investment policy — ethical corporate behaviour, good labour relations, environment-friendly performance and positive human rights records. The 1998 OPSEU survey of labour trustees indicated increasing discussion of such social concerns on governing fiduciary bodies.

Research has tended to confirm long-term small-cap out-performance of large-cap stocks. This phenomenon is explained by the underlying business characteristics of the former, such as small size, youth and a propensity for growth. Indeed, many small-caps reflect emerging SMEs in knowledge-based and technology-intensive industries. Because the stock issues of these are low-information and low-price, high returns are possible, especially when investment specialists are used to target prospects and maintain a patient focus. There are, however, above average costs and risks at this relatively illiquid end of the trading spectrum.

### **America's Shareholder Activism**

Pension shareholder activism in the United States sprung to life in the 1980s when public sector and Taft-Hartley (jointly-trusted, private, multi-employer) funds first led anti-takeover resolutions. This topic remains important among other current corporate governance issues, such as director elections, executive powers and compensation, control deals, re-organizations and various social concerns. One measure of this activism has been phenomenal growth in the number of proposals forwarded by shareholders (740 in 1998), many of them pension-led.

America's largest fund, the California Public Employees Retirement System, has been a major activist force, prompting changes in corporate boardroom relationships whereby private negotiations on shareholder concerns, previously unheard of, are now common. This approach, and the fund's continued high profile intervention in under-performing firms, has been found by research (Wilshire Associates, 1995) to enhance returns. In 1994, workplace practices were added to its

governance criteria, as productivity was found to grow from such examples as positive labour relations and training.

Small-cap investing also has an economic context. Once fast-growing SMEs leave private capital markets through an initial public offering (IPO), they may continue their progress as small-caps. Through seasoned offerings, some will follow an upward trajectory to higher-capitalization and, in some cases, become blue chips.

Perhaps not surprisingly, some of the best performing of recent small-caps, such as COM DEV International and Hummingbird Communications, are past graduates of the venture capital market. However, such growth has not yet reshaped the industrial mix of large-caps which remain weighted towards traditional manufacturing, resources and services. High technology stocks were little more than 10 percent of the TSE 300 in 1998. This is in contrast with the United States where almost one-fifth of publicly-listed firms are technology-intensive.

### ***Pension Funds and Small-caps***

Understandably, most investors — pension funds included — prefer large-cap, high-information, high-price stocks associated with leading enterprises in the national economy. In recent years, small-caps have gained favour in risk-adjusted portfolios due to evidence of their cyclical out-performance. With their very recent gravitation to public equity, numerous private and public sector pension funds of all sizes have pursued small-cap investment, though this is difficult to quantify due to the current absence of data.

One major mega-firm advising Canadian pension fiduciaries estimates that about 80 percent of its clients have exposure to small-caps, averaging 5 percent of total assets. CLMPC research found that large fund exposure varies widely, but often falls below this level. In 1997-98, PIAC began collecting data on the small-cap holdings of its members. Though unpublished to date, this effort may yet provide a definitive snapshot

of the acknowledged billions of pension dollars flowing in this direction.

CLMPC research also found pension participation in small-cap investing may be particularly vital over time. Due to low turnover in holdings, funds reportedly exhibit comparative patience in exchanges, an important consideration as illiquid small-caps approach a cycle's end or prove volatile.

Many pension funds are also committed to improving shareholder value through an interest in corporate governance. A close, consultative relationship between investor and investee firm can contribute to effective growth strategies, particularly where the governance concerns of fiduciaries are clearly and consistently expressed. In the United States, shareholder proposal tracking reveals significant incidence of governance issues involving small-cap companies listed on the Russell 2000 Index. Many of these proposals are pension-led and tend to be more performance-oriented than average.

A pension fund's approach to small-cap stock-picking can be direct, indirect or both. The direct approach entails in-house location of investment specialists (in the case of large funds) that assess small-cap issues on a growth or value basis. These tasks are also handled indirectly by externally-managed pools or by balanced asset managers possessing the expertise (in the case of funds of all sizes). In Canadian public securities exchanges, these options are well-developed for funds, though there is evidence that mounting small-cap demand since the early 1990s has not been met by sufficient numbers of specialty managers and pooling vehicles.

The following are illustrations of both direct and indirect systems in Canada.

### ***Examples of pension participation***

- ✓ **DIRECT:** Unlike most pension funds, OMERS has allocated assets to small-caps for over two decades and currently has holdings of \$800 million-plus. One-half of the amount forms a dedicated pool, managed internally, established in

the mid-1980s, that conducts stock-picking beginning at \$50 million. The investment style is value-oriented, meaning the target is under-priced stocks, along with an interest in growth potential.

- ✓ **DIRECT:** The in-house money manager BIMCOR also conducts a dedicated small-cap pool for the Bell Canada group of plans. This pool, totalling approximately \$200 million in 1998, got underway in the late 1980s and utilizes a value strategy that is also attentive to growth indicators. Small-cap investing is done to a limit of \$500 million and among listings on the TSE and the Montreal Exchange (ME).
- ✓ **INDIRECT:** At \$1.2 billion in 1998, Van Berkorn and Associates is one of Canada's largest pools specializing in small-caps. Since 1984, this pool has operated with a growth investment mandate, concentrating on expanding firms on the TSE and ME with revenues ranging from \$50-750 million. Based on syndicated pension assets, the Van Berkorn portfolio has included such successful new companies as JDS Fitel.

### **Pension Activism, Made-in-Canada**

Anecdotal evidence suggests that pension shareholder activism has accelerated in Canada since its inception in the mid-1980s. High profile interventions, such as those of the Caisse de dépôt and Ontario Teachers PPB in opposition to concentrated executive authority at two top banks in 1997, often mask what is even greater incidence of formal and informal consultation and negotiation on corporate governance matters behind closed doors. Many pension managers argue that, in contrast to the United States, this low-key, consensual approach is more typical in Canada.

Beginning in 1983, PIAC has crafted corporate governance standards to assist Canadian pension fiduciaries in various aspects of the activist process, including proxy voting. Criteria are articulated under four topic headings — obligations of boards of directors, such as accountability and independence; executive compensation;

takeover protection, based on informed procedures to approve major corporate changes, and; rights of shareholders, such as in defence of stock values and against undue influence.

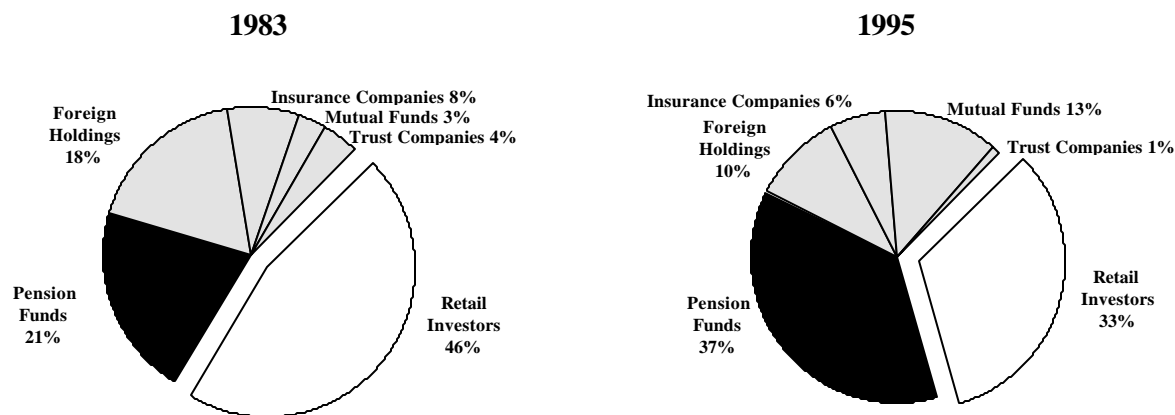
- ✓ **INDIRECT:** Bissett and Associates is another small-cap growth investor that syndicates pension assets through two pools. Valued at over \$700 million in all, these pools target stock issues of \$70-500 million and those below this level, respectively. Stock-picking emphasizes firms in most industries and all exchanges, although Bissett's Calgary location permits attentiveness to Alberta Stock Exchange trends.
- ✓ **INDIRECT:** One of the few Canadian pools mandated to invest in low-capitalization equity from a value perspective is Saxon Small Cap, managed by Howson Tattersall Investment Counsel. The latter pioneered many of the specialist techniques relevant to a value strategy, beginning in 1985. The Saxon pool, 50 percent of which was pension-supplied in 1998, targets stocks of \$200 million or less.

### ***The Local Dimension***

A local context to public equity investing is perhaps less meaningful than it is for private capital markets, especially since only one-fifth of all trading occurs off-site of the TSE. Nonetheless, public securities listing and trading activity is at least important to the economies of Alberta, British Columbia, Manitoba and Quebec — and to growth-oriented SMEs in these economies — and there is probably something to be said for pension investment in small-cap stocks at this level.

Certainly this is the view of the Caisse de dépôt as it situates most securities transactions (67 percent in 1997) at the ME to help re-inforce Montreal's viability as an international financial centre. The Caisse also backs development of Quebec financial infrastructure, expertise and human

## Estimated Total Shareholding in Canada by Institutional Investor, 1983 and 1995



*Note : SEI Inc. has estimated pension fund shareholdings in 1996 to be 40% of total TSE 300 ownership*

Source : TSE, 1997

resources, including a more substantial mutual funds sector.

Interestingly, 1997 research by the University of Wisconsin-Milwaukee Center For Economic Development (UWMCED) proposed inception of an economically-targeted investment program for state-based, low-capitalization public equity. It was argued that a small-cap index pool may facilitate pension asset allocations and thereby support Wisconsin SMEs.

### ***Concluding Thoughts***

Public securities exchanges in Canada are smaller, less liquid and less structurally evolved than those south-of-the-border. Such characteristics imply significant challenges for investing in small-cap, low-information, low-price stocks. These challenges are of concern as investment in the latter reflects an important public market avenue for new and developing Canadian business, especially SMEs emerging from private capital markets. Indicative of this may be the fact that knowledge-based and technology-intensive firms are very well-represented among small-caps, but not as yet on the TSE 300.

### **The Newest Activists**

The 1990s have witnessed increasing labour interest in pension shareholder activism that exerts a positive influence on corporate

governance. In the United Kingdom, the Trade Union Congress (TUC) has adopted trustee guidelines concerning the exercise of voting rights on a range of governance items, including the accountable and independent conduct of boards of directors, executive compensation, and merger and takeover decisions. Also relevant is a British firm's job record, both at home and abroad, that is held to equity and productivity standards.

The American Federation of Labor-Congress of Industrial Organizations has introduced similar guidelines and Taft-Hartley pension funds have backed these with shareholder resolutions on such topics as executive pay and anti-takeover measures. The new Center for Working Capital exists to expedite this process. Both American and Canadian unions have also joined church groups, et al, in supporting social responsibility votes at shareholder meetings, though only in the United States have pension assets assumed a role in such initiatives.

Anecdotal evidence suggests that pension participation in small-caps may be restricted, partly because of Canadian under-supply of experienced, specialty management and inadequate marketplace organization that can facilitate pension internal and external asset allocations. CLMPC research found that some unsatisfied demand in the 1990s was the likely result. In addition, some fiduciaries may have misconceptions about small-cap

transaction costs and risks and how these may be effectively controlled. This is unfortunate since this segment of exchange activity can probably gain most from the long-term focus of pension funds and the strategic interest of a growing number in corporate governance and performance issues.

A more precise understanding of the role assumed by Canadian pension investing in small-cap public equity awaits more and better aggregate data that is made publicly available. PIAC's recent survey work or other market analysis sources may help rectify this situation in future.

## 7. Pension Funds and Real Estate Investing

The real estate market (or markets) consists largely of investor purchases of land or property and their development. Development or redevelopment refers to the financing and undertaking of construction of new real estate or renovations (improvements, up-gradings, expansions) to existing stock. These can be either residential (i.e., owner-occupied or rental housing) or non-residential (commercial or industrial sites).

Canadian and international real estate investing has undergone dramatic cyclical and structural shifts in recent years and especially after the boom and bust of the 1980s. These shifts have substantially altered supply and demand. Among the many factors influencing long-term market development today are demographic changes, the impact of technological change on business properties, and a reduced government presence in developmental housing.

In Canada, restructuring in the 1990s has led to contracted markets, fewer realty companies and less investor participation, including the participation of pension funds. Needless to say, much residential and non-residential development has also been neglected.

Investment in real estate is fundamentally a private capital market activity and, thus,

shares many of the same characteristics of markets serving private SMEs. Hamilton and Heinkel's *The Role of Real Estate in a Pension Portfolio* (1994), detail these and the barriers they present to pension funds. Among the most prominent are:

- ✓ Asset immobility, meaning that real estate, such as land and buildings, are rooted in distinctly local settings.
- ✓ Long asset lifespans or the tendency of real estate properties to last with periodic alterations or improvements.
- ✓ Low turnover in real estate ownership (on average, ten years), indicating illiquid investing.
- ✓ High capital costs due to generally large-scale real estate projects, influenced locally.
- ✓ Long time horizons in major development and redevelopment initiatives.

### *Their American Cousins*

Among many vehicles for allocating pension assets to real estate in the United States is the Housing Investment Trust (HIT), established by the American Federation of Labor-Congress of Industrial Organizations in 1964 with a mandate to support affordable housing development that also gave union members the work. Today, HIT invests nationwide at a rate of \$400 million per year, primarily in partnerships that yield new construction or rehabilitation of single and multi-family dwellings. Projects in the \$1.9 billion portfolio also favour low and middle-income families and healthcare and retirement facilities. HIT reports having facilitated 50,000 housing units, 40,000 jobs, and strong returns, since inception.

In 1987, HIT was joined by the Business Investment Trust (BIT). With \$700 million in total assets in 1998, the second trust extends financing to development of commercial and industrial properties and rental housing (35 percent of the portfolio). HIT and BIT capitalization is provided by over 400 and 70 investors, respectively, the vast majority of

which are jointly-trusted multi-employer and public sector pension funds.

Taken together, these features suggest a certain degree of cost, risk and long-term duration of investment that can be overcome only by use of specialty managers with localized knowledge and innovative financing methods. These are well-developed in Canada for pension funds and other investors, although the supply of experienced specialists is believed to be limited. Increasingly, strategies are also being generated in more liquid public securities exchanges, through the stock issues of large realty companies and the Real Estate Investment Trust (REIT) model. REITs are publicly-traded, open-ended vehicles for raising capital to invest in mortgages and diverse property types.

Spending on developmental real estate is well-documented in research literature for creating large economic spin-offs, particularly when cycles are strong. This was shown recently in a simulation by Informetrica for a \$1 billion financing of additions or alterations to housing stock (Canada Mortgage and Housing Corporation, 1998). Along with economy-wide effects, beneficiaries included the construction industry and manufacturers contributing materials. The job creation impact in these is substantial. An assessment of pension-supplied California development over fifteen years found that a \$4 billion investment ultimately produced 230 million person-hours.

Another economic and social outcome of such investment activity is improvements to the quantity and quality of residential housing stock, business infrastructure and public works.

Informetrica has also provided analysis of the significant economic and job multipliers from investing in the related development of communications and transportation infrastructure, both private and public. Recently, pension fiduciaries across North America have turned their attention to this new asset class.

### ***Pension Funds and Real Estate: Then and Now***

Real estate is a traditional source of Canadian pension portfolio diversification. Aggregate pension asset exposure was greater in the 1980s than it is currently because of the financial disruption caused by the late-decade bust and succeeding trends. *Benefits Canada* gives some evidence of the consequences as total allocations among the top 100 funds fell from 6.7 percent in 1993 to 4.2 percent in 1997.

Canadian real estate markets appeared to rebound in 1993. This included a rise of capital commitments by pension funds to almost \$19 billion in 1997, mostly from large public sector funds, such as those associated with British Columbia's OCIO. Hamilton and Heinkel argue that it is reasonable for holdings to increase still further to an average of 5 percent of total assets per plan.

In general, pension investment follows a buy-hold-sell pattern in relation to existing real estate that is spread out geographically and by property type. Large, non-residential properties, such as hotels, industrial sites, office buildings, retail outlets and shopping centres, tend to be preferred. Some amount of expenditure on development and redevelopment usually occurs in this process.

There is a much broader menu of vehicles for expediting pension participation in real estate than are found in other private capital markets. Funds can engage directly, often through a separately-capitalized subsidiary and through co-investment with other suppliers and developers (in the case of large funds). Here, specialized, management-intensive tasks, including property administration or development, are handled chiefly in-house. Indirect vehicles of prevalence include corporate structures and pools wherein costs and risks are shared (in the case of funds of all sizes). The following illustrate direct and indirect systems active in Canada.

### ***Examples of Pension Participation***

- ✓ **DIRECT**: Canadian National Railways Pension has for years invested in real estate in a fashion that is representative of the large fund approach. In 1998, holdings of residential and non-residential property and land located across the country were valued at \$465 million and managed by the subsidiary Canapen Group. Occasionally, the fund also syndicates with real estate companies on major development deals, such as the International Civil Aviation Organization complex in Montreal.
- ✓ **DIRECT**: After years of experience, the Caisse de dépôt established in 1993 its Caisse Real Estate Group, comprised of five internally-managed subsidiaries for comprehensive acquiring of commercial and industrial properties, housing, land, mortgages and shopping centres, over 40 percent of which is Quebec-based. The aggregate portfolio was valued at \$4.8 billion in 1997. Subsidiaries also invest and co-invest in various developments and redevelopments, such as the building of 300 houses on Nun's Island.
- ✓ **INDIRECT**: Since 1975, one of Canada's largest syndicators of pension assets for real estate investing has been Morguard Investments. Through Pensionfund Realty, thirty-three funds act as shareholders and contribute to Morguard's acquisitions and development transactions involving commercial and industrial properties. At the end of 1997, holdings totalled 138 at a value of \$1.2 billion. Morguard also manages a REIT. Another major specialty manager is Penreal Capital Management.
- ✓ **INDIRECT**: The \$300 million Greystone Properties was initiated in 1989 to supply affordable rental housing to Vancouver and has since added multi-family, for-sale housing and commercial and industrial real estate throughout British Columbia to this goal. Currently, the portfolio comprises twelve development projects.

Capitalization comes from twenty-four funds, many of them jointly-trusted and multi-employer. The similarly supplied and mandated Mortgage Fund One was created in 1992.

### ***The Local Dimension***

As real estate demand and supply conditions are uniquely local, so too are the economic and social outcomes for Canadian communities and regions. Development and redevelopment projects generally utilize local contractors, construction firms, workers and providers of inputs and services. The community also obtains the new or improved housing or business infrastructure.

Current property-holding and development activity backed by pension assets, both direct and indirect, are also local in context. The primary beneficiaries, in this instance, are large Canadian urban centres where most commercial and industrial properties and related investment opportunities reside. Some funds, such as those associated with British Columbia's OCIO and the Caisse de dépôt, have tried to cast the net wider.

The positive local effects of some pension-supplied real estate investing have been documented. Greystone Properties, for example, has calculated its own generation of over four million hours of local work (by union members) since inception. In addition, CMHC has credited Greystone with playing a disproportionately large role in financing construction of new, affordable housing in Vancouver when it was experiencing chronic shortages. A 1997 University of California study found that comparable American syndicates had enabled two small pension funds to create jobs and substantially augment affordable housing in several state communities.

### ***Concluding Thoughts***

The economic significance of real estate investing is indisputable, especially if there is a developmental component. This is perhaps most apparent locally due to the immediate stimulus of project-driven jobs and the quasi-

permanent supply of housing, commercial or industrial property, communications and transportation facilities and other forms of infrastructure. Some of this development has been overlooked recently, in part because of the cyclical and structural changes embracing real estate markets.

### **Infrastructure: The Newest Asset Class?**

Like some real estate development, infrastructure — physical facilities that move people, goods and information, as well as energy, waste and water — has been neglected somewhat in the 1990s. The Federation of Canadian Municipalities estimates the shortfall at over \$20 billion. This is potentially costly, as research shows infrastructure to contribute substantially to business growth, productivity, environmental protection and jobs. The persistent dilemma of gaps in financing for infrastructure investment has led to a search for new capital supply sources, such as pension funds.

Funds in Canada and the United States have just recently responded to this challenge by considering the design of strategies for overcoming cost and risk barriers specific to this new asset class. To this end, the 1993 Commission to Promote Investment in America's Infrastructure recommended government-private sector partnerships. In 1997, OMERS called for similarly-concerted Canadian revitalization activity involving pension funds and is presently investigating its own projects in Ontario municipalities and elsewhere.

Canadian pension funds play a vital role in supplying real estate's capital resources. In general, this role has emphasized long-term property-holding and related development that favours non-residential sites in local sub-markets with strong economies. A few large public sector funds are primarily responsible for the very recent top-up of pension investment in this asset class after what has been a steady decline since the 1980s. Hamilton and Heinkel and other analysts note

that further increases in aggregate pension portfolio exposure depend on addressing the barriers implicit in real estate's essentially private market structure. There is evidence of this occurring in a broadening array of participatory vehicles (e.g., REITs).

American real estate markets may suggest still more alternative means and structures. This includes those that support pension fiduciary interest in certain niche investing in real estate, such as filling several of the gaps left by government in construction of residential housing or in infrastructure. Precedents set in both Canada and the United States indicate the potential of such asset-targeting, often through government-private sector partnerships.

## **8. Pension Barriers to Financing New Economy Investment**

In 1998, there was some degree of pension investment activity in capital markets relevant to a new economic context in Canada. Central to most of these markets, however, are impediments to further initial or sustained pension asset allocations. Rooted in relative, specific inefficiencies, obstacles are most daunting in private capital markets. To better understand these and their impact on the investment decision-making of pension trustees and money managers, the CLMPC compiled a list of fourteen barriers drawn from 1997-98 interviews and North American research sources.

Most of the fourteen have the pension experience in markets for venture and non-venture equity as an immediate reference point, however, they apply equally to other forms of privately-placed debt and equity, such as term lending and mezzanine financing. Relevance can also be found for many aspects of investing in real estate and infrastructure.

### ***The CLMPC-PIAC Survey***

In 1998, PIAC agreed to submit the CLMPC's list of barriers as an opinion

survey to its membership of 127 pension organizations (managing almost 350 funds and \$400 billion in assets). By April 1, 53 percent of PIAC members had responded. These were broadly representative by size (from assets of less than \$500 million to over \$5 billion) and predominantly observed external asset management styles. The CLMPC presented survey findings to a PIAC conference and workshop (Victoria, April-May, 1998).

CLMPC-PIAC survey results are valuable in illuminating the potential limits and opportunities of a financial role for pension funds in a changing Canadian economy.

The first finding of significance is that nine of the fourteen barriers received an overall rating of *important* or *very important*. Six, all pertaining to problems inherent to private capital market structures, were so rated by wide margins — from nearly two-thirds to three-quarters of total PIAC respondents (particularly those from large funds). The apparent suggestion is that, experienced in them or not, pension fiduciaries believe such markets present clear obstacles to their participation.

The following is an overview of the barriers, in order of PIAC member ratings and comments. This is accompanied by some preliminary discussion of alternative means and structures intended to strategically overcome barriers. These mostly derive from CLMPC research of assorted private capital markets in North America and Australasia — and, in particular, highly-evolved private equity markets in the United States — usually as barrier-specific responses developed over time by practitioners on the demand or supply sides and frequently with the support of public policy. In many cases, innovations have been pension-led as the supply role of funds in these jurisdictions expanded and gave them more influence in the evolution of market infrastructure.

Primary examples of strategic responses addressing the top-rated barriers identified in

the CLMPC-PIAC survey may be generally categorized in the following manner:

- ✓ Introduction of “best practices” to conventional pooling vehicles and syndicates (e.g., limited partnerships in private equity investing);
- ✓ Establishment of alternative pooling vehicles (e.g., fund-of-funds: pools that intermediate between pension suppliers and external specialty managers);
- ✓ Establishment of asset-targeting pools and strategies (e.g., ETIs for real estate, SME financing, etc.)
- ✓ Development of seasoned, skilled investment specialists;
- ✓ Development of market-specific advisers and agents (e.g., gatekeeper intermediaries for pension funds and SME agents in private equity investing);
- ✓ Creation of private capital market returns databases, measurement tools, et al;
- ✓ Improvement of private capital market education for pension fiduciaries;
- ✓ Establishment of government-private sector partnerships for leveraging, cost-sharing or otherwise advancing any of the above initiatives.

Further clarification of these and other examples is found under *Of Pools and Pooling, What’s a Gatekeeper?* and *What’s an ETI?*.

***1. Concern that such investment activity is management-intensive and, hence, will result in unacceptably high pension operating costs.***

THE ISSUE: There are substantial up-front and on-going costs for specialty managers and pension suppliers attempting to negotiate information-intensive private capital markets.

At a 78 percent rating of *important* or *very important*, this was the top barrier for PIAC members. For them, costs include the financial charge practices of external

investment specialists and internal expenditure on performance oversight and evaluation for what is a modest asset allocation. Such may violate the fiduciary imperative of low overhead in operations.

Obtaining cost-adjusted returns can be problematic in private capital markets, especially in small-dollar term lending and venture financing. Canadian fiduciaries may consider the American experience of pension-led initiatives in private equity and subordinated debt markets that have effected savings. These include “best practices” introduced to external pools (i.e., limited partnerships) regarding fees, performance incentives, etc. Cost sensitivities were also behind new syndicate models, such as fund-of-funds. Finally, the recent rise of market-specific advisors and agents is instructive. Critical to pension funds are gatekeepers who assume much of a client’s management-intensive tasks. These developments have also benefited ETI programs.

***2. Too few knowledgeable, qualified and/or experienced investment specialists to effectively manage pension assets internally or as part of an external pooling arrangement.***

**THE ISSUE:** Small and often under-developed private capital markets in Canada may not have a sufficient stock of skilled, value-adding professionals needed to achieve risk-adjusted returns.

73 percent of PIAC respondents rated this barrier as *important* or *very important*. In general, it was argued that the finite numbers of top professionals are too expensive to hire either externally or internally. A concerted search for quality specialty managers is also consuming of pension fiduciary time and resources.

***Of Pools and Pooling***

In the United States, close to 80 percent of venture and non-venture private equity and subordinated debt flows through limited partnerships. As top suppliers to these markets, pension funds have pushed

qualitative changes to them over time to ensure their interests received due attention from specialty managers. Recently, nine large public sector funds commissioned a study (William M. Mercer, 1996) as a means of establishing “best practices” in pool operations. Among others, the California Public Employees Retirement System has included Mercer-identified practices in criteria for joining partnerships under its Alternative Investment Management program.

American pension funds are also diversifying their participatory means, such as the fund-of-funds model that pools assets for selective allocation to limited partnerships. Raising \$4 billion alone in 1997, this vehicle offers funds lower costs, diversification opportunities for investors of smaller size and a safe entry point for those new to markets. The fund-of-funds also gives participants data and advice about, and access to, the best specialist professionals.

One of the duties of American (and Australian) gatekeepers (mentioned under Barrier # 1) is to help fiduciaries find, screen and assess investment specialists and pools according to prescribed criteria. For this reason, they may be a welcome organizational innovation to Canadian private equity investing. Market analyst Mary Macdonald has also proposed cross-border co-operation (north-south alliances) to draw on further management experience and knowledge. This may include specific expertise found in asset-targeting ETI programs.

***3. Lack of adequate information about private capital markets with which pension managers can make investment decisions and monitor performance over time.***

**THE ISSUE:** The information intensity of private capital markets implies that data are not readily available for the purposes of pricing, deal-making or analyzing financial performance.

69 percent of PIAC respondents rated this barrier as *important* or *very important*. They

observed that pension funds encounter major difficulties acquiring quality information about private investment activity (e.g., long-term returns data). This gap impairs the process of allocating assets and of monitoring and reporting to trustees on performance trends.

Much of the data in question is confidential to private, closely-held business clients and is collected primarily for transacting. Fiduciaries only acquire these at a price. Once again, infrastructure for American privately-placed debt and equity markets provides models, as gatekeepers and deal-making operatives for SMEs and pools ensure that reliable fact-finding occurs at reduced cost. This is also the function of market research firms. In the early 1990s, the federal Administration also established the E2 DataBank to assist pension funds in contacting marketplace sources about ETI options.

**4. A perception that risk-adjusted returns from such investment activity are inadequate or unreliable.**

THE ISSUE: Investment returns in the middle and venture capital markets, among others, must be superior to liquid securities to justify costs and risks assumed by pension funds.

66 percent of PIAC respondents rated this barrier as *important* or *very important*. It was noted that there is no financial returns “history” in some Canadian private capital markets to inform pension fiduciaries. Moreover, while long-term returns may be superior, they may also be volatile. Some current pension participants argued such perceptions were simply incorrect.

PIAC members recommended overcoming this barrier with better flows of quality, market-specific financial information (mentioned under Barrier # 3) and, particularly, through the development of an accessible, comprehensive database for Canadian private equity market returns, among others. See also Barrier # 6.

**5. Concern that such investment activity may result in high profile failures and/or severe cost liabilities.**

THE ISSUE: Business failures and deal write-offs common to certain private capital markets can attract unwanted publicity to pension funds or involve them in costly legal liabilities.

64 percent of PIAC respondents rated this barrier as *important* or *very important*. Many commented on trustee sensitivity to negative media attention when individual investments fail and the unavailability of legal recourse options in conflicts with managers. Others felt these consequences to be acceptable facts of high-risk markets that ultimately deliver superior returns.

In the United States, recent pension-sponsored reforms of limited partnership arrangements in private equity markets include new terms for jointly negotiating liabilities, terminating managers or pools and resolving other conflicts. Canadian fiduciaries may be interested in investigating and emulating some of these new “best practices”.

**6. Conflict between traditional methods for measuring pension asset performance and the longer-term performance of such illiquid investment activity.**

THE ISSUE: Conventional averages and indices used by pension fiduciaries for assessing and benchmarking liquid securities in the short-term are ill-suited to private capital markets.

64 percent of PIAC respondents rated this barrier as *important* or *very important*. This rating is based on the fact that core asset classes found in pension portfolios are stocks and bonds held or traded in public securities exchanges. Performance measurement tools are geared to these. Shifting fiduciary focus to longer-term investing raises several organizational and technical challenges.

For much privately-placed debt and equity, there is no universal financial performance standard. Until securities are liquidated, the long-term progress of an investment or investment portfolio is not easily captured by a single measure. For the purposes of initially assessing specialty managers and pools, some fiduciaries rely on historical and forecasted returns. For benchmarking purposes, they often adapt public indices to private securities, among other methods. PIAC members indicated an interest in developing more sophisticated benchmarking and performance measurement techniques for a range of illiquid financial instruments in future.

**7. *Insufficient familiarity with, or support for, such investment activity among governing fiduciaries (i.e. trustees or sponsors) and/or managers of pension funds.***

**THE ISSUE:** Trustees tend not to be knowledgeable about investing in high-risk, illiquid securities and frequently have misconceptions about the actual costs and risks.

61 percent of PIAC respondents rated this barrier as *important* or *very important*. Many agreed that the investment decisions of pension stakeholder representatives with diverse backgrounds often reflect little acquaintance with the structure of private capital markets or with strategies for cost and risk management. Consequently, they tend to resist participation.

PIAC's *Effective Pension Plan Governance* (1997) asserts the need for extensive capital market education in a model process of trustee selection and organization. Some PIAC members suggested this include primers on certain private debt and equity capital markets, followed by regular provision of up-dated data and analysis at the board level.

**What's a Gatekeeper?**

A sign of evolution in American private equity markets since the 1980s is the fast-growing body of independent advisors, agents and

intermediaries available to both the demand and supply sides. For pension funds, one of the most significant professions added to advice and agency infrastructure has been gatekeepers who offer market intelligence and access to top investment specialists at comparatively low cost.

Some gatekeepers are primarily advisors to fiduciaries who also assume many of their management-intensive tasks according to pre-determined criteria. Others are more interventionist, assuming direct responsibility for such activity as negotiations with externally-managed pools. These may possess discretion over pension asset allocations through fund-of-funds or through separate accounts. Other agent-advisors focus on SME deal-making or attracting supply to limited partnerships. All have helped pension funds, directly or indirectly, undertake private equity investing more efficiently.

**8. *In the case of small and medium-sized pension funds, the fact that insufficient size may prohibit diversification into such investment activity.***

**THE ISSUE:** Funds with assets of around \$1 billion or less encounter a "critical mass" barrier to entering private capital markets and can only do so through externally-managed pools or syndicates.

59 percent of PIAC respondents rated this barrier as *important* or *very important*, while those that are small and medium-sized gave it a 68 percent rating. The latter noted that limited mass implies more difficulty handling management-intensive costs and potential volatility. Many are not aware of viable external vehicles in existence for sharing costs and risks with other investors.

Several smaller size Canadian funds have syndicated assets for real estate investing and other private investment activity (e.g., venture financing in Quebec). In the United States, there is a more developed array of vehicles for expediting broad-based participation, such as the fund-of-funds. The fund-of-funds model supports pension asset diversification

at a reduced cost and is especially valuable to small or medium-sized funds which are new to markets. Many ETIs also include pension suppliers of all sizes.

**9. *Reluctance based on bad past experiences in private capital markets.***

THE ISSUE: Much fiduciary unwillingness to participate in private capital markets of all kinds derives from a negative experience for many pension funds in the 1980s.

55 percent of PIAC respondents rated this barrier as *important* or *very important*. In commenting on various barriers, many respondents cited anecdotes of their bad experiences or financial outcomes in such private capital markets as merchant banking, real estate and venture capital in the previous decade. A minority attested to better experiences, at least in the long-term.

Canadian market analysts and practitioners have testified to greater maturity in middle market and venture investing in the 1990s, due to such factors as increased expertise and specialization in managers and pools and more sophisticated entrepreneurship. This is currently on display in such high technology regions as the Ottawa Valley. Trends in even more established American private capital markets also suggest the contribution of organizational and technical innovations as described under Barrier #1.

**What's an ETI?**

The economically-targeted investment (ETI) is an American phenomenon whereby pension asset allocations obtain both market-grade returns and economic or social benefits by addressing perceived financing gaps and under-investment. Having evolved over nearly four decades, multi-billion dollar ETI programs gained traction in the 1990s due chiefly to sponsorship by public sector funds in California, New York, Pennsylvania and other states, as well as government support. Recently, regulators made their approval of ETIs official, so long as risk-adjusted returns remain the guiding priority.

Today, ETI programs are ubiquitous and diverse in character. Targets include affordable housing and other real estate, high technology start-ups, infrastructure, investing that prefers unionized workers, local economic development, minority and women entrepreneurs, plan member mortgages, restructuring manufacturers and SMEs. New York City pension funds sponsor several ETIs, including a loan program for rehabilitating poor neighbourhoods, financing low-income home ownership and term loans averaging \$100,000 for local SMEs.

**10. *A perception that high-risk investment activity is inconsistent with fiduciary responsibilities to pension plan members.***

THE ISSUE: Pension investment in high-risk, illiquid securities is widely seen by fiduciaries and their advisors as violating prudence and the "pension promise" to retirees.

47 percent of PIAC respondents rated this barrier as *important* or *very important*. Those arguing this view say that the basic nature of most alternative/non-traditional asset classes should preclude them from portfolio inclusion. Others felt this barrier is rooted in fiduciary misconceptions that can impair diversification goals in a modern pension portfolio. Educational programs were recommended (mentioned under Barrier # 7).

**11. *Insufficient familiarity with the needs and constraints of pension funds on the part of qualified professionals managing external pools.***

THE ISSUE: Even if the stock of investment specialists is adequate, many are not attuned to the uniqueness of the pension investment process and fiduciary procedures.

46 percent of PIAC respondents rated this barrier as *important* or *very important*. Based chiefly on unsatisfactory past interactions, commentary focussed on external management products and services that failed to relate to pension interests.

New marketplace advisors and agents in American (and Australian) private debt and

equity placement activity, such as gatekeepers (mentioned under Barrier #1), frequently specialize in products and services designed to meet pension client needs. In addition, advisory committees to limited partnerships, among other mechanisms, have emerged there and in Canada, giving fiduciaries more input and control in operational matters key to protecting and aligning interests.

**12. A perception that there are not enough high quality small business investment opportunities to warrant participation.**

THE ISSUE: There is concern that in private capital markets geared to SMEs, there may be plentiful supply chasing after too few quality investment opportunities.

43 percent of PIAC respondents rated this barrier as *important* or *very important*. A high rating is based on beliefs that pension participation in some private capital markets (e.g., venture financing) is inhibited by over-supply and that Canadian entrepreneurship can produce only so many examples of exponential growth. The latter are certainly hard to find unaided.

As discussed earlier, market-specific advice and agency infrastructure is crucial to SMEs seeking required private debt and equity financing alternatives. It is equally important to pension funds trying to locate the best SME investment prospects and obtain help in arranging deals. Numerous advisor-agents are highly specialized vis-à-vis business clients in private equity and subordinated debt markets operating south-of-the-border. Such also serve selected ETIs. The effectiveness of domestic middle and venture capital markets is also being enhanced with the recent emergence of vital SME advisor-agent firms, particularly in central Canada.

**13. Certain impediments to participation that may be caused inadvertently by public policies, such as tax treatment of limited partnerships.**

THE ISSUE: Managing fiduciaries have pointed to tax policies that may obstruct or distort the goal of portfolio diversification into alternative/non-traditional asset classes.

33 percent of PIAC respondents rated this barrier as *important* or *very important*. The minority knowledgeable of this subject noted that the tax treatment of limited partnerships (i.e., as foreign property) is one illustration of how legislation creates investment disincentives. Some felt that the 20 percent foreign content limit on pension portfolio holdings also acts as an impediment. PIAC is currently pursuing these issues with the federal government.

**14. Concern that such investment activity may violate the letter or spirit of government prudential regulations.**

THE ISSUE: There is evidence that some pension fiduciaries avoid certain private investment activity out of uncertainty about the specifications of Canadian law.

At a 16 percent rating of *important* or *very important*, this barrier was least emphasized by PIAC members. Several nonetheless argued that federal and provincial regulatory authorities should provide further and more explicit clarifications on this topic to dispel misconceptions that still exist.

**Concluding Thoughts**

PIAC survey responses confirm the significance of the structure of private capital markets as a general impediment to pension participation. The transactional problems of high-risk, low-information, illiquid investing can only be overcome by long-term pension expenditure on specialty managers, internal oversight and diverse technical adjustments. For most PIAC members, large and small, the costs seem great and entail uncertainty, especially if fiduciary confidence in superior returns is not there.

Since structural issues are at the crux of limited pension participation, solutions must invariably feature innovations in Canadian market organization, relationships and methods that compensate for inefficiencies. In particular, infrastructure must be developed to support pension asset allocations with particular emphasis on co-investing, partnerships, pools and value-adding resources. Many models of efficacy are suggested in American and Australian markets for privately-placed debt and equity, and other venues, that involve a range of pension funds and stakeholders, sometimes including government.

Creative strategies designed for overcoming barriers are also crucial to realizing key Canadian economic and social objectives. This is as much true for pension investment activity that is driven exclusively by maximizing financial returns, where collateral benefits may be incidental, as it is for well-established American ETIs and comparable Canadian asset-targeting models (e.g., the Caisse de dépôt, Greystone) where benefits are planned as a subset of earnings. Ultimately, both must find effective means for negotiating complex market structures in a manner that satisfies prudential practice and the law.

Public policy in all Canadian government jurisdictions can assist sustainable pension participation in private capital markets. Possible initiatives include tailoring tax policies, facilitating the development of marketplace infrastructure that deals with specific impediments, co-investing or partnering with funds on certain asset-targeting projects (i.e., where collateral benefits are intended), leveraging new asset allocations with fiscal incentives and providing asset-specific insurance or underwriting (e.g., real estate).

## Conclusion

The unprecedented size of Canadian employer-sponsored pension funds has made them a major receptacle of national savings. This is mainly of significance to their public policy mandate of providing supplemental retirement income to working households. It is also significant, as never before, to the financial system's challenge to ensure savings are effectively mobilized to meet the productive investment and capital formation priorities of most consequence to a changing, restructuring economy. A key measure of success is the long-term results for jobs.

*Patience, Prudence and Jobs* has been an investigation of themes relevant to an enhanced role for pension funds in Canada's transition to a new economy and employment base. A critical aspect of this role is support for SMEs in accessing capital, nationally, locally and by industry. As the 1998 CLMPC-PIAC survey has confirmed, funds encounter formidable barriers in this regard because of private capital market costs and risks. There are also barriers at the low-capitalization end of public securities exchanges, as well as in real estate and infrastructure investing.

To overcome barriers, organizational and technical innovations that pertain to individual capital markets must be developed. These must deal with the fact that such markets are small and, in some instances, not fully mature. Furthermore, new strategic means must account for fiduciary needs, constraints and marketplace outlooks unique to pension funds as multi-stakeholder, government-regulated institutions. If there is failure on this score, pension participation will not occur or will not be maintained. Furthermore, as the 1980s experience in several Canadian markets has abundantly demonstrated, failure once confirmed may preclude any return in future.

In the Introduction, it was observed that returns-maximizing pension investing often generates collateral benefits to the economy or society, intentionally or unintentionally. To the extent pension portfolios have exposure to investment activity in some of the capital markets discussed here, there is a better opportunity for such effects to materialize. These will come from assisting new business formation and growth in knowledge-based and technology-intensive industries, as well as in more traditional construction, manufacturing, resource and service

industries. In this case, the benefits may be the creation or preservation of "good" jobs.

Collateral benefits may also include community and regional economic development. In other cases, benefits may also be new or improved stocks of residential (rental or owner-occupied) housing or commercial and industrial property. Alternatively, it may be public works and communications and transportation infrastructure. It may be any of these with additional equity features attached. The list goes on.

Of course, as *Patience, Prudence and Jobs* has stated repeatedly, pension investing will satisfy fiduciary responsibility only if these and other possible benefits are strictly ancillary to optimal financial returns.

This CLMPC report has provided evidence of how pension funds go about obtaining satisfactory earnings that may also yield collateral benefits. Options range from the direct, internally-managed programs and subsidiaries of large funds to assorted indirect, externally-managed vehicles — corporate syndicates, limited partnerships, by-project co-investments, etc. As discussed in relation to the CLMPC-PIAC survey, capital markets in other industrialized countries (and especially the United States) suggest still more alternatives that may prove instructive, including exclusively market-driven models, models that target assets and earnings (e.g., American ETIs) and government-private sector partnerships. Canadian pension stakeholder groups in business, labour and government each have a role in finding potential solutions.

The topic of investing and managing pension assets in an economic context is still a fairly new one. Members of the pension community and their stakeholders will hopefully see *Prudence, Patience and Jobs* as a useful first step in understanding and appreciating the contribution of funds as agents of promising change in the Canadian economy of tomorrow.

## A Brief Glossary of Terms

*Co-investment:* In general, the process by which several financial institutions and/or investors lower a transaction's cost and risk by pooling (or syndicating) their resources.

*Collateral benefits (of investing):* Positive effects (e.g., in the economy) produced by an investment subordinate to financial returns.

*Corporate governance:* The policies and practices associated with managing a business.

*Debt (also known as credit or loans):* Financing offered by a lending institution, repayable with interest over an agreed-upon period of time.

*Due diligence:* A comprehensive process by which a financial institution or investor evaluates a potential business client prior to completion of an investment agreement.

*Economically-targeted investment (ETI):* An investment chosen (a.k.a., asset-targeting) for both its financial and economic return merits.

*Employer-sponsored pension funds:* Funds based on the deferred wages of workers intended to provide income upon retirement. Statistics Canada uses this term to describe the universe of employment-based, occupational or workplace plans, the vast majority of which are trustee. In fact, the sponsors of many pension plans are both employers and employees.

*Equity capital:* Financing offered by an institution or investor in private or public markets that entails some degree of firm ownership.

*Fiduciaries:* Persons charged with the legal responsibility of administering pension assets, be they governing (trustees), managing or operating fiduciaries.

*Fiduciary responsibility:* The legal obligation that fiduciaries administer pension assets with care, diligence, prudence and skill and in the sole interest of plan members.

*Gatekeepers:* Professional advisor-agents operating in (American) private equity markets on behalf of pension fiduciaries.

*Initial public offering:* The stage at which a small company may first become publicly-listed and traded on securities exchanges.

*Institutional investor:* This term usually refers to such large financial entities as pension funds and insurance companies.

*Investment financing:* Capital (debt or equity) that enables productive investment within an enterprise.

*Investment infrastructure:* Very generally refers to the programs, support services and structures, etc., in place to expedite investment activity and/or add value to investment projects.

*Joint trusteeship:* Arrangements whereby administrative powers are equally shared between employer and employee representatives. These are often found in co-contributory, multi-employer and public sector plans.

*Limited partnership:* A pooling vehicle often used in private equity markets to syndicate the assets of investors (general partners) under specialty management (limited partners).

*Lending institution:* A generic term for a bank, *caisse populaire* or credit union, etc.

*Matchmaking:* Very generally, the process of linking business demand with appropriate sources of financing. More specifically, this term is used to describe formal efforts to strategically link entrepreneurs with suppliers of private debt and equity capital.

*Merchant banking:* Also known as investment banking, this refers to privately-placed debt and equity activity in the middle market.

*Mezzanine financing:* Also known as subordinated debt, this is debt-like financing that possesses equity features for the purpose

of assuming more flexibility and higher risk in a transaction.

*Middle market:* The market for privately-placed debt and equity capital available for generally sizeable investments in established medium-sized and larger enterprises.

*Pension governance:* The policies and practices associated with administering a pension fund.

*Pools or pooling vehicles:* Generic terms for the funding mechanism utilized by many financial institutions or investors (frequently for reasons of sharing costs and risks) to make debt or equity investments.

*Private placement:* A generic term for debt and equity investments of all types in private capital markets. Term lending and venture financing can fall in this category, though these tend to be identified independently.

*Seasoned offering:* The stocks periodically issued by active firms with established listings on public securities exchanges.

*Shareholder activism:* The process by which an individual or institutional holder of stocks in a firm actively asserts ownership rights to ensure value. This usually happens by a shareholder interest in corporate governance.

*Small and medium-sized business:* Enterprises so-defined because they have total assets, employees or sales that are comparatively small in size (e.g., 500 employees or less). Most such firms are

private (i.e., they are not listed on public securities exchanges) and closely-held.

*Small-capitalization (small-cap) stocks:* Public equity of small dollar worth, determined by multiplying the price by the number of shares outstanding. Such capitalization is frequently defined as being less than \$1 billion.

*Small dollar projects:* A generic term for investment deals requiring very small amounts of financing. In the case of equity, this is sometimes defined as being below \$500,000, and in the case of debt, below \$50,000.

*Start-up:* A new business at an especially early stage of development.

*Subordinated debt:* See *Mezzanine financing*.

*Syndicate or Syndication:* A generic term that usually refers to a partnership of financial institutions and/or investors on a single transaction (i.e., a co-investment) or as part of a more formal pooling arrangement (e.g., a corporate syndicate, a limited partnership).

*Trustees:* See *Fiduciaries*.

*Trusteed pension funds:* By far, the largest component of the employer-sponsored fund universe whereby funds are legally-registered according to a trust agreement.

*Venture capital:* High risk financing supplied to new and developing enterprises, unsecured by collateral and involving a significant long-term equity position.

## Selected Reference Materials

Note: The following is a brief selection of some key research sources. A full list, including data sources for individual pension funds, is found in the **Technical Report** (see **Preface**).

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