



UNIVERSITY OF
TORONTO

Administrative Response to the Report of the
President's Committee on Investment Policies,
Structures, Strategies and Execution

David Naylor, President

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Acknowledgments

I wish in the first instance to acknowledge the members of the President's Committee on Investment Policies, Structures, Strategies and Execution [hereafter Committee or PCI]. As the biographical sketches appended to the PCI report indicate, all the members of the Committee have a multiplicity of obligations and commitments. They have nonetheless spent many hours to complete a difficult and important task in a matter of weeks. Their recommendations constitute a major contribution to the evolution of the management of the University's financial assets, including our endowed funds and those funds which the University holds in trust for our pensioners.

For their work throughout the late summer and fall of 2009, and their insights and counsel regarding these important matters, I wish to thank, specifically: the chair, Henry N.R. Jackman; the vice chair, Larry Wasser; and members as follows: Judy G. Goldring; William E. Hewitt, Hugh Mackenzie, Mayo Moran, and Jason Z. Wei. The administrative assessors, to whom I am also indebted, were Vice Presidents David Palmer and Catherine J. Riggall.

The independent directors of the University of Toronto Asset Management Corporation [hereafter UTAM]* have framed, at my invitation, a response to the PCI report. The Board's fiduciary commitment to UTAM has been evident throughout a period when financial markets were in turmoil and UTAM had three different CEOs at the helm (an outgoing CEO, an interim CEO, and the current CEO, Mr William Moriarty). I am grateful that the UTAM Board has engaged constructively in this review process. I am also encouraged that there is far more convergence than disagreement between the Committee and the independent UTAM directors.

* Allan Crosbie, Catherine A. (Kiki) Delaney, Ira Gluskin (Chair of the Board), William E. Hewitt, Eric F. Kirzner (Chair of the Audit Committee), Florence R. Minz, Robert W. Morrison (Vice Chair of the Board), Thomas H. Simpson (Chair of the Compensation Committee), Bonita Then, and John Varghese.

Goals of the Review

My charge to the PCI is included as an appendix to their report. It seems appropriate here to highlight the overarching goals of the review process.

The University of Toronto has obligations to current and future pensioners, and must fund those obligations using resources that include contributions that pensioners made while employed by the University. Similarly, donors generously entrust funds to us for specific purposes, and the University is obligated to meet the relevant commitments. The inference is obvious. The oversight and management of the University's pension funds and endowment must be undertaken with a laser-like focus on these important obligations – obligations that translate into long-term financial responsibilities.

UTAM has been in existence for a decade as a subsidiary corporation to manage the University's assets, with University oversight mechanisms structured accordingly. Given the investment results of the last 18 months, and many other developments since UTAM was established, a re-examination of our investment policies, structures, strategies and execution was necessary. Members of the University community should know that these funds are managed accountably, transparently, and efficiently. There should be minimal ambiguity about decision-making, roles, or responsibilities. And there should be clear communication about broad investment strategy.

A Call to Action

The PCI report reached me near the end of 2009. It offers a clear call to action, and the Administration is already responding actively to the report.

Background work is underway to examine options for implementing various of the PCI's recommendations. We have begun consultation with legal counsel conversant with corporate governance and compliance. There will need to be discussion in the weeks ahead to clarify the intersection between anticipated changes and the mandate of the new Pension Committee which the University is preparing to move through Governance.

From the standpoint of University-wide oversight, the Executive Committee and entire Governing Council have already been briefed on the recommendations made by the PCI. Several items will require further off-line consultation with governors and co-opted board members if we are to fine-tune an effective implementation track for certain broadly-framed recommendations. Some changes will also require formal governance concurrence and approval.

In general, the Administration will follow the recommendations of the PCI, having appropriate regard for other factors and inputs including the UTAM independent directors' response, legal advice, and discussions with affected stakeholders. The movement underway should therefore be understood as an indication of the Administration's resolve to respond to the substance and spirit of the PCI's recommendations. Our goal is to complete implementation during 2010.

Investment Performance Redux

Over the last year, many thoughtful members of our University community, including alumni and friends, have opined on UTAM's performance. This is not surprising given the 29% decline in the main portfolios in 2008. While this result was in line with that experienced by US universities with similar portfolios, it was significantly worse than other Canadian universities. As UTAM's volunteer directors have stated, these results were surprising and disappointing.

I do not underestimate the importance of the retrospective analyses of performance that have been undertaken, or the need to consider carefully the divergent perspectives on past performance and future strategy. Contemporary portfolio management is a complicated business, and experts will often disagree on key issues such as the optimum asset mix to achieve certain risk and return targets, or the most appropriate currency strategy for a given portfolio in a given jurisdiction. Such issues must be addressed in the near term and in the years ahead.

Here, however, I shall focus only on the Committee's seven recommendations.

Recommendations and Responses

1. Appoint a Chief Investment Officer for the University

The CEO of UTAM should become the Chief Investment Officer (CIO) of the University. Investment decisions will continue to be made by the professional staff of the CIO, with appropriate review by an Investment Committee, under the day to day oversight of the University senior administration

I concur with this recommendation. Such dual roles are not uncommon in the non-profit sector. The double appointment must be structured, however, to ensure that if the roles conflict, the University's interests remain paramount.

I would also emphasize that the PCI envisages that the CEO and staff of UTAM will work within the current corporate entity, and the staff will continue to report to the CEO without other changes in their accountability. We are fortunate that the current CEO of UTAM, William Moriarty is a seasoned professional with deep expertise in risk management, and that there is a skilled team in place at UTAM.

It is essential to acknowledge, however, that the University's senior administration cannot claim specialized expertise in portfolio management. In that regard, I do not intend as President to second-guess UTAM's day-to-day decision-making. The proposed CIO designation instead reflects the PCI's concern that UTAM be better linked to the University, not any intention that the President of the University be the *de facto* CEO of UTAM.

The next recommendation by the Committee addresses the issue of expert oversight.

2. Create an Investment Committee

Create an Investment Committee with a mandate to review reports on investment matters, including investment strategy, asset allocation and risk and risk mitigation strategies, manager selection and investment performance. The committee would provide the necessary due diligence

to support the administration's recommendation for investment matters to be approved by the Business Board. The members of the committee should be recruited for their investment expertise and diversity of perspectives, and specifically asked to assist with investment oversight. The relationship between the Investment Committee and the Pension Committee mandated by the recent arbitration award between the University and the Faculty Association will need to be clarified.

I strongly support this recommendation, subject to some deliberation about optimum implementation.

In the first instance, for example, we need to determine whether the Investment Committee would be appointed by the Business Board on the recommendation of the Administration, or appointed by the Administration with advice from the Business Board. The level of detail and content in the Committee's mandate also requires consideration

While these matters require fine-tuning, the appointment of an Investment Committee will clearly strengthen oversight of investment management by the University. The Investment Committee could be involved in offering expert advice to the University's President regarding UTAM, and receive regular reports from the CEO of UTAM/University Chief Investment Officer. .

The Investment Committee could also be a strategic resource for the Pension Committee. On that latter count, the PCI report rightly highlights the need to clarify the relationship between the Investment Committee and the Pension Committee.

3. Retain UTAM as a Corporation but Change the Governance.

Retain UTAM as a corporation, to maintain OSC registration, but change the governance structure to bring it closer to the University of Toronto structure. Reduce the number of directors to the minimum permitted (3), all to be members of the senior administration.

I accept this recommendation in principle, and note five issues that need to be resolved before changes are made by the Governing Council.

First, we need to confirm that a streamlined Board structure meets the requirements of OSC registration and relevant legislation.

Second, it may be appropriate to include a representative from University governance on the revised UTAM Board.

Third, an arbitrator stipulated as part of the negotiations between UTFA and the University for 2008-09 that UTFA be given a seat on the UTAM Board. One issue to be addressed with UTFA, accordingly, is how to operationalize the spirit of this award within any new UTAM Board structure.

Fourth, it is not trivial to change the governance of a corporation, especially in this circumstance where UTAM is also a subsidiary of the University with related oversight elements in the University's structures and policies. Continuity of governance of UTAM is also important, both from a corporate standpoint and given the complexity of UTAM's assets. The Administration will, therefore, need to move forward with appropriate prudence.

Fifth, in the past the UTAM Board has provided investment advice to the CEO along with its governance functions. The new UTAM Board would be reduced in size and no longer providing such advice, and the Investment Committee will be focused on oversight from the University's perspective, not day-to-day decision-making. There is, however, no reason why the CEO cannot obtain external counsel by structuring his own advisory mechanisms, provided it is clearly understood that the CEO/Chief Investment Officer and not the advisors alone bears responsibility for the execution of the strategy set out by the Investment Committee.

Acceptance of this recommendation, even in principle, presages an eventual change in the composition of the current UTAM Board. I therefore want to take this opportunity to acknowledge again the contributions of members of the UTAM Board of Directors, past and present, who have overseen the University's assets during a particularly turbulent decade. The University is committed to working closely with them in this transitional period..

4. Reassess the Risk and Return Targets

Reassess the risk and return targets and ensure that the implications of changing risk and return targets are clearly stated and understood. These must still be approved by the Business Board which has overall accountability for the financial well-being of the University. The University administration would present the recommendations for review by the Investment Committee before bringing the recommendation forward. This would ensure that the implications of these decisions for the University as a whole would be taken into account and that recommendations would be considered by an expert committee who would have the time to consider and debate them fully. Similarly, performance benchmarks and asset allocation should be approved by the Business Board on the recommendation of the University administration after review by the Investment Committee.

I support this recommendation, with the caveats above regarding the roles of the two relevant committees (Investment and Pension) and the need for clarification of roles and responsibilities in regard to the management of the endowment. On that latter point, as but one example, previous analysis has resulted in the same return and risk targets for the endowment and the pension fund, but this may not always be the case.

I should note that the University's return target is entirely consistent with many peer organizations, and the unusual drop in asset values in 2008 cannot be attributed solely to unreasonably aggressive return targets leading to undue risk. That said, higher return targets are inevitably associated with higher risks, in particular a higher degree of short- and medium-term variability in returns.

Our ability to withstand even short-term interruptions of these returns is limited. The costs of backfilling endowment support and making pension solvency payments in any given year may seem modest in the context of our annual operating budget. However, with University-wide budgets so tightly drawn, the impact is large.

Last, while the University does regularly review its return and risk targets, I agree that these conversations may need to be deeper and wider in future. We need to keep examining and re-examining the difficult trade-offs among steadier lower returns, higher but more volatile returns,

pension assumptions and capitalization, health of the operating budget and balance-sheet, and endowment pay-out levels. Similarly, as the UTAM board wisely suggests, we must solicit stakeholder input on given sets of risk parameters and return targets.

5. Upgrade the Risk Management Process

Provide the CIO with the resources needed to properly assess and manage risk. Ensure that risks are explicitly identified and that the related risk mitigation strategies are also identified and discussed. Consideration should be given to creating a specific risk management position reporting to the CIO.

I am grateful that the UTAM Board and current CEO have taken early steps to address this recommendation. Its continued and full implementation is clearly important given UTAM's recent history.

In the background there is a question that has bubbled up in discussions around UTAM for some years. It was raised by Mr Keith Ambachtsheer in his 2007 review, and again by the PCI and the independent UTAM directors.

As the investment vehicles for any set of assets become more complex, external management fees rise, and internal overhead costs almost always rise as staff are added to ensure due diligence. In the universe of large pension funds, and compared to many US university endowments, the total value of the assets managed by UTAM is modest. This leads to concerns about the matching of the mix of investments to staffing levels, and the net returns achievable in smaller organizations with complex asset mixes. Some argue for economies of scale, i.e. pooling of assets to mitigate the proportional impact of these fees and charges while ensuring proper staffing. Others argue that higher fees and overheads represent unrecoverable costs that inevitably compound adversely over time. Others again argue that fees and overheads can both be contained by simplification of the asset mix, without adverse impacts on either risks or net returns. The Investment Committee will need to consider the various options here, and its determination will presumably be reflected in any statement of investment beliefs (see below).

6. Improve Communications

Recognizing that the University is a community of stakeholders with different interests and levels of knowledge of investment matters, care must be taken to ensure that information is provided to all stakeholders in a way that can be clearly understood and that addresses the specific concerns of each stakeholder group.

I support this recommendation. A plan to operationalize it will be developed in near future by the University's senior administration in collaboration with UTAM. In future, the primary responsibility for communication must be taken by the University.

7. Create a Statement of Investment Beliefs

A general statement should be created to describe the investment philosophy of the University of Toronto. It should describe in general terms the balance to be maintained between striving for returns and preserving capital; the kinds of risks that are acceptable and those that are not; and should outline the reasons for the beliefs.

A University by definition puts a premium on rational discourse and the explication of positions and assumptions. I concur, accordingly, that such a statement is worthwhile. However, as summarized above, there are sharply divergent perspectives on many issues related to the University's asset management. The statement should therefore focus on broad principles, rather than setting out detailed investment strategies.

The PCI does not prescribe a process for developing this statement. In the weeks ahead, a process will be defined that involves both the new Investment Committee and key stakeholders.

Conclusion

I want to close by expressing again my gratitude to the President's Committee on Investment Policies, Structures, Strategies and Execution [PCI] for their important report and their thoughtful recommendations. I also appreciate the constructive response of UTAM's independent directors. As the University Administration continues to implement various of the PCI's recommendations, we shall be engaging governors and governance bodies, a range of employee groups, the UTAM Board of Directors, and external experts. Much remains to be done. However, I believe the anticipated changes are both evolutionary and transformative. They should enable greater clarity about responsibilities for oversight of the University's assets, improved processes for defining investment parameters, enhanced accountability and communication, and, more generally, strong long-term management of our endowment and our pension funds.