University of Toronto Asset Management Independent Directors Response to the Report of the President's Committee on Investment Policies, Structures, Strategies and Execution

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Summary of Recommendations

The independent directors of University of Toronto Asset Management are painfully aware the value of the University's main investment portfolios declined 29% in 2008. We remain shocked and upset by this result and feel disappointment and regret the portfolios were not better positioned to weather the storm in major markets that year.

Given this performance, the independent directors fully supported the need for thoughtful review of what transpired and changes to be considered for the future. We have studied the report of the President's Committee on Investment Policies, Structures, Strategies and Execution chaired by Hal Jackman (the "Jackman Report") and appreciate the opportunity to share our perspective formally.

We have chosen not to analyze and comment on all of the specifics of the Jackman Report. Rather, we have attempted to focus on the Recommendations and the topic of Performance. We comment briefly on what we believe went right and wrong. This reflection leads us to recommend a number of steps to improve the oversight structure, implementation and understanding of the University's investment program in the future.

Broadly, the recommendations of the independent directors support the spirit of many found in the Jackman Report. We hold a different view of where the responsibility should rest for executing investment portfolio decisions and where the responsibility for oversight should reside. We believe the separation of those two functions should be maintained at both the staff level and the expert volunteer advisory group level.

In summary, we make the following recommendations:
1. Reassess the Financial Strategy of Relying on Equity Market Returns;
2. Create a Statement of Investment Beliefs;
3. Reassess the Risk and Return Targets;
4. Reassess Overall Investment Approach;
5. Improve Communications;
6. Create a Financial Advisory Committee;
7. Retain UTAM under an Investment Manager and Client Model;
8. Enhance UTAM Governance;
9. Benchmark UTAM Resources; and
10. Upgrade the Risk Management Process.

We are convinced the adoption of these recommendations will prepare the University and its portfolios for a complex investment environment in coming years, even though certainty may not be associated with the performance of capital markets.

Performance

The value of the University's investment portfolios declined 29% in 2008. The independent directors feel disappointment and regret and accept our share of responsibility for the result. In the past, UTAM has provided the University of Toronto good investment performance. Unfortunately, it provided poorer absolute performance than its peer group in 2008, even though it managed to cushion the University's equity positions relative to the broad public equity markets – no mean feat.

Let's remember the 29-percent decline in the value of investments managed by UTAM in 2008 came amid a 39-percent downturn in global public equity markets.

Yes, a typical Canadian university peer investment portfolio suffered only a 19-percent decline. However, the returns of different managers reflected specific investment objectives set for them. Managers have a responsibility to adhere to the guidelines set by clients. The University set a goal to maximize returns with a high minimum target of four-percent plus inflation. It set up UTAM to achieve its goal with a high level of equities and a low level of bonds, compared to its Canadian university peers.

In judging performance, all investment time periods must be considered to make a fair assessment. For example, in contrast to 2008, from 2003-2007 the University of Toronto's approach to asset management through UTAM produced almost $1 billion more than the University's minimum goal for investment returns. Also, UTAM achieved this while assuming less risk than the University's tolerance for losses stated in 2003.

Compared with other Canadian universities, the University of Toronto's five-year returns outpaced 95% of the peer group, even after deducting fees and expenses. Annual returns net of expenses in every year 2003 through 2007 ranked in the top half of Canadian universities.

In 2008, UTAM managers took steps to reduce portfolio risk further.

Because bonds were not expected to earn the University of Toronto's required return over the long term, only 20% of the portfolios were invested in them, but still 5 percentage points more than the normal 15%. Within the investment guidelines, UTAM managers leaned toward caution. Other Canadian universities had typical investment guidelines calling for a normal 40% in bonds.

Likewise, as equity markets sank, a decision to hold relatively better performing alternative investments such as private equities, hedge funds and real assets helped preserve relative wealth and average down overall losses, demonstrating the benefits of diversification.

In 2008, UTAM managers effectively protected against the risk of losing money on foreign currencies. However, UTAM managers did not trade currencies for profit. Unlike some peer managers with better absolute performance for the period in question, the

University of Toronto's portfolios did not make the currency gains some others luckily earned as the Canadian dollar unexpectedly fell 25% over a four-week period in the autumn of 2008 after investment bank Lehman Brothers failed.

This difference of investment approach was significant. The 10 percentage-point spread between University of Toronto and its typical peer could be attributed to its earning 7 percentage points less in bonds, earning 3 percentage points less in the currency swing, but having bettered its performance by 1 percentage point with its alternative investments, with the balance of the difference related to investment execution.

University of Toronto Asset Management has been attentive to the University's guidelines for risk and return.

From 2003 to 2007, the University's investment objective was to maximize returns without exceeding its risk tolerance – an objective accomplished.

After 2007, the University of Toronto changed UTAM's objective to achieve a target return while minimizing risk and in no event exceeding specified risk tolerance. At UTAM's prompting, the University lowered its sights on the upside and preferred guarding against loss.

However, the decision to change the Chief Executive Officer of UTAM just before credit markets seized in August 2007 proved to be the most unfortunate timing. The new CEO – UTAM's senior investment manager – was not in place until late April 2008. He spent some months to assess the portfolios inherited. This slowed the repositioning of the portfolios to new objectives, harming performance as markets deteriorated.

Over the 10 years ended 2008, the University of Toronto and 95% of its Canadian university peers fell short of the University's objective of a 4% real return. The market correction of 2008 – the biggest since the 1929 Crash – detracted from the results of a decade of improved investment management. The University's 10 years of taking a global perspective for its investment management returned 7.2% annually to the end of 2007. Even with the "tech wreck" market correction, the strategy achieved the University's current target return within the University's risk tolerance. Over the same period, some other Canadian universities did better and some did worse; the University of Toronto found itself in the middle of the pack, a greatly improved position than before the mid 1990s (and the creation of UTAM), when the University of Toronto's investment performance had been among the worst among its peers.

The independent directors of University of Toronto Asset Management do not believe one year of poor results indicates the abandonment of an investment philosophy, especially one predicated on long-term performance. The independent directors still believe in global investing and the benefits of managing risk through diversification across many equity alternatives.

Recommendations

The independent members of the UTAM Board agree with the spirit of many of the recommendations of the Jackman Report, and make some of the same recommendations (with what we believe to be refinements), particularly with respect to oversight processes and roles. We hold a different view about how to structure execution and oversight, because we believe the separation of those functions needs to be maintained at the levels of both the staff and the expert volunteer advisory group. We think UTAM should continue its role as investment manager, and the senior Administration should act as client in an oversight role. The senior Administration should be responsible for the client and oversight roles set out in recommendations 1, 2 and 3. The senior Administration and UTAM should share responsibility for the roles set out in recommendations 4, 5 and 7. We recommend point 6 because UTAM has a volunteer group with investment expertise providing advice to the CEO of UTAM, and we think the senior Administration also needs a volunteer group with expertise to provide advice about the client oversight role. UTAM should be responsible for the proposals in recommendations 8, 9 and 10.

1. Reassess Financial Strategy of Relying on Equity Market Returns

The University should reassess the extent of its reliance on equity market returns to supplement pension contributions and enhance benefactor gifts. If it expects to continue such reliance on equity markets it should seek to gain stakeholder buy-in for the level and types of risks to other future revenues and assets of the University should efforts fail to generate the sought after returns, which are well beyond the risk-free rates available in the market today.

2. Create a Statement of Investment Beliefs

To inform the Financial Strategy, create a Statement of Investment Beliefs to describe the investment philosophy of the University of Toronto. The statement should describe in general terms: (1) the balance to be maintained between seeking returns and preserving capital and (2) acceptable and unacceptable risks. Reasons should be set out for these choices. This statement could be used to evaluate overall investment approach options and their feasibility to meet investment objectives. The University should gain stakeholder buy-in for its investment philosophy.

3. Reassess the Risk and Return Targets

After completion of the Statement of Investment Beliefs, regularly reassess the risk parameters and return targets and ensure that the implications of changing risk parameters and return targets are clearly stated and understood. These and related performance benchmarks should be approved by the Business Board because of its overall accountability for the financial well being of the University. Curtail the use of performance benchmarks not approved by the Business Board to evaluate investment performance. The University should gain stakeholder buy-in for its risk parameters and return targets.

4. Reassess Overall Investment Approach

Regularly re-evaluate whether the University's chosen overall investment approach of global equity investing, diversified across many alternative equities with currency risk management, will effectively meet the University's immediate and future investment objectives, understood in terms of both risk and return. If not, evaluate other approaches or modify investment risk and return objectives. Note that the University makes the decision of the overall investment approach because it has such long-term implications in determining the people retained and the potential holding period of investments. This is different from the investment strategy and asset allocation decision made by UTAM to execute it. Evaluate whether the University's overall investment approach can be implemented in practice at a reasonable price. Keith Ambachtsheer raised this issue in his March, 2007 report as to whether the University's portfolios were large enough to employ the investment approach cost effectively. This matter should be addressed in the choice of overall investment approach and in recommendation #9. The University should gain stakeholder buy-in for its overall investment approach.

5. Improve Communications

Recognizing that the University is a community of stakeholders with different interests and levels of knowledge about investment matters, care must be taken to provide all stakeholders with easily understood information that addresses the specific concerns of each stakeholder group. The use of third-party assessments can be particularly useful to meet the needs of stakeholders without investment expertise. The Administration should take direct responsibility for stakeholder communications, with assistance by UTAM. UTAM undertakes to continue to make communications about matters within the scope of its activities a priority.

6. Create a Financial Advisory Committee

Create a Financial Advisory Committee consisting of a volunteer group with expertise in finance, conventional investment, alternative investment strategies and pension trusteeship. This Committee would counsel the Administration. Its membership would also include persons cross appointed to or from the UTAM Board, the new Pension Committee and possibly the Business Board. The mandate of the committee would be to provide advice to the Administration based on the regular review of *matters contained in our recommendations* above and of other matters put before it. The Committee would maintain an independent client advisory oversight role and avoid making or endorsing investment management execution decisions, to maintain its status as a third party. It would provide the third-party assessment of financial strategies related to the endowment, the pension fund and investment matters, including choice of performance benchmarks and fund performance assessment. The Financial Advisory Committee would not duplicate the work of the current UTAM Board, which is limited to overseeing the execution of the overall investment approach, including investment strategy, asset allocation and risk and risk mitigation strategies, manager selection and investment performance. The Committee would provide the independent counsel to support the Administration's recommendations for financial and investment matters to be approved by the Business Board. UTAM would stand ready to help the President or the Financial Advisory Committee with any requests for assistance.

7. Retain UTAM Under Investment Manager & Client Model.
Retain UTAM under a Discretionary Investment Management model, with UTAM acting as the Investment Adviser, to make investment portfolio decisions, and with the University acting as Client, to monitor whether those decisions meet agreed upon needs. Be vigilant in maintaining this separation of roles and responsibilities so that the University does not fall into the mode of a Do-It-Yourself investment model, in which the client becomes responsible for oversight of its own investment decisions. For example, it should be made clear to the CEO of UTAM that he reports to President of the University, representing the client, and the President should play that role. If the CEO of UTAM reports as CIO of investment management to the President acting as CEO of investment management, then the President will be responsible for every investment decision. That will compromise the desired separation of the investment management and client oversight roles.

8. Enhance UTAM Governance.
The UTAM Board should remain as an advisory group to the CEO of UTAM, particularly given the sophisticated investment approach taken by the University. The Board should establish a clear mandate, form a governance committee and develop a skills matrix for its members so that in managing succession it selects those best qualified to perform the governance function using the best practices of any well-run investment management organization, notwithstanding that UTAM has a single client. This will help UTAM attract and retain talented investment staff that might otherwise prefer not to work in a University environment. A separate UTAM with its own governance is also the most conducive structure for a successful investment management execution process. Investment professionals understand this model so they will understand their roles and responsibilities.

9. Benchmark UTAM Resources.
UTAM should conduct a benchmarking study of investment management organizations with similar levels of assets under management to determine whether UTAM has adequate resources to effectively execute the University's active investment strategy.

10. Upgrade the Risk Management Process
Upgrade the risk management process to implement the University's new risk objective introduced in December 2007. Provide UTAM with the resources needed to properly assess and manage risk beyond portfolio volatility. The goal would be to ensure risks are explicitly identified and that the related risk mitigation strategies are also identified and discussed with the Administration.

Appendix

Names of University of Toronto Asset Management Independent Directors

Allan Crosbie

Catherine A. (Kiki) Delaney

Ira Gluskin, Chairman of the Board

William E. Hewitt

Eric F. Kirzner, Chairman of the Audit Committee

Florence R. Minz

Robert W. Morrison, Vice Chairman of the Board

Thomas H. Simpson, Chairman of the Compensation Committee

Bonita Then

John Varghese