



UTFA Information Report

University of Toronto Faculty Association March 27, 2009

Information Report #9¹ – part III

Inconvenient Truths

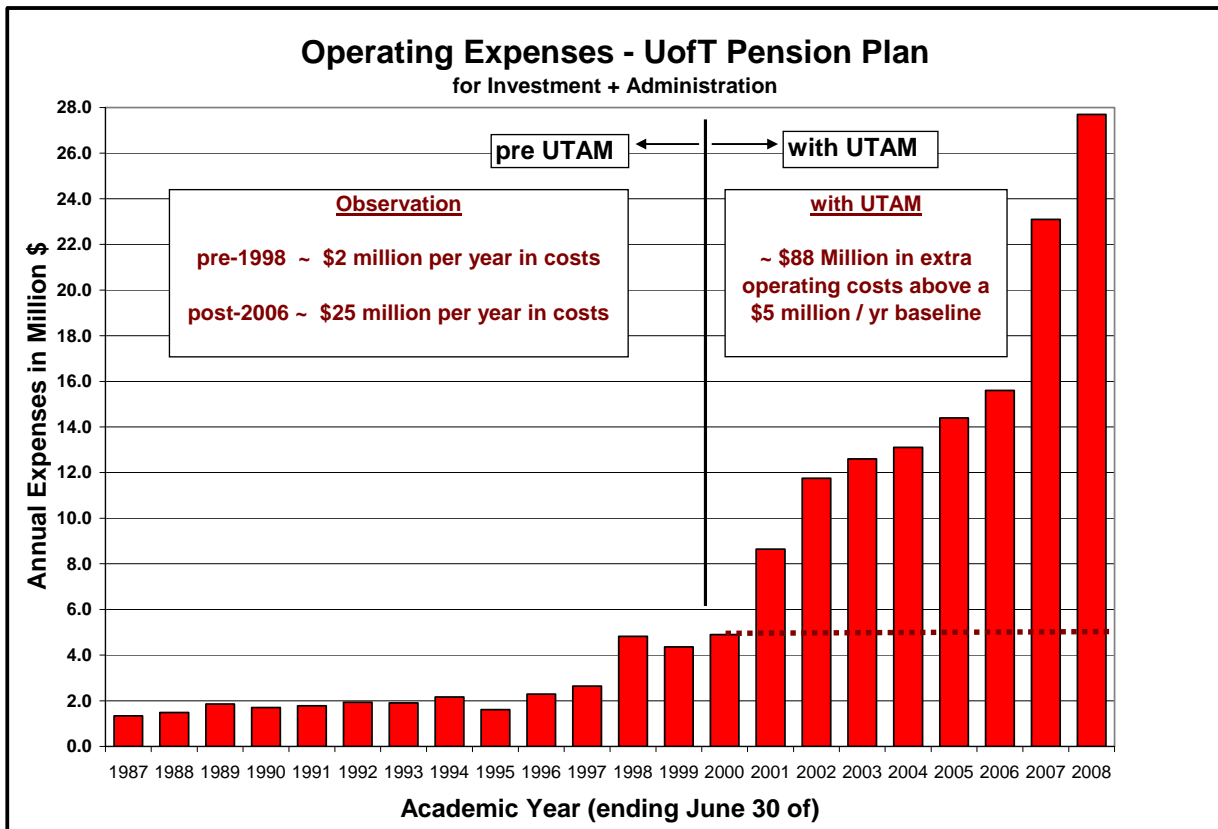
about the

U of T Pension Plan: operating costs

Academic budgets are everywhere being reduced. University administrators are talking tough about controlling costs. Are they also looking at non-academic costs?

The annual operating costs² for the U of T pension plan have increased by more than 500% in the past decade. Many millions of dollars are involved. The impact on base budgets will be felt for years to come.

Are the cost increases justified? No. This information report will show why.



The chart above illustrates how total annual pension plan operating costs have increased over time.

¹ This Information Report, including parts I, II and the Appendix to Part II, can be accessed via links at the UTFA website, <http://www.utfa.org>

² Operating costs do not include pension plan contributions by or pension payments to plan members. They include only the pension plan administrative costs, the actuarial costs, and the costs for investing the assets of the pension plan. Currently investment costs dominate other operating costs. This report considers only the Pension Fund. **But similar issues would apply to the operating costs of the Endowment Fund.**

Evidence of mismanagement?

(1) Costs. The 2007-08 annual operating cost for the U of T pension plan was almost \$28 million. A few years ago, it was only \$2 million – representing a fivefold³ increase over the past decade. How did this happen? The short answer is UTAM⁴, which the Administration created in 2000 to manage endowment, pension and cash flow monies. Costs have soared under UTAM's management because there are now three new levels of expensive active management fees (UTAM fees, invested fund fees and the 'fund-of-fund' fees). Prior to 2000, pension assets were managed in-house via low-cost funds.

Overall the current annual operating cost is about 1% of the \$2.7 billion in total assets. How does this translate to individual UTFA members? In 2007-08, on a pro rata basis, approximately \$18 million of the \$28 million total cost can be attributed to the 4,700 active and retired faculty and librarians or on average about \$3,800 for each active or retired member. For faculty at or near retirement with a full career and so with \$1 million or more in lump-sum pension assets, the 2007-08 annual operating cost would be \$10,000 or more. This should seem excessive to someone receiving a \$70,000 annual pension at retirement.

Costs matter and cumulative operating costs are significant. As illustrated in the chart on the first page, **the extra operating cost for the eight UTAM years is about \$88 million**, above an assumed baseline cost of \$5 million per year. And nothing about UTAM's current investment policy points to anything other than further increased costs in the future.

Investors cannot control market returns, or inflation, or currency fluctuations, but investors can and should control investment costs. In the long run cumulative investment costs such as fees and other frictional costs can represent a very substantial fraction⁵ of the total asset base. And it gets worse...

(2) Hedge funds⁶. In 2007 and 2008 UTAM's investments - our pension monies - were exposed to over 400 hedge funds⁷, including investments with Bernard Madoff and his Ponzi scheme. The result was about a \$5 million outright loss⁸ for UofT. Not only are hedge funds expensive, they can also be quite opaque, making it difficult to know exactly where assets are allocated – as the Madoff loss shows – and often have exit restrictions. We must ask how any exposure to hedge funds by a pension plan is justified.

(3) Fund-of-funds (FoF)⁹. UTAM has had exposure to some 16 hedge funds known as fund-of-funds. This makes no sense at all. It is worth quoting David Swensen¹⁰ on the issue of fund-of-funds:

Fund of funds are a cancer on the institutional-investor world. They facilitate the flow of ignorant capital. If an investor can't make an intelligent decision about picking managers, how can he make an intelligent decision about picking a fund-of-funds manager who will be selecting hedge funds? There's also more fees on top of existing fees. And the best managers don't want fund-of-fund money

³ On July 1, 2008 the market value of the assets in the pension plan were \$2.7 billion. Since the size of the asset base has doubled since 1997, the cost per unit of asset has only increased about fivefold, not tenfold.

⁴ The University of Toronto Asset Management Corporation. See <http://www.utam.utoronto.ca/site3.aspx>

⁵ See William J. Bernstein's 'Bequeathing Your Assets to Your Broker' at <http://www.efficientfrontier.com/ef/996/broker.htm>

⁶ Unlike mutual funds, hedge funds are typically exempt from regulations governing short selling, derivative contracts, leverage, fee structures and the liquidity of interests in the fund. Hedge funds are normally open only to a limited range of professional or wealthy investors.

⁷ See page 10 of the minutes of the Dec. 15, 2008 meeting of Business Board of Governing Council at <http://www.governingcouncil.utoronto.ca/Assets/Boards+and+Committees/Business+Board/2008-2009+Academic+Year/r1215.pdf>

⁸ This \$5 million loss is not included in the \$28 million operating cost for 2007-08.

⁹ A "fund of funds" (FoF) is an investment fund that uses an investment strategy of holding a portfolio of other investment funds rather than investing directly in shares, bonds or other securities. Thus it has two layers of management fees.

¹⁰ David Swensen, Chief Investment Officer, since 1985 at Yale University. Author of *Pioneering Portfolio Management* 1999 and 2009 editions.

*because it is unreliable. You need to be in the top 10% of hedge funds to succeed. In a fund of funds, you will likely be excluded from the best managers. [Mr.] Madoff also relied enormously on these intermediaries. He wouldn't have had nearly as much resources were it not for fund of funds.*¹¹

(4) Currency hedging. Most investors agree that market timing is a losing proposition. Likewise, the wisdom of betting on changes in foreign currency exchange rates can be questioned. The 2007 UTAM annual report¹² indicates that our pension plan had considerable exposure to “currency overlay”. David Swensen’s views on this are, “*Foreign currencies, in and of themselves, provide no expected return*” and “*Sensible investors avoid currency speculation.*”

(5) Comparing UTAM Returns. How does a passive low-cost-index investment return compare to UTAM’s performance from 2000 to 2007? Clearly if UTAM’s returns were superior to index returns, it might¹³ justify its increased operating costs and investment selections. However, that is not the case.

At the April 28, 2008 meeting of Business Board, UTFA’s presentation provided an answer¹⁴. **The comparison showed that a passive portfolio of 50% bonds and 50% TSX index equities outperformed UTAM’s actual performance over the eight UTAM years by about \$200 million - and with lower volatility.**

This same 50-50 passive portfolio had a negative return of -13.4% in 2008. The UTAM number for 2008 is not yet public. It should be available at the April 27, 2009 Business Board meeting and we can then update the \$200 million underperformance number.

(6) UTAM CEO Turnover. At Yale, David Swensen has been Chief Investment Officer for the past twenty-four years, since 1985. Turnover of senior management is costly, both in dollar terms and in disruption to investment policies. In the nine years of its existence UTAM has had three different CEOs and Presidents, Don Lindsey, Felix Chee, and currently William Moriarty. In the transition from Lindsey to Chee UTAM incurred about \$1.5 million in severance costs. And the salaries of senior UTAM executives are high by UofT standards. To illustrate, in 2007 Felix Chee earned \$562,200 and his second-in-command at UTAM, John Lyon, earned \$473,400.

(7) UTAM Staff Turnover. Like the CEO turnover, UTAM staff turnover has also been excessive. Typically UTAM consists of about 11 to 13 staff plus the CEO. Judging by the list of staff names in the UTAM annual reports, in 2004 at least five staff left, in 2005 at least four staff left, in 2006 at least four staff left, and in 2007 at least four staff left. In total, over the four years, there were 17 or more departures. Why? What is the staff retention problem at UTAM? How does it reflect in investment continuity and resulting performance?

(8) Admonition by Hal Jackman. The Honourable Henry N. R. Jackman took an interest in UTAM and the Business Board when he was Chancellor of the University of Toronto. In a presentation to a class at the Rotman School of Management on March 30, 2006, he stated:

¹¹ David Swensen, in The Wall Street Journal, 13 January 2009

¹² See <http://www.utam.utoronto.ca/Assets/reports/Utam+Annual+Report+2007.pdf> page 28 shows the return to the pension plan in 2007 due to ‘currency overlay’ as 7%. Without this boost, the overall return would have been negative in 2007. Because of the decrease in the Canadian dollar in 2008, one expects this to be a negative factor in 2008. At the time of writing of this report, the 2008 UTAM annual report is not yet available.

¹³ The author is well aware that short-term investment return comparisons are fraught with problems and statistical uncertainty. It truly can be difficult to distinguish skill from random luck or its absence. In the short term, high returns by themselves do not prove skill and conversely low returns do not prove ineptitude. However, there is considerable academic literature attesting to the long-term outperformance of passive investing – given its cost advantage – over more expensive active investing. For example, Nobel laureate William Sharpe writes: *After costs, the return on the average actively managed dollar will be less than the return on the average passively managed dollar. These assertions will hold for any time period. Moreover, they depend only on the laws of addition, subtraction, multiplication and division. Nothing else is required.*

¹⁴ See page 4 in <http://utfa.org/images/file/UofT%20Bus-Bd%20Apr-2008-final.pdf> Additional links to other UTFA pension presentations to Business Board can be found at http://utfa.org/index.php?option=com_content&task=view&id=87&Itemid=102

Furthermore no proper mechanism was put in place to change the benchmarks or to otherwise ensure that the investment manager would vary from the benchmarks to preserve the fund's capital. **The additional losses to the University's Endowment and Pension Funds in the 2001-2002 period, over and above the median performance of the RBC balanced universe, totaled over \$200 million – not an insignificant figure. ...** ... I mention the UTAM experience as it shows what can happen if there is a miscommunication between the investment manager and the client. In this case both parties felt that changes in asset allocation were the other's responsibility. As a result nothing was done.

(9) Other issues. A number of additional issues could be raised, such as: (i) Why are the UTAM annual reports so uninformative and self-serving? (ii) Why is the discussion of 'risk' so inadequate? (iii) How does the UTAM compensation model, including bonus / incentive payments, align agent-client interests? (iv) Who on the UTAM board speaks for passive investing? (v) Why do the pension funds have the same asset allocation as the endowment funds? (vi) Is a long-term target of a 4% real rate of return realistic? (vii) What are the pitfalls and risks of chasing past performance in alternative assets? (viii) What are the uncertainties in assessing the market value of illiquid assets? (ix) Et cetera, et cetera ...

Unfortunately space limitations do not allow us to discuss everything that could or should be discussed.

Conclusions:

Costs matter when investing. Lower costs correlate with higher investment returns. It seems UTAM has lost sight of this.

And naively trying to emulate yesterday's winners does not work.

In a recent hour-long television interview with Charlie Rose¹⁵, Warren Buffett gave his critical view on how good new ideas go wrong. He called this "natural progression" the "three Is". *First come the innovators, who see opportunities that others don't. Then come the imitators, who copy what the innovators have done. And then come the idiots, whose avarice undoes the very innovations they are trying to use to get rich.*

Whether UofT's belated experiment with UTAM falls under Buffett's *imitators* or *idiots* label we cannot judge. But the unfortunate and inconvenient truth is that UofT's experiment with the Yale/Harvard endowment style of active investing has been a failure. It has cost our institution many millions of dollars, millions we cannot afford. We should not continue to throw good money after bad to further enrich the financial industry.

The evidence from the past eight years suggests that, for the good of the pension plan and our institution, it is time to withdraw from UTAM.

Part IV in this *Inconvenient Truth* series will examine pension governance issues.

I welcome any and all comments and questions.

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¹⁵ On the web at <http://www.charlierose.com/view/interview/9284>