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Date: April 27, 2009  
To: Governing Council Business Board Members  
From: George Luste, President, University of Toronto Faculty Association (UTFA)  
Re: **Agenda item #4. - Investments - University of Toronto Asset Management (UTAM) and its Annual Report for 2008**

My 5-minute time limit requires I be selective and very brief in the few issues I can raise.

Background. UTFA members are the major stakeholder group in the UofT Registered and SRA pension plans. The UofT pension plan lost about \$900 million in 2008. Approximately 65%, or about \$600 million, of this loss relates to faculty and librarians. While I shall restrict my comments to the pension fund, similar comments would be applicable for the endowment fund. UTAM manages both funds.

Many of the following issues have been raised in past years by UTFA at this Business Board.

**Issue #1. UTAM returns lag those of a simple passive index portfolio.**

**1.8% is the annual investment return for the nine UTAM years, from 2000 to 2008.**

The UTAM annual compound return was 1.8% with a standard deviation of 14.1% over the nine UTAM years. The annual inflation rate (CPI) over the same time period was 2.1% with a standard deviation of 1.0%. In short, the overall UTAM returns were less than inflation. The target return rate for the pension plan is 4.0% above inflation.

**5.3% is the return for a simple passive investment policy over the same 9 years**

This comparison is detailed further in Appendix-A on page 5 in this memo. While the 5.3% return is still less than inflation at 2.1% plus the target 4.0% real return, it is considerably better than the actual UTAM result of 1.8%. And the passive portfolio has a lower volatility, with standard deviation of 9.7% instead of UTAM's higher 14.1%. In six of the nine years, the lower volatility passive portfolio outperformed the UTAM results and in the other three years the UTAM results were better than the passive portfolio

**\$665 million difference. The above 3.5% return difference compounded over the nine years translates to about \$665 million in reduced pension assets at the end of 2008. Not an insignificant sum.**

**Issue #2. Costs matter. Unit costs have increased by 500% over the past decade. Yet investment costs are still not discussed in the 2008 UTAM report, even after repeated requests, over several years, for such discussion.**

The continuing and alarming increase in pension plan costs is discussed in the attached UTFA newsletter of March 27, 2009, before the UTAM report for 2008 was available. Annual costs are now about \$25 million more than in years prior to 2000 (pre UTAM). The cumulative excess cost, above a \$5 million baseline, totals about \$88 million from 2000 to 2008. Since the plan is in deficit, this extra cost (of \$88 million) will, in due course, impact the UofT operating budget. This same point was made here a year ago.

Annual pension plan operating costs, including investment costs, were about 1% of assets last July 1<sup>1</sup>. The compounding loss of 1% over the life span of a pension plan member, say from age 30 to age 80, reduces an initial investment by about 40% -- a frictional loss that can be and should be minimized.

Investment costs, even for active management, were much less in the pre-UTAM years. In the 1999 Annual Report of the President's Investment Committee one reads:

“Fees for passive management would be less than 5 basis points whereas the average fee paid to active managers would be about 20 basis points.”

**Issue #3. After reading the nine UTAM annual reports one cannot discern any consistent long term investment policy. Instead one observes the opposite, a pattern of continuous change in policy and practice.**

To illustrate with a few examples:

- (1) Initially it was deemed advisable to have different asset allocation policies for the pension fund and the endowment fund. Recently those policies have become the same, with no justification for why the policy was changed.
- (2) Initially, in 2000, the equity-to-bond ratio was set at 60:40<sup>2</sup>. In the 2008 report fixed income (bonds) were reduced to about 15% of assets. In 2008 this

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<sup>1</sup> As reported for our pension plan in the Hewitt Annual Actuarial Report for July , 2008. Neither this number nor any other cost number can be found in the UTAM report.

<sup>2</sup> Recent fixed income returns demonstrate, once again, that there can be extended periods when equities will underperform fixed income. The historic return tables in Appendix-B on page 6 bear this out. With hindsight it is unfortunate that UofT did not take Robert Korthals' advice in 1999-2000. The Business Board minutes from that time read:

“... Looking ahead, Mr. Korthals reported that the President's Investment Committee had likely held its last business meeting, with responsibility to pass to the new corporation. **With respect to the year ahead, decisions would have to take into account the fact that the equity markets had enjoyed strong returns for a sustained period of time, and those markets were now substantially overvalued by historical standards. Consequently, it would be possible to make a case for favouring government bonds, which had performed well in recent weeks in spite of increases in short-term interest rates. ...**”

underweighting in fixed income resulted in a 510 bp loss relative to the Reference Portfolio.

- (3) Currency hedging policy has flip-flopped over the nine years, from 0%, then to 50% - 100%, then to only 100% and now in 2009 to 50%. In 2008 this unfortunate hedging increased overall losses by 12.9%. Academic studies have shown that currency speculation does not add value.
- (4) The *Enhanced Index Platform* investment practices were first introduced a few years ago. In 2008 they suffered substantial losses and are now being discontinued.
- (5) The current emphasis on Alternative Assets, at 46% of assets, is also a recent development. This is a questionable change and appears to be an attempt to imitate the Yale investment model, which realized exceptional returns from 1985 to 2007. But not in 2008. Late imitation is not a prescription for success - in particular if there is no evidence that UTAM understands what resources Yale required to successfully implement its asset allocation. In addition, Alternative Assets are by their nature illiquid and do not have direct market valuations. There is no clear valuation standard. Thus any claims for short term gains in Alternative Assets must be critically scrutinized.
- (6) Fund-of-hedge-funds. Another short lived and unfortunate asset allocation policy. More on this in the next section.

**Issue #4. The fund-of-hedge-fund mistake. David Swensen of Yale has described investments via fund of funds as ‘ignorant capital’. Hedge funds, in themselves, can be costly, opaque and very risky. Fund-of-hedge-funds are doubly so.**

A year ago, the 2007 UTAM annual report reads:

“At year-end, there were investments with 19 hedge fund managers, of which 14 were fund-of-funds managers that represented 93% of the hedge fund investments. ... effectively with hundreds of underlying hedge fund managers.”

The 2008 UTAM report indicates that 33.1% of pension assets are still in hedge funds but that UTAM is now moving out of fund of hedge funds. It notes:

“We formed a view that most fund of hedge funds would struggle to differentiate their strategies and generate acceptable returns.”

This is not surprising but comes a bit late. This mistake could have been avoided with forethought and sound judgment. Yale’s David Swensen observes:

*“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 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."*

The reader might ask: "What are the chances of UTAM selecting the top 10% of hedge funds?" Swensen's analysis shows that median hedge fund returns are typically less than passive returns.

And regrettably no mention is made of UofT's losses in 2008 to the Madoff scam in the UTAM 2008 report. Why not? This omission prompts the obvious question: "How many other unwelcome details are omitted?."

**Issue #5      **The UofT Pension Plan is now even more seriously underfunded. The 2008 market loss further accentuates the consequences of the 17 years (from 1987 to 2004) of missing pension contributions.****

Underfunded by how much? Pick your number and date. But the reader should understand what each number assumes and what it leaves out.

First, here are the official Hewitt numbers as of July 1, 2008.

(i) **\$165.4 million** notional shortfall in a going concern valuation.

(ii) **\$217.2 million** notional shortfall in a solvency valuation.

(iii) **\$1,139.0 million** real shortfall in wind-up valuations.

Secondly, here are my estimated update numbers as of December 31, 2008

(iv) **\$860 million** notional shortfall in a going concern valuation.

(v) **\$910 million** notional shortfall in a solvency valuation.

(vi) **\$1,830 million** real shortfall in wind-up valuations.

**Further Issues**

Additional issues could be raised, such as (i) How does the UTAM compensation model, including bonus / incentive payments, align agent-client interests? (ii) Is a long-term target of a 4% real rate of return realistic? (iii) What are the pitfalls and risks of chasing past performance in alternative assets? (iv) What are the uncertainties in assessing the market value of illiquid assets? (v) What is the proposed new 'active fixed income mandate' about? What new risks are being introduced? (vi) Who on the UTAM board speaks for passive investing?

**Conclusions      **The evidence of the past nine years, not just the catastrophic losses in 2008, suggest that it is time to admit, for the good of the pension plan and our institution, that the UTAM experiment has been an expensive mistake.****

## Appendix A

### UTAM vs a Passive Index of Bonds & Equities– Comparing Returns

**Question:**

How do passive investment returns compare to UTAM's active management returns for the UofT pension plan?

Assume the passive is a 50:50 mix of the All-Canadian-Bond index and the TSX equity index. (This is the same passive mix as was used a year ago, at the April 28, 2008 presentation by UTFA to Business Board of Governing Council.

See [http://utfa.org//index.php?option=com\\_content&task=view&id=87&Itemid=102](http://utfa.org//index.php?option=com_content&task=view&id=87&Itemid=102) )

**Answer:**

The passive return beat the UTAM return in six of the nine UTAM years, from 2000 to 2008 inclusive, with a lower volatility.

The compounded annual return is 5.3% for passive vs 1.8% for UTAM.

This translates to about a \$665 million total difference in favour of passive over UTAM, for the UofT pension plan. (Less about 10-15 basis points on assets, or \$20-\$30 million total, for passive management costs.)

The table below provides year by year details. The annual returns are for the calendar year, the pension plan asset value is taken as that in mid-year, on June 30<sup>th</sup>.

	<b>Assets</b>	<b>Passive</b>		<b>Active-UTAM</b>		<b>Difference</b>
Year	Pension Assets on Jun 30 \$ in Billions	Passive Mix 50% All-Can Bonds and 50% TSX	Passive Pension Gain or Loss in \$ Mil	Active UTAM returns	UTAM Pension Gain or Loss in \$ Mil	Passive \$ less UTAM \$ in Millions
2000	2.26	8.8%	199	5.2%	117	82
2001	2.06	-2.3%	-46	-1.5%	-30	-16
2002	1.94	-1.9%	-36	-7.0%	-135	99
2003	1.86	16.7%	311	15.9%	296	15
2004	2.11	10.8%	228	11.4%	241	-13
2005	2.32	15.3%	355	12.3%	285	70
2006	2.49	10.7%	266	12.1%	301	-35
2007	2.93	6.8%	198	6.0%	175	23
2008	2.72	-13.3%	-362	-29.5%	-802	441
Compounded %		5.3%		1.8%		
St Dev		9.7%		14.1%		
Average %		5.7%		2.8%		
<b>Sum</b>			<b>\$1,113</b>		<b>\$448</b>	<b>\$665</b>

## Appendix B

### Year by Year Returns, in Canadian Dollars, in Various Indexes

Nominal annual pretax returns in Canadian dollars													
Year	Annual Canadian Inflation	3 month T-bills	Short Canadian Bonds	Long Canadian Bonds	All Canadian Bonds	Real Return Bonds	TSX Composite	S&P 500	Wilshire 5000	MSCI EAFE	MSCI Emerging Markets	Gold Bullion	Year
1970	1.3%	6.7%		16.2%			-3.6%	-2.5%		-16.1%		-0.2%	1970
1971	5.0%	3.8%		14.8%			8.0%	13.2%		29.9%		15.0%	1971
1972	5.1%	3.6%		8.1%			27.4%	18.2%		36.7%		46.0%	1972
1973	9.4%	5.2%		2.0%			0.3%	-14.7%		-14.1%		67.1%	1973
1974	12.3%	8.0%		-4.7%			-25.9%	-26.8%		-22.5%		71.5%	1974
1975	9.5%	7.5%		8.0%			18.5%	40.7%	42.1%	40.6%		-21.8%	1975
1976	5.8%	9.3%		23.6%			11.0%	23.0%	25.6%	3.0%		-4.8%	1976
1977	9.5%	7.8%		9.2%			10.7%	0.7%	5.6%	29.5%		33.0%	1977
1978	8.4%	8.5%		4.1%			29.7%	15.5%	18.4%	45.6%		48.5%	1978
1979	9.8%	11.8%		-2.8%			44.8%	16.8%	23.7%	4.5%		123.1%	1979
1980	11.1%	13.4%	9.1%	2.1%	6.6%		30.1%	35.5%	36.7%	27.2%		17.8%	1980
1981	12.2%	19.3%	8.3%	-2.1%	4.2%		-10.2%	-5.6%	-4.4%	-1.7%		-33.1%	1981
1982	9.2%	15.5%	28.8%	46.0%	35.4%		5.5%	26.0%	23.0%	2.8%		19.2%	1982
1983	4.6%	9.9%	14.9%	9.6%	11.5%		35.5%	24.0%	25.0%	26.1%		-15.3%	1983
1984	3.7%	11.6%	12.9%	16.9%	14.7%		-2.4%	12.9%	9.4%	14.5%		-14.2%	1984
1985	4.4%	10.1%	15.1%	26.7%	21.2%		25.1%	39.4%	40.3%	65.8%		11.8%	1985
1986	4.2%	9.5%	11.4%	17.2%	14.7%		9.0%	17.2%	14.7%	67.8%		19.8%	1986
1987	4.2%	8.5%	7.0%	1.8%	4.0%		5.9%	-0.9%	-3.7%	17.6%		15.1%	1987
1988	4.0%	9.6%	8.4%	11.3%	9.8%		11.1%	7.0%	8.2%	18.0%	28.8%	-22.3%	1988
1989	5.2%	12.5%	10.4%	15.1%	12.8%		21.4%	27.8%	25.4%	7.6%	60.1%	-5.7%	1989
1990	5.0%	13.7%	10.5%	4.3%	7.5%		-14.8%	-2.9%	-6.0%	-23.0%	-10.3%	-1.2%	1990
1991	3.8%	9.8%	17.9%	25.3%	22.1%		12.0%	29.9%	33.6%	12.0%	59.2%	-10.4%	1991
1992	2.1%	6.7%	8.6%	11.6%	9.8%	3.9%	-1.4%	18.4%	19.9%	-3.0%	22.5%	3.7%	1992
1993	1.7%	5.5%	13.3%	22.1%	18.1%	18.8%	32.5%	14.5%	15.7%	38.2%	81.8%	22.4%	1993
1994	0.2%	5.3%	-1.0%	-7.4%	-4.3%	-13.7%	-0.2%	7.5%	6.0%	14.6%	-1.7%	3.8%	1994
1995	1.8%	7.3%	15.5%	26.3%	20.7%	16.7%	14.5%	33.9%	32.8%	8.5%	-7.8%	-1.7%	1995
1996	2.2%	4.8%	10.7%	14.2%	12.3%	11.7%	28.3%	23.6%	21.8%	6.9%	6.5%	-4.1%	1996
1997	0.7%	3.1%	4.9%	18.5%	9.6%	4.7%	15.0%	39.2%	37.0%	6.5%	-7.7%	-18.0%	1997
1998	1.0%	4.7%	6.7%	12.8%	9.2%	6.0%	-1.6%	37.8%	32.3%	29.0%	-20.0%	6.3%	1998
1999	2.6%	4.8%	2.3%	-6.0%	-1.1%	8.0%	31.7%	13.9%	16.3%	19.8%	56.6%	-5.1%	1999
2000	3.2%	5.5%	8.2%	13.0%	10.2%	16.6%	7.4%	-5.6%	-7.4%	-10.6%	-27.9%	-1.8%	2000
2001	0.7%	4.4%	9.4%	6.1%	8.1%	0.6%	-12.6%	-6.4%	-5.4%	-16.3%	3.7%	7.0%	2001
2002	3.9%	2.5%	6.3%	11.1%	8.7%	15.3%	-12.4%	-22.8%	-21.6%	-16.5%	-6.9%	24.4%	2002
2003	2.0%	2.9%	5.1%	9.1%	6.7%	13.2%	26.7%	5.8%	8.2%	14.4%	28.4%	-1.5%	2003
2004	2.1%	2.3%	5.1%	10.3%	7.1%	17.5%	14.5%	2.8%	4.4%	11.9%	16.8%	-3.0%	2004
2005	2.2%	2.6%	2.4%	13.8%	6.5%	15.2%	24.1%	1.5%	2.9%	10.3%	30.2%	13.9%	2005
2006	1.6%	4.0%	4.0%	4.1%	4.1%	-2.9%	17.3%	16.0%	16.1%	27.1%	32.9%	23.5%	2006
2007	2.4%	4.3%	4.1%	3.4%	3.7%	1.6%	9.8%	-10.3%	-10.1%	-5.0%	18.9%	12.2%	2007
2008	1.2%	2.8%	8.6%	2.7%	6.4%	0.4%	-33.0%	-22.6%	-23.0%	-30.0%	-42.5%	28.2%	2008
<b>Geo Mean</b>	<b>4.5%</b>	<b>7.3%</b>	<b>9.1%</b>	<b>10.3%</b>	<b>10.1%</b>	<b>7.5%</b>	<b>9.1%</b>	<b>9.8%</b>	<b>12.3%</b>	<b>10.0%</b>	<b>11.1%</b>	<b>8.9%</b>	<b>Geo Mean</b>
<b>Std Dev</b>	<b>3.4%</b>	<b>4.0%</b>	<b>5.8%</b>	<b>10.5%</b>	<b>7.8%</b>	<b>8.9%</b>	<b>17.3%</b>	<b>18.1%</b>	<b>17.3%</b>	<b>22.8%</b>	<b>31.8%</b>	<b>29.2%</b>	<b>Std Dev</b>
Average	4.6%	7.4%	9.3%	10.7%	10.4%	7.9%	10.5%	11.3%	13.6%	12.2%	15.3%	12.0%	Average
<b>Min</b>	<b>0.2%</b>	<b>2.3%</b>	<b>-1.0%</b>	<b>-7.4%</b>	<b>-4.3%</b>	<b>-13.7%</b>	<b>-33.0%</b>	<b>-26.8%</b>	<b>-23.0%</b>	<b>-30.0%</b>	<b>-42.5%</b>	<b>-33.1%</b>	<b>Min</b>
<b>Max</b>	<b>12.3%</b>	<b>19.3%</b>	<b>28.8%</b>	<b>46.0%</b>	<b>35.4%</b>	<b>18.8%</b>	<b>44.8%</b>	<b>40.7%</b>	<b>42.1%</b>	<b>67.8%</b>	<b>81.8%</b>	<b>123.1%</b>	<b>Max</b>

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Nominal annual pretax returns in Canadian dollars - over the nine UTAM years													
Year	Annual Canadian Inflation	3 month T-bills	Short Canadian Bonds	Long Canadian Bonds	All Canadian Bonds	Real Return Bonds	TSX Composite	S&P 500	Wilshire 5000	MSCI EAFE	MSCI Emerging Markets	Gold Bullion	Year
2000	3.2%	5.5%	8.2%	13.0%	10.2%	16.6%	7.4%	-5.6%	-7.4%	-10.6%	-27.9%	-1.8%	2000
2001	0.7%	4.4%	9.4%	6.1%	8.1%	0.6%	-12.6%	-6.4%	-5.4%	-16.3%	3.7%	7.0%	2001
2002	3.9%	2.5%	6.3%	11.1%	8.7%	15.3%	-12.4%	-22.8%	-21.6%	-16.5%	-6.9%	24.4%	2002
2003	2.0%	2.9%	5.1%	9.1%	6.7%	13.2%	26.7%	5.8%	8.2%	14.4%	28.4%	-1.5%	2003
2004	2.1%	2.3%	5.1%	10.3%	7.1%	17.5%	14.5%	2.8%	4.4%	11.9%	16.8%	-3.0%	2004
2005	2.2%	2.6%	2.4%	13.8%	6.5%	15.2%	24.1%	1.5%	2.9%	10.3%	30.2%	13.9%	2005
2006	1.6%	4.0%	4.0%	4.1%	4.1%	-2.9%	17.3%	16.0%	16.1%	27.1%	32.9%	23.5%	2006
2007	2.4%	4.3%	4.1%	3.4%	3.7%	1.6%	9.8%	-10.3%	-10.1%	-5.0%	18.9%	12.2%	2007
2008	1.2%	2.8%	8.6%	2.7%	6.4%	0.4%	-33.0%	-22.6%	-23.0%	-30.0%	-42.5%	28.2%	2008
<b>Geo Mean</b>	<b>2.1%</b>	<b>3.5%</b>	<b>5.9%</b>	<b>8.1%</b>	<b>6.8%</b>	<b>8.3%</b>	<b>2.8%</b>	<b>-5.4%</b>	<b>-4.8%</b>	<b>-3.2%</b>	<b>2.4%</b>	<b>10.8%</b>	<b>Geo Mean</b>
<b>Std Dev</b>	<b>1.0%</b>	<b>1.1%</b>	<b>2.4%</b>	<b>4.2%</b>	<b>2.1%</b>	<b>8.4%</b>	<b>19.9%</b>	<b>12.8%</b>	<b>13.2%</b>	<b>18.5%</b>	<b>26.8%</b>	<b>12.1%</b>	<b>Std Dev</b>
Average	2.1%	3.5%	5.9%	8.2%	6.8%	8.6%	4.6%	-4.6%	-4.0%	-1.6%	6.0%	11.4%	Average
<b>Min</b>	<b>0.7%</b>	<b>2.3%</b>	<b>2.4%</b>	<b>2.7%</b>	<b>3.7%</b>	<b>-2.9%</b>	<b>-33.0%</b>	<b>-22.8%</b>	<b>-23.0%</b>	<b>-30.0%</b>	<b>-42.5%</b>	<b>-3.0%</b>	<b>Min</b>
<b>Max</b>	<b>3.9%</b>	<b>5.5%</b>	<b>9.4%</b>	<b>13.8%</b>	<b>10.2%</b>	<b>17.5%</b>	<b>26.7%</b>	<b>16.0%</b>	<b>16.1%</b>	<b>27.1%</b>	<b>32.9%</b>	<b>28.2%</b>	<b>Max</b>

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# UTFA Information Report

University of Toronto Faculty Association March 27, 2009

## Information Report #9<sup>1</sup> – part III

### Inconvenient Truths

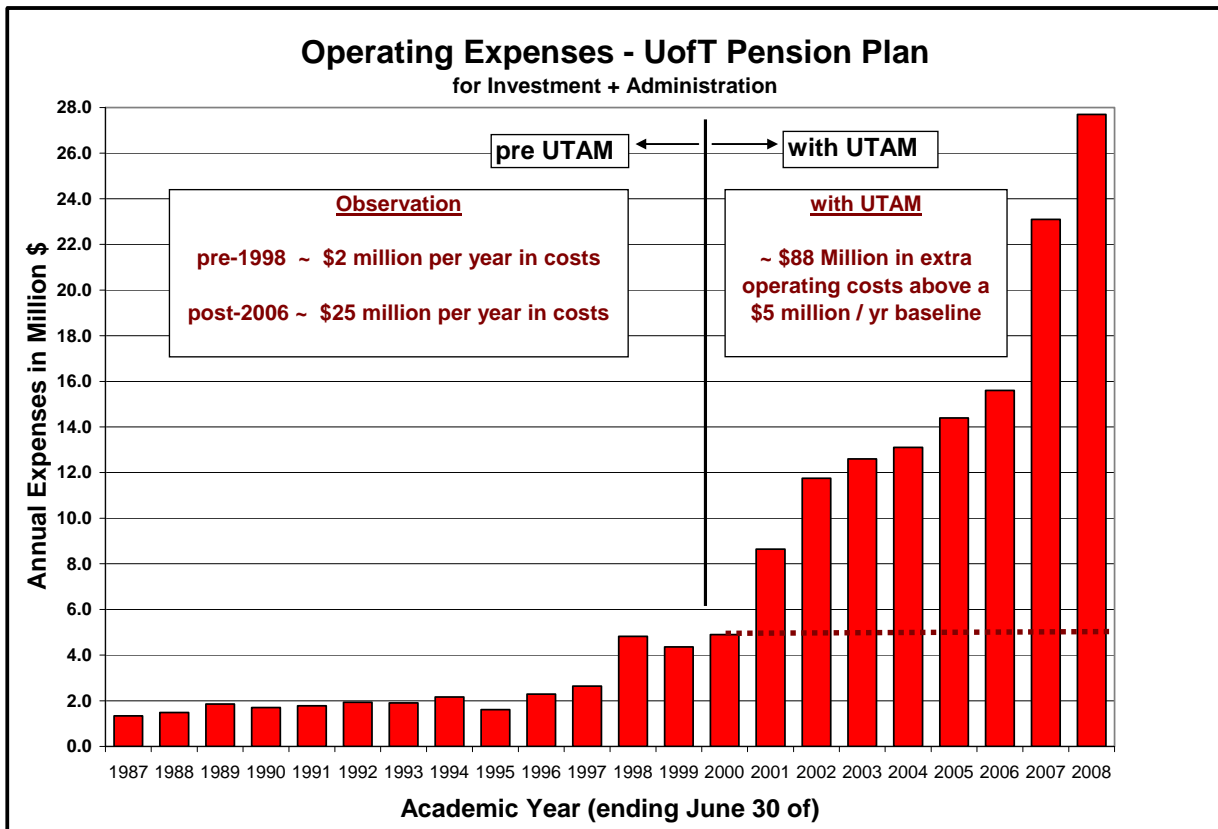
about the

### 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 costs<sup>2</sup> 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.

<sup>1</sup> 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>

<sup>2</sup> 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 fivefold<sup>3</sup> increase over the past decade. How did this happen? The short answer is UTAM<sup>4</sup>, 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 fraction<sup>5</sup> of the total asset base. And it gets worse...

**(2) Hedge funds<sup>6</sup>.** In 2007 and 2008 UTAM's investments - our pension monies - were exposed to over 400 hedge funds<sup>7</sup>, including investments with Bernard Madoff and his Ponzi scheme. The result was about a \$5 million outright loss<sup>8</sup> 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)<sup>9</sup>.** 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 Swensen<sup>10</sup> 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*

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<sup>3</sup> 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.

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

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

<sup>6</sup> 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.

<sup>7</sup> 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>

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

<sup>9</sup> 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.

<sup>10</sup> 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.*<sup>11</sup>

**(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 report<sup>12</sup> 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 might<sup>13</sup> 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 answer<sup>14</sup>. **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:

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<sup>11</sup> David Swensen, in The Wall Street Journal, 13 January 2009

<sup>12</sup> 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.

<sup>13</sup> 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.*

<sup>14</sup> 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](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 Rose<sup>15</sup>, 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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<sup>15</sup> On the web at <http://www.charlierose.com/view/interview/9284>