UNIVERSITY OF TORONTO

THE GOVERNING COUNCIL

REPORT NUMBER 3 OF

THE PENSION COMMITTEE

Friday, June 10, 2011

To the Governing Council,
University of Toronto.

Your Committee reports that it held a meeting on Friday, June 10, 2011 at 10:00 a.m. in the Council Chamber, Simcoe Hall, with the following members present:

Mr. W. John Switzer, In the Chair
Professor George Luste, Vice-Chair
Professor Laurence Booth
Professor Ettore Vincenzo Damiano
Ms Nancy Edwards
Mr. Thomas Finlay
Ms Judy Goldring
Ms Shirley Hoy
Mr. Joseph Mapa
Mr. Alex McKinnon
Mr. Gary Mooney
Mr. Philip Murton
Ms Helen Rosenthal
Mr. Howard Shearer
Mr. Andrew Ward
Mr. W. David Wilson

Non-Voting Assessors:

Ms Sheila Brown, Chief Financial Officer
Ms Catherine Riggall, Vice-President, Business Affairs

Mr. Louis R. Charpentier, Secretary of the Governing Council, Secretary of the Committee

Secretariat:

Ms Cristina Oke, Recording Secretary

Regrets:

Mr. Brent Belzberg
Mr. Steve (Suresh) K. Gupta
Professor Angela Hildyard
Ms Melinda Rogers
Ms Rita Tsang

In Attendance:

Mr. William da Silva, AON Hewitt
Mr. William W. Moriarty, President and Chief Executive Officer, UTAM
Mr. Allan Shapira, AON Hewitt

The Chair welcomed members to the meeting. He acknowledged that some material had been distributed the day prior to the meeting and said that he would work with the Agenda Planning Group to develop a process for the timely submission of meeting documentation.

1. Report of the Previous Meeting

Report Number 2 of the Pension Committee (April 6, 2011) was approved.

2. Business Arising from the Report of the Previous Meeting

Professor Luste referred to the comments at the end of the second paragraph of agenda item 4 on page 2 of the Report. Mr. Moriarty had clarified that the investment returns had been reported to December 30, 2010 because the University of Toronto Asset Management Corporation (UTAM) operated on a calendar year basis, and had noted that, in future, the information would be reported based on the pension plan year end of June 30th. Professor Luste requested that the investment returns be reported both on a calendar year and the pension plan year basis. Mr. Moriarty replied that UTAM would report results for both time periods.

3. *University of Toronto Pension Master Trust:* Consultation Draft Investment Volatility Risk and Return Targets

The Chair noted that this information was being considered over two meetings. The intent of this presentation was to provide members with an opportunity to review the work that had been done to date and the resulting recommendations. If the Committee wanted additional information before considering a revised policy at the September meeting, clear direction would be given to the administration. The Chair reminded members that their role was to accept, reject or refer back recommendations; the Pension Committee was a governance body, not a working committee.

a) Presentation on Pension Volatility Risk and Return Targets

Ms Brown provided the Committee with a presentation on the University's Pension Investment Volatility Risk and Return Targets. Highlights of the presentation are summarized below.

Investment Targets

- Current Investment Targets were:
  - A return volatility risk target of a 10% standard deviation over 10 year periods.
  - A real return target of at least 4%, net of investment fees and expenses, over 10 year periods.
  - The risk target overrides and constrains the return target.
  - A lower tolerance for downside risk.

Review Process

- The process to review the risk and return targets had included:
  - September 2010: consultation with focus groups;
  - December 2010 – January 2011: preparation of asset-liability modeling;
  - February – March 2011: analysis and interpretation of asset-liability projection results;
  - April – May 2011: development of draft recommendations by applying judgment to focus group views and modeling results.

Focus Groups

- The majority of focus group participants had supported a balanced capital preservation and return approach, with little support for higher investment return targets.

Selecting Risk and Return Targets

- An Efficient Frontier Analysis had been conducted by AON Hewitt for which portfolios were constructed with the highest level of return for a given unit of risk. Although the analysis required asset allocation, this analysis was **not** intended to recommend a particular asset allocation.
- The volatility risk was 3.4% higher for the 5% Real Return Target portfolio than for the 1.3% Real Attainable Least Risk Portfolio (LRP). All portfolios had a risk of less than 10%, except for the 4.9% Real Return Reference Portfolio (RP), which had a risk of 13.8%.

3. *University of Toronto Pension Master Trust:* Consultation Draft Investment Volatility Risk and Return Targets (cont'd)

Asset Liability Modelling

- An economic scenario generator had been used as the underlying econometric model, and had produced:
  - returns on asset classes in both public and private markets;
  - bond yields, exchange rates and inflation;
  - 5,000 forward-looking scenarios over a 10-year projection period;
  - "very optimistic", "expected", and "very pessimistic" outcomes.
- All assumptions and scenarios were calibrated to market conditions as of September 30, 2010.
- The modeling took into account:
  - any contribution fluctuations from various outcomes attributed to employer;
  - the January 2011 preliminary funding and financing strategy.
- All other plan provisions remained unchanged during the 10-year projection period.
- Only the U of T Pension Plan was included in the modeling (representing 97% of master trust assets.)

Going Concern Funding Status

- At the 'very pessimistic' funded status level, the funded status was 6% lower for the 5% real return portfolio than for the 1.3% real attainable LRP portfolio.
- The difference between the 'expected' and 'very pessimistic' funded status for the 1.3% portfolio was 6%, while the difference for the 5% portfolio was 29%.

Employer Total Contributions Present Value 2011 – 2020

- The total contributions varied widely depending upon the choice of investment return target and market conditions.
- At the 'very pessimistic' level of total contributions, $1.10 billion more was required for the 1.3% portfolio than for the 5% portfolio.
- At the 'expected' level of total contributions, $1.28 billion more was required for the 1.3% portfolio than for the 5% portfolio.
- The difference between the 'very pessimistic' and 'expected' levels of total employer contributions was $ 470 million for the 1.3% portfolio and $650 million for the 5% portfolio.

Employer Total Contributions 2014 – 15

- For 2014 – 15, a higher investment return target resulted in lower total contribution levels.
- At the 'very pessimistic' level of total contributions in 2014-15, $189.3 million more was required for the 1.3% portfolio than for the 5% portfolio.
- At the 'expected' level of total contributions, $237.3 million more was required for the 1.3% portfolio than for the 5% portfolio.
- The difference between the 'very pessimistic' and 'expected' levels of total employer contributions in 2014-15 was $ 80.2 million for the 1.3% portfolio and $128.2 million for the 5% portfolio.

Employer Special Payments 2014 – 15

- For the 1.3% portfolio, there was a 99% chance of the special payments being higher than the $66 million estimated in the funding and financing strategy of January 2011.
- For the 5% portfolio, there was a 42% chance of the special payments being higher than the $66 million estimate.

Employer Current Service Contributions 2011 – 12

- $97.3 million more in employer current service contributions was required in 2011-12 for the 1.3% portfolio than for the 5% portfolio. As noted above, a higher investment return target resulted in lower total contribution levels.

3. ***University of Toronto Pension Master Trust:* Consultation Draft Investment Volatility Risk and Return Targets** (cont'd)

Role of Judgment

- There were no mathematical models that captured all elements of risk or that predicted what behaviours would follow as various possible outcomes began to unfold. The models were tools that helped in assessing risk, but they did not provide a complete and comprehensive assessment of all the risks associated with making investment choices.
- This modeling had focused on return volatility and its resulting impact on going concern funded status and contributions.

Summary

- There was little difference between target returns for very pessimistic levels of Going Concern funded status in 2020.
- There was a high probability for all return targets that employer special payments would be greater than the currently estimated $66 million in 2014.
- Employer current service contributions were much higher at lower investment return targets.
- A 4% real return target was still achievable within a 10% risk target.

Recommendations

- A return volatility risk target of a 10% standard deviation over 10 year periods.
- A real return target of at least 4%, net of investment fees and expenses.
- The risk target overrides and constrains the return target.
- A lower tolerance for downside risk.

The Chair thanked Ms Brown for her presentation. He informed members that Professor Luste had requested an opportunity to make a presentation to the Committee. A copy of the presentation had been distributed to members the day prior to the meeting.

Presentation on UTAM investment performance and related risk issues

Professor Luste provided the Committee with a presentation on UTAM investment performance and related risk issues. He stated that the following issues should concern members of the Pension Committee:

- The transparency of investments and assets: Do members know where pension funds are invested?
- The complexity of investments: Do members understand how assets are invested?
- The validity of valuations for illiquid assets.
- Investment cost issues: Why are UTAM unit costs high?
- Investment management people issue.

Professor Luste explained he had calculated that, between 1985 and 1999 (pre-UTAM years), the annualized investment return for the University of Toronto Pension Plan had been 11.7%, while the Consumer's Price Index (CPI) had been 2.9%. Between 2000 and 2010 (UTAM years), the annualized investment return for the University of Toronto Pension Plan had been 2.7%, while CPI had been 2.1%.

Professor Luste compared the asset growth of $2 billion from 2000 to 2010, based on UTAM's actual returns, with returns from the Healthcare of Ontario Pension Plan (HOOPP), median returns of DEXIA Pension Plan Universe, and 50% Equity plus 50% Bond Index returns. His calculations indicated that, by 2010, UTAM's actual returns had been less than the returns of HOOPP, DEXIA Median, and the Index. Based on his calculations, he raised the following questions:

- Why did UTAM underperform the mean return for the pension universe from 2000 to 2007?
- Why did UTAM have a 30% decline in 2008, while other pension plan investments had a lesser decline?
- Why was there no recovery from 2008 in 2009 and 2010?

3. *University of Toronto Pension Master Trust:* Consultation Draft Investment Volatility Risk and Return Targets (cont'd)

Presentation on UTAM investment performance and related risk issues (cont'd)

Professor Luste stated that, in his view, volatility was not the same as investment risk, and provided a number of quotes to support that statement. He also provided quotes in support of the definition of investment risk.

Professor Luste concluded his presentation with a reference to one of the sentences in the Jackman-Wasser Committee Report:

> *In short, we believe that the pension and endowment funds should be invested primarily in publicly traded stocks and bonds.*

The Chair thanked Professor Luste for his presentation.

Discussion

The Chair commented that his interpretation of risk was that it was the consequence of establishing target returns. Mr. Shapira noted that the two most frequently asked questions about a pension plan were how well a plan was funded and the contribution amount that was triggered by a specific target return. The funding status of a pension plan had to be constantly measured and adjustments made.

A member noted that the going concern valuation of a pension plan was calculated annually while the solvency valuation of a pension plan was calculated every three years. He understood that there were assumptions that were used to adjust the going concern valuation. He expressed his concern about the loss of capital in the pension plan during the past few years and stated that, in his opinion, 4% was not a realistic return.

Mr. Shapira reminded members that the funding of the University's pension plan was based on a 4% target return.

A member then asked what the restraints were in achieving a 4% return and how the return limited risk. Mr. Moriarty commented that, over the long term, the return on equity had been approximately 4% greater than the return on bonds, while the return on bonds was approximately 2% better than the return on cash. In the past it had been possible to generate a 4% real return on a portfolio of 60% equity and 40% fixed income. In the current market situation, a real return of 4% was potentially attainable, but would require a thoughtful active management approach.

In light of the discussion, the Chair requested that the administration consider the impact of target returns of 3.5% on the funding status, contributions, and liabilities of the pension plan, and take those into account when making recommendations for the target return and risk to the Committee in September 2011. Ms Brown asked whether the Committee would like the administration to consider .25% increments between the 3% and 4% target returns. The Chair agreed.

A member requested additional information concerning negative scenarios, given the current economic situation. Mr. Shapira agreed to report at the September meeting of the Committee on what drove negative scenarios.

The Chair asked Mr. Moriarty to comment at the September meeting on the concerns raised about investment returns.

3. *University of Toronto Pension Master Trust:* Consultation Draft Investment Volatility Risk and Return Targets (cont'd)

Roles and Responsibilities

A member expressed her confusion about the roles and responsibilities of the Pension Committee, the UTAM Board and the President's Investment Advisory Committee. She suggested that this matter be addressed at the September meeting of the Committee. Ms Riggall replied, briefly, that the UTAM Board was responsible for hiring the Chief Executive Officer (CEO) of UTAM, and that individual was responsible for hiring the staff of UTAM. The President's Investment Advisory Committee advised the President and the Chair of the UTAM Board on investments. The Pension Committee was responsible for approving the target return, risk and asset allocation for the pension plan.

4. University of Toronto Pension Plans: Actuarial Assumptions

Ms Brown stated that the document was intended to provide members with background information prior to considering the recommendation for approval at the September 2011 meeting of the actuarial assumptions for the July 1, 2011 valuation. She explained that the annual review of the actuarial assumptions was currently underway, and that some possible changes had been identified.

Members requested that a mention of real return bonds and information about pension plans at other universities be added to the documentation on actuarial assumptions.

5. Update on Draft Communication Plan

Members received for information Report Number 1 from the Pension Communication Working Group.

6. Assessors' Reports

Ms Riggall reported that a question concerning the level of investment fees for the pension plan had been raised by the Financial Services Commission of Ontario (FSCO). The question and response would be circulated to members once the response had been finalized.

7. Date of the Next Meeting

Members were reminded that the next regular meeting of the Pension Committee was scheduled for Thursday, September 28, 2011 at 3:00 p.m.

8. Other Business

a) Communication regarding the University of Toronto Asset Management Corporation (UTAM)

Ms Rosenthal explained that the questions she had raised in her email dated May 24, 2011 had resulted from her concern about the level of UTAM fees that were paid by the University's pension plan. She wanted to know what level of control the Pension Committee had over UTAM. Ms Riggall responded that the Pension Committee had no control over UTAM. Investments were made by UTAM on the request of the University. Ms Riggall drew the attention of members to the responses that had been provided to Ms Rosenthal's questions and had been included in the meeting documentation.

8. Other Business (cont'd)

a) Communication regarding the University of Toronto Asset Management Corporation (UTAM) (cont'd)

A member asked whether the Committee could make recommendations to the Governing Council. The Chair replied that, if circumstances warranted, recommendations could be made. The Committee had an obligation to raise issues and send them to the appropriate administrative office or governance body for consideration. The Chair reminded members that the Committee could accept, reject or refer back recommendations made by the administration.

b) Committee Self-assessment

The Chair encouraged members to complete the self-assessment form that had been distributed electronically earlier in the week. All members of Governing Council Boards and Committees had been asked to complete the self-assessment.

c) Concluding Remarks

The Chair thanked members for their work, and offered his best wishes for a relaxing summer.

The meeting adjourned at 12:15 p.m.

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Secretary Chair

August 31, 2011