UNIVERSITY OF TORONTO

THE GOVERNING COUNCIL

REPORT NUMBER 4 OF

THE PENSION COMMITTEE

Wednesday, September 28, 2011

To the Governing Council,
University of Toronto.

Your Committee reports that it held a meeting on Wednesday, September 28, 2011 at 3:00 p.m. in the Council Chamber, Simcoe Hall, with the following members present:

Mr. W. John Switzer, In the Chair
Professor George Luste, Vice-Chair
Mr. Richard B. Nunn, Chair of the Governing Council
Mr. Donald Andrew
Professor Laurence Booth
Professor Ettore Vincenzo Damiano
Mr. Thomas Finlay
Mr. Alex McKinnon
Mr. Gary Mooney
Mr. Philip Murton
Ms Jane Pepino
Ms Melinda Rogers *
Ms Helen Rosenthal
Mr. Howard Shearer
Mr. Keith Thomas
Ms Rita Tsang
Mr. Andrew Ward

Non-Voting Assessors:

Ms Sheila Brown, Chief Financial Officer
Professor Angela Hildyard, Vice-President, Human Resources and Equity
Ms Catherine Riggall, Vice-President, Business Affairs

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

Secretariat:

Ms Cristina Oke, Acting Secretary

Regrets:

Ms Nancy Edwards
Mr. Steve (Suresh) K. Gupta
Ms Shirley Hoy
Mr. W. David Wilson

In Attendance:

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

Opening Remarks

The Chair welcomed members to the first meeting of the 2011 – 2012 governance year and invited them to introduce themselves. He informed members that the self-assessment of the Committee had been generally positive, however more time for discussion had been requested, and future meetings of the Committee would seek to respect this feedback.

* Participated via conference call

1. Report of the Previous Meeting

Report Number 3 of the Pension Committee (June 10, 2011) was approved.

2. Business Arising from the Report of the Previous Meeting

Professor Luste referred to agenda item 6 on page 6 of the Report regarding the University's response to the question raised by the Financial Services Commission of Ontario (FSCO) concerning the level of investment fees for the pension plan. The response is attached to this Report as Appendix A.

3. Review of Investment Performance to June 30, 2011

Mr. Moriarty reviewed the performance of the pension investment portfolio. The return for the Pension Master Trust had been 12.7% for the period June 30, 2010 to June 30, 2011, compared to the 14.3% return for the Reference Portfolio for the same period. Compared to the Reference Portfolio, the Pension Master Trust was overweight in private investments, real assets and hedge funds, and underweight in Canadian equity and fixed income. The return for alternative investments for the period had been 8.9% for hedge funds, 16.6% for private investments, and 15.0% for real assets. Mr. Moriarty noted that the return for private investments and real assets was reported with a 3-month lag. The lag in reporting affected the return rate somewhat.

A member asked why the comparison to a Benchmark Portfolio was no longer being used. Mr. Moriarty replied that, in his view, the Benchmark Portfolio was not as good a measure of returns as the Reference Portfolio since it did not take account of the significant differences in asset mix and thus was an easier target to meet. For June 30, 2010 to June 30, 2011, the return for the Benchmark Portfolio had been 12.2%.

A member asked how much of the Pension Master Trust portfolio was invested in private investments. Mr. Moriarty replied that 13.4% of the portfolio was invested in private investments. He noted that when he had arrived at the University of Toronto Asset Management Corporation (UTAM), there was between $700 and $800 million in uncalled but committed capital in the Private Markets area. The amount had been reduced to $300 million.

A member commented that he understood that the return on the Harvard endowment had been 21.4% and the return on the Stanford University endowment had been 22.4% for the period June 30, 2010 to June 30, 2011. Mr. Moriarty replied that the U.S university returns were measured in U.S. dollars. Viewed from a U.S. dollar perspective, the return on the University's investments would have been 24%.

4. University Pension Plans: Integrated Approach to Pension Plan Decisions and Investment Targets and Actuarial Assumptions

The Chair reminded members that the investment targets and actuarial assumptions were the main focus of the meeting. Since the June meeting, additional material had been provided. Following a request after the meeting of June 10, 2011, information on the effects of lower target rates had been included in the documentation, and a Memorandum dated September 21, 2011 from Professor Luste had been circulated to Committee members.

The Chair referred to UTFA Information Report #18, dated July 14, 2011, that had been included with Professor Luste's Memorandum, and commented that, in his view, steps had been taken by the administration to address the concerns raised in the document, including the restructuring of UTAM, the appointment of Mr. Moriarty as Chief Executive Officer (CEO), a new reporting structure, and the creation of the Pension Committee.

4. University Pension Plans: Integrated Approach to Pension Plan Decisions and Investment Targets and Actuarial Assumptions (cont'd)

The Chair commented that the documentation and recommendation had been put together with a great deal of thought. It was the opinion of the administration, the actuary, the President's Investment Advisory Committee (PIAC), and UTAM that the recommendation being considered by the Committee was appropriate.

a) Introduction

Ms Brown summarized the highlights that had been included in the Cover Sheet.

- Decisions to be made in the next few months regarding the University's Pension Plans included:
  - The investment policy (to be decided by the Pension Committee);
  - Actuarial assumptions (to be decided by the Pension Committee);
  - Plan design, including member contributions (to be decided by the University and employee groups through bargaining); and
  - Funding strategy / policy (to be decided by the Business Board).

- The main objectives of the decisions were to ensure the sustainability of the pension plan by:
  - Protecting the benefits for current and future retirees;
  - Providing prudent plan funding with appropriate margins (for potential adverse future environments effects) in the event of poor investment results on a long-term basis; and
  - Maintaining the affordability of the pension plan in the context of the University's academic mission and priorities, which included satisfying the government's requirements to participate in the solvency funding relief program.

- The *Integrated Approach to Pension Plan Decisions* was prepared by the Plan Actuary, AON Hewitt, based on the following assumptions:
  - A 4% real investment return target for the investment policy;
    - The comparison between the current 4.0% real investment return target and the lower investment return targets indicated that the lower investment targets required higher employer contributions while producing little difference in going concern funded status at the "very pessimistic" level and foregoing potential upside at the expected level, and
    - The risk target should be changed to respond to debate about the usefulness and appropriateness of the current return volatility target, the difficulty in maintaining a numeric return volatility target, and changes in the relationship between the University and UTAM.
  - Plan funding in accordance with the preliminary funding and financing strategy presented to the Business Board in January 2011 [1] and the Budget Report 2011 – 12.
  - An increase in member contributions of 1.8% below the Canada Pension Plan (CPP) maximum salary and 2.4% above the CPP maximum salary as presented in the without prejudice proposal made by the University to CUPE, USWA and UTFA, and which has been ratified by USWA;
  - Actuarial assumption changes effective July 1, 2011:
    - Moving to a generational mortality table to reflect ongoing improvements in longevity;
    - Reducing the real investment return assumption by 0.25% from 4.0% to 3.75% to provide an appropriate margin between the real investment return target of 4.0% and the long-term investment results anticipated in the actuarial valuation;
    - Reducing the assumed interest credited on member contributions to better reflect actual interest being credited to member contributions; and
    - Extending the asset smoothing period from 3 years to 4 years to maintain the affordability of the pension plan for the University.
- Based on these assumptions, the estimated savings target established by the Ontario government of 8.2% to 8.9% for the University pension plan to qualify for solvency relief funding was projected to be met.

[1] http://www.governingcouncil.utoronto.ca/AssetFactory.aspx?did=7486

4. University Pension Plans: Integrated Approach to Pension Plan Decisions and Investment Targets and Actuarial Assumptions (cont'd)

Discussion

A member asked whether there had been any disagreement with the actuarial assumptions during negotiation with USWA. A member replied that the actuarial assumptions would not have been a bargaining matter.

A member asked how the University measured risk. Ms Brown replied that a numeric return volatility target had been introduced in 2003. There was now a closer relationship between UTAM and the University that enabled a different approach. Mr. Moriarty commented that once an investment return target had been chosen, active management, which would include a comprehensive risk management approach with a number of key risk measures, would be used to meet it.

b) Integrated Approach to Pension Plan Decisions

The Chair invited Mr. Shapira to provide an overview of the *Integrated Approach to Pension Plan Decisions*. Mr. Shapira highlighted the following points:

- The estimated going concern unfunded liability of the Pension Plans at July 1, 2011 was $899 million, while the estimated solvency deficit at July 1, 2011 was $1.06 billion.

- The employer special payments budget was assumed to increase as follows:
  - $30 million per year as of May 1, 2011 (funded in 2011-12 budget);
  - $20 million per year as of May 1, 2112 (signaled in 2011-12 budget document);
  - $10 million per year as of May 1, 2013 (signaled in 2011-12 budget document);
  - $10 million per year as of May 1, 2014 (not yet signaled).

- Additional member contributions would be used to increase the funding of the Pension Plans; the intent was to not reduce University current service contributions below the levels as at the last filed valuation of July 1, 2008, expressed as a percentage of the salary base..

- The impact of the proposed change in actuarial assumptions and methods included :
  - increasing the accrued liability by $175.9 million which would have to be funded by additional University special payments.
  - adding $133.6 million of asset losses to the $287.7 million of asset losses to be recognized in future valuations.
  - lengthening the period over which University special payments to the Pension Plan could be made;
  - increasing the estimated annual University special payments from $63.1 million to $66.4 million from July 1, 2011 to July 1, 2014.

Discussion

A member asked whether the going concern and solvency deficits included the $150 million payment made prior to July 1, 2011. Mr. Shapira replied that this special payment had been included in the estimation of the deficit at July 1, 2011.

A member asked whether the savings target would be met if the University's current service cost contributions were not being reduced as a result of the increase in member contributions. Mr. Shapira noted that under the calculations to determine if the savings target had been achieved, the change in actuarial assumptions, which will increase the University current service cost. would come before the increase in member contribution rates. Therefore, there would be a savings associated with bringing the University's current service cost contribution from the higher level after the change in actuarial assumptions back down to the current level (that is the level based on the last filed actuarial valuation as of July 1, 2008).

4. University Pension Plans: Integrated Approach to Pension Plan Decisions and Investment Targets and Actuarial Assumptions (cont'd)

c) Presentation by Professor Luste

Professor Luste provided to the Committee the following information which he had prepared:

- characteristics of the Pension Plan in 1986 and 2010:

	1986	**2010**
Ratio of active members to retired members	3.9	1.8
Ratio of $ paid in to $ paid out	2.7	0.9
Real return assumption	2.25%	4.0%

- real return assumptions and the University's contribution to the Pension Plans for the years 1985 to 2007;

- real return bond rates from January 1996 to September 2011;

- annualized pension plan returns for 1985-1999 (pre-UTAM) and 2000-2010 (UTAM);

- market volatility – S&P/TSX from July 1, 2010 to September 2, 2011;

He raised the question of what would happen if, on July 1 2014, the next solvency valuation date, the University's annual 3-year return was closer to 2.7% per year (the UTAM annualized return for the past 11 years) rather than the assumed annual 6.25% return, and predicted that the registered pension plan deficit would increase by an additional $300 million**.**

He proposed two amendments to the recommendation brought forward by the administration on the investment target and actuarial assumptions:

- Given that the current actuarial assumption for the going concern nominal investment return is 6.5%, with an accompanying going concern pension plan deficit of approximately one billion dollars, in order to defer any additional drastic funding consequences, we recommend the assumption be reduced by only 0.25% to 6.25%. This means the real return actuarial assumption is reduced from 4.00% to 3.75%; and

- Given that the real investment return target should approximate the actuarial assumption used in the UofT Registered Pension Plan, it is recommended that the real investment return target for the University of Toronto Pension Master Trust be continued at its current rate of at least a 4.0%. The target return does not necessarily represent the *expected return* in the near term. The pension investments must have a strong emphasis on avoiding a permanent loss of capital.

Discussion

A member suggested that the return assumptions for the years 2000 to 2010 had been reasonable, but the actual return on investments had been less than expected.

Ms Brown noted that pension contribution holidays were taken because the amount of surplus funds in the pension plans prohibited contributions from being made. The ratio of contributions over the 25 year period ending June 30, 2011 had been in the ratio of $2 from the employer for each $1 from employees. She also noted that the return for the year ended June 30, 2011 was in the 13% range, and that the return for the period from July 1, 2011 to August 31, 2011 was about -2.4%.

Mr. Shapira stated his agreement with the premise that there was a higher probability now than there had been 10 years ago that the return on investments would not reach 4.0%. Ms Riggall noted that the University did a valuation of the pension plans each year as a matter of policy. The Pension Committee would review the valuation each year, and be informed of the return on investment.

4. University Pension Plans: Integrated Approach to Pension Plan Decisions and Investment Targets and Actuarial Assumptions (cont'd)

Discussion (cont'd)

A member stated his view that the long-term real rate of return achieved in the past would not be replicated in the future. He also commented that the decrease in the ratio of active to retired members from 3.9 in 1986 to 1.8 in 2010 increased the need for the real return on investment to be achieved.

A member stated that it was important to determine the best estimate for the long-term rate of return and stated his view that the assumption that more risk resulted in higher returns was not always accurate.

Mr. Moriarty reminded members that the pool of pension funds was a long-term investment, and the focus had to be on long-term return prospects. Data from the United States that had been gathered for the period 1926 to 2010 showed that the return on equities had been approximately 4% greater than the return on bonds during that time. There were two levers that affected returns – a varied asset mix that included both equity and fixed income, and the selection of pockets of investments that were slightly different from the asset mix and had possibilities for higher returns. Valuation parameters concerning beginning and end points were important in determining returns. UTAM had been working with the President's Investment Advisory Committee to generate return expectations for the next five years using a building block model. International and emerging markets could be added to the investment portfolio to increase returns. A real return of 4% would be difficult but not impossible to achieve, but would require thoughtful and professional active management. It was important for the Committee to set target returns for UTAM.

A member commented that, over the short-term, it was not possible to distinguish among luck, skill, volatility and risk. The return from private equity and real estate was not different but the top and bottom dispersal was different from other asset classes.

Motion, Debate and Vote

It was moved and seconded

THAT, effective July 1, 2011, a real investment return target of at least 4% over 10-year periods while taking an appropriate amount of risk to achieve this target, but without undue risk of loss, be adopted for the University or Toronto pension Master Trust, and the going concern, solvency and hypothetical wind-up assumptions contained in Attachment 3, Appendix 1 to this memo be adopted for the University of Toronto Pension Plan, the University of Toronto (OISE) Pension Plan and the Supplemental Retirement Arrangement.

The Chair explained that, under Section 9.4 of the Committee's Terms of Reference, [2] the Committee could accept, reject or refer back proposals for further consideration of a particular aspect(s) from the appropriate assessor(s). The Committee could also amend proposals developed by the assessors which were minor amendments (a) that did not contravene the sense of the original motion or negate it, and (b) that were accepted by the appropriate assessor.

Ms Riggall indicated that she did not accept the amendments that had been proposed because most of the actuarial assumptions that had been in the original motion had been excluded.

[2] http://www.governingcouncil.utoronto.ca/Assets/Governing+Council+Digital+Assets/Boards+and+Committees/Pension+Committee/pctor.pdf

Motion, Debate and Vote (cont'd)

The mover of the motion suggested that the original motion be approved and requested that the minutes reflect the Committee's concerns with the difficulty of achieving the proposed target rate of return in the near term. Professor Luste stated that he had no problem with the other actuarial assumptions, but thought that the motion should reflect the view that the Committee hoped to get the target returns but did not necessarily expect to achieve them.

A member asked what time frame would be required if the motion was referred back for additional wording concerning risk and returns. Ms Brown replied that the actuarial valuation results were scheduled to come to the Committee at its meeting on December 14, 2011. The valuation had to be filed by March 31, 2012.

Several members of the Committee spoke in favour of referring the motion back to the administration for additional wording.

The Chair called the question, with the understanding of the Committee that, if the motion were defeated, it would be referred back to the administration for additional wording to reflect the debate concerning risk and return. A recorded vote was requested.

In Favour	5
Opposed	8
Abstentions	2

The motion was defeated.

The Chair suggested that a Special Meeting of the Committee be scheduled prior to the December meeting to consider the motion with the additional wording.

5. Role and Relationship among Pension Committee, UTAM Board, and President's Investment Advisory Committee

Members received information concerning the role and relationship among the Pension Committee, UTAM Board and President's Advisory Committee. The Chair indicated that any questions on the slides provided could be raised at the December meeting.

6. Calendar of Business

Members received for information the Committee's Calendar of Business for 2011 – 12.

7. Assessors' Reports

There were no reports from the assessors.

8. Date of the Next Meeting

Members were reminded that the next regular meeting of the Pension Committee was scheduled for Wednesday, December 14 at 5:00 p.m.

9. Other Business

There was no other business.

The meeting adjourned at 5:45 p.m.

Secretary Chair

October 19, 2011

Appendix A

FINANCIAL SERVICES

June 27, 2011

Financial Services Commission of Ontario
Pension Plans Branch
5160 Yonge Street
Box 85
Toronto ON M2N 6L9

Attn: John Khing Shan, Senior Pension Investment Analyst

Dear Sir:

Re: your letter of May 19, 2011, Registration Number 0312827

In response to your letter of May 19, 2011 regarding the 1.1% investment management fee of the University of Toronto Pension Plan for the year ending June 30, 2010, we are submitting this response to provide you with the context behind the fees as well as our go-forward expectation in terms of future fees.

The University of Toronto Pension Plan invests its assets through the University of Toronto Master Trust (MT). The assets within MT are in turn managed by UTAM, the wholly-owned investment management subsidiary of the University of Toronto, by employing a diversified multi-asset class investment strategy that takes into account the long term nature of the Pension Plan's liabilities. This is a strategy that has been used quite extensively in the US and one which is pursued by Canadian funds such as OTTP and CPPIB. One of the key components of the investment strategy is to exploit the portfolio's inherent liquidity position (due to the pension plan's long-term liability profile) to extract enhanced risk-adjusted returns compared with the traditional, highly-liquid and generally efficient investments such as public market bonds and equities. It is also a strategy which is designed to increase diversification and thus reduce the volatility of returns. To this end, the portfolio has a sizeable allocation to alternative investment strategies and structures such as hedge funds and private investment partnerships which, notwithstanding their constrained liquidity profile, offer superior expected long-term risk-adjusted returns. These alternative assets also have investment management fee structure that is higher than traditional public market assets and especially in the early years of introducing such a program. As at June 30, 2010, MT's investments in the various major asset categories are as follows:

Traditional Public Markets Assets		
-	Equities (Cdn, US, Intl):	44%
-	Fixed Income (Cdn, US):	21%
Alternative Strategies/Assets		
-	Hedge Funds:	17%
-	Private Investment Partnerships (Private Equity, Real Estate, etc)	18%
		100%

Note that fees paid on alternative asset funds are typically not charged directly to investors. Instead, such fees are usually charged to the fund which is in turn reflected in a fund's return (i.e., net of investment management fees). This is the same as other pooled or mutual funds where investment management fees (MERs) are deducted from the Net Asset Value reported rather than being paid by the unit holders

215 Huron Street, 2nd Flr, Toronto, ON M5S 1A2 Canada
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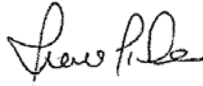
continued…

directly. UofT's policy in terms of reporting fees is that, notwithstanding such fees are not charged directly to the University, they are 'looked through' as if they were paid directly and therefore fully disclosed to provide the highest degree of transparency.

In closing, we believe that the overall investment management cost of 1.1% is reasonable when taking into consideration an investment strategy that has a sizeable allocation (more than one-third) to alternative assets. As indicated, UofT reports alternative assets' investment management fees on a "look through" basis as if they were paid directly, but we are unsure if other plans with significant alternative assets report on a similar basis to provide a meaningful peer comparison.

We would also point out that the actual amount of fees paid has been declining, as we have restructured and simplified the portfolio holdings. This trend is expected to continue.

Sincerely,



Pierre Piché
Controller and
Director of Financial Services
University of Toronto