UNIVERSITY OF TORONTO

Pension Fund Master Trust

Statement of Investment Policies and Procedures

June 5, 2013

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# Preamble

The Governing Council of the University of Toronto (“the University of Toronto” or “the University”) is the legal administrator of the University of Toronto Pension Plan and the University of Toronto (OISE) Pension Plan to provide pension benefits to its employees. These plans are contributory defined benefit plans registered under and subject to the Pension Benefits Act (Ontario).

Although each of the registered pension plans is a separate legal entity and funds cannot be transferred between them, for investment and other financial management purposes the two plans are managed together. For investment purposes, the University of Toronto Pension Plan and the plan for its OISE employees are pooled into a pension master trust (PMT). This pooling enables both funds to enjoy economies of scale and eliminates discrepancies in investment performance.

The Pension Committee of Governing Council is composed of 11 members of Governing Council and 9 members representing employee groups with members who participate in the pension plans. It has delegated authority[1] to act for Governing Council to approve the Statement of Investment Policies and Procedures for the PMT, which includes return objectives, normal risk tolerance, asset allocation and benchmarks for the evaluation of performance. It is also responsible for approving the terms of the delegation of authority to a University-controlled asset management corporation (or other entity established for a similar purpose) to manage the investment of the PMT and carry out oversight. The Committee reviews, at least semi-annually, reports on the investment of the PMT, with such reports including, among other things, reports on investment performance and risk being incurred.

The return expectations, the risk tolerance and the asset allocation for the PMT are established via this University of Toronto Pension Fund Master Trust Statement of Investment Policies and Procedures, which is approved annually by the Pension Committee.

The University owns the University of Toronto Asset Management Corporation (UTAM). The University has formally delegated to UTAM the authority for management of PMT investments.

[1] The Pension Committee performs the role with respect to pension plan administration that was previously delegated by the Governing Council to the Business Board. The general limitations on that delegated authority are identical to those that apply to the Governing Council’s delegation of authority to the Business Board.

# Plan Description

## Type of Pension Plan

The pension plans are contributory defined benefit plans registered under and subject to the Pension Benefits Act (Ontario). The University of Toronto is the registered plan administrator. The current plans provide defined pension benefits for eligible employees, currently members of the academic, librarian, administrative and unionized staff of the University, the OISE division of the University and its related affiliated organizations.

As of August 1, 2000, the University of Toronto pension fund for its OISE division was pooled into a master trust for investment purposes with the University's main pension fund. While they are two separate and distinct plans (University of Toronto Pension Plan registration number 0312827 and OISE Pension Plan registration number 0353854), the pooling for investment purposes enables both funds to enjoy economies of scale and eliminates discrepancies in investment performance. The plan provisions for the OISE Plan are identical to those of the University of Toronto Pension Plan.

## Nature of Plan Liabilities

The purpose of the plans is to provide retirement income for members of its plans. The plans provide an annual pension benefit to members based on a prescribed formula applied to years of participation and salary near retirement. Pension benefits are adjusted each year by an amount equal to the greater of: a) 75% increase in the Consumer Price Index (CPI) for the previous year, or b) the increase in the CPI for the previous year minus four percentage points.

As of July 1, 2012, the University of Toronto Pension Plan had 9,149 active members, 4,934 retired members, 2,564 terminated vested members, and 207 members with exempt or pending status. The average age of active members was 47.5 years, average service was 12.1 years, and average pay was $92,536. As of July 1, 2012, the market value of assets of the plan was $2,515.8 million versus going concern accrued liabilities of $3,631.0 million. As of July 1, 2012, total current service contributions are $135.9 million and pension payments to pensioners are $147.9 million. With special payments to amortize the funding shortfall, contributions are expected to exceed benefit payments for the foreseeable future.

As of July 1, 2012, the OISE Pension Plan had 73 active members, 162 retired members, 21 terminated vested members and 3 pending members. The average age of active members was 58.9 years, average service was 26.7 years and average pay was $117,943. As of July 1, 2012, the market value of assets of the plan was $76.5 million versus going concern accrued liabilities of $117.8 million. As of July 1, 2012, total current service contributions are $1.55 million and pension payments to pensioners are $6.0 million.

The going concern liabilities are influenced by real interest rates, salary increases, CPI increases, turnover, mortality and retirement age patterns. Appropriate allowance is made for these factors in the assumptions used for actuarial valuation purposes and it is not expected that actual experience will vary significantly from the valuation amounts over the long term.

The duration (a weighted-average sensitivity measure) of plan going concern liabilities is 15 years and 12 years respectively for the University of Toronto and OISE pension plans. Duration is lengthened due to the plans' automatic inflation protection, which increases benefit payments over time. The long duration of liabilities is indicative of a long-term investment horizon for the assets.

Going concern liabilities are inflation linked before retirement (based on the final average salary nature of the plan formula) and after retirement (based on the indexing of pension benefits by 75% of the increase in CPI). Therefore, the focus is on real investment returns over the long term. Short term nominal market interest rates will impact solvency liabilities (which exclude the value of the plan indexation provision) which in turn can impact cash contributions given the shorter amortization periods associated with solvency deficits.

The University of Toronto and OISE pension plans are managed as one plan from a design (with harmonized provisions), administration and investment management perspective. The intent is to merge the OISE Pension Plan into the University of Toronto Pension Plan at the appropriate time. As such, the investment policy does not reflect the closed nature of the OISE Pension Plan and the maturity of the liabilities that results from the plan being closed.

# Investment Policies and Procedures

## Return Objective, Risk Tolerance and Asset Allocation

In order to meet the planned payment of pensions to current and future pensioners at the existing contribution levels, the return objective is a real investment return of at least 4.0% over 10-year periods, while taking an appropriate amount of risk to achieve this target, but without undue risk of loss.

Asset allocation is defined as the division of a portfolio's assets among a variety of asset classes in accordance with long-term policy goals. The major decision underlying this choice is the proportion of assets that are allocated to the broad category of equity investments. The aim is to fulfill the policy goals over a full market cycle lasting at least 5 to 15 years.

Asset allocation is the primary driver of variability in returns and risk. To define the risk tolerance and to set an appropriate asset allocation, a Reference Portfolio approach has been established.

The **Reference Portfolio** represents a "shadow" portfolio which is believed to be appropriate to the PMT's long-term horizon and associated risk profile and yet capable of achieving the return objective. The principle underlying its composition requires exposures which are: low-cost, simple and passive; generally representative of the investable market; and, appropriate to the objectives of the University. By design, the Reference Portfolio is not exposed to active management investment decisions and thus is expected to be reviewed only periodically. Consequently, it also provides a transparent replicable benchmark against which to compare an active management approach, although over shorter periods of time the PMT's real return can and will deviate from the longer term expectation.

Given the current environment, it is believed that a Reference Portfolio that is limited to 60% equity exposure (and the associated level of risk) may have difficulty achieving the 4% real return objective. In order to achieve the objective, successful active management decisions will need to be implemented. They include altering asset class weights, adding assets and strategies not included in the Reference Portfolio and hiring top tier managers, etc., while ensuring that such changes do not result in the assumption of undue risk.

Given the decision to allow an active management approach, it is prudent to establish a PMT-level risk limit integrating market risk and credit risk within which UTAM has discretion to make and implement investment decisions with the objective of earning returns above the Reference Portfolio. This PMT-level risk limit is defined as the risk determined for the Reference Portfolio plus 75 basis points (0.75%). In conjunction with this, UTAM will provide a periodic risk report to the Pension Committee.

In addition, minimum and maximum weights have been established for each of the major asset groupings within the Reference Portfolio. Taken together, these risk limits are viewed by the University as being large enough to permit UTAM the flexibility to achieve the value-added objective but not so large as to put PMT assets at undue risk of loss relative to the performance of the Reference Portfolio. The **Current Portfolio** reflects the actual asset allocation of the PMT at March 31, 2013.

Table 1

| | | Reference Portfolio | Benchmark Index | 31/3/2013 Portfolio % | ------- Bands ------- Min. % | Max. % |
|---|---|---|---|---|---|---|
| **Equity:** | | | | | | |
| | Canadian | 16 | S&P TSX Composite Total Return Index | **15.9** | 11 | 21 |
| | US | 18 | S&P 500 Total Return Index | **17.9** | 13 | 23 |
| | EAFE | 16 | MSCI EAFE Total Return Index (Net) | **16.0** | 11 | 21 |
| | EM | 10 | MSCI Emerging Markets Total Return Index (Net) | **10.1** | 5 | 15 |
| | **Total** | 60 | | **60.0** | **50** | **70** |
| **Credit:** | | 20 | DEX Investment Grade Bond Total Return Index | **20.0** | 10 | 25 |
| **Rates:** | | 20 | DEX Government Bond Total Return Index | **10.4** | 10 | 30 |
| **Other:** | | 0 | | **9.7** | 0 | 15 |
| | | 100 | | **100.1** | | |
| **FX Exposure:** | | 22 | | **25.1** | 14 | 30 |

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As implied above, actual investment performance will be evaluated against the return and risk objectives over time and also compared to the performance of the Reference Portfolio to provide a measure of the degree of success of the active management program.

## Portfolio Diversification

The objectives of diversification are: to reduce the PMT's total return variability; to reduce the exposure to any single component of the capital markets; to reduce the risk of returns not tracking or exceeding inflation; and, to increase the longer-term risk-adjusted potential of the PMT.

To achieve diversification, the PMT will invest, directly or indirectly, in the securities or assets of any issuer or business that would be lawful if carried on in Canada and is domiciled in any country with which Canada maintains normal relations and if the investment is not limited by the Ontario Pension Benefits Act or the Income Tax Act. The table below provides a list of the assets and investment strategies in which UTAM does or could invest.

| Main Risk Drivers | Basic Building Blocks | Assets and Strategies |
| --- | --- | --- |
| Growth / Equity | Cdn. & Internat'l Developed Market Equities | Developed Market Equities, Emerging Market Equities, Frontier Market Equities, Small Cap Equities, Equity Long/Short Funds, Venture Capital Funds, Growth Equity Funds, Buyout Funds, REITs, etc. |
| Income / Credit | Canadian Investment Grade Corporates | Investment Grade Bonds, Crossover Bonds, High Yield Bonds, Mortgages, Foreign Corporate Bonds, Credit Long/Short Funds, Structured Credit, Senior Loans, Mezzanine Loans, Core Real Estate, etc. |
| Rates | Canadian Government Bonds | Canada Debt, Provincial Debt, Municipal Debt, Agency Debt, Foreign Sovereign Debt, etc. |
| Other | Cash | Money Market Securities, Real Return Bonds, Absolute Return Funds, Commodities, etc. |

## Use of Derivatives

Derivatives may be used for hedging, risk management and portfolio rebalancing, including the hedging of foreign currency exposure.

Derivatives may also be used as a substitute for more traditional investments if they are based on and consistent with achieving the PMT"s asset allocation and return objectives. These may include fixed income, equity, commodity and currency futures, options, swaps and forward contracts whether directly or through pooled, mutual or segregated funds that employ derivatives and synthetic products for purposes consistent with the approved investment strategy of the PMT.

## Currency Hedging

The current hedging policy of the Reference Portfolio is to hedge 65% of developed markets' currency exposures and 0% of emerging markets currency exposure.

## Liquidity

Liquidity is defined as the time required to convert an asset to cash. Different assets have different liquidity profiles. UTAM will track and report regularly on the liquidity profile of the PMT assets.

## Valuation of Investments Not Regularly Traded at a Public Exchange

Many investment strategies are housed in structures (e.g., limited partnerships) that are not regularly traded on a public exchange thus necessitating periodic valuations. Investments in these pooled funds are valued at their reported net asset value per unit and adjusted if necessary for the estimated return of the fund through June 30 of each year. Annual financial statements for the funds are independently audited.

Some assets are comprised of externally managed funds with underlying investments in private equities, debt, real estate and commodities which are based on the valuations of the underlying investments performed on a periodic basis by the investment managers of these interests. The valuations are adjusted for subsequent cash receipts and distributions from the fund and cash disbursements to the fund through June 30 of each year. Annual financial statements of the private investment interests are audited and are also provided by the investment managers.

## Restrictions

The policy will adhere to the restrictions specified within the Pension Benefits Act, Regulation 909 of the Revised Regulations of Ontario 1990, and the federal Income Tax Act, all as amended from time to time.

# General

## Conflict of Interest Guidelines

Anyone involved directly or indirectly with the University's fund investments shall immediately disclose to the Pension Committee, at the time of its discussion of the policy or of matters related to the investment of Pension funds any actual or perceived conflict of interest that could be reasonably expected to impair, or could be reasonably interpreted as impairing, his/her ability to render unbiased and objective advice to fulfill his/her fiduciary responsibility to act in the best interests of the funds.

This standard applies to the University and to its employees, to the members of the Governing Council, its boards and committees, and to employees and members of the board of UTAM as well as to all agents employed by them in the execution of their responsibilities under the Pension Benefits Act (Ontario) (the "Affected Persons).

An "agent" is defined to mean a company, organization, association or individual, as well as its employees who are retained by the University to provide specific services with respect to the investment administration and management of the assets of the plans.

UTAM shall maintain a Code of Ethics that governs employees' conduct, including situations where potential conflicts of interest may arise.

**Disclosure**

In the execution of their duties, the Affected Persons shall disclose any conflict of interest relating to them, or any material ownership of securities which could impair their ability to render unbiased advice, or to make unbiased decisions, affecting the administration of the Plan assets.

Further, it is expected that no Affected Person shall make any personal financial gain (direct or indirect) because of his or her fiduciary position. However, normal and reasonable fees and expenses incurred in the discharge of their responsibilities are permitted upon notification to the University.

No Affected Person shall accept a gift or gratuity or other personal favour, other than one of nominal value, from a person with whom the employee deals in the course of performance of his or her duties and responsibilities for the Plan.

It is incumbent on any Affected Person who believes that he or she may have a conflict or interest, or who is aware of any conflict of interest, to disclose full details of the situation to the attention of the Pension Committee immediately. The Pension Committee, in turn, will decide what action is appropriate under the circumstances, but at a minimum, will table the matter at the next regular meeting of the Pension Committee.

No Affected Person who has or is required to make a disclosure as contemplated in this Policy shall participate in any discussion, decision or vote relating to any proposed investment or transaction in respect of which he or she has made or is required to make disclosure, unless otherwise determined permissible by unanimous decision of the Pension Committee.

## Related Party Transactions

The University, on behalf of the Plan, may not enter into a transaction with a related party unless

- The transaction is both required for operation and or administration of the Plan and the terms and conditions of the transaction are no less favourable than market terms and conditions;
- Securities of the related party are acquired at a public exchange; or
- The combined value of all transactions with the same related party is nominal or the transaction(s) is immaterial to the fund.

For the purposes of this section, only the market value of the combined assets of the Plan shall be used as the criteria to determine whether a transaction is nominal or immaterial to the Plan.

A “related party” is defined to mean the administrator or the Plan, including any officer, director or employee of the administrator, or any person who is a member of the University. It also includes UTAM and their employees, investment managers and their employees, a union representing employees of the employer, a member of the plan, a spouse or child of the persons named previously, or a corporation that is directly or indirectly controlled by the persons named previously, among others. Related party does not include government or a government agency, or a bank, trust company or other financial institution that holds the assets of the Plan, where that person is not the administrator of the Plan.

In the case of fixed income or cash equivalent securities issued by a related party that otherwise meet the requirements specified above, such transactions will be considered nominal if they are held within a pooled fund, selected by a manager acting independently, and constitute in the aggregate less than 5% of the market value of that pooled fund. In the case of any other asset class, a transaction or series of transactions will be considered nominal if the combined value of all transactions respecting a related party does not exceed 3% of the market value of the plan assets. In determining the amount of any transaction or series of transactions:

- Any contingency or potential liability related to or arising from the transaction or series of transactions must be included;
- If the level of risk attached to any assets of the PMT is affected by the transaction, the total value of these assets must also be included; and
- For this purpose, if the transaction is part of a series of transactions that may continue in the future, the value of all projected transactions must be included.

## Securities Lending

The securities of the PMT may be loaned to investment dealers and banks as part of the trustee/custodian's lending program when it is deemed that such lending may add to the return of the PMT at minimal risk and provided that the loan is collaterized in accordance with industry standards and marked-to-market and adjusted on a daily basis.

## Exercise of Proxies and Voting Rights

Proxy or other voting rights associated with any of the PMT investments must be exercised in the best interest of the PMT. UTAM will require the investment managers' proxy voting policies to reflect this standard.

Subject to certain exceptions, annual reports of voting must be maintained. For segregated account mandates where voting is done externally, a proxy report will be required to be sent to UTAM by each investment manager periodically or upon request by UTAM. Proxy voting reports from pooled fund public markets investment managers will be provided to UTAM where they are obligated by regulation to produce them.

## Responsibilities of Fund Managers and Professionals

The University has overall responsibility for the plans. The University has delegated certain responsibilities to UTAM and to third party agents.

### Investment managers:

The University has delegated investment manager responsibility to UTAM. UTAM will require that each external investment manager:

- In the case of segregated account mandates, invests the assets of the Plans in accordance with this policy; in the case of pooled fund mandates, UTAM will ensure that investment is consistent with this policy.
- Notifies UTAM in writing of any significant changes in the investment manager's philosophies and policies, personnel or organization and procedures and otherwise responds to UTAM's enquiries.
- Reconciles their own records with those of the custodian or administrator regularly.
- Meets with UTAM as required and provides written reports regarding their past performance, their future strategies and other issues requested by UTAM.
- Files compliance reports as frequently as required by UTAM.
- Adheres to this policy and shall follow the investment policies and goals with the care, diligence and skill that a person skilled as a professional investment manager would use in dealing with pension plan assets and shall use all relevant knowledge and skill that the

investment manager possesses or ought to possess. Investment managers are expected to be in compliance with the standards of professional conduct and the code of ethics administered by the CFA Institute or such other standards that are deemed by UTAM to be satisfactory.

**Custodian/Trustee:**

The University has overall responsibility for custody of pension assets, appoints the custodian and delegates operational oversight of the custodian to UTAM. The custodian/trustee will:

- Maintain safe custody over the assets of the Plans.
- Execute the instructions of the University, of UTAM and of the investment managers.
- Record income and provide monthly financial statements to the University and to UTAM as required.
- Meet with the University and UTAM as required.

**Actuary:**

The University appoints the actuary. The actuary will perform actuarial valuations of the Plans and meet with the University as required.

**Accountant (External Auditor):**

The University appoints the accountant (external auditor). The accountant (external auditor) will conduct an annual audit of the financial statements of the Plans and meet with the University as required.

The University has the authority to retain other consultants/suppliers as it deems necessary from time to time.

## Policy Review

This statement shall be reviewed at least once a year and either confirmed or amended as necessary.

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Sheila Brown, Chief Financial Officer

June 5, 2013