TO: Business Board

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DATE: March 20, 2003 for April 7, 2003

AGENDA ITEM: 6(a)

ITEM IDENTIFICATION:

Pension Fund Master Trust Investment Policy (Statement of Investment Policies and Goals)

JURISDICTIONAL INFORMATION:

Business Board approves all policies with respect to financial programs and transactions.

PREVIOUS ACTION TAKEN:

The Pension Fund Master Trust Investment Policy was last approved by the Business Board on November 19, 2001.

HIGHLIGHTS:

This policy has not changed in any substantive way from last year. Statistical information on members, assets and liabilities has been updated to July 1, 2002. The attached revised policy is black lined to show the changes from the previous policy.

This policy contains a more conservative asset mix (at 60% equities and 40% fixed income) than the university funds investment policy and is subject to legislation under the Pension Benefits Act of Ontario. This policy will be thoroughly reviewed from the liability side during 2003-2004 and the revised policy will be submitted to the Business Board once that review is complete.

FINANCIAL AND/OR PLANNING IMPLICATIONS:

No change.

RECOMMENDATION:

It is recommended that the Business Board approve:
The Pension Fund Master Trust Investment Policy (Statement of Investment Policies and Goals), replacing the policy of the same name that was approved by the Business Board on November 19, 2001.

UNIVERSITY OF TORONTO

PENSION FUND MASTER TRUST INVESTMENT POLICY

(STATEMENT OF INVESTMENT POLICIES & GOALS)

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UNIVERSITY OF TORONTO

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(STATEMENT OF INVESTMENT POLICIES & GOALS)

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PENSION FUND MASTER TRUST INVESTMENT POLICY

(STATEMENT OF INVESTMENT POLICIES & GOALS)

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1. PLAN DESCRIPTION AND GOVERNANCE

1.1. Type of Pension Plan

The pension plan is a contributory defined benefit plan registered under and subject to the Ontario Pension Benefits Act. The Governing Council of the University of Toronto is the registered plan administrator. The current plan provides 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 ~~Department of National Revenue~~ registration number 0312827 and OISE Pension Plan ~~Department of National Revenue~~ 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 the University of Toronto P~~p~~ension P~~p~~lan~~ for service in the OISE division after December 31, 1996 for academic staff and librarians, and after June 30, 1997 for administrative and unionized staff~~. Required member contributions under the plan each year are 4.5~~3.9~~% of salary up to the year's maximum pensionable earnings (YMPE), plus 6% of salary in excess of the YMPE.

The Governing Council has delegated management of the plan's assets to the University of Toronto Asset Management Corporation in accordance with the Service Agreement dated May 1, 2000 between the Governing Council and the University of Toronto Asset Management Corporation (UTAM). The investment decisions of UTAM and its Board of Directors are subject to the overall policy direction of the Business Board as reflected in this policy and in amendments the Board may make from time to time.

1.2. Nature of Plan Liabilities

The plan provides an annual pension benefit to members based on a prescribed formula applied to years of participation.

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, 2002~~June 30, 2001~~, there were 6,759~~6,504~~ active members in the University of Toronto pension plan, 3,813~~3,642~~ retired participants, 724~~677~~ terminated vested members and 1,033~~868~~

exempt or pending status. The average age of active members was 46.9 years, average service 13.2~~13.6~~ years, and average pay was $68,070~~$65,369~~.

As of July 1, 2002 the market value of assets of the plan was $1,940.0 million versus going concern accrued liabilities of $1.903.9 million~~As of June 30, 2001, the surplus was $337.7 million, the surplus reserve $105.4 million and the surplus after reserve $232.3 million. The surplus reserve is set at 5% of the actuarial value of the assets and represents the surplus reserved to provide for future adverse fluctuations in the value of the assets~~.

As of July 1, 2002~~June 30, 2001~~ the OISE plan had 194~~210~~ active members, 129~~119~~ retired members, and 16 terminated vested members. The average age of active members was 53.2~~52.8~~ years, average service was 19.3~~18.6~~ years and average pay was $72,127~~$68,409~~. ~~The surplus was $29.8 million, the surplus reserve $5.2 million and the surplus after reserve $24.6 million.~~
As of July 1, 2002 the market value of assets of the plan was $94.7 million versus going concern accrued liabilities of $77.9 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 liabilities is 13.7~~13.0~~ years and 13.5~~13.6~~ 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 determined using long-term assumptions and are not affected by short-term changes in interest rates. Solvency liabilities do fluctuate from year to year with market interest rates, but because the plans provide guaranteed indexing of 75% of the increase in the CPI, the market interest rate used to determine solvency liabilities depends more on the yield of real return bonds than on nominal bond yields. Real yields on real return bonds have been less volatile than nominal interest rates. Since both plans are well funded on a statutory solvency basis, fluctuations in solvency liabilities caused by real interest rate changes are unlikely to have an impact on cash contributions or pension expenses.

2. Philosophy of the Fund

Historical results show that the investment objectives would have been met by the appropriate asset mix and the utilization of passive management. In order to achieve superior returns and increase diversification, the philosophy of the fund is to invest a portion in active management through the use of specialist managers when there exists the potential to exceed the returns of standard market indexes on a fee-adjusted basis.

3. Investment Policies and Goals

3.1. Investment Policy, Objectives and Risk Tolerance

The purpose of the plans is to provide retirement income for members of the plans. UTAM shall seek to broadly diversify the assets within the fund in order to mitigate risk and diminish the impact of a decline in any one sector of the world market. Given the nature of fund liabilities as well as the long duration of the liabilities, an asset mix favoring a higher weighting in equities relative to bonds is prudent. However, relative to the endowment fund, the pension plans have a liability stream that is less within the University's control. Consequently, a somewhat higher allocation to fixed income would be expected for this fund in comparison to the endowment fund.

Investments will be made according to the "prudent person portfolio approach", in accordance with the Office of the Superintendent of Financial Institutions. This approach recognizes that risks that would be unsuitable for an individual investment may be prudent in the context of a diversified portfolio of assets congruent with the purpose and circumstances of the plans. The University recognizes that highly volatile investment strategies will be combined with less volatile investment strategies in order to achieve the optimal balance between capital preservation and capital growth. Through proper quantitative analysis, it is possible to combine a broad range of investment strategies in such a way to meet these competing objectives. In essence, volatility can be reduced by combining strategies that have a low correlation to each other. Historical data indicates that fixed income assets do not provide a long-term real rate of return that is high enough to protect the purchasing power of the fund. The heavy weighting in equity securities overcomes this shortfall, and it is acknowledged that the probability of short-term volatility and the potential for negative returns in the short run is greater with a portfolio that is more heavily weighted in equities relative to a portfolio that is more heavily weighted in bonds.

3.2. Asset Mix

The long-term asset mix will be determined by these factors:

a) Demographics of plan membership and the expected future growth of faculty and staff;

b) Projected long-term cash flows;

c) The correlation between the plans' assets, liabilities and cash flows;

d) The objective for real rate of return;

e) The desire to maintain a stable level of contribution for the members;

f) The historic pattern of equity investments producing higher rates of return than debt instruments over the longer term, which pattern is expected to persist;

g) Role of foreign markets and special asset classes in optimizing the trade off between risk (defined as volatility) and return, recognizing the restriction on foreign content for pension funds in the Federal Income Tax Act as amended from time to time.

The normal policy mix will be as follows:

Long-Term Asset Mix

	Minimum	**Normal**	**Maximum**
Equities	50%	**60%**	70%
Fixed Income	30%	**40%**	50%

UTAM shall establish mandates and then select investment managers to be responsible for the management of the portfolios in accordance with those mandates. Funds will normally be allocated to external managers, or, when determined to be advantageous, may be allocated to internal management.

Each investment manager shall adhere to this policy and shall follow the investment policies and goals with the care, diligence, and skill that a person of ordinary prudence would use in dealing with the property of another 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 code of ethics administered by the Association for Investment Management and Research (AIMR).

3.3. Portfolio Diversification

The objectives of diversification are to:

a) Reduce the fund's total return variability;

b) Reduce the exposure to any single component of the capital market;

c) Reduce the risk of returns not tracking or exceeding inflation;

d) Increase the longer-term risk-adjusted return potential of the fund.

To achieve diversification the fund will invest in the following asset classes subject to indicated limits based on total market value.

I.	**Equities**	**Minimum**	**Normal**	**Maximum***
a)	Canadian stocks and equivalent	5%	**10%**	40%
b)	U.S. stocks and equivalent	10%	**25%**	40%
c)	Non-North American stocks and equivalent	10%	**25%**	40%
d)	Private equity and real estate **	0%	**Not specified**	25%
c)	Overall	50%	**60%**	70%

* Subject to compliance with foreign content limitations

** Includes investments in venture capital, buyouts, subordinated or mezzanine debt, distressed securities, energy, mining, timber and real estate properties. Investments in these categories are included in other equity categories for performance measurement purposes.

II.	**Fixed Income**	**Minimum**	**Normal**	**Maximum**
a)	Money market securities	0%	**0%**	20%
b)	Bonds, debentures, term loans, mortgages and real return bonds	30%	**40%**	50%
c)	Overall	30%	**40%**	50%

To achieve the above mix, derivatives and other synthetic products may be employed.

3.4. Categories and Subcategories of Investments

Investments that are permitted shall be classified within the general categories of :

3.4.1. Equity Investments

Public and private equity securities, including common shares of domestic, foreign and emerging markets equity, ADR's, warrants, convertible bonds, initial public offerings, and equivalent exposures using derivatives.

3.4.2. Fixed Income Investments

Money market securities, including cash on hand both domestic and foreign, call loans, demand deposit notes, treasury bills, promissory notes (secured and unsecured), term loans (secured and unsecured), banker's acceptances, commercial paper, swap deposits, repurchase and reverse repurchase agreements, foreign pay bills, other money market securities, and equivalent exposures using derivatives.

Bonds, debentures, term loans, mortgages, real return bonds, including short and long dated publicly-traded debt securities, foreign-pay bonds, preferred shares, private placement debt and equivalent exposures using derivatives.

3.4.3. Private Equity, Real Estate and Other Investments

Real estate equity and debt, managed futures, venture capital and private equity, distressed securities, resource properties, leveraged buyouts, mezzanine financing, oil and gas, hedge funds, market neutral and long/short strategies.

Investment Managers may use pooled fund unit trust, mutual fund, or limited partnership vehicles that include any of the above categories.

3.5. Use of Derivatives

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

They may also be used as a substitute for more traditional investments if they are based on and consistent with achieving the fund's long-term asset mix goal and rate of return objectives. Such products include debt, equity, commodity and currency futures, options, swaps and forward contracts and pooled, mutual or segregated funds that employ derivatives and synthetic products for purposes consistent with the investment objectives of the fund.

Synthetic products used as a substitute for more traditional investments will not be used to gain leveraged exposure to various asset classes and will be collateralized by cash equal to the risk-adjusted market value of the synthetic exposure.

3.6. Restrictions

Investment restrictions apply within the context of the overall fund objectives and the asset mix policy described above.

Restrictions listed in this policy are in compliance with those that must be adhered to as specified within the Pensions Benefits Act, Regulation 909 of the Revised Regulations of Ontario 1990, and the Federal Income Tax Act, all as amended from time to time.

3.6.1. Minimum Quality Standards for Debt Securities in the Fixed Income Asset Allocation

Credit ratings of individual holdings in passively-managed mandates will be in accordance with the construction of the major Canadian fixed income indexes. Corporate bonds, debentures and other debt securities purchased for the fund in actively-managed mandates shall have a rating of “A” or better or the equivalent thereof according to a recognized bond rating service.

In the case of private placements not rated by a recognized bond rating service, active managers shall apply standards consistent with a minimum “A” rating.

Short-term notes and other evidences of indebtedness of corporations, banks and trust companies shall have a rating of R-1 or the equivalent thereof according to a recognized bond rating service.

For the purposes of this policy, the approved credit rating and the approved credit line for counterparties, with respect to over-the-counter options and forward contracts or its equivalent debt shall be equal to or higher than the “A” rating level as above.

3.6.2. Limitations on Securities of any Single Issuer

Maximum 10% of the book value of plan assets to be loaned to any person, partnership or association.

Maximum 5% of the book value of plan assets invested in any single holding categorized as real property and Canadian resource property.

Maximum 15% of the book value of plan assets in aggregate holdings of Canadian resource properties.

Maximum 25% of the book value of plan assets in aggregate of all properties.

Maximum 10% of the book value of total plan assets invested in any one equity holding.

3.6.3. Investment Manager Constraints

Investment Managers may not:

i) make loans or invest with persons that have fiduciary, employer or employee status with respect to the fund;

ii) use derivatives for financial leverage purposes;

iii) except with the written consent of UTAM, purchase or sell pre-specified derivative financial instruments;

iv) except with the written consent of UTAM, borrow money to purchase securities, purchase securities on margin or short-sell securities.

3.6.4 Foreign Content Limitation

In accordance with the Federal Income Tax Act, foreign content shall not exceed the limitation for pension funds, currently 30% of the book value of the plans' assets since January 1, 2001.

3.7. Rate of Return Objective

It is expected that the fund will over any four-year period:

a) achieve an annualized total rate of return of at least four percentage points over the Consumer Price Index increase for the same period;

b) exceed the following composite benchmark of standard market indices as measured over the same period:

TSE 300	10%
Russell 3000	25%
MSCI EAFE	25%
SC Bond Universe	24%
SC Long Bond	16%

c) achieve above-median return in comparison to an appropriate investment fund universe comprised of funds with similar asset mix and return objectives.

4. GENERAL

4.1. Securities Lending

The securities of the Pension Master Trust 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 fund 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.

4.2. Exercise of Proxies and Voting Rights

Unless the University advises UTAM otherwise, proxy or other voting rights, associated with any of the Pension Master Trust investments must be exercised by the investment manager in the best interest of the fund.

4.3. Valuation of Private Placements & Other Non-traded Investments

The valuation of private placements and other infrequently traded securities shall be determined by the trustee/custodian of the fund. In the case of direct investments in real estate and resource properties, the valuation shall be based on independent opinions of qualified appraisers at a minimum of every three years.

4.4. Conflict of Interest Guidelines

Anyone involved directly or indirectly with the University's fund investments shall immediately disclose to the Business Board, at the time of its discussion of the policy or of matters related to the investment of University 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.

4.5. Custody

To maintain a proper segregation of duties and adequate controls, all securities held shall remain with a third-party custodian.

4.6. Policy Review

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

Felix Chee
Vice President, Business Affairs
April 2003~~November 2001~~