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Sustainable Pension Design • Effective Pension Management

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PETER DRUCKER'S PENSION REVOLUTION IN ACTION:

HOW 'CANADIAN PENSION MODEL' ORGANIZATIONS USE PRIVATE MARKETS TO CREATE VALUE

"Through their pension funds, American workers own at least 35% of America's equity capital, which is more than enough for control. That percentage is sure to rise in the decades ahead."

Peter Drucker (1976)

"We explore how some pension funds streamline the corporate value chain in order to capture a greater proportion of the upstream value creation and earn greater returns for their beneficiaries."

Sebastien Betermier, Eduard van Gelderen, Barbara Zvan (2023)

Peter Drucker's Unseen Revolution and the Pension Fund Industry

The second quote above comes from a just-released research paper titled "Five Examples of Direct Value-Creation and Capture in the Pension Fund Industry"[i]. The paper, written by *McGill University* Prof. Sebastien Betermier, *PSP Investments* CIO Eduard van Gelderen, and *UPP* CEO Barbara Zvan, offers important insights and lessons for the pension fund industry today, which are reviewed and assessed below. However, the *Letter* starts with an equally important topic: the historic developments that led to pension funds actually being directly involved in the economic value creation and capture process today.

The origins story begins with the publication of Peter Drucker's 1976 book *The Unseen Revolution*, which set out the principles and best practices of modern pension design, governance, and investing. A key insight in the book is captured in the first quote above. Workers would not overthrow capitalism by a violent Marxian revolution, but change it quietly through their increasing ownership of the means of production in their growing retirement savings pools.

That 1976 Drucker insight continued to be indeed largely 'unseen' in the subsequent two decades of pension investing. Instead, these decades featured the rise of the 'Efficient Markets Hypothesis' and its logical consequence: passive index fund investing. What passed for 'active management' were mainly activities which the great economist John Maynard Keynes had already labelled 'beauty contest investing' in the 1930s.[ii] The essence of these contests was to predict which stocks investors would find most (buy!) and least (sell!) attractive six months hence. Empirical studies confirmed the obvious outcome of these 'beauty contest investing' strategies. Despite the considerable management fees being charged, these strategies did not produce consistent investment winners and losers over long time horizons.

Implementing the Drucker Formula for Successful Pension Design and Management

As we have set out in detail elsewhere[iii], Drucker's formula for successful pension management can be captured in two words: 1. Legitimacy, and 2. Effectiveness. The former means that the sole purpose of pension organizations must be to serve the interests of beneficiaries. The latter means it must achieve that purpose in a measurable 'value for money' manner.

These Drucker dictates were the foundation of a Report mandated and funded by the Government of Ontario in 1987 titled "*In Whose Interest?*". The recommendations in the Report were accepted by the Government and by the *Ontario Teachers' Federation*, leading to the enactment of the *Teachers' Pension Act* in 1990, and the creation of the *Ontario Teachers' Pension Plan* (*OTPP*) in 1991.

The new legal structure was brought to life through the appointment of inaugural Board Chair Gerald Bouey who has just finished his final term as Governor of the *Bank of Canada*. The Board hired two exceptional executives for the CEO and CIO positions. Actuary Claude Lamoureux had been a senior executive at *Met Life*, and Bob Bertram had been a senior finance executive at *Alberta Government Telephones*. Notably, none in this trio has direct governance or management experience in the pensions field.

It was this combination of a robust legal structure and the right people that led to the design and implementation of *OTPP*'s organizational infrastructure. These events in turn laid the foundations for what would eventually become the internationally recognized *Canadian Pension Model*. The launch of *CEM Benchmarking* in 1991 facilitated 'value for money' measurement at *OTPP* since its inception, and at other Canadian pension organizations as they began to adopt the features of the *Canadian Pension Model*. The *CEM* results confirmed the ability of this new pension model to generate superior 'value-for-money' results.[iv]

OTPP Makes Its First Big Move

Not surprisingly, the first example of value creation and capture in the new "Five Examples" paper is *OTPP*'s privatization of publicly-traded real estate giant *Cadillac Fairvew* (*CF*) in 2000. In summary:

- Lamoureux and Bertram convinced the *OTPP* Board that real estate assets were a good match against inflation-sensitive pension liabilities.
- While the *CF* acquisition would represent 10% of the *OTPP* asset portfolio, this risk was offset by two important considerations: 1. the well-diversified *CF* portfolio of coast-to-coast landmark properties, and 2. the strong *CF* real estate management team.
- Further, having direct control of the operating business facilitates the management of operating and transition risks through the life cycle of real estate projects.
- Its growing specialized knowledge in the real estate management sector would give *OTPP* a comparative advantage in doing future deals internationally. This has turned out to be the case, for example, with transactions in the UK, Brazil, Chile, and Australia.
- The *CF* acquisition would make a statement that *OTPP* is an exciting place to work, and thus help attract and retain key talent in the organization in the years to come.

This highly visible transaction sent an important message to the pension fund sector around the world. Being focused, skilled, and bold can lead to measurable positive payoffs for pension beneficiaries, and at the same time change the pension investment paradigm from passive to active. Peter Drucker's pension revolution was 'unseen' no longer.

Three Other 'Pension Capitalism' Examples

Yet, notably, the other three 'pension capitalism' examples set out in the Paper were initiated in 2015 and 2018. Clearly, the global pension investment sector had not rushed to follow *OTPP*'s 2000 example.

- *Antares Capital* was acquired by *CPP Investments* in 2015 from *GE Capital* for US$12B. It is a private loan platform, lending to mid-sized firms in the USA. The investment provides synergies to *CPP Investments* in the sense that it is both the equity owner of the private loan platform, and a user of the platform to make loans to *Antares*' clients. The firm's loan book has grown to UD$61B today. The investment offers *CPP Investments* two important advantages. First, by owning the platform it does not have to pay fees to go through third party lending platforms. Second, *Antares* staff collaborates with *CPP Investments*' own private credit team on loan structures, underwriting strategies, and credit markets intelligence in general. It controls *Antares* at the Board level, and does not get involved at the management level. *CPP Investments* has also sold 16% of the firm to *Northleaf Capital Partners*, a global private markets investment firm, to gain access to further market knowledge and expertise in the field.

- *Mahi Pono Farming Opportunity*: in 2018, *PSP Investments* acquired 41,000 acres of a former sugar cane plantation in Hawaii to establish *Pomona Farming*. Its vision was to transform unproductive sugar cane land into a thriving hub of mixed agriculture. This process is now well underway. *PSP*'s rationale for the investment included diversification, inflation hedging, and scale economies. To hedge the associated stakeholder/political risks, the venture is managed by US-based *Pomona Farming*. The firm has strong local connections and experience. Its social license to operate is based on emphasizing job opportunities and economic diversification. As a footnote here, Canada's Federal Government recently created a $15B *Canada Growth Fund* to be managed by *PSP Investments*, signaling a strong vote of confidence in its investment expertise.
- *Reseau Express Metropolitain (REM)*: *Caisse de Depot et Placement du Quebec* (*CDPQ*) created *CDPQ Infra* in 2015 to design and manage the *REM* project, a new rail transportation system for the City of Montreal. This is to be accomplished in partnership with the Quebec and Canadian Governments, with delivery occurring between 2023 and 2027. Its ultimate success will require managing multiple risks. These include its complex financial structure, with a target long-term return of 8-9% for *CDPQ*. There is technical complexity to be managed requiring high-levels of engineering expertise. A high level of political expertise will also be required to keep a long list of potential stakeholders (including local governments in the Montreal area) on board.

Taken together, these four case studies offer important 'do' and 'don't lessons for pension fund value-creation and capture through investing in private markets.

Three Lessons Learned

The three are:

1. Investment Policy: private markets investing offers a direct route to owning long-horizon assets that are also good inflation-hedges. Note that the examples in the Paper cover real estate, infrastructure, natural resources, and mid-market credit provision. A related facilitator of this strategy is Canada's smart 'going concern' regulatory environment for pensions, which avoids imposing short-term solvency-related rules which require high degrees of liquidity.
2. Implementation Efficiency: the strategies make a clear distinction between ownership and operating accountabilities. Ownership eliminates third-party fee drag, while at the same time permitting experienced operators to run the business in typically fragmented markets. Even better, these experienced operators can provide value-adding advice and connections to the pension fund's own investment people. Such synergies also help attract and retain high-quality people in both the operating subsidiary and at the pension fund itself.
3. Risk Mitigation: there would be considerable reputational risk attached to a pension fund getting directly involved in running real estate, transportation, agricultural, or private credit businesses. It is far more effective to own businesses in these fields and ensure they have clear business mandates and strong governance structures.

In closing, the Paper authors note that all four 'private market' investment examples involved pension funds with over C$200B in pension assets. What about smaller pension funds? Does their lack of scale preclude them from cost-effectively participating in private market investing? The final part of the Paper addresses this important question.

The *UPP* Story

The *Universities Pension Plan* was founded in 2021 to amalgamate the pension plans of Ontario's universities, with current assets under management of C$12B. *UPP*'s management understands the value-creating potential of private market investing, but does not have the scale to acquire its own operating entities in these markets. Instead, its chosen path is to develop strategic relationships with high-quality commercial General Partners (GPs) that do have that scale. The reciprocal value for the GP is signaling: if *UPP* is in a deal, it is likely to be a good deal.

However there are important caveats to the *UPP* story. For example, it takes a strong management team to create this strategy, and a 'high conviction' Board to approve it. On the risk side, the reputational risks attached to something going wrong in executing this strategy are considerable. Also, the entire *UPP* organization needs to understand the strategy as its execution requires access to sources of liquidity (e.g., derivatives, synthetic securities) for implementation reasons.

'Unseen' No Longer

The Paper concludes by reminding readers that the successful execution of these investment strategies goes beyond generating competitive investment returns for the pension funds themselves. It cites research findings showing that these efforts also lead to greener buildings, lower emission power generation, and greater firm productivity in general.

Slowly but surely, Peter Drucker's pension revolution continues to unfold….and is 'unseen' no longer.

Keith Ambachtsheer

Endnotes:

i. *Betermier, van Gelderen, Zvan (2023), "**Five Examples of Direct Value Creation and Capture in the Pension Fund Industry**". SSRN.*

ii. *See Chapter 12 of Keynes' 1936 opus "The General Theory of Employment, Interest, and Money" for the full exposition of Keynes' thoughts on investing. He had personal experience as the manager of Cambridge University's endowment assets from 1921 until his death in 1946.*

iii. *Ambachtsheer (2021) "**The Canadian Pension Model: Past, Present, and Future**", Journal of Portfolio Management.*

iv. *Full disclosure: I am a co-founder and co-owner of CEM Benchmarking.*

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