2:35 p.m.
[Mr. Hutton in the chair]

THE CHAIR: Good afternoon, everyone. This is the Alberta heritage savings trust fund meeting, and we're going to start with housekeeping before we do introductions. In front of you, you have little mikes. Please do not touch anything. We have *Hansard* at the back that is trying out the new technology, so keep your fingers off the buzzers, please. They will handle it when you're about to speak. The whole crew back there, as a matter of fact, is from *Hansard*.

So welcome to everyone. I'd like to introduce some of the guests that are here at our meeting. The last time this august group met was in Whitecourt at our annual general meeting. George got half of the town and half of the next town to our annual meeting, and we're thankful for that, George.

We have today the Minister of Revenue, the Hon. Greg Melchin, and his deputy minister, Robert Bhatia. We have Paul Pugh and we have Peter Orcheson – that's from the Ministry of Revenue – and also Gord Vincent. Is Glenn back there? Yeah, Glenn's here, the executive assistant. From Alberta Finance we have Gisele Simard and we have Dave Pappas. From the office of the Auditor General we have Rene Boisson and we have Graeme Arklie. I am introducing Karen Sawchuk for the first time. Karen is taking over the role of secretary of the Alberta heritage savings trust fund committee, and she's been a great asset already to me and getting organized for this meeting. Also, I'd like to welcome Robert, because since our last meeting he's the new Deputy Minister of Revenue. So welcome.

I will now call the meeting to order, and I would ask for a motion to move the agenda before you. Do I have a motion? Rob Lougheed moved that the agenda for the February 13, 2002, Standing Committee on the Alberta Heritage Savings Trust Fund meeting be adopted. All in favour? Okay.

Now, to approve the minutes of the September 24 meeting that you, I'm sure, all read, can I have a motion?

MR. BONNER: So moved.

THE CHAIR: Bill Bonner moved that the minutes of the September 24, 2001, Standing Committee on the Alberta Heritage Savings Trust Fund meeting be adopted as circulated. All in favour?

I'll turn it over to our guests for item 4, Business Plan for 2002-2005, Alberta Revenue. And, hon. minister, I forewarn you. With the mike, don't stick your nose into it. It can get quite loud. Thank you, Mr. Minister. I turn it over to you.

MR. MELCHIN: Thank you, Mr. Chairman. It's a pleasure to be able to be here today and to review the business plan. For that matter, we'll also have a chance later to talk about the first and second quarters of the Alberta heritage savings trust fund. So we look forward to this opportunity to I think ensure that we have the appropriate oversight and management and policy and direction of the fund, and it's appropriate we take the opportunity.

A couple of things just for process that I thought we'd highlight before we get going anywhere. The business plan that's before you today has already been through legislative requirement, through a number of stages. Alberta Revenue staff actually initiated the review to be brought forward to the Investment Operations Committee. You may be aware that obviously there is an Investment Operations Committee, chaired by the Deputy Minister of Revenue and consisting of private-sector members that bring policy advice and direction to the oversight of the policies and benchmarks of the heritage savings trust fund.

From that point forward it has to be approved by myself as the Minister of Revenue, and then it has gone forward to Treasury Board for approval of the business plan itself. So it has been through all of those processes. It has received the approval at each of those stages. So we are here at an all-party legislative committee now to likewise seek approval of the business plan for the upcoming years, 2002 to 2005.

I'd like to make sure that we still reaffirm an objective set out in the fund that is there to maximize long-term financial returns, being one of the restructuring objectives of the plan from 1997. Two portfolios were established: the transition portfolio, to generate income, which was primarily to meet the obligations of the fiscal needs of the province; and secondly, an endowment portfolio, to pursue the objective of maximizing long-term financial returns of the fund.

The assets of the transition portfolio were to be completely put into or transferred to the endowment portfolio. No later than 2005 was the requirement. As you recall, previous policy decisions were made in light of the fiscal objectives of the province to, I'd say, quicken that pace. So this transition will actually be completed by no later than August of this year, of 2002, and all of the funds will have moved from the transition portfolio to the endowment portfolio. As a result, that gets into a blend of the diversity of the asset mix, which calls for greater investment and a diversified portfolio including a greater investment in equities.

One of the things I'd like to highlight in the business plan is – maybe I could have you turn to page 4 of the business plan. We talk about a number of changes that are incorporated into this plan that are new from the previous years. There are two or three points in particular that outline those changes. You've probably had the chance at this stage to go through that. I thought I'd just touch on and highlight a little bit those significant changes.

The first one, as you see, was to "increase the exposure of the fund to real estate and private equity, and introduce absolute return strategies to continue the focus on [maximizing] the long term." That balance of the portfolio is still taken within the mix of . . . The benchmark of the endowment portion of the heritage savings trust fund was to have a mix of 65 percent in equities and 35 percent – that was the policy benchmark – in fixed income. So when we talk about increasing the exposure in private equities – 2 percent there, up to 3 percent in absolute return strategies, and 10 percent in real estate – that's still within the total equity component, 65 percent. That's where that mix comes from.

I'd like to also then outline, I guess, that part of why this recommendation has come forward from our chief investment officers of the fund and certainly our investment operations advisory committee is that research continues to demonstrate that increasing exposure to these instruments like real estate, private equity, and absolute return strategies creates a portfolio with an improved risk return possibility. I think it's important that we recognize that it's both maximizing return but also minimizing risk that are important components of it.

A 15 percent benchmark exposure would be phased in over two years. I mentioned that the 2 percent in private equities, 3 percent in absolute return strategies, and 10 percent in real estate would be the benchmark exposures.

Secondly, something that has to then change with the plan would be the weightings of the nontraditional asset classes. New benchmarks and new benchmark allocations would then be recommended.

> The recommended policy benchmarks for the real estate, private equity, and absolute return strategy asset classes are inflation, as measured by the [Consumer Price Index], plus 5%, 8%, and 6%, respectively.

So those benchmarks for the returns on those will be geared to inflation indices plus a percent related to them.

> Benchmarking these investments at the policy level to a spread over inflation is consistent with the objective of the endowment funds to generate a return that will protect the real value of the fund and facilitate spending [anything] over this amount.

The final recommendation, 3, that's before you there on page 5 deals with – I touched on it briefly in the introductory remarks – the endowment portfolio. It now exceeds the transition portfolio, and

> the Transition Portfolio's focus has moved to providing greater liquidity to facilitate the transfers to the Endowment Portfolio. This requires the Portfolio maintain short-term assets that act as a drag on the total fund performance. To maintain the Heritage Fund performance and reduce the "cash drag" the transfers [will continue at the current level] so as to liquidate the Transition Portfolio by August 2002. This would also allow flexibility [in order] to take advantage of market conditions or opportunities without compromising the discipline of "dollar-averaging" (the systematic investing of funds over time) used in the transition.

2:45

Right here on page 7 we've used September 30, 2001, which is just the last quarter information we have that was released to the public. The third quarter will be out shortly. The other pages – when you look at the goals, performance strategies, outcomes, performance measures – are basically the same as what we've had in the previous years.

When you look forward to page 11 and you see the asset class mix, it still is the same in goal 2. In the far left-hand column, Strategies/Outputs, about the middle of the page down where it talks about asset class, fixed income interest-bearing securities can range from 25 to 45 percent inside of the endowment portfolio and equities anywhere from 75 percent to 55 percent.

You'll see in the right-hand column where it talks about the benchmark for fixed income being 35 percent of it and equities being 65. You see the various components where that would be divided as to the benchmark portfolio and the return indices that would be used to measure the performance of this fund over time.

Well, I'll conclude my remarks there, and we'd be happy to entertain any questions that the committee would have on the business plan. Thank you, Mr. Chairman.

THE CHAIR: Thank you, Mr. Minister, for taking the time.

Are there any comments, questions?

MR. BONNER: I have a few. My first question would be on page 5. You talk about the absolute return strategy. What are the risks associated with this strategy?

MR. MELCHIN: It might be better to have Paul Pugh, who is our chief investment officer. I think it might be useful for him if you would outline a little bit about absolute return strategies and then, obviously, the risks associated with it.

MR. PUGH: Thank you. Let's go back to square one and look at what we want to do with absolute return strategies. Absolute return strategies are just what they are: you try and make money irregardless of the market direction. For instance, if the TSE was down 20 percent or 15 percent, which it has been, you would expect in absolute return strategies that you would make money, even in bad markets. The way this is done is by, if you will, going short the market; i.e., you sell stocks that you don't like, and you buy stocks that you do like. So when the market goes down, you hope to make money by buying back the stocks that you don't like when they've fallen in price and you've sold them. For instance, if you sold a stock at $50 – i.e., shorted the stock – and it fell to $30, you would buy it back at $30 and make the $20 profit. So when the market falls generally and you are short the market, you expect to make these returns.

If you look at the statistics, the risks or the volatility in absolute return strategies is actually less than in the regular marketplace, in the cash marketplace. Generally, absolute return strategies as a basket have a volatility which is about half that of the volatility in the regular cash markets; i.e., the TSE and the S & Poor. What you try and do is capture the gains for being, shall we say, short the market.

Does that answer your question?

MR. BONNER: That's great, yes. Thank you, Paul.

How long have these strategies been around? You've just mentioned, you know, their track record.

MR. PUGH: The absolute return strategies have been around for 50 years. They were generally the domain of high net worth people because they had a better appreciation, if that's the term to use, of their need to generate revenue on a regular basis and not suffer the volatility of the marketplace.

Over the last 10, 15 years, because of the growing volatility in what we call the cash markets, the TSE, et cetera, there's been a genesis or a move by institutions to capture this absolute return and not suffer the negative returns. So the market has grown dramatically in the last 10, 15 years, but historically they have been around for high net worth individuals. They have now moved more into the institutional marketplace.

MR. BONNER: I do have more questions, but other people have some too.

THE CHAIR: We'll go to one of the others and then back to you, Bill, if that's okay.

MR. BONNER: For sure. Perfect.

MR. LOUGHEED: With respect to the comment you made earlier, Greg, on cash drag, could you maybe elaborate a little bit there and talk perhaps about measuring against any kind of index for other funds? You've got measurements for all sorts of things. Do you compare to cash positions of other funds? Certainly cash drag is not a drag if in fact the equities are falling.

MR. MELCHIN: We're going to have Paul respond to that question, but I would say that it's more in light of the fact that we're moving out of the transition portfolio to the endowment portfolio that that's become the issue.

Paul, I'll have you supplement.

MR. PUGH: That's really the impact. By holding the cash in the portfolio, we miss opportunities in the cash markets, the equity markets, et cetera. Plus, by having to convert, shall we say, a one-year piece of paper into a three-month piece of paper in anticipation of transferring it over, we're losing a bit of that extra income. So as we keep on holding, the term of the transition portfolio gets shorter, and it becomes more and more cash, which historically has been a negative impact on the portfolio.

MR. LOUGHEED: I can accept that historically, but can you measure, have you measured any of those against other fund benchmarks where they may have decided consciously to not take a cash position kind of as an interim measure or a forced measure but as a conscious decision to stay or to increase cash position?

MR. PUGH: The response I'd give to that is that most of the funds that we – and I hate using the term "compare to" – look at to review have a very low cash position, because everybody has taken the view, a long view, on the markets that over the long term your equity markets should return more and your bond markets should return more than the cash markets. So most of the funds we look at have a very low cash allocation, 1 to 2 percent. As we say in the business, it's frictional cash. It allows you to trade the portfolio, or it's cash moving in as you move from one asset category to the other; i.e., Canadian equities to U.S. equities or fixed income. We look at it, but we don't measure other funds against ourselves per se. Our benchmark on cash is 2 percent, so we're trying to stay at that level all the time.

THE CHAIR: Mr. Bonner.

MR. BONNER: Thank you very much. Are there any plans to go beyond the 3 percent exposure for the absolute return strategies?

MR. MELCHIN: As you know, this business plan is for the period of the next three years, starting April 2002 through March of 2005, so the business plan does not contemplate any change. That's not to say that we couldn't revisit a change in the benchmark or a change in the asset mix so that it has a higher percentage. Today all that we are proposing is that it's a new strategy for us, that we have the opportunity to work with investing in the absolute return strategies, and we'll have an opportunity then to come back and revisit how we've done and whether or not we'd like to change the asset mix further in a future year.

THE CHAIR: George? Or did you have another supplemental, Bill?

MR. BONNER: Go ahead, George. I can come back again.

MR. VANDERBURG: Well, just back to selling short. I mean, any of us that have been, you know, in the stock market have sold short for a long time. So are you saying that we're just going to start selling, that this is just a new strategy, that we haven't been selling short in the past?

2:55

MR. PUGH: The answer is that we do not sell short. Our policies have not allowed us to sell short. We have not shorted the market. We've always been, in the parlance of the marketplace, long the market. This strategy is an attempt to capture some of those strategies. Maybe one thing to emphasize is that we're going to hire what are called fund-to-fund managers to do this. We don't have the bodies around, if you will, to pick individual managers, so we'll get somebody to do that for us. But we do not short stocks now.

MR. VANDERBURG: Okay. And it will not be in-house, you said.

MR. PUGH: No. We'll hire external fund-to-fund, absolute return strategy managers to implement this for us, and we'll allocate money to their pools.

THE CHAIR: Thank you.
Mr. Bonner.

MR. BONNER: Thank you. On page 13 of the business plan you point out that "fund assets are to be invested prudently and cannot be used directly for economic development or social investment purposes." I was wondering if you could outline for us what you mean by social investment. A follow-up to that question: would this preclude investing in a socially responsible manner?

MR. MELCHIN: When we talk about not being "used directly for economic development or social investment purposes," in the past the heritage fund has had a history of having been invested for different purposes. Some of it has been capital projects; some of it has been specific loans. As you know, we have one in particular that's still left in the heritage fund, the Ridley Grain terminal. It's those kinds of loans that are anticipated. That's not the mandate, and we won't be directly involved in a business loan particularly for purposes other than we're investing in a balanced TSE 300 or the S & P 500. We invest in more the large blue-chip types of stocks in the various countries, but we won't specifically go out and pursue loans for one company or one specific social objective.

That doesn't mean our investments aren't accomplishing the social objectives that we have, and that is to maximize the benefit for the long term for the province in that we invest in legitimate, very highly reputable companies that have the reputation and acceptance of the public markets and literally investors worldwide. So they've already had all of that scrutiny. They meet, I would say, the objectives of the public. That's why they are listed on the TSE 300 and the S & P 500 and throughout the European exchanges.

THE CHAIR: Any further questions? Mr. Knight.

MR. KNIGHT: Thank you, Mr. Chairman. To the minister. On page 10, under the goals, goal 1 is: "Earn income to support the government's consolidated fiscal plan." I guess, Greg, if you don't mind, what I need to try to get clearer is the idea to "reduce the Fund's investment in Alberta provincial corporations, subject to liability management considerations." I don't know what that means. Could I have that explained?

MR. MELCHIN: I'm just looking for the point you were saying. Oh, there it is.

We have in the transition portfolio loans like Ridley Grain, and we've had other loans. So the objective has been to reduce it in those. When you also talk about reducing "the Fund's investment in Alberta provincial corporations, subject to liability management," I'm going to have Paul supplement.

MR. PUGH: We have a number of loans to the Alberta Social Housing Corporation and things like that, and they can be matured early, but that's at the discretion of the liability people who manage the liability book for the province. We would like to get some of those off our books, but it's dependent on them repaying them when they can pay them.

MR. KNIGHT: Okay. So then if you just go to the outcomes side of the thing, debentures paid on interest rate reset dates, the idea, then, is that the reset dates may have a penalty attached to them.

MR. PUGH: No penalty. This would be the ability to pay the debt off at par when this reset date is set.

MR. KNIGHT: But that's where the liability people would come in to play.

MR. PUGH: That's right.

MR. KNIGHT: All right. Thank you.

MR. VANDERBURG: Since you brought up Ridley Grain terminal twice – I thought I'd leave it alone, but, you know, it's just like you're baiting me, so I've gone for it. It's been shut down for about 18 months; hasn't it? It's not even turning a wheel.

MR. MELCHIN: I don't know if Robert or Paul is best to update you specifically as to the operations. We are still pursuing actively with the holder of that note to see that we find a settlement on it. We're too premature here to say that it will be settled, but we are still actively trying to find a settlement on that investment.

Robert or Paul, I don't know who'd have the best information on the operations.

MR. BHATIA: Thank you, Mr. Minister. Just briefly on the terminal. It hasn't necessarily been shut down for all of that period of time, but you're right that it has been operating at a very low level of throughput on and off for the last several years. That's just one of the issues in the consideration of how and when to exit the investment.

MR. MELCHIN: We're delighted that we baited you to at least ask the question. We were pleased to respond.

MR. VANDERBURG: I wouldn't sell short on that one.

THE CHAIR: If I may, for a point of clarification. As far as the heritage trust fund, there is a separation. For the Department of Revenue or Finance, are there two separate issues here? Is the exposure for us of the heritage trust fund all that we've got exposed, or is the government as a whole beholden to us?

MR. MELCHIN: There were two separate investments. One, the remaining investment that is on the books, is only in the Alberta heritage savings trust fund. There's another loan in the general revenue fund that was written down some time ago.

THE CHAIR: Thank you.

Any other questions or comments?

MR. BONNER: While we're on risk management, I have a few questions. I'm looking at page 4 here. What happens if these benchmarks are missed, and how are our managers to be held accountable if the benchmarks are not attained? How do we take corrective action if a strategy proves inappropriate?

MR. MELCHIN: I'm certainly going to put our own chief investment officer on the spot on this question too, but I would say that the reason why we do want to set benchmarks is so that we can measure performance. There's no guarantee that we will always meet every benchmark every year. There are risks inherent in every investment strategy, so you use the prudent investment rules to ensure that you follow all the strategies. That's why we're placing some new ones before the committee today. That's why you diversify your portfolio. That's why you actively look and recruit and train, so that we have professionals in the industry that have all the education, have the background and experience so that we can manage those funds to a high level of performance. We are fortunate actually to have people, I would say, like Paul Pugh and many throughout who hold the designations and who have had a tremendous background in the investment industry.

Those are questions that we're going to have to continuously ask and expect them to set, not only that we meet the policy benchmarks, but then we'll look towards the performance: why did we not? Those are very good questions. This committee has a responsibility to ensure also that we approve not just our investment strategies and benchmarks but that we look also at the accountability. Are we satisfied with our strategies? If we've been meeting our benchmarks, has that been in relation to: are we happy with the administration that's there? That's something that we actively work with and look at as the Minister of Revenue and as deputy ministers as to our own performance.

I'm going to have Paul supplement a little bit as to how he feels, following up on his being held accountable.

MR. PUGH: Benchmarks make it easier to terminate managers. That's the simple answer.

3:05

We use the benchmarks to monitor the performance of the fund. We use the benchmarks to monitor the performance of strategies to see if we're using the right strategies. I'll use an example of the absolute return strategy. This is a change in our strategy, and it's directed at trying to smooth out some of the volatility in the revenue flows for the heritage fund. If we can take out some of that volatility, it'll benefit the performance plus the government's revenue stream. So we're always looking at how we're performing against the benchmarks, how our strategies are working against the benchmarks, and whether or not we should change the strategies vis-a-vis the objectives of the fund.

THE CHAIR: Are there any further questions or comments? One last question, Bill?

MR. BONNER: Yes. Are there any plans? I haven't seen any plans in here to inflation-proof the fund.

MR. MELCHIN: There is the ability presently, even with the Department of Revenue, to make the recommendations to retain income to inflation-proof the fund if we're talking about strict inflation-proofing of the fund. The prime objective of the government – and I would say that it doesn't necessarily help the Alberta heritage savings trust fund, but when you look at the overall balance sheet of the government, the priority of savings has been the repayment of debt. While we might not be growing the fund, we are diminishing debt in substantial amounts and the requisite interest requirement in payments that go with it, so it may not be pulling in the fund or the return to this specific fund, but to the overall government there continues to be an improvement in the net asset position even by paying down the debt. So over the last number of years, really throughout the life of the fund, it's generated upwards of $25 million that has gone to service priorities of the government: health, education, repayment of debt, and all of the service delivery requirements of the provincial government.

I just want to say that this business plan contemplates again that the priority has continued to put an emphasis and priority on repayment of the debt and that the income would go towards that objective rather than just building up the fund.

THE CHAIR: Thank you.

At this time could I have someone move that the Standing Committee on the Alberta Heritage Savings Trust Fund accept the draft 2002-2005 Alberta heritage savings trust fund business plan as presented?

MR. VANDERBURG: Just before that, because this is recorded in

Hansard – I think the minister said $25 million. It's probably $25 billion, so I think that we should have the information correct in *Hansard*.

THE CHAIR: Thank you, Mr. VanderBurg. So noted.

MR. MELCHIN: Thank you for the correction. It is $25 billion. Yes, absolutely. Thank you.

MR. VANDERBURG: If it was not on *Hansard*, I wouldn't have commented.

THE CHAIR: Thank you, Mr. VanderBurg.

Could I have a motion that

> the Standing Committee on the Alberta Heritage Savings Trust Fund accept the draft 2002-2005 Alberta heritage savings trust fund business plan as presented?

MR. KNIGHT: I so move.

THE CHAIR: All in favour, say aye. Opposed?

Now we'll move on to item 5, the first- and second-quarter updates for the 2001-2002 quarterly reports, Alberta Revenue. Will I be turning that back to you, Mr. Minister?

MR. MELCHIN: Thank you, Mr. Chairman. Maybe I'll have you focus in on the second quarter. I'll just touch briefly on some highlights of the second quarter. If you have questions on either quarter, we'd be happy to entertain the questions.

Maybe you can refer to page 1 of the second-quarter update. There are a number of quarterly review points that I think are pertinent for you to look over. The second quarter, being September 30, came at a very low point in time in the marketplace. We know the events of the stock markets internationally post September 11, and the results of this fund and its income over that period of time reflect that. The fund recorded a realized investment loss of $239 million during the second quarter, resulting in a net loss of $81 million for the first half of the fiscal year. Over six months the fund earnings of $259 million from investments and bonds, notes, short paper, and real estate were offset by net losses of $350 million from equity investments. I'm just highlighting some of the points in that report. The declining world equity markets over the past 12 months, the events of September 11, and the write-downs of investments in technology stocks contributed to a net loss from the equity investments.

We know by having shifted to a policy where you're looking to long-term returns that putting a weight and moving away from just investing in fixed income towards also having a balanced portfolio that includes equities means you're going to have volatility, and in particular in the first six months and in the second quarter we've seen the magnitude of the kind of volatility that can happen in a short time. The third-quarter reports are not out yet, will be there shortly. Just having watched the marketplace post September 11, there has been, you know, quite a substantial rebound over that period of time, but it isn't a matter of just one quarter or two. The policy benchmarks that we just approved in the business plan is the strategy that we have to be prepared to live with. In any one quarter you can get this kind of fluctuation, but if we are patient with this over the years, five to 10 years, this will outperform, just having taken a very conservative strategy investing in fixed income.

So I wanted to make sure we are aware that there was an investment loss of $81 million through the first six months. That's quite significant when you look at the investment income of $530 million for the previous year for the same period of time. The forecast for the year, though, was still to see that the fund itself for the fiscal year of March 31, 2002, would still have an income of $175 million. So there would be a rebound even in our forecast from the second quarter through to the end of the year. We've seen some of that already happening just by watching the world equity markets subsequent to September 30.

I don't know that I have more comments. I'd be happy to entertain any questions you might have on either of the two quarters, and I'll end my comments there.

THE CHAIR: Thank you, Mr. Minister.

Are there any questions or comments? Mr. Bonner.

MR. BONNER: Yes, just a couple here. What I've been asked often is: did we have shares in Enron in the heritage savings trust fund? Do we still have them? If we have sold them, how did we come out of the deal financially? If you could please give us an update on that, Mr. Minister.

MR. MELCHIN: Sure. I'd be happy to. The answer is that we did have some shares in Enron, and I'll have Paul Pugh, our chief investment officer, respond.

MR. PUGH: Yes, we did own shares in Enron through our U.S. managers and through our participation in the S & P index fund. In September our exposure was roughly $5 million. As things, shall we say, became more and more uncertain, our managers started to lighten up, and by the end of the year they were all out of the shares. We took a loss on it of roughly 2 and one-half million dollars, $3 million, but it represented, at the maximum, less than one-tenth of a percent of the fund's assets. So, yes, we were hurt, but it was not a major event because of the diversification through the portfolio.

MR. BONNER: Thanks, Paul.

MR. MELCHIN: I'd like to just supplement. Part of the strategy of investment is you're going to pick the broad indices, you know, the TSE 300 and the S & P 500, and you are going to find some failures. Not every individual stock is going to perform well or to your expectations, but that's part of diversifying the risk. You don't want to choose to just invest in the Enrons of the world or else you would substantially face those problems. By having balanced it out, you'll find a lot of stocks that have performed very well, and that is the history of investing in the broad indices.

3:15

THE CHAIR: Well, thank you very much, Mr. Minister.

I now will ask that somebody move that

> the Standing Committee on the Alberta Heritage Savings Trust Fund receive the first- and second-quarter investment reports as distributed.

Mr. Bonner. Thank you. All in favour, say aye. Opposed? Thank you.

At this point in the proceedings on behalf of the Alberta heritage trust fund committee I'd like to thank the minister and Mr. Bhatia, Mr. Shepherd, Mr. Pugh, Mr. Orcheson, Ms Chance, and Mr. Vincent for coming, attending, and presenting the reports. We'll let you go now, Mr. Minister, and we'll move on to our other business. I would ask if Mr. Pugh would mind staying behind with regards to that item. If Mr. Vincent and Ms Chance want to stay behind, that's fine too.

MR. MELCHIN: Great. Thank you.

THE CHAIR: Thank you.

I'd also like to thank the Auditor General's department. You're leaving as well? Thank you, gentlemen.

I'll ask the committee now to move to tab 6. As we'd mentioned at the September 24 meeting of the Alberta heritage savings trust fund committee, we would take written submissions from any member to present to the committee. I now turn this over to Mr. Bonner to discuss his written request.

MR. BONNER: Thank you very much, Drew. What I would like to propose today is an alternate method in the way in which we invest in the heritage savings trust fund. This is looking from the aspect of socially responsible investing. It would certainly not have to be done as a total part of the fund. We could also, you know, introduce it slowly. We could do it partially. We could certainly check its progress. What I would like for us to do is take a look at ethical investments. At its core it is about investing in things that benefit society while not harming it at the same time. We should know and realize that what is bad for society is also bad for business. Investors hate risk since it threatens profitability. So if a company's practices go against social standards, chances are it will catch up to them and investors will pay the price. In addition to financial information, socially responsible investors take environmental, social, and community interests into account when they decide which companies to invest in.

Why should we do it? The investment decisions of the government should reflect the values of its citizens. When Albertans buy shares in a company through the heritage savings trust fund, they're not just loaning money to a company and getting interest payments in return. They're actually taking partial ownership of that company. Ownership implies responsibility for the activities of that firm. We should invest according to our collective principles. If the government has no principles other than profit at all costs, then the people should be made aware of this since it is their money that is being invested.

Albertans view the heritage savings trust fund as a long-term investment. Ethical firms are more likely to have fewer surprises, such as toxic waste cleanup costs, personal injury claims, poor employment and customer relations. They will also likely provide better disclosure about their activities, including any errors or problems. Wouldn't Enron investors liked to have had someone looking into that company or some advance warning of where they were headed?

In Canada ethical funds represent about 3 percent of all mutual fund assets, but the asset growth recently has been around 75 percent per year. In the U.S. social and ethical funds account for about 13 percent of the market, with the growth rate almost as high as what we have in Canada. Many private-sector and institutional investors alike are recognizing the importance of ethical standards.

Back in June the chairman of CDP Capital, caisse de depot et placement du Quebec, was quoted as saying that a fund manager must be aware of the convictions and the social, political, and environmental values of its client and that by taking all of these variables into account, the fund manager may very often minimize risk and maximize returns. This is quoted in the Montreal *Gazette*, June 6, 2001. As well, another example, your second largest pension fund, PGGM, the Dutch health workers' pension fund, appointed Friends Ivory & Sime, FIS, a fund management company with £34.8 billion of assets under management, to oversee 4 billion of its funds. FIS is a world leader in socially responsible investments, having been in this market niche since 1984. This evidence suggests that - Canadians as well as citizens around the world are interested in not only quality returns but also where their money is going and what it will be used for.

Does ethical investing reduce performance? There are a number of studies that show funds outperforming or at least performing as well as the major benchmark indices. One is State Street Global Advisors. Back history of the GSI 60 from December 1994 to December 1999 found that it outperformed the TSE 300. Over the past six months, during the depressed equity market, America's Jantzi Social Index returned .55 percent, as compared to the six-month return on the TSE 300 of just .19 percent. In the U.S. the Domini Social Index outperformed the Standard & Poor's 500 throughout the 1990s with a total return of 538.29 percent, compared to 434.87 percent. Our source for these particular figures was the Social Investment Forum.

A number of studies have found that no significant statistical difference in financial performance exists between ethical and nonethical funds despite the fact that ethical funds choose securities from a restricted universe of investments. Of course, there are other studies that find exactly the opposite of these results. The point is that there is no conclusive evidence that supports the myth that investing ethically hurts the bottom line. In fact, there is a growing evidence suggesting that ethical investments perform as well if not better than other assets.

How would we do this? How would we make it work? Ideally, we would look into having a reputable firm similar to FIS oversee our investments to make sure that the heritage savings trust fund is not only earning the returns Albertans deserve but also that it is invested in a way that reflects the values of our citizens. If that is proven to be too costly or otherwise unsuitable, then there are numerous strategies for integrating ethical criteria into our investing policy.

Some suggestions: we could institute guidelines for our current managers, track other ethical fund holdings, add another nongovernment member who specializes in ethical investments to the Investment Operations Committee. If we are to have a broad socially responsible investment strategy similar in spirit to the city of Edmonton's ethical policy, then the government must provide proof that it is attempting to exert influence over the business practices of firms alleged to be behaving contrary to the values of Albertans. If firms fail to change behaviour that reflects poorly on our policy and on our public, then holdings should be removed from the heritage fund or any other public investment assets. The key to this is public disclosure of holdings of the heritage savings trust fund so that groups with an interest in human rights can review them and point out any company that has questionable practices. The managers of the fund can then examine this evidence and take appropriate action.

So we certainly don't want to in any way tie the hands of the people that are investing for the fund. We think that by moving to a model of socially responsible investing, the fund will perform as well or better than it currently does and that it will reflect the values of the people of Alberta.

Thank you.

3:25

THE CHAIR: Thank you, Bill, and thank you for providing a written note to me with regards to this.

I had the opportunity to ask Mr. Pugh if he could respond to where the Alberta heritage savings trust fund is with regards to ethical funds. If you wouldn't mind, Paul.

MR. PUGH: This is a very complex subject. The whole world of socially responsible investing is very complex. One comment I'll make up front: we are ethical investors; we don't do anything unethically. We invest to the best that we can for the heritage fund and, hopefully, Albertans. The issue of socially responsible investing comes up quite frequently. We do look at companies for, shall we say, their ethical standards, their views on labour, environmental issues, et cetera.

Where you have the difficulty, when you talk about socially responsible investing, is: whose conscience am I going to use in deciding what is socially responsible and what is socially not responsible? I can only work on, if you will, what is in front of me and choose companies that show good corporate governance. I agree with you. Good corporate governance leads to better firms, and good corporate governance leads, I think, to socially responsible investing. So we try to choose companies that show good corporate governance.

There are issues with some companies, and one of the issues that always comes up is Talisman. No one has ever proven that their activities in the Sudan are harmful to the Sudanese. In fact, some people say that they are very positive. I think Talisman is a very well run company, et cetera. They have made a strategic decision to be in the Sudan. From all the reports that we get, they have also looked at exiting from the Sudan. Are they socially irresponsible? I don't think so. I think that 90 percent of the business that they do, if you just ignore the Sudanese, is very socially responsible. They show good corporate governance, and they've shown good performance, et cetera. On that basis I want to invest in that company, and we are investing in that company. Who is going to make the determination that Talisman is not socially responsible?

MR. BONNER: Would you like me to respond now?

MR. PUGH: Are you going to make it? Is the committee going to make it? This is where I as a manager have a problem. You wouldn't want me imposing my conscience on the fund, so I invest on the basis of what I think is good corporate governance, good financial statements, good financial results. You can tell me as an investment manager not to buy Philip Morris because they produce cigarettes. I still like it as a company because roughly 50 percent, 60 percent of its business comes from producing food that feeds us all.

MR. BONNER: Breakfast cereals. You're absolutely right.

MR. PUGH: Who is going to impose those guidelines on me? I have to go from, you know: whose conscience do I follow? I think our conscience, as we're investing, is good corporate governance, potential for good returns. If somebody is polluting the environment, we would probably not invest in them because it's going to show in the returns. If there are issues with the company but we still think it's a good company, we can exercise our proxy, et cetera, for or against management or significant things. That's, I guess, our approach to it.

Socially responsible investing is a very complex subject, and I don't know what the answer is. I think that just following good financial procedures, being a good investor from the point of view of looking at companies that have good corporate governance in place, should at the end of the day produce good returns for the fund and lead to what I would consider socially responsible investors.

What else can I say? I don't know.

MR. BONNER: I think that probably, Paul, in the long run we're going to be correct by following that practice many more times than we would be wrong.

MR. PUGH: I would hope so.

MR. BONNER: You know, just to speak on Talisman, the fact that they are in the Sudan has certainly, as investment managers have said, decreased the value of their shares at this particular time. So, you know, if there is a backlash, where people are not in agreement with what they're doing, then we are not getting in the fund the returns on our money that we should. I think the world has different ways, as well, to put pressure on those people. I know that there are, as we indicated here, funds that have gone to ethical investments. There are organizations that do specialize in this type of investing.

MR. PUGH: I don't dispute the fact that there are funds that have allocated a portion of their fund to specific vehicles that are deemed to be socially responsible, ethical, however you want to define it. There are services that will rate companies on their social responsibility, et cetera.

THE CHAIR: Mr. Knight.

MR. KNIGHT: Thank you, Mr. Chairman. Paul, I guess the question that I had relates to something that Mr. Bonner brought up with respect to an amount of the heritage savings trust fund that could possibly be set aside, building on that to at some point in time total involvement. My question would be: if you look at the level of investment of the Alberta government and the relatively small percentage of the so-called socially responsible funds, what potential would we have to manipulate in either a positive or negative manner the value of those funds if we moved in that direction?

MR. PUGH: I'm not sure I'm going to respond properly to this. Some of these funds are a relatively good size, and some are quite small. Depending on how much we allocate, how much we put into the fund, some of the managers might not be able to handle it, so we might have a potentially negative impact on some of these funds. Other ones could handle our allocation and should perform to the level that they are quoted as performing at. It would be just like we hire other managers now, and we look at their capacity to handle the allocation we want to give them, et cetera. I think it would be a 50-50 thing.

MR. VANDERBURG: I don't know who can answer this. I haven't looked into ethical funds. Have you had a chance to pick out 10 ethical funds and analyze the return on them?

MR. PUGH: No, we have not sat down and gone through 10 ethical funds and seen what they return. A number of these funds are geared to individual investors. They're mutual funds which we could not participate in. There are some institutional funds and also some institutional services that will rank companies, and you can choose from that list. If we were going to participate in socially responsible funds, we would go to an institutional manager who had the systems in place, I think, rather than recreating the wheel.

3:35

MR. VANDERBURG: You know, a while back everybody was talking about investing in green power. Personally, I looked at the rate of return on the funds that were invested in green power, and it wasn't too bad. You know, it wasn't a bad investment. So I'm not closing my eyes to it, but I was just wondering if we've had some examples of how these funds were doing.

MR. PUGH: Anecdotally some of the funds do quite well. I think Mr. Bonner's statistics are probably accurate. With all things in life there's some good and there's some bad. Some of the funds in the

States have allocated – I mean, some religious groups have specific allocations and specific screening mechanisms so they don't invest in what they consider unethical.

THE CHAIR: Thank you, Mr. Pugh.

MR. LOUGHEED: I just have a question or two, Bill. You've thought through this a whole bunch, so maybe you could just answer a question I might have. I think it was right near the start, and I think it was Paul who commented on the purpose of the fund, which I guess should be self-evident, and that is to increase the value of the fund and the revenues to the province. If we consider that to be the goal of the fund, which seems appropriate, you talked about investing in ethical funds which would reflect the values of citizens. If, in fact, the value that people place on whatever they wish to invest in is there, then it would be, I think, the fund managers who would be investing in such a way that they'd be perceiving that increased value and increased belief of the citizens that those are the things they view as important. They would be moving in that direction, whether we formalize it somehow or not, as part of their investment strategy; wouldn't they?

MR. BONNER: I don't believe that we will ever get to that point, Rob, without a formal structure and without a strategy to get us there. As well, any of the research that I have done certainly indicates that this type of investing would certainly meet the goals we've outlined in the business plan as far as the long-term prosperity of the fund.

MR. LOUGHEED: So, in other words, it would be better to have somebody sit in judgment of these things ahead of time, in advance of citizens' feelings about their values and their investments themselves in these.

MR. BONNER: We would certainly want, Rob, some mechanism to look at what Albertans value. I think one of the more obvious examples is if we look at Nike. When pressure was put on them because of child labour, certainly they made corrections in their policies. When we look at something as simple as McDonald's using a styrofoam container for their hamburgers, when children started to put the pressure on McDonald's, they reacted to that pressure very quickly.

I think, as Paul has said, there are people that are already doing this type of investing in the world. We certainly could look at the criteria that they have set up. It certainly wouldn't be too difficult to go to the people of Alberta and get their input – we've done it for so many other things – and see if that criteria fits with their values. We could certainly implement that or, if we so chose, have that external manager that does do socially responsible investing handle this for us.

MR. LOUGHEED: So, Bill, would you suggest, then, that a committee convene to determine the value of some shoe manufacturing company's contribution to the economy in another country and their use of child labour and so on and decide ultimately that that would be negative? Would that be a more quick mechanism than some prudent investment manager, sensing that there was trouble in the Third World and wanting to bail out of his investment in that company, making a quick decision to no longer invest in that company because of these difficulties that he would foresee coming to pass?

MR. BONNER: I would say, Rob, that probably that investor – and again we would be looking at certainly an investor with a track record that has had proven performance over the years. We would look at that person, and if they had the credentials that we wanted, we would realize that we wouldn't require a committee here to redo or reinvent the wheel. We could set what we wish, based on the values of Albertans, as our priorities in investing and what we wish not to invest in and certainly give that direction to these managers.

MR. LOUGHEED: Given that same kind of thinking, then, you've also commented on avoiding companies that have bad practices, because there's going to be cleanup costs, there's going to be litigation, and so on and so forth. Right?

MR. BONNER: Correct.

MR. LOUGHEED: So a prudent manager, it would seem, would automatically avoid investing as soon as he knew about such activities or, in fact, bail out of those companies. Would that not be the case?

MR. BONNER: Oh, most definitely. I think, Rob, all we have to do is look at what's happened with Enron in the States right now. With all the watchdogs that are presently involved, people lost millions; people lost life savings. Certainly they were on best practices at that particular time.

MR. LOUGHEED: Would that have been an unethical fund a year ago?

MR. BONNER: I do not know. I have not done that; I could not make that evaluation right now.

MR. LOUGHEED: So essentially you're left with prudent decisions by financial managers that would be investing in the best companies, and you submitted that the best companies are ones that operate in an ethical manner. So it would seem to me that almost any fund manager we would have would be operating an ethical fund in the best interests of all Albertans anyway.

MR. BONNER: What we would do if we were looking at an ethical method of investing, Rob, is certainly not to look only at investing and getting good returns on our money. I think there are other things involved here as well, and those would reflect what Albertans wish in their investments. People throughout the world are doing this, and it is a growing field, ethical investing. It's certainly something where there are people that have expertise in this particular area. I think overall we've done exceptionally well when we look at the Alberta heritage savings trust fund, but that doesn't mean that we can't do it better.

MR. LOUGHEED: So just to clarify, then, it would appear that there'd be a convergence between the behaviour of our fund managers who would be investing prudently and ethical fund managers.

MR. BONNER: I would think that overall I would not see a great deal of difference here, but I certainly think that people who look at ethical investing look at companies that reflect the values of society. Certainly right now we are relying on the governance of those companies and their track record more than we are on the reflection of the values that we think are important, whether those be in regards to child labour, violation of human rights, environmental concerns, whatever.

3:45

MR. LOUGHEED: Just a last question. We were talking earlier about selling short, and you had some discussion questions on that. Would you view selling short in nonethical funds to be an ethical practice?

MR. BONNER: If we were to sell short – would you please repeat that?

MR. LOUGHEED: Well, if you were to sell short in funds that were deemed nonethical, would that be ethical?

MR. BONNER: I don't know where you're going with this, Rob. I'm sorry.

MR. LOUGHEED: Well, that's just a question. Do ethical fund managers do that?

MR. BONNER: I don't have an answer for that. I'm not sure what their practices are when it comes to this.

THE CHAIR: I'd like to interject here at this point and say that this goes back to the beginning of this whole discussion. I think what Mr. Pugh said right at the start was that this is a very complex issue and a complex subject completely, and right now, at the present time, you're not doing anything unethical. You have ethical fund managers; correct?

MR. PUGH: As far as we know, they're ethical.

THE CHAIR: Yes. And you would not exclude ethical funds, by definition, from your portfolios for any reason. If they were prudent in return, your fund managers would look at them.

MR. PUGH: The answer is yes.

THE CHAIR: So, then, to further this: is there a need for us to open the act with regards to looking at what all Albertans would like as far as ethical funds? That could be changing or not changing with regards to – using Enron as an example, what was ethical a year ago is unethical today perhaps. Do we need to open the act to that? I put the question to the committee: do we want to open the act on something as complex and nebulous as that?

MR. KNIGHT: I'd like to comment on that, if I could, Mr. Chairman. The company name Talisman was brought up. It has been suggested that merely by Talisman's corporate presence in the Sudan they therefore would become ineligible under our new way to invest. Of course, as Mr. Bonner has pointed out, the guidelines that we would have to use would be: what would Albertans consider to be ethical? I think that if you canvassed every Albertan that has an investment portfolio today, you may very likely find that more than 50 percent of them would have investments linked to Talisman or companies very similar to that. So how are we going to decide whether we would strike Talisman off or not?

THE CHAIR: I have to agree. That's what I'm saying: the complexity of this and to incorporate it into the act. To not diminish, Mr. Bonner, you moving forward, you cited Nike and Talisman. They are reviewing their practices. Talisman is looking at the Sudan as Nike had looked at their practices in the likes of Pakistan and other areas of the world. I mean, we certainly want to pressure countries or companies to continue to be ethical in the treatment of human rights and the like, but to move to open the act to deal with ethical and unethical, I think, again becomes very complex. What process would we go through to do that? We have prudent and ethical fund managers at the present time.

I again put the question to this committee: do we want to open up the act, to start down the path of changing ethical and unethical funds mandated. It may end up at some point in time that they may shift, and we'd have to come back and look at the act again. Then it handcuffs our fund managers. So I ask the question. Would somebody move – I guess Mr. Bonner has – that we open the act to look at ethical funds?

MR. VANDERBURG: I just want to make a comment.

THE CHAIR: Go ahead, George.

MR. VANDERBURG: You know, I am not prepared to change our investing scheme or investing principles solely on a feeling that we should have a certain portion of our funds in ethical funds, but I'm saying that we should be open-minded. I'm sure that our management is very open minded, that we do indeed look strongly at ethical funds. They may be a great return on our investment. I'm sure that management will look at that and do look at that, you know, if there are specific funds, and I will too. I've never really given it a lot of thought. I don't want to tie the hands through legislation or through changing the way we do business, but I do encourage management to investigate so-called ethical funds to see if they are indeed a good investment for our trust fund.

THE CHAIR: Thank you, Mr. VanderBurg. I agree completely with your comment.

Mr. Bonner, I commend you for bringing forward this item so that we do, all of us, consider looking at the practices out there. I'm sure that Mr. Pugh and his staff, as I indicated earlier, don't exclude ethical funds if it's prudent and they are a good investment. So I think our best practices right now do include them. Is that right, Mr. Pugh?

MR. PUGH: From the perspective that all our managers are ethical and follow good corporate governance in their investing, the answer is yes.

THE CHAIR: Thank you.

MR. BONNER: Just a point of clarification, if I can, Drew. At no time today in our discussion did I or Paul or anyone indicate that we should get out of Talisman. It was just the example that Paul and I brought up. Like with any other company that we want to invest in, if we did have some guidelines or some procedure, they would be judged as any other company.

THE CHAIR: No, Mr. Bonner, I didn't take it that you were singling out Talisman. It was just that you cited an example. What we were looking at is the complex issue of opening the act.

MR. LOUGHEED: Can we have a motion?

THE CHAIR: Bill has actually got it. He's asked in this letter that we open the act. So do you so move?

MR. BONNER: I so move.

THE CHAIR: All in favour?

AN HON. MEMBER: Seconder?

THE CHAIR: No, we don't need it in this committee. [interjection] We would? Okay.
Second? It dies.

MR. BONNER: Well, thank you very much for your considerations. It's been a very good discussion, and I certainly enjoyed it. Thank you very much for the opportunity, Drew, of bringing it up here.

THE CHAIR: Thank you, Mr. Bonner.

MR. VANDERBURG: Again a point, Mr. Chairman. I don't believe that the comment is appropriate that it dies. I think the management should always continue to look at all funds, including ethical funds, to see if there is a return for Albertans.

THE CHAIR: So noted, and my comment was with regards to opening the act only, not with regards to looking at ethical funds in any way, shape, or form, Mr. VanderBurg. Thank you.
The next meeting I will call at the appropriate time. I now ask for a motion of adjournment.

MR. LOUGHEED: So moved.

THE CHAIR: Thank you, Mr. Lougheed. All in favour? Opposed? Thank you very much, everyone.

[The committee adjourned at 3:54 p.m.]