Legislative Assembly of Alberta

The 28th Legislature
Second Session

Standing Committee
on the
Alberta Heritage Savings Trust Fund

Annual Public Meeting, Edmonton

Thursday, October 9, 2014
4:30 p.m.

Transcript No. 28-2-4

Legislative Assembly of Alberta
The 28th Legislature
Second Session

Standing Committee on the
Alberta Heritage Savings Trust Fund

Casey, Ron, Banff-Cochrane (PC), Chair
Jablonski, Mary Anne, Red Deer-North (PC), Deputy Chair

Amery, Moe, Calgary-East (PC)
Barnes, Drew, Cypress-Medicine Hat (W)
Dorward, Hon. David C., Edmonton-Gold Bar (PC)
Eggen, David, Edmonton-Calder (ND)
Khan, Hon. Stephen, St. Albert (PC)
Quest, Dave, Strathcona-Sherwood Park (PC)*
Sherman, Dr. Raj, Edmonton-Meadowlark (AL)
VanderBurg, George, Whitecourt-Ste. Anne (PC)**

* substitution for Stephen Khan
** substitution for David Dorward

Ministry of Treasury Board and Finance Participants

Aaron Brown	Director, Portfolio Management, Capital Markets
Lowell Epp	Acting Assistant Deputy Minister, Treasury and Risk Management

Alberta Investment Management Corporation Participants

Leo de Bever	Chief Executive Officer
David Goerz	Executive Vice-president, Investment Strategy and Risk Management

Office of the Auditor General Participant

Merwan Saher	Auditor General

Keynote Speaker

Randall Morck	Professor, University of Alberta School of Business

Support Staff

W.J. David McNeil	Clerk
Robert H. Reynolds, QC	Law Clerk/Director of Interparliamentary Relations
Shannon Dean	Senior Parliamentary Counsel/ Director of House Services
Philip Massolin	Manager of Research Services
Stephanie LeBlanc	Legal Research Officer
Nancy Robert	Research Officer
Corinne Dacyshyn	Committee Clerk
Jody Rempel	Committee Clerk
Karen Sawchuk	Committee Clerk
Christopher Tyrell	Committee Clerk
Rhonda Sorensen	Manager of Corporate Communications and Broadcast Services
Jeanette Dotimas	Communications Consultant
Tracey Sales	Communications Consultant
Janet Schwegel	Managing Editor of *Alberta Hansard*

Transcript produced by *Alberta Hansard*

Standing Committee on the
Alberta Heritage Savings Trust Fund

Public Participants

Ken Allred
Colin More
Mark Zeltserman

4:30 p.m. **Thursday, October 9, 2014**

[Mr. Casey in the chair]

The Chair: Good evening. Welcome to the 2014 annual public meeting on the Alberta heritage savings trust fund. My name is Ron Casey, and I'm the MLA for Banff-Cochrane and chair of the standing committee on the fund.

It's certainly a pleasure to be holding this meeting for the first time on the University of Alberta campus. The U of A was chartered in 1906 and started operation in 1908 with just 45 students. One hundred and six years later current enrolment sits at 35,000-plus students, and the U of A is recognized as one of the finest educational institutions in the country. By holding the meeting here, we had hoped to engage more students in the discussion involving the Alberta heritage savings trust fund since they will be the beneficiaries of many of the decisions made as we move forward and plan the future of the fund.

The $17.5 billion Alberta heritage savings trust fund is a large part of a better Alberta for tomorrow. We're here today to discuss what's new for the fund in 2014 and how the fund will continue to provide a brighter future for our province in the years ahead.

I'd like to begin the meeting by introducing the rest of the panel. The members of the standing committee, beginning on my right, are: Mr. Dave Quest, MLA for Strathcona-Sherwood Park, who is substituting for the hon. Stephen Khan; Mr. Moe Amery, MLA for Calgary-East; Dr. Raj Sherman, MLA for Edmonton-Meadowlark; and to my left, Mr. Drew Barnes, MLA for Cypress-Medicine Hat; Mr. George VanderBurg, MLA for Whitecourt-Ste. Anne, who is substituting for the hon. David Dorward; and Mr. David Eggen, MLA for Edmonton-Calder. I should mention that our deputy chair, Mary Anne Jablonski, unfortunately fell last night and broke her shoulder, so she is unable to attend the meeting with us.

We are the Standing Committee on the Alberta Heritage Savings Trust Fund, which is an all-party committee of the Legislative Assembly. Part of our mandate is to review and approve the performance of the fund and report back to Albertans and the Legislative Assembly. The President of Treasury Board and Minister of Finance is ultimately responsible for the fund and its investments. The department looks after setting the fund's long-term strategy, developing its investment policies, and monitoring the performance of its investments.

Joining us onstage from Alberta Treasury Board and Finance are Mr. Lowell Epp, acting assistant deputy minister of treasury and risk management, and Mr. Aaron Brown, director of portfolio analysis, capital markets.

The Alberta Investment Management Corporation, or AIMCo, is responsible for making and managing investments in stocks and bonds and other investment instruments within the fund's portfolio. Joining us from AIMCo are Dr. Leo de Bever, CEO, and David Goerz, executive vice-president, investment strategy and risk management.

We're also pleased to welcome to our panel today Dr. Randall Morck, who joins us from the Alberta School of Business here at the University of Alberta. I'll introduce Dr. Morck more thoroughly in a moment.

I'd like to remind everyone that tonight's meeting is being broadcast live on Shaw TV and streamed on the Legislative Assembly website at www.assembly.ab.ca. I would encourage everyone to join the conversation and contribute to our discussions during the live broadcast. You can submit your questions through Twitter, by e-mail, or by calling in. The information can be seen on the bottom of your screen. This meeting is also being recorded by *Alberta Hansard*, and transcripts from this meeting will be available online on the Assembly website.

Now, we have a panel made up of a number of experts and politicians. While not necessarily our style, we will try to keep our points and answers as brief as possible to allow us to address as many of your questions and comments as possible during the question-and-answer segment of the meeting, which will immediately follow our panel presentations. Your input is important to us, and I would encourage everyone to participate. I need to hear, we need to hear and understand what Albertans expect of this amazing legacy fund. By the end of this meeting we will have walked you through the history, mission, long-term performance, and future of the Alberta heritage savings trust fund.

In the spring of 2013 the Fiscal Management Act was passed by the Legislature. The act renews Alberta's fiscal framework and creates the requirement for an operational plan, a savings plan, and a capital plan. Under the new savings plan over the next few years contributions will increase until ultimately 100 per cent of the income is retained within the savings fund by 2017-18.

In 2014 a number of new, important endowments were established within the heritage fund, which our guests from Alberta Treasury Board and Finance will elaborate on later. Some very exciting changes are on the horizon, changes that will ensure that the fund is relevant and valuable for our children and grandchildren.

With that, let's take a moment and watch the following video on the Alberta heritage savings trust fund before we begin our presentations.

[A video was shown from 4:36 p.m. to 4:44 p.m.]

The Chair: Thank you.

I'd now like to invite Mr. Lowell Epp, with Alberta Treasury Board and Finance, to walk us through a financial update and the new endowments established within the heritage trust fund.

Mr. Epp: Thank you, Chair Casey. Thank you for allowing us the opportunity to make this presentation.

The heritage fund was established, as said in the video, in 1976 by an act of the Legislature and has grown to 17 and a half billion today. The investment objective of the fund is set out in the heritage fund act, the Alberta Heritage Savings Trust Fund Act, and it is to maximize the long-term investment earnings of the fund within a prudent level of risk.

The fund has a long-term view. It is not concerned with short-term volatility in the markets but takes a long-term view because it is for the long-term benefit of Albertans. This long-term view allows the fund to earn higher returns over time.

Meeting the heritage fund's investment objectives requires a global focus. The heritage fund is well diversified across many asset classes in its investments and is diversified with investments throughout the world.

Cost is also an important factor. The Alberta Investment Management Corporation manages the fund along with, in total, approximately $70 billion of pension and public funds. This allows for cost-effective investment management, much more so than if it was invested on its own.

The next slide, please. The target asset allocation is shown on the slide. The target asset allocation is, in general, the target for where the fund should be invested. Money market and fixed income make up 20 per cent of the fund typically. Inflation-sensitive and alternative investments make up 30 per cent, with equity investments making up 50 per cent of the fund. Ranges are established for each asset class. This ensures that the fund's manager, AIMCo, has the ability and the flexibility to adjust the allocations to various asset classes as it sees fit to take advantage of opportunities that it sees in the market. This policy portfolio is one expression of the province's risk tolerance for the fund. The actual allocation of the fund at March 31 was money market and fixed income of 19 per cent, inflation-sensitive and alternative investments of 27 per cent, and equities at 54 per cent.

During the year the fund generated a record income of $2.3 billion. The equity portfolio earned $1.8 billion in income, with the majority coming from global equities. The inflation-sensitive and alternative investments earned $256 million, and the fixed-income portion of the portfolio earned $171 million.

While this was a record year, the fund has been contributing to the province's budget since its inception. Since 1976 the heritage fund has contributed over $36 billion to the Alberta budget or the general revenue fund to pay for Albertans' priorities.

In addition to this money, there are two additional endowment funds that have been created from the Alberta heritage savings trust fund. The medical research fund and the scholarship fund were both created with seed contributions from the heritage fund. The Alberta Heritage Foundation for Medical Research endowment was started in 1980 with $300 million from the heritage fund and now stands at a balance of about $1.5 billion. The Alberta heritage scholarship fund was established with $100 million from the heritage fund in 1981 and each year helps fund scholarships for postsecondary students. This fund now has a balance of approximately $1.1 billion.

4:50

When we look at historical performance, as we said earlier, long-term performance is the most important measure for the heritage fund. When we look at historical performance, we will see that this year we earned 16 per cent but that over the last five years we've earned a return of 12.7 per cent. Over 10 years, which includes the down markets in the late part of the last decade, we have averaged a return of 7 and a half per cent. Those are strong returns. The heritage fund over the long term is expected to earn a 4 and a half per cent return over inflation, a real return of 4 and a half per cent on a moving five-year period. Over the last five years inflation has averaged 1.8 per cent, so we are well ahead of that target.

In terms of last year's performance you can see on the graph that global equities were the strongest performer, with a 28.3 per cent return. Canadian equities were also very strong, at 18.8 per cent. Private equities were very strong, 9.6 per cent, but we also had good contributions from real estate. Infrastructure and fixed income had lower returns. Interest rates are low, so we can't expect to earn a tremendous return from fixed income, clearly. The fund is weighted towards equities for a reason. These classes produce the highest returns on average over a long period of time, and last year certainly bore that out.

As mentioned earlier in the video, the Fiscal Management Act was passed by the Legislature last year, starting with an implementation in 2015-16, in that fiscal year. Five per cent of the first $10 billion in nonrenewable resource revenue will be dedicated towards savings, 25 per cent of the next $5 billion in revenue from nonrenewable resources will be dedicated towards savings under this act, and for any revenues from natural resources above $15 billion, 50 per cent of that will go into savings for the province.

The contingency account will be topped up to $5 billion. That's what the act said. The government's first-quarter fiscal report showed that the balance of that account is $5 billion and will not need to be topped up with future natural resource revenues.

At the present time the general revenue fund is the recipient of all investment income from the heritage fund except for a small amount that is set aside every year for inflation-proofing. As part of the Fiscal Management Act, that was passed by the Legislature, going forward, starting in the fiscal year 2015-16, 30 per cent of the fund's investment income will be retained, in 2016-17 50 per cent of the income will be retained, and starting in 2017-18, the act requires that all income of the fund be retained within the fund to allow it to grow. The only exceptions will be endowments. For the endowments within the heritage fund, which I'll talk about in the next slide, money to support those priorities will come out of the fund.

There are four endowments within the heritage fund. The access to the future fund supports advanced education, some spending in advanced education. The social innovation endowment and the agriculture and food innovation endowment: these were both new, announced in the most recent budget. The social innovation endowment is to encourage innovative research and programming in the social space. The agriculture and food innovation endowment is intended to provide money for innovation and commercialization programs within the agriculture and agribusiness sectors.

The social innovation endowment has a balance of $500 million this year. It will be increased to a billion under the legislation next year. The agriculture and food innovation endowment has a balance of $200 million. The access to the future endowment has a balance of about $1.1 billion. All three of these endowments have spending priorities attached to them. Ultimately, for each of these endowments 4 and a half per cent of the value of these endowments within the heritage fund will be transferred to pay for spending as outlined in their objectives. The 4 and a half per cent allows them to spend an amount that allows the fund to grow and so allows spending on current priorities but also to maintain the value of the fund over time and, as the fund grows, to increase the amount of income transferred.

The Alberta future fund: $200 million will be allocated in each of the next 10 years, ultimately to a balance of $2 billion plus whatever investment earnings go with it, to fund priorities of Albertans. Before this money can be taken out, it has to be authorized by a vote of the Legislature, but if there is a priority of Albertans that can benefit future Albertans or current Albertans, this money is available should the Legislature decide to spend it. There is no annual income allocation that comes out of the fund with respect to the Alberta future fund.

It should be noted that these funds are not stand-alone investments. They are integrated within the heritage fund, and they are a notional account in many ways. They are part of the heritage fund.

With that, I will pass it back to the chair. Thank you.

The Chair: Thank you, Mr. Epp.

I'll now call upon Dr. Leo de Bever, chief executive officer of AIMCo, to provide us with a market update.

Dr. de Bever: Good afternoon. I've entitled my presentation Investing in Alberta's Long-run Productivity at a Profit, and that came out of something that Doug Horner found when he went to talk to the population about what they would like the heritage fund to be. He found that a consistent theme was that they wanted some small portion of the heritage fund to be deployed in investments that would make the Alberta economy more productive right now. As you saw in the video, a lot of the heritage fund is designed to be deployed once the oil runs out, in some sense, but there was a notion that something in the order of 3 per cent – call it $500 million – should be devoted to make the current economy more productive, which indirectly would help government revenues both from royalties and taxation.

Now, my presentation will have two parts. The first part will be pretty depressing, and it's about what the future is supposed to be. Then I'll get into why we should be able to make that future a lot better if we do follow that long-term investment strategy.

My main points are that the typical outlook that you get from economists – and I should admit that I'm a recovering economist myself – is pretty depressing because you basically extrapolate from what you see around you, and demographics and fiscal policy tend to put a lot of pressure on the outlook, and the improvement in standard of living would seem to be limited. What I'm trying to tell you in the second half of this presentation is that we don't have to accept that. If we don't like the future that the economists spell out for us, imagine a better one, and then try and figure out how you implement it.

What role can the heritage fund play in that? Well, it turns out that that long-term future needs long-term capital, and an endowment like the heritage fund is in a very good position to make very long-term decisions. It would only do so, obviously, if the return were to be superior, with the fact that you have to wait longer for it to materialize.

The typical economic outlook, in the next slide, is weak. A lot of people say, you know, that the glass is half empty, and the reason for that is that a lot of our fiscal policy and pension policy was designed 40 years ago. Some of the premises behind those policies turned out to be wrong, and what's happening now is that governments are trying to deal with the implications of that. On top of that we've not been particularly good at making social decisions that make productivity higher, and everybody is looking for somebody to do something about it except I don't know who that somebody is.

5:00

Now, things probably are not quite as bad as the numbers would indicate. When you hear growth numbers, they're measured against a measuring stick that's probably not quite accurate. I won't get into the details, but it probably underestimates economic growth and somewhat overestimates inflation compared to if you did it completely the right way.

Now, if you look at inflation, the next slide, it's pretty benign right now – as was said earlier, it's running in the 1 to 2 per cent range – and part of the reason for that is that we have an enormous amount of innovation and technological change going on. That tends to be deflationary in some sense because it tends to – like, look at computers. I mean, you used to have to pay $5,000, $6,000 to buy a computer. Now you can buy a similar computer or a better one for $1,000 or for $500. That's one indication of how technology works. Because inflation has been so low – that's part of the reason that interest rates are low, and as you can see here, from the '50s till about '81 interest rates rose. Some of you may remember in the early '80s mortgage rates being somewhere around 20 per cent. Now those days are long gone. Inflation is much lower. Interest rates have dropped with it.

We seem to be at an inflection point. What that means is that holding a lot of bonds is not very profitable. As I've said in a number of different contexts, there are really only two outlooks for bonds: terrible and really terrible. The terrible one means that you have interest rates that stay very low, so you have a consistent low yield. But if interest rates go up, that means that if you hold long-term bonds, you're going to have capital losses because those old bonds are at low interest rates. The newer bonds are at high interest rates, so relative to the new bonds the old bonds are less valuable, and that shows up in a reduction in the capital value of those bonds.

The next slide is a bit geeky if you're not an economist by training or have never taken an economics course. This solid line is something called the efficient frontier. It basically says that on the horizontal axis you've got risk, on the vertical axis you've got return, and the central notion is that if you want to have a higher return, you have to take more risk. That's the way it usually works, and that would reflect an efficient market. We can argue over efficient markets, but in the near term they're not likely to be very efficient, and that thin line is the way AIMCo currently sees that efficient frontier.

The weird part about it is sort of reflective of what I just told you. At the low-risk end of the spectrum – in other words, the bonds and treasury bills and sort of lower risk kinds of investments – the returns on those assets are not likely to be very high whereas on the high end of the risk spectrum the return on risk is likely to be pretty decent if you take a 10-year horizon. Now, this week that's not particularly the case. If you've been following the stock market, it's been down quite a bit. Stock markets go up and down, but in the long run they tend to deliver a return that is sort of commensurate with a higher risk than you're having on bonds.

Now, let me shift from the depressing part to something that should be a bit more uplifting. I think we have to imagine a better future, and what I mean by that is that the future that's been handed to us is not a given. We can change it. You know, we're human beings. We can figure out what's causing it to be slow and see what makes it better, and one of the key ingredients in that, if you want an economy to grow faster, is to get more leverage out of what you do with your capital and your labour; in other words, become more productive. To have higher growth given the same labour force, you need to either make more investments in innovative technology or you make your people more productive, and we can do both. In that context endowment funds can play a role, and they can make money doing so. Commercialization of new technology requires capital. It requires other things as well, and that can increase the growth rate of the economy.

Why do I think that that is possible? The next slide. The future is better than you think. There's a book by that name, and for 10 bucks you can download it. It's actually quite a breezy little book that shows you that in almost every sector of the economy innovation and technological change are accelerating. Now, there are some downsides to that in that if you happen to be in a sector that's being phased out – say, take cars. Cars are a much smaller part of the economy than they used to be. The reason is that making cars is becoming a lot easier, and the car industry is a lot more productive. Over time you have to shift people out of making cars to making something else.

You have that increased technological change, and you also have a reduction in scale of almost every new technology that is coming along. This slide says that we have the return of the backyard tinkerer. In almost every sector you find that people that really don't have a lot of capital but have a lot of ideas are coming to the fore with some really drastically new ideas.

Finally, or almost finally, we also find monies being invested not just to make a return for things that are worth while in economies like ours, but people like Bill Gates and Warren Buffett are investing to solve problems in economies that normally don't have the capital to deploy solutions to these. Newton said that if I can see farther, it's because I'm standing on the shoulders of giants. What he meant by that was that new ideas come from old ideas with some retooling. What is happening is that we're having more smart people having more access to more information at lower cost than any time in history. That's part of what is driving that acceleration of innovation.

Okay. That's all very interesting, but how does AIMCo fit into this? Well, first of all, as Lowell pointed out, we run our own business in a very efficient way. We can do that because we're managing a lot of money. As you manage more money, up to about $200 billion, the unit cost of doing almost anything will fall as you do it. The Canadian pension model, which is sort of what AIMCo is the latest entrant to, has had a 20-year history of innovation, of investing more efficiently and investing in new asset classes that at least initially had a much higher return. As a result they were able to deliver a lot more value to their customers.

You have to be realistic, and you have to have realistic expectations. That year that we had for the heritage fund last year is not going to be every year, and 14 or 16 per cent is double what is a normal year. You have to take the good with the bad. You're going to have some bad years and some good years, and on average, as was pointed out, 4 and a half per cent plus inflation is probably in the very long term something that's quite feasible. The thing that AIMCo adds to that is not what the markets deliver. Markets go up; markets go down. I don't control that. What we deliver is extra value by seeking out investments that at any given point in time have a higher than average rate of return for the risk we have to take.

Now, the trouble is that past innovation is no longer the edge that it was. I was one of the pioneers of investing in timberland and infrastructure and commodities within pension plans. Well, there's so much capital flowing into those asset classes that the return has come down. I'm of the view that you can't do extraordinary things with ordinary means, so you have to come up with a new way to deliver that extra return. When you look at pension and endowment experts, the one thing that we haven't done that we should have been doing and that we say we're doing is to take a very long view on investments and see if we can capture opportunities where that long-term horizon delivers an incremental return.

Now, since I've been at AIMCo, we've had four big themes in trying to seek out those opportunities. They've been energy, food, materials, and something that we call enabling technology, which is basically digistic robotics, anything that improves the general operation and productivity of the economy. It just so happens – and we didn't design it that way – that three of these factors are very important for Alberta, energy in particular. I'll be talking a bit more about energy, but when you look at what is possible in those sectors and what we see happening in those sectors right now, the new things in progress are quite amazing.

AIMCo has a lot of investments, not just in conventional energy, but we have them in wind power, solar, fuel cells, and so on. Energy has been a driver of almost any revolutionary change in the economy for almost 2,000 years, okay? The invention of the wheel was, in a sense, the use of energy. The introduction of oil allowed us to get a lot more oomph out of a given weight of energy. The internal combustion engine allowed us to make better use of that energy. So there's been a lot going on in energy almost since the beginning of human civilization.

5:10

In food we have a lot going on in Alberta that could be useful in terms of exports to Southeast Asia. We have a rising middle-class population there. They want higher quality foods, and some of that food can be provided by Alberta. Western Canada is going to be one of the five exporting regions in food in about 15 or 20 years.

In materials we see all sorts of change. For instance, we see in forest products that the demand for newsprint has gone down, but the demand for forest products has not. The demand has been replaced by the use of wood as a source of biomass to make energy or to make chemicals. Of course, enabling technology, the use of data centres to crunch data and get more information out of them to improve how economies run, is now no longer a secret. One of the most promising things that affects the Alberta economy – a lot of things go under the label of big data – is continuous monitoring of pipelines and industrial operations, for instance, to predict when a pipeline might be about to have a weakness that cause a rupture. It's better to find that before it happens than to have to clean up after it happens. So there's a lot of energy being devoted to that.

Now, let's focus on energy for a moment. Looks like we lost energy here for a moment. Innovating investment is necessary for two reasons. In Alberta we've seen oil go up from $20 to $100 in the last 15 or 20 years. It's not going to go to $500, I can guarantee you. There's some debate about whether the increase in the demand for energy is going to drive up the price. I would argue that that's offset by the fact that there's more energy being found. For instance, North America is going to be almost energy sufficient, and no one had predicted that even 10 years ago.

The other thing that's happening is that the high cost of energy has caused conservation of energy, so there's less per unit of GDP. There's less demand for energy. On top of that you've got the replacement of conventional oil and gas and conventional energy with things like wind and solar and so on. Those things are growing at about 10, 15, 20 per cent compound rates. Within 10 or 20 years, within that kind of a period you're going to have 30 per cent of total energy being provided by these alternative energy sources.

Now, we have a problem in Alberta. Right now we are a very high-cost producer. Heavy oil, which is going to be increasingly the bulk of what we produce, tends to be very energy intensive, water intensive, and as a result has the additional problem of being environmentally CO_2 intensive, which is not a good thing in the current environment. But I think there's technology around to fix all of those things. If you can reduce energy intensity, water intensity, CO_2 intensity, then you can do two things. You can make the sector more productive, but you can also make yourself the poster child of being responsible energy developers.

One problem that comes in there, which fits in with what the heritage fund is designed to do is that energy has the longest lead time in innovation of any sector other than pharmaceuticals; in other words, going from the technology that's pretty well proven but not commercialized yet to that implementation phase. You may be familiar – sometimes it takes 20 or 25 years to get something commercialized in pharmaceuticals. It's not quite as long in energy, but it's close. In fact, some of the technologies that we're using now in the oil sands are 50 or 60 years old. There have been adaptive changes, marginal changes to that technology, but what we need now is a disruptive change that dramatically resets the bar in terms of lowering the cost of getting oil out of the ground and upgrading it to higher value added product.

Now, let's go for a moment to this concept of long-term investing. I keep joking – I'm getting tired of hearing myself saying it – that long-term investing is acceptable to my clients as long as it makes money in the short run. But by definition that doesn't work. If there is a superior long-term return in the kind of project that we're talking about, then I should not be able to replicate that by taking a bunch of short-term investments and stringing them together and get the same outcome. Long-term investing means long-term investing; you have to wait a long time for the result of the decision you make to be obvious.

Now, what are the obstacles to long-term investing? If you look at AIMCo, most of the obstacles are behavioural. If you're the guy making a decision to do something but you're not going to see the reward for that because it's 15 years out and most people don't last in the same job for 15 years, then are you really going to be motivated to do it? I am of the view that if it's the right thing to do, you do it, but we have to structure things so that people don't get penalized for taking the short-term hit to make that long-term benefit possible. Those behavioural restrictions exist everywhere. Regulators tend to be short term, boards of directors are, and people doing valuations of illiquid investments do the same thing. So that's a problem.

Corporations have the same issue. When we talk to corporations, we find that they fund a lot of innovation at the short end, where they basically write it off. It's something you do in a university with lab experiments, and that's fine. They can do implementation of new technology once it is commercialized, once they know that all they have to do is shove it into a two-year business plan and it will work. The stuff in the middle they can't do because shareholders don't give CEOs of listed companies a benefit from investing in something that takes two, five, 10 years to implement. So that's a problem, and that's why there's a scarcity of long-term capital.

Now, the investments in this kind of technology tend to be done by venture capital funds, private equity funds, and they tend to be short-dated vehicles, and because of the long horizon that I just talked about, they tend to run out of money just about the time that they've figured out which of their investments have become productive and which ones are going to need money to get them to that commercialization space. We have too much financial engineering in those vehicles and not enough real engineering. That's what we've set out to get our minds around in designing an innovative long-term investment program at AIMCo.

Now, what other things do we have to do, or what do we have to do in total to make all of this possible? In addition to providing long-term capital, which I just talked about, we also have to get better at making social decisions. In a democratic society it's very difficult to get things done. It's much easier to stop stuff from being done than to actually do it because opposition to almost anything you do, whether it's building a road or a power plant or a manufacturing plant or whatever, is very vocal. So it takes often a very long time for things that are economically and socially beneficial to get done because of the opposition.

We also have to get better not just at capitalizing great companies better but surrounding them with better management. We invest with a company in Silicon Valley, and one of our biggest disappointments was not because they invested in a technology that wasn't viable but because they didn't have the right management in place to execute on a business plan. Entrepreneurs that have ideas tend to be a little starry-eyed. They have to have a good board and a good executive team to execute on a business plan that's going to commercialize that technology.

Here's the punchline that I want you to think about. Adoption of new technologies tends to take a long time. Like, it took 30 years for the electrical motor to be optimally deployed in society. We don't have 20 years in Alberta. We're going to have to figure out in the next five years how to become quickly more productive in energy, or we're going to miss the boat.

Now, I believe that the people who say that the future is going to be bleak are going to be wrong. I believe that the people who say that we can change that and we can do it by deploying technology more effectively are probably right. But we have to set our mind to it. We can't just sit back and let things happen. Things will not happen on their own. They'll only happen when people who have the conviction that things can be changed for the better step up to the plate and have their influence felt.

Thanks very much.

5:20

The Chair: Thank you, Dr. de Bever.

I'd like to just take a moment and recognize the amazing work that Dr. de Bever has done and AIMCo has done for the province of Alberta and for the residents. A 16 per cent return last year on the heritage trust fund amounted to a $2.1 billion return for Albertans. That's an amazing number, but as he points out, that was an exceptional year. What is exceptional is that in five years we've had an average rate of return of 12.7 per cent and over 10 years, 7.5 per cent. So AIMCo has done an amazing job for Alberta and continues to do that, and they deserve a great deal of credit for the management of this fund.

It's now my pleasure to introduce our keynote speaker. Dr. Randall Morck holds the Stephen A. Jarislowsky Distinguished Chair in Finance and is a distinguished university professor at the Alberta School of Business here at the University of Alberta. Dr. Morck has served as a consultant to the Canadian and U.S. governments, the World Bank, and the International Monetary Fund on corporate governance and other economic issues. He is a frequent speaker at academic, business, and government seminars and conferences in Canada and abroad, and today we are honoured to have Dr. Morck speak with us on the topic of sovereign wealth funds.

Dr. Morck.

Dr. Morck: Thank you very much. It's an honour to be here.

I don't have a lot to add to what Dr. de Bever said. I agree with quite a lot of it, in fact. The idea that the world is coming to an end and that technology is slowing I think is something that's been proved wrong over and over again. It's not a new idea, that we're coming to the end of technological progress, and everybody who's said it has been wrong.

What I'll do instead is talk about sovereign wealth funds, investment funds run by governments. These are becoming a very big deal. The Alberta heritage fund was one of the first, but there's also an Alaska fund and a Texas fund and a Norway fund and a bunch out of China and some Russian ones. Economists have been looking at these funds in increasing detail and with increasing interest.

So let me begin by talking about my two favourite sovereign wealth funds. I hope that you won't be offended that the heritage fund is not my favourite in the world. My two favourite investment funds are the Kiribati revenue equalization reserve fund and the Nauru phosphate royalties trust.

What are they? Well, the Kiribati revenue equalization reserve fund was set up in 1956. Kiribati was a natural resource rich economy. It's a little island in the Pacific, and for millions and millions of years birds had been flying over this island and dropping their bird droppings on it until there were dozens of metres thick of bird droppings. So you can mine this and get phosphate out of it. Nauru is another island. It's also in the Pacific Ocean. It was another target of these birds, and it likewise had dozens of metres of bird droppings on it. They also set up a sovereign wealth fund to invest their revenue from mining bird droppings.

The Kiribati revenue equalization reserve fund hired professional managers to run their fund and reinvest their bird droppings revenues. The fund assets are now about $600 million, and there's an ongoing income stream that's funding low taxes and construction of airports and roads and stuff on the island of Kiribati.

With the Nauru phosphate royalties trust the politicians there didn't want to trust professional money managers, so the politicians invested the money themselves. They invested it in Air Nauru, which was an airline where all the politicians, you know, got special treatment, a bunch of real estate ventures, a musical, and all sorts of nation-building exercises. The net asset value of the Nauru phosphate royalties trust a few years ago was negative, hundreds of millions of dollars negative, but now it's zero thanks to a capital injection from the Republic of China, Taiwan. So Nauru now recognizes Taiwan as the sole legitimate government of all of China.

I think that those two kind of represent extremes of sovereign wealth funds. Fortunately, Alberta is a bit more like Kiribati, and that's a good thing, but it's not totally clear that we want to go all the way and just build up wealth in our sovereign wealth fund. You know, we can reinvest all the revenues; we can keep on building up wealth and have more and more money. But is that really a good thing? Well, if you believe that having more savings is always good, then you think that's probably a good thing, but it's not entirely clear that leaving a huge bundle of stocks and bonds to future generations is kind of the best bequest we could give them, and the politicians who favour the use of nation-building objectives for sovereign wealth funds point out that you can build up the economy and that that's a way of leaving a legacy to future generations.

There are intermediate approaches to sovereign wealth fund management, and the two that the heritage fund has experimented with or adopted to different degrees over the years are budget smoothing and a wealth buffer. The idea of a wealth buffer is that you get a whole bunch of money from oil and gas when oil and gas prices are high. You can't spend it all immediately, so you put it in stocks and bonds, and then you draw that down and build hospitals and schools and roads and so on over time. So you convert the financial assets into real assets, infrastructure and so on. The idea there is that the hospitals and schools are a better legacy to future generations than stocks and bonds might be.

The budget smoothing, the rainy-day fund idea, is also popular in sovereign wealth funds. The idea there is that you buy securities when the economy is booming, and then when the economy is doing badly, you sell them and use them to inject money into the government and make government budgets predictable. That kind of makes sense, too. The problem with that is that it guarantees that you're always buying high and selling low, right? You're buying stocks in booms and selling them in busts systematically always, all the time. It's hard to have, you know, a consistent high return when you're required to do that.

Which of those policies we take is kind of up to the politicians, and in Alberta that means that it's up to the voters. It's a democratic exercise. I think increasingly now we're coming towards the idea that we don't want to do nation-building, that we want to build up a portfolio of financial assets for times when the price of oil will be lower and when government revenues will be more restricted.

There's a lot of other economics research on sovereign wealth funds. Another thing that Dr. de Bever didn't mention is that sovereign wealth funds are kind of good for all the rest of us because when sovereign wealth funds buy stocks, the price of the stock tends to become higher and stay higher, and we think that's because people like Dr. de Bever, when they're watching a stock, tend to make sure that nonsense doesn't go on that might go on if nobody was watching the CEO. There's perhaps a pressure for good governance that comes from these sovereign wealth funds in general. That effect is larger for more transparent sovereign wealth funds buying the stock. It's larger if the sovereign wealth fund has more knowledge about the industry or the country that the stock is in. Most importantly, it's larger if the sovereign wealth fund is more insulated from political influence.

The effect also has an interesting econometric flavour. I'm getting geeky again; I apologize. The basic idea is that when sovereign wealth funds buy some stock, the price of the stock goes up, but when a sovereign wealth fund buys a lot of the stock in the company, the price actually doesn't go up and maybe can even go down. There's one study in the *Journal of Financial Economics* that looks for an inflection point. I'm not sure how reliable that is. The idea behind it is that you want sovereign wealth funds to have minority interests in a lot of companies, but you don't really want them controlling companies, and that may be because there's a problem of political influence in many of these funds.

There's also real evidence to back up what Dr. de Bever was saying about long-run investments by sovereign wealth funds. For instance, during the financial crisis in 2007 and 2008 what we find is that sovereign wealth funds were buying into the stock market when everybody else was selling. They were actually a stabilizing influence.

5:30

Other people have tried to look at the trading behaviour of sovereign wealth funds: "When do they buy? When do they sell?" One of the things that we worry about in financial markets is herding, the idea that all the investors are kind of chasing trends. That pushes stock prices too high, and then when they all sell, it pushes stock prices too low. The evidence is that sovereign wealth funds tend on average to work against that. They tend to sell when everybody else is buying and buy when everybody else is selling, and that's probably a good thing.

The policy options that are in place for different sovereign wealth funds vary quite remarkably from country to country. It depends on which of those different objectives that I talked about is the key objective for the sovereign wealth fund. In general, the performance seems to be much better if you keep the fund away from politicians. Now, we've got a lot of politicians here, and they're very good people, but politicians are human beings, and they're tempted just like the rest of us. You know, "If by getting a sausage factory employing more people in Three Hills we could win that riding, that would be worth just a little bit of money, wouldn't it? Wouldn't it?" So you have to kind of tie them to the mast to make sure they can't do that sort of stuff, and that's difficult.

One book that I highly recommend to all of the politicians here and anybody who's interested in sovereign wealth funds is a book by Pierre Arbour called *Québec Inc. and the Temptation of State Capitalism.* That book is about the Caisse de dépôt et placement du Québec, a sovereign wealth fund run by the Quebec government. It was founded in 1967 with professional management. Money managers with expertise in finance were supposed to be in charge. It had mandatory independence from politics. Then the Parti Québécois took power in Quebec. What they did was that they merged that fund with another fund, and the other fund had no insulation from politics, so that meant that the merged fund would take over the bylaws and rules governing the politicization. The politicians fired the professionals and hired politically sensitive people. The Caisse ended up with huge problems.

For instance, one of the things they did was a socially responsible investment. At the time the asbestos companies were scaling back their operations because they were concerned about lawsuits, so asbestos mines in Quebec were laying people off. In order to stabilize society, the Caisse ended up injecting money into asbestos mines so they could increase employment. The Caisse even actually bought control of asbestos companies, and the result was that when all the lawsuits hit the fan, it was actually the Quebec government that was being sued by everybody indirectly through the Caisse.

The Caisse has been reprofessionalized now, and again it's being run by professional money managers, but I think that's a cautionary example. It shows how easy it is for a sovereign wealth fund to be politicized even if all the regulations and charters and parliamentary promises and rules and regulations say that it's going to be professional, that it's going to be arm's length. It's impossible for parliament to pass a law that parliament can't later repeal. You know, that's a great thing about democracy, I guess, but it does mean that we have to be vigilant about these things as we go forward.

I don't think that it's a problem for the heritage fund now. All of the things that Dr. de Bever talked about are things that professionally managed investment funds do. There's no evidence that they're going to be politicized, that there's going to be any kind of cronyism or political influence over this. I'm confident that going forward, we will continue to have a well-run fund, but it's okay for the voters to kind of just keep an eye on that, I think.

Thank you.

The Chair: Thank you very much for your great and enlightened presentation here, Dr. Morck.

I'd like to just introduce a couple of MLAs that have come in and are sitting in the audience: first of all, the Minister of Service Alberta and MLA for St. Albert, Mr. Stephen Khan; also Ms Jacquie Fenske, MLA for Fort Saskatchewan-Vegreville; and a former MLA, Ken Allred, from St. Albert. Welcome.

That concludes the formal presentations. Before I open the floor to your questions, I would like to remind everyone that you are welcome to join the conversation and submit your questions to the committee or our panel of experts. You can submit your questions to the Twitter handle @legassemblyofab using #abheritagefund, by e-mail to committees@assembly.ab.ca, or by calling 780.427.1348. For those outside Edmonton, dial 310.0000 for a toll-free connection. You can also see the contact information on your screen. Once again, your comments are important to us, and we will attempt to answer as many questions as possible during the meeting.

I'll now open the floor for questions from our in-house audience. Please be sure to state your name for the record before you begin speaking. Are there any questions from the floor?

Mr. Allred: Yes. Ken Allred is my name. Just a question to Mr. Epp. For clarification, the heritage fund stands at $17.5 billion or $17.6 billion, I think you said. Does that include the other funds – the endowment funds, the medical research fund, the scholarship fund – as well, or are those outside of that $17.6 billion?

Mr. Epp: The medical research fund is outside, as is the scholarship fund. We have four primary endowment funds in Alberta, the heritage fund being about 17 and a half billion, okay? The Alberta Heritage Foundation for Medical Research endowment fund, its official name, is at about $1.6 billion. That is separate from the heritage fund. You've got the Alberta heritage scholarship fund at about $1.1 billion, again separate from the fund that we know as the heritage fund. The Alberta Heritage Foundation for Science and Engineering Research endowment fund is about $900 million. Those are four distinct funds, in total 17 and a half billion plus $3.3 billion, so about 20 and a half billion if my math is right.

Mr. Allred: You also mentioned the access to the future fund.

Mr. Epp: The access to the future fund, the Alberta future fund, the social innovation endowment, and the agricultural research endowment are part of the heritage fund.

Mr. Allred: Okay. Thank you for that clarification.

Just a second question. The inflation-sensitive and alternative investments: could you just clarify what that is?

Mr. Epp: We title it inflation-sensitive and alternative investments because that's the goal of those investments, to protect against inflation. So that would include investments in real estate, timberlands, infrastructure projects, and . . .

Dr. de Bever: Real return bonds.

Mr. Epp: Real return bonds. Thank you.

Mr. Allred: Okay. I guess I'm having a hard time distinguishing that from equities, et cetera, which are also inflation sensitive. I guess that's my concern.

Dr. de Bever: Okay. The simplest example is a real return bond. It gives you a certain return, which currently is around 1 per cent plus the rate of inflation, so it's fully indexed to inflation. That's the simplest one. In real estate it's a little trickier. You tend to have a return that reflects the rental rates on commercial properties, and they tend to go up with inflation and with the general economic cycle. That is once removed but still close. The same with infrastructure: if you, say, invest in a pipeline or a transmission company, the regulated return on those things tends to be very sensitive to inflation, or they go up or down with inflation. The reason you want inflation-sensitive assets, by the way, not so much for the heritage fund but for, say, pension plans, is that the benefits are indexed to inflation to some degree, so you need to cover off the risk of things moving up and down with inflation. Does that make sense?

5:40

Mr. Allred: Partially.

Thank you.

Dr. de Bever: Okay.

The Chair: Thank you.

I think we have a question that came in electronically to us.

Mr. Quest: We do, Mr. Chair. We have a question from the phone. Mr. Gannon in Edmonton is asking: how does the fund benefit today's seniors, particularly those who have financial, health, or mobility issues?

The Chair: All right. Does anyone want to give that a go, one of the committee or one of our experts?

Mr. Epp: I think that's for the committee.

The Chair: Okay. Go ahead.

Mr. Quest: Well, I'll take that question. As former associate minister for seniors I'm somewhat familiar. The answer would be that currently the revenue that's generated by the fund annually, with the exception of inflation-proofing, goes into general revenue for the province. A percentage of that general revenue would go to health and seniors' programs. Particularly, we're talking about financial, health, and mobility issues. Mobility issues would be covered off for health for lower income seniors either by Alberta seniors' benefits, aids to daily living – there are a number of other programs – the seniors' property tax deferral program. There are a number of seniors' programs funded by the province, that I would invite you to inquire about; 310-0000 would be able to get you some answers. That would be the short answer. Revenue from the fund does go into general revenue for the province. It goes into supporting health and seniors.

Dr. de Bever: Mr. Chairman, maybe there is another, related answer.

The Chair: Certainly.

Dr. de Bever: I talked about how the Finance minister asked us to invest in technologies that are going to make the system in Alberta, or the economy, more productive. The health care sector actually is the one that is very promising in terms of being able to become more cost-effective. Right now, if my memory serves me right, health care is about 50 per cent of the provincial budget, maybe even more, and it's growing much faster than the GDP. So it's really incumbent on us to find better ways of delivering service, more cost-effective ways of delivering the service. The investment initiatives that I was talking about, investing in technology to bring down the unit cost of delivering certain services, will in the long run be helpful to that.

The Chair: Okay. Thank you, Dr. de Bever.
Yes. A question from the floor.

Mr. Zeltserman: We heard many times that long-term performance of the fund was covered over the last 10 years while it was set almost 40 years ago. Is there any particular reason why it's presented in this way?

Mr. Epp: A significant change happened in 1997. Prior to 1997 much of the fund was invested in what Dr. Morck would describe as nation-building investments. There was a capital projects division, for example, that built social housing. Kananaskis Country was built with money from the heritage fund. These didn't produce a financial return, right? There was a Canada division, that lent money to other provinces. Those earned a financial return but not a return that could have been earned in the market. It was lower than market because we were helping other provinces. To do a financial return prior to 1997 was difficult because while there were some commercial investments in the fund, much of the fund was invested for other purposes.

In 1997 the act that governs the fund was changed. Over about a five- to seven-year period those shall I call them noncommercial investments, investments that weren't done solely for earning or maximizing investment returns, were transitioned out of the fund, and it became the fund that it is today, where we are attempting to maximize the investment returns over the long term within a prudent level of risk. While we could go back a certain degree, really those returns going pre-97 and even pre-2002 are a mixture of return-maximizing investments and nation-building or other-purpose investments. So that's why we go back 10 years.

Mr. Zeltserman: The next question would be, then: what mechanisms would prevent a swing back to the nation-building mode in the future?

Mr. Epp: Well, I think that, partially, that question can be answered by committee members because ultimately they have the vote. Right now the Alberta Heritage Savings Trust Fund Act would need to be changed, right? It does not allow the capital of the fund to be taken from the fund right now. But, as Dr. Morck said, any act of parliament or the Legislature can be changed by a future Legislature.

I will cede the mike to the colleagues at the other table.

The Chair: Well, thank you.

I think the important point here is that when we went out last year and the year before and asked Albertans what they wanted to do with the fund, the one thing they did say was: we want it to grow. They didn't see $17.5 billion as being large enough to sustain future generations in Alberta. They felt there was a real need to see the fund grow. Now, will there be a day when it reaches a point where Albertans say, "Wait a minute. The fund is big enough. Now let's reinvest in Alberta today"? That question may very well arise, but certainly right now the priority that was made very clear to the government in the last year or two is that they want us to save and that they want us to make sure that the heritage trust fund grows.

On the other side of that, though, the endowments allow the revenue from those endowment portions, at least a portion of it, to be withdrawn and for some of that money to be utilized on a yearly basis. So the new endowments that are within the fund do allow some advantage for Albertans as time moves forward.

I'm sorry. I don't think we caught your name when you came to the mike.

Mr. Zeltserman: Mark Zeltserman.

The Chair: Thank you very much, Mark.
Mr. Barnes, I think you had a question.

Mr. Barnes: Yeah, I do. Thank you, Mr. Chair. I'd like to ask Mr. Epp or Dr. de Bever, please: from a practical standpoint and an everyday standpoint, when it comes to making investments, how do we trade off the idea of maximizing our investment return versus what I heard earlier, where there is a notion that Albertans would like to see this fund have some value for creating jobs and opportunities within Alberta? I'd also like to hear how that impacts on the percentage of private equity and our notional funds. What is our situation for application and for choosing which projects and which research are supported, particularly right here in Alberta?

Mr. Epp: I will begin, and certainly Dr. de Bever can add to my answer. Under the legislation there is no ability to favour Alberta-centred investments. For any investment in Alberta – and we certainly have investments in Alberta; we certainly invest in all of our publicly listed companies and many of our other companies, I have no doubt – the legislation is quite clear in that the goal when investing the fund is to maximize long-term investment returns while paying attention to risk. There is no provision in the act that states that we can violate that, shall I say – that sounds a little bit too harsh – and we can't neuter that or lessen that because it's an investment of Alberta.

5:50

Dr. de Bever: Yeah. We have, last time I looked, about 8 per cent of our assets in Alberta companies or projects or whatever. We certainly don't discriminate against investing in Alberta, but you should understand that part of the reason why we're so globally diversified is to make sure that the return we earn from the heritage fund is not unduly dependent on what goes on in Alberta. We do have a very high dependence on energy revenues in this province, so if all your investments were in Alberta and were sensitive to the same kind of dynamic, that wouldn't be very good in terms of stabilizing the return on the heritage fund.

Having said that, there are a large number of good opportunities available to us in Alberta, and some of them we invest in. The problem – and all sovereign wealth funds and pension funds have this issue – is that the closer to home you invest, the more contentious it becomes. In fact, my Dutch peers and I have a standing arrangement: why don't you invest in Alberta, I invest in the Netherlands, and we both avoid any political interference? That works up to a point.

We don't discriminate, and if we see a good opportunity in Alberta, we'll certainly capitalize on it.

Mr. Epp: Just one more point. As part of the investment policy, which is ultimately approved by the Minister of Finance – and the Department of Treasury Board and Finance works with AIMCo in setting this investment policy – when it was changed about five years ago, we reduced the amount of exposure to Canadian equities, and that has benefited our returns quite greatly. If you look at last year's results, global equities returned about 28 per cent versus Canadian equities at about 19 per cent. Because we had a greater exposure to global equities, we earned on that amount of money 10 per cent or 9 per cent more. That certainly benefits all Albertans.

Dr. de Bever: You know, to pick up on that point, Canadian equities are much more commodity sensitive than global equities because we are so resource dependent still. That talks about that offset – right? – the diversification. If the commodity cycle runs, we won't pick up as much of that through global equities, but when it doesn't run and the cycle is flat to down, what Lowell is talking about is indeed a good factor, that we pick up the return from the global scene.

Dr. Morck: Could I interject? The Norwegians have something that they call the statens pensjonsfond utland, and it's often touted as the best governed sovereign wealth fund in the world. It actually is forbidden from investing in anything in Norway. The reason for that is, in part, because of the risk-diversification things that were just talked about. You don't want to be invested in the Norwegian economy because if the Norwegian economy goes into recession, well, then all your asset values fall, and that's bad for you.

But there's a second reason, and that is that during periods when the oil price is very high – Norway is an oil-sensitive economy – there tends to be overheating in the Norwegian economy, so the thought was that if they invest all the revenue from that abroad rather than in Norway, then that mitigates the overheating problem and tends to leave the local economy on kind of more of an even keel. Economists refer to that as the Dutch disease, this problem of an entire economy overheating because one sector is really booming.

Dr. de Bever: I won't take that as a racial slur, being Dutch myself.

But there is a reality. In fact, the reason that Horner came to me and said, "You know, let's invest in productivity" is that we have a scarcity of skilled labour in this province. To the extent that we can alleviate the Dutch disease by making that labour force more productive, we reduce cost overruns. They are a fact of life. I can't think of any energy project that ever comes in on budget, and the reason is that we don't have enough good people in this province to run it when everybody is trying to invest all at the same time.

Dr. Morck: And, of course, expanding universities is a helpful way to get more well-trained people.

The Chair: Well, thank you very much.

There was a question that came in by e-mail just wanting to inquire if we were going to put the presentations online, and the answer is yes. They will be on www.assembly.ab.ca.

Dr. Sherman: To all the guests and Dr. de Bever and AIMCo: I'd like to first of all thank you for doing a wonderful job. Dr. Morck, thank you so much for joining us. I think I should have you manage my money as well. Those are great returns.

When Premier Lougheed initially brought in the fund in 1976, 30 per cent of nonrenewable resource revenue was put away. The fund went from zero in 1976 to about $12.6 billion in '84. From the rules that Premier Redford brought in recently, it says: 5 per cent of the first $10 billion. Now, I took the liberty of looking at the budgets. In 2012-13 I think nonrenewable resource revenue was about $7.7 billion, expected to be $9.2 billion in 2014-15 and $10 billion in '16-17. It seems to me that the majority of the growth of the fund in the future will be based on the returns that you will generate. Should we as policy-makers, when we go back to the Legislature, maybe attempt to save a bit more than 5 per cent of the first $10 billion, seeing as how revenues have never exceeded $10 billion?

Dr. de Bever: Well, I'm the manager – okay? – so I manage whatever money people leave in the fund. It's a policy decision how you allocate the return. You can make the case that if the objective is to make the fund grow, then you should leave more of the revenue in. I think that's what the latest few budgets have tried to do, so that's consistent with that policy. But, ultimately, it's not my decision. I'm not greedy in the sense that I want the money because I get to manage more money. That's not the objective. It should be a social decision or a policy decision how you want to make that allocation. That's not up to me.

The Chair: I think it's safe to say that when the Minister of Finance went out and went across the province and sat down with people in town halls and community centres all over the province, what he heard time and time again was: we want you to save. They weren't saying: we want you to save everything. In fact, they were saying: we want you to save, but at the same time we want you to be able to build schools, we want you to build roads, we want you to build hospitals, but, yes, at the same time we want you to save.

There's always going to be a balance point between how much you save and how much you put into building Alberta. At the rate of growth we have in Alberta today, with over a hundred thousand people moving to Alberta every year, we simply need to keep building Alberta. If we compromise that ability, then the only option we have is to then stop building capital. That simply is not an option for us from what we have heard from people. If the number is too high, then you either stop or you borrow more money. I mean, it's no different than you in your own household. If you save more than you can afford to save, then you end up going to the bank to borrow to cover your savings account. There is always going to be a balance point.

Five per cent, again, amounts to $500 million. When you compound that year after year after year with the kinds of returns that we've seen AIMCo achieve, that is not an insignificant number, and it's not an insignificant growth rate. We have to remember that that's only that portion of the fund. On top of that, by 2017-18 a hundred per cent of the revenue generated by the fund will stay in the fund. It's not just the 5 per cent that's going to grow this fund; it's the revenue from the fund as well. Last year that would have been $2.1 billion plus another $500 million from nonrenewable resource revenue, an incredible number. That still allows us to achieve our capital plan, to go ahead, build Alberta, and achieve the goals that Albertans told us they want us to do. Is it too low? Well, I don't know, but making it too high, in my opinion, comes at a very real cost for the province of Alberta.

6:00

Mr. Quest: I think, if I can just add one comment to that, that we have to remember that we have somewhere in the area of $5 billion in our sustainability fund, that we've built up in the last couple of years also, and that we want to maintain that fund at a level of $5 billion. So that's more like the chequing account as opposed to the savings account. That's another fund that we need to keep sustained also in the short and long term.

Dr. Morck: I can just throw in my two cents as well. The issue is whether leaving our future generations a big portfolio of stocks and bonds is a better thing to do than leaving them good bridges and roads and schools and universities and hospitals. I think there's an exercise there where you build more schools and universities and hospitals and roads and bridges up to the point where building another one of those is not really worth it, and you'd be better off leaving more stocks and bonds to the next generation. Where that point is is something in a democratic society that the voters decide themselves, but it's pretty clear that the voters want the government to do things that are the core competence of government: health care, education, transportation, infrastructure, and so on. Those are things that governments do that private companies don't do very well in comparison, and we want governments to do them.

The Chair: Thank you, Dr. Morck.
Mr. Eggen, I believe you have a question.

Mr. Eggen: Yes. Thank you very much, and thank you for the presentations this evening. Certainly, it's been edifying, as usual. I think that Albertans pay a great deal of attention to their heritage trust fund and its contribution to the overall economy of the province.

I have been here long enough to remember its inception and the impact it had on that idea of building our province, nation building as it were, but also making significant savings for the future. It's always troubled me and, I think, a lot of Albertans that the capital has essentially remained static for many years in the heritage trust fund at the very time when I think that we need to look at this fund as not just a bit of a savings account for a rainy day but a way to help transform our economy into a more sustainable one.

I don't think that anybody who runs these sorts of accounts around the world or any prudent government would say that running your operational budget or large portions of your operational budget on nonrenewable resources is a sustainable way to run your economy. It's very important, I think, that we don't just say: yes, Albertans want to save more. I think that we want to save a lot more in the heritage trust fund and make those investments so that we're not running our operations on nonrenewable resources. I would just be curious to ask our eminent experts here today: are there equivalent funds around the world, in Alaska or Texas and so forth, that are making more substantial savings so that we can in fact move away from running our operations on nonrenewable oil and gas?

Dr. Morck: Well, yes. The Alaska fund and the Norway fund have accumulated more savings. Like I said, I don't know that that's necessarily good or bad. Just having more and more savings, unless you have some sort of religious belief that savings are always good, is not necessarily the right thing to do. It may be that having a better road system, you know, a divided highway to Fort Mac, for instance, is a better use of the province's money than buying more stocks and bonds. I think that that's what we elect politicians to do, and if the politicians decide that we should save more money, then I think: that's great; we should. But it's not clear to me that there's a cut-and-dried answer that says: saving more is always better. Governments have core competencies, and we want governments to do those things. It's when governments make sausage factories and stuff that we need to slap them back.

Mr. Eggen: Well, I guess the second part of my question, then, is the obvious elephant in the room. The heritage trust fund was created in 1976 to save the royalties that were realized from nonrenewable energy resources with the idea that they're not around forever. So the royalty rate was at a sufficient level that the heritage fund could grow both as a savings and a nation-building account for the province of Alberta. The very time when our royalty rates went down was the time that the heritage fund became static, basically. So there's an obvious question here. We say: oh, well, we won't have enough money to build schools and roads. But we would if we had a sufficient revenue reform to ensure that we capture the royalties that do belong to us as owners of those resources and then start to save those and build the roads and schools as well.

Dr. Morck: Tax policy is something the politicians should answer, I think.

The Chair: Mr. Amery, I believe.

Mr. Amery: Yeah. Thank you very much, Mr. Chair. I think my question is either to Mr. Epp or Dr. de Bever. Albertans are so attached to their heritage trust fund. We look at it as a sacred – sacred – trust. They have been very consistent over the years in their support of the fund and the maintenance of the fund, the maintaining of the fund. Now, when we tell Albertans that they have 17 and a half billion dollars in that fund, I wonder if you could explain in lay terms: what does that involve? Is it stocks, bonds? Is it solid assets? If we were to liquidate that fund, like, tomorrow or in the next few days, would they get 17 and a half billion dollars?

Mr. Epp: Well, it's a combination of a variety of financial and real assets. There are stocks and bonds, which are financial assets – those that are traded in the public equities and public bond markets could probably be sold without much impact on their market value – but we also have real assets, like real estate. Those would take longer to sell, and the quicker we sold them, generally speaking anyways, the worse the price we would get. There are investments in private companies, similar to real estate, that would take time to sell. The speed at which you wanted to sell them would impact the value. So there is a variety.

Now, there's a reason why we invest in some things that can't be liquidated immediately, and that's because that very lack of liquidity that they have – in our terms; maybe that's not layman's terms – that very lack of ability to sell quickly without impacting the price, is what gives us additional returns, and that's why we've put money there. So, no; I'm quite sure that we could not liquidate it in a short period of time without reducing its value, but because the legislation says that we are not to liquidate it, that we are to maximize long-term returns – that's why we can invest and we can earn those higher returns.

I'm not sure if that answers your question.

Mr. Amery: You did. Thank you.

The Chair: All right. We've got a question here by e-mail. It's from Ian Meaden. He's asking:

> Why is it not Government policy today to direct a portion of the Government revenues based on the budget immediately to savings, both [to] the Heritage Savings Trust Fund … and [into] the Contingency Account? For example, in Budget 2013, the GOA revenues were forecasted to be nearly $45 [billion], why can't we direct 10% ($4.5 billion) of this revenue right off the top (deposited on a quarterly basis) to the [Alberta heritage savings trust fund] so that it ensures continued principal growth [of the fund]?

Mr. VanderBurg: I can answer that.

The Chair: Please, go ahead.

Mr. VanderBurg: It's pretty clear that 5 per cent of the first $10 billion in annual nonrenewable resource revenue and 25 per cent of the next $5 billion in nonrenewable resource revenue, up to the annual amount of about $15 billion, and about 50 per cent of the annual nonrenewable resource revenue in excess of $15 billion will be implemented by 2015-16. The contingency account will be topped up to $5 billion once this is done, and money will be allocated to savings funds.

6:10

The Chair: Okay. Thank you.

We have a question at the mike, I believe. If you wouldn't mind stating your name, please.

Mr. More: I'm Colin More. I'm going to continue abusing that side of the room.

The Chair: We appreciate that, actually.

Mr. More: I'll get to you in a moment.

First of all, I have kind of a theoretical question, I guess, mostly for Dr. de Bever. In your presentation you had a graph of risk-reward curves, so the theoretical market, kind of idealized, and then the market as AIMCo sees it. Where does that actual curve come from? How is that calculated?

Dr. de Bever: Well, I must say that, you know, having been an economist for 40 years, I've lost some of my religion about the efficiency of markets. I think that what's happening right now – the lower end of the risk spectrum has a very unusually low return. Part of that is because of manipulation by central banks of interest rates. Of course, that started out with all good intentions in 2008 to make sure that the economy would not fall into recession. So there was an enormous amount of liquidity created that made interest rates unusually low; in other words, after inflation real interest rates are next to nothing. In fact, in Europe you have to pay to have a bank take your short-term deposits. It's a concept that we're not used to here, but it does happen.

So markets aren't always efficient. You know, you'd think that that curve that we outlined for you would straighten itself out, but it's not necessarily the case. Eventually, it will but not in the short run. Markets are not always efficient, but they're still very difficult to beat, and that's our problem. We may see what I showed you in that graph, but taking advantage of it is not as clear-cut as it may seem. I mean, in our pension and endowments we are very careful of what we do with fixed income because we, as I said, don't feel that there is a lot of return on those assets in the next five years. But that's an opinion, and in my business if you get it right 6 out of 10 times on a short-term horizon, you're doing pretty well. You're doing way better than your peers.

Mr. More: All right. So that curve, like, the real one, mainly comes from just watching the marketing scene, where things fall in the risk-reward spectrum.

Dr. de Bever: Right, and ex post that curve is not in line with – in other words, if you look back 10 years, in any given 10 years, it doesn't look quite as straight as the efficient market theory would have it.

Mr. More: To make the question slightly more political, then: how is it determined where to invest on that curve? Where is the marginal benefit seen to not be with risk?

Dr. de Bever: The politicians, if you wish, or the government or the bureaucrats, whatever you want to call it, give us an allocation, and it's supposedly more reflective of the amount of risk they want us to take. Then it's up to us within relatively wide ranges that we can deviate from. Say, for instance, that typically 80 per cent are in liquid assets. Of that, 60 per cent are in stocks and 40 per cent in bondlike instruments, and then there are 20 per cent in illiquids like real estate, infrastructure. So that's the menu they gave us. We use that to infer how much risk tolerance the heritage fund has.

But then we have the option – say, for the sake of argument: if we have 40 per cent allocation in equities, we can vary between 35 and 45 depending on how we see that curve and the trade-off between risk and reward. The object for us is not to take risk. The object is to make money on the risk we take. So we constantly sit there and say: would we be better off shifting the money from here to there because the payoff from the amount of risk we take here is higher than it is over there? That's basically what we do.

I tell my staff that we are risk managers more than we are asset managers because assets are just envelopes for risk, and there is little risk per dollar of bonds, in principle, over the long run, and there are a lot of risks per dollar of equities in the long run. Does that help?

Mr. More: Sure does. That's so interesting. Thanks.

Mr. Epp: I would add to that. Leo alluded to the bureaucrats and so on.

Dr. de Bever: Sorry about that.

Mr. Epp: That's okay. You know, it is what it is.

When we set that, we looked at a number of factors. I mentioned earlier that we shifted away from Canadian equities to global equities, and that was done for diversification and risk purposes. We look at a number of factors.

Liquidity needed. When virtually a hundred per cent of the income is transferred out of the fund, we need a certain amount of liquidity. The legislative change that says that a hundred per cent of the income will stay in the heritage fund allows us an opportunity to change that allocation. We currently are doing research towards that end, and we're always working with AIMCo along that end.

Volatility of various sectors. You know, how much does the government, or the people of the province, ultimately, want to risk in any one single-year period? In 2008, I believe, the heritage fund lost 14 per cent if I remember correctly. Don't quote me on that because I might have that wrong. That was better than the average market participant, by the way. That was better than the stock market did. Because we were diversified, we should have been better than the stock market. That wasn't heroic or anything. That was a terrible financial year. We're going to have those years again in the future, so how much are we willing to risk in any one single year? That's the question. That can have implications on the provincial budget.

There are a lot of factors that go into it. We try to be long-term investors, but long-term investing, as has been said many times by both Dr. Morck and Dr. de Bever, is a lot easier said than done.

Dr. de Bever: This comes back also to valuation. People have this notion that there is some kind of godlike creature out there called the market and it sets fair prices, but really prices at any given moment are just the intersection between the most desperate seller and whoever is on the other side of that. You know, there has to be a balancing of markets. The advantage of the heritage fund is that it doesn't need the money tomorrow, so if a year like 2008 rolls around and the values go down, it almost doesn't matter because you don't have to sell. It only matters if you have to sell. So, yes, there's a need for liquidity, but the need for liquidity is relatively minor to the overall size of the fund.

Mr. More: This is all fascinating, actually. Thanks very much.

The Chair: Thank you.

Dr. Sherman, I believe you had a question.

Dr. Sherman: Thank you, Mr. Casey. Mr. Epp, I think you just set my question right up. We all know that nonrenewable resource revenue is very unstable and that, yes, the value of the asset may drop from $17 billion to $14 billion, as can the revenue. Now, when they put 30 per cent away, the politicians and policy-makers, to do their budgeting, relied on, one, prudent fiscal management and, two, on taxation policy to pay for daily operational spending. We have been 100 per cent dependent – not 100 per cent dependent, but we have used 100 per cent of nonrenewable resource revenue for operational spending as of recently. As you know, the sustainability fund was $17 billion. It's down to $5 billion. In fact, it was lower than $5 billion.

We all want to build this province. We all want to build roads and schools and bridges, absolutely, and operationally fund them. But is it good policy to spend 95 cents of every dollar of nonrenewable resource revenue as soon as it comes out of the ground? The challenge is that the cushion that the government needs – you know, it's easy to spend all the money during election time, as Dr. Morck has said, you know, about politicians having their little pet projects. If you take it all out of the ground, spend it right away, it's easy to spend it.

Would it not be prudent to not rely on 95 per cent of nonrenewable resource revenue to pay for daily operational bills? Wouldn't that be a better idea?

6:20

Mr. Epp: That's not really a question for me; that's a public policy question. As Dr. Morck said, that's ultimately decided by the voters. So I would turn that around to you and your colleagues on the committee to answer that question, with all due respect. We are given a job to invest the money, not to decide how much goes in or comes out.

Dr. Sherman: I thought I'd just respond. Recently the Auditor General came out with a report talking about lack of accountability, lack of oversight on money that was being spent by the government. Because it has a lot of money, it spends it. I believe that one of the reasons that Premier Lougheed brought this in was not only to save it because it wasn't going to be there forever but also to ensure that the government prudently spent the money that it had and appropriately taxed to pay for the daily bills.

Thank you.

Mr. Quest: I can respond. Oh, I'm sorry. I think it was directed at you. I can follow up if one of you folks wants to go first.

Mr. Epp: No. Please go ahead.

Mr. Quest: Okay. It is more of a policy question.

First of all, I think that Dr. Sherman said that 95 per cent of those energy revenues were spent for operations. That's not actually the case. A lot of that, of course, goes into capital build. What Dr. Morck was talking about earlier, whether you're better off to have the cash in your fund or to have the school in your neighbourhood for your kids, is definitely a policy equation.

The other thing we talked about was the sustainability fund and the $17 billion. Almost all of the sustainability fund, actually, went directly into capital, went directly into assets. Dr. Morck referred to this earlier, you know, that you still have the asset; it's just an asset that's a hospital or a school or a road or something that you can use every day.

When we talk about – this came up earlier, I know – the different funds around the world and the Norway comparison, in Norway I believe that they do put a hundred per cent of their energy revenue into their – I can't pronounce it; Dr. Morck, you were so much better than me – their GPF, the general pension fund, which has a fairly substantial balance in it. But I think that if we're going to talk about going in that direction, then you have to understand what the overall situation is in Norway revenuewise, which is that they have a 25 per cent value-added tax there. So their sales tax is 25 per cent as opposed to 5 per cent in Alberta, 5 per cent federal. Of course, we have no provincial sales tax. They have amongst the highest personal and corporate income taxes in the world. They're a country, and of course we're a province as part of Confederation. So if you work in federal transfer payments, I think they net out at roughly $20 billion a year. Plus, remember that their GPF, as I understand it, Dr. de Bever, contains all their pension funds and so on, and of course you manage about $70 billion for us, not just $17 billion, if you include the pensions.

There are a lot of different things, I think, that Albertans have to consider if we're going to commit more and more or all of our energy revenues to savings, what that would mean with respect to much higher taxation levels for all Albertans.

The Chair: Thank you. I do want to emphasize again that when the Alberta heritage trust fund was set up in 1976, I doubt that anyone envisioned, to be honest, even though they were visionaries in their own way, where we are today and the absolutely astronomical growth that has not only occurred over the last 10 years but, really, has been occurring for the last 40 years.

If you have 1 per cent growth in a municipality or in a province, that is barely sustainable. You can barely stay ahead of the infrastructure needs. We have exceeded that year after year after year, as have our municipalities. So when you have to make the choice between bonds and schools, to be honest, Alberta has tried to make the choice of trying to stay ahead of the infrastructure curve, but even though we've consciously made that choice, we've fallen behind because the rate of growth for the last 10 years has been so extreme that we simply cannot catch up to it.

I don't think it's a matter of making some choice of not saving or wanting to save. I mean, from the Alberta heritage trust fund since its inception there has been $36.5 billion go into general revenue. That didn't go to operations. Some of it did, certainly. Of course it did because service levels increased. So of course operations increased. Our province grew. But a tremendous amount of that went into building infrastructure. The new hospitals you see in the province, the new roads, the new schools, and so on and so forth are all part of that. You can't contribute $1 from it to a particular project.

What we're saying going forward is that Albertans have made it clear that they want us to save, so we'll begin to save, and from a committee point of view we're going to see this fund grow. Will it grow fast enough? Well, for some, yes; for some, too much, too quickly; but for others, not quickly enough. But we've made the conscious decision that we are going to grow this fund, that we are going to have a savings account, because as Dr. Morck pointed out, that's clearly something that the electorate has directed us to do. That's why the fund has moved in this direction and will continue to move in this direction. That's why the Fiscal Management Act is there today, to recognize that direction.

We're almost out of time here. With that, I think we'll likely have to cut questions off. I'd like to thank everyone for coming out tonight. Unfortunately, we have run out of time, but before I close, I'd like to sincerely thank all of you for your participation tonight. I think I speak on behalf of the entire committee when I say that we have enjoyed spending the evening with you and engaging in conversation about your Alberta heritage savings trust fund. In turn, we hope you have found the meeting informative and valuable.

I would like to especially thank Dr. Morck for being with us tonight as our guest speaker and the representatives from AIMCo and Alberta Treasury and Finance.

Hopefully, we've been able to address many of your questions this evening, and we thank you for your comments. This evening's discussion has been invaluable to us as we move forward building the Alberta heritage savings trust fund. For those of you who would like to offer additional feedback on the meeting, please go to www.assembly.ab.ca and answer the short survey.

To our TV and online viewers, thanks so much for tuning in, and to those of you who made it here tonight, we appreciate your taking the time out of your busy lives to be in the audience with us.

I'd like to just remind everyone that a repeat broadcast of this meeting will air on Shaw TV at 7 this evening across Alberta.

If you're interested in finding out more information about this committee and its mandate, it can be found at www.assembly.ab.ca/committees/abheritagetrustfund.

With that, I'd like to thank you, all, for your attention and for your input.

Good night. Thank you.

[The committee adjourned at 6:29 p.m.]

Published under the Authority of the Speaker
of the Legislative Assembly of Alberta