Legislative Assembly of Alberta

The 27th Legislature
First Session

Standing Committee
on the
Alberta Heritage Savings Trust Fund

Monday, December 1, 2008
8 a.m.

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Alberta Heritage Savings Trust Fund

Forsyth, Heather, Calgary-Fish Creek (PC), Chair
Elniski, Doug, Edmonton-Calder (PC), Deputy Chair

Blakeman, Laurie, Edmonton-Centre (L)
DeLong, Alana, Calgary-Bow (PC)
Denis, Jonathan, Calgary-Egmont (PC)
Johnston, Art, Calgary-Hays (PC)
Kang, Darshan S., Calgary-McCall (L)
MacDonald, Hugh, Edmonton-Gold Bar (L) *
Notley, Rachel, Edmonton-Strathcona (NDP)
Olson, Verlyn, QC, Wetaskiwin-Camrose (PC)

* substitution for Darshan Kang

Department of Finance and Enterprise Participants

Iris Evans	Minister
Robert Bhatia	Deputy Minister
Sandie Hay	Manager, Endowments and Pooled Investments
Kari-ann Kuperis	Public Affairs Officer
Rod Matheson	Assistant Deputy Minister, Treasury and Risk Management
Dave Pappas	Senior Manager, Investment and Debt Accounting

Alberta Investment Management Corporation Participants

Leo de Bever	Chief Executive Officer
Douglas Stratton	Director, Fund Management

Auditor General's Office Participants

Merwan Saher	Assistant Auditor General, Audit Division
Betty LaFave	Principal

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Standing Committee on the
Alberta Heritage Savings Trust Fund

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Stephanie LeBlanc	Legal Research Officer
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[Mrs. Forsyth in the chair]

The Chair: It's 8 o'clock, so I'm calling the meeting to order and welcoming everyone to the meeting. I'd like to have everyone start by introducing themselves. I'm going to start on my right.

Mr. Elniski: Thank you. Good morning. Doug Elniski, MLA for Edmonton-Calder.

Mr. Johnston: Good morning. Art Johnston, Calgary-Hays.

Ms DeLong: Alana DeLong, Calgary-Bow.

Mr. Olson: Good morning. Verlyn Olson, Wetaskiwin-Camrose.

Ms Friesacher: Good morning. Melanie Friesacher, communications consultant, Legislative Assembly Office.

Dr. Massolin: Good morning. I'm Philip Massolin. I'm committee research co-ordinator, Legislative Assembly Office.

Mr. Pappas: Good morning. Dave Pappas, Finance and Enterprise.

Ms Hay: Good morning. Sandie Hay, Finance and Enterprise.

Mr. Stratton: Good morning. Doug Stratton, Alberta Investment Management Corporation.

Dr. de Bever: Leo de Bever, Alberta investment company.

Ms Evans: Iris Evans, Sherwood Park.

Mr. Bhatia: Robert Bhatia, Deputy Minister of Finance and Enterprise.

Mr. Matheson: Good morning. Rod Matheson with Finance and Enterprise.

Mr. Saher: Merwan Saher, office of the Auditor General.

Ms LaFave: Betty LaFave, office of the Auditor General.

Ms Kuperis: Kari-ann Kuperis, Finance and Enterprise.

Mrs. Dacyshyn: Corinne Dacyshyn, committee clerk.

The Chair: Before I start, I just want to let everyone know that due to some organizational changes we've lost Jody Rempel. Everyone knows how much we enjoyed having Jody sitting at the table and how hard she worked. We've now been blessed with Corinne Dacyshyn, who is going to take over as committee clerk. I look forward to working with her.

We need, first of all, to have approval of the agenda, so if someone would like to move that the agenda for the December 1 meeting of the Standing Committee on the Alberta Heritage Savings Trust Fund be adopted as circulated. Art Johnston. All those approving? Great.

Minutes. Again, if we could have someone move the minutes. Verlyn. All those in favour of the minutes of the September 9, 2008, meeting of the Standing Committee on the Alberta Heritage Savings Trust Fund being adopted as circulated? Approved.

Items Arising from Previous Meeting: Update on Heritage Fund Comparables. We received a memo from the Minister of Finance and Enterprise which provides information in response to questions raised by committee members at the September 9, 2008, meeting. If there are any questions for the minister or staff, we'd be pleased to entertain them.

Well, seeing no questions, Madam Minister.

Ms Evans: Thank you very much. First of all, let me take this opportunity to congratulate you, Madam Chairman, and our MLA for Edmonton-Calder for the excellent organization of your annual meeting and the attempts that you made to ensure that it was as broadly broadcast as possible. Of course, we couldn't account for the various activities nation-wide of the election and all the other things that might have encroached on the opportunity. People might have availed themselves to come and listen to more about the heritage fund, but at that occasion I thought it was an exceptional opportunity.

On that occasion presentations were made on behalf of AIMCo. Gary Smith, as you'll recall, did an excellent overview. Today we're very privileged to have our CEO, Dr. Leo de Bever. He's coming forward with a presentation later, and we're very pleased to have him onboard.

You asked about the comparables, and they were circulated to you by a memo responding on November 26. It shows the heritage fund comparables with OTPP and Norway both in Norwegian currency and in Canadian currency. You will be interested to note that the Ontario Teachers' Pension Plan did slightly better in some years than the heritage fund. During that period Leo was in charge in Ontario, so he had an excellent track record with his conglomerates there. He then moved to Australia and was in Adelaide when he was attracted back to Canada.

The implication, Leo, of course, is that you're going to excel in your performance here with the heritage fund, and we're very confident.

Anyway, let me talk about the second-quarter update, which is the reason I'm here. You know that the cut-off is at the end of September. At that time we published the heritage fund value at $15.8 billion, which was down $1.2 billion from the 2007-08 year-end. Now, that was at the cut-off on September 30, 2008. Again, Madam Chairman, it's no surprise considering that would be relevant to the economic turmoil and the sharp decline in world equity markets. In terms of income loss the heritage fund had first-quarter income of $155 million but then had a subsequent loss of $605 million in the second quarter, so the overall income loss ending September 30 was some $450 million. Most of the loss came in U.S. and non-North American equities. Overall, there was an income loss, or decline, of $1.2 billion in the fund's fair value.

I'd like to just note that when you look at the five- and 10-year performance of the heritage fund, reminding you that in the past five years the heritage fund's annual return has been 7.3 per cent and, over 10 years, 5.3 per cent, in the comparables table it illustrates, at least in the six-year annualized, the comparable over the longer term. Although we're currently impacted by a volatile market, over the longer term the fund has done exceptionally well.

We're continuing to experience market fluctuations. Since September 30 the developed markets have dropped almost 14 per cent while emerging markets have fallen over 24 per cent. So when you look to the third quarter, there is an anticipation that with the current slump in the economy and energy prices, we will still have some volatility, which has potential for a negative impact. I might add, though, that any time you've seen the price of oil vacillate by as much as $10 a day, it has been unprecedented, and although people reference the depression in the '30s as, you know, a time of unheralded difficulties in the economic market, the swings have been much more volatile. Nobody has seemingly been able to predict with accuracy what one would hope would be there, what will happen over the next period of time.

The savings strategy. As you are aware, we've had our savings strategy report released, the Mintz report, which is currently, in the context of several other things, under consideration by our government. Before year-end I think it will be abundantly clear what we've determined to do on the savings strategy.

As I conclude my remarks, may I just say that especially in the recent past where I watched the AIMCo board members and staff launch and mix with Albertans to have conversations with them about various investments, about the AIMCo experience both in the past and what it will continue to be, speaking with people in Calgary on Thursday and here in Edmonton on Wednesday, I'm very confident that even though there continues to be volatility in the markets, we will be extremely well served by the activities of the Alberta Investment Management Corporation.

With that, Madam Chairman, I would suggest that we go directly to the presentation by Leo, and then you'd have an opportunity, unless there are questions on the second-quarter update, to quiz further. In terms of detailed financial information and relative to what I've given you the overview of, it may be better to go there first, but we're at your pleasure.

The Chair: What we need to do, Madam Minister, if I may, is to get a motion. Then we'll go to the presentation.

If I can have a motion that

> the Standing Committee on the Alberta Heritage Savings Trust Fund receive the 2008-09 second-quarter report on the Alberta heritage savings trust fund as presented.

Alana. All those in favour?

We've had some of our other members join us. I'm going to start with some introductions.

8:10

Ms Blakeman: Good morning, everyone. As always, welcome to my fabulous although not yet sunlit constituency of Edmonton-Centre. My name is Laurie Blakeman.

Ms Notley: Rachel Notley, MLA, Edmonton-Strathcona.

Mr. MacDonald: Good morning. Hugh MacDonald, Edmonton-Gold Bar.

The Chair: Hugh is substituting – and we were notified – for Darshan. Thank you.

Okay. Committee members will recall from the June meeting that the committee discussed inviting representatives from the Alberta Investment Management Corporation to make a presentation to the committee. Dr. de Bever, chief executive officer, and other officials from AIMCo are here today. They have provided their PowerPoint slides for information.

I understand that you have a 20-minute presentation, after which you will entertain questions from committee members. If we can go ahead.

Dr. de Bever: Good morning, Madam Chairman and committee. As the slides indicate, I would like to provide some background to what's been happening at AIMCo and towards the end give you some idea of what the opportunities are in what is currently a very volatile environment. As you know – slide 2 – AIMCo has been turned into a Crown corporation, being previously part of the Department of Finance and Enterprise.

The division of responsibilities – slide 3 – between AIMCo and the department is as follows. We work with the department to set the investment strategy fund, and then the implementation is our responsibility.

On slide 4 we document the current total assets that AIMCo manages. The heritage fund is a little over 20 per cent of that, pensions are about a third, and then over 40 per cent is other government endowments and short-term balances.

On slide 5 you can see that the bulk of the assets are in fixed income, and most of that is because the short-term government assets are in that category. The endowments and the pension funds are more 60-40 equities to fixed income.

Slide 6. The reason AIMCo was structured the way it is now was to create an independent, more commercial, entrepreneurial, and innovative investment organization. The hope was, of course, that when you do all of that, you create an excellent organization, one that can deliver superior returns.

Slide 7. The conclusion that the Capelle report came to after surveying sort of global conditions in investment management is that if you can create an organization with a strong government structure, if you have the size – and AIMCo does have the size – to attract and pay good staff, if you can, by attracting good internal staff, manage funds internally, which is far more efficient and cost-effective, if you have a culture that seeks out new opportunities, and if you back that up with strong IT systems, strong procedures and controls, that is the foundation for a superior performance in the long run.

The new government model – slide 8 – that you settled on was to create an organization with structural independence and a very strong board and have that board delegate to strong management; in other words, have the investment decisions made quickly and within certain parameters, within management control but, of course, being supervised by strong controls by the board.

The AIMCo board of directors has the characteristics, the skill set that you see on slide 9. For your information the appendix lists the qualifications of individual directors. I won't take you through that. The point of creating a strong board was to have that strong range of skill sets required to supervise an investment management organization.

I must tell you that when I took this job, looking at this board, I was somewhat intimidated and worried that it was so strong that it might feel it was in the best position to run this organization rather than delegate it to management. But after discussing this with the chairman and talking to individual members, it was clear that they wanted to be a governance board and were quite in tune with creating a strong, independent, fast-reacting management organization.

The object of this whole exercise was to create an excellent organization, and that's always a loaded term. I always cringe a bit when I hear that we're aiming to be excellent. Excellent is the end result; it's not something that you just have the recipe to create. The main way I measure excellence is that in the long run we provide superior returns for the people of Alberta in the funds they've entrusted to us.

The limited resource that we have to do that is the tolerance for risk that our clients have or our partners have. Our objective is to maximize the long-term return on that risk. I stress long-term return because the last year has reminded us that risk is risk, meaning that most of the time you get paid very well for taking risk, but once in a while you run into a year like this, and it doesn't feel so good to have a lot of risk in your asset allocation.

The problem with pursuing a long-term strategy – and the reason we can do this is that we do have funds that aren't needed tomorrow and are not needed next year; they're not even needed long after I retire. They're needed in the long run, so we can take a long-term strategy. The convention is to judge the result of that strategy against short-term market measures, and that's just a necessary evil.

In an endowment fund like the heritage fund you typically have about 60 per cent equities, 40 per cent bonds, and the long-term return, if you believe 107 years of history for which we have good information, is about CPI plus 4 and a half. Given that that's the average, you would think that over some reasonable period of time you can generate CPI plus 4 and a half.

Now, the next slide shows you that that is not necessarily the case, that there are long periods where it's relatively easy to produce superior returns and others where it isn't. Let me take you through this slide. This slide assumes that we're sitting here in 1899, which was the top of a bull market. You probably remember it well. At that point the fund was in relatively good shape and was 150 per cent funded.

Then assume that you just maintain that asset mix and run it forward for the next 107 years and see what happens over that period when you judge it against CPI plus 4 and a half. Initially you're dramatically overfunded because you had the benefit of a strong bull market at the end of the last century. Then you can see that between 1900 and 1920 it was very difficult to generate CPI plus 4 and a half. The funding ratio against that kind of target would have dropped dramatically, from 150 to 40 per cent. So this gives you some indication that volatility is not a new phenomenon. It has existed for a long time.

Then you get the Roaring Twenties, and that next dip is the crash. Maybe it's somewhat surprising. That crash was concentrated in severity, but it is not any different from what went on in the earlier part of the century. Of course, then you had recovery up to World War II. Between then and about 1965 not much happened. Even I recall, personally, the weak stock market period in the '70s up until about '82.

8:20

Then look what happened after that. For about 20 years it was relatively easy to create continuous improvement in the performance of a fund like this, judged against CPI plus 4 and a half. Even with the 2000 hiccup you can see that things recovered quite nicely and that only now are we coming back to sort of a long-term norm. It's all by way of illustrating that having an average target is obviously important, but being able to deliver on that average target in any kind of period is very difficult. I would suggest that we've just gone through the best 25-year period in a hundred years, which generated roughly double the return we should have expected from being invested the way we were. Going forward, we may have a period of more average returns, so the next 10 years, the next 25 years may generate something closer to CPI plus 4 and a half rather than the CPI plus 8 that we saw in the last 25 years.

Now, we're going to try and do that. We're going to try and keep pace with markets, obviously. It will always be true – slide 13 – that most of our return will come from being in invested in the right asset classes, but it is true that better governance, better systems, better people seem to be able to deliver an extra 1, 2, 3 per cent, depending on who you believe on that recipe. The basic building blocks of that success are just good blocking and tackling, doing the basics better, having good systems, having good controls, and taking maverick risks. Sarah Palin has sort of destroyed that term, the way it's being used elsewhere, but in investments being a maverick basically means looking outside the normal range of asset classes to find superior return, being a little bit faster and a little bit better at finding things that don't fit any particular asset class but are a good investment opportunity.

In doing the basics better, I have found in my career that costs are certain, returns are not, so being hyperefficient is certainly a very good starting point for superior returns. For instance, I found in my last position that poor cash management cost us somewhere between a quarter to a half per cent, and that is particularly a problem in a structure like we have. We're managing $70 billion, but it's spread across 20 different pots of money. Maintaining consistency between those portfolios and making sure you're not running into unnecessary costs in transacting those 20 portfolios is a significant part of being superior. In the last 10 years there's also been a creep in complexity of products, and I have found that simplicity has its virtues and that complexity, particularly when it's combined with opaqueness, is usually not a good place to be.

The final thing. A lot of what I've done has been to contrast opportunities, not just by hardline returns but by return on risk, and what you find in that is that managing risks separately rather than in combination across the portfolio is relatively inefficient. What that means from an organizational point of view is that you have to run an investment organization without having stock and bond silos. You have to have a team that can discuss opportunities across a range of asset classes and identify opportunities that fall in between. There are tremendous economies of scale in investment management; therefore, having a pool of $70 billion and being able to manage it as $70 billion has tremendous advantages.

I've got three organizations there: Ontario Teachers', AIMCo, and VFMC, the organization I ran in Melbourne. They're a vastly different scale, and they all cost around $200 million to run. The costs of running these organizations in terms of basis points is dramatically different by implication. So scale matters, and we intend to use that scale to our maximum advantage.

Slide 16. One of the things that strikes you when you compare Ontario Teachers' and AIMCo, for instance, or VFMC, is that 75 per cent of our assets are managed internally, but 75 per cent of our costs are external. Now, when you work the math, that means that per dollar of assets managed, the external cost is nine times higher than the internal cost. That gives us plenty of opportunity to look across the asset spectrum and say: "Okay. Where can we attract people to do better internal management and to do more internal management?"

The difference in cost is particularly acute in the more expensive asset classes: private equity, infrastructure, and what are called alternatives or hedge funds and so on. We intend to first of all be very careful about where we invest in these things. Second of all, I've already attracted the staff to be able to do more of those things directly.

One of the pitfalls we try to protect ourselves from – slide 17 – is overdiversification. Those of you who took finance know that diversification works, but it only works up to a point. Once you get past 30 or 100 assets in a portfolio, the benefit of diversification starts to get very minimal. In most pension and endowment portfolios you actually have thousands of assets. I think there's merit in making sure you're not overdiversified.

The second pitfall is not as true as it was when I originally crafted this slide. Most endowments and pension funds assume that the markets are working, so liquidity is a drag in that cash returns are typically lower than, say, long-term equity returns. In the current environment what is very different is that the financial system stopped working, and if you rely on the ability to transact in selling some of your assets to rebalance your portfolios, that opportunity has not existed over the last six to nine months. Liquidity right now is at a premium, so any estimate that I might have had before about how much liquidity you needed in a fund like this would have to be hiked by the fact that at the present time you need a lot to protect yourself against being able to execute on certain positions you have that require cash if they run against you.

Again, unnecessary complexity is a common pitfall. People buy stuff that's interesting. They don't always understand what they're buying, and that's certainly something I want to avoid.

There's a fear of derivatives in certain organizations. A lot of the poor behaviour that we've witnessed in recent markets has been in areas where derivatives have been misused or have been poorly understood. Derivatives are an easy way to do quickly what otherwise would take a long time. For instance, if you want to get quick exposure to equity markets, it's easier to buy an indexed derivative rather than to buy all the underlying stock.

The final one, the "me too" allocation to alternatives, comes back to a comment that the minister made about Ontario Teachers' fund performance. Part of the reason we had good performance in our alternative asset classes was that we were early movers. We bought some of these assets quite early in the game, in the late '90s. Then when everybody started to imitate us, it drove up the prices, so it made us look a lot better than we had the right to because the returns from those early investments were much higher.

This comes back on page 18 to what happens in alternatives. When you identify an alternative early – an alternative is basically an esoteric investment category, and because it's esoteric, not too many people have looked at it, and the return is high. Then people discover it, they pile into it, and the return comes down. It often comes down to below the rate where it remains attractive, and then it sort of cycles as the thing matures. Some categories like real estate have gone through that three or four times, and they're now fairly conventional.

Coming back on 19 to innovation and maverick risk, our single-minded goal is return on risk. The thing I mentioned to the board, when I was asked how I would run this place, is that we're not necessarily going to imitate Teachers' or CPP or anybody else. We're going to have to find our own alternatives because the ones that we invested in in the '90s no longer have the excess returns that are attractive.

As I already mentioned, we will do direct deals if we have the skills. I hired a director that used to work with me at Ontario Teachers' to do exactly that last week. We have to engage in something called creative destruction. I tell my staff to come in every morning and ask two questions: what should we stop doing because it's no longer useful, and what should we start doing because it's the new best thing?

8:30

AIMCo is not a greenfield operation – slide 20. It was a competent organization. If you look at a four-year history, it did relatively well in that it had a measure of excess performance over markets that was fairly good, actually, but we are convinced that we can make it do better.

The thing I have found in looking at AIMCo since I've been here is that there has been an underinvestment in systems, process, people, procedures. We're working very hard to correct that as quickly as possible because, as I told you earlier, that is really the foundation of a successful organization. If you don't have that strong foundation, the results may not come because you may not be able to identify mistakes that you're making along the way.

Now, when I got here, the board thought that I faced – on slide 21 – certain restrictions, one of them being: being far away from major financial centres. It turns out that's only a problem for direct transactions, and we fixed that. We opened a small office in Toronto that will rely on our analysts here in Edmonton, but it will canvass the deals in New York and Toronto from the east.

The second concern was that we would have a limited professional population base and would not be able to attract people. That hasn't turned out to be the case. AIMCo is an opportunity that by itself is starting to attract professionals, but we're working with both the universities in Calgary and Edmonton to make sure that we build a bigger base of financial professionals to help not just AIMCo but other organizations in Edmonton and Calgary.

The AIMCo of tomorrow. If I'd just summarize what we're trying to do, we're going to focus very much on being able to identify our risks so we can make better decisions on return on risk. The moment I walked in the door, I signed for a new portfolio management system because the one we have is a bit out of date. Next year we're hiring quite a bit, and, I must tell you, obviously we have a lot of jobs, but creating jobs is not the main objective; creating results for the people of this province is. We need big increases in staffing and operation and IT support because we're very weak there right now. We're moving to new premises in January 2010. It's a building on Jasper and 108th Street, the old Professional Building.

Madam Chair, that is what I intended to say. I'm sure that members of the committee will have other things they want to know about.

The Chair: Thank you very much for your presentation. The committee appreciates that.

We've got about 30 minutes for questions. Laurie, your hand is up.

Ms Blakeman: First off the board. Thank you very much. I have a series of questions, but I know there'll be a long list, so I'll just keep putting myself at the back of the bus.

My first question. You've talked quite a bit about risk. I'm wondering how you approach the concept of ethical investment. This is citizens' money that you are working with on our behalf. I think there's a strong argument that it is government money and that it should not be used to do things that could hurt its own people. I'm sure you're aware that Norway has, for example, an ethical investment policy. Are you considering that for AIMCo? What's your position on that?

Dr. de Bever: In the past I have signed on to any number of United Nations and other protocols that deal with the ethics of investing, so that's not a big issue. Most of the time ethics and good business sense coincide, and that's a happy coincidence. Sometimes they do not. When they do not, you get into issues of: whose ethics are you trying to manage? That can be very difficult. Those instances are fairly rare, actually. I think that if the people of Alberta or the government or this committee or whoever sets the rules for the money I manage has views on how we should approach certain ethical questions, I will invest to that. I will manage by that. The problem is that one person's ethics are not always the same as another person's ethics. We have different views.

I'll give you an example. Some people feel we shouldn't be investing in companies that make alcohol because alcohol is a bad thing. Other people say: well, it's perfectly all right. Well, that is not a decision for me to make. If you have a strong view or if the people that ask us to invest the money have a strong view, then they should tell us what that view is. If I do not have a specific instruction, I will use, I guess, return and good business sense as the guideline, but I must tell you that most of the time that doesn't conflict with any reasonable notion of ethical investing.

Ms Blakeman: Okay. I'll go back on the end of the list, please.

The Chair: Art.

Mr. Johnston: Thank you. Just more of a clarification, on page 15, the economies of scale. If I understood, it's $200 million a year to run. Is that a year to run AIMCo?

Dr. de Bever: That's right. That's about 40 basis points or somewhere in there.

Mr. Johnston: I'm sorry. Forty?

Dr. de Bever: Yeah, .4 per cent.

Mr. Johnston: Okay. I just need an explanation on greenfield operation, if you could help me with that, please.

Dr. de Bever: A greenfield operation is where you start an organization completely from scratch as opposed to taking an existing organization and trying to make it work better. For instance, say that you have an existing power plant and you try to make it more environmentally friendly. That would be a brownfield plant as opposed to building a new one from scratch that has the latest technology embedded in it. So this would be seen as a brownfield in that terminology, meaning that it is an existing organization. It works pretty well, but we're trying to make it work better.

Mr. Johnston: Okay. Thank you.

The Chair: Alana.

Ms DeLong: Thank you very much. You spoke earlier about how important it was to keep costs down, but then you talk later about adding more staffing, moving to new premises, new IT support, a new management system. Are you looking at increasing your costs?

Dr. de Bever: Well, there will be increases in costs for two reasons. One is all those measures. To give you an example, the cost of a portfolio management system or a risk system is, essentially, the cost of a really bad trade that you capture because you have the systems to monitor it. In other words, having good systems to monitor what's going on is incredibly important. Costs are relatively small. In other words, all the staffing in this organization is .02 of 1 per cent of the assets of the company. So costs are relatively small, but they still need to be contained.

Ms Evans: Can I just add something here, Heather, to this?

The Chair: Yes.

Ms Evans: You'll notice in this presentation that it cites the need for improving IT and some of these things to make more efficiency. In our government over the last few years – and I think it's referenced in this last Auditor General's report – it's noted that some of the IT systems have been less proficient than what would be desirable. It's my view coming into the department and reviewing some of the comments from the Auditor General that when we've made decisions to put education and health and some of the other service levels at a higher plateau, this department has been getting the short straw in trying to manage some of these areas, which, of course, AIMCo fits within the context of and has been served by Finance and Enterprise.

The issues that Leo is trying to address to make AIMCo more efficient are also issues that we're well aware of in our department that we have to be more efficient on, but with that comes an investment that Finance traditionally has not made. Over this coming year we're struggling with that because we also have the added responsibility of the teacher pension liability fund.

8:40

When you look at what we are proposing for budgets when those come forward next year, we are also conscious that we have needs to improve our IT systems in the department as well as AIMCo has as an arm's-length Crown corporation. It has been something that's built for some period of time, not because there hasn't been a desire to have better but because this group, like the prudent parent, has been giving to others first and to themselves last. I can certainly attest to that from having been in other ministries.

I'm sorry to interrupt, Leo, but that's a good part of what I see that has mitigated or fettered the ability of AIMCo to really be there in a more efficient fashion and probably overall has added to the cost because there has to be some expenditure to improve that.

Dr. de Bever: Just to add to that, the Auditor General's report at various times has observed that too many systems at AIMCo are manual, and that is an invitation for error and loss. What we should also factor in: you've probably read a lot about the need for better governance following what's been happening on Wall Street. Well, better governance is desirable, and I support it, but it costs money. The costs, by the way, are not astronomical. As I pointed out, 75 per cent of that $200 million right now goes to external managers. The internal cost is around $50 million. Of that, only about $15 million or $20 million is salaries, and the rest of it is rent and whatever else.

Ms DeLong: Thank you.

Do I get a follow-up question?

The Chair: No. I'll put you back on the speakers list.

We've got Doug and then Laurie.

Mr. Elniski: Thank you. Thank you, Leo. It's good to finally meet you here today. I have a question about the structure of the organization and particularly as it relates to what you're referring to as the alternative or maverick risk portfolios. How are your portfolio managers structured? Do you have specific people that are looking for alternatives, or is that kind of an aggregate activity? How are we doing that?

Dr. de Bever: Well, the term "alternatives" has been abused in that it can mean everything and nothing. It's sort of like the term "hedge fund." It can cover any number of good and bad investment strategies. I am, frankly, a bit of a cynic on some of that stuff. But what I mean by alternatives – and I'll use infrastructure as an example. When we started investing in it, it had certain characteristics that were very desirable for my clients. I needed a real return stream that was long term and fairly stable, so we started investing in toll roads, in transmission systems, in things of that sort where you have a quasi-monopoly that is regulated. In return for that regulation the client gets a stable cost, and the investor gets a stable return. So that's the kind of asset that would rank as alternative.

I've just hired a former colleague named George Engman to do direct investment in private equity. Private equity, again, has been one of these areas where, if you invest in it prudently and at low cost or at as low a cost as you can get it, you can get some very attractive long-term incremental returns. So we do have experts in that area.

Another person we are bringing in is Brian Gibson, who at Teachers' introduced a concept of relationship investing. He was, for instance, very active in the creation of WestJet. He took a very big position in that company and helped it in structuring its business while it was growing.

These are some examples of experts that we can bring in if we can offer them competitive salaries with the real private sector as opposed to the pension sector. They find it very attractive to work in an environment like this because, unlike an investment management company like, say, Goldman Sachs, you don't have to look for the capital. The capital is here. Your job is to find the best investment opportunity for it.

Mr. Elniski: Thank you.

The Chair: Ms Blakeman and then Mr. MacDonald.

Ms Blakeman: Thanks very much. I'm interested in how the managers are rewarded. Do the portfolio managers within AIMCo receive bonuses based on the investment returns?

Dr. de Bever: They do. I've been very cognizant of the optics that that creates. Just to give you some example, the benchmark in some sense, of course, is what markets will deliver. To the extent that we can do better than that in the long run, that is the managers' performance. A split is in the order of for every dollar in excess return that managers generate, we aim to give 97 cents to the client, and 2 or 3 cents goes into the reward for the managers. So they are incented on financial returns, as I think is quite appropriate.

What we find in comparing that system with what, say, a typical investment manager gets paid or how he gets paid is that their systems tend to be much more dominated by measures of how many assets they manage. I don't really care how many assets we manage. All I care about is how much excess return we produce for our clients, so I want my managers to be paid for the results that they add to the bottom line for the client.

Ms Blakeman: So you're the oversight for that?

Dr. de Bever: No, the board is ultimately the oversight. We had a board meeting on Friday that created the basic framework around how we're going to do that, and we set targets in conjunction with the board. They're long-term targets, four years typically. I'd like them to be a lot longer, but for tax reasons we can't do that. The tax office won't allow us. The reason I like long term is that our strategy is long term, and in our business four years is really not long enough, but I'll take what I can get in terms of the period over which we pay. So the board sets the targets and provides the oversight.

Ms Blakeman: Thank you.

The Chair: We've got Hugh and then Jonathan.

Mr. MacDonald: Yes. Thank you. You state on page 4 of your PowerPoint presentation, assets under management, that you have 34 and a half per cent in pensions. What are the losses in the public pension funds in the second quarter of this year?

Ms Evans: Just a point of clarification for me because I'd like to understand whether or not your mandate is about the pension fund or about AIMCo's management of the heritage fund. I'm seriously asking the question without some sure thing about where we're supposed to go with that. Can I just have that confirmed?

The Chair: My understanding is that it's under the heritage fund and the management.

Ms Evans: So where, properly, could the MLA for Edmonton-Gold Bar receive his answers relative to the pension fund management? Would that be from the pension fund boards?

The Chair: Yes.

Ms Evans: Madam Chair, I just bring that to your attention because in the House I've tried to differentiate that. The pension fund boards, in my view, direct the level of risk and liabilities associated with the fund. AIMCo does that management, but AIMCo is not accountable through to the Legislative Assembly for the management of that pension fund.

The Chair: That is correct.

Ms Evans: Those are their degrees to manage. As the government does appoint the board members for the pension fund, that in terms of the way they choose to manage those funds is the limit of what I am to do. Is that not correct? Could you comment on this, please, Robert?

Mr. Bhatia: That's basically right.

Ms Evans: So with that understanding do you want Leo to proceed with some answer to Mr. MacDonald?

The Chair: First of all, Mr. MacDonald, you're okay with writing the pension to get some answers is what the minister is saying.

Mr. MacDonald: Well, I don't think that that should be necessary. We have a presentation here from AIMCo that indicates that 34 per cent of the total investment pool is for public-sector pensions. We went through a long list here. It's certainly on the agenda, and I don't think the question is unusual, unreasonable, or out of order.

Dr. de Bever: Well, let me answer the question in general terms, okay? When you set an investment policy that has 60 per cent equities in it, the bulk of your return will come from how equities perform in the market. For the sake of argument, if you have 60 per cent equities and equity markets go down 10 per cent, well, that cost you 6 per cent. They've gone down a lot more than 10 per cent. But when you embark on a strategy like that, you factor in that on average having 60 per cent equities gets you roughly 4 per cent more than you would get from a bond portfolio, but in any specific year you won't.

8:50

For instance, if you go back to 1982, and you had set a strategy of 60 per cent equities, it would have delivered over that period, even with the current downturn, exactly what you would expect from that. But in some years it's ridiculously easy to get good returns, and other years it is not. Last year, obviously, it was not. The specific loss from a 60-40 split, given that the bond side of that equation has worked reasonably well, you're still getting positive returns, has been, depending on when you looked at it – for instance, this morning markets are down 5 per cent. They're moving so quickly, it's hard to put a pin in it. But somewhere around a 15 per cent loss in an aggregate portfolio is probably pretty typical for a 60-40 split.

We're not alone in that. You may have seen that Harvard managed to do much worse than we did, and the reason for that is that their risk profile is much higher than ours. In other words, their clients signed up for a risk allocation that was much larger than ours. For a number of years that worked wonderfully well. This year it worked terribly because risk has no return this year. It has a huge loss. You have to take the good with the bad, and that's often what we forget. When stock markets generate 15, 20 per cent, we're patting ourselves on the back, but we sometimes forget that there's a flip side to that. You are going to get years like the one we're having now.

Mr. Denis: My question also related to pensions. I'd ask you to go to the next person on the list.

The Chair: Verlyn.

Mr. Olson: Thank you. I'm interested in the 75 per cent, 25 per cent split in terms of internal management to external management. In a perfect world would your ideal be that it would be a hundred per cent internally managed? What are the determinants of managing it internally and externally?

Dr. de Bever: We're brutally pragmatic about that. You never should manage money in an asset class where you don't have any expertise because that's an invitation to losing money that you shouldn't lose. So we will only manage money inside if we have the skills to do it. Most of what is managed externally is in the alternative asset class field, where the fees are very, very high and where we did not have the expertise to lower those costs. If you can invest alongside a partner with your own people and your own analysis, that often lowers the cost dramatically, and that's the process by which we're engaging.

We're graduating from relying completely on outside managers to doing some of it ourselves to in some cases leading a transaction. I would think that within one or two years you will see us leading an infrastructure or a private equity transaction because we will have graduated to the point where we will have the skills inside to do that effectively. But I would never do anything of the sort unless I had those skills inside, and what that means is that you're paying a lot if you try to do it externally.

Does that answer your question?

Mr. Olson: Yeah, I think so. It's not that we're not at a hundred per cent because of some deficiency somewhere and we should be trying to get to a hundred per cent.

Dr. de Bever: No. You don't get to a hundred per cent because I cannot afford to have the skills on board to do certain things that are maybe very profitable. But in areas like private equity and infrastructure and in most categories of active equity investing, we will eventually be able to do most of that ourselves, and then you will see the cost equation flip from 75-25 to 50-50. When you look at Teachers', I think the dominant proportion of cost is internal, but of course the cost per dollar of assets managed because of that is very much lower, and that's where you get the economy of scale effect.

Mr. Olson: Thank you.

The Chair: Alana and then Laurie.

Ms DeLong: Actually, Verlyn just asked my question.

Ms Blakeman: I'm interested in the risk profile. On behalf of my constituents walking around through the park there, can you describe to us how that risk profile – you just missed them, but thank you for looking. Yeah. They just walked behind the trees, not to worry. I knew you'd check. They're right there. But what is that risk profile, and how do you arrive at it? You must set a certain amount of it, but then I'm assuming that some comes from the board; some comes from the minister; some may come from this committee. Can you talk about those two sides of things? What is the risk profile, and where does the determination of that particular amount of risk come from?

Dr. de Bever: Okay. When I talk about risk, I mean losing money in a really, really bad year. That's my sense of risk. How bad can things get given the asset mix that you've invested given that you don't control markets, right? Markets will do whatever they do. Markets are driven by human behaviour. When people are feeling good and they are positively disposed, particularly to equities, markets will go up. Then you'll get fear setting in, and all of a sudden everybody pulls out of the market and sits in cash, which is what we're currently experiencing.

Maybe one of the things that hasn't been done as well as it could have been before in a lot of organizations is to focus on what risk really is. When I was in Australia, the first thing I did was that I went to the government and said: do you realize that you're running 10 per cent volatility, meaning that in 1 out of 6 years you could lose 10 per cent of your assets? That's what volatility means. Volatility is a 1 in 6 worst annual outcome. Now, 1 in 6 is not even all that uncommon, right?

For instance, in our strategy with the heritage fund the risk is set so that in 1 in 6 years you could expect a shortfall from that expectation of your CPI plus 4 and a half of about a billion dollars. This is obviously a much worse year than that, right? The markets have come down a fair bit more. But keep in mind that accepting that risk is acceptable in that if you do it long enough, risk will have a return. Risk has a return of about 4 per cent a year on average, but that average is composed of outliers, both on the upside and on the downside. We feel very good when things are on the upside and not so good when they're on the downside.

That's what risk means to me. But how we set it: traditionally what people do is that they invite asset-mix consultants and so on to come up with a mix of stocks and bonds and alternatives that gives us a measure of how bad things could get in 1 year in 6 or 1 year in 20 or 1 year in 100. That process is increasingly starting to be a co-operative process between our partners and clients and our own staff because we're starting to develop a fairly sophisticated capability to guide our clients in that. But we keep bringing it back. Rather than, saying, you know, "How much money do you want to have in the stock market?" we say: "How much can you really tolerate? How much can you stomach?"

In the case of pension funds there is a limit that is imposed by how those funds are regulated. In the case of the heritage fund there isn't such a direct driver. You can afford, if you desire, to have a fairly aggressive asset mix that has a lot of downside risk and therefore a lot of upside on average if you're prepared to do that because you don't have a regulator that says that you have to show against some target. Of course, for a pension fund that is the liabilities that they owe to the pensioners; you have to be fully funded. The heritage fund doesn't have that restriction, so the process by which you set a risk target for the heritage fund is somewhat different than what it is for a pension fund. It can afford, because of its long-term nature, to be a bit more aggressive.

Does that answer your question?

Ms Blakeman: Half of it. The other was: who is setting that risk?

9:00

Dr. de Bever: Who is setting it? Well, it's a co-operative process. In this case we work with the Department of Finance and Enterprise to determine what's appropriate, and we give them our input. Jointly we then say: well, okay; if that's our risk tolerance, what fits within that range in terms of assets we could invest in? Then we execute on that policy. That's the process.

Ms Evans: The ultimate responsibility for policy direction is the minister's. As you'll recall, at the last meeting I came here and amended the documents relative to the heritage fund, noting the responsibility of the minister and the government relative to policy.

Ms Blakeman: Thank you.

The Chair: Okay. We're already out of time, and I still have three questions. Dr. de Bever, would you be okay with taking three more questions?

Dr. de Bever: Sure. Absolutely.

Mr. Elniski: Okay. Wonderful. This won't take very long, Leo. On that question of economies of scale I'm noticing that you do have, in fact, some actions identified here at a pretty high level. When do you anticipate results?

Dr. de Bever: Well, I'll give you an example. This portfolio management system is a key component to knowing where our assets are. Knowing where your assets are is a key component to figuring out that they're not in the wrong place and that they're not sitting idle. Putting an IT system of that sort in place, even when you run like heck, like we are right now, is an 18-month to two-year process. We're bringing in a credit risk system. That can probably be done in six months. Of course, credit risk has been a particular weakness for a lot of organizations, ours included. That's the time frame. Depending on what kind of monitoring system you're talking about, it could be between six months and two years.

Mr. Elniski: Okay. Good. Thank you very much.

The Chair: Mr. MacDonald and then Jonathan.

Mr. MacDonald: Yes. Thank you. Is there a concern here in Alberta with a shortage of liquidity with any of the funds under the management of AIMCo?

Dr. de Bever: Not really. We've tried with the help of the minister to ease that liquidity constraint a little bit. The accumulation of funds on the government side has been very rapid. Traditionally, these funds have been kept in very, very short instruments, mostly cash, bonds. We have a bit of room there, on the one hand, to give the government some really attractive returns on that cash because cash is gold right now. At the same time, having that cash then allows us to manage the endowments and the pensions a bit better than we otherwise could.

You may have seen, for instance, that the Caisse de dépôt had a huge problem with cash in part because of what happened in the market. I wouldn't blame them for doing something wrong, but as you may have seen, their problem arose because all of a sudden they had $13 billion in commercial paper that turned out not to be commercial paper cashable in 90 days anymore. That was a very nasty surprise.

Liquidity is extremely important. We try to economize on it as best we can and to find as much of it within the overall portfolio. You may have seen that others have found new solutions to it. PSP just issued a $500 million bond issue. PSP is the public service pension plan, based in Montreal. Teachers' has done that on occasion as well. Sometimes it's because they have liquidity constraints and sometimes it's because they find, regardless of whether there is a constraint or not, that the return on what they can invest in is much higher than what they can borrow at.

Mr. MacDonald: Thank you.

Mr. Denis: Earlier you talked about Brian Gibson's concept of relationship investing. I know that it relates to for-profit companies like WestJet. I wonder if you could talk about the difference in how that concept applies to a public management fund vis-à-vis a listed company like WestJet.

Dr. de Bever: Well, WestJet was an investment of Ontario Teachers', so this would be the same thing. Brian is starting with us on Wednesday, actually, and what I would expect him to do on occasion is take a rather significant position in the public company. He did it with Fording on another occasion. So you take a big position in a public company, from an AIMCo point of view, and you use that position to work with management to restructure the capital of the company to get a better return for shareholders.

Did I get your question, or did I misinterpret what you were asking?

Mr. Denis: I was just talking about the concept of relationship investing from a private company versus a public fund.

Dr. de Bever: Well, it doesn't matter who the investor is. What matters is that the relationship you have or the relationship you're building is with the public company. Now, you can do it in private equity, if that's what your question was. Private equity, basically, says that we can't restructure the company in public because quarterly reports cause us to be under strains that are very difficult to deal with when we're trying to do the best for the company in the long run or the best for its owners. So we take the company private, and we do all that stuff without having to worry about quarterlies. Is that the gist of your question?

Mr. Denis: Roughly, yes.

Dr. de Bever: Okay. Well, sometimes you don't have to take a company private to do all of that. That's the short answer to it. In other cases the company has so many problems that you might as well take it private.

Mr. Denis: I trust we're not at that point.

Dr. de Bever: No, no, no.

The Chair: We want to thank you as a committee for presenting. I think it was very informative. On behalf of the committee I thank you. We hope to see you again in the future some time.

Dr. de Bever: Thank you.

The Chair: Thank you so much.

Ms Evans: Could I just ask a question? On a regular basis I get from AIMCo a rather delightful summation of the state of the nation on the finances. Would committee members here appreciate being on that link? I think it's not only very useful information; I have found Gary Smith, who has been doing it thus far, a rather delightful read. You know, the weeks that the market has been rather horrific, he has expressed it in most colourful language, and it's entertaining reading if you want to read about the history. We could get the committee members if they would appreciate it – would everybody like to be on that list?

The Chair: Yes.

Ms Blakeman: Is this short or long? Are we talking 10 pages?

Ms Evans: Oh, no. You can read it quite simply, and it takes about five minutes to read on your e-mails.

The Chair: Through the clerk, please, Madam Minister. If you can send the information through the clerk, she'll distribute it to the members.

Ms Evans: Very good.

The Chair: Great idea. Thank you.

We're going to move on to item 7, report on the 2008 annual public meeting in Edmonton. As everyone's aware, the public meeting was held on October 16 in the Edmonton-Calder constituency. Melanie Friesacher, a communications consultant, has some information for us on the public meeting.

Ms Friesacher: Thank you, Madam Chair. As you mentioned, it was held on Thursday, October 16, in the constituency of Edmonton-Calder. The meeting attracted approximately 32 members of the public, and media coverage included Global TV and CBC radio. Of the public that attended, about 11 people did address the committee.

The demographics that we have, based on questionnaires: 38 per cent fit into the 60-plus age category, 15 per cent between the ages of 36 and 45, and 46 per cent in between there. So a good mix of people.

How did people hear about the meeting? Fifty-four per cent heard about the meeting through the newspaper, and 31 per cent heard about the meeting through their MLA. The majority of people were somewhat satisfied with the information about the heritage fund, about 70 per cent, and would like to hear more about long-term plans.

In measuring website activity, the number of user sessions was 842. That indicates how many users actually visited the site and requested a page. The most active day was October 16, which was the day of the public meeting, with 150 user sessions. Our site was visited, actually, quite lengthily. The average user session length was six minutes and four seconds, which meant that they stayed around and had a look. The spikes that we saw were actually between October 6 and October 19, which coincided with our advertising campaign.

The Chair: Melanie, thank you.

Ms Friesacher: You're welcome.

The Chair: Are there any questions for Melanie? Go ahead.

9:10

Ms Blakeman: Yes. Thank you. Earlier I'd asked a question about whether there was a formula or a way of distinguishing between hits on the site and actual individual users. Now, those 800 – thank you for that information; it's very useful. Were you able to come up with a formula that we could reference back to the – I think it was 3,000, wasn't it? It was some amazing number of hits on the site that we were talking about at the September meeting and trying to distinguish between people that had accidentally stumbled on the site looking for the Heritage Mall as compared to looking for the heritage savings trust fund.

Ms Friesacher: Right. Now, the site I'm referring to is actually our committee site. I think the one that you had a question on was the heritage fund site. So I'll let you respond to that one.

The Chair: Yeah. That's the next item on the agenda.

Ms Friesacher: Oh, it is? Okay.

Ms Blakeman: I was actually talking about the committee site, but that's okay. I'll take both answers. I won't turn anything down.

The Chair: We've kind of put on the agenda item 7(a) and 7(b), so we can do both if you wish. We received a memo from the minister. Have you got that?

Ms Blakeman: I'm sure I did.

The Chair: It's there. It's dated November 25. Laurie, if you look at it, it's very interesting. It's a two-sided memo. It came with your package, anyhow.

Ms Blakeman: Sure.

The Chair: If we can go to Kari-ann about this. Do you have an extra copy?

Ms Kuperis: I can give you mine.

The Chair: It came at the very end of the package. It's probably attached to your AIMCo thing.

Ms Blakeman: Thanks.

The Chair: Laurie, go ahead and ask your questions.

Ms Blakeman: I was looking for – oh, yeah, here it is. It was a very high number. Yeah, that's it. When I'm looking at all of these hits, there's an enormous number of them, and what I was trying to figure out is how many people were actually spending time on the site as compared to counting hits. Do you have a way of doing that?

Ms Kuperis: No. The hit count is the actual number of page views versus visits. Like a visit could be – you look at a school or a library; they have one IP address, so we'd only count that once. There could be 70 people looking at the page, but it would only count once. That's what I count, hits, as opposed to visits.

Ms Blakeman: This one's counting IP address visits?

Ms Kuperis: No. This is counting hits, like page views. The number of computers visiting the site versus the number of pages that are viewed.

Ms Blakeman: Okay. Is that a common measurement?

Ms Kuperis: You can count it both ways. I think it's more accurate if you count the number of page views versus the number of computers that are looking at it.

Ms Blakeman: I agree.

Ms Kuperis: You had asked about an industry standard for just counting inadvertent visits.

Ms Blakeman: Yes.

Ms Kuperis: The web co-ordinator is not aware of anything like that. There is an example in the memo. She used Heritage Mall, so she searched heritage fund versus Heritage Mall in the examples. The results are there. She's not aware of any industry standard to discount a certain amount of views.

Ms Blakeman: Okay. So we take these numbers, then, as coming from one computer but spending some time on the site because they're looking at different – they're actually requesting certain pages.

Ms Kuperis: Yeah. It's the page views. I don't know if it's the number of minutes. I don't know if we can count that, but it's the actual page views.

Ms Blakeman: Okay. That's helpful. Thank you for both reports.

The Chair: Thank you. Any other questions?

Okay. We're moving on. Other business. Is there any other business members would like to raise? Seeing none, we'll move on.

The date of the next meeting is at the call of the chair following the release of the third-quarter update on the fund, usually in late February.

The last item on the agenda is a motion to adjourn. Before we do that, I'd like to wish everybody a happy holiday and Merry Christmas. After all, it's the 1st of December. We won't see you until the new year under this committee. I wish everybody the best.

If we can have a motion to adjourn. Jonathan. Thank you.

[The committee adjourned at 9:14 a.m.]

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