The Changing Role of the Asset Owner

Moderator: Christine Williamson, Senior Reporter, Pensions & Investments
John Denham, CPA, CFA, Workplace Safety & Insurance Board (WSIB)
Ashby Monk, Ph.D., Global Projects Center, Research, Stanford University
Eduard van Gelderen, CFA, FRM, APG Asset Management N.V. & APG Group
Richard Young, State Street Corporation
DIALOGUE 1:
The Changing Role of the Asset Owner

Ashby Monk
Executive and Research Director
Global Projects Center
Stanford University
Short termism is endemic
Lack of investment dollars for critical “projects”
While finance is increasingly out of step with industry, it’s getting more profitable.
Some investors, however, have noticed...

**Wall Street Fees Wipe Out $2.5 Billion in New York City Pension Gains**

By PATRICK McGEEHAN  APRIL 8, 2015

The Lenape tribe got a better deal on the sale of Manhattan island than New York City's pension funds have been getting from Wall Street, according to a new analysis by the city comptroller's office.

The analysis concluded that, over the past 10 years, the five pension funds have paid more than $4 billion in fees to money managers and have received virtually nothing in return. Controller Scott M. Stringer said in...

**Fees matter more than asset allocation**

John Authers

Investment strategy study confirms importance of cost control

Real Returns
1913 to 2013
The ‘low cost’ investment model...

‘LOW COST’ Institutional Investors

Fund of Funds, Placement Agents, oCIO, Consultants

Asset Managers

Buy Side Banks

Sell Side Banks

Investment Opportunities

Opportunity Sponsors: Companies, Governments Etc.

FEES!

MAGIC!
What are we doing at Stanford to try to help?

“We seek to facilitate understanding of the financing, development, and governance of critical infrastructure worldwide.”
We think a better understanding of the fees and costs in investment products – internal and external – is akin to a better understanding of the ingredients in your food...

We think investors need to start shopping at “whole finance”!
We focus on helping the $100 trillion find better and more aligned access to the “real economy”. This has led to an over-arching research focus on the following:

1) Professionalization of Asset Owners
2) Re-Intermediation of External Service Providers
3) Technological Adoption
4) New Conceptual Tools
Today’s session: internal capabilities is an important part of the solution...

- Investors need to take responsibility for how their assets are invested;
- They need to professionalize;
- They need to realize that they have to be run as a business;
- They need to realize that they are the principals in the long chain of principal-agent relationships;
- They need to realize that they set the incentives for their agents;
- They may need to get closer to the underlying assets and remove some of the layers of intermediation.
Thanks, Ashby! In-sourcing does seem great. Look at me go!
Yeah, Thanks, Ashby!
The Pyramid of Direct Investing Excellence...

Based on 20 case studies of asset owners with direct investment capabilities.

Clark and Monk 2012
Dialogue 1: The Changing Role of the Asset Owner

Eduard van Gelderen, CFA, FRM
Chief Executive Officer, APG Asset Management N.V.
Chief Investment Officer, Member of the Executive Board, APG Group
APG as an Asset Owner

- APG Group is owned by two large Dutch pension funds
- APG Group is financially sound, whilst profitability is not the main driver
- Concentrated client base
- Total AuM = € 425 bn
- 10-year track record: 7.1% - 8.1%
- 4.5 mil participants
Mission Statement APG AM

• We are investors of pension money. Our clients and their participants are at the forefront of our thoughts and actions

• We use all of our experience, expertise and innovative power to invest the pension premiums in a sound, responsible and cost effective way

• We contribute to a high quality and affordable pension for the participants of our clients, by realizing a stable, long term return on investments, while taking measured and controlled risks.

• Helping to achieve a sustainable world is an inherent part of our investment process
### Role of the assets

<table>
<thead>
<tr>
<th>Cash Flow</th>
<th>Return</th>
<th>Diversification</th>
</tr>
</thead>
<tbody>
<tr>
<td>Treasuries</td>
<td>Developed Equity</td>
<td>Emerging Market Debt</td>
</tr>
<tr>
<td>Inflation Linked Bonds</td>
<td>Emerging Equity</td>
<td>Hedge Funds</td>
</tr>
<tr>
<td>Credits</td>
<td>Real Estate</td>
<td>Commodities</td>
</tr>
<tr>
<td>Infrastructure</td>
<td>Private Equity</td>
<td>Opportunities</td>
</tr>
</tbody>
</table>

**Investment Strategy per Asset**

- **Smart β**
- **Market β**
- **α**
Internal vs External Management

- Cashflow (35%)
- Return (45%)
- Diversification (20%)

Opportunities:
- Treasuries
- Inflation Linked
- Credits
- Infrastructure
- Equity Developed
- Equity Emerging
- Private Equity
- Real Estate
- Emerging Market Debt
- Commodities
- Hedge Funds
- Opportunities

Internal vs External controls:
- 0%
- 20%
- 40%
- 60%
- 80%
- 100%
Role of external managers

• The use of external managers is related to:
  • complexity of the asset class / investment strategy
  • duration and level of excess return of investment opportunity
• Most external managers can be found in the $\alpha$-part of the investment triangle; most of the smart-$\beta$ strategies are done in-house due to clear cost benefits
• External manager selection and monitoring is responsibility of the building bloc; no use of external investment consultants
• Compliance with APG AM’s set of fee principles as well as ESG principles is non-negotiable
Challenges

- Due to aging more reliance on investment returns than pension premiums
- Alternative investments offer interesting investment premiums above standard market β
- In-house investments require (costly) set-up of people, market intelligence and technology
- Trustees’ focus on costs and not fully comfortable with dealing with scalable illiquid long-term investments
- Current regulatory framework is biased towards capital market investments
DIALOGUE 1:
The Changing Role of the Asset Owner

Pension Funds DIY: A Hands-on Future for Asset Owners
Featuring Preliminary Results of the
State Street 2014 Asset Owner Survey

June 16, 2015
Richard Young, Senior Vice President

This presentation features data from the
State Street 2014 Asset Owner Survey
conducted by the Economist Intelligence Unit
State Street 2014 Asset Owner Survey

About the Research: Pension Fund Respondents

On behalf of State Street, EIU conducted a global survey of institutional asset owners during July and August of 2014. The survey garnered 134 responses from pension fund executives, spanning both defined contribution and defined benefit assets.

Respondents by Institution Type

- 31% Private sector pension or retirement system
- 52% Public sector pension or retirement system

Respondents by Region

- 42% Americas
- 36% EMEA
- 22% APAC

Executive Summary

This executive briefing explores how pension funds are adapting to the challenges of a new investment environment.

<table>
<thead>
<tr>
<th></th>
<th>Five trends are reshaping the industry</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Risk</td>
</tr>
<tr>
<td></td>
<td>3 out of 4 pension will ramp up their risk appetite as the search for returns intensifies in a tough investment climate, with 25% investing in hedge funds for the first time</td>
</tr>
<tr>
<td>2</td>
<td>Investment</td>
</tr>
<tr>
<td></td>
<td>Private equity will be biggest winner from a surge in alternatives investment by pension funds</td>
</tr>
<tr>
<td>3</td>
<td>Insourcing</td>
</tr>
<tr>
<td></td>
<td>Insourcing changes the game as 4 out of 5 pension funds plan to take control of their destiny and manage more of their assets in-house</td>
</tr>
<tr>
<td>4</td>
<td>Performance</td>
</tr>
<tr>
<td></td>
<td>Pension funds set a new threshold for performance from their asset managers</td>
</tr>
<tr>
<td>5</td>
<td>Governance</td>
</tr>
<tr>
<td></td>
<td>Half of pension funds will prioritize improvements to governance as regulatory scrutiny intensifies</td>
</tr>
</tbody>
</table>

Five Trends Are Reshaping the Industry
Getting Hands-on With Investment Risk

More risk on the horizon for 3 out of 4 pension funds

Where do you see investment opportunity for your institution increasing or decreasing?

<table>
<thead>
<tr>
<th>Market Type</th>
<th>Strongly increasing</th>
<th>Slightly increasing</th>
<th>No change</th>
</tr>
</thead>
<tbody>
<tr>
<td>Developed Markets</td>
<td>19%</td>
<td>62%</td>
<td>16%</td>
</tr>
<tr>
<td>Emerging Markets</td>
<td>11%</td>
<td>52%</td>
<td>35%</td>
</tr>
<tr>
<td>Frontier Markets</td>
<td>5%</td>
<td>21%</td>
<td>65%</td>
</tr>
</tbody>
</table>

0% Strongly increasing | 50% Slightly increasing | 100% No change

# Five Trends Are Reshaping the Industry

## Big Bets on Alternatives

60 percent of pension funds set to increase allocations to private equity

<table>
<thead>
<tr>
<th>Category</th>
<th>Increase Allocation</th>
<th>Decrease Allocation</th>
<th>Invest for the First Time</th>
<th>No Change</th>
</tr>
</thead>
<tbody>
<tr>
<td>Private Equity</td>
<td>60%</td>
<td>2%</td>
<td>5%</td>
<td>28%</td>
</tr>
<tr>
<td>Direct Loans</td>
<td>54%</td>
<td>2%</td>
<td>6%</td>
<td>28%</td>
</tr>
<tr>
<td>Real Estate</td>
<td>45%</td>
<td>2%</td>
<td>2%</td>
<td>45%</td>
</tr>
<tr>
<td>Infrastructure</td>
<td>39%</td>
<td>2%</td>
<td>9%</td>
<td>50%</td>
</tr>
<tr>
<td>Hedge funds (single)</td>
<td>29%</td>
<td>2%</td>
<td>3%</td>
<td>25%</td>
</tr>
<tr>
<td>Fund of hedge funds</td>
<td>20%</td>
<td>3%</td>
<td>27%</td>
<td>29%</td>
</tr>
</tbody>
</table>

**Source:** State Street 2014 Asset Owners Survey, conducted by the Economist Intelligence Unit. As of August 2014.
Five Trends Are Reshaping the Industry
DIY on Asset Management

4 out of 5 pension funds plan to manage more of their assets in-house

Insourcing Intentions: Over the next three years, do you plan to...

- Increase the proportion of your portfolio that is managed in-house
- Make no change to the proportion of your portfolio that is managed in-house
- Decrease the proportion of your portfolio that is managed in-house

Five Trends Are Reshaping the Industry  
The Relationship With Asset Managers Evolves

Pension funds set a new threshold for performance from their asset managers

Have you experienced any of the following over the past year with respect to your external managers?

<table>
<thead>
<tr>
<th>Issue</th>
<th>Major challenge</th>
<th>Minor challenge</th>
</tr>
</thead>
<tbody>
<tr>
<td>Gaining a complete picture of risk-...</td>
<td>18%</td>
<td>40%</td>
</tr>
<tr>
<td>Ensuring their interests are aligned with...</td>
<td>16%</td>
<td>36%</td>
</tr>
<tr>
<td>Conducting due diligence post-hire to...</td>
<td>10%</td>
<td>28%</td>
</tr>
<tr>
<td>Conducting due diligence when hiring...</td>
<td>8%</td>
<td>28%</td>
</tr>
<tr>
<td>Justifying the fees</td>
<td>6%</td>
<td>23%</td>
</tr>
</tbody>
</table>

Five Trends Are Reshaping the Industry
Fortifying Governance

Improved governance is a high priority for more than half of pension funds

What level of priority will your institution place on strengthening the following areas over the next three years?

<table>
<thead>
<tr>
<th>Area</th>
<th>High Priority</th>
<th>Medium Priority</th>
<th>Low Priority</th>
</tr>
</thead>
<tbody>
<tr>
<td>Regulatory compliance</td>
<td>61%</td>
<td>35%</td>
<td>4%</td>
</tr>
<tr>
<td>Data management</td>
<td>55%</td>
<td>39%</td>
<td>6%</td>
</tr>
<tr>
<td>Overall governance</td>
<td>51%</td>
<td>41%</td>
<td>8%</td>
</tr>
<tr>
<td>Cybersecurity</td>
<td>24%</td>
<td>43%</td>
<td>33%</td>
</tr>
<tr>
<td>Contingency planning</td>
<td>10%</td>
<td>46%</td>
<td>44%</td>
</tr>
</tbody>
</table>

Focus for the Future

To succeed in today’s complex investment environment, pension funds will need to develop strategies in each of the following five areas:

1. **Manage the Risk Budget Across the Portfolio**
   - Invest in specialist tools and capabilities to improve analysis across multi-asset portfolios.

2. **Master the New Investment Mix**
   - Learn how to blend alternative investments with low cost strategies to strike a new balance on risk and return.

3. **Think Strategically on Insourcing**
   - Understand where your in-house talent can add more value. Create the operating model to optimize in-house asset management.

4. **Develop Strategic Partnerships with Key Managers**
   - Many pension funds are concentrating on developing fewer but deeper relationships with their asset managers.

5. **Professionalize Governance**
   - Ensure professional oversight on risk and governance. Make better use of expert trustees and / or specialist advisors.

Survey Methodology

• The international State Street survey was conducted by the Economist Intelligence Unit in August 2014. The information presented is based on the survey results of 134 senior executives in the pension fund industry. Respondents are from 15 countries, with the majority being drawn from the US, UK, Australia and Canada.

• Just over half (52 percent) of respondents came from public sector pension funds, 31 percent from private sector pension systems, and 16 percent from superannuation funds. Most respondents (62 percent) came from organizations that oversee both defined benefit (DB) and defined contribution (DC) funds.

• This survey sought to explore how pension funds are adapting to the challenges of a new investment environment. The survey was conducted online and consisted of ten multiple-choice questions.
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Risk associated with equity investing include stock values which may fluctuate in response to the activities of individual companies and general market and economic conditions.

Bonds generally present less short-term risk and volatility than stocks, but contain interest rate risk (as interest rates rise bond values and yields usually fall); issuer default risk; issuer credit risk; liquidity risk; and inflation risk. These effects are usually pronounced for longer-term securities. Any fixed income security sold or redeemed prior to maturity may be subject to a substantial gain or loss.

Investing in foreign domiciled securities may involve risk of capital loss from unfavorable fluctuation in currency values, withholding taxes, from differences in generally accepted accounting principles or from economic or political instability in other nations.

Investments in emerging or developing markets may be more volatile and less liquid than investing in developed markets and may involve exposure to economic structures that are generally less diverse and mature and to political systems which have less stability than those of more developed countries.

Investing in REITs involves certain distinct risks in addition to those risks associated with investing in the real estate industry in general. Equity REITs may be affected by changes in the value of the underlying property owned by the REITs, while mortgage REITs may be affected by the quality of credit extended. REITs are subject to heavy cash flow dependency, default by borrowers and self-liquidation. REITs, especially mortgage REITs, are also subject to interest rate risk (i.e., as interest rates rise, the value of the REIT may decline).

There are risks associated with investing in Real Assets and the Real Assets sector, including real estate, precious metals and natural resources. Investments can be significantly affected by events relating to these industries.

Hedge funds are typically unregulated private investment pools made available to only sophisticated investors who are able to bear the risk of the loss of their entire investment. An investment in a hedge fund should be viewed as illiquid and interests in hedge funds are generally not readily marketable and are generally not transferable. Investors should be prepared to bear the financial risks of an investment in a hedge fund for an indefinite period of time. An investment in a hedge fund is not intended to be a complete investment program, but rather is intended for investment as part of a diversified investment portfolio.
Dialogue 1:
Changing Role of the Asset Owner

June 16, 2015
John Denham, Chief Investment Officer
Workplace Safety & Insurance Board
WSIB Overview

• WSIB assets under management are $25 Billion.

• We manage two pools of assets as follows:
  – $22.5 Billion Workers Compensation Fund
  – $2.5 Billion Employees Pension Plan Fund

• All investments are managed pursuant to pension prudent person investment rules

• We serve 200,000 injured workers in Province of Ontario

• We have ~4000 employees and ~8000 active and retired members of the pension plan
Increased Focus on Risk Governance

• Post financial crisis regulatory fallout
• Enterprise risk management rebirth (ERM 2.0)

Challenges

• Principal/agent risks
• Risk appetite vs. risk tolerance
• Risk awareness vs. risk measurement vs. risk management
• Risks inherent in “stretching” for return in a “low for long” environment
Strategic Insourcing, Partnerships, and Governance

Strategic approach assesses decisions along a continuum

Use of Strategic Partnerships varies along the continuum

- Insourced
- Passive
- Active
- Outsourced

Board of Directors
- Strategic Asset Allocation
- Risk
  - Tolerance/Appetite
  - Governance

Investment Committee
- Policies
- Risk Oversight

Management
- (monitoring, hiring/fire, risk management)
- Operational Excellence

Staff
- Research
- Implementation
- Risk Measurement
The Global Future of Retirement
June 14-16, 2015 | New York | The Waldorf Astoria

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