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A Conversation With... Tony Gage

To mark its 15th year of publishing, **Benefits and Pensions Monitor** is featuring a series of conversations with people who have made a significant contribution to the industry. Tony Gage is former chairman, president, and chief executive officer of Phillips, Hager & North **Investment** Management Ltd.

The following is an edited version of the conversation between Gage and **Benefits and Pensions Monitor** Executive Editor Joe Hornyak.

BPM: What would you say has been biggest change since you started in the industry?

TG: Canadian money managers now face a much more difficult environment. The elimination of the 30 per cent foreign property rule and the shift to liability driven investment (LDI) moves people away from a standard balanced, equity and fixed income fund. They can reproduce these by indexing and save themselves costs.

They have had to evolve in terms of not only the clients they have and the mandates they have, but in the way they manage money.

BPM: Is that why we're seeing a serious erosion of style? There was a time where a value manager was a value manager and a growth manager was a growth manager. Now, each year when we do our survey of money managers, we're asking if they're growth or value or 'other,' and they're selecting all.

TG: Consider a money manager who basically says 'we're just going to do global balanced mandates.' If he goes through a period of poor performance, investment risk just became business risk.

As you get larger, you want to offer different mandates so that business risk never impinges on investment risk.

Another consideration is over the last 10 years the number of foreign firms listed among the top managers in Canada has more than doubled. Elimination of the 30 per cent foreign property rule is part of the reason, but the other part is that these managers were able to respond to this changing environment. So, all of a sudden, an indexer like Barclays Global becomes a large hedge fund provider or TD Asset Management goes from being known as an 'index operation' – and they're still a significant one – to managing private equity.

Most Canadian money managers never reach that point. As a result, they're not getting the incremental flow. I looked at the dollar amounts that foreign firms manage. In 1997, foreign firms managed approximately 10 per cent of Canadian pension assets. As of June 2006, the comparable number was 27 per cent.

That's the challenge Canadian money managers face. There has been this evolution that Canadian money managers have not participated in and it has led them to being vulnerable to these changes.

Clients have changed as well. When I got into the business, clients were just getting into the game of relative performance and this was leading to the development of companies such as A. G. Becker and, later, SEI.

That has changed. Clients are not as inclined to care how they're doing relative to other people. Now they're saying 'we expect you to deliver this, with this kind of risk profile,' and it's against, where they can find it, a passive index.

Plus, when you underperformed 20 years ago, you probably could buy a reasonable period of patience. However, prudent person rule legislation in the early 1990s meant sponsors started to write these expectations: 'You shall, in fact, provide us with two per cent over the S&P/TSX on a moving four year basis.' If the manager doesn't meet the target, what does the sponsor do?

BPM: So, in essence, it meant pension funds had to start chasing returns?

TG: It left them very vulnerable because they had to fire money managers at their relative low and hire managers at their relative peak.

One of the most difficult things, which has always been the case, is people cannot convince either themselves or their bosses to hire a fourth quartile manager whose style is completely out of favour. Still, I remember one client who allocated cash flow inversely related to the relative performance of their managers. It was an incredibly successful strategy, but it required a degree of courage. I don't think most people would actually have the fortitude to follow such a strategy.

Because I was a bond guy and the bond market has a lot of mean reversion, I've had the philosophy that if a money manager has no other issues, you are simply hiring a style and you want to hire the firm when their style is out of favour. Pension funds won't do that, so they end up actually hurting their results with the hiring and firing process.

BPM: What about the impact of computers and technology?

TG: Most of the financial theory that we use as a base today – Capital Asset Pricing Model, Efficient Market Thesis, Option Pricing – was developed between 1950 and 1975. Our actual execution of these theories, knowing full well that there are some weaknesses to them, has occurred in the period of 1990 on because of the advent of better databases and technology. We were able to start using the power of computers to actually manipulate these numbers: the result being a proliferation of quantitative strategies. For example, asset liability models today, in my opinion, are much more realistic than they were 15 years ago.

BPM: About two years ago, I was at a PH&N conference and I heard you give an excellent speech on saving Defined Benefit pension plans. Do you hold out hope for them?

TG: There are still huge benefits to providing a Defined Benefit pension plan. Unfortunately, as I see it today, the differentiation between being in the public sector versus the private sector has only grown. That's not to say that the workers in the public sector don't contribute. If you look at the contribution rates of an Ontario teacher or a B.C. civil servant, they're quite significant. Clearly, to have a good pension plan, you do have to put money away.

However, in the private sector, there are many plans which are now being closed and replaced with Defined Contribution plans. The Defined Benefit component is a mature plan which will run off over a period of time. The question is how do you manage that. So we're seeing a lot more emphasis on liability driven investment where people are saying 'how much am I willing to put into a risk budget to achieve a higher rate of return?'

If interest rates back up some more from these levels, you'll see plans that have not gone to the liability-driven side move to it, particularly if the equity markets hold up. If plans can stay on the surplus side of the equation, there will be a window of opportunity for plans to quasi-immunize their mature liabilities.

In my speech I noted a number of weaknesses as it related to 401(k) plans. Since that time, we have seen improvements. There is a requirement of automatic enrolment and there is the growing use of life cycle funds, rather than money market funds, as the default option.

BPM: There are some who say the return to fully funded positions for these DB plans will also give plan sponsors a window of opportunity to close plans to new entrants or shut them down and move to DC plans.

TG: I think there will always be pressure in that way. Consider the U.S. which obviously has a large majority of DC plans now. I think they now have more assets on the DC side than on the DB.

In the UK experience, legislation has had the impact of accelerating the closing of DBs, and opening up DCs. The potential impact on the financial statements and the uncertainty surrounding assumptions are a nightmare for chief financial officers so I think the shift from DB to the DC side will continue.

BPM: And yet, it seems to be taking place at a snail's pace in Canada. We're still in a situation where there are only about 10 per cent of assets in DC compared to DB.

TG: You're talking stock versus flow and you've always got to be a little wary of those comparisons because the stock of DBs, particularly in the private sector, will start to shrink as those plans start to wind down.

On the other side of the equation, in the DB sector, there are these big public sector pension plans, some of which are mature, but some of which are not. They're looking at ways of diversifying and trying to find markets in which there is informational advantage or inefficiencies in the marketplace.

They're also looking at their liabilities and they're becoming more aggressive. They're using more leverage. They buy a real estate property and put a mortgage on it, that's leverage. If they go into a private equity fund, they're using leverage. Hedge funds are certainly using leverage. Measuring risk has improved, but we are being naïve if we think that a 'Value at Risk' calculation captures the actual risk we are taking.

Tony Gage is former chairman, president, and chief executive officer of Phillips, Hager & North Investment Management Ltd. His career at PH&N spanned more than 20 years. Prior to that, he was an assistant vicepresident at Confederation Investment Counselling, the pension fund management arm of Confederation Life. In fact, he contends his career is a classic example of the 'Peter Principle.' Now retired, he remains active in the industry as a director of PSP Investments and Sky Investment Counsel and as head of the management committee of JEA Pension System Solutions.

BPM: Just going back to LDI for a minute, one of the concerns I hear is there may not be enough fixed income product. As a fixed income manager, what is your view?

TG: I'm not as inclined to worry about the 'shortage side' of the equation. First of all, if there is demand, investment bankers will find the supply. With the ability now to hedge currencies, it seems to me that you could basically, albeit with some tracking error, buy fixed income securities on a global basis and hedge it back.

BPM: Has the rise of the Canada Pension Plan Investment Board had any impact on the pension fund industry in this country? I ask that because when I started with the magazine 10 years ago, the CPPIB was just being launched. At that time, unlike today, you didn't hear much about private equity or infrastructure.

TG: I think the CPPIB is following other people. If you look at Ontario Teachers' Pension Plan or the Caisse de dépôt et placement du Québec, they've been using these assets for a long period of time. The BCE auction has merely raised the profile of large public sector pension funds. ■