Sticking to the Fundamentals During a Time of Crisis

Remarks by Bert Clark
President & CEO, Investment Management Corporation of Ontario

C.D. Howe Institute, May 13, 2020

Thank you, Bill and Mitch.

And welcome to everyone participating by WebEx today.

IMCO

Let me start with a quick overview of IMCO.

IMCO was created in 2016 to manage public funds in Ontario.

We currently manage approximately $70B on behalf of 4 clients: the Ontario Pension Board; the WSIB, the WSIB Pension and the Provincial Judges Pension.

We are in effect Ontario's version of BCI, AIMCO or CDPQ with one important difference, membership is voluntary. We need to convince public funds to join IMCO.

Our value proposition for members has three legs:

(1) strong asset mix advice and total portfolio management (which we believe have more impact on overall risk and returns than almost all decisions within asset classes).

(2) better access to investments than members could achieve on their own (which our scale allows us to do by lowering costs and through internalization); and

(3) strong risk management and reporting (again things that are difficult to do without scale).

When we began to manage funds on behalf of the WSIB and OPB in 2017 we could not credibly say we were able to offer clients this value proposition.

Today we can, and we are beginning to add clients.

The current environment

To state the obvious, we are living in unprecedented times.

While corona viruses are not new, this strain is still very poorly understood and extremely virulent.

We still do not know:

- how many people it has affected because there appear to be many asymptomatic carriers.
- why people seem to have such significantly different responses; or
- whether people who have recovered are immune forever or only for a short while.

It is now present on all continents.

And currently, there is no cure or vaccine.

This has elicited unprecedented public health responses by most countries.

The borders of the largest economies of the world are effectively closed.

Billions of people have been living with significant restrictions on their freedom.

But unlike other recent crisis – like the GFC - there is not really a short term or long-term plan. And there is not anywhere near the American global leadership.

The Economy

The public health response to COVID-19 has triggered one of the quickest and deepest recessions ever.

In the fourth quarter of 2019, all major economies were growing.

In December of 2019, the IMF was predicting global growth in 2020 of 3.4%.

The US economy had been growing for more than 10 years and unemployment was at 3.5%.

Since then the decline in economic growth of the largest economies has been startling:

The IMF is now predicting:

- negative 6% GDP growth this year in Canada and the US; and

- negative 7.5% growth in Europe.
- Chinese growth in 2020 is expected to be about 1%, which is a 5% drop from what was expected late last year.

In the US 20 million people lost their jobs in April bringing in the unemployment rate to 15%.

Today, we do not expect global GDP to recover to 2019 levels until late in 2021, at the earliest.

It is simply not possible to turn off an economy and expect there to be no residual damage when you turn it back on.

Marginal companies are likely to be very damaged.

Healthy companies will have added debt.

Ongoing restrictions will limit overall growth and severely impact some industries more than others.

And the “animal spirits” that are so critical to economic growth and vibrant markets are likely to be subdued for some time.

This will be a serious recession.

The Markets

The change in the capital market environment has also been quick.

At the end of 2019, the US stock market had been in the longest bull run in history.

The S&P reached an all time high in February.

It had been a glorious decade for investors.

The annualized return on the S&P over the last 10 years was 13%.

And the annualized returns to holders of US 30-year Treasuries over that same period was 8%.

It was hard to go wrong.

In fact, in 2019, you made double digit returns whether you were an owner of long-term government bonds or equities.

But, year to date the S&P is down 11%.

And, this masks the 34% decline from its high this year to its low so far this year.

And oil has traded at negative values.

Central bank and government intervention

Governments have been very quick to act, likely because the lessons of the GFC were not that far off.

The breadth and extent of the fiscal and monetary intervention has been enormous.

Governments have launched stimulus programs that are likely to result in deficits unlike anything before.

The Government of Canada is set to run a $250B deficit or 12% of annual GDP.

And the US Government is set to run a $4 Trillion deficit or 18% of annual GDP.

Central banks are also intervening in the capital markets to an unprecedented extent.

The Federal Reserve is projected to expand its balance sheet to somewhere in the range of $9 Trillion.

Because of this massive intervention, we do not think there is anything inconsistent with thinking that asset prices may fair better over the near term than the economy overall.

While lower government bond rates may not get people back on to planes or into restaurants, they can drive up the value of financial assets.

One has only to look to the last 10 years to see the effects of sustained central bank involvement in the capital markets.

The total market capitalization of US stocks has grown significantly quicker than the economy as governments ran deficits, central banks expanded their balance sheets and interest rates were driven lower. Ten years-ago the value of all stocks

was about 62% of the economy. Today it is more than double that – at about 132%.

So, what is an investor to do

So, what are investors to do today?

At IMCO we do not pretend to have a crystal ball.

But that does not mean you cannot have a strategy. Your strategy just needs to consider how unpredictable things are.

And there are certain strategies we follow, in good times and bad.

Diversification

The most important strategy for us is asset class diversification.

Asset class diversification – which at its core consists of owning a balanced portfolio of both government bonds and risk assets - can seem prudish when times are good (like at the end of the long bull late last year) or risky when times are scary (like right now).

But, over the long run it leads to better risk adjusted returns.

You do not get too far out on the limb when markets are up, and you do not miss buying opportunities when markets are driven by fear.

Over the last 20 years this strategy has also been powerful on account of the incredibly strong performance of government bonds. They have provided diversification and healthy returns.

Today we are still rebalancing into equities to the extent that these have declined but not becoming overly defensive by going significantly overweight bonds or cash.

We maintain a balanced portfolio through times of exuberance and times of fear.

Liquidity

The second most important strategy for us is ensuring adequate liquidity. You cannot be a long-term investor if you put yourself in a position where you are forced to sell risker assets in times of market strain.

This may seem like common sense, but every time there is a crisis there is at least one big well-known investor who is forced to sell at the worst time and they hard-wire in losses. Its easy to fall into this kind of situations when you combine leverage and illiquid assets.

As I mentioned earlier, we do not believe this recession will be quick.

And it is unlikely that we have seen the last bout of volatility.

So, today we continue to watch our liquidity very closely and we have entered several arrangements with specialist managers to be buyers of high-quality publicly traded assets like credit and real estate during bouts of volatility, which we expect.

Targeted Pursuit of NVA

The third principle for us is being very targeted in our pursuit of net value add. Some public market segments have proven very difficulty to outperform. And, in some cases, it is not worth devoting significant resources to trying to do so. And private markets no longer offer the automatic illiquidity premium that was available when it is was less common for institutional investors to invest in private markets. Today to be a successful private market investor requires lower costs and real operational expertise.

Today, we believe there will be real opportunities for investors who are skilled at helping companies rework their balance sheets in a stressed economic environment. We expect these opportunities to emerge over time and we are exploring partnerships now to be ready to pursue these opportunities.

Costs

The fourth principle for us is cost efficiency. Costs are one of the few things you can control as an investor. And costs matter even more when you are operating in an environment of potentially lower returns. We always have our eye on costs and that is especially true now.

Today the so-called 2 and 20 fee structure would result in annual base fees that are more than 3 times the yield on 10-year government bonds. This common cost structure was developed in an investment environment where returns were much

higher than we expect them to be going forward. But the fee structure has not evolved.

So, we are continuing to rationalize our manager roster, eliminate managers of managers and funds of funds, and focusing on investing both directly and alongside a core set of strategic managers. We are also continuing to expand our asset base by adding members to spread costs over a larger base. We are always cost conscious.

<u>Navigating big trends</u>

Finally, we believe that it is important to have the discipline to act on the big trends.

These trends are generally obvious. For instance, on-line shopping was not a secret, but not many large organizations had the discipline to adjust their portfolios to deal with this risk before it was too late.

The challenge for large institutional investors is often the same as the challenge for any large organization – having the discipline to evolve to reflect a changing world.

Better run asset managers are no different from better run companies in other sectors. The best ones are not necessarily the ones with unique insights who are way ahead of the pack. The best run large organizations are the ones that leverage their natural advantages (for example economies of scale and a long investment time horizon) but also have the discipline to adapt their large diverse and often illiquid portfolios to reflect big powerful trends. In other words, it is just as much – maybe more – about hard work than it is about unique insights.

So, we are spending lots of time these days thinking about how we evolve to adapt to powerful trends.

What else are we doing today?

Let me say a thing or two about big trends.

There are several trends that we believe were underway before the COVID 19 crisis that have been accelerated or given more force by the crisis.

Our thinking is still at a relatively early stage, but for each them we are asking ourselves “so what does this mean for us as an investor”.

Lower for longer

To give a few examples…

Before the crisis we were of the view that we were in a lower for longer return environment.

We expected returns to be lower over the next ten years than they were over the last ten years as a result of several forces including demographic trends in the largest economies and overall debt levels.

We believe this trend has not changed. In fact, it has been reinforced by COVID 19.

We do not believe investors can outrun this broad return environment.

And therefore, we believe that more than ever it is important to be diversified at the asset class level – because you cannot afford to get it wrong on a big asset class bet. More than ever it is important to not get caught in a liquidity squeeze, because you will not be able to make up for hard-wired losses. More than ever you need to avoid wasting time and resources pursuing NVA where it is unlikely. And, now more than ever, costs ought to be an area of focus.

Government intervention in the economy

Before the crisis we were also of the view that markets were being driven more than anything else by central bank intervention.

Some might argue that this goes back as far as the so-called “Greenspan Put”.

Whether it goes back that far or not, there is no doubt that since the GFC central banks in Canada, Japan, Europe and the US have been very active and significant and ongoing participants in the capital markets. Investors have come to rely on central banks to not only maintain but increase the value of financial assets.

The Federal Reserve had a balance sheet of about $1 Trillion before the GFC. It grew to about 4.5 Trillion before the COVID 19 crisis. And it is now projected to grow to at least $9 Trillion as a result of the extraordinary measures it is taking, including buying investment grade and high yield credit.

To put $9 Trillion in perspective, that is about twice the size of either Vanguard or Blackrock and represents about 40% of US GDP. It is about 40% of the US national debt. And it is equivalent to about 1/3 of the value of all listed stocks in the US.

In some ways we are already living in the era of big government. Not big government meaning direct ownership of big companies. But big government in the sense of ongoing significant government intervention in the capital markets.

We do not see that changing, especially as consumers, businesses and governments themselves adjust to lower rates, and governments seek to maintain lower rates to cushion the impact of their own large debts.

We are beginning to consider the implications of this.

But at a high level we believe it reinforces our lower for longer expectation in the near to medium term. It is hard to imagine how governments continue to "prime the pump" to the same extent that they did over the last 10 years when the 10-year bond yield is below 1%, governments are already running deficits and central banks are already the largest institutional investors.

So, we come back to our core investment strategies.

Other trends that we believe have been accelerated include slowed or altered globalization, remote working, on-line shopping and the dominance of larger companies.

Conclusion

To wrap up….

We believe that we will be in a stressed economic environment for some time, that there will also be unpredictable public health responses and significant and ongoing fiscal and monetary intervention. All of this makes for a complicated investment environment.

We don't have a crystal ball, but we believe the best overall strategy is to stick to the big things that generate value over the long term, like diversification, liquidity management, very targeted investment strategies, cost efficiency and navigating the big trends. And we are investing based on those beliefs today.

Thank you.