IMCO'S JOURNEY THROUGH PERIODS OF VOLATILITY: HOW TO STAY INVESTED FOR THE LONG TERM

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CHECK AGAINST DELIVERY

Welcome

Thank you, Terri, for that introduction, and thank you to the organizers at Institutional Connect for inviting me to be here today.

And welcome to everyone participating, virtually.

In my remarks today I hope to do three things. I will provide an overview of IMCO and our value proposition for small public funds. I will describe what I believe are the biggest challenges faced by investors today. And I will outline what we at IMCO are doing to navigate those big challenges.

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 $70 Billion 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.

Today, in Ontario there are close to 100 funds that can join IMCO. The vast majority are in the $250 Million to $ 1 Billion range. These include municipal reserve funds, university pensions, crown agency pensions and various other pools of public capital.

Most of these public funds are subscale. That is, they do not have the size to do some of the most important things well when it comes to investing.

This includes:

- keeping costs down through selective internalization;

- building robust risk management capabilities; and

- ensuring funds are invested in a way that aligns with their ESG beliefs.

Therefore, IMCO was set up. We can provide these public funds with a low cost, end-to-end investment solution.

The Markets in 2020

2020 has a been a wild year when it comes to the capital markets.

March saw the S&P500 drop 35% in the span of just one month; a loss that took one-year during the Global Financial Crisis and a year-and-a-half during the 2000 tech crash.

And yet here we are today, the pandemic is ongoing, and Year-to-date returns are positive for US equities, US and Canadian nominal and real return Government bonds, gold and Investment grade credit.

The fact that indexes are above pre-Covid19 levels does not tell the whole story – the market indexes mask the fact that there have been big winners and losers this year.

For example, the Year-to-date performance spread between the best and worst industry sectors in the S&P is 94%, nearly matching the highs from the Global Financial Crisis (Technology: +49%; Energy: -45%).

Central bank and government intervention

The fact that market indexes are where they are today is in large part due to very quick Government and Central Bank intervention.

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 we seen in a very long time.

The Government of Canada is set to run a $380 Billion deficit or 17% of annual GDP this year. To put this in perspective, the last time Canada posted a deficit anywhere near this large was during World War II (1943: 22.5%/GDP).

And the US Government is set to run a $3.3 Trillion deficit or 16% of annual GDP. Again, the last time the US ran deficits this large was in WWII.

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

The Federal Reserve is projected to expand its balance sheet to somewhere in the range of $7.5 Trillion, by the end of the year.

And not only did the Federal Reserve buy Government bonds, it bought investment grade and high yield debt (which in many cases is close to equities in terms of its risk).

Because of this massive intervention, we don't think there is anything inconsistent with thinking that asset prices may continue to 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.

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Before answering that question, it is important to outline the big challenges all investors face today.

The first challenge is that returns over the next decade are likely to be lower than they were over the last decade, across most asset classes. This was true before the pandemic, but COVID19 has only reinforced this trend. It is the result of several large powerful trends, including the ageing of populations and growing debt levels in the world's largest economies. The impact of these demographic and debt trends has been somewhat mitigated in recent years by the ongoing involvement of central banks in markets and declining interest rates. But given today's interest rates, this is not something that can be relied on over the next decade. As a result, returns are likely to be lower.

The second challenge for investors is the significant and ongoing central bank involvement in the capital markets. Twenty years ago, central banks influenced short-term interest rates, had very small balance sheets and made intentionally vague public statements about the future path of interest rates. Today, the Federal Reserve balance sheet is bigger than the largest asset managers in the world, it intervenes directly in the market to influence bond pricing across the entire interest curve, it buys investment and high yield credit and its pronouncements about future rates are unequivocal. This presents two challenges. Over the long-run markets of any sort don't tend to work well when they are dominated by Government intervention. And by driving rates across the curve into negative real territory they have forced most investors to alter their asset mix even more towards risk assets (equity, credit, infrastructure and real estate). As a result, investors portfolios are generally riskier today.

The third challenge faced by investors today is the fact that COVID19 has not impacted all stocks and market segments equally. While many indexes sit about where they were pre-crisis, this is mostly the result of unparalleled central bank intervention. And it ignores the high dispersion of results within the index. This has created both large risks and opportunities for investors.

There is no silver bullet solution for navigating these challenges. In fact, we believe it is dangerous to try to completely outrun broad market environments. However, there are certain core investment strategies that will improve risk adjusted returns over the long-term. These are the strategies we always follow, and we are following today.

Diversification

The most important strategy for us is diversification.

In an ideal world, investors would build a portfolio that performs equally well in different macro-economic environments. But that is only possible in an ideal world. Most investors cannot afford to have significant portions of their portfolios invested in government bonds.

In order to meet their long-term investment objectives, most investors have portfolios that are heavily titled to risk assets such as public and private equity, credit, infrastructure and real estate. The typical investor's portfolio is built to perform well in periods of growth and stable inflation but will perform much less well in periods of deflation or stagflation.

So, for us, diversification doesn't mean building a portfolio that can perform under all future macro-economic environments, it means something less ambitious – that is, building a portfolio that is not overly reliant on one asset class or return enhancing strategy.

The ability to predict the relative future performance of asset classes – EM market equities versus US equities, for instance - is not sufficiently reliable to warrant large asset class over weights or under weights. And "getting it wrong" with a large asset class weighting can materially affect overall portfolio returns.

We also caution against over-reliance on any one return enhancing strategy. There are only so many ways for investors to earn higher returns and they generally involve adding one type of risk or another: adding risk assets to your asset mix; pursuing net-value-add within asset classes; accepting illiquidity or complexity; or adding leverage to assets or the portfolio itself.

This may sound obvious, but in their search for returns, a high proportion of investors do build portfolios that include an asset class overweight or an overreliance on one return enhancing strategy.

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.

Most investors have a large bias to risk assets to enhance their potential returns. And the benefits of risk assets generally come from holding them for longer periods of time. Risk assets are priced to generate higher returns over the long-term to compensate for near-term price volatility. To successfully benefit from these long-term phenomena, you also need to have a plan around liquidity - so you know you will not be forced to sell risk assets early or at the wrong time.

Again, 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. Today, it is easy to fall into this kind of situation when you combine leverage and illiquid assets.

The volatility in the price of risk assets also represents a potential opportunity for investors with a plan around liquidity. They can be buyers of risk assets when prices drop.

Today we are monitoring our liquidity carefully and are positioned to be buyers during bouts of volatility.

Targeted Pursuit of Net Value Add

The third principle for us is being very targeted in our pursuit of net value add.

Outperforming is hard to do to and the truth is that many asset managers do not outperform their benchmarks after costs. And even less do so after considering incremental risk.

Asset managers are like any other organization: they can only be good at so many things. In our view, outperforming is more likely where you focus your efforts in areas where you or your partners have an actual competitive advantage (like a tolerance for complexity or illiquidity, a longer investment time horizon and the ability to partner with best-in-class investors). Ideally, your investment thesis, leverages your competitive advantages and involves both effort and skill. If your investment thesis is simply that you are smarter than everyone else or the market is "wrong" you are likely to be disappointed.

Today, we believe the investment environment created by COVID19 will create real opportunities for outperformance. Not all companies have been affected equally. As I mentioned earlier, there has been a wide dispersion of results. One of the things we are focusing on is partnering with investment firms that have demonstrated expertise in navigating complex investment environments with a particular focus on credit and balance sheet restructurings.

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 that is common for private assets and hedge funds would result in annual base fees that are many times more than the yield on 10-year US Treasuries. 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. We believe that paying these kinds of fees will make it hard to achieve satisfactory net returns.

So, today, we are continuing to rationalize our manager roster, avoid managers of managers and funds of funds, and focus 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.

Navigating big trends

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

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 run companies aren't necessarily the ones with unique insights who are way ahead of the pack. The best run companies are the ones that leverage their natural advantages and have the discipline to adapt their large, diverse and often inflexible operations and investments to reflect big powerful trends. In other words, it is just as much – maybe more – about hard work and discipline than it is about unique insights.

So, today, we are spending lots of time thinking about how we need to adapt our clients' portfolios to the powerful trends that are afoot.

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 COVID19 crisis that have been accelerated or given more force by the crisis. For each them we are asking ourselves "so what does this mean for us as an investor".

Lower for longer

As I mentioned earlier, 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 because of several forces including demographic trends in the largest economies and overall debt levels.

For example, for 10-year US Government bonds to generate the same kind of returns they have generated over the next 5 years that they generated over the last 5 years, the yield on those bonds would need to drop to -2.92% and for the S&P to generate the same kinds of returns it has generated over the last five years (without earnings per share growing at a faster pace), the P/E ratio for the index would need to rise from 26 today to 43.

We do not believe investors should try to outrun broad return environments. And therefore, we believe that if returns are going to be lower across most asset classes, 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 you are unlikely to succeed. And, now more than ever, costs ought to be an area of focus.

ESG

Today most investors recognize that taking ESG factors into account when making investments is not at all inconsistent with their fiduciary duties. In fact, it represents sound long term management of funds.

Companies with better governance, policies around inclusion and diversity and plans around how to adapt to an economy that is less carbon intensive will tend to perform better over the long-term.

Most portfolios managers don't need convincing of these things. Its pretty obvious.

That is why ESG is important to us, our existing clients and our potential clients.

The real challenge with ESG is ensuring it truly is embedded in your investment processes. It cannot be a tick the box or marketing exercise.

At IMCO, today, we do many things to ensure that we are taking ESG into account in all our investment decisions: (a) we evaluate all direct investments from the perspective of ESG; and (b) we review the ESG approach of any external advisor we hire.

We are continuing to further develop our approach to key elements of our ESG strategy, which we know are crucial for our clients and key to ensuring that their portfolios are sustainable over the long-term. These include:

Climate scenario analysis and stress testing our portfolio,

Developing specific sustainable investing targets,

Developing an explicit screening framework, and

Engaging more directly with the companies in which we invest around our focus areas: climate change, diversity and corporate governance.

<u>Other Trends</u>

There are several other trends that were underway before COVID19 that we believe have been accelerated. These include on-line shopping (which has heavily impacted retail real estate), work from home (which will have some impact on office real estate – although it is too early to say how profound an impact) and altered globalization (which is affecting supply chains and US leadership).

We are currently studying these trends to determine how and if our clients' portfolios need to be adapted.

<u>Conclusion</u>

To wrap up….

We believe that we will be in a stressed economic environment for some time – likely until there is a widely available and effective vaccine or treatment. We also believe that there will be significant ongoing fiscal and monetary stimulus. And all of this makes for a complicated investment environment.

We don't have a crystal ball, but we believe that 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.