# 2017 INVESTMENT COMMITTEE ANNUAL REPORT

UNIVERSITY OF ALBERTA

# Investment Committee Annual Report
# For the Year Ended March 31, 2017

## Contents

# Message from the Board Investment Committee Chair

I am pleased to present the 2017 annual report on behalf of the University of Alberta's Investment Committee. The investment assets under the oversight of the Investment Committee were $2.15 billion at March 31, 2017, of which $1.30 billion represented endowments. These assets generated nearly $37 million for program spending purposes such as scholarships and research, an increase of $1.2 million from the prior year.

The Unitized Endowment Pool's (UEP) rate of return for the year was 14.9% which lagged its benchmark return of 15.9%, but exceeded its absolute target of 7.25%. This target has also been achieved over the four years ending March 31, 2017 with an annualized rate of return of 11.1%. The Non Endowed Funds returned 4.4%, which was in line with their benchmark.

Nearly all equity markets performed strongly during the year amidst several high profile political events, namely Brexit and the US election. Global equities as measured by the MSCI World Index returned 19.0% in Canadian dollar terms. Real estate performed in line with expectations while fixed income markets experienced significant challenges amidst a period of rising interest rates. The UEP benefited from being broadly diversified across global markets and asset classes.

Over the past year Management conducted significant policy work with the strategic advice of the Investment Committee. This included an externally facilitated review of the Statement of Investment Principles & Beliefs, as well as reviews of the UEP Spending Policy and University Funds Investment Policy. Management continues to implement the strategic organizational plan and related recommendations from last year's independent external review of the University's investment management practices.

In the coming year, Management will finalize and implement the UEP Spending Policy and University Funds Investment Policy with the assistance of the Investment Committee. A key area of focus will be to ensure that the investment risk profile remains appropriate for the University while meeting spending requirements in what may be a more challenging future investment environment.

On behalf of the Investment Committee, I would like to acknowledge Management's hard work and dedication this past year. I would also like to thank and recognize the contributions of Jane Halford and James Heelan whose appointment terms ended during the year.

Dave Lawson, CFA
Chair, Board Investment Committee, University of Alberta

## Investment Committee

March 31, 2017

**Appointed**

Dave Lawson, CFA Chair

Jim Drinkwater, Vice-Chair

Derek Brodersen, CFA

John Butler

Gordon Clanachan

Allister McPherson

Sandy McPherson, CFA

Peter Pontikes, CFA

**Ex-Officio**

Michael Phair

Douglas Stollery, QC

Dr. David Turpin, CM, PhD, LLD, FRSC

# Executive Summary

The investment assets of the University of Alberta that are under the oversight of the Investment Committee had a total market value of $2,153 million as of March 31, 2017 (2016 - $1,958 million). This consists of $1,304 million (2016 - $1,150) in Endowed Funds and $849 million (2016 - $808) in Non Endowed Funds.

With very few exceptions, the Endowment Funds are pooled together and invested collectively in the Unitized Endowment Pool (UEP). The investment objective of the UEP is to achieve a long-term rate of return that in real dollars (i.e. adjusted for inflation) meets or exceeds total endowment spending, as outlined in the UEP Spending Policy. This is done in order to provide a comparable level of support to future generations that current beneficiaries receive.

The Non Endowed Investment Pool (NEIP) consists primarily of expendable operating and research funds. It is predominantly short-term in nature, with a focus on capital preservation and liquidity.

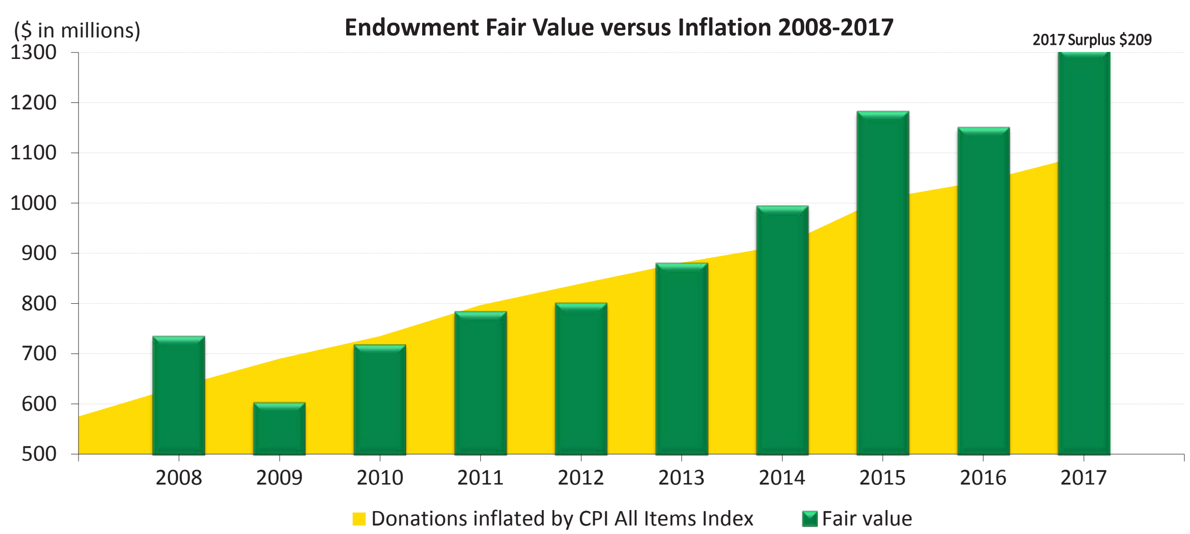
## Endowment Funds - Highlights

- The UEP returned 14.9% during the year as returns from virtually all asset classes were positive. Fixed income was the exception as returns were negative for the year.

- The market value of the endowment increased to $1,304 million, up $154 million from the end of fiscal 2016. This increase is comprised of $171 million in investment gains plus $35 million in donations, less the $37 million spending allocation, $8 million administrative assessment, and $7 million for investment management costs.

- During the year, the real value of the endowments increased by 9.1%. This increase was due to the aorementioned return of 14.9% on the investment assets less total expenditures of 4.2% and inflation of 1.6%. The value of the endowments over their cumulative inflation adjusted objective increased to $209 million as at March 31, 2017 (2016- $106 million) or 19.1% (2016- 10.1%) as outlined in Exhibit 1.

Exhibit 1




## Non Endowed Funds - Highlights

- The NEIP recorded an overall return of 4.4% for the year, and provided $40 million in investment revenue to the University's operations.

- Both the Liquidity and Return-seeking allocations exceeded their benchmark returns.

# Major Initiatives During the Year

## Review of Key Policy Documents

An externally facilitated review of the Statement of Investment Principles & Beliefs (SIP&B) was completed. The updated SIP&B documents the consensus views of the Committee and provided the foundation for further policy work that was initiated during the year and will help guide future investment strategy development.

A comprehensive review of the UEP Spending Policy was initiated during the year with the assistance of an external consultant. Policy enhancements and simplifications will be proposed during the coming year.

A review of the University Funds Investment Policy was initiated by Management, with asset allocation analysis being conducted internally. Policy changes with a focus on return enhancement and improved diversification for both the UEP and the NEIP will be proposed during the coming year.

## Private Markets Advisor

The University issued a request for proposal for an advisor to help Management with the strategy development, construction, manager selection, and monitoring of the private markets portion of the UEP. During the year, there were no allocations to private markets in anticipation of the engagement of this advisor. The advisor will be appointed in the coming year.

## Continued Implementation of the UEP Target Asset Allocation

Within the UEP's Growth strategy the allocation to emerging market equities was increased via funds redeemed primarily from Canadian equities. Capital continued to be called by several private equity funds that were committed to in prior years. Due to the prolonged investment period in private equity, it is anticipated that an overweight allocation to global equities will be maintained for the foreseeable future.

The Inflation Sensitive strategy saw the initiation of a commodities manager search that is expected to be completed in the coming year.

In the Diversifiers strategy, further hedge fund of funds redemption proceeds were received shortly after year end.

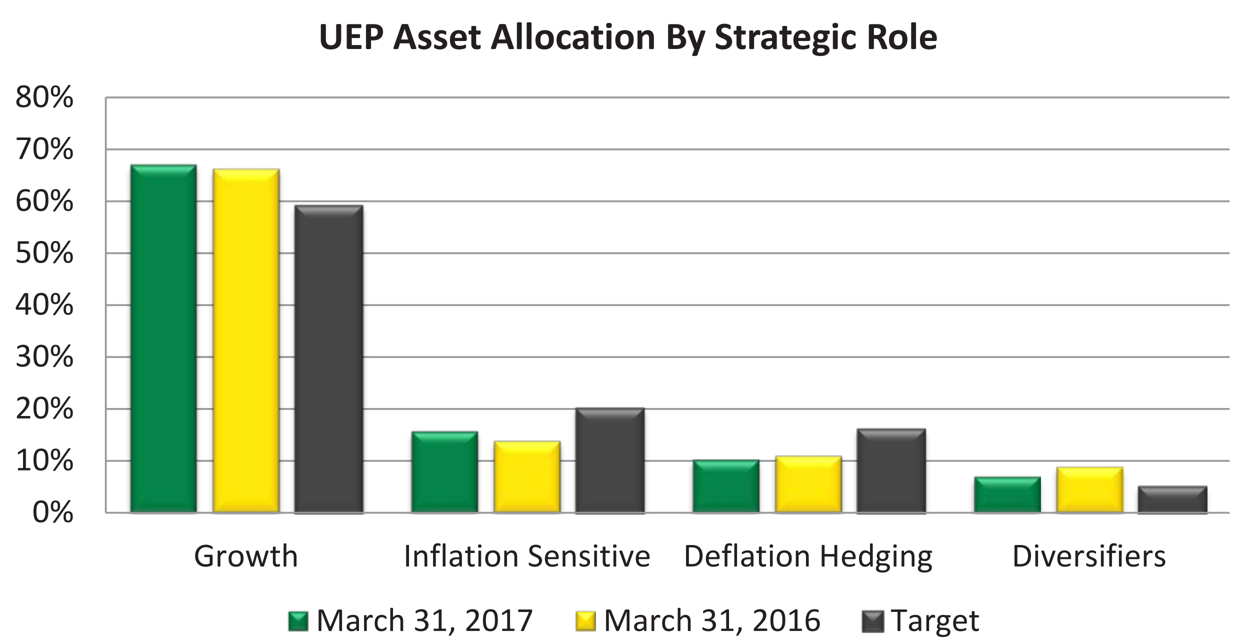
# Endowment Funds

The primary investment objective for the UEP is to achieve a long-term real rate of return that equals or exceeds total endowment spending. Emphasis is placed on preserving intergenerational equity to ensure all beneficiaries, current and future, receive comparable benefit. Assets are classified based on the strategic role they perform within the portfolio, specifically: Growth, Inflation Sensitive, Deflation Hedging, and Diversifiers.

- To meet spending targets and grow the value of the assets over time, a large allocation to public and private equities, hedge funds, and other assets with exposure to equity market returns is necessary.
- Inflation sensitive assets are those that adjust to unexpected and/or rising inflation. The assets in this category include real estate, natural resource equities, commodities as well as exposure to private equity energy funds.
- Deflation hedging assets are those that remain liquid and increase in value during times of extreme economic and capital market turmoil. This asset class consists of high-quality sovereign bonds.
- Diversifiers are any asset classes or investment strategies that have low or no correlation with the capital markets and inflation, such as managed futures and cash.

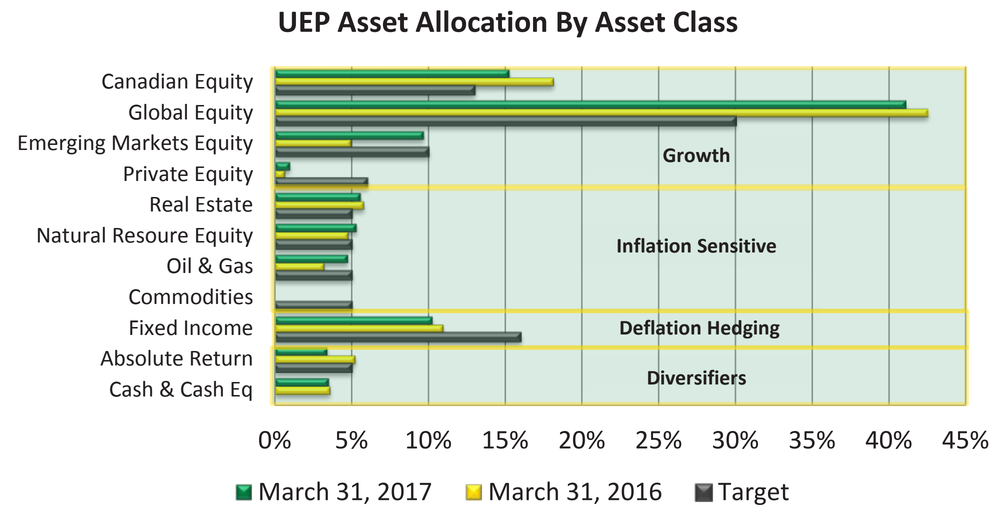
Endowment investments are categorized by Strategic Role in Exhibit 2.

Exhibit 2



Investments are also categorized by Asset Class in Exhibit 3.

Exhibit 3



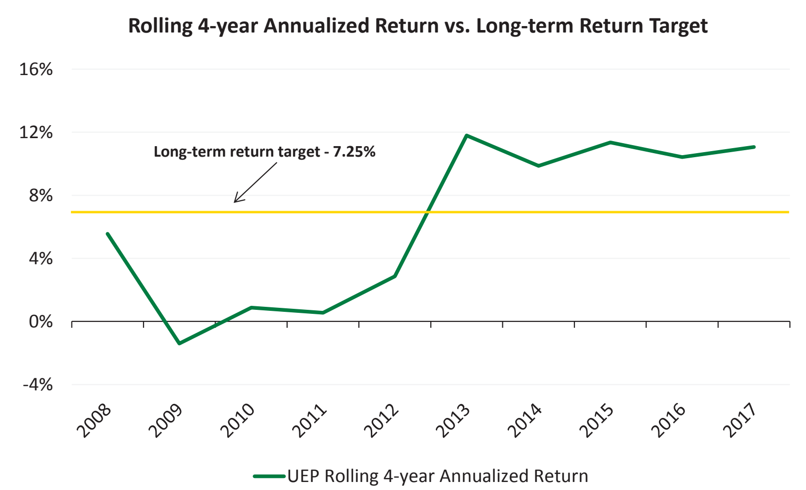

## Investment Performance Relative to Objectives

The UEP recorded a return of 14.9% for the year ending March 31, 2017 which exceeded total spending plus Consumer Price Index (CPI) of 5.8%. The four year annualized return for the period ending March 31, 2017 was 11.1%, while annualized spending plus CPI for that time period was 5.7%. The return of 14.9% reflects:

- A significant allocation to public equities at the expense of fixed income, commodities, private equity and absolute return strategies.
- Strong performance from public equity markets relative to other asset classes,
- Canadian dollar depreciation against most other currencies.

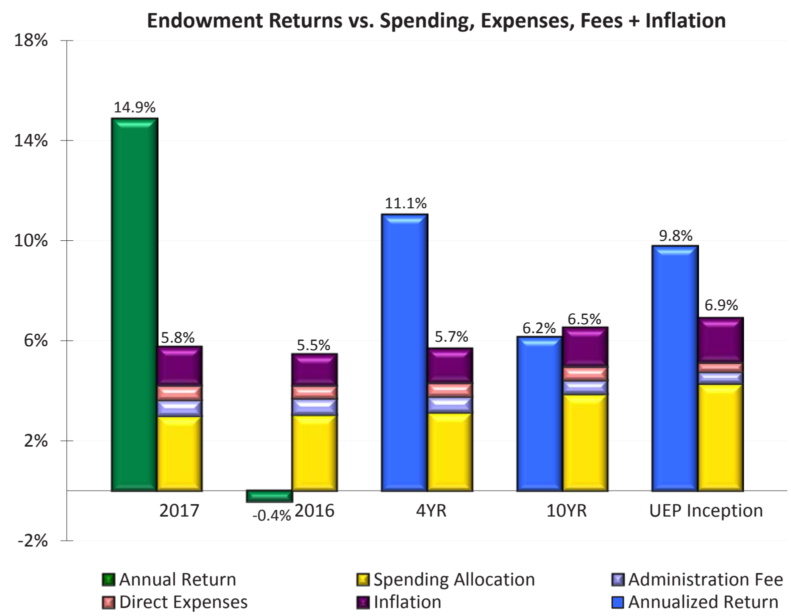
The UEP is invested for the long-term and is expected to provide a return in excess of spending and inflation in some years to compensate for years when this is not the case. Exhibit 4 illustrates the UEP's historical performance relative to the return objective of 7.25%.

Exhibit 4



As shown in Exhibit 5, the UEP has, since its April 1989 inception, produced an annualized return of 9.8%. This return has exceeded annualized total endowment spending plus inflation of 6.9% over that time period. This objective has also been achieved over most other time frames in the graph below. The shortfall in returns over total spending plus inflation for the 10 year annualized period reflects the negative impacts of the global financial crisis.

Exhibit 5




## Further Perspectives on Investment Performance

The returns of individual asset classes in the UEP are measured against their respective benchmarks. The total fund return is measured against the benchmark outlined in Exhibit 6. The difference between the UEP and its benchmark return reflects the impact of strategic allocation decisions by Management together with active management decisions by our investment managers.

Exhibit 6

| UEP Investment Policy Benchmark | |
|---|---|
| MSCI Canada IMI | 15% |
| MSCI World IMI | 39% |
| MSCI Emerging Markets IMI | 10% |
| IPD/Realpac Canada Property Index | 5% |
| S&P Global Natural Resources Index | 5% |
| Dow Jones North America Select Junior Oil/Gas Index | 5% |
| FTSE/TMX All Federal Bond Index | 16% |
| HFRI Fund of Funds Composite Index | 5% |
| | 100% |

While the UEP return of 14.9% was strong in absolute terms, it lagged the benchmark return of 15.9%. The difference in return is attributable to security selection in growth strategies, more specifically Canadian, global, and emerging market equities. In aggregate the defensive nature of the UEP's public equity managers led to underperformance during a strong period for equities. With respect to allocation, the value added by the overweight to global equity and underweight to fixed income was largely offset by the underweight to natural resource equity and oil & gas. Poor performance from diversifiers was also a negative contributor to relative performance.

## Growth

Public equities in aggregate generated significant returns over the past year. Accommodative monetary policy from most central banks continued to drive investors into riskier assets with equities being a significant beneficiary. Emerging markets generated slightly higher returns than developed markets while Canada lagged. With respect to the UEP, managers with a value and small cap bias outperformed their growth, low volatility, and large cap counterparts.

The UEP's existing private equity funds in the secondaries and venture capital space continued to call capital and are progressing through their investment periods.

## Inflation Sensitive

Real estate investments continued to generate solid returns, but with the majority of returns coming from income, returns were lower than in prior years. The UEP's core funds in Canada and the US continue to perform as expected. Value added strategies in the US and Europe are nearing the end of their respective investment periods and are beginning to exit positions on an opportunistic basis.

Natural resource and energy equities had a particularly strong year following two consecutive years of very poor performance. The US election and a significant reset in inflation expectations drove a rally in most commodities. The UEP has exposure to these asset classes through Exchange Traded Funds that performed as expected.

The UEP's existing private equity energy funds continued to call capital and are progressing through their investment periods. In addition, during the year the first co-investment was completed in an Alberta based oil & gas company.

## Deflation Hedging

The Canadian government bond portfolio recorded a small loss during the year as interest rates increased across the yield curve, which more than offset the coupon payments. The portfolio continues to be managed with an emphasis on capital preservation to support endowment spending during times of economic turmoil rather than return enhancement.

## Diversifiers

The UEP's absolute return strategies in aggregate also recorded a small loss as the underlying investment managers in general were unable to profit from equity market beta during the year. Cash was maintained at a level higher than is typically expected and was a drag on overall portfolio performance.

## Investment Performance Relative to Peers

The University of Alberta participates in benchmark studies sponsored by the Canadian Association of University Business Officers (CAUBO) and, in the United States, the National Association of College and University Business Officers (NACUBO) in conjunction with Commonfund. The most recent published data from these organizations is for the periods ending December 31, 2015 and June 30, 2016 respectively. This data may make shorter-term comparisons less than informative due to timing. The University's ten year return of 6.2% for the period ending December 31, 2015 was comparable to the CAUBO 10 year median return of 6.0%. The University's 4.2% return for the ten year period ending June 30, 2016 trailed the NACUBO 10 year median return of 5.0% in US dollar terms.

### Costs

The fund incurred direct expenses (investment management and custodial fees) of $7 million or 0.6%. As part of a process of monitoring and managing costs, Management participated in the 2015 CEM Survey. CEM Benchmarking Inc. is a Toronto based firm that specializes in measuring the performance and costs of pension plans, foundations, and endowments. The report found that the UEP's actual costs were 0.11% higher than those expected for funds of similar size and structure. This reflects the UEP's higher use of external active management and performance fees associated with fund of funds for private equity and hedge fund investments.

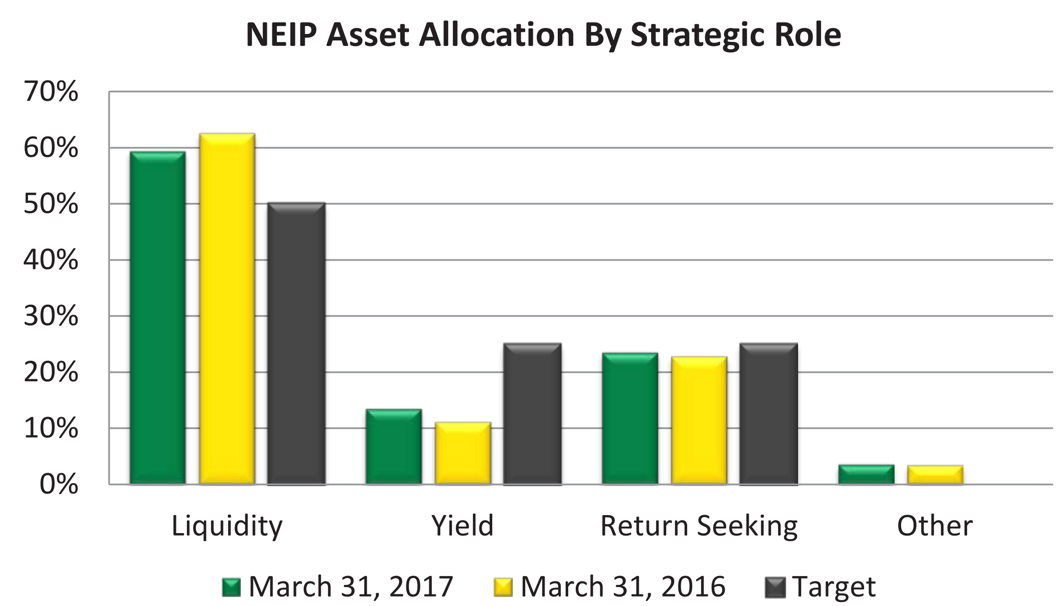
An administrative fee to support centrally funded indirect costs associated with endowment programs is charged to the endowments. For 2017 this amounted to $8 million or 0.7%.

# Non Endowed Funds

The Non Endowed Investment Pool (NEIP) represents the University's operating, capital, and restricted funds and are pooled together for investment purposes until required. Long-term cash flow projections indicate that a substantial portion of these funds will likely not be required on an urgent or unplanned basis for at least five years. Accordingly, Non Endowed funds are invested across three distinct strategies with varying maturity profiles as summarized in Exhibit 7.

- To meet the University's cash flow requirements, the Liquidity strategy is focused primarily on the preservation of capital and invests predominantly in government and Canadian bank issued money market securities maturing within one year.
- In order to enhance the earnings, while remaining focused on the preservation of capital, the Yield strategy invests in government and Canadian bank issued bonds maturing within five years.
- To further enhance the long-term earnings, the Return Seeking strategy invests in the UEP.

Exhibit 7



The NEIP recorded an overall return of 4.4% for the year and performed in line with its benchmark. Investments in the Liquidity strategy accounted for 59% of NEIP holdings as at March 31, 2017 and returned 0.9%. This outperformed the 91 day benchmark return of 0.5% due to the continued focus on longer-dated (up to one year) provincial and bank products.

The NEIP's Yield strategy also returned 0.9% but underperformed the benchmark return of 1.3%, given the strategy's higher credit quality. This underperformance was partially mitigated by a lower than target allocation to the strategy.

The allocation to the Return Seeking strategy, or UEP, performed strongly and significantly enhanced the NEIP's overall performance.

The NEIP has benefited from its allocations to the Yield and Return Seeking strategies over the longer term. The 10 year annualized returns fully reflect both the global financial crisis and continued low interest rates around the developed world. Over this time period the NEIP returned 2.3%, outperforming the FTSE TMX Canada Treasury 91-day Index return of 1.3%.

# Going Forward

Following this year's strong investment results the real value of the Unitized Endowment Pool (UEP) has been substantially restored. Going forward increased emphasis will be placed on ensuring the real value is preserved during what will likely be a more challenging investment environment. Greater emphasis will also be placed on intergenerational equity given several years of healthy investment performance.

With the oversight of the Investment Committee, Management will undertake the following initiatives during the 2018 fiscal year:

- Complete the review of the UEP Spending Policy,
- Complete the review of the University Funds Investment Policy including revised asset allocations for both the UEP and NEIP with appropriate commensurate risk profiles,
- Recruit two additional Investments & Treasury staff to meet the challenges of an increasingly complex investment program,
- Engage an advisor to assist Management in the construction of a robust private markets program,
- Develop revised investment proposals for the UEP Diversifiers strategy to help offset the equity market risk,
- Develop revised investment proposals for the NEIP Liquidity and Yield strategies to enhance returns,
- Continue to increase the investment manager monitoring and compliance capabilities,
- Continue to assess the ongoing appropriateness of all existing investment strategies and mandates, and
- Work toward developing a risk budgeting framework for all aspects of the investment strategy including the performance monitoring process.

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