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Alberta Investment Management Corporation:

An Examination of a Corporatization Project: Preliminary Assessment

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ABSTRACT

The study examines the decision in 2006–2007 by the Alberta government to establish an arms-length, board-governed, investment management corporation expressly to improve investment performance and build local expertise in investment management. The comparison of the investment returns achieved by Alberta Investment Management Corporation (AIMCo) for four provincial funds versus those achieved previously in the Department of Finance against established benchmarks shows little, if any, improvement. A second method of analysis, the Difference-of-Differences (DiD) method, indicates improving performance of AIMCo relative to its public sector investment management peers and its predecessor organization. All comparisons are highly sensitive to time periods chosen.

AIMCo commenced operations in January 2008 when the financial crisis was still evolving. Consequently, the period to March 31, 2008 (Heritage Fund) and to December 2007 (pension funds) is used for the Alberta Investment Management (AIM) performance. The performance numbers for AIMCo commence on January 1 2010 for three pension funds and April 1, 2010 for the Heritage Fund and thereby exclude losses incurred in the 2008–2009 financial tumult. The reader is cautioned that the analysis is carried out at a high level and it may still be too early to fairly judge outcomes since AIMCo "inherited" its investment portfolio. Moreover, the investment policies that are given to AIMCo by the funds' trustees to manage under have changed; specifically a move to place more funds in investment classes that cost more to manage, carry more risk, but offer potential higher returns.

The study also shows the major beneficiaries of the transformation appear to be the senior managers and particularly the senior executives of AIMCo, whose pay has increased significantly. Unfortunately, there were no clear, public performance standards established for AIMCo as a whole and therefore no public assessment or debate of the success of the AIMCo corporatization project.. Given a new government assuming power, several policy suggestions are advanced including a detailed and careful review of AIMCo's performance and governance structure.

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1. INTRODUCTION

In 2007, the *Alberta Investment Management Corporation Act*[1] was passed creating a board-governed provincial corporation that would manage approximately $65 billion in government assets and public pension plan assets. This development was consistent with an earlier period of reform of Alberta's provincial corporation sector where liquor retailing was privatized, registries privatized, and Alberta Treasury Branches moved from a governmental structure to an independent, board-governed financial institution.

The rationale advanced for either selling government assets and associated organizations to third parties or changing the organizational structure from a department to a corporate form rests on a variety of assertions. It is held that a corporate form eliminates centralized, bureaucratic controls over hiring and salary grids, thereby allowing the organization to attract the best people. The best talent will improve corporate performance and attract more talent. In addition, boards of directors, who are typically selected for their business acumen and financial skills, can better direct the corporation to improve efficiency and financial performance. Prior to final corporatization in 2008, the Alberta Investment Management Division (AIM) of Alberta Finance was responsible for investing these assets. Commencing in 2008, a "blue ribbon" board was appointed with directors from Alberta and outside Alberta and Canada.[2] An international CEO search was conducted which lead to the hiring of a high profile CEO with significant Canadian and international investment management experience.

This study explores the question: did investment fund performance improve coincidental with the change in corporate form and governance? The comparative analysis will be based on four-year or five-year overall rates of return achieved in one regulated fund and three large pension plans against a benchmark target selected by the funds' trustees themselves.[3] This will allow

1 *Alberta Investment Management Corporation Act*. ChapterA-26.5, Statutes of Alberta, 2007.

2 Order in Council 354/2007, 1 August 1 2007 and O.C. 483/2007, 24 October 2007. Outside Alberta expertise included two ex- TD bank alumni Charles Baillie and Andrea Rosen and Virginia Holmes from AXA- London U.K.

3 The regulated fund is the Alberta Heritage Savings Trust Fund with $17.9 billion in net assets at March 31, 2015 ($16.4 billion at March 31, 2008); the public sector pensions plans are: Local Authorities Pension Plan ($30.8 billion at December 31, 2014 and $15.6 billion at December 31, 2007); the Public Service Pension Plan ($9.8 billion at December 31, 2014 and $5.9 billion at December 31, 2007) and the Management Employees Pension Plan ($3.9 billion at December 31, 2014 and $2.4 billion at December 31, 2007).

us to determine if and where performance improved or did not improve. Given the short life of the corporation's investment record, *only preliminary findings can be posited*. As the research project unfolded, it became clear that such a straightforward analysis could not be undertaken without important caveats (discussed below). The achievement of another objective of corporatization: building in-house expertise by repatriating external management and lowering costs, is also explored. Comparisons with other provincial government-established investment management organizations are also explored. A concluding section examines whether the objectives established for the corporation by the government have been achieved. Several recommendations and suggestions for further study are advanced.

2. BACKGROUND

With the election of Ralph Klein in December 1992 as leader of the Progressive Conservative Party of Alberta and Alberta Premier, a new approach to government was adopted. His predecessor, Don Getty was saddled with an expensive government infrastructure "addicted" to high oil and natural gas prices. In 1985–6, oil prices fell significantly and the government immediately faced a deficit situation. This, in turn, led to a collapse in non-renewable resource revenue and a real estate meltdown in Alberta. During the downturn, a number of Alberta financial institutions faced liquidity and solvency issues. Casualties included two Alberta-based chartered banks, Alberta's credit union system,[4] Principal Group, Northwest Trust, and Heritage Savings and Trust. These institutions were heavily exposed to Alberta's real estate and energy sectors. The provincial government stepped in to rescue the credit unions and investment contract holders of Principal Group subsidiaries.[5] However it was investments in a failed magnesium plant in southern Alberta, government financial support for the Husky Bi-provincial upgrader, loan guarantees to induce pulp and paper investment, and support for Peter Pocklington's Gainers' meat packing operations, which became Getty's legacy. Debt ran up rapidly, and by the time the Tories were looking for a new premier, their party was polling in the high teens.

Klein's twin mantras were: "the government has a spending problem, not a revenue problem" and "government should be out of the business of being in business." The government initially privatized several aspects of government operations including liquor stores (operated by a highly unionized workforce) and motor vehicle registries. These privatizations were controversial at first, and opposed by labour unions and observers concerned that alcoholism would increase and more liquor store openings would degrade neighbourhoods.[6]

4 A complex financial rehabilitation worth approximately $750 million was undertaken in 1985.

5 See Wendy Smith, *Pay Yourself First*, 1993. Premier Getty was photographed on the golf course during the Principal Group imbroglio. See also *Final Report of the Inspector William E. Code*, 18 July 1989.

6 On liquor privatization in Alberta versus Ontario see Malcolm G. Bird, *The Rise of the Liquor Control Board of Ontario and the Demise of the Alberta Liquor Control Board*, Ph.D. Dissertation, School of Public Policy and Administration, Carleton University, 2008 and "Alberta's and Ontario's liquor boards: Why such divergent outcomes?" *Canadian Public Administration*, Volume 53, Number 4 (December 2010), pp. 509–530.

Government interests in the Alberta Energy Company and Vencap Equities were sold and ownership and head offices restrictions for TELUS (formerly Alberta Government Telephones) and NOVA – An Alberta Corporation, were removed.

As the 2000s dawned, Alberta Finance was faced with challenges in keeping staff in their Alberta Investment Management Division. The financial services industry, including the management of investments of a burgeoning baby boom generation (and hundreds of billions still held by their depression-era parents), had, since the late 1980s, been expanding as a result of a confluence of factors.[7] Firstly, communications technology now linked global stock, commodity, futures, and derivatives markets into a virtual 24 hour trading hub that required investment management teams to be trading "ahead of the other teams." Secondly, processing speeds of computers were doubling every year or two allowing analysis of extremely large databases to discern anomalous patterns in securities' pricing. This led financial firms to employ Ph.Ds in mathematics or physics who could be easily lured away from academe with an outlandish salary (by academic standards), but low by Wall Street standards.[8] Thirdly, a period of what Alan Greenspan called "financial innovation" was underway.[9] In the mid-1980s, innovative derivative financial products, known as interest rate swaps, equity swaps and foreign exchange swaps, emerged. Essentially these products were sold by investment bankers (market intermediaries) and allowed counterparties to exchange streams of cashflows. For example, one party – a government – that has a comparative advantage of access to relatively cheap fixed-rate funding, would swap a stream of its fixed rate interest payment obligations with, for example, a bank that had access to low cost floating-rate deposit liabilities. The bank would pay "fixed" at a cheaper rate than it could get directly on the market while the government could borrow at a floating rate more cheaply than directly in the market. The investment banker shaved off a

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7 Bank for International Settlements, *Recent Innovations in International Banking*," April 1986. For an excellent discussion see Charles Freedman and Clive Goodlet, C.D. Institute "Financial Stability: What it is and Why it Matters," Commentary 256, November 2007, p. 4. On challenges these developments pose for the stability of the financial system: "Advances in technology have facilitated the real-time marking-to-market of positions, leading to a shortening of the time frame for decision making in the management of portfolio positions. Certain trading strategies use real-time data and often assume adequate market liquidity in all circumstances."

8 See Michael Lewis, *The Big Short: Inside the Doomsday Machine*, on the role of financial wizards. Also the movie starring Brad Pitt, Christian Bale, and Steve Carrell. Paramount Pictures, 2015. For an amusing and sobering social depiction of a financial institution in trouble because of its exposure to poor investments watch the film *Margin Call* with Kevin Spacey and Jeremy Irons, Before the Door Pictures, 2011.

9 *The Age of Turbulence*, pp. 369–372. For the role of hedge funds and credit default swaps.

share of the spread. These markets grew explosively.[10] By the turn of the century no finance department or financial institution was credible unless it was actively managing its interest rate or FX exposure with derivatives.

Investment banks led the charge in directing their whiz kids to develop more products for the "street" made up of institutional investors such as municipal governments, state and federal government treasury departments, public pension plans, private pension plans, insurance companies, and mutual fund dealers. One risk that was also swapped was *credit risk* – the risk that a large commercial or government borrower, or pools of securitized loans, would default. Serious computing and mathematical prowess was required to analyze the probability of default of one government, let alone thousands of mortgages or car loans. On top of these relatively straight-forward pools of loans was added another feature – "structured finance." Structured finance was a way of taking these pools of loans and wrapping insurance or credit default swaps to create new complex securities with different credit ratings that would appeal to different "risk appetites." Further complicating the mix was the existence of guarantees by governments or government agencies which `would lead to "moral hazard."

One asset class that has become more popular is private equity. This class of investment emerged in the 1980s when investment funds saw opportunities to take public companies private or re-finance private companies with debt. Typically the new management improved efficiencies and profits and sold the revitalized corporation into public equity markets at a significant profit.[11] Another asset class that has also gained prominence over the past two decades is infrastructure investment (also known as "private income"). These types of investments are normally projects like roads, bridges or airports that have monopoly like characteristics and which produce a stable and usually growing cash flow after the initial outlay. The initial investment process and oversight of these investments is usually labour-intensive and highly specialized.

Another example of an innovative financial product is exchange traded funds (ETFs). ETFs are premised on two notions: firstly consumers were paying too much for mutual funds that actively manage (buy and sell) a portfolio but

10 See Bank for International Settlements, *Triennial Central Bank Survey of foreign exchange and derivatives market activity in 2013*, Basel: September 2013. www.bis.org/publ/rpfx13.htm, Accessed 28 May 2015.

11 The first blockbuster transaction of this sort was RJR Nabisco takeover by KKR in 1988. In Canada, Onex Corporation is a publicly traded company that acts as private equity investor. Blackstone Group in the United States is one of the world's largest private equity investors. Return expectations are typically 15 to 30 per cent when the company is sold again through an initial public offering (IPO).

over time rarely beat the market indices when fees are taken into account. Secondly, instead of paying more **not** to beat the index, why not pay less and get the index less a few basis points? This could be achieved through passively, and more cheaply, replicating the index. Before AIMCo was formed AIM had an investment group that formulated passive investment strategies.[12] These instruments, unlike mutual funds, can be bought and sold through equity exchanges. And list grows longer each day – literally.[13]

Given the above, it is evident that to be serious in the investing game requires capital for: trading information; trading desks; back office processing of transactions; travel to assess investment opportunities; sophisticated accounting and reporting systems; and human resources that can leverage the information and infrastructure to, essentially, outsmart the market.[14] These were then some of the factors that were leading senior Alberta Finance department officials and elected officials to the view that it was necessary to change the organization's structure to permit it to operate outside government strictures to attract the talent to *maintain* adequate returns, let alone *improve* returns, above current performance. AIM officials were frustrated in the hiring process as rapidly rising salaries in the investment industry were seen as a growing impediment to attract talent to the organization. Talent was being lost to the private sector, often young, employable, financial analysts. This challenge came at a time when investment complexity was growing and more sophistication was seen as, not only desirable, but essential. As an interim measure, salaries in AIM were adjusted upward towards "market-based" salary levels commencing in 1998–99.[15]

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12 Heritage Fund, *Annual Report*, 2006–07, pp. 23, 25, 43.

13 Further products include ETFs that use leverage, that hedge away currency risk, or utilize high frequency trading. For instance "Horizons BetaPro S&P500 VIX Short Term Futures Inverse ETF."

14 Capelle Associates, "Organization and Governance Review of Alberta Investment Management," Sessional Paper 99/2007 at page 9. "Techniques based on the mathematics of modern finance have been essential to the efficient implementation of the new risk-based investment policies and related investment mandates. However, the effective adoption of these techniques is not without cost. Their effective use requires a combination of highly trained and skilled people, high-powered mathematics, and significant, ongoing expenditures on information technology. The modern in pay-backs."

15 AIM's Chief Investment Officer was paid more than the Deputy Minister commencing in 1998–99– $176,000 versus $170,000.

2.1 Capelle Associates Report[16]

In 2005, the Finance Department issued an RFP to commission a report examining the organizational and governance structures of the Alberta Investment Management division. The authors addressed the following questions in their report:

- Is the current AIM organization optimal?
- If not, what are the alternative organization / governance alternatives, what are their advantages and disadvantages, and what is the best alternative?
- If AIM is going to achieve excellence, what are some other related factors that are important?
- If AIM is going to achieve excellence, what are the key success factors in relation to the chosen organization / governance alternative?[17]

They examined three governance / organizational options: (1) improvements to the status quo; (2) outsource the investment operation; or (3) create a separate corporate structure. Option 2 was dismissed quickly on the basis of information asymmetry: the seller of the services (i.e. Goldman Sachs) knows more than the buyer (i.e. Alberta Finance). Moreover this option would likely be very costly with potentially high transition costs. Furthermore, Alberta Finance would still need expert staff to oversee the investments to ensure value-added was being received.[18] As well, the agency problem would still remain as ministerial accountability for investment performance was part of the minister's job description under our Westminster parliamentary form of government. And finally, this option would vitiate the desire to build a strong, Alberta-based investment management organization.

The authors then documented a long list of disadvantages of the status quo. These disadvantages included:

- The Minister and Deputy Minister were too busy to effectively oversee the investment management function;[19]
- Restrictive human resources and budget policies and processes making it difficult to attract the right people to achieve "investment excellence";[20]

16 Ron Capelle and Keith Ambachtsheer were the joint authors.

17 *Ibid*, p. 4.

18 *Ibid*, pp. 6, 12.

19 Normally in government this problem is solved through administrative delegation.

20 While living in Edmonton was not seen as a big drawback, living in Edmonton and working for the government was seen as a clear disadvantage.

- There could emerge conflicts when the policy side of the department recommended changes to royalty rates, for example, that would affect the securities prices of investment holdings;[21]
- AIM's investment philosophy "provides a smorgasbord of individual asset class-based, active and passive strategies with which to implement the various 70–30 strategies." The authors advanced the view that AIM should be following the investment policies of the Ontario Teachers' Fund ;[22] and
- Incremental changes to improve compensation or systems still remained at the discretion of Treasury Board and the Minister. [23]

2.1.1 "Investment Excellence"

In building the case for moving investment management outside government, the authors promoted a case for "investment excellence". Arguing that the investment environment had moved from a world of "known risk and return volatilities" to one that challenged this view – that is, actual volatilities were much higher – should lead to a re-thinking of investment philosophy.[24] Drawing on an approach adopted by the Ontario Teachers' Fund in the mid to late 1990s, "fundamental investment choices" were broken into 1) risk minimization, 2) short-term risky, and 3) long-term risky. The authors noted that the adoption of this approach materially rewarded pensioners of the Ontario Teachers' plan and two plans in the Netherlands – ABP and PGGM.[25] In the Appendix comparing the investment beliefs of Ontario Teachers' with AIM, the authors stated: "We believe Teachers' potential excess return advantage is in the *2%– 3%* per annum range."[26]

Based on the forgoing analysis, option 3 was chosen: corporatizing Investment Management and Investment Administration Divisions. A board of directors with the "appropriate accountabilities and authorities … carefully spelled out"

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21 *Ibid*, p. 10. This could be managed and had been managed by strict firewalls within the department for years.

22 *Ibid*, p. 11. "The reality is that AIM is currently not a thought-leader in the global "investment beliefs" arena. We are convinced that becoming such a thought leader would benefit Albertans in two ways. First, we believe it would, together with the change to the governance structure recommended above, materially boost future endowment and pension fund investment returns. Second, such a shift would boost Alberta's reputation as a global thought leader in investment fund management, with significant, positive spin-off effects for the finance and investment faculties at the Universities of Alberta and Calgary."

23 *Ibid*, pp. 4–6, 10–12.

24 *Ibid*, p. 9.

25 *Ibid*, p. 11.

26 Ibid, p. 14. Emphasis added.

would direct the corporation.[27] The board would select a CEO, determine a risk management framework, establish performance targets, review performance, and "ensure an optimal organization design including compensation." [28]

2.2 Bill 12

Bill 12, the *Alberta Investment Management Corporation Act* was introduced and passed by the Legislative Assembly in April 2007. According to Finance Minister Dr. Lyle Oberg the principal reasons for creating a new provincial agency were: consistency with other provinces, such as British Columbia; "improved governance; operational flexibility; and a much more focused investment culture."[29] The Minister of Finance stated:

> We agree with these conclusions (of the Capelle report) and expect that these improvements will result in a greater investment return for AIM's clients over time. For example, every tenth of a per cent in net value-added investment returns per year would mean $16 million per year net income to the Heritage Fund or close to $50 million per year on all the *balanced* investment portfolios AIM manages. Mr. Speaker, in the study they predicted that we would be seeing increases of 100 basis points, which would rise to around a $500 million improvement on a per year basis if we achieve that. We're slightly more conservative, and we're expecting to receive anywhere from 25 to 50 basis points, but even at that we're looking at a potential of $250 million.[30]

The Minister added the government would appoint a "professional" board of directors. The Regulation under the Act set out clearly the professional qualifications of board members: "Individuals … must have proven and demonstrable experience and expertise in investment management, finance, accounting or law or experience as an executive or a director in a senior publicly

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27 There is a long and rich history of crown corporations in Canada stretching back to the Canadian Broadcasting Corporation, the Bank of Canada and Ontario Hydro. There is also a rich academic literature. See for example: H.V. Nelles, *The Politics of Development: Forests, Mines, and Hydro-Electric Power in Ontario*, 1849–1941, Second Edition, Montreal and Kingston: McGill-Queen's University Press, 2005 and G. Bruce Doern and Allan Tupper, editors, *Public corporations and public policy in Canada, Montreal: Institute for Research on Public Policy*, *1982*.

28 *Ibid*, pp. 15–16. A precedent was set in 1996 with Alberta Treasury Branches' board recruiting a new CEO and then recommending the candidate to the Minister and to Cabinet.

29 *Alberta Hansard*, 26th Legislature, 3rd Session, 4 April 2007, p. 411.

30 *Ibid*. Emphasis added.

traded issuer."[31] AIMCo's budget would still require approval through the normal business planning and budgetary processes of government, which seems at variance with the Capelle report.

In concluding his remarks at Second Reading the Minister emphasized that the change was not because the government was "unhappy" about AIM's performance but rather that the new corporation would "provide more flexibility" and "have the *potential* of creating an investment centre in Alberta."[32] The corporation's role was to provide "investment management services" to "designated" entities determined by the Minister. In effect, AIMCo was to be given a *monopoly* over providing investment management services to provincial agencies, pension plans and regulated funds.[33]

Debate surrounding the Bill addressed such items as ethical investing policy, the potential for patronage in appointing the board, the need for appropriate legislative oversight and accountability, and the rates of return compared with other funds, such as Harvard's Endowment Fund.[34] Liberal MLA Hugh Macdonald was critical of the Bill because he felt that the Capelle Report was based on very limited

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31 Section 5 of the Alberta Investment Management Corporation Regulation A/R 225/2007. Section 4(1)(b) of the Act required the Deputy Minister of the responsible ministry to serve on the board. This provision excludes about 99 per cent of the Alberta population from qualifying. A two section Bill, introduced in March 2009, and passed in November 2009 removed the deputy minister from the board. According to Iris Evans, the Minister of Finance at the time, the amendment reflected the fact that the deputy minister had been appointed to AIMCo's board as the organization *transitioned* to provincial agency status. Since AIMCo had transitioned successfully, the removal of the deputy minister was consistent with its arms-length status from the government. *Hansard*, 3 November 2009, p. 1703. Another plausible reason for removing the deputy minister was the Report of the Board Governance Review Task Force, *At the Crossroads*, in October 2007 which recommended that deputy ministers not sit on provincial agency boards. At page 24. This recommendation has not been followed in the case of the Alberta Capital Finance Authority and the Credit Union Deposit Guarantee Corporation. Another issue that arose bearing on this decision was the investment by AIMCo in 2009 in Precision Drilling. News reports speculated a government motive. In the debate around Bill 56, Hugh MacDonald the Chair of the Public Accounts committee stated he was not convinced this was a good measure citing internal control concerns of the Auditor General. *Alberta Hansard*, 5 November 2009, pp. 1771–1772. See also comments by Rachel Notley about executive compensation and the Precision Drilling transaction. *Alberta Hansard*, 17 November 2009, pp. 1841–1842. See also Claudia Cattaneo, "Alberta boost for Precision is investment, not aid: AIMCo" *Financial Post*, 19 April 2009. www.edmontonjournal.com/business/Alberta+comes+Precision+Drilling/1514986/story.html Accessed 27 March 2016.

32 Hansard, *Op.cit*., p. 411. Emphasis added. Certainly the reduction of the use of external managers for cost reasons as well as employment reasons was important.

33 Section 6. See AIMCo Annual Report, 2008–09. On page 3 is a listing of funds, agencies and pension plans that had been designated. In 2013, the Universities Academic Pension Plan began farming out 20 per cent of its investments to Beutel, Goodman and Company and Fiera Capital. UAPP *Annual Report*, 2013, pp. 2, 5.

34 *Alberta Hansard*, Op.cit., p. 428.

discussions and interviews with a narrow group of public service officials.[35] Another key question Macdonald raised was whether the pension funds, whose assets would be managed by the new AIMCo, had provided letters in support for the corporatization Bill. In all, this Bill consumed less than three hours of the Legislative Assembly's time with the bulk of the discussion over a failed amendment to prohibit the corporation from investing in tobacco companies.[36]

2.2.1 "The Start of Something Big"[37]

In August 2007, Charles Baillie and George Gosbee were appointed chair and vice-chair respectively of the new AIMCo board.[38] Charles Baillie was the erstwhile President and Chairman of the TD Bank. Gosbee was the Chairman, President and CEO of Tristone Capital Inc., a Calgary investment bank. In November, the Government announced additional appointments to AIMCo's board. Included in the "blue chip" board were two other senior financial executives from outside Alberta, Andrea Rosen, former Vice-Chair of TD, and Virginia Holmes, a former CEO of AXA Investments living in London England. Rounding out the board were prominent Alberta investment executives and businessmen Daryl Katz, David Bissett, Frank Layton, and Mac Van Wielingen.[39] Four board committees were created: Audit; Human Resources and Compensation; Investment; and Governance. The board had adopted a Standard of Conduct and promulgated a Code of Conduct and Ethical Standards for the organization.[40]

AIMCo came into being on January 1, 2008. On 30 April 2008, after an international search, AIMCo announced the appointment of Leo de Bever as President and Chief Executive Officer.[41] Dr. de Bever holds a Ph.D in economics from the University of Wisconsin, Madison and had worked at the Bank of Canada, Crown Life Insurance, Manufacturers Life Assurance, Ontario Teachers Retirement Fund and the Victoria State Pension Fund.

35 *Ibid*. p 428–9. See also Mr. Elsalhy's comments on patronage and questioning the merits of creating another government owned entity. *Alberta Hansard*, 17 April 2007, p. 623–624.

36 *Alberta Hansard*, 18 April 2007, pp. 649–655.

37 The title of AIMCo's first annual report for 2008–09.

38 Order in Council 354/2007, 1 August 2007. The recruitment process took place prior to the proclamation of the *Provincial Agencies Governance Act* that required a more transparent recruitment process.

39 Order in Council 483/2007, 24 October 2007. All Alberta members have contributed substantially to the Alberta Progressive Conservative Party either personally or through associated corporations or both. See Ascah forthcoming 2016.

40 *Annual Report*, 2008–09, pp. 22–23.

41 AIMCo, News Release, 30 April 2008.

2.2.2 Compensation Philosophy

Critical to the organization's success was "relating incentive compensation to risk adjusted returns."[42] In the investment industry, the overall goal of compensation philosophy can be summed up as: 1) aligning the economic interest of the portfolio manager with the economic interests of the fund's beneficiaries; 2) motivating the employee and 3) retaining the employee. The new CEO emphasized the requirement to invest in people, systems, and processes necessary to find and manage investment opportunities.[43] In the 2009–10 *Annual Report* the organization's compensation philosophy was laid out:

> AIMCo's total rewards package is designed to attract, retain and motivate performers with the specialized professional skills to produce persistent value-added. AIMCo pays competitive base salaries plus annual and long-term incentives totalling about three to five cents for every dollar of value added… Our base salaries and variable compensation plan targets are set at the median for the larger pension fund managers in Canada as determined by investment management compensation surveys conducted by consulting firms William H. Mercer and Towers Watson.[44]

The board subsequently adumbrated the following principles of organizational compensation practices:

1. Alignment with the vision of the organization; that is to be a world class global investor with talent sourced throughout the world;
2. Pay based on performance with the largest portion in variable pay;
3. Pay based on sustained *long-term* performance over a rolling four year period;
4. Fairness based on market comparables based on *independent* expert advice;
5. Incentives for active value added investment; and
6. Pay also based on qualitative factors such as improved "employee engagement" and "communications initiatives."[45]

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42 *Annual Report*, 2008–09, p. 4. The notion of compensating investment professionals based on "risk adjusted returns" is a difficult one to implement. The approach taken by AIMCo is to compare a benchmark which is an appropriate comparator to the asset mix or asset class that is being managed. However, a portfolio manager may take considerably more risk to gain a higher reward. However the benchmark's return should be adjusted upward to reflect the risk being taken which appears to be not the case.

43 *Ibid*, p. 4.

44 *Annual Report* 2009–10, p. 27.

45 *Annual Report* 2013, pp. 59–60. (Emphasis added.)

The new and evolving compensation system was made up of an annual incentive plan (AIP), a long-term incentive plan (LTIP), and "restricted fund units (RFUs)" designed to retain senior management and other key employees. The annual plan gives eligible employees the incentive to earn up to twice their base salary calculated on "value added performance over a four year period weighted to total fund and asset class (where applicable) and 2) individual performance aligned to the achievement of corporate objectives."[46] The LTIP program payments were based on compound rates of returns of investments measured against benchmarks over a four-year period with a value at maturity between zero and three times the original "grant" based on a portion of salary. In 2012, a Special Long-term Incentive Plan was set up to reward sustained and superior performance over an eight year period "where applicable".[47]

Each employee's annual variable compensation is calculated based on a weighting between individual performance targets, AIMCo's four-year total investment performance, and corporate objectives.[48] Corporate objectives are based on the corporation's "key success drivers" which include: strategic performance; investment performance; client satisfaction; financial and operational performance; and "doing business the right way". Non-financial metrics allow executive management discretion to award bonuses when target investment performance has not been met in order to "retain talent." Central to good pay-outs are value-added returns to the investment funds over the benchmarks.

Restricted Fund Units vest over a one to three-year period and, unlike the LTIP, the value is based on the total return of investments, not the return relative to a benchmark.[49] While Annual, long-term and special long-term plans have "high variability" in pay-out and therefore risk, the RFUs have a lower variability. In sum, because there were no shares to be sold to employees, the board with the input of management and human resources consultants created a `phantom share` program to mirror compensation arrangements in the private sector or other provincial investment management corporations.[50]

46 *Annual Report*, 2014, p. 62.

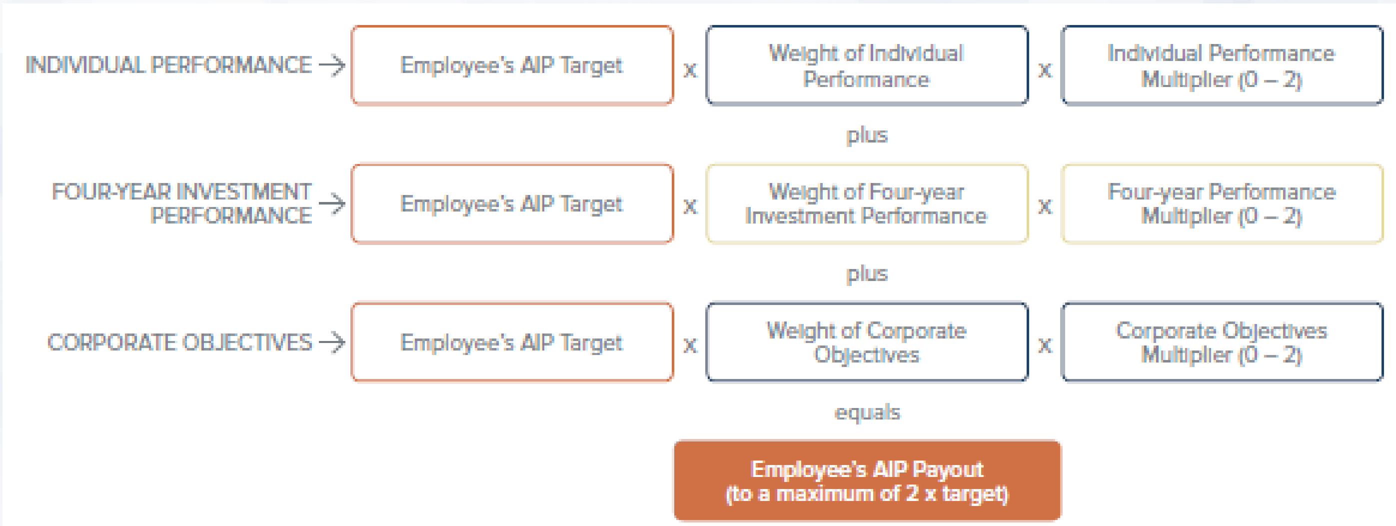
47 This payment could be made when "uncapped investment performance over any LTIP period (four years) exceeds the cap of 3X. Once granted, the SLTIP has the same mechanism as the LTIP. *Ibid*.

48 *Ibid*, p. 62.

49 *Annual Report* 2009, p. 32.

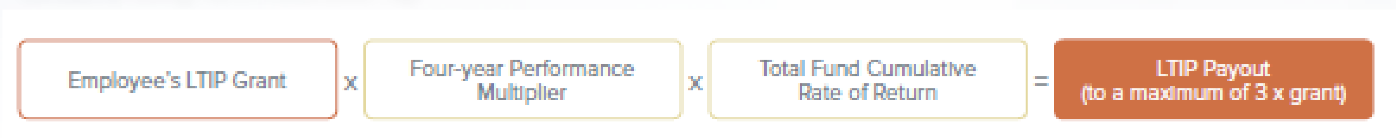
50 Transitioning employees from AIMCo could choose to remain in the MEPP or PSPP plan but new employees were required to join a new defined contribution plan. This followed the precedent with ATB Financial.

Exhibit A. Annual Incentive Pay



Source: AIMCo Annual Report 2014, *Invested in People*, p. 64.

Exhibit B. Long-Term Incentive Pay



Source: AIMCo Annual Report 2014, *Invested in People*, p. 65.

By 2014, the compensation system was developed and more fully disclosed. Other recent developments on the compensation front include the provision of an *opinion* from an *independent expert* that the "total amount of incentive payments … is reasonable in the context of market…. We believe that the compensation program at AIMCo continues to be generally aligned with market practices."[51]

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51 *Annual Report*, 2014, p. 61. It must be noted that an "independent expert" in this context would not be hired by AIMCo's board or management but by the pension boards themselves or by the Government of Alberta. In a forthcoming paper, the author examines executive compensation at four large Alberta provincial corporations: ATB Financial, the Alberta Securities Commission, AIMCo and the University of Alberta.

2.2.3 Performance Factors

A key determination in the LTIP bonus is the manager's asset class performance. This performance factor is averaged over the last four years and the result is multiplied by a "target bonus." As a whole the organization targets a "value –added performance" which is a cumulative total of the goals for the various asset classes.[52] The target value added for an $83 billion portfolio was $269 million in 2014 resulting in an investment factor of 1.0 although AIMCo "strives to achieve a stretch goal of three-times target each year." A key determination made by the board, presumably on the recommendation of the CEO, is the target value-added. If the target is set low, this means that mediocre performance is rewarded. There is limited information in the annual reports to judge whether the board is setting appropriate targets.

A second question is whether mediocre or risky investment performance is rewarded. A target bonus is achieved when a four-year average performance factor of 1 or more is realized. Depending on how the formula works (which is not disclosed), a manager may have his or her worst years subject to a floor with no ceiling for superior performance. The effect of such a formula would mean that a manager may have an incentive to increase risk (and potential reward) while knowing that very poor years will be capped on the downside. Thus the portfolio manager is insulated somewhat from downside risk, which is underwritten by the funds being managed.

2.3 Role of Pension Boards, Regulated Funds

Before examining the investment performance of AIM versus the newly created AIMCo, it is necessary to outline the role of the boards that act as trustees to pension plans or officials accountable for the performance of the Heritage Fund. The *Alberta Investment Management Corporation Act* is silent with respect to the setting of investment *policy* for the various pension plans and regulated funds whose investments are *managed* by the new entity. The responsibility of the various pension fund boards and officials in Treasury Board and Finance includes setting a statement of investment policies. For example, in the case of LAPP, the Trustees set the mix of investments by establishing a Statement of Investment Goals and Policies that identifies about a dozen investment categories and sets minimum and maximum investments as a percentage of the total portfolio or a target.[53] In the case of the Heritage Fund,

52 *Ibid*, p. 63.

53 LAPP, *Annual Report*, 2013, p. 22.

the Minister approves a Statement of Policies and Guidelines.[54] Investment Policies typically prescribe a range for investments of various types such as fixed income (short and long-term), equities (international, global, Canadian), and alternative investments such as real estate, private equities or infrastructure investments. AIMCo, as with AIM in the past, has managed "pools" of funds for the various funds and agencies in categories such as money market, mortgages, long-bonds, and private equity.[55]

While AIMCo does not have complete discretion over the asset allocation of the investments they manage, these policies do give AIMCo wide latitude. For example LAPP's investment asset mix allows a minimum of 25 per cent in equities and a maximum of 50 per cent.[56] Thus AIMCo portfolio managers still can beat the individual benchmarks through stock or asset selection or by assuming more risk within the given investment policy. More generally, the overall benchmark could also be beaten by raising allocations in investment categories that perform well during a particular period. For example, a higher allocation in U.S. equities relative to Canadian or Global equities would have improved overall returns due to the rising value of the U.S. dollar and superior performance in U.S. equity markets over the past several years. So while investment policy theoretically remains the domain of the boards, practically AIMCo still has broad degrees of freedom to add value for each fund under study. (Appendices A and B show the asset allocations set by boards and the actual investment breakdown in 2007–08 and 2014–15.)

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54 Heritage Fund, *Annual Report*, 2013–14, p. 7.

55 AIMCo, *Annual Report*, 2013, p. 19.

56 LAPP Board of Trustees, Statement of Investment Policy and Goals, Effective 1 February 2015. Includes a sub-allocation for hedge funds under the "Short-Horizon" asset class.

3. ANALYSIS

The main purposes of establishing the new corporation were to improve investment returns and to build a strong centre for investment management in Alberta. As noted above, the minister anticipated that the new corporation should be able to add 25–100 basis points of value above the existing investment performance. The analysis that follows will compare the investment performance of the former Alberta Investment Management division of Alberta Finance to December 2007 (March 2008 – Heritage Fund) with the investment performance of AIMCo to December 2014 or March 2015 (Heritage Fund), the most recent performance information available. We choose not to include investment returns in 2008–9 because of the financial crisis. Secondly, the organization was also in transition to a new structure.

The investment return data is derived from the annual reports of the four major balanced funds that AIMCo manages: the Alberta Heritage Savings Trust Fund; the Local Authorities Pension Plan (LAPP); the Public Sector Pension Plan (PSPP); and the Management Employees Pension Plan (MEPP). These funds represent a total of about $62.4 billion at December 2014 and March 2015 and constituted nearly 75 per cent of the assets managed by AIMCo. These assets are long-term in nature, feature a balanced fund approach, and are better barometer of comparison than the short-term money market assets managed for other funds.[57]

It is important to note that while the various boards set the performance benchmarks for their respective funds and investment categories, AIMCo determines the benchmarks on which their incentive pay is calculated. It is also important to note that the Heritage Fund reporting of performance against benchmarks has an active management target of one per cent. This reinforces the original intention of the Minister and government that the new corporation should be able to outperform AIM's historical performance. The analysis below however is more conservative: it compares AIM's performance against the set benchmarks and AIMCo's in the same manner (i.e. without imposing an extra 50 or 100 basis points "hurdle".) As noted below, AIMCo has, to date, achieved a 100 basis points value add in only one the four funds examined (Table 1).

57 For example, the Debt Retirement Fund, the Sustainability Fund, or the Workers Compensation Board Funds are short-term investment portfolios where value-added performance is measured in a few basis points and is challenging to achieve.

3.1 Caveats

The measurement and comparison of investment performance is a difficult undertaking for a number of reasons.

1. It is necessary to compare a fund's performance against an *appropriate* benchmark. Such a benchmark reflects the nature of the assets managed and risks taken on. Selecting the "right" benchmark is a highly technical business and the choices made may often result in significant variations in compensation outcomes. In the case of private equity investments and infrastructure, benchmarking can be extraordinarily difficult in part due to the more subjective nature of valuing companies that are not traded in public markets.[58]
2. As the asset mix and investment philosophy adapts and evolves over time (as is the case with practically all large investment funds), the benchmarks must necessarily change. This reality makes it difficult to compare investment managers' performance over time. Still, the concept we are trying to capture, and on which performance is compensated, is *value-added* performance through professional investing. This means that the benchmark four-year rate used by, for example, LAPP in 2007 to judge AIM's performance will be constructed differently than the four-year benchmark used by LAPP in 2014.
3. As the investment composition changes over time, so does the risk of the portfolio. Current thinking is to take on more risk in a managed way and therefore one must compare *risk adjusted* returns.[59] This adjustment in risk should be reflected in the benchmarking used by the Boards to evaluate AIMCo's performance.
4. The disclosure of expenses incurred by investment management has changed. AIMCo discloses expenses of its external managers whereas under AIM, external managers' costs were netted against investment income. That said, rates of return are both reported under AIM and AIMCo on a *net of fees* basis.
5. Another caveat is the matter of "legacy" investments. The Capelle report seemed to suggest that the investment management style at AIM,

58 For example see note 2(f) and 3 (b) in LAPP`s 2014 financial statements on measurement uncertainty and valuing financial instruments.

59 This approach has not been implemented for reporting or compensation purposes.

to put it charitably, was antiquated.[60] The new board and CEO inherited the systems, investments, and staff of AIM. If AIM's investments proved to be poor, then the new organization's performance would be negatively affected, especially in the early years, due to no fault of the new board and CEO. For example, in AIMCo's first annual report, it was noted that balanced funds had been overweight in global equities and fixed income credit which declined significantly during 2007–09.[61] To address this problem we have excluded investment performance of AIMCo in 2008 and 2009. Nevertheless problems in any investment portfolio can lie hidden for some time and will affect performance under the "new regime." But this is a common problem with *all* investment funds when new management takes over. For the purposes of this study we do not dissect every investment and adjust investment returns to allocate losses to prior periods.

6. In analyzing the performance of any investment fund, the choice of the time horizon is critical. Ideally, we would compare returns for eight to ten years that would provide some sense of the quality of *long-term* investment through a business and/or credit cycle. However, if one excludes calendar 2008 and 2009 for legacy investments, the time horizon is not as long as would be preferable.
7. In a number of tables, the author has calculated investment returns for periods that were not reported by the various funds. These calculations are based on reported, audited information and not detailed internally-generated information used in calculating the reported rates of return. The author believes that the simplified calculation of rates of return is adequate for the purposes presented here.
8. Certain large public sector investment managers like Ontario Teachers' and the Canada Pension Plan Investment Board make use of leverage. The use of debt is a controversial subject but it does allow the investment fund to improve returns under favourable conditions relative to funds that do not use leverage. In section 3.7 we make adjustments to try and take into account the use of leverage. The use of leverage really depends on the decision-maker's appetite for risk. Leverage can also be built into real estate investments and it's not clear

60 This claim is arguable. While systems and internal controls were problematic (See Annual Report of the Auditor General of Alberta, 2006–2007, pp. 90–94), as shown in the annual reports of the funds examined by 2007 AIM was using derivatives extensively, had invested in private equites, real estate, real return bonds timberlands (which proved problematic), and private infrastructure.

61 *Annual Report*, 2008–09, p. 14.

from Alberta reports how much leverage is used when making these investments, if any.

9. AIMCo uses derivatives (futures and index swaps, currency forwards, credit default and interest rate swaps, options) to "quickly and effectively implement asset and currency allocation strategies."[62] It is impossible, based on the information publicly available, to make adjustments to make clear peer to peer comparisons.

Notwithstanding the above, it seems reasonable to judge the competency of managers using net returns against benchmarks. Asset allocation and hedging strategies and risk appetite will always vary. What's important is the bottom line – the actual value added for the pensioner, member or taxpayer.

3.2 Investment Performance of Heritage Fund

The Alberta Heritage Savings Trust Fund was established in 1976 to save non-renewable resource revenue for future generations of Albertans. Initial investments included provincial corporation debentures, province-building investments such as Alberta Energy Company, Vencap Equities, and Prince Rupert Grain Terminal, and investments in Canadian provincial bonds.[63] Beginning in 1982–83, all investment income was sent to the Province's General Revenue Fund and inflows reduced from 30 per cent to 15 per cent of non-renewable resource revenue. In 1986–87, all non-renewable resource revenue transfers were suspended. As a consequence, the real value of the Fund declined precipitously over the next two decades. In the mid-1990s, a review of the Fund took place and its investment approach was shifted towards an endowment approach. A transition period of 10 years was prescribed. By the mid-2000s, given the shift in asset mix, the volatility of the Fund's income had increased. Other legislative measures included a provision to inflation-proof the Fund. This inflation-proofing activity has been episodic depending on the Province's overall fiscal circumstances.

For the Heritage Fund, the five-year investment return to March 2008 was an annual compound rate of 11.1 per cent compared to a benchmark target rate of 10.2 per cent. The net value added from active investment management was 0.9 per cent or 90 basis points.[64] For 2014–15, the five year return was 11.7

62 *Annual Report*, 2014, p. 37.

63 See Robert L. Ascah, "Savings of Non-renewable resource revenue: Why is it so Difficult?" in *Boom and Bust Again- Policy Challenges for a Commodity-based Economy*, Chapter 8.

64 Heritage Fund, *Annual Report* 2007–08, p. 8.

per cent against a benchmark of 11.2 per cent for a net value add of 50 basis points. The report notes an expectation of active management, exceeding the benchmark, of an incremental 100 basis points.[65] Thus while AIMCo outperformed the benchmark by 50 basis points, the organization failed to outperform the benchmark by an expected 100 basis points. Investment expenses as a percentage of assets managed have increased by 110 per cent on an asset base that has grown modestly.

65 Heritage Fund, *Annual Report*, 2014–15, p. 12.

TABLE 1 Investment Performance

	AHSTF	LAPP	PSPP	MEPP	Total
Assets ($billions) (1) – 2007–8	16.4	15.6	5.9	2.4	38.8
Assets ($billions) (1) – 2014–15	17.9	30.8	9.8	3.9	62.4
2007–8 Investment expenses ($billions)	0.06	0.06	0.02	0.01	0.136
2014–15 Investment expenses ($billions)	0.15	0.17	0.05	0.03	0.3875
Investment Expenses – 2007 – % of Assets	0.37%	0.37%	0.31%	0.21%	0.35%
Investment Expenses – 2014–15 – % of Assets	0.82%	0.54%	0.49%	0.68%	0.62%
Value Added – 2007 – AIM	0.90%	1.0%	0.6%	0.6%	N/A
Value added – 2014–15– AIMCo	0.50%	0.5%	1.0%	0.6%	N/A
Value added comparison ($billions) AIMCo–IMD * Assets	–0.036	–0.077	0.020	0.000	–0.093
Sources: Annual reports 2007–8 and 2014–15 (1) At March 31 for AHSTF, December 31 for other funds. N/A = not applicable					
Change in investment management expenses	130%	186%	167%	430%	167%
Change in Investment expenses as % of assets	110%	45%	60%	221%	72%

3.3 Local Authorities Pension Plan (LAPP)

LAPP, established in 1962, is the largest Alberta public sector pension plan with 423 employers and 237,000 members and pensioners. The defined benefit plan includes employees in the health services sector and municipal governments. For the four years ending December 31, 2007, the plan earned a compound annual return of 10.8 per cent and AIM out-performed the defined benchmark by one per cent.[66] For the four-year period ending December 31, 2014 the rate of return achieved by AIMCo was 10.1 per cent versus a policy benchmark of 9.6 per cent leaving a value added of 50 basis points.[67] Based on these comparisons, AIM outperformed AIMCo significantly in the management of LAPP's assets. Investment expenses as a percentage of assets managed increased by 45 per cent over the last seven years.

3.4. Public Sector Pension Plan (PSPP)

The PSPP is the defined benefit pension plan for non-management employees of the provincial government and 31 provincial agencies. The plan has approximately 82,000 members and pensioners. PSPP reports the value added returns to the Fund. These value added returns are computed on the basis of the realized returns (net of expenses) less the benchmark that is chosen by the Fund Trustees. For the four years ending December 31, 2007, the plan earned a compound annual return of 9.3 per cent and out-performed the benchmark by 60 basis points.[68] For the four-year period ending December 31, 2014 the rate of return achieved by AIMCo on behalf of PSPP was 10.2 per cent versus a policy benchmark of 9.2 per cent leaving a value added of 100 basis points.[69] In this case AIMCo improved markedly on AIM's performance but still did not meet the expectations set by the proponents of corporatization for a 50–100 basis points improvement *over* AIM. Between 2007 and 2014, investment expenses climbed by 60 per cent as a percentage of assets under management.

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66 Local Authorities Pension Plan, *Annual Report*, 2007, p. 20.

67 Local Authorities Pension Plan, *Annual Report*, 2013, p. 20.

68 Public Sector Pension Plan, *Annual Report*, 2007,pp.15–16.

69 Public Sector Pension Plan, *Annual Report*, 2014, p.19.

3.5. Management Employees Pension Plan (MEPP)

The MEPP was established in 1972 as the Public Service Management Pension Plan for management employees of the Government of Alberta and approved agencies, boards and commissions. The Plan provides pensions and disability benefits for management employees of the Government of Alberta and certain agencies. The Plan has 21 employers and about 10,900 active members and pensioners. It is a defined benefit plan funded by employers and employees. As with the other funds, MEPP measures the investment performance against clearly defined benchmarks identified in the Statement of Investment Policies and Procedures.[70] For the four year period ending December 31, 2007, the annualized four-year return was 9.9 per cent versus a benchmark of 9.3 per cent for a value added by AIM of 60 basis points.[71] For the four year period ending December 31, 2014, the annualized four-year return was 10.1 per cent versus a benchmark of 9.5 per cent for a value added by AIMCo of 60 basis points.[72] AIMCo's performance was same as AIM's based on the measure of value-added over the assigned benchmarks. The costs of investment management as a percentage of assets for MEPP rose by 221 per cent under AIMCo.

3.6 Investment Costs to Funds

A key metric in evaluating the efficiency and effectiveness of investment managers is the cost of investment management as a percentage of the assets of the funds. In the private mutual fund business, the management expense ratio (MER) is used as an indicator of the efficiency (and profitability) of investment management. Mutual funds normally cost retail investors between one percent and three per cent MER[73] whereas it is expected that large pools of investments such as a pension fund would have an expense ratio well below one per cent and usually less than 50 basis points. As Table 1 illustrates, in every case AIMCo's expenses, as a percentage of assets, rose.

Investment expenses are deducted from the income and net assets of the fund or the pension plan and hence reduce the net assets available for

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70 Management Employees Pension Plan, *Annual Report*, 2007, p. 11.

71 *Ibid*.

72 Management Employees Pension Plan, *Annual Report*, 2014, p. 17.

73 In response to retail investors' concerns over the high cost of mutual funds and lack of the transparency of costs, the Canadian Securities Administrators have studied the problem for the past decade or so. A new policy – the "customer relationship model" is being implemented starting in 2016.

beneficiaries. The expense ratio is very important because in a growth phase of a fund, the compounding of returns is vital to the funding status of these plans. In MEPP's 2013 annual report, the reader was advised that in 2012 and 2013 investment management expenses increased by 72.2 per cent and 41.2 per cent, respectively while assets under management rose only 8.1 per cent and 14.7 per cent, respectively.[74] Over the past seven years, the costs to these funds have more than doubled, and in MEPP's case tripled. What was the cause of these expenses increasing so rapidly?

There are four primary reasons for the increased costs: 1) higher salaries, wages, and benefits paid to AIMCo employees; 2) a higher number of AIMCo employees; 3) higher external management fees; and 4) a shift in assets to alternative investments such as private equity or public infrastructure.

With respect to salaries, as Table 2 illustrates, the number of employees at AIMCo grew at a very rapid rate as the mandate of the new board and executive management was, in part, to develop an Alberta-based centre of investment management expertise. While employee numbers grew by 20 per cent annually, *total* salaries, wages and benefits grew faster at 32 per cent. However *average* salaries grew at a much slower rate of 4 per cent per annum.[75] Table 2 also reveals that the average salary of the top named executive officers at AIMCo grew by 35 per cent annually from 2008–09 to 2014–15, well above the average salary of the average employee.[76] There may be several reasons why this may be the case. As the Capelle Report argues, the complexity of professionally managing investment portfolios made up of assets such as private equity and infrastructure requires highly qualified and remunerated employees to oversee such investments. These individuals often must be lured to Edmonton after a global search. As well, travel and due diligence activity including consulting, legal, and finance fees drive up the price of overseeing such investments.

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74 *Ibid*, p. 14. See also comments in LAPP's 2013 *Annual Report*: "A concern to note is the increase in reported investment expenses over the last three years. The Board has raised this concern with the Department of Treasury Board and Finance and with AIMCo. There are several factors at work including changes in accounting policy for reporting performance expenses, asset mix and the build out of a new organization. However, in the long run, the growth rate of investment costs cannot exceed the growth rate of the assets of the Plan. AIMCo has clearly indicated an intention to remain mindful of this principle."

75 The average salary number should be taken with a grain of salt. It is highly sensitive to when people start work, the level hired, and any extraordinary large payments made during the year. The trend is what is important.

76 In Table 2 we exclude the 2008–09 data for the CEO and the Top Five in the computation of annual increase due to a retiring allowance and a long-term deferred incentive grant given to the former Chief Investment Officer. The CEO salary for 2014–15 includes $3.7 million in total compensation (nine months) plus $136,000 for three months' base salary of the incoming CEO. The retiring CEO will receive $2.6 million in future estimated compensation that has a minimum pay out of zero and maximum pay-out of $5.3 million over the 2015–2018 period. *Annual Report*, 2014, pp. 69–70.

TABLE 2 AIMCo Employees, salaries, External and Administrative Costs

	2007–08	2008–09	2009–10	2010–11	2011–12	2012–13	2013–14	2014–15	Annual Growth Rate
Number of employees	138	170	208	250	303	334	360	370	20%
($thousands)									
Total salaries	21623	26231	38647	47840	59090	74661	76979	76369	32%
Average Salaries	157	170	204	209	214	234	222	209	4%
CEO/Chief Investment Officer	604	2103	1569	1988	2087	4049	3659	4357	36%
Total Top Five	N/A	7234	4094	5656	6224	10928	9703	11330	35%
($millions)									
External Investment Management fees (including performance-based fees)	N/A	174.1	169.3	135.8	140.7	229	255.9	240.3	6%
Performance-based fees	N/A	19.9	25.7	19.1	31	103.8	114.7	95.1	63%
External Asset Administration, legal and other fees	N/A	N/A	N/A	35.3	88.8	62.7	70.4	76.9	29%

Sources: Annual Reports
Notes: Annual rates of increase for CEO and Total Top Five begin in 2009–10 because of exceptional pay-outs.
For others computation starts in 2008–09 or 2010–11 for External Asset Administration, legal and other fees.
N/A = not applicable

The third cause of the increase in expenses to the various funds was the escalating cost of external investment management fees. As noted, one of the objectives of corporatization was to bring "in house" investment management expertise and to build up a strong, Alberta-based investment management team to take over some of the specialized investing that had been contracted out. Table 2 shows that total fees increased six per cent per annum or by $66 million over six years. Fees fell quite dramatically in 2010–11 and 2011–12 only to rebound by 50 per cent the following two years. These rapid increases are due to pay-outs associated with "performance-based fees" which rose by 63 per cent annually from 2008–09. These costs are volatile. Typically the hedge fund receives 20 per cent of the realized gains, in addition to a two per cent annual fee, while the owner takes 80 per cent of any gains. External Asset Administration and legal and other fees increased from $35.3 million in 2010–11 to $76.9 million in 2014–15 or by 29 per cent annually. It should be pointed out that, over time, the costs of external management *should* come down materially.[77]

77 After the financial crisis, institutional investors had the ability to negotiate these fees downward.

Internal management of like assets would cost only 50 basis points annually and five per cent of the private equity gains leaving considerably more to the funds *if* these investments make money.[78]

The fourth cause for the rise in investment costs is the increase in the quantum of alternative investments.[79] From March 31, 2009 private equity portfolios[80] grew from $1.4 billion to $2.2 billion at December 31, 2014. Real estate investments grew from $4.8 billion to $10.4 billion while infrastructure investment grew to $4.1 billion from $1.5 billion in 2009.[81] Timberland investments grew from $233 million in 2009 to $1 billion in 2014. [82] These types of investments are attractive because investment professionals believe they are inflation sensitive and therefore their value will increase if inflation stages a comeback thus protecting the real value of the investment. This attribute is crucial as the pension funds have legal obligations to increase pension payments as the consumer price index rises.

3.7 External Comparators

So was the claim that was presented by the promoters of AIMCo in 2006 and 2007 – that 25 to 300 basis points in additional investment returns could be achieved – realistic? Thomas Picketty cites data on U.S. university endowments that suggests scale or size does matter. He presents data showing that the average annual return from 1980 to 2010 of U.S. university capital endowments earned 8.2 per cent but the three largest (Harvard, Yale and Princeton) yielded 10.2 per cent – a compelling two per cent value-add.[83] Picketty opines "the higher returns of the largest endowments are not due primarily to greater

78 According to AIMCo's calculation the value-added captured by AIMCo and its employees is only 5.1 per cent versus 18 per cent for external managers. *Annual Report*, 2014, at page 61.

79 Of course, legacy investments of this kind may have increased in market value which should not have increased management expenses. We have not delved into this detail.

80 For AIMCo as a whole.

81 AIMCo and its predecessor organization have used a host of numbered companies to invest in real estate. Up until 2010–11, the Heritage Fund published a detailed breakdown of its investments. Included in real estate investments were a number of limited partnerships under names such as 116249 WAM DEV, 1260634 AB CAMERON, 1331430 ONT YORK, 91454090 PVM PROP, and 156 STC. Heritage Fund, *Detailed List of Investments*, March 31, 2011, (Unaudited), p. 93.

82 AIMCo *Annual Report*, 2008–09, pp. 16–18 and 2014 Annual Report, pp. 38–40.

83 *Capital in the Twenty-first Century*, p. 448.

risk taking but to a more sophisticated investment strategy that consistently produces better returns."[84] But thus far we have found that AIMCo has not produced more value-added than its previous incarnation. Higher costs to these funds, without the promised value-added, are very significant as, over time, the compounding effect of even a ten basis point rise in fees reduces available funds for beneficiaries.

To provide further context on the relative performance of AIMCo, we examine five large public sector organizations that manage pension and other funds for four other major jurisdictions in Canada. Table 3 lists these entities and records the size of the assets managed as well as their four-year or five-year returns. Regrettably these entities report with different year ends and with different time horizons so comparisons can be difficult. In addition, some plans like Ontario Teachers', the Caisse de depot et Placement, and the Canada Pension Plan use debt to leverage their investment returns.

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84 *Ibid*, p. 450.

TABLE 3 AIMCo Comparators

Institutional Investor	Total Assets ($ billions)	Net Assets ($ billions)	Simple Leverage Total Assets/ Net Assets	Most recent 4-Year Rate of Return (%)	Notes
Alberta Investment Management Corporation – a)	83.9	N/A	N/A	9.3	
B.C. Investment Management Corporation – b)	123.6	N/A	N/A	11.1	
Caisse de Depot et Placement – a)	225.9	272.7	1.21	9.6	
Canada Pension Plan Investment Board – b)	264.6	321.8	1.22	12.3	5 years
Ontario Municipal Employees Retirement – a)	72.1	94.3	1.31	7.9	5 years
Ontario Teachers – a)	154.5	196.3	1.27	11.7	

a) December 31, 2014
b) March 31, 2015
Sources: Annual Reports
N/A = not applicable

As the table reveals, Ontario Teachers' and the CPP Investment Board have the best four and five-year rates of return, with BC Investment Management placing a respectable third. The Caisse de Depot, AIMCo, and OMERS have the poorest recent track records.

Table 4 attempts to capture a little more comparative information. The table is divided into two sections to ensure that the reporting periods are consistent. Within each sub-set are four, five and ten year comparisons. Information in annual reports do not make it easy to *directly* compare performance. The table also examines the *reported* value-add of the investment manager. The best sample of comparison is the four year returns for AIMCo as a whole and its three largest pension plans. Here AIMCo's performance is superior to the Caisse but inferior to B.C. Investment Management and Ontario Teachers'. The five-year benchmark used by the Heritage Fund shows a much higher benchmark and return than OMERS' overall performance and non-reported benchmark. Compared to the CPP, AIMCo's whole portfolio has a materially lower return while AIMCo bests OMERS by about one per cent. Ten-year performance is not relevant (since AIMCo has been in existence only 7 years) although it is interesting how returns, other than for Ontario Teachers', cluster around 8 per cent with OMERS significantly lower and Ontario Teachers' the top performer.

TABLE 4

Investment Manager	Four-Year	Four-Year Benchmark	Value-Added	Five-Year	Five-Year Benchmark	Value-Added	Ten-Year	Ten-Year Benchmark	Value-Added
March 31, 2015 year-end									
Heritage Fund – AIMCo	NA	NA	NA	11.7	11.2%	0.5%	8.0%	7.9%	0.1%
BC Investment Management	11.1%	9.1%	2.0%	NA	NA	NA	8.1%	7.3%	0.8%
CPP Investment Board	NA	NA	NA	12.3%	NA	NA	8.0%	NA	NA
December 31, 2014 year-end									
Alberta Investment Management – a)	9.3%	8.4%	0.9%	9.0%	8.2%	0.8%	NA	NA	NA
Local Authorities Pension Plan – AIMCo	10.1%	9.6%	0.5%	NA	NA	NA	7.5%	7.7%	–0.2%
Public Sector Pension Plan – AIMCo	10.2%	9.2%	1.0%	NA	NA	NA	NA	NA	NA
Management Employees Pension Plan – AIMCo	10.1%	9.5%	0.6%	NA	NA	NA	NA	NA	NA
Caisse de Depot et Placement	9.6%	9.3%	0.3%	NA	NA	NA	NA	NA	NA
Ontario Municipal Employees RetirementSystem	NA	NA	NA	7.9%	NA	NA	7.0%	NA	NA
Ontario Techers Pension Plan	11.7%	10.0%	1.7%	NA	NA	NA	8.6%	7.2%	1.4%

Sources: Annual Reports
a) for all AIMCo funds
Notes: NA = not available

3.7.1 Difference-in-Differences (DiD) approach

Another approach to evaluating AIMCo's performance relative to AIM is to use the Difference-in-Differences (DiD) approach. First we take the performance of comparable institutions with the same year end and that did not undergo the same change.[85] We then use the formula below to see how well AIMCo's management of these four funds compares with AIM's performance.

[Return (AIMCo) – Return (X after 2009)] – [Return (AIM) – Return(X before 2007)]

where "X" refers to the external comparator, for example, OMERS. A positive sign indicates AIMCo's relative performance was better than AIM's. Table 5 illustrates the results of this analysis.

The results shed a very different light on the performance of AIM versus AIMCo relative to its peers. The results indicate that AIM's performance relative to the *Caisse* and Ontario Teachers' regarding the management of the three large pension funds was much worse than AIMCo's performance. Indeed AIMCo performed better than the *Caisse* in the past four-year period and the wide gap with Ontario Teachers' has been closed somewhat. Comparing AIM's investment performance on the Heritage Fund versus that of the CPPIB also shows AIM's performance is worse than AIMCo's.

Since one year's investment performance makes a huge difference, and the transition to AIMCo from AIM occurred in 2008, Table 5 also runs the test with 2008–09 data assuming AIM was "principally" responsible for the four- and five-year returns to those periods.[86] 2008 was the key year of the financial crisis (Bear Stearns, Lehman Brothers, AIG and Fannie Mae) and the one-year returns reflect the risk taken on and the investment "bets" made *before* the crisis. Also March 2009 was the nadir in stock market evaluations and since then equity markets have risen steadily. These one year returns can have a profound impact on four- and five--year returns. The result of this test produces a contradictory result from the 2007–08 data. AIM's performance relative to its peers narrows significantly thus altering the interpretation. Further research into this difference is desirable but it appears initially at least that the use of leverage by the Caisse, Teachers', and CPP caused a significant reversal compared with AIM's more conservative management style.[87]

85 This is not to say that investment philosophies did not shift nor that executive management or boards remained static during this period.

86 The author calculated the rates of return from annual information contained in the various annual reports of the four funds. A simple weighted average of assets was used to estimate combined four-year LAPP, MEPP, and PSPP returns. The same methodology was used to estimate the 4-year returns for the *Caisse* and the five-year returns for the CPPIB.

87 The *Caisse* had about $10 billion in non-bank sponsored asset-backed commercial paper that became illiquid in August 2007 necessitating huge write-downs. Caisse de depot et placement, *Annual Report*, 2008, pp. 34. In 2007 and 2008 the *Caisse* recorded a $5.3 billion provision on $12.8 billion in total ABCP. AIM-managed funds had limited exposure to the impugned Canadian ABCP investments.

Overall, the DiD approach does give us another means of assessing AIMCo's success. The 2007–08 data suggests that AIMCo upped its game but when returns are compared with benchmarks, the promise of returns commensurate with Ontario Teachers' has still not been met.

TABLE 5 Difference-in-Differences Approach

2007 Year-end Data	AIMCo	AIM	DiD
LAPP, MEPP, PSPP combined – a)	10.1%	10.3%	(4 years)
Caisse de Depot et Placement	10%	12.4%	
Ontario Teachers Pension Plan	11.7%	12.3%	
Difference in Absolute Return			
Caisse de Depot et Placement – b)	0.5%	–2.1%	2.6%
Ontario Teachers Pension Plan	–1.6%	–2.0%	0.4%
Alberta Heritage Savings Trust Fund	11.7%	8.8%	(5 years)
CPP Investment Board – c)	12.3%	12.8%	
	–0.6%	–4.0%	3.4%
Using 2008 Year-end Data			
LAPP, MEPP, PSPP combined – a)	10.1%	2.9%	(4 years)
Caisse de Depot et Placement	10%	3.3%	
Ontario Teachers Pension Plan	11.7%	3.3%	
Difference in Absolute Return			
Caisse de Depot et Placement – b)	0.5%	–0.3%	0.9%
Ontario Teachers Pension Plan	–1.6%	–0.4%	–1.2%
Alberta Heritage Savings Trust Fund	11.7%	11.1%	(5 years)
CPP Investment Board – c)	12.8%	11.7%	
	–1.1%	–0.6%	–0.5%

Sources: Annual Reports
a) Author's calculation
b) In 2008 the Caisse reported 1, 3, and five year returns. Four is author's calculation
c) CPPIB was not reporting five year returns in 2007 and 2008. Four year return is author's calculation.

3.7.2 Leverage

Four of the major funds we've compared use leverage. Leverage is a technique which enables the investment fund to borrow at government or near government borrowing levels, and invest in a class of investments that normally earn significantly higher return than the interest rate of borrowing. In order to understand the effect of leverage, the author calculated the rates of return of Teachers, CPP,[88] OMERS, and the Caisse by re-stating returns based on *gross* investments, as opposed to *net* investments.

Table 6 illustrates two facets of leverage. In a normal market, where borrowing rates are lower than rates of return for asset classes such as equities and inflation sensitive assets, leverage improves returns significantly. When the financial crisis occurred, the drying up of certain asset markets (e.g. asset backed securities and structured products such as specialized investment vehicles) made it difficult both to sell and price these financial instruments. Leverage can be highly destructive to an investment portfolio when the gross value of investments has to endure a significant write-down since more investments are subject to write-down through leverage. The leveraged pension funds examined here performed poorly especially CPPIB and the Caisse whose investment losses were not recouped for three years. In the case of AIM- managed funds, the performance was a little better but not much better than Teachers'.

Examining the adjusted performance of AIM and AIMCo in relation to the leveraged funds, Alberta's investment managers look competent and periodically beat the other fund managers as in 2004 and 2014 for the Heritage Fund. As noted earlier, it is difficult to determine the degree to which leverage is employed by AIMCo in its management of its pooled funds. Real estate investments frequently involve mortgage financing but public reports from AIMCo or the various pension funds do not disclose if leverage is used. A second type of leverage is entering into derivative contracts where cash flows are exchanged between counter-parties based on agreed upon indices such as LIBOR or exchange rate. The calculation of the amounts to be swapped is based on a "notional" sum of money and it is expected that the exposure to pay, or receive from a counterparty, will be a small per cent of the notional amount. However, if interest rates, commodity prices, or exchange rates swing significantly, actual payments or receipts can be significantly higher (lower). In the case of negative returns, the adjustments actually improve the returns because the denominator is larger. In the case of the CPP reported rate of return in 2009 was –18.6 per cent vs. an adjusted rate of –20.2 per cent.[89]

88 CPP only began to employ leverage significantly since 2012.

89 That year, the fund lost $23.7 billion on total investments of $126 billion at March 31, 2008 and $109.2 billion (March 31, 2009) and net assets of $122.7 billion (2008) and $105.5 billion (2009).

TABLE 6 Annual Rates of Return – Adjustment for Leverage

Years/Fund Manager	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015
Percent (%)												
Ontario Teachers Pension Plan, adjusted – a)	11.3	12.7	9.4	3.0	−13.3	8.3	10.0	7.8	8.1	7.0	7.9	
As reported	14.7	17.2	13.2	4.5	−18.0	13.0	14.3	11.2	13	10.9	11.8	
CPP Investment Board, adjusted – b), c)	28.4	10.8	16.3	12.2	−0.3	−20.2	13.3	10.8	5.8	8.4	13.1	14.3
As reported	17.6	8.5	15.5	12.9	−0.3	−18.6	14.9	11.9	6.6	10.1	16.5	18.7
Caisse de Depot et Placement, adjusted – a)	12.2	14.7	14.6	5.6	−25.0	10.0	13.6	4.0	9.6	13.1	12.0	
As reported	10.8	15.2	17.8	5.6	−25	10	13.6	4	9.6	13.1	12	
OMERS, adjusted – a)	9.2	11.9	11.6	6.2	−13.0	7.3	8.3	2.0	7.6	4.7	7.4	
OMERS – as reported	12.1	16	16.4	8.7	−15.3	10.6	12.0	3.2	9.8	6.5	10.7	
Alberta Heritage Savings Trust Fund – b)	22.5	7.7	15.2	12.4	−0.7	−18.1	17.8	10.4	8.2	11.6	16	12.5
Local Authorities Pension Plan – a)	10.4	14.3	14	4.7	−15.1	9.6	9.9	6.7	11.1	11.3	11.4	
Public Sector Employees Pension Plan – a)	9.7	12.2	14	1.8	−19.2	14.1	9.7	3.6	11.4	14.1	12.2	
Management Employees Pension Plan – a)	10.2	13.1	14	2.7	−17.6	15.1	10.1	2.4	12.3	14.9	11.3	

Sources: Annual Reports
a) December year-end
b) March year-end
c) highly dependent on timing of asset transfer in 2004–06 period before leverage used

4. PRELIMINARY ASSESSMENT

It is still early to form a definitive judgment on the success or failure of the corporatization of Alberta's investment management function. However, after nearly eight years since its inception, it seems fair to offer a *preliminary* assessment of AIMCo's performance as against the objectives set out by the government when it was established.

4.1. Enhanced investment returns

Based on advice contained in the Capelle report, the Minister and government expected a return of 25 to 100 basis points *above the performance of AIM*. As noted in section 3 and Table 1, based on four year and five- year returns as reported by the funds, AIMCo has underperformed AIM in the case of the Heritage Fund (40 basis points), LAPP (50 basis points), performed at the same level in the case of MEPP, and has out-performed AIM by 40 basis points for the PSPP. Table 1 calculates the value of the enhanced performance by multiplying the value added by AIMCo over the four or five year period by the average assets managed over the most recent AIMCo management period. As the Table shows, AIMCo did not add any value relative to the value-added performance by AIM resulting in an annualized $93 million lower return assuming that AIMCo matched AIM's "out-performance" of its benchmarks. It may be tentatively concluded that the investment performance of AIMCo has not met expectations. And the test we are applying is not as severe as the promise of adding 25 to 100 basis points of value added which, on the combined portfolio, would be about $620–830 million *per annum*.

The following quotation from MEPP's 2013 report suggests that active management over the past eight years and for 20 years (including AIM) has *not* added any value!

> In order to measure the investment performance from AIMCo's active management decisions, such as security selection, the investment return for each asset class and the overall performance of the Plan's assets are measured against clearly defined benchmarks that have been established in the MEPP IP (Investment Policy). The policy benchmark return is determined by multiplying the benchmark return for each asset class by its percentage of the total investment portfolio. Over the

past four years, the value added return from AIMCo is 0.7 per cent per annum including a valued added return of –0.2 per cent in 2013. On an eight-year basis, the value added return from the investment manager is 0.0 per cent per annum. Over the longer term of twenty years, the value added return is 0.0 per cent.[90]

As stated earlier, it could be objected that AIMCo management inherited a "smorgasbord" portfolio and it takes years, if not a decade, to remedy the situation to generate the 200 to 300 basis points thought possible by Capelle and Ambachtsheer. Of course we will not know that for several more years. With the growing complexity of financial markets, the uncertainty of future "black swan" events, one questions whether there are too many factors to control for what might enable an impartial observer to identify decisions made by individual managers, the board or CEO that would have added value *consistently* over time. Moreover, there is a whole literature suggesting that the case for paying higher fees for investment management is, at best, unproven.[91][92]

90 MEPP, *Annual Report*, 2013, p. 15. In the past 8 years, the value-add for MEPP was 0.2 per cent. MEPP, *Annual Report*, 2014, p. 17

91 For a succinct argument see William F. Sharpe, "The Arithmetic of Active Management," *The Financial Analysts' Journal*, Vol. 47, No. 1, January/February 1991. pp. 7–9. http://web.stanford.edu/~wfsharpe/art/active/active.htm A key problem with active management is what some critics term the "churning" that goes on with "actively managing" a portfolio. See also Harvey, Liu and Zhu (2013) who examined 313 financial studies testing the statistical significance of factors that governed investment returns. The authors propose that the test for statistical significance be increased (t-statistic) noting that perhaps one- half of the "factor discoveries" driving investment returns are false. This study underlines the quest in both academe and in finance to discover market factors and to exploit for private gain those factors.

92 According to the 2014 AIMCo report, AIMCo added $130 million in value in 2009, $221 million in 2010, $715 million in 2011, $1,284 million in 2012, $589 million in 2013, and negative $401 million in 2014. AIMCo, *Annual Report*, 2014, p. 32. In 2014 there was a "one time adjustment of $437 million due to the revaluation of certain insurance-related investments made in prior years." See also *Report of the Auditor General of Alberta*, October 2014, pp. 198–200 and follow-up October 2015, p. 158. AIMCo had $1.3 billion in "life settlement" investments at December 31, 2013. $325 million of unrealized gains on these investments were taken by making a change to the discount rate used to value the investments which are not traded on financial markets. According to the Auditor General: "Management recognized one-day gains for the life settlement investments by purchasing the investment at one price and then revaluing the investment to a higher price shortly after the purchase." At page 199. Dr. de Bever was severely criticized in 2011, several years after he had left the Victoria Funds Management Corporation as Chief Investment Officer, for a similar life insurance contract investment. See Rafael Epstein, ``State sinks $500m on dud scheme," March 2, 2011. Victoria, The Age, www.theage.com.au/victoria/state-sinks-500m-on-dud-scheme-20110301-1bd9t.html Accessed 21 March 2016.

4.2 Building In-house Expertise

In AIMCo's 2010–11 annual report, entitled *From Vision to Action*, Chair Charles Baillie noted a 22% increase in staffing, observing :

> People are joining us from locations around the world to be part of building a nimble and innovative investment management firm. Strengthening AIMCo's operational and investment capacity has not raised unit costs. The entire cost of improving operations to-date and a 22% increase in staff has been financed by reducing external management expenses without any detriment to investment returns since internal management is inevitably far more cost-effective.[93]

The number of employees at AIMCo has grown from 138 to 370. Growth of this magnitude in seven years is indeed a major achievement for the management of the provincial corporation and, in particular, the human resources department of AIMCo. Whether staff of 370 is a "critical mass" for managing and delivering superior investment performance over the long-term remains to be seen. Certainly the increased salaries paid to the organization's staff, which rose from $22 million to $77 million, has added to disposable income in the Edmonton region. Furthermore, paying an "in-house" investment manager of private equity based in Edmonton is considerably less costly than an individual based in London or New York. Clearly, the transformation from a division in a government department to a provincial agency has decidedly improved the average salary for those who moved to and stayed with the organization.[94] Accordingly, the primary beneficiaries of the corporatization appear to be the hundred or so employees that made the transition and remained, who have captured "rents" from the pensioners and members of the large public sector plans. We use the term "rents" advisedly because if AIMCo had performed as anticipated, then the higher managerial salaries, and significantly higher executive salaries, would have been justified.

A second facet of the corporatization promise is the reduction in the use of external investment management and a concomitant decline in fees. The 2009–10 report noted that at the end of March 2010, 83 per cent of AIMCo's assets were managed internally but only 26 per cent of the costs were attributed to internal management. AIMCo was also responsible for 172 per cent of value added while the external management destroyed value-added.[95] Despite this inauspicious comparison, as Table 2 illustrates, the total fees paid by the funds are now materially higher than the first year when the organization was initially

93 AIMCo, *Annual Report*, 2011, p. 3.

94 The increase in salary is probably understated since there is no available data from Finance to determine average salaries of AIM employees in 2006–07.

95 *Annual Report*, 2009–10, p. 26.

established. Interestingly, the comparison between AIMCo's performance and the external managers included in earlier reports is no longer available. This begs the question as to what changed in 2012–13 that led to much higher performance-based compensation of the external managers. It also raises the question that if external managers were "bonused" for extraordinary performance what percentage of value-add did the professionals inside AIMCo contribute overall.

In response to concerns about rising costs, AIMCo has maintained:

1. We manage more assets internally at a fraction of the external costs which required an investment in people, process and technology.[96]
2. We manage more pension assets with a higher allocation to equities, which are more expensive to manage than bonds.
3. Our clients are asking us to hold more high-cost private assets.
4. Our success in adding value with active management has increased performance fees.[97]

While the first point may be true it is inaccurate relative to its predecessor organization and external management and administrative costs have continued to increase substantially. The second point and third points are valid as the equities and private equites portfolio grew by about $25 billion between 2009 and 2014. However, the final point seems incongruous because more assets are managed internally but the big performance fees were paid to *external* managers. Perhaps what the writers were getting at was AIMCo's acumen in picking and rewarding the best external managers operating in London, New York and elsewhere.

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96 "The operations side of AIMCo was starved for resources in the decade prior to AIMCo." *Annual Report*, 2010–11, p. 34.

97 *Annual Report*, 2012, p. 18.

4.3 Final Comments, Recommendations and Areas for Further Research

This study evaluates the success of the Government of Alberta's decision in 2006–07 to create an arms-length investment management services organization. The Minister at the time articulated the "promise" that the new organization would create significant extra value for the beneficiaries of the funds managed by the new entity. Quite remarkably, the Government of Alberta or the Minister of Finance did not establish performance expectations for AIMCo as a whole at the start of AIMCo's life or a five, seven, or ten-year review process to evaluate the success, or otherwise, of the corporatization project. [98]The evidence presented in this study show that the performance thus far has not met the promise. At an admittedly high level, the investment returns achieved by AIMCo on behalf of the four pension and regulated funds studied have been no better than that achieved by AIM and, in fact, overall have been generally worse based on benchmarks established by the funds. In addition, the costs of management have roughly doubled as a percent of assets.

The size of the organization has more than doubled and average salaries had grown by nearly 50 per cent by 2013. Executive salaries have risen dramatically with most of the salaries paid in variable pay, based on investment performance. But investment performance has thus far been no better and, in some cases, worse when compared with the *status quo ante* and with other large public sector investment managers. This result raises questions about the quality of oversight exercised by the AIMCo board. Why are managers and executives receiving significant bonuses when the benchmark of one per cent superior performance to AIM is not being achieved? Has the board set the performance thresholds at too low a level? Should the Boards of the pension funds have a role in determining compensation? Should the pension fund boards be able to move their assets to other investment managers if performance is poor?

The DiD analysis approach does offer some optimism as AIMCo's performance, relative to AIM and its peers, has shown improvement. This analytical approach also illustrates how extraordinarily difficult it is to adequately compare the performance of funds who use different reporting periods and often change multi-year performance reporting periods.

Compensation remains a thorny and controversial issue. In the past two decades, the pay of financial professionals has escalated significantly. Persons with MBAs and Chartered Financial Analyst (CFA) designations are highly

98 Section 19 of the *Provincial Agencies Governance Act* requires a review of the corporation every seven years by the responsible minister. The Act did not come into force until June 2013.

sought after by banks, insurers, consultancies, and institutional investors. A recent study by Thomas Lemieux and Craig Riddell illustrates a shift in the composition of the top one per cent of income earners.[99] The study shows that from 1981 to 2011 there has been a progressive shift in high paying jobs from medicine to commerce and, by industry, to finance and insurance, mining, oil and gas, and to business services.[100] Alberta's proportion of one per cent income earners has risen from 14.5 per cent in 1981 to 20.8 per cent of the Canadian total by 2011.[101] Lemieux and Riddell conclude that, on balance, the increase in high income *is evidence of rent extraction rather than competitive markets*. However they note that the number of hours of work of these high income earners has increased over the past two decades.[102]

Over the past two decades Alberta has clearly become a magnet for high income earners. Alberta's low personal and corporate tax environment, support for free enterprise and market-based solutions, have created a hospitable environment for individuals seeking high incomes and low taxation. (This reputation exists at all income levels whether for welders, doctors, or retail workers.) Yet, the assumption that attracting individuals with the "right skills" seeking ever high compensation levels will produce superior investment performance over time remains unproven. And, as noted earlier the case for active, as opposed to passive management, remains hotly debated.

Traditionally, investment managers were regarded as "salaried trustees" whose principal job was growing the savings of wealthy families and investing pension funds safely and conservatively. The recent financial crisis has demonstrated that investment managers and investment bankers were given too much leeway to game their incentive system by risking depositors,' investors,' and pensioners' moneys, not their own.[103]

This paper is a *preliminary* assessment. The quality of investment management is ideally assessed over decades through business and financial cycles. A better judgment on the merits of corporatization can be made in three to five years' time.

So was corporatization a sound public policy decision? Certain assumptions about the benefits of corporatization were valid, namely: more flexible salary and budget

99 "Who Are Canada's Top 1 Percent?" *Income Inequality: The Canadian Story*. Montreal, Institute for Research on Public Policy, 2015, Chapter 1.

100 *Ibid*, Table 2, p. 18.

101 *Ibid*, Table 2, p. 19.

102 *Ibid*, p. 32.

103 *Ibid*, p. 31. "In the case of finance, deregulation and lack of oversight have created opportunities for finance professionals to earn extraordinarily large incomes by taking substantial risks *with other people's money* – and in some cases, by camouflaging the nature of those risks." (Emphasis added.)

arrangements and building up a stronger infrastructure of people and systems. The promise of investment returns may have been too optimistic. The *execution* thus far has unfortunately not produced the desired results as rising costs and middling investment performance bring into questions the wisdom of the 2007 legislation. The process, not the form, is what matters.

4.3.1 Recommendations

With respect to board governance, the quality of oversight exercised by the board on the rising expenses charged to pension funds is a concern. Board members were recruited on the basis of business and finance acumen and yet have no statutory accountability to the hundreds of thousands of pensioners and employees that depend on sound investment management to live out their final years comfortably. Under section 11 of the *Alberta Investment Management Corporation Act*, directors have the responsibility to: "(a) shall act honestly and in good faith and with a view to the best interests of the Corporation, and (b) shall exercise the care, diligence and skill that a reasonableand prudent person would exercise in comparable circumstances." This provision is standard in Canadian corporate law but in some financial institutions statutes, the best interests of the corporation are defined to include the interests of depositors.[104] While this fiduciary role is undertaken by the boards of the pension funds and elected and appointed government officials, such boards have no power to refuse to pay investment expenses or to seek investment management services elsewhere. It would be desirable for the major pension plans, and possibly, a representative of the Minister, to appoint highly qualified individuals to sit on AIMCo's board. Section 11 of the AIMCo Act should be revised to explicitly require the board to take into account the interests of the members of pension plans and the Crown in Right of Alberta. Section 5 of the AIMCo regulation should also be repealed to eliminate the eligibility requirement that board members must have experience in investment management, finance, accounting or law or experience as an executive or a director in a *senior* publicly traded issuer. This hurdle is too elitist, too narrow, and as we have seen is no guarantee of the quality of directors and oversight of the affairs of the corporation.

With respect to compensation, it appears that the board is generally unaware that the investment performance of the major funds examined has been sub-

104 Section 24(2) of the *Alberta Treasury Branches Act* states: "In considering whether a particular transaction or course of action is in the best interests of Alberta Treasury Branches, a director or officer shall have due regard to the interests of the Crown in right of Alberta and the depositors of Alberta Treasury Branches." Revised Statutes of Alberta, 2000, Chapter A-37.

standard and conflict with the optimistic tone of reports published in AIMCo's annual reports. A review of the risk-adjusted returns (Sharpe ratio) of the major funds under AIM and now AIMCo would more conclusively show the success or not of the corporatization initiative. It is recommended that a qualified third party, without ties to the investment or human resources consulting firms, be brought in by the government to examine whether improvements to performance have occurred and whether the increased compensation of staff and executives was justified. Further, the adequacy of compensation disclosure should be enhanced. In particular, the rationale for the setting of the "stretch" targets as well as how the calculation of the four-year performance factor is determined should be more fully disclosed.

It is also recommended that the government remove the ministerial designation requirement that gives AIMCo a monopoly on managing public sector plans and the Heritage Fund. These funds should have the ability to value shop for investment management services. On the other hand, AIMCo should also have the capacity to shop its wares on the market as well. The latter will invoke push-back from some industry sources yet these same sources will be able to bid for significant business from currently captive government funds.

With a new provincial government in place, and after nearly eight years operating as a provincial corporation, it is time for a *public* review of the investment performance and governance of AIMCo. It is also time to re-examine some of the market-based assumptions used for compensation employed by the board for managing investment performance. This is not a call to necessarily reconfigure the organization and start anew, but rather to carefully assess the strengths and weaknesses of AIMCo's business model and contemplate the status quo against other configurations.

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APPENDIX A. Investments 2007–08 vs. 2014–15

	Heritage Fund		LAPP		PSPP		MEPP	
Percent (%) – Actuals	**2008**	**2015**	**2007**	**2014**	**2007**	**2014**	**2007**	**2014**
Fixed Income and Money Market	32.1	17.3	30.9	29.9	24.3	27.2	33.4	15.2
Real Return Bonds			5	3.8	5.5	5.1	3.5	10.1
Absolute Return Strategies	5.2	1.6	4.5	1.5	2.8	0.7	0.7	1.9
Equities	46.1	44.2	43.9	42.2	56.6	46.9	52.4	55.3
Private Equity	3.6	7.2	4.9	4.2	0.9	2.7	2.6	5.6
Real Estate	10.8	20.1	10.3	12.5	7.1	10.7	7.4	6.7
Infrastructure (Private Income)	1.7	7.3	0.6	4.7	1.6	5.2		5.2
Timberlands/Commodities	05	2.3	0.5	1.2	2.2	1.5		
Totals	100	100	100	100	100	100	100	100
Sources: Annual Reports								

APPENDIX B. Investment Policy 2007–08 vs. 2014–15

	Heritage Fund		LAPP		PSPP		MEPP	
Percent (%)	2008 (Target)	2015 (Range)	2007 (Target)	2014 (Range)	2007 (Target)	2014 (Range)	2007 (Target)	2014 (Range)
Fixed Income and Money Market	25	15–45	23.5	20–40	21.5	12–21	23.5	10–40
Real Return Bonds	a)	0–10	5	0–10	3	0–7	3.5	
Absolute Return Strategies	6	0–2	5	0–10	4	–	1	
Equities	45	35–70	39.5	25–50	54.5	31–53	52	40–70
Private Equity	6	0–10	10	3–9	2	0–6	3	15–40
Real Estate	10	10–20	10	10–20	6	10–19	7	
Infrastructure (Private Income)	6	5–15	5	5–15	5	5–12	4	
Timberlands/Commodities	2	0–5	2	0–5	4	0–4		
Totals	100		100		100		100	
Sources: Annual Reports a) Included in Fixed Income and Money Markets.								

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