

Research Project # 14: The Impact of Pension Funds on the Ontario Government

Research Paper: Pension Funds: Their Role in Capital Markets, Corporate Governance and a Competitive Economy

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EXECUTIVE SUMMARY

This paper examines the investment patterns of pension funds in Canada and their impact on capital markets and corporate governance. The analysis made in the paper is under the following five heads:

1. Asset allocation patterns of Canadian pension funds.
2. Pension funds' impact on capital markets.
3. Recent trends in pension fund investments – private equity and venture capital.
4. Pension funds' influence on corporate governance.
5. The role of pension funds in policymaking and regulatory changes.

For the purpose of analysis, the paper uses a combination of data, for which the main source is Statistics Canada, scholarly literature on the subject, field surveys and reports of current events. The conclusions drawn in the paper with reference to the five heads listed above are summarized below.

1. Asset Allocation Patterns of Canadian Pension Funds

Pension funds are large investors in various assets, such as stocks, bonds, private equity and other securities and assets. The asset allocation patterns in the investments of Canadian pension funds are examined, and the following are the major conclusions drawn from the study:

- (i) Over the period studied, stocks traded in the public capital markets have remained more or less stable at about 40 percent of the total assets of pension funds, and are an important asset class for the funds;
- (ii) Foreign holdings by pension funds more than doubled to 30 percent, while holdings of Canadian securities have correspondingly fallen during the period;
- (iii) Holdings in fixed-income securities declined by a quarter, from 41 percent to 32 percent of the assets of pension funds during the period;
- (iv) There appears to be a small, but steady, interest for new varieties of investments such as venture capital and private equity. According to available data, the value of such investments was over \$70 billion in 2006; and

- (v) The data available on the asset allocation patterns of Ontario pension funds reveals that the pattern of asset allocation by Ontario pension funds is more or less in line with their non-Ontario counterparts.

2. Pension Funds Impact on Capital Markets

Most of the investments of pension funds are in publicly-traded securities, and this makes pension funds a powerful force in these markets. The paper examines how the presence and operations of pension funds impact the capital markets, and draws the following conclusions:

- (i) Pension funds are important players in the capital markets. The trading activity of pension funds is significant to the functioning of the capital markets in that it enhances the efficiency of the public market and adds liquidity. In the 13-year period between 1993 and 2006, pension funds made net purchase of over \$350 billion in the stock market.
- (ii) Pension funds earn significant profits on the sale of securities, and derive revenues from investment income. However, profits on sale of securities have emerged as the more important source of revenue for pension funds. Investment income fell from over 58 percent in 1990 to less than 27 percent in 2004. Net profits from the sale of securities, which represented less than 3 percent of the revenue of pension funds in 1990, rose to a high of almost 54 percent in 2000, and were about 30 percent in 2004. Although the trend with profits on sale of securities is variable during the period, their importance in the revenue structure of pension funds has been gaining in significance.
- (iii) There is mixed evidence about the performance of pension funds relative to market benchmarks.
- (iv) Pension funds have some influence on the corporate governance practices of public issuers, and their presence in the capital markets enhances investor protection and public confidence in the capital markets

3. Recent Trends in Pension Fund Investments – Private Equity and Venture Capital

Since the 1990s, some pension funds have increased investments in private equity and venture capital, marking a break from their traditional practice. The paper analyzes the significance of the trend for private equity and venture capital investment by pension funds, and makes the following findings:

- i. Large pension funds have invested in new varieties of investments, such as venture capital or private equity. Thirty-two of the 100 largest pension funds have assets in venture capital and private equity, and these assets represent 8 percent of their total asset value. In comparison, only 2 percent of smaller funds have invested in private equity and venture capital, and their assets in this category, including real estate, are just 3 percent of their total.

- ii. Investments in private equity and venture capital require greater scrutiny, transaction costs and overall involvement, both at the pre-investment stage as well as in the post-investment phase.
- iii. Some data indicate that private equity investments are profitable for pension funds. For example, Ontario Teachers Pension Plan (OTPP) earned a return of 31.4 percent on its investments in this category while its overall rate of return was only 17.2 percent.

4. Pension Funds and Corporate Governance

Pension funds are significant shareholders in public corporations. This raises the question of their role in influencing the governance of these corporations. The paper examines the issue and draws the following conclusions.

- i. Canadian pension funds have undertaken systemic efforts to promote good governance among corporations primarily through suasive methods. The Canadian Coalition for Good Governance (CCGG) was launched mainly by pension funds and is an important vehicle. Its activities include regularly examining current issues and preparing policy guidelines for its members. In addition, Pension Investment Association of Canada (PIAC) also provides guidance to its members on playing an effective role in their capacity as shareholders in corporations.
- ii. The literature on the subject finds that the involvement of institutional investors, including pension funds, in corporate governance has myriad implications, both positive and negative. The positive ones include the size of the holdings and ability to influence corporate behaviour through suasion, litigation and effective use of the threat of exit. Some negative aspects of pension fund involvement in corporate governance include free-riding by other shareholders, conflicts of interest situations for pension fund managers and absence of proprietary interest on the part of pension fund managers.
- iii. In general, pension funds in Canada place reliance on informal discussions with corporate managers for resolving corporate governance issues, and prefer to avoid more confrontational methods, such as negative voting, litigation or proxy campaigns. This influence is difficult to measure objectively.
- iv. Pension funds have generally not been keen on seeking representation on the boards of directors of corporations. This trend may reverse for large funds with more private equity investments.
- v. Data on shareholder proposals is insufficient to arrive at clear conclusions on the use of this instrument by pension funds to intervene in corporate governance.
- vi. A minority of pension funds (about 30 percent) funds surveyed in 2006 delegated the task of voting to their investment managers. Of these, about 70 percent gave freedom to the investment managers to decide on how to vote. This may indicate the constraints of lack of resources and expertise on the part of smaller pension funds to effectively exercise their voting rights as shareholders of corporations.

5. Pension Funds' Role in Policy Making and Regulatory Changes

Pension funds operate in a complex regulatory environment, and have an important stake in the formulation of policy and legislation with respect to corporations, corporate governance, securities markets and pension fund investments. The last part of the paper examines the role of pension funds in influencing policy and bringing about regulatory changes, and the following are the important conclusions.

- (i) Pension funds play an active role and appear to be quite effective in campaigning for regulatory changes in which they are interested as investors in the capital markets. The amendments made to the *Canada Business Corporations Act* in 2001 with respect to proxies and shareholder communications, as well as the removal of the Foreign Property Rule from the *Income Tax Act* in 2005 are prominent examples of the efficacy of pension fund activism in bringing about policy and regulatory changes.
- (ii) Campaigning for policy and regulatory changes is done both at the collective level – through organizations such as the Canadian Coalition for Good Governance (CCGG) and Pension Investment Association of Canada (PIAC), and by larger pension funds such as Canada Pension Plan Investment Board (CPPIB) and Ontario Teachers Pension Plan (OTPP).