CPP INVESTMENT BOARD

Focusing Capital on the Long Term

CHAMPIONING A LONG-TERM STRATEGY IN A SHORT-TERM WORLD

Address to the CVCA - Canada's Venture Capital & Private Equity Association

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CHECK AGAINST DELIVERY

Thank you, Rakesh. I'm delighted to be here this morning. First, my compliments to the CVCA for choosing one of the world's most inspiring venues for your conference this year.

Venture capital and private equity play an important role 'fuelling' the Canadian economy. The Government's recent announcement to implement a market-oriented approach to providing funding to the venture capital industry is an encouraging step to driving growth and innovation in Canada. Those of you familiar with CPPIB's investment portfolio will know that we are a significant supporter of the Canadian private equity market, with $2.4 billion invested.

The investment decisions we take every day have a lasting impact on the retirement security of generations of Canadian workers. As we invest on behalf of 18 million CPP contributors and beneficiaries – almost everyone in this room - we benefit from a clear arm's-length, investment-only mandate and an internationally recognized governance framework that enables us to relentlessly focus on providing long-term, risk-adjusted returns without shortsighted interventions.

Today I'm going to cover two areas in my remarks: CPPIB's private investing strategy, and the crucial role that private equity plays in championing long-term thinking in a short-term world.

First a quick overview of CPPIB's private investments.

Of the $183.3 billion in CPP Fund assets, we have approximately 38% invested in private assets, including private equity, real estate equity, infrastructure, private debt and private real estate debt.

Private equity comprises a significant portion of these private assets. Our Funds & Secondaries group is a fundamental element of our private equity strategy. We commit capital to top-quartile managers globally who have expertise in a wide range of investment strategies, geographic regions and sectors. We also have a large, global direct private equity business.

Our overall approach towards private equity is driven by three key factors.

- First, the deep relationships we form with world-class partners enables our global co-investment and co-sponsorship models, and generates opportunities for our other investment groups.

- Second, the size of our Fund – our direct investments are typically **at least $200 million**.

- And finally, the exceptionally broad and deep internal expertise we bring to evaluate and execute investments.

In Canada, we independently source, execute and manage direct private equity investments. Of interest to our local Alberta audience, these are mostly in the oil and gas industry.

Outside Canada, our strategy is to invest as equals alongside private equity partners with whom we have invested in their funds. Over the past three years, we've seen great success with this strategy investing about $6.6 billion in a number of industries including industrials, healthcare, media, natural resources and technology.

At CPPIB, we believe there is a link between the private governance model and long-term value creation. This is a fundamental reason why we continue to grow this asset class.

As everyone here knows all too well, the private equity industry is in flux as it emerges from the aftermath of the global financial crisis. Acquisition prices for companies are high, driven by frothy credit markets, pressure on large private equity firms to deploy the last portion of capital raised in 2007 and 2008, and continuing uncertainty in the macroeconomy.

But at CPPIB, we continue to believe that private equity has the potential to outperform public markets in the long term. The main reason is your ability to act as owners… to steward companies towards long-term value creation.

Many of you here today are pursuing **long-term strategies** in what is otherwise a **short-term world**.

In his ground-breaking 1989 Harvard Business Review article, *The Eclipse of the Public Corporation*, American economist Michael Jensen described:

> “the widespread waste and inefficiency of the public corporation and its inability to adapt to changing economic circumstances”.

In response to this, Jensen predicted the rise of the active investor.

These investors would manage organizations, “*not* to maximize earnings per share, but rather to **maximize value**, with a strong emphasis on cash flow.”

Jensen made his prediction about active investing nearly **25 years ago**. Progress instilling active, engaged, **long-term** minded ownership in our markets has been slow.

It largely took the Financial Crisis of 2008-2009 to ignite a discussion around the failings of our public markets. Yet much of this discussion has yet to turn into tangible action. Unfortunately, today this vital need for long-term change can be too easily overlooked.

Yesterday in a keynote speech that I made in Toronto, alongside McKinsey and Company’s Global Managing Director Dominic Barton, CPPIB and McKinsey launched an initiative called *Focusing Capital on the Long-Term*.

As part of this project we carried out a global survey of directors and senior executives. **63%** of business leaders[i] told us that the amount of pressure on their senior executives to demonstrate strong short-term financial performance **has increased** in the past five years.

However, if their senior executives took a longer-term view to business decisions, respondents identified innovation and strong financial returns as the top two benefits their company would realize.

McKinsey and CPPIB’s goal is to change the short-term attitudes and behaviours that have become all too deeply ingrained in business, investment and society. And to identify the changes that need to happen to foster a long-term mindset.

You'll be pleased to know in our speech we held up your industry as an example of enlightened, value-creating ownership.

Many of us here today are long-term investors, yet **none of us** are immune to the negative impacts of short-termism. The business and political environments we operate in are structurally and psychologically focused on the short term and this, in our view, negatively impacts our investments over their lifespan.

But short-termism is not a concern solely for institutional investors and other private equity investors. Public markets and other areas of the investment universe seem to consistently give short shrift to long term thinking:

- From 1975 to 2010, the average period for holding stocks on the New York Stock Exchange declined from six years to close to six months. Considering that it takes about 5 to 7 years to build a business, it's easy to see a fundamental disconnect.

- Boards and managers are under increasing pressure from shareholders, analysts and the media to deliver short-term gains and explain short-term losses.

- CEOs are often not around long enough to experience the consequences of their decisions.

- Individual savers are increasingly dependent on their own investments for retirement income and tend to use short-term performance metrics to manage these investments. Lured by aggressive advertising, savers are switching funds on average every four years or less.[ii]

- US active equity mutual fund managers on average turn-over more than three-quarters of their investments every year…and high frequency trading has increased from 20% of US equity turnover volume in 2005 to about 60% in 2010, but even if you ignore this, the trend to the short-term is staggering.[iii]

Investors and individuals face a choice about the kind of future we want to build. And in building it, we have much to learn from the private equity model.

The question is - how can we apply the private investing approach to other asset classes? How can public markets learn from the example set by the private equity industry? These are exactly the questions that CPPIB and McKinsey want to answer.

We've begun by proposing a new working definition of long-term.

In our view, 'long-term' goes *beyond* a product cycle, *beyond* the average tenure of directors or the CEO, and *beyond* an investment cycle. These time frames vary by industry and asset type, but in general they are at least five to seven years.

This is the paradigm that many private equity firms operate in today. They are aligned around five year performance targets, with incentive structures based on exit valuations. The net result of this long-term perspective is that private equity ownership is associated with higher returns. A recent study shows that average US private equity buyout funds outperformed the S&P 500 by more than 3% per year.[iv]

I believe there are three lessons we can take from private equity firms on how to think long term:

First, private equity boards are more engaged. As directors, you put in more than twice as many days as directors on publicly-listed boards.[v] And there is often greater transparency and accountability between board and management. Boards meetings may be bi-monthly with monthly update calls. Directors have greater access to data and to middle managers, enabling more informed decisions. This accountability drives down through non-executive ranks, with higher expectations for expertise and engagement.

Second, directors of private equity companies firmly focus on value creation[vi]. Research has shown they are 3 ½ times more responsive to changes in investment opportunities than public firms.[vii]

Stakeholders in private companies are all aligned around a longer horizon. With a perspective that is typically 5 years (not one quarter or one year) it is easier for them to choose to make an investment with a longer payback and to fund project start-up costs. It's also easier for their boards to remove management teams if they are not delivering against that horizon. Studies show that after an IPO, companies that were previously privately held cut their capital investment rates by 2.8 times.[viii]

Many privately held firms also have a singular focus on cash flow, making it easier to cut unproductive businesses or projects or write down assets so as to free up cash for projects with higher expected rates of return.

Private equity companies are not only focused on long-term value – but have the benefit to steadfastly retain this focus and make the hard decisions required to generate long-term value – decisions which are tough to do in the public eye.

And finally incentives are long term. Owners and management are typically compensated on the same long-term payout horizon, with a greater portion as variable compensation. Middle management and non-executives are often included in this structure.

In sum, private equity owners and directors actively steward the assets they own to create long-term value. The question we need to ask is how can other investors do the same?

Of course, at CPPIB we're naturally interested in the role institutional investors can play in fostering this long-term mindset.

Although in our work with McKinsey we are only beginning to explore these issues, of relevance to this group today, are potential ideas we are examining to instil long-term mandates for fund managers.

For example, engaging with equity managers to design mandates with increased weight on long-horizon factors. Or, structuring asset manager fess to reward a long-term approach, by paying additional fees when warranted for managers to effectively engage companies on Environmental, Social and Governance matters - matters with a *drastic* ability to enhance sustainable, long-term value creation.

Take any two investment choices. All else being equal, if you pick the company whose management team demonstrates better ESG performance; you are choosing the company that will generate more long-term value than its peers.

We're also examining how to 'activate' passive holdings of institutional investors. One potential way we're exploring is to leverage the expertise and resources of long-term oriented activists or engagement asset managers to selectively partner on engagement by more actively using votes associated with passively held shares.

Let me take a few minutes now to tell you what we've done at CPPIB to position our Fund to benefit over the long-term from the advantages of the private ownership approach.

First, we are focused on building and fostering long-term relationships with leading fund managers who are aligned with our long-term approach and strategy. A good example here at home is our customized mandate with Northleaf. Northleaf focuses on making investments on our behalf in Canadian small and mid-market buyout funds and venture capital funds. We initially committed $400 million in 2006 and a further $400 million in 2010.

Next, we've built a Portfolio Value Creation group to create long-term value within our investee companies through careful stewardship, enhanced governance, and improvement in assets, operations and profitability. This internal capability allows us to capture special opportunities available only to large, sophisticated investors.

And, by applying a private equity approach to public markets, our Relationship Investing program seeks to benefit from being a long-term focused owner in public markets. By taking significant direct minority investments (typically a 5-25% ownership stake) in public companies – or companies about to go public – we can help management generate longer-term outperformance relative to their peers. Each arrangement includes an active, ongoing relationship with management teams and boards of directors.

In most cases, we obtain governance rights commensurate with the importance of our stake.
The company for their part benefits from having a patient and supportive major investor.

Our success with Progress Energy shows this model can work. In 2010 and 2011 we invested $384 million in the company, with an eye towards helping them grow. We subsequently sold our 16% stake for $780 million when the company was acquired by PETRONAS. We worked with management and the board of directors to generate value through the purchase of Suncor lands, helped grow the company's exploration and development program and then helped to make the sale to PETRONAS.
We're not the only major institutional investor seeking to benefit from such an approach. For example, the CalPERS Focus List was launched to invest in underperforming companies and engage with management privately to drive a long-term change in the strategy and management approach. Within two years of intervention by CalPERS, Focus List companies have outperformed the market by 20%. [ix]

My final example of how CPPIB builds long-term, private-minded thinking into our investment process is our in-house Responsible Investing team, who work across our investment departments to integrate

ESG factors into decision making and conduct ongoing ESG monitoring in our investments with the goal to enhance long-term value creation.

And other big investors are doing the same in pursuit of enhanced long-term returns. Generation Investment Management, an $8 billion investment fund based in London co-founded by Al Gore and ex-Goldman Sachs banker David Blood, integrates a view of long-term sustainability into their investment approach, and compensates on a three year performance basis. They have outperformed the benchmark over eight years.

These are examples of how private equity principles can be applied to public markets… how acting like engaged owners can encourage a focus on addressing challenges and opportunities and create long-term value.

The question is - can such strategies work for other investors who are smaller in scale or have different capabilities?

Through our *Focusing Capital on the Long Term* initiative with McKinsey we are seeking to understand how to scale the benefits of a private equity-like investing approach for other investors. What are the models and approaches that will work for different asset classes and that can be scaled to fit investors of all sizes and shapes?

In closing today, the central thought I want to leave you with is that the private equity industry is a natural champion of long-term thinking.

Private equity investors – like everyone else -- have to deal with short-term thinking and actions among your own investments, from your own investors, from governments and so forth. Nevertheless, you have the privilege of operating without the short-term pressures of public markets. As McKinsey and CPPIB undertake a monumental task to find out how public markets can learn from the example set by the private equity industry, we welcome your insights.

The private equity industry has the ability to drive systemic change. What I'm asking you today is to harness your considerable influence as investors… to leverage your personal and professional networks and jump-start a discussion around the barriers to long-term value creation, and how to bring them down.

Thank you very much. And now I'd be pleased to answer your questions.

[i] McKinsey and CPPIB conducted a global survey of board members and executives using the McKinsey Quarterly survey panel. 1,038 people completed the survey: 71% were responding as a C-level executive, 29% as an independent Board member; 64% either work as executives, at or serve as board members for, privately held companies, 29% from publicly-listed companies; 34% are located in Europe and 30% are located in North America; 54% of respondents were from companies with revenues above $100m. All data quoted is for respondents from companies with revenues above $100m.

[ii] ICI, Cerulli, PSCA - The average American saver with a 401(k) defined contribution plans is switching funds every four years based on only one or two year's underperformance

[iii] McKinsey analysis using Strategic Insight dataset of US active equity mutual funds ($4.19tr out of $4.28tr market, and a wider capital pool in equities of $13tr in 2012)

[iv] Harris, Jenkinson, Kaplan, 'Private Equity Performance: What do we know?' (Chicago Booth, February 2012)

[v] ibid

[vi] McKinsey Quarterly survey, June 2011; Interviews with ~20 UK-based directors who serve on boards of both private and public companies (most with EV >£500m)

[vii] Source: Asker, Farre-Mensa, Ljungqvist (2012). Comparing the Investment Behavior of Public and Private Firms – Private firms are 3.5x more responsive to changes in investment opportunities than are public firms

[viii] ibid

[ix] Pensions & Investments