A CONVERSATION *with* PATTI CROFT

An economist's perspective.

By: Lisa Ritchie & Anne Maggisano

In the spring of 2021, the Women of Burgundy hosted a conversation between Patti Croft, one of Canada's most respected economists, and Burgundy's vice presidents Lisa Ritchie and Anne Maggisano. Patti discusses the economic environment in which we find ourselves, and the mechanics and intended effects of monetary and fiscal policy. Through the lens of her director positions at Ontario Teachers' Pension Plan and the Ontario Pension Board, she outlines the fundamentals of pension investing, the importance of financial liquidity, sound crisis management, and the history and principles of environmental, social and governance (ESG) considerations in investment decision-making.

Anne Maggisano (AM): Patti, you're an expert in studying the economy. One year into the COVID-19 pandemic, we have central banks indicating that they're going to keep interest rates low for an extended period of time. We have governments around the world spending money and continuing with their stimulus programs. We have businesses that are continuing to suffer disproportionately from the impact of the lockdowns. What's your view on what's happening?

Patti Croft (PC): It's a fascinating time. I think we're going to see an economic recovery that could really catch us off guard in terms of its strength, particularly in the United States. March 2021 retail sales were enormous, up 10% month over month as people were spending the money that the government sent them. There's a lot of pent-up demand. I think the recovery is going to be multi-faceted. It's going to be led by the United States. It has everything to do with the vaccine rollout and the race between the vaccine and the variants.

There's tremendous uncertainty about the outlook for inflation. No matter what business you're in, inflation matters. If you're in banking, mining, pension plans, money management, the outlook for inflation and interest rates is critical. And let's be very clear, COVID and the recession that followed, that was not your garden variety recession. That was a recession caused by a natural disaster, not by a central bank that tightened too quickly.

The recession affected economic activity, clearly, but it also affected our health. It became a matter of life and death for people around the world. It affected politics, and it affected geopolitics as well. In terms of the response, we saw massive stimulus spending by governments. Canada had one of the largest amounts of stimulus spending, $350 billion. As a share of our economy, the deficit in 2020 was 16%, which is four times the amount of stimulus following the great financial crisis. Basically, the bottom fell out of economies, and governments had to step in with support, a bridge to take us from recession into recovery. At some point, though, we're going to have to take that bridge away and, we've heard in Canada, we're going to probably see those support payments to businesses and individuals begin to taper off in September 2021.

In addition to the fiscal response, interest rates are near zero - the monetary policy response. So, I think we are at a paradigm shift in terms of policy; it used to be that monetary and fiscal policy were very distinct. In the good old days, we had what I would call MP1, Monetary Policy version 1.0. If the economy was running too hot and inflation was beginning to rise, central banks increased interest rates, if the economy went into recession, they lowered rates to spur recovery. Then came the great financial crisis in '08/'09, and we embarked on MP2, Monetary Policy version 2.0, and this time, it was monetary policy coupled with fiscal policy; we saw central banks begin to use something called quantitative easing, which quite simply is printing money to finance fiscal spending. That was very different - we saw increasing integration of monetary and fiscal policy. And then came the COVID-induced recession, and this is the paradigm shift because now I think we're in the midst of what I would call MP3, Monetary Policy version 3.0. This is the complete fusion of monetary and fiscal policy to the extent that we've never seen before. This is unprecedented, a bit of a grand experiment. Interest rates are close to zero in Canada and the United States, negative elsewhere. Central banks are buying enormous amounts of debt. Right now, the Bank of Canada owns about 35% of federal debt outstanding, and that debt accounts for 70% of the Bank's balance sheet.

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How does this all work out? Because, in the midst of all this, the Federal Reserve in the United States made a small but subtle change in the way that it runs monetary policy. Historically, monetary policy's mandate has been full employment and targeting inflation. But they changed it last year to what's called "inflation average" targeting, meaning, sometimes they'll let inflation be below 2%, but sometimes they'll let it be above 2%. And the U.S. Federal Reserve has clearly signaled to the markets that it intends to lag in terms of its response to what could be a blockbuster economic recovery.

Usually, central banks are proactive. They're now saying, "We're going to just sit and see what happens." They do think inflation's going to rise. They believe it'll be transitory. I hope they're right, but my concern is that inflation could take hold in what could be a much stronger than expected economic recovery with little increase in supply, people with a lot of cash ready to spend. I think that we could be sowing the seeds of higher inflation.

Most of us are used to a disinflationary period that's been in place now for many years. We don't have experience with inflation, unless you were around in the '70s and you experienced it firsthand. In terms of that long term downtrend, disinflation, a lot of that was driven by globalization, and a lot of that was driven by China as it became the manufacturing workshop of the world. China joined the World Trade Organization in 2001, causing an enormous increase in the supply of labour to the world economy. Eastern Europe helped as well, and that was part of an enormous disinflationary trend. But that trend has ended. De-globalization started before COVID, but it's been accelerated by COVID. What we're seeing is that companies and countries are much more focused on domestic supply chains, ensuring those are in place, which means economic nationalism is at the fore.

No one's talking about free trade agreements currently. Everybody's talking about securing the vaccine for their population. It's a very different environment. I think that de-globalization, coupled with climate change costs, more resilient corporations, all of this could add up to potentially a surprise on the inflation front, and that has implications for investors and certainly for pension plans as well.

Lisa Ritchie (LR): That's an excellent backdrop to segue into investments and talk about pension investing. You're on the board of two very important pension plans. Tell us the purpose of these plans and who they serve.

From left to right: Patti Croft, Lisa Ritchie, Anne Maggisano at Crow's Theatre.

PC: The Ontario Pension Board administers the pension plan for public sector workers in the province of Ontario. One of the big stakeholders is AMAPCEO, which is 14,000 unionized professional people who work for the Ontario government, and it also provides pensions for judges, crown attorneys and the Ontario provincial police as well. This pension plan has about 90,000 active and retired members. Its mission is to deliver outstanding service and to pay the pension promise for that constituency. It's quite a mature pension plan. It's a very interesting board to sit on because when you take the position, you actually become a civil servant of the province of Ontario; there's a big component of public service and giving back. This resonates with me.

The other board that I sit on is the Ontario Teachers' Pension Plan Board, which administers the pension plan for the teachers of the province of Ontario. It is the largest single profession plan in Canada with 330,000 active and retired members and $220 billion in assets under management. We're currently 103% funded. The funded position is all about sustainability. You want to be over 100% because that's the measure of assets you have that will pay for the liabilities, the pension payments. So, there's $103 of assets attached to every $100 of liabilities.

It's fascinating being on a pension plan board because there are a number of risks you have to consider. Inflation risk is one, because the benefits can be indexed to inflation. Another risk is longevity risk; it turns out that the teachers in the province of Ontario live a very long time. Right now, we have 147 pensioners that are over 100 years of age. It's a very mature plan; you can gauge that by the ratio of active to retired members. That ratio right now is only 1.2 active members contributing to the plan to pay for the pensions of one retired member (in 1990 the ratio was four to one). So, you can see the challenge; you need to consider a very long-term timeframe and ensure you have sufficient assets to pay the pensions.

LR: Ontario Teachers' Pension Plan is admired around the world for its investment strategy. Tell us about the strategy that's employed to ensure the long-term feasibility of the plan.

PC: It's all about sustainability. It is referred to as the "Canadian Model" of pension plans. Ontario Teachers' was at the forefront of this model, and so was CPPIB and many others. There are several factors that contribute to the model's success, and one of the key ones is governance, the "G" in "ESG". It's very important to have independent professional boards that oversee the assets. In terms of Ontario Teachers', it's based on a skills matrix. We create a matrix of the skill sets needed to manage a $220 billion pension plan. So, around the table, we have actuaries, economists; we have experts in accounting, in investing, in talent management; and we also have a retired member of the Ontario Teachers' Federation. It's that professional, independent board that's very important from a governance perspective, but beyond that, a couple of other things are important. One is the long-term timeframe. We are patient capital. We don't have to do quarterly earnings reports. We don't have to flip investments to get a quick rate of return. That's an advantage.

The third element is the way that these pension plans are structured. It's about bringing investment management in house, having expertise resident within the plan, which reduces your costs. You have to have scale to do this well. And then, lastly, it's about diversification. Ontario Teachers' is invested in over 50 countries around the world, seven major asset classes, and increasingly moving towards private assets to pick up the so-called illiquidity premium. These investments require patient, long-term capital.

This is the combination of factors that have made the Canadian pension model one that is very much emulated and admired around the world.

AM: It would have been an incredible challenge to manage the pensions through the early days of COVID, where for example we saw public equity markets decline by over 30%. What was the experience at Ontario Teachers' over the last year?

PC: I have to start with recognizing how challenging the past year has been for the teachers of the province of Ontario in the classrooms, dealing with closures, openings, personal protective equipment, vaccinations. I want to recognize how tough a year it's been for our members and for the civil servants of the province of Ontario.

In terms of the last year, for both pensions, the focus was first and foremost on people. It was ensuring the safety, the health, and the wellbeing of our people. At Ontario Teachers', they partnered with a major private sector health-care provider, and every week, any employee in the world could dial in and listen to a medical doctor talk about what was happening and then participate in a Q&A period. As time went on, they added a psychiatrist who talked about wellbeing and mental health, and gave simple but important tips for how to continue to be resilient.

Beyond that, of course, we're running a pension plan. We have a pension payroll to meet. So basically, we moved into crisis mode. We held a weekly meeting with management where the members of management informed us with: "here's what's happening in Hong Kong; here's what's happening in London; here's what's happening with the operations; here's what's happening with our people", and, very importantly, "here's what's happening with liquidity" because when you invest in illiquid investments as we do, you can't sell those assets quickly to meet the pension payroll. Liquidity became very, very important. So that was a real focus of those meetings as well.

AM: You mention liquidity being a real issue over the last year. Because the pension plan owns private holdings, it had an obligation, a responsibility, to ensure that those private companies would be able to survive through some really tough business conditions.

PC: Yes. That was a big challenge. Normally, the primary raison d'être for investors is to manage investments, and either buy assets or sell assets, but this was a period of pens down. We own 80 portfolio companies in different businesses; we own five airports in Europe. You can imagine the situation they were in when air passenger traffic fell by 75%. We own Cadillac Fairview, which, of course, is shopping malls and office towers here in Canada, and also properties around the world. The investment team was very focused on ensuring the safety, health, and wellbeing of the people, and also ensuring our companies had adequate liquidity to get to the other side.

AM: The other major lesson, of course, is the value of diversification. Tell us how diversification helped the plan be resilient over the last year.

PC: It is said that diversification is the only free lunch in investing. We are geographically diverse, in 50 countries and diversified by asset class. We're in the public sector, in equities and fixed income, of course, but beyond that, we're in credit, in infrastructure, in private

From top to bottom: Anne Maggisano; Lisa Ritchie, Patti Croft, Anne Maggisano; Lisa Ritchie.

equity. We're in inflation-linked assets. We're in commodities, absolute-return strategies. It's all about distributing your risk budget across asset classes to produce a risk-adjusted rate of return that in totality allows you to pay the pension promise not just today, but tomorrow as well. Portfolio construction is of paramount importance; you need a total fund perspective, but beneath that, be extremely diversified so the portfolio can withstand very different economic environments.

AM: And diversification is one of the ways that you can prepare for and be resilient through an uncertain economic context, for example if we were to experience higher than expected inflation.

PC: Yes. And I think on this front, if you know that inflation is going to be 2% this year and 2.25% next year and 2.5% the year after, that's not a problem. We can plan for that. It's when you've had a long period of inflation being under control, and, if anything, being below target, and then suddenly there's a whiff of more significant inflation beginning to come back I think that's the more problematic scenario.

One of the things that you do on a board is you look at risk all the time, and we try to look at emerging risks. There are risks that we can understand and mitigate, and we also try to think about what's out there that could be a problem but isn't quite here yet. I would put an inflation surprise on that emerging risk register for pension plans and for others as well.

Despite all the preparation that you do, you're still going to be caught off guard. COVID-19 taught us that no matter how much planning you do, how resilient you think your people are and your portfolio is, there are always going to be surprises.

LR: Canadian pension plans are considered leading edge in terms of environmental, social, and governance (ESG) analysis, with these considerations being part and parcel with investment decisions. How do pension plans navigate ESG issues in their investment decision-making?

PC: I would argue that Europe is probably ahead of Canada, but Canada is ahead of the United States. ESG has been around for a long time, but say, 30 years ago, it was very much siloed and off in a corner. There was a lot of interest, to be fair, particularly amongst endowments and foundations, those mission-driven organizations who were early adopters of ESG practices.

I think in terms of the "E", the "S" and the "G,'" the first one that came was the "G," that notion of governance. And here in Canada, I think we're very proud of our governance structure. Part of that included the establishment of the Canadian Coalition for Good Governance, of which Burgundy's founder, Tony Arrell, was one of the founding members. Following the focus on governance, the shift was to the "E," the environmental part. Climate is very much top of mind when we talk about the environmental piece.

Now, the focus is also increasingly on the "S," the social issues, because of what happened in the last 12 months. COVID laid bare the reality of social issues in many economies. Here in Canada, it was referred to as the "she-cession," where we saw that at one point, women's participation in the labour force hit its lowest level in 30 years. We saw racialized communities that were severely affected, and less well-off communities were hurt as well. There was a statistic published for the U.S. that showed that the 25% lowest income zip codes accounted for 40% of the COVID cases. So, again, it's that inequality that has come to the fore.

ESG is front and centre now. There's a lot of excitement, and we can see this in terms of things like the United Nations Principles for Responsible Investing (UNPRI) having 3,100 signatories now. That's 20 times where it was 10 years ago. There's tremendous momentum. The pension plans that I'm on are signatories. As a board member, what I see is that ESG is just in the DNA of the organization. It's embedded deeply into the investment process. I'll give you an example. At the board at Teachers', if we have a new deal we're looking at, for example an investment in Peru, we receive a 30 to 40 page deck to read, and several pages are devoted just to ESG considerations. What are the physical risks and the environmental risks? What are the impacts on the communities where we intend to work and invest? And what are the governance issues that may arise as well? It's your fiduciary duty as a board member today to ensure that the ESG lens is applied all across the organization.

In January we announced net-zero carbon emissions by 2050. We're very proud of that. It's going to be a very complex process because we're operating in multiple countries and own many portfolio companies. We've already measured the carbon footprint of our portfolio, and we'll look at how we reduce its carbon intensity over time. With clear metrics, guidelines and mile posts we will track the

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progress towards that transition to net zero. I'm very hopeful, very optimistic. We hear a lot about the climate risks, and these risks are real - the physical risks, the transition risks, but there are tremendous opportunities as well, in renewables and clean technology in Canada and around the world. It's important that people recognize both the risks and the opportunities. I think Mark Carney has said that in terms of opportunities, it could require investments of up to $10 trillion as we transition to a low-carbon economy. So, there will be all kinds of exciting new technologies as we make that transition.

LR: You mentioned that the "she-cession" and the awakening around social inequalities have really brought the social aspect, the "S" of ESG, to the fore over the last year. How does Ontario Teachers' negotiate the "S"?

PC: The past year has been incredibly tumultuous on many fronts, but with the death of George Floyd roughly a year ago, and the increasing focus on systemic black racism in Canada and elsewhere, both Ontario Teachers' and OPB have signed the Black North Initiative.

To sign that, your CEO has to make a pledge that recognizes that there is systemic black racism within this country. And you must make a commitment to increase the representation of black leaders at the boardroom table and within the executive ranks. COVID-19 has really shone a light on these social issues. I also think there's a movement afoot, accelerated by COVID-19, and it's away from shareholder capitalism towards stakeholder capitalism. We really believe at Ontario Teachers' that you can earn a rate of return, and you can also have a social purpose.

Our purpose is to invest to shape a better world. So ideally, when we invest, we want to ensure that the people, the communities, the companies we touch, are better off after they've dealt with Ontario Teachers'. It's a shift in belief. I think that, for a long time, people believed you had to sacrifice return in order to get the social piece. I don't think that's the case anymore, the fact is you can have both. You can invest with purpose. You can pay that pension promise, and at the same time leave the world a better place.

I'll give you an example. One of the companies that Ontario Teachers' invests in is called Spandana, based in India. It provides unsecured micro-finance loans to women in small rural Indian communities. These are women starting up businesses to support their families. Again, it's that lens we apply when we're looking at doing a deal or making an investment: how does this make the world a better place?

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Performance and purpose can live side-by-side. You don't have to sacrifice one for the other. And increasingly, of course, our stakeholders are demanding that. We just had our annual general meeting for Ontario Teachers', and we got over 500 questions. Most of them focused on responsible investing, and a lot of them on climate. Our stakeholders are demanding that we have purpose as top of mind in our investment decisions.

AM: As a leader for women throughout your career, please share your perspective on where we are now, how you think we've done, and what still needs to be done.

PC: I am hopeful. I do see that progress is being made. When I look at the board of Ontario Teachers', we are ten people, and five are women and five are men. Similarly at Ontario Pension Board we are nine people, five women and four men, and the Chair and the Vice Chair are both women. On gender diversity, I think we are making some progress. If I look at the number of women on boards in broader corporate Canada, that picture is improving slower than I would like, but it is improving.

Having said that, if I look at the board of Ontario Teachers' and OPB in terms of diversity beyond gender, we need to do better. I hope that before I leave these two organizations, particularly as chair of the governance committee of Ontario Teachers', we can improve.

I think there's much more work to do on the social part of ESG. I've learned so much in the last year about myself and the unconscious biases that I have. I think all of us have to do a little bit of soul searching and homework in that regard, because my lived experience is not the same as someone working at an organization who is black or indigenous or a person of colour. My lived experience is not the same as theirs, but I can listen, and I can learn.

I have five grandchildren and my hope is that I will leave the world a better place for them. I'm excited by what I'm seeing in terms of momentum on climate, on diversity, on equity and inclusion. But if I may just leave you with one thing, a bit of a call to action. When we think about things like climate, it's just so big and so complex, and we think, "What can I do?" Consider the saying, "If you are not part of the solution, you are part of the problem." Whatever motivates you, I think we could all agree that we do want to get on the train and do something about climate and biodiversity and all these other issues. If we bring it down to the personal level, I think that we can, on an additive basis, make a difference. **M**