Invest in Canada – Analysis of Pros and Cons

Since the publication of the Open Letter signed by more than 90 business and union leaders in Canada addressing the role of pension funds in the Canadian economy, a much-needed debate has arisen on how Canada can reverse its declining prosperity. We welcome such an important conversation and kindly thank all the signatories for helping to start it.

The document presents the arguments that are being made and analyses their basis. Some of the analysis is simple fact checking of claims that are being put forth (returns, failure of dual mandates, …). Other analysis discusses commonly accepted precepts and their application (linking allocation to size of market, government regulatory role, …). Finaly there are novel concepts that appear not yet well understood (role of domestic investment, how the pension manager perspective is severely limited compared to the wider macro-economic perspective, …).

There are evidently straw men being put forth that are easy to burn down but are not what is being discussed. Some examples include: this is a debate about public equity; governments want to go back to the 10% rule; the proponents of greater Canadian prosperity are conflicted; pension funds will be asked to increase their Canadian investments rapidly; …

The essence of the Open Letter is not to force pension funds to do anything or limit their flexibility. It is about figuring out how not to ignore the enormous impact and benefits that domestic investment can have on the Canadian economy and the role pension funds, as aggregators of the largest pool of institutional savings in the country, can and must play in Canada's future development.

We encourage you to read this analysis and hope you will find it useful.

Various references

Open Letter: https://www.lba.ca/publication/open-letter-canada/

Executive summary: https://www.lba.ca/invest-in-canada-executive-summary-presentation/

PMAC Speech: https://www.lba.ca/speech-2023-11-13-pmac-en/

General: https://www.lba.ca/invest-in-canada/

Invest in Canada – Analysis of Pros and Cons

1 - Canadian governments need to make Canada a better place to invest and then, but only then, will pension funds commit Canadian savings to Canada.

A - If Canada was a better place to invest, pension funds would invest more. This must mean that Canadian returns are subpar.

Private equity, real estate and infrastructure returns are hard to come by and are usually suspect because they are hidden behind a valuation veil. But public market returns are available, and they are very favourable to Canada.

For the last 5, 10, 15, 20, 25 and 30 years, the Canadian stock market has done better than the average emerging and developed market except for the United States. When we exclude the Magnificent 7, Canadian returns have been competitive with those offered by the rest of the S&P 500.

Market Returns to December 2023	5 years (%)	10 years (%)	15 years (%)	20 years (%)	25 years (%)	30 years (%)
Canadian Equities (TSX)	11.3	7.6	9	7.7	7.7	8.2
US Equities (S&P 500)	14.9	14.5	14.5	9.8	6.9	10.1
US ex Magnificent 7	10.4	11.2	12.1	8.0	5.5	8.8
Europe, Australasia, and the Far East (MSCI EAFE)	7.4	6.5	7.5	5.7	3.8	5.3
Emerging Markets (MSCI EM)	3	4.9	7.1	6.9	6.9	4.4
Differences in returns to December 2023	5 years	10 years	15 years	20 years	25 years	30 years
Canada vs US	-3.6	-6.9	-5.5	-2.1	0.8	-1.9
Canada vs US ex Mag 7	0.9	-3.6	-3.1	-0.3	2.2	-0.6
Canada vs EAFE	3.9	1.1	1.5	2.0	3.9	2.9
Canada vs EM	8.3	2.7	1.9	0.8	0.8	3.8

A recent study by UBS of world stock market returns over the last 100 years shows Canada having the second-best risk return ratio, ahead of the United States and every other developed country except Australia. These numbers may surprise even shock, but Canada has been a great place to invest.

B - Governments should sell off their airports and highways to attract Canadian savings. What this suggests is that Canada could be attractive if only investors could buy government developed monopolies. That surely would be attractive to anybody.

C - Canada must create opportunities to attract investors. Surely, but this reflects a very passive view of the investor's role, one with little or no agency. Another view would have the investor given responsibility over vast sums identify and create the opportunities. The active investor fosters a dynamic environment, nourishes enterprises, and seeds businesses.

D - Canada has seen a significant decline in the vibrancy of Canada's capital markets. Has Canada become so small and uninteresting that it may as well fully consolidate its capital markets with the US — eliminate the TSX, eliminate all Canadian investment dealers and market intermediaries, eliminate Canadian securities regulatory authorities, eliminate Canadian public equities? The active investor would want to develop Canadian capital markets.

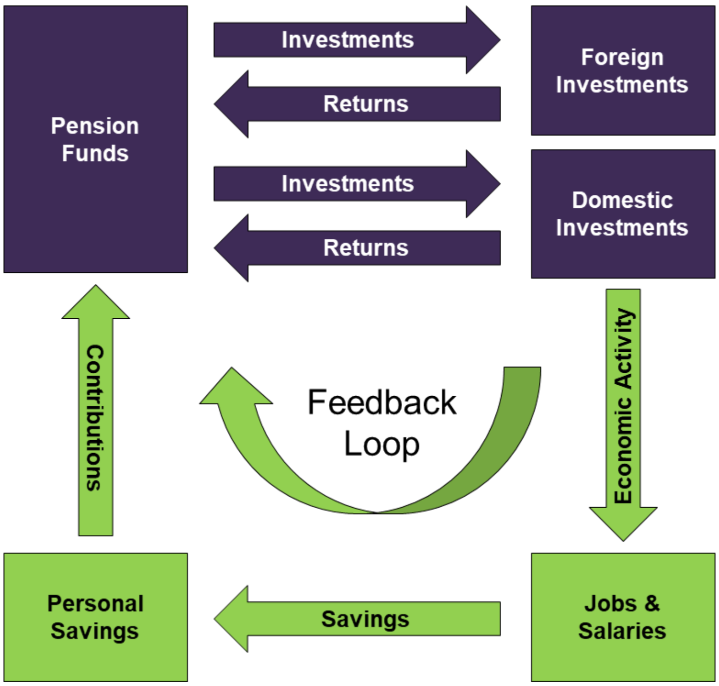
E - There are business challenges everywhere. Canada is the largest democratic country on the planet, it is rife with resources, has a well-educated labour force, a developed legal system. Endow any businessperson with that and they should not come up blank. Developing Canada`s economy will make it a better place for all, even investors.

Invent in Canada – Analysis of Pros and Cons

2 – Fiduciary responsibility requires pension managers focus on returns and risks.

Agreed.

A - But the impact pension funds have on their members is not limited to returns. There is a feedback loop that feeds the economy and pension contributions that cannot be ignored. Without domestic investment, incomes suffer, and contributions would dry up before long. The relative decline in Canadian incomes, productivity, and GDP per capita are all consistent with not investing in our future.



B - The impact of domestic investment is considerable. A recent study by The Canadian Centre for Economic Analysis (CANCEA) indicates OMERS contributed $13.7 billion to Ontario's the economy in 2023. Approximately $9.7 was due to pension payments and operating expenses, none of which depends on where OMERS invests, leaving a $4.0 billion benefit from investments. OMERS holds approximately $20 billion in Canadian equities, private and public, real-estate, and infrastructure. Thus, an additional $1 of GDP for every $5 invested domestically.

C - The experience of the CDPQ in Quebec is similar. The world champions they have helped create and grow have been a positive contribution to the Caisse, to Quebec, to Canada. A proper analysis shows that CDPQ's returns have not suffered, and the Caisse's returns have been comparable to CPP's.

D - Assuming nonetheless a negative return impact of 2%, the result would be a decline in returns of $0.10 for every $5 invested. Clearly the $1 pick up in GDP from the $5 investment dwarfs the $0.10 loss in returns. It is important to work hard to retain the $0.10 return, but it is equally, if not more important, not to forego the ten-fold, $1 contribution to GDP of the domestic investment.

E - The feedback loop and its impact on pension member's incomes and savings must not be ignored through inattention. Foregoing the benefits of domestic investment must be a conscious decision.

F - Acting in the best interests of Plan member should be the sole responsibility of plan trustees. Pension mangers cannot easily assess the benefits of domestic investments on their members. There is nothing that enters their calculus. But this does not mean that the impact of domestic investment is not felt by their members.

G - Only the government can modify the equation to reflect the enormous benefits we are foregoing. Returns need not suffer.

H – Depriving Canada of its savings may be acting against the overall best interests of plan members by foregoing the benefits on their incomes of domestic investment.

Invest in Canada – Analysis of Pros and Cons

3 – The Government Has No Role to Play When It Comes to Pension Funds

A – Pension funds are government creations. Without empowering legislation and regulations, pension funds would not exist.

B – Pension plans benefit from substantial tax subsidies. Governments are properly concerned that tax benefits accrue to initiatives that benefit all Canadians.

C – Pension funds are the largest reservoir of institutional savings in the country. Because of their size and the nature of their assets, pension funds can present system risks that need to be monitored and controlled. Pension funds are as large as the Banks and 50% larger than the Insurance Companies.

D – The 8 largest plans in the country, accounting for 70% of pension savings, are all government sponsored plans, many managed through government corporations.

E – Macroeconomic policy is in the government`s domain. Pension assets are stable, long-life savings which are ideally suited for capital investments which fuel growth. These funds are largely being diverted away from Canada.

F – Governments have regulated financial institutions for decades. Banks, insurance companies, financial markets have all been regulated by governments for decades without undue interference or complaint. The important role of government in addressing system risks and economic policy is well understood and accepted.

Invest in Canada – Analysis of Pros and Cons

4 – Canada accounts for approximately 2.5% of the World economy and public markets. Ergo, a 3-4% allocation to Canada is about in line with the MSCI.

A – Indexing is mechanical. It is easy, requires no effort, and pays no attention to the fundamentals of the economy. There is no analysis of natural advantages, no understanding of industries and their outlook, no search for innovative companies or those with unique products, services, special skills, or lower costs.

B – Indexing is not the search for best returns or excellence. The logic of indexing is completely contrary to claims of pursuing the best investments. It seeks the average return offered by the market. Nothing more, nothing less.

C – Is this how professional managers should manage? Indexing is not what a businessperson would do. Business investment strategy relies on understanding the above fundamentals.

D - Should there be a relationship between what Canada represents as a percentage of world GDP and how much Canadian pension plans invest in Canada? Why is any reference to the world relevant?

E – How indexing double counts the effect of size is a little more difficult to explain. Let's start with an example.

F – An example: A country that represents 50% of world markets would allocate 50% of its 50% of world savings or 25% of world savings to its domestic economy. A much smaller country representing 2.5% of world markets would allocate 2.5% of its 2.5% share of world savings or 0.063% of world savings to its economy.

G - Despite being only 20 times the size of the smaller country, the larger country invests 400 times more in its own development (25% / 0.063% = 400). The indexing logic erroneously squares the effect of size on the level of self-financing, a form of double counting.

H - China represents 17% of the global economy but invests much more than 17% of its savings in its own economy. Should the rest of the world invest 17% of their savings in China? What of governance, currency, and other risks?

I – If the US directs 70% of its savings to domestic investments, then Canada should also keep 70% of its smaller savings for investment in its smaller economy.

J – The day Canadian pension funds are given the responsibility of investing all the world's savings, of which 2.5% would be Canadian, then allocating 2.5% to Canada would make sense. But until then, it may sound good on the surface, but it is not, neither economically nor mathematically. An analogy would be a company that reinvested only 2.5% of its cashflow in its own operations by virtue of being only 2.5% of its industry. This would only make sense if the company were part of a committee responsible for allocating the industry's total cashflows, in which case attributing 2.5% to itself would be correct. But evidently the company is not part of such a committee, it is only allocating its own cashflow. Canadian pension funds are allocating only the Canadian savings pool.

K – A dissymmetry which is difficult to justify occurs when small countries allocate only a small portion of their savings to their own development while larger countries allocate a large portion of theirs to their development. This can only serve to expand the GDP gap between countries.

L – If investing only 2.5% of its national savings where the right answer for Canada, then this would mean that the country would become 97.5% dependent on foreign investment for its development and would be 97.5% owned by foreigners. Is this what is wanted?

Invest in Canada – Analysis of Pros and Cons

5 – CDPQ's dual mandate has caused returns to suffer.

A – CDPQ`s 10 year returns to December 31, 2023, where 7.4% and CPP's were 9.3%. On a compounded basis the difference is 1.8% in CPP's favour.

B – CDPQ had on average a higher fixed income weight because the plans it manages are generally more mature an require a higher fixed income weight. Over the 10 years, equity market returns averaged 6.9% better than fixed income markets. CPP had an 11% lower fixed income weight than CDPQ. The combined effect of fixed income weight and return explains approximately 0.8% of the return difference.

C – CPP had considerably more invested in foreign currencies than CDPQ who more closely matched its Canadian denominated liabilities. During the period, the Canadian dollar fell from $1.0636 to the US dollar to $1.3186, a 24% decline, or 2.2% per year compounded. The foreign currency exposure difference between the two funds averaged about 36%. The combined effect of currency weight and return explains another approximate 0.8% return difference. To replicate this impact over the next 10 years, the Canadian dollar would need to fall to $1.74 Canadian dollars for $1 US or $0.57 US per $1 Canadian.

D - The combined effect of fixed income and currency explains approximately 1.6% of the 1.8% return difference between CPP and CDPQ.

E – The dual mandate of CDPQ did not seem to have hindered CDPQ's returns in any way. No need to invoke the dual mandate to explain the return differences between CDPQ and the other members of the Maple 8.

Invest in Canada – Analysis of Pros and Cons

6 – The Canadian market is too small to absorb Canadian Savings.

A – Public equity markets are 39% of household savings in Canada while they are 37% in the United States. The Canadian market is comparable to the US market adjusting for the size of the economy.

B – The total market value of public equities represents 123% of GDP in Canada, less than the 164% in the US but comparable to the 127% in Japan, and greater than the 91% in the United Kingdom.

C - The security with the largest market capitalisation in Canada is 6% of GDP while it is 12% in the US. The largest 100 companies total 104% of GDP in Canada and 113% in the US.

D - Non-residential capital investment in Canada in 2021 was approximately 10% of GDP while it was 13% in the US, 30% more. If we further adjust for the lower GDP per capita in Canada, the US invested 75% more per capita than Canada did. This means that there is ample room and need for additional investment in Canada. If the US can do it, so can we.

E - The largest pension fund in Canada represents 20% of GDP and only 3% of GDP in the US. The top 10 funds represent 79% of GDP in Canada and only 12% of US GDP. The concentration of savings is 6 to 7 times larger in Canada than in the US.

F – If all assets were invested in public equities, the average holding by the largest fund in the US would be 3% / 164% = 2% of each company while in Canada it would be 20% / 123% = 16%, 8 times larger. Taking the top 10 funds together, their combined holdings would be 79% / 123% = 64% of the average company compared with 12% / 164% = 7% in the US.

G – But all assets are not invested in public equities and they would not be under any reasonable scenario. Private equities, real-estate and infrastructure investments are alternatives and already account for more than 47% of the Maple 8's assets. Adding to this the 21% invested in private credit and fixed income, leaves only 22% for public equities. The averages in F above can then be cut by five. Evidently, creating more world class companies is also possible.

H – The liquidity issue relates more to the concentration of the savings pools and not to the size of the investable opportunities.

I – The Maple 8 accounted for 76% of pension assets at the end of 2022, up from 27% at the end of 2000. They also accounted for 20% of total Canadian household savings in 2022, up from 6.9% in 2000. As a group, their share of pension assets and household savings continues to grow.

J – The marginal gains derived from the concentration of the savings pools should not be allowed to estop the benefits of increased domestic investment.

K - The Maple 8 invests six times more in foreign infrastructure than in Canada. A 2020 study by Deloitte entitled "A vision for a thriving Canada in 2030" estimated that Canada will need between $11 trillion and $22 trillion in investment to meet infrastructure and real estate needs over the next 50 years. The federal government ACT report indicated that Canada would need $88 billion per year in supply chain infrastructure to maintain the competitiveness of the 62% of Canada`s GDP that depends on trade.

L - If you want to conquer, you need to invest in your own base. World leaders invest in themselves. Canada does not lack capacity to absorb investments.

Invest in Canada – Analysis of Pros and Cons

7 – Points Made in Open Letter.

A – Pension funds are investing much more in foreign economies than in Canada's. They invest 13 times more in foreign private equities, 8 times more in foreign public equities, 6 times more in foreign infrastructure, and 2 times more in foreign real-estate than in Canadian ones. The problem is not limited to public equities.

Asset Class	%	Can	Non-Can	Non-Can to Can
Fixed Income	21%	13%	9%	1 x
Credit	10%	2%	9%	5 x
Subtotal Debt	**32%**	**15%**	**17%**	**1 x**
Private Equities	21%	1%	19%	13 x
Public Equities	22%	3%	19%	8 x
Infrastructure	13%	2%	11%	6 x
Real Estate	13%	4%	9%	2 x
Subtotal Equity	**68%**	**10%**	**58%**	**6 x**
Grand Total	**100%**	**25%**	**75%**	**3 x**

B – Pension funds represent 37% of institutional savings in Canada; as large as the Banks, 50% larger than the insurance companies.

C – The Maple 8 had more invested in China (roughly $88 billion) than in Canadian public and private equities (roughly $81 billion).

D – For every dollar Canadians invest in startups, the United States invests $40.

E – Non-residential investment per worker in Canada is less than half of the United States.

F - Pension funds should not fear but rather embrace with enthusiasm the challenge of investing in Canada. The positive impact these investments have on their member's incomes and development should not be ignored.

G – We must create more global champions in Canada.

H – Governments should not tell pension funds where to invest but the impact domestic investments have on the economy needs to be factored into the rules governing them.