2017 PRIVATE DEBT ROUNDTABLE

MEMBERS ONLY

PRIVATE DEBT GIVES PENSION FUNDS AN EDGE OVER PUBLIC BONDS

CIBC Asset Management

Sun Life INVESTMENT MANAGEMENT

Bonds just haven't been the same since 2008—and the more bloated central bank balance sheets have become, the more long-term investors like pension funds have sought other ways of attaining much-needed yield and long-term returns to match their liabilities. While we know plan sponsors have been using alternative asset classes to take equity market volatility off the table, traditional public debt has proven a bit more challenging to replace. This is one key reason why private debt has been getting a lot of attention lately. Today, more than half of institutional investors globally invest in private debt, and, according to alternative asset research firm Preqin, 57% of investors plan to increase their allocations in 2017.

Now there's no better time to explore the role private debt plays in Canadian pension portfolios. To do that, we invited four top investment managers to talk about their experience with the asset class at our first-ever Private Debt Roundtable. During our wide-ranging conversation, we covered a lot of ground, including answering the following: Will Canada's Infrastructure Bank help the space grow? Could the Trump presidency affect the U.S. market? What are the risks and opportunities for pension funds looking at this asset class?

Read on to find out what these managers had to say at the event.

EXPERT PANEL

Moderator and writer:
CAROLINE CAKEBREAD, Editor, *Canadian Investment Review*

CARLO DILALLA
Vice-president and head of client portfolio management, Fixed Income
CIBC Asset Management

CARL BANG
President
Sun Life Institutional Investments (Canada) Inc.

GITESH GOYAL
Vice-president, Global Fixed Income, Infrastructure and Power
CIBC Asset Management

PHIL GILLIN
Executive vice-president, portfolio manager
Bentall Kennedy (Canada) Limited Partnership and Sun Life Investment Management

CIBC Asset Management

CIBC Asset Management (CIBC AM) is one of the largest asset managers in Canada with approximately $126 billion in assets under management (as at March 31, 2017). With a 40-year history of active management, we maintain a strong tradition of disciplined investment processes to prudently manage risk and develop innovative solutions across a spectrum of asset classes. At CIBC AM, we believe investment research guided by a rigorous and consistent process will yield better results for our clients. Our commitment to best-in-class research is demonstrated by large research teams with multiple sector and regionally focused analysts who are dedicated exclusively to industry research and security-specific idea generation. As the asset management subsidiary of CIBC, CIBC AM combines the flexibility and focus of a boutique firm, with the robustness and resources of CIBC, one of the strongest major banks in North America.

Sun Life INVESTMENT MANAGEMENT

The Sun Life Investment Management group of institutional investment management companies comprises Sun Life Institutional Investments (Canada) Inc. and Bentall Kennedy (Canada) Limited Partnership in Canada, and Prime Advisors, Inc., Ryan Labs Asset Management and Bentall Kennedy (U.S.) Limited Partnership in the United States.

These operations have combined third-party assets under management of $56 billion (as at March 31, 2017). Sun Life Investment Management is supported by the investment division of Sun Life Assurance Company of Canada, which manages $142 billion in assets under management for the Sun Life Financial group of companies (as at March 31, 2017).

WHAT FACTORS HAVE DRIVEN GROWTH IN THE PRIVATE DEBT SECTOR—PARTICULARLY POST-2008?

Phil Gillin
The financial crisis created a negative reaction in some of the more exotic financial products in the marketplace. Right before the 2008 crisis, there was a large number of triple-A securities available created through securitized vehicles. Investors were surprised and shocked when they discovered that those investments weren't of the quality or durability they'd expected based on the assigned rating. Since then, there has been a return to more understandable products. At the same time, volatility in the public markets in 2008 created dramatic losses in equities for pension plans. Combined, these two trends have paved the way for private debt and other diversified strategies that performed well over this period.

Carl Bang
The financial crisis of 2008 also disrupted markets; traditional sources of capital dried up in the real estate sector as well as for companies looking to raise money. As that has happened, pension funds have also been changing how they view their mandates, which is ultimately to fund liabilities in the future. Private debt has emerged as a way for some companies to diversify their sources of capital post-2008, and it's also become a good way for pension funds to address liabilities and enhance returns.

Carlo DiLalla
Several factors have driven the growth in private debt post-2008. First, as investors have sought long-term, stable cash flows, they've come to realize there's now an untapped source of yield through illiquidity premia. At the same time, while there's a wide spectrum of private debt strategies available, the investment grade, long duration approaches are interesting for pension plans to consider because they can be used as a partial fixed income replacement.

CAN SMALLER PLANS ACCESS PRIVATE DEBT, OR IS IT JUST FOR BIGGER PLANS?

Phil Gillin
Private debt is accessible to plans large and small. Depending on the size of the plan, you can choose to either invest directly or go through funds. The big pension funds in Canada are invested in all the key areas of private debt: mortgages, real estate, and private fixed income, as well as infrastructure, timberland, and farmland. Because of their size, the larger funds have the teams to manage and invest in those assets. The smaller funds, which may not have the resources to manage and invest in these asset classes on their own, can access all of these areas through funds that invest in mortgages, real estate, private fixed income, and infrastructure.

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>
> *– PHIL GILLIN*

Carl Bang
I agree. Funds can be an efficient and effective way to get exposure to private debt. Successful managers have invested heavily in deal-sourcing expertise, sophisticated legal input, and professional teams to manage money. The upfront costs for investment in this asset class are high; therefore, funds could allow mid- to small-size investors to find economies of scale.

Gitesh Goyal
There are many opportunities for smaller plans to access private debt in Canada right now, especially in the infrastructure and power spaces. In Canada, there are several billion-dollar projects unfolding as the public sector seeks to off-load building costs and tap into the private sector for expertise. Institutional investors are going to see private debt increase

in Canada over the next few years. As these new opportunities arise, we'll continue to see more room for smaller pension funds to participate.

Phil Gillin
However, one caveat is that plan sponsors need to consider their own liquidity needs—that's a key factor. Private debt is less liquid; that's one of the trade-offs pension investors need to consider carefully before investing.

Gitesh Goyal
Phil makes a good point. But it's also important to consider that you're giving up liquidity but getting a good well-structured investment in exchange—an asset that produces a regular income through contracted cash flows.

Carl Bang
But there's a cost to maintaining liquidity. If you have liquidity and conserve it in cash, you're paid nothing today. That's a huge sacrifice in terms of your overall return. How you spend and use your liquidity is important in order to manage your portfolio efficiently.

"How you spend and use your liquidity is important in order to manage your portfolio efficiently."

– CARL BANG

CANADA'S NEW INFRASTRUCTURE BANK IS GETTING MIXED REVIEWS FROM SOME CORNERS OF THE PENSION INDUSTRY. HOW COULD IT HELP OR HINDER THE PRIVATE DEBT SPACE?

Gitesh Goyal
The details of the Infrastructure Bank are still not final, but it could actually help projects and create more of them. The Government of Ontario wants to procure roughly $190 billion of infrastructure within the next 13 years, and the federal government is looking for $120 billion in investment. It's not all going to be financed through public debt. Money that comes from the provinces and the federal government through direct funding can go through the Infrastructure Bank, and, far from eating into the private debt space, it will just consolidate funding into a different channel. I understand that even some municipal projects that were on hold will now be funded through the bank. Overall, this is a positive development for all of us in this space.

Phil Gillin
I agree. I think the mood of government—both in the U.S. and Canada—is to invest in infrastructure, and that's going to provide opportunities. The Infrastructure Bank may well facilitate the equity components, and I think that will increase the universe of the investment opportunities for investors.

Carl Bang
The Infrastructure Bank puts Canada at the forefront of an ongoing global response to the financial crisis: infrastructure spending. We need a massive spend to modernize our infrastructure. From an investor's perspective, the new bank has the potential to change the risk-return profile of infrastructure projects in Canada and draw more money in. And, as Gitesh mentioned, there are projects at the municipal level that are normally too small for big players to invest in—these can also get funding. Logistically, the Infrastructure Bank can aggregate deals and match investors with opportunities. It's a trend that we'll see over the next 10 or 20 years as pension schemes in Western economies create massive demand for long assets with protective return profiles like private debt. There will be a lot of capital to invest—if the government can structure the approach correctly.

Carlo DiLalla
This is happening at a time when pension plans are looking for high-quality, long-duration fixed income securities like private debt to help match liabilities instead of simply using government debt as a match. It's a good opportunity for institutional investors.

WHERE ARE THE BEST OPPORTUNITIES, EITHER ACROSS COUNTRIES OR WITHIN PARTICULAR SEGMENTS OF THE ECONOMY?

Carlo DiLalla
If you want to focus on private debt as a substitute for fixed income, there are a lot of Canadian opportunities. It works especially well, given that pension plans here have Canadian liabilities and need to keep their fixed income close to home. Capital raising in Canada is mainly focused on infrastructure, but the power sector is also raising money in this space.

Phil Gillin
Renewable power seems to be one of the favoured asset classes right now. Investors are paying attention to sustainability and environmental, social, and governance analysis. Traditional utilities—and, in particular, ones that are reliant on thermal coal—are falling out of favour. Governments are now encouraging more use of renewable power, and, as that happens, they'll have to modernize their own power systems to become more environmentally friendly. This need for new infrastructure is also creating opportunities in private debt.

Carl Bang
Demographics are important. Private debt is being used to fund long-term care facilities for an aging population. In Canada, there's also a need for bridges, hospitals, and other public services. But I do think it's important to look globally because the opportunities in Canada are finite. Countries to focus on would be the U.S., the U.K., and Australia, where the rule of law protects investors' interests. The credit spreads in these countries are also very attractive—in some cases, the U.S. is providing better returns than Canada.

Phil Gillin
I think Ontario has been an exemplar for public-private partnerships, particularly the design, building, financing, and maintenance models for infrastructure projects such as hospitals across the province. As Carl mentioned, people are coming to Canada to learn how Canadians do this and how we do it successfully. We've learned a lot and have a great deal of expertise. Private debt markets can help get infrastructure delivered, especially for healthcare facilities as demographics create more demand.

YOU'VE TALKED ABOUT PRIVATE DEBT IN THE U.S. WHAT IMPACT COULD SOME OF PRESIDENT TRUMP'S POLICIES HAVE ON THE SPACE?

Phil Gillin
The movement from thermal coal to renewable power in the United States may not be as strong as it was two or three years ago, given the change in politics. Trump ran on a platform promising to put the coal miners back to work, so I don't think renewable power is going to be a big opportunity in the U.S. for the short term—but, strategically, it's still a good area to focus on. I hope the shift away from renewable power in the U.S. is only a short-term issue; the rest of the world is moving away from high greenhouse gas emission industries and power production. In my opinion, it's going to happen—it has to.

Gitesh Goyal
Part of Trump's platform is to spend money renewing infrastructure in the U.S. At the moment, however, the U.S. doesn't really use public-private partnerships in a substantive way; instead, most infrastructure is financed through tax-exempt bonds. They do want to learn, and they send people to Canada to learn how our governments are procuring infrastructure. That doesn't mean there aren't opportunities for private debt financing outside of Trump's own infrastructure plans. The U.S. university sector includes triple-A-rated universities that are now leaning on private financing to grow. For example, The Ohio State University did a very large public-private financing partnership to expand and run its energy management system; it issued nearly US$800 million of private debt. That's just one example. The university space in the U.S. is huge.

WHAT ARE THE TOP QUESTIONS YOU HEAR FROM PLAN SPONSORS AND THEIR TRUSTEES ABOUT PRIVATE DEBT?

Carlo DiLalla
We definitely get questions about liquidity. If they're investing in an open-end fund, they want to understand whether the illiquidity premium offers risk-adjusted value and how they can liquidate their holdings if they need the money down the road.

Phil Gillin
I think there's an overall thirst for knowledge. Plan sponsors know that returns from the traditional 60/40 equities-fixed income model can be very volatile versus their long-term liabilities. Pension funds now realize they have to move away from that model, and they know what they need to consider: alternatives like real estate, mortgages, and private fixed income, which are more correlated to pension plan liabilities. There's a good opportunity for investment managers to educate institutional investors on the benefits of these

asset classes and help them structure their portfolios. The industry needs to help plan sponsors understand that these assets have less volatility and can improve portfolio returns.

Gitesh Goyal
Obviously, if you're a plan sponsor that wants to allocate money to this, you need to know whether it's a viable business over the long term—is private debt going to be around in the future? All investors need to understand that private debt as an asset class isn't going to go away. There is a strong pipeline of deals out there.

They also ask about ratings, especially because private debt investors have to rely on manager ratings, not standard rating agency grades. In that context, it's incumbent upon managers to explain how we rate these products and what existing knowledge we're drawing on to evaluate these assets and structure the deals.

Phil Gillin
Of course, there's no magic to the rating an agency gives. It's all about fundamentals.

Gitesh Goyal
Exactly. Institutional investors need to know this is a viable, long-term business—and that there is a pipeline of other projects waiting to be funded.

Carl Bang
Private markets are a fast-growing segment of asset management in Canada—and even in North America. That trend is firmly entrenched because, as a whole, the industry is under-allocated to liability-matching assets. As more pension funds go through their own asset-liability studies, there will be more demand for assets like this. We've already had the initial discussions about what it is and what its benefits are. As we move toward greater allocations, the market will only continue to grow.

Phil Gillin
From a risk standpoint, investors do need to understand the underlying covenants. They also need to know the asset, the borrower, the source, and the strength of the asset's cash flow. You have to start with the fundamentals in order to get an asset that has the quality you want.

WE MENTIONED RATINGS EARLIER, BUT WHAT ABOUT BENCHMARKS? HOW SHOULD PLAN SPONSORS MEASURE PERFORMANCE OF PRIVATE DEBT?

Phil Gillin
Right now, an objective third-party benchmark is lacking in much of the private debt space. You can get comparisons between funds and against public bond benchmarks, and, of course, we all look at one another's performance. But, at this point, there haven't been widely accepted external benchmarks, particularly for more esoteric strategies. I can see it happening in the future, but it will take time.

Carlo DiLalla
The common practice right now is to use existing fixed income benchmarks as a proxy, simply because they help the plan and the consultant understand the allocation and how it's tracking. It's actually a good way to measure because it's a long-term measure that fits with the long-term nature of the pension promise.

Carl Bang
Back in the 1990s, when everyone started investing in hedge funds, there was no benchmark. You could never really capture one important thing—the degree of risk undertaken in exchange for those returns. There's a lot we can learn from the experiences of hedge fund investors two decades ago. For example, in the private debt space, especially in the mortgage space, the different degrees of risk are underwritten. And, as an astute investor, you need to look through the risks you're taking to make sure you're being compensated appropriately.

Carlo DiLalla
Pension plans, especially the biggest ones, are already moving away from traditional benchmarks. They're looking at asset performance relative to their liabilities, which is their main benchmark. Benchmarking private debt against the objectives and internal targets of the plan itself rather than through an external measure is a step in that direction.

Gitesh Goyal
I agree. The success of private debt is about how it fits within a pension fund's overall asset allocation. It's not just about how many basis points an investor can get over a universe benchmark. The most important consideration is the risk-reward trade-off within the context of the plan itself. A benchmark that everyone uses won't tell you much.

Phil Gillin
The bigger imperative is whether or not private debt can generate the yield pension funds need in order to meet liabilities—it's not about a benchmark. Those are two different things. In my opinion, pension investors can't afford to be in a purely no-risk area—

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>
> *– GITESH GOYAL*

and they may not want to be in a high-risk area. They need to be somewhere in the middle. In my view, an external benchmark is a secondary issue.

LET'S FOLLOW THAT LINE OF THINKING. WHERE DOES PRIVATE DEBT FIT IN A PENSION PORTFOLIO? CAN IT PLAY A ROLE AS PENSION FUNDS ADOPT LIABILITY-DRIVEN INVESTING?

Carlo DiLalla
Investment grade private debt can be used as a partial fixed income replacement and a yield enhancer, and it can be a great long-term asset to match a pension liability.

Carl Bang
Private debt can definitely help plans manage longevity risk. As the duration of liabilities gets longer, debt and cash flows need to match up. In the public space, there's a finite amount of long debt. Corporate debt can expose you to business model risk and technology obsolescence, which are not risks you want to take over the long term. Private debt allows plans to invest in long-term assets with less risk, often because these investments are loaned against specific projects and known cash flows with a high degree of certainty. It may also allow them to pick up extra returns—potentially 1% to 2% a year in added gross returns over a 30- or 40-year time frame. That's an important match for pension liabilities.

Gitesh Goyal
Long-term corporate bonds are a good match, but there's only so much you can buy of companies like Enbridge or TransCanada before you hit a concentration limit. Private debt is simply another way to deploy cash to meet long-term liability needs.

HOW DO THE COSTS COMPARE TO OTHER ASSET CLASSES?

Phil Gillin
It's certainly a more cost-intensive area compared to exchange-traded funds, for example. It's a whole different realm. If you want to get a high-quality manager that has the resources to do the due diligence and underwrite appropriately, you have to pay for it. These are asset classes that require more management—that should be offset by a higher level of return.

Carlo DiLalla
When you go from public to private, a switch gets turned on and suddenly there's a jump in fees. In the private debt space, you need to pay for what you're getting. And, if you're in the high-quality space, fees are marginally higher, but they do remain relatively low versus other private strategies.

WHAT BARRIERS STILL EXIST FOR PLAN SPONSORS? ARE THERE STICKING POINTS HINDERING GREATER ADOPTION OF PRIVATE DEBT?

Phil Gillin
Liquidity and expertise are the two primary barriers since these are more complex asset classes. It can give institutional investors, particularly smaller ones, some cause for concern. They ask questions like "How can I access this asset class when I don't know how to originate it or how to underwrite it? Will I have a liquidity problem if I can't sell it?" But investors are becoming much more sophisticated. They know they need to earn higher returns on their fixed income portfolios in today's low interest rate environment. They need to consider investing a portion of their assets in less-liquid asset classes.

Carlo DiLalla
There are so many asset classes out there and all of them have 10- or 20-year track records. In this space, funds have, on average, one- to three-year track records. That can be an issue for some investors. Like any newer asset class, reliance on capability is key.

Phil Gillin
Investors really have to understand and accept the risks. For example, timing is key, if you consider the speed with which technology and the environment changes. If you're investing in a 20-year utility, for example, there are things that can happen to disrupt that investment over the next two decades that you can't even contemplate now. Think about Kodak. Investors' money was incinerated due to technological change. In the private debt space, these risks exist, but you have to address them through underwriting analysis and try to mitigate them through deal structuring.

IS THERE ENOUGH CAPACITY TO ACCOMMODATE MORE LARGE INVESTORS?

Phil Gillin
I think it's a more competitive space. The banks have now become much bigger lenders in the commercial mortgage business than they were 10 or 15 years ago. I think the Canadian marketplace does have its limitations—it's only so big. It's why you see more players going abroad. Increasingly, you'll need to get into bigger markets in order to place the capital.

Gitesh Goyal
Compared to the public debt space, it's much better. For most public debt deals, there's a food fight right now as people struggle to get meaningful allocations.

Phil Gillin
That's a polite way of expressing it!

Gitesh Goyal
Public debt deals are now four to six times oversubscribed. But in the private debt space, deals are still being done based on relationships with issuers. Managers can still fill orders because of that.

Carlo DiLalla
I'd argue that there's much more room to grow here in Canada. Compared to global investors, Canadians have been slower to adopt private debt.

"Investment grade private debt can be used as a partial fixed income replacement and a yield enhancer..."

– CARLO DILALLA

Gitesh Goyal
I'm very bullish on this space. I think the pipeline is robust, and, every year, as more deals are done, it becomes a much more accepted form of financing. It needs to be structured well—and we haven't had any mishaps in the space yet.

Phil Gillin
A big growth area right now is in the mortgage space; I see consistent demand here every year. Like Gitesh, I'm quite bullish on private debt. I think there are going to be opportunities for all institutional investors moving forward.

Carl Bang
The illiquidity premium that can be earned in the private debt space is a free lunch sitting in people's portfolios. Investors' appetite for this is quite large; it can allow them to build more efficient portfolios. Moreover, with the push to rebuild and renew infrastructure, there will continue to be fiscal policy that pushes toward this. That's a trend that's going to be with us over the next 10 or 20 years. Demographics will drive it—and, in my opinion, that's exactly where investors should be looking. ■