Lead Left Interview – Edwin Cass

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This week we chat with Edwin Cass, Chief Investment Strategist, Canada Pension Plan Investment Board. Mr. Cass is responsible for CPPIB's overall fund level investment strategy. He also chairs the Investment Planning Committee, which approves all new investment programs and oversees all portfolio risks, including passive, active, credit and liquidity risk.

The Lead Left: Ed, we're witnessing market turmoil, yet the worries seem to be familiar ones. What's different now?

Edwin Cass: We have been asking ourselves the same question internally. What we're seeing now is a series of bad data points in the U.S. The U.S. has been the engine of growth and has made the most progress in terms of economic stimulus. If the U.S. heads into a downturn, then the knock-on effects to the financial system could be pronounced. This comes at a time when oil has taken a further leg down, jeopardizing earnings and further impacting CAPEX.

The same is true with concerns about China and its transition to a consumer-driven economy from an export and investment-driven one. These risks became increasingly transparent during 2015, but didn't really hit until this year.

TLL: Are any risks that are surprising to you?

EC: There are certainly lots of risks in the market, but they didn't really impact pricing in a material way until now. We saw valuations go up last year, but spreads have subsequently widened significantly more recently. Are prices correct or cheap? It's a mixed tale, and it's hard in some cases to disentangle sector effect from the market more generally.

Currently the opportunity set is greater than we see on average. There are certainly enough assets being offered, but we are trying to be very selectively focused. These opportunities are everywhere, but most particularly in the credit and energy space.

TLL: Are you prepared for the next downturn?

EC: When we look back at 2009, we feel that there were very attractive valuations in the market, but we didn't necessarily have the investment framework then to take advantage of them. We saw opportunities in 2008-09 in credit, infrastructure, direct private equity, and real estate that we thought offered good risk-adjusted returns. Ideally we would have increased our overall risk appetite back then to take advantage of the situation, but we were constrained by anchoring our risk appetite close to that of our Reference Portfolio.

TLL: What was the balance between equities and fixed income in the Reference Portfolio?

EC: The Reference Portfolio was comprised of 65% equities and 35% debt. We had active risk limits which specified how much we could deviate from those weightings, but practically speaking our ability to deviate was limited. Looking back at those opportunities the question to ask is: can we put in place a governance framework that will allow us to more easily take advantage of those situations?

TLL: Do you selectively stretch your risk parameters to meet your returns?

EC: That's a mistake we try not to make. We don't target returns, per se. We calibrate our risk tolerance every year, then work to maximize our returns under those parameters. Otherwise you could engage in activity that involves stretching for yield, which is very dangerous. You end up having to overleverage to meet your return objectives when markets are the most richly priced.

TLL: What's the biggest change you've made since 2009 to adapt to what you learned then?

EC: We've changed our orientation from relative returns to total, or absolute, returns. In the past, with the Reference Portfolio, the majority of focus was on generating relative returns. We got caught in this relative performance bind back in 2009. The question is how to alter our strategy to optimize flexibility and incorporate an absolute return focus as well.

Back in 2009, after our March 31st fiscal year-end, we reported minus 18% returns. It made front page headlines in all the Canadian newspapers. What was not highlighted was the fact that we had record relative returns 200 bps better than the market – but no one cheered returns being down 18% instead of 20%!

So we then instituted a program called "CPPIB 20/20," which re-examined where we were, and where we wanted to be by 2020. One of our conclusions was there needed to be a greater focus on total or absolute returns. Total returns are important. They pay our stakeholders.

For example, we believe strongly that we can maximize total risk-adjusted returns through efficient diversification, but we had never been explicit on specific desired allocations for each asset class – whether it's private equity, infrastructure, or credit. Now we publish a strategic portfolio indicating how we want to be invested across regions and asset classes.

To be continued the week of Feb 29

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