# Memorandum

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| **Date:** | **August 18, 2020** |
| **To:** | **Skagit Environmental Endowment Commission** |
| **From:** | **Brendan George & Michelle Richardson** |
| **Subject:** | **Investment Policy Review** |

## Summary

George and Bell was engaged by the Skagit Environmental Endowment Commission (the "Commission") to review the Commission's investment policies. In this memo, we provide the results of our review of the Commission's investment policies ("SIPP").

Our review of the SIPP culminated in the following key suggestions:

A) Set an absolute return as the primary return objective;
B) Define specific asset allocation and permitted ranges for the overall fund;
C) Determine whether the Commission would like to include and implement a socially responsible investment policy; and
D) Consider adding additional sections and wording that address some of the more minor issues summarized in the "SIPP Review Checklist" section that starts on page 4.

The following section discusses each of these suggestions in further detail and contains suggested wording specific to the Commission's portfolio.

## Suggestion Details

**Suggestion A:** Set an absolute return as the primary return objective.

- The intent of this is to set a clear quantitative objective that is reflective of the Commission's goals and spending needs.
- Based on information provided that the Commission's spending is targeted to 4%, we recommend an objective of CPI + 4%.
    - Caveat: Based on the current asset mix, we believe this target is too aggressive given our expectations regarding future returns. In order to achieve a real return of 4% per annum, our assumption is that changes to the asset mix noted in Suggestion B would be implemented.
- Suggested wording to add to the Investments – Overall Goals section of the SIPP would be:
    - *"The long-term investment goal of the Fund is to achieve a minimum annualized rate of return of 4%, net of investment management fees, in excess of the Canadian*

*Consumer Price Index when measuring the total Fund's return in Canadian dollars, and in excess of the U.S. Consumer Price Index when measuring the total Fund's return in U.S. dollars. This goal is consistent with the overall investment risk level that the Fund could assume in order to maintain the purchasing power of the expenditures, and normally will be assessed over a longer time period of five years or more."*

        - Note: We have included different currency measurement parameters to reflect the fact that CIBC reports the Canadian and U.S. accounts in those respective country's currencies. If reporting was all available in Canadian dollars, we would recommend simply comparing performance of the total fund in Canadian dollars against the Canadian CPI.
        - Consideration could also be given to include slightly different targets for the Canadian and U.S. accounts if the current set-up of separate asset mix targets for each account is maintained. Currently, the U.S. account has a higher risk return potential than the Canadian account.

**Suggestion B:** Define specific asset allocation and permitted ranges for the overall fund.

- The first suggested step would be to define a target asset mix.
    - In order to achieve the Suggestion A objective, an asset mix review should be done to determine a suggested asset mix that is appropriate to meet the Commission's objectives.
        - If the risk / return profile of that asset mix is not acceptable to the Commission, consideration should be given to lowering the target return objectives.
    - Using George & Bell's 2020 Capital Market Assumptions, we ran a 25-year analysis using the Commission's current asset mix (which is roughly 50% fixed income and 50% equities).
        - The details of the analysis are summarized in Section 8 of our CIBC report.
        - It showed that the current asset mix is expected to yield a long-term nominal return of 4.7% per annum.
        - With inflation currently estimated at 2% per annum, this means the current asset mix is only expected to realize a real rate of return (and thus only permit a spending rate) of 2.7% per annum.
- Once a target asset mix is determined, ranges should be set for each asset class that ensure there are limitations on how far actual asset class weightings are permitted to deviate from the target.
- The target policy mix is also often used to set a secondary benchmark objective.
    - The primary objective in Suggestion A is meant to measure the success of the Fund (asset mix and investment strategy) in meeting the Commission's objective.
        - Consistent underperformance could either indicate that the overall investment strategy (i.e. asset mix) is not sufficient to meet the objective and/or that the investment manager is underperforming.
    - A secondary objective would measure how well the Commission's active investment manager (on a net of fee basis) performs compared to a passive benchmark.
        - Consistent underperformance would mean that the investment manager is underperforming and could indicate an issue with the quality of that active manager.

**Suggestion C:** Determine whether the Commission would like to include and implement a socially responsible investment ("SRI") policy.

- During our review of CIBC, it was evident that SRI discussions had been underway for some time between the Commission and the investment manager.
- There is no mention of SRI or environmental, social and governance ("ESG") concerns in the Commission's current SIPP, and only minor references to it in CIBC's Know your Client policies.
- We believe that formalizing the Commission's views on this and clearly articulating them within the SIPP will provide clarity and consistency on how this issue should be approached with the investment manager.
- Once the Commission's viewpoint is clearly communicated, monitoring of how the investment manager undertakes and implements those SRI directives can then occur.

**Suggestion D:** Consider adding additional sections and wording that address some of the more minor issues.

- Minor suggestions to make the SIPP more robust are summarized in the "SIPP Review Checklist" section that starts on page 4.
    - An easy alternative to incorporating wording on these various items would be to simply delegate it to the Investment Manager. Sample wording would be:
        - *"The Investment Manager is responsible to ensure that all investments have clearly defined investment policy statements and that any potential items of concern are brought to the attention of the Commission. Where the pooled funds of the Investment Manager are used, it is understood the investment guidelines of those specific pools will take precedence over this document. On this basis, it is the responsibility of the Investment Manager to ensure that the pooled fund guidelines are acceptable to the Commission before entering into such an investment."*
- The organizational structure we typically use for client SIPPs and what we would suggest as a SIPP Outline for the Commission if they wish to further enhance the SIPP are as follows:
    - Section 1 – Purpose and Background
        - This would summarize what the purpose of the Fund is, the purpose of the SIPP, and provide any background information on the Commission that is relevant to understanding the overall goals and objectives of the investment policy.
    - Section 2 – Delegation of Responsibilities
        - This outlines who is responsible for what tasks in the management of the Commission's funds. It states the responsibilities of the Committee, Investment Manager, and any other parties relevant to the Fund's investments.
    - Section 3 – Investment Philosophy
        - This section typically would contain wording regarding the Commission's investment beliefs and risk tolerance.
    - Section 4 – Asset Mix and Monitoring
        - This would contain the content of our first two suggestions (return objective and asset mix targets and ranges).
        - Details about how the performance and investments are to be monitored can also be included here or as a separate section. Asset class specific return

objectives (i.e. benchmarks such as the S&P/TSX Composite Index and the FTSE Canada Universe Bond Index) would be included here.

- Section 5 – Permitted Investments & Other Matters
  - This section typically includes definitions of permitted investments, minimum quality requirements (for fixed income), maximum quantity restrictions, and the Commission's policies on derivatives, securities lending and related party transactions.
  - If a client's policy contains extensive details, these are often split into two sections.
- Section 6 – Socially Responsible Investment
  - While this is an optional section and not required by legislation, it is something we are seeing an increasing number of clients include based on their organization's beliefs and values.
- Appendices
  - Some of the items that could be included within an appendix but aren't necessary include:
    - Benchmark history
    - Reasons to terminate an investment management firm
    - Considerations when hiring an investment management firm
    - Commission's Investment Beliefs

## SIPP Review Checklist

The B.C. Pension Benefits Standards Act ("the PBSA") and the B.C. Pension Benefits Standards Regulation ("PBSR") regulate employment pension plans covering British Columbia employees. While non-pension funds such as the Commission's funds are not bound by these regulations, we have used these regulations as a basis with which to evaluate the Commission's investment policies.

The following pages summarize the sections of the Commission's policies that are applicable to each guideline along with commentary on any key recommendations we believe would improve the Commission's policies.

| PBSR Guideline | Current Policy | Key Suggested Revisions |
|---|---|---|
| 51(2) In establishing the statement of investment policies and procedures, the administrator must have regard to all factors that may affect the funding and solvency of the plan and the ability of the plan to meet its financial obligations, including, without limitation, the following: | | |
| *51(2)(a)* categories of investments, including derivatives; | Not included | - The current SIPP does not state clear permitted categories of investment. While most SIPPs go into fairly significant depth, this could be simply summarized by stating which asset classes the Commission is permitting in their portfolio (i.e. public equities, fixed income, short-term securities, cash, infrastructure, real estate, mortgages, etc.). We recommend specifying that the |

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| | | permitted categories include "*Mutual, pooled, or segregated funds which may invest in any or all of the above asset classes.*"<br>- Most clients have restrictions on when derivatives can be used. This would be something that could be discussed with CIBC as they can clarify the current approach within the Commission's various investments. |
| *51(2)(b)* diversification of the investment portfolio; | Investments – 4. Risk Tolerance | - The SIPP currently states that the Commission "accepts the risks associated with a balanced portfolio of fixed income securities and equities".<br>- We recommend clarifying the Commission's views on what constitutes a "diversified" portfolio. We find that many investors are looking outside of traditional equity and fixed income asset classes and exploring more illiquid options such as real estate, infrastructure, private debt, and mortgages. |
| *51(2)(c)* asset mix and the basis on which that mix is determined, including by reference to volatility and rate of return expectations; | Investments – 1. Overall Goals | - (See Suggestions A and B in the previous section for suggestions). |
| *51(2)(d)* liquidity of investments; | Distributions – 2. Annual Distribution 3. Optional Distribution<br>Investments – 2. Liquidity | - Distributions 2. refers to the time period from 2003 -2006. We suggest updating it to reflect the Commission's long-term targets for distributions.<br>- Consider documenting details regarding the liquidity requirements of the funds. Examples include when cash for distributions is typically needed/redeemed from the investment manager, what the percentage target is for distributions, or any differences between fund redemptions from the Commission's Canadian versus U.S. accounts. |
| *51(2)(e)* the lending of cash or securities; | Not included | - Our suggested wording for the Commission would be: *"The securities of the Fund may not be loaned except within pooled funds that permit securities lending."* |
| *51(2)(f)* the retention or delegation of voting rights acquired through investments; | Not included | - While voting rights can only be controlled for segregated investments, not pools, most clients delegate this task to their investment manager.<br>- Our suggested wording for the Commission on the pooled fund investments is: *"The investment manager shall disclose their proxy voting policies and any changes thereto and report annually on (1) whether all eligible proxies were voted on the Fund's behalf* |

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| | | *and (2) if the proxy guidelines were followed and report on any deviations."*<br><br>- We recommend the Commission review whether they would like to specify any proxy voting policies for their segregated assets in conjunction with a review of the Commission's SRI policies as mentioned in Suggestion C. |
| *51(2)(g)* the method of, and the basis for, the valuation of investments that are not regularly traded at a marketplace, as defined in section 2(1) of the PBSR; | Not included | - The Commission is currently not invested in any non-publicly traded securities so this does not apply. If the Commission were to invest in private assets (such as real estate, infrastructure, private equity, etc.,) we suggest stating that an estimated fair value of such investment will be supplied by the investment manager not less frequently than quarterly. |
| *51(2)(h)* related party transactions permitted under section 17 of federal Schedule III and the criteria to be used to establish whether a transaction is nominal or immaterial to the plan. | Not included | - While it rarely is ever an issue, especially for a fund of the Commission's size, related party wording typically states: *"The Fund may not enter into a transaction with a related party unless:*<br><br>*(a) The transaction is required for the operation or administration of the Fund and the terms and conditions of the transaction are not less favorable to the Fund than market terms and conditions; or*<br><br>*(b) The combined value of all transactions with the same related party is nominal or the transaction(s) is immaterial to the Fund.*<br><br>*For this section of the policy, market value of the combined assets of the Fund will be used as criterion to establish whether a transaction is nominal or immaterial to the Fund. Transactions less than 0.5% of the combined market value of the assets of the Fund are considered immaterial.*<br><br>*The restrictions on related party transactions do not apply in respect of investments in a pooled fund. "* |
| *51(3)(a)* a description of the factors to which the administrator had regard when establishing the statement; | Distributions, Investments | - This is often covered in the Purpose and Background section as described in our suggested SIPP Outline under Suggestion D. |
| *51(3)(b)* how those factors were applied to establish the policies and | Not included | - Consideration of those factors are normally reflected through the SIPP's wording on investment objectives, asset allocation, and risk expectations. |

| PBSR Guideline | Current Policy | Key Suggested Revisions |
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| procedures set out in the statement. | | |