

2018 INVESTMENT COMMITTEE ANNUAL REPORT







Investment Committee Annual Report For the Year Ended March 31, 2018

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Letter from the Board Investment Committee Chair

On behalf of the University of Alberta Investment Committee, I am pleased to present the 2018 annual report. The investment assets under the oversight of the Investment Committee totaled \$2.25 billion as of March 31, 2018, of which \$1.38 billion represented endowments. Over the year \$38 million for program spending purposes such as scholarships and research was generated by endowment assets, an increase of \$1.2 million from the prior year.

The University Endowment Pool's (UEP) return for the year was 8.0% which outperformed its benchmark return of 7.0%, and exceeded the long-term target of 7.25%. This target has been consistently achieved over the four and ten year investment periods ending March 31, 2018 with annualized returns of 9.3% and 7.7% respectively. The Non-Endowed Investment Pool (NEIP) returned 2.9%, which exceeded its benchmark return of 2.0%.

Equity markets continued to perform strongly this past year, led by global synchronized expansion and strong growth in emerging markets. Unfortunately Canada lagged significantly. Global equities as measured by the MSCI World Index returned 9.8% in Canadian dollar terms, while the MSCI Emerging Markets Index returned 20.8%. Canadian equities as measured by the S&P/TSX Composite Index trailed with a return of 1.7%. Volatility returned to capital markets in early 2018 over concerns related to trade protectionism, inflation, and rising interest rates after several years of relative tranquility. Over the past year fixed income posted losses due to rising interest rates. Real estate continued to generate stable income with modest capital appreciation, commodities began to turn the corner following several years of poor performance, and there was a strong rebound in natural resource equities. The UEP continued to benefit from being broadly diversified across global markets.

Over the past year the Investment Committee finalized major policy initiatives that will impact the long-term asset allocation of both the UEP and NEIP. This included significant changes to the UEP Spending Policy, the University Funds Investment Policy, and various Investment Proposals covering both pools of assets. Management continues to implement the strategic organizational plan and related recommendations to ensure the University maintains strong investment management practices.

In the coming year Management will continue to identify and allocate capital to investment opportunities in a variety of asset classes and strategies for both the UEP and NEIP with the oversight of the Investment Committee. Another key initiative will be to ensure that the investment risk profile of the UEP and NEIP is more accurately measured and remains commensurate with their respective return objectives and time horizons.

I would like to acknowledge the hard work and dedication of both Management and members of the Investment Committee this past year to the University and its stakeholders.

Dave Lawson, CFA
Chair, Board Investment Committee, University of Alberta

Investment Committee

March 31, 2018

Appointed

Dave Lawson, CFA, Chair

Jim Drinkwater, Vice-Chair

Derek Brodersen, CFA

Charlene Butler

John Butler

Gordon Clanachan

Allister McPherson

Sandy McPherson, CFA

Peter Pontikes, CFA

Ex-Officio

Michael Phair

Douglas Stollery, QC

Dr. David Turpin, CM, PhD,
LLD, FRSC

Executive Summary

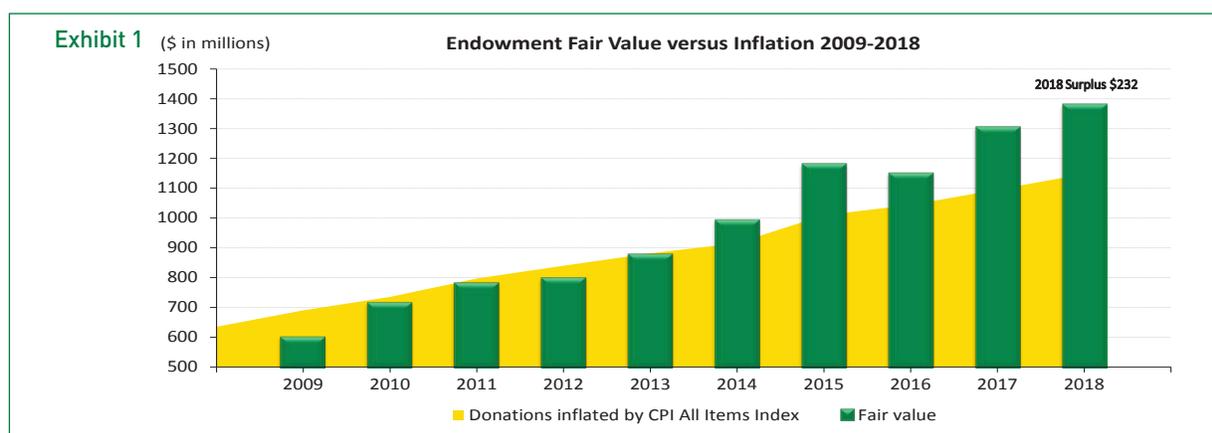
The investment assets of the University of Alberta that are under the oversight of the Investment Committee had a total market value of \$2,252 million as of March 31, 2018 (2017 - \$2,153 million). This consisted of \$1,380 million (2017 - \$1,304) in Endowed Funds and \$872 million (2017 - \$849) in Non-Endowed Funds.

With very few exceptions, the Endowed Funds are pooled together and invested collectively in the University Endowment Pool (UEP). Endowment funds represent permanently restricted capital, and only a portion of the annual earnings can be spent for their specified purpose. The investment objective of the UEP is to achieve a long-term rate of return that in real dollars (i.e. adjusted for inflation) meets or exceeds total endowment spending, as outlined in the UEP Spending Policy. By meeting this objective the University is able to provide a comparable level of support to future generations that current beneficiaries receive.

The Non-Endowed Investment Pool (NEIP) consists primarily of expendable operating and research funds. It is mainly shorter-term in nature, with a greater focus on liquidity and capital preservation.

Endowment Funds - Highlights

- The UEP returned 8.0% during the year as returns from virtually all asset classes were positive. Fixed income was one of the exceptions posting negative returns for the second consecutive year.
- The market value of the Endowment Funds increased to \$1,380 million, up \$76 million from the end of fiscal 2017. This increase is comprised of \$101 million in investment gains plus \$27 million in donations, less the \$38 million spending allocation, \$8 million for investment management costs, and the \$6 million administrative assessment.
- During the year, the real value of the endowments increased by 1.7%. This increase was due to the aforementioned return of 8.0% on the investment assets less total expenditures of 4.0% and inflation of 2.3%. The value of the endowments over their cumulative inflation adjusted objective increased to \$232 million as at March 31, 2018 or 20.2% as outlined in Exhibit 1. A surplus of this magnitude or greater is required to help ensure spending sustainability in periods of capital market downturns.



- For the fiscal year, \$38 million was made available for program spending on academic programs, chairs and professorships, and research and scholarships; this represents an increase of \$1.2 million from the previous year.
- The fund's benchmark returned 7.0%, indicating UEP outperformance of 1.0% over the past year. On a four and ten year basis the fund has outperformed its benchmark by an annualized rate of 0.8% and 0.9% respectively.

Non Endowed Funds - Highlights

- The NEIP recorded an overall return of 2.9% for the year, and generated \$31 million in investment earnings of which \$25 million was realized during the year.
- Returns from all underlying NEIP investment strategies exceeded their benchmark returns, resulting in aggregate outperformance of 0.9%.

Major Initiatives During the Year

Private Markets Advisor

The University completed its search for an advisor to assist Management with the strategy development, construction, manager selection, and monitoring of its private markets program. During the year, other than investments and co-investments with existing managers, there were no new allocations to private market investments in anticipation of the engagement of this advisor.

Continued Implementation of the UEP Strategic Asset Allocation

Within the Growth strategy, capital continued to be called by several private equity funds that were committed to in prior years. Due to the prolonged investment period in private equity, it is anticipated that an overweight allocation to global equities will be maintained for the foreseeable future. The Inflation Sensitive strategy saw the completion of a commodities manager search that will be funded in the coming year. In the Diversifiers strategy, a search was initiated for a bespoke hedge fund platform provider that will be completed in the coming year.

Performance Measurement and Custodial Bank Service Providers

The University also completed a request for proposals for its performance measurement and custodial banking services. The incumbent was retained for custodial duties; however, performance measurement was awarded to a new service provider.

Key Policy Document Changes

Changes to the UEP Spending Policy were finalized and will take effect on April 1, 2018. The new spending policy is based on a policy spending rate of 4.0% that is applied against a 60 month average market value. Under the new spending policy the 0.85% administrative fee to support centrally funded indirect costs associated with endowment programs will be reduced to 0.60% over a period of five years. The effective spending rate, expressed as a percentage of market value, will increase from 2.9% in fiscal year 2018 to 3.5% in 2019. The new spending policy will increase program support to students, researchers, and the University community by \$10 million for a total of \$48 million in funding, while maintaining a high level of transparency.

A review of the University Funds Investment Policy was completed by the Investment Committee, with asset allocation analysis conducted by Management. Changes to the UEP's strategic asset allocation included increases to private markets and the Diversifiers strategy, with corresponding reductions to public equity markets and Deflation Hedging. The changes to the NEIP's strategic asset allocation focused on establishing an expanded investment opportunity set for its Yield strategy to enable enhanced funding of future strategic initiatives. The asset allocation analysis focused on increasing returns while aiming for mid-term bond-like volatility. The result is a multi-asset approach that will ultimately benefit the University community as a whole.

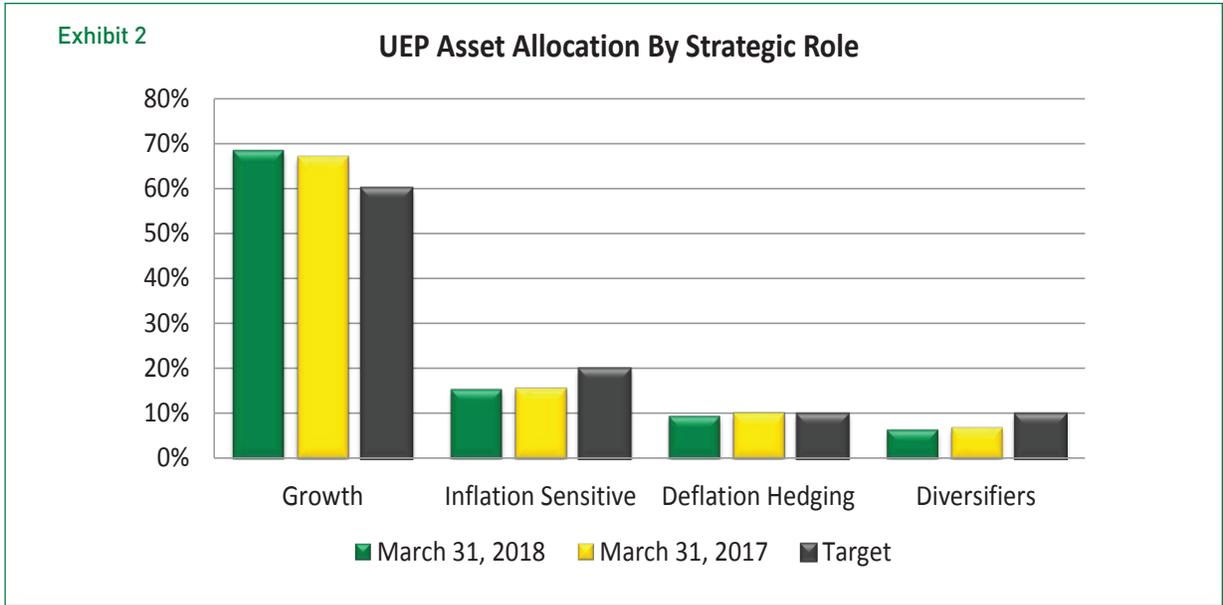
Endowment Funds

The primary investment objective for the UEP is to achieve a long-term real rate of return that equals or exceeds total endowment spending. Emphasis is placed on preserving intergenerational equity to ensure all beneficiaries, current and future, receive comparable levels of support. Assets are classified based on the strategic role they perform within the portfolio, specifically: Growth, Inflation Sensitive, Deflation Hedging, and Diversifiers.

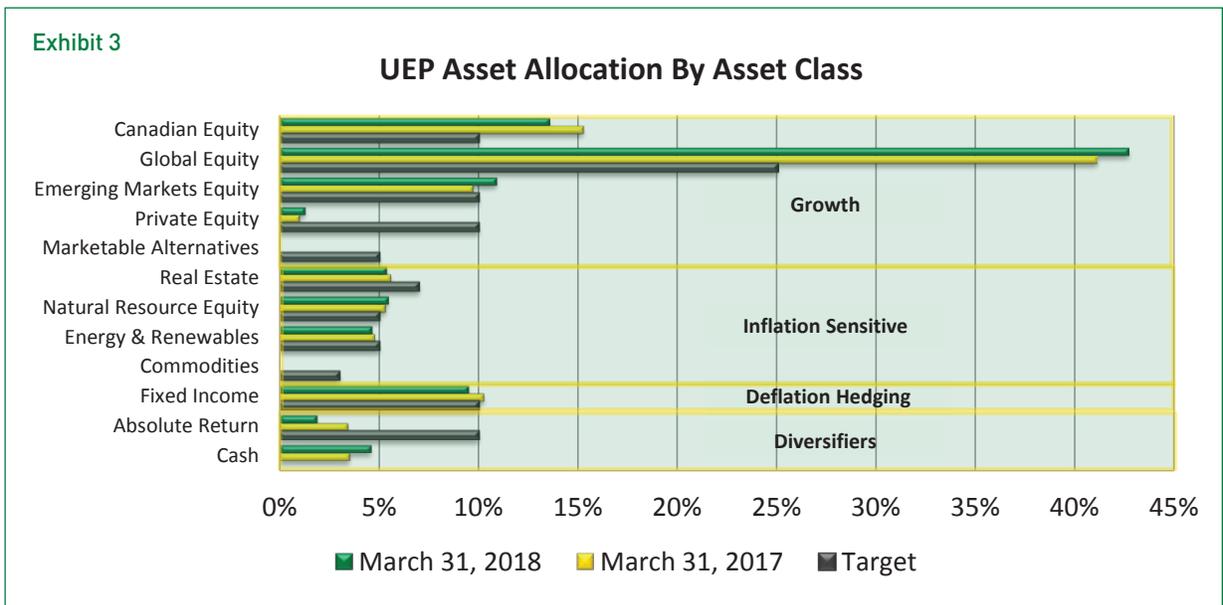
- To meet spending targets and grow the value of the assets over time, a large allocation to public and private equities, hedge funds, and other assets with exposure to equity market returns is necessary.
- Inflation sensitive assets are those that adjust to unexpected and/or rising inflation. The assets in this category include real estate, natural resource equities, energy and renewables, and commodities.
- Deflation hedging assets are those that remain liquid and increase in value during times of extreme economic and capital market turmoil. This asset class consists of high-quality sovereign bonds.
- Diversifiers are any asset classes or investment strategies that have low or no correlation with the capital markets and inflation



Endowment investments are categorized by Strategic Role in Exhibit 2.



Investments are also categorized by Asset Class in Exhibit 3.



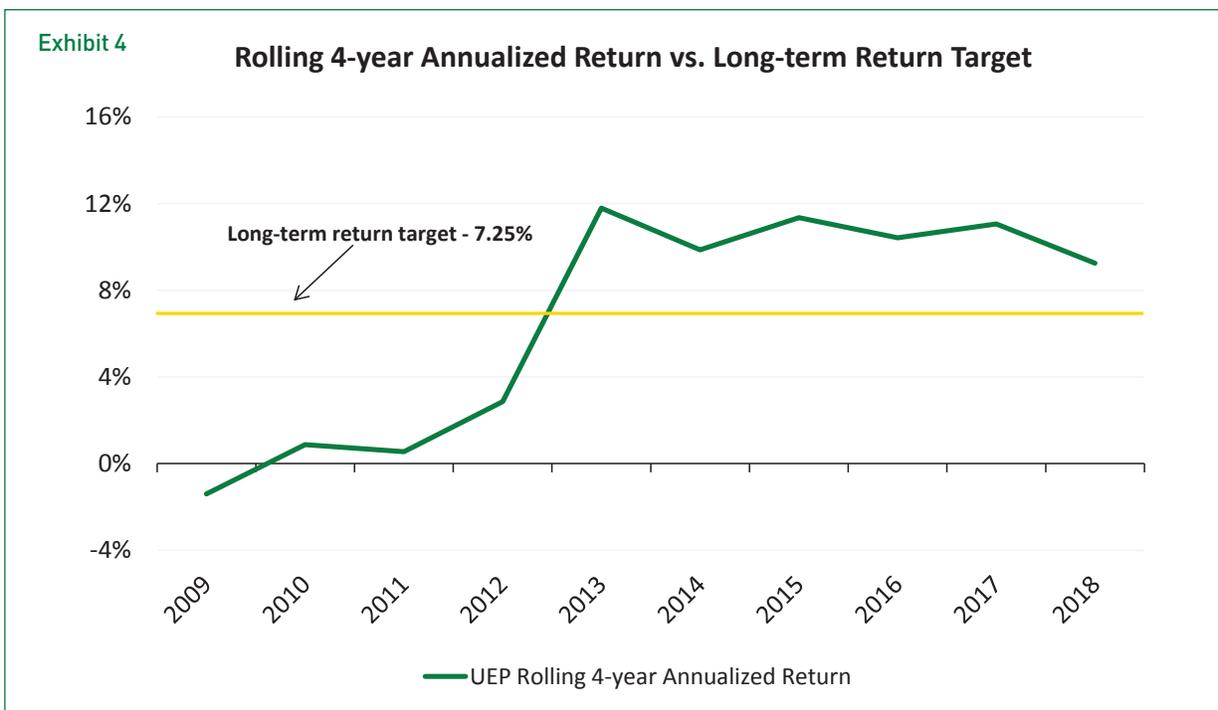
Investment Performance Relative to Objectives

The UEP return over the past year exceeded total spending plus CPI by 1.7%. The four year annualized excess return to spending and inflation for the period ending March 31, 2018 was 3.6%.

The fiscal 2018 return of 8.0% reflects:

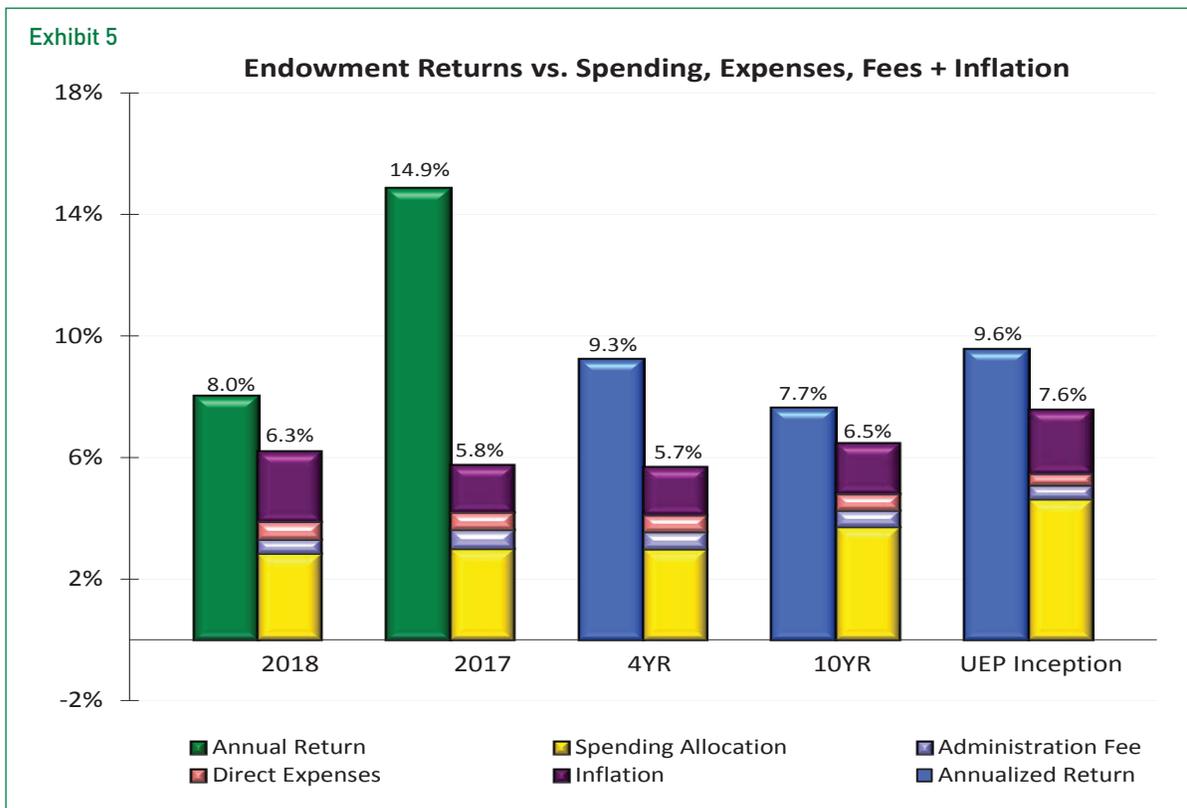
- Strong performance from public equities relative to other asset classes,
- A significant over-weighting of public equities at the expense of other asset classes,
- Active managers adding value in aggregate,
- Canadian dollar appreciation on balance which dampened returns.

The UEP is invested for the long-term and is expected to provide a return in excess of spending and inflation in some years to compensate for years when this is not the case. Exhibit 4 illustrates the UEP's historical performance relative to the return objective of 7.25%.





As shown in Exhibit 5, the UEP has, since its April 1989 inception, produced an annualized return of 9.6%. This return has exceeded annualized total endowment spending plus inflation of 7.6% over that time period. This objective has also been achieved over all other time frames shown in the graph below, and indicates that the UEP is currently in a position to allow for increased support for students, researchers, and the University community.



Further Perspectives on Investment Performance

The returns of individual asset classes in the UEP are measured against their respective benchmarks. The total fund return is measured against the benchmark outlined in Exhibit 6. The difference between the UEP and its benchmark return reflects the impact of strategic allocation decisions by Management together with active management decisions by our external managers.

The UEP return of 8.0% outperformed its benchmark return of 7.0%. The outperformance is primarily attributable to security selection within growth strategies, specifically global equity. In aggregate the UEP's active public equity managers were able to add value during a relatively strong period for equities. With respect to allocation, the value added by the overweight to global equity also contributed positively to performance as did an overweight allocation to natural resource equity. The underweight allocation to diversifiers was also a positive contributor to relative performance as this strategy performed poorly during the year.

Exhibit 6

UEP Investment Policy Benchmark

| | |
|---|-------------|
| MSCI Canada IMI | 15% |
| MSCI World IMI | 45% |
| MSCI Emerging Markets IMI | 10% |
| IPD/Realpac Canada Property Index | 5% |
| S&P Global Natural Resources Index | 5% |
| Dow Jones North America Select Junior Oil/Gas Index | 5% |
| FTSE/TMX All Federal Bond Index | 10% |
| HFRI Fund of Funds Composite Index | 5% |
| | <u>100%</u> |



Growth

Public equities in aggregate generated robust returns over the past year. Diverging monetary policy from central banks led to an uptick in volatility towards the end of the fiscal year resulting in an attractive environment for active managers. Emerging markets generated strong returns while some developed markets lagged, particularly Canada. With respect to the UEP, managers with a quality- growth and small cap approach outperformed their value orientated and low volatility counterparts.

The UEP's existing private equity funds in secondary and venture capital strategies continued to call capital and progress through their initial investment periods. During the year a follow on investment was made to a secondaries fund through an existing manager relationship.

Together with the newly appointed private markets advisor, Management has developed its implementation plan for private equity that will serve as a guide to identify and execute on investment opportunities over the coming years.

Inflation Sensitive

Real estate investments generated modest returns in aggregate with the majority of returns coming from income rather than capital appreciation. The UEP's core funds in Canada and the US continue to perform as expected, while value added strategies in the US and Europe are continuing to sell buildings on an opportunistic basis.

Natural resource equity produced healthy positive performance while publicly traded energy investments were down sharply as performance between the companies and the underlying commodities diverged materially. The UEP has exposure to these asset classes through exchange traded funds that performed in line with the indices being tracked.

The UEP's existing private equity energy funds continued to call capital and are nearing the end of their investment periods. During the year three additional co-investments were completed through an existing relationship.

Deflation Hedging

The Canadian Federal government bond portfolio produced a negative return for the second straight year, and underperformed its benchmark index as interest rates increased sharply across the yield curve particularly at the shorter end. The portfolio continues to be managed with an emphasis on capital preservation in order to support endowment spending during times of capital market stress.

Diversifiers

The UEP's absolute return strategies, in aggregate, also recorded a loss as managed futures performed poorly during the year. While the strategy was able to profit from the uptrend in equities, this was offset by losses in commodities, currencies and interest rates. Cash was maintained at a level higher than is typically expected and helped to somewhat mitigate this loss.



Responsible Investment

The University's Statement of Investment Principles and Beliefs (SIP&B) was modified in 2017 to include the following statement on responsible investment:

As a long-term investor, the University of Alberta believes that investments in companies with positive attributes such as high ethical standards, respect toward their employees, human rights, and a commitment to the communities in which they do business can improve long-term financial performance. Conversely, investments in companies that manage their environmental, social and governance (ESG) risks poorly can negatively impact returns. The university believes that a proactive approach of engagement on ESG risks and opportunities is more constructive than excluding particular investments.

In addition the University Funds Investment Policy was revised to include the following:

As a responsible owner, the University will regularly engage and collaborate with its active investment managers on matters related to environmental, social and governance (ESG) risks and opportunities.

Specifically the University will:

- *Integrate the consideration of ESG factors into the investment process as an additional criterion in the selection and ongoing monitoring of active investment managers.*
- *Regularly review and track the engagement of active investment managers with their investee companies and their proxy voting records on ESG related issues.*
- *Obtain and evaluate annual disclosure from all active investment managers on how ESG factors are incorporated into their investment decision making processes.*
- *Collaborate with other institutional investors and industry associations on ESG matters where appropriate.*
- *Disclose and publish a detailed listing of its investments annually, and report on ESG matters in the Investment Committee's annual report.*

Management has initiated the actions outlined above; and will once again publish its holdings online. As of March 31, 2018 the UEP had 87% of its assets managed externally. Of these assets, 88% were managed by signatories to the Principles for Responsible Investment (PRI), a United Nations sponsored organization founded in 2005 and leading proponent of responsible investment. An additional 6% of assets are with managers who belong to the United Kingdom's Stewardship Code or Global Reporting Initiative Sustainability Reporting Guidelines. Thus, in aggregate, 94% of the UEP's externally managed assets are being invested with Environmental, Social, and Governance (ESG) issues taken into account.



Specific examples of engagement or investments undertaken by external managers and Management over the past year are outlined below:

Environmental

During the year, the University co-invested alongside an existing private equity energy manager, who is a PRI signatory, in a company that is seeking to disrupt the market for carbon black, a vital raw material used in the production of tires and industrial rubber products. The current process for making carbon black relies on the partial combustion of crude oil and has significant negative environmental impacts. Instead of burning crude oil, this company's innovative process uses natural gas as the feed stock. This results in the production of high quality cost competitive carbon black, but with 70% less CO₂ emissions, 76% less NO_x emissions and 95% less SO_x emissions. A co-product of the company's process is hydrogen gas (H₂), which will be sold under a long-term contract to an electrical utility, displacing the burning of coal. The burning of H₂ produces no greenhouse gas emissions – only water vapour.

Social

Pursuant to an ESG rating downgrade by an independent rating agency of CEMEX, a Mexican firm specializing in concrete building materials, one of the University's emerging markets equity managers, a PRI signatory, initiated their own ESG review and report on the company. The manager reported on CEMEX's "Zero4Life" program, where information technology is being paired with robust health and safety educational programs, with the objective of achieving zero work place fatalities. The manager also reported that CEMEX has committed to achieving United Nations Sustainable Development Goals by 2030 and has implemented initiatives for 11 of the goals, highlighting those involving commensurate pay, affordable living, and occupational health and safety. Of particular note was the fact that the ratio of entry level pay to local minimum wage at CEMEX stands at 1.4x. Based on their own review, the emerging markets equity manager has maintained its position in CEMEX.

Governance

Walt Disney Company asked that shareholders vote in favour of a compensation package for its CEO that was tied to its planned acquisition of 21st Century Fox. This included stock based compensation that was benchmarked against the S&P 500 Index. The compensation package had a potential value of \$48.5 million USD a year over four years and equity worth \$100 million USD. While one of our global equity managers, a PRI signatory, generally believes that executives should be incented to outperform targets, they were of the opinion that the hurdle in this case was too low and that the proposal was not aligned with shareholder interests. Our global equity manager and other shareholders voted down the compensation proposal. It is rare for S&P 500 companies to fail in securing shareholder approval for executive compensation.

Investment Performance Relative to Peers

The University of Alberta participates in benchmark studies sponsored by the Canadian Association of University Business Officers (CAUBO) and, in the United States, the National Association of College and University Business Officers (NACUBO) in conjunction with Commonfund. The most recent published data from CAUBO is for the period ending December 31, 2016. This data may make shorter-term comparisons less than informative due to timing. The University's ten year return of 5.8% for the period ending December 31, 2016 was comparable to the CAUBO 10 year median return of 5.6%.

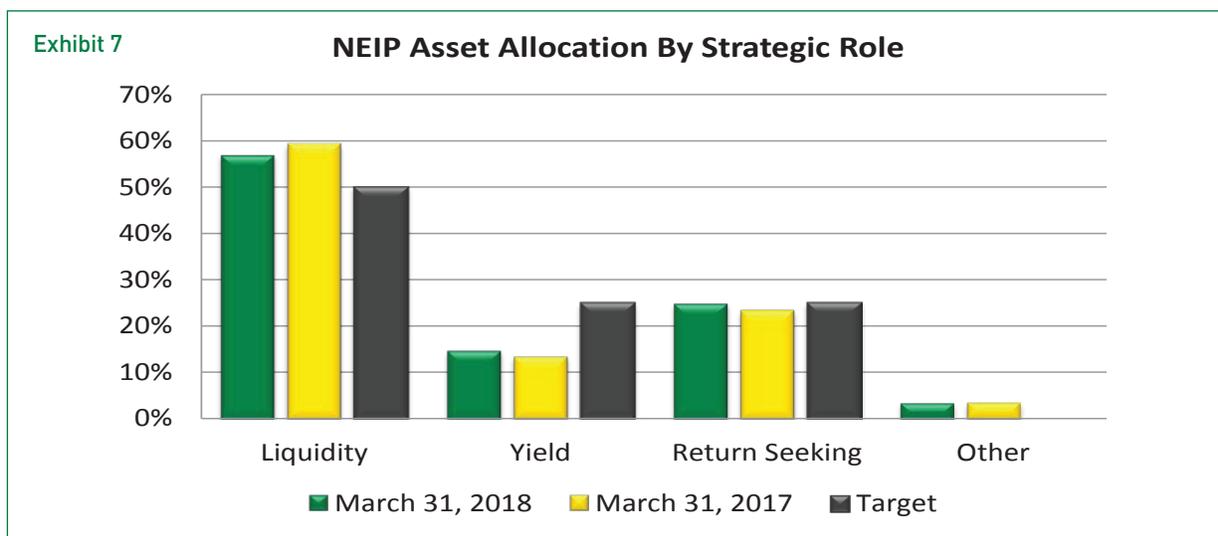
Costs

The fund incurred direct expenses (investment management and custodial fees) of \$8 million or 0.6%. As a percentage of assets under management, these costs are consistent with those of the prior year. An administrative fee to support centrally funded indirect costs associated with endowment programs is charged to the endowments. For 2018 this amounted to \$6 million or 0.5%.

Non Endowed Funds

The Non-Endowed Investment Pool (NEIP) represents the University's operating, capital, and restricted funds and are pooled together for investment purposes until required. Long-term cash flow projections indicate that a substantial portion of these funds will likely not be required on an urgent or unplanned basis. Accordingly, Non-Endowed funds are invested across three distinct strategies with varying maturity profiles as summarized in Exhibit 7.

- To meet the University's cash flow requirements, the Liquidity strategy is focused primarily on the preservation of capital and invests in high quality money market securities maturing within one year.
- To enhance earnings while remaining focused on the preservation of capital, the Yield strategy maintained its investments in government and Canadian bank issued bonds maturing within five years.
- To further enhance long-term earnings, the Return Seeking strategy accesses global public and private markets by investing in the UEP.



The NEIP recorded an overall return of 2.9% for the year which outperformed its benchmark return of 2.0%. Investments in the Liquidity strategy accounted for 57% of NEIP holdings as at March 31, 2018 and returned 1.3%. This exceeded the 91 day benchmark return of 0.8% due to the continued focus on longer-dated (up to one year) provincial and bank issued products and contributed positively to overall NEIP performance.

The NEIP's Yield strategy returned -0.1% but outperformed the benchmark return of -0.4% given the strategy's higher credit quality. This outperformance was also accretive to overall NEIP returns due to an underweight allocation. The poor absolute returns reflect this year's rising interest rate environment. To generate higher returns on funds not required for immediate expenditures, the revised Yield strategy will focus on investments with low correlations to equities, higher expected returns, and a time horizon of up to ten years. Allocations to Canadian and global fixed income, preferred shares, mortgages, private credit, and absolute returns are being considered.

The allocation to the Return Seeking strategy (UEP) performed strongly and significantly enhanced the NEIP's overall absolute performance.

The NEIP has benefited from its allocations to the Yield and Return Seeking strategies over the longer term. The 10 year annualized returns reflect both the global financial crisis and continued low interest rates around the developed world. Over this time period the NEIP returned 2.8%, compared to the FTSE TMX Canada Treasury 91-day Index return of 0.9%.

Closing Thoughts and Outlook

Following another year of robust investment results the real value of the UEP remains strong, allowing for increased spending to benefit students, researchers, and the University community. Over the past year, the Investment Committee completed significant changes to the UEP Spending Policy and University Funds Investment Policy that will shape the long-term strategic direction of both the UEP and NEIP. This review saw the formal introduction of a commitment to responsible investment with increased emphasis on reporting and monitoring of Environmental, Social, and Governance (ESG) issues through the relationships with our external investment managers. Over the next year Management will increase its investment manager monitoring and compliance capabilities with particular emphasis on ESG. In addition, the proposed development of enhanced risk budgeting will assist Management with assessing the ongoing appropriateness of all existing investment strategies and external managers and to better understand underlying sources of risk in the University's investments.

Under the purview of the Investment Committee Management will carry out the continued implementation of both the UEP and NEIP's strategic asset allocations over the coming year. With respect to the UEP, ongoing projects in commodities and diversifiers will be completed, and the strategic allocation to private equity will continue to be developed. The NEIP's revised Yield allocations will also see capital deployed in global fixed income, preferred shares, mortgages, private credit, and absolute return strategies. Moving forward additional focus will be placed on ensuring the risk profile of the UEP and NEIP remains consistent with their respective objectives and time horizons.









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