Pedagogical Notes | MIPC 2019

Mind the GAAP | HEC Montreal

Proposal at a Glance

Mind the GAAP (MTG) proposes a comprehensive and sustainable investment strategy to fulfil NLPIB's dual mandate while balancing both environmental and social responsibilities. The team has developed a three-pronged strategy from a macroeconomic standpoint: 1) Increase sustainability of direct investments, 2) Diversify fund assets globally with additional asset classes, 3) Expand investment reach into local industries.

Portfolio Construction

MTG's proposal focuses on NLPIB's mandate to maintain an optimal return and sustainably contribute to the NL economy. Given the unachieved target return over the past decade, MTG's strategic allocation will maximize return per risk through a 13% increase in public equity, a 4% increase in alternatives investments and a 17% decrease in fixed income allocation, as well as a floor of 25% for fixed income in order to have adequate liquidity. The proposal recognizes that an immediate, complete divestment of NLPIB's oil assets despite rising costs in oil and gas (O&G) would be irrational for an economy depending on this sector. However, to achieve higher returns and stability, NLPIB should expand its investments into more global markets and asset classes, as well as focusing more on NL's local industries.

Increasing Sustainability of Direct Investments

In its proposal, MTG shuffles NLPIB's stakes in the fund's direct investments to improve the sustainability of the portfolio. More importantly, the fund continues its participation in NL's key industries, including offshore oil, mining, aerospace, tourism and energy, as part of its effort to ensure environmental and social responsibility in the province's economic advancement.

NLPIB's stake in the **South White Rose** oil field will be divested partially, given NL's dependence on the O&G sector and the fund's retained influence to promote low-carbon technology. The increasing risks of such dependence, the lower contribution of the sector to local employment, and the expected lower demand in fossil fuel due to environmental concerns are key factors contributing to this divestment. Prospective buyers of the fund's stake would be major O&G companies with operations in NL.

The fund should maintain its investment in the **Labrador Iron Ore**, as it has been a sustainable investment for 50 years and ensures another 25 years of production. It brings stable revenue from its outstanding iron quality and capital performance. A steady demand for iron ore and pellets is also expected to supply iron needed in automobile manufacture and infrastructure development of emerging countries.

The position in **St. John's International Airport** is held, in order to profit from NL's growing tourism with an expected $2 billion in annual spending by 2030. Moreover, the investment benefits NL's second largest employment sector and lowers the province's dependence on natural resources. Since the airport already delivers strong financial results and completes expansion projects within budget and timeline, MTG suggests that NLPIB reinvests its profits in sustainable tourism facilities.

NLPIB's financing in **Muskrat Falls** should be reorganized into a 3% equity participation and a 5% financing position. Despite doubling initial costs and contaminating indigenous food supply, the project will provide energy to 98% of NL residents and a perpetual investment horizon and revenue stream to the fund. The investment is backed by the federal government and Nalcor's exclusive power purchase agreement with the province, while excess energy can be exported to the North American power grid to produce greater profit.

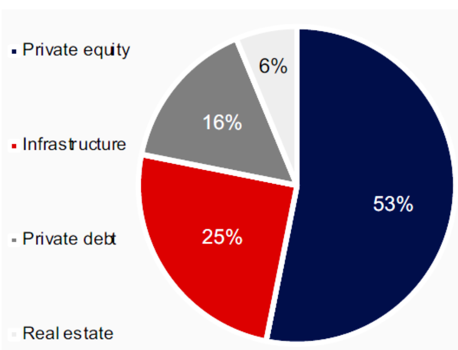
Diversification of Indirect Investments

MTG proposes to reduce NLPIB's home bias towards Canadian indirect investments in favor of greater exposure to international markets. The fund could further diversify its portfolio by expanding into more asset classes, such as private equity, real estate, and infrastructure.

Public equity exposure should be increased in Canada, US, EAFE, and EMEA, while NLPIB can increase its **private equity** holdings through pooled funds or direct PE investments, the latter being an integral part of MTG's third strategy. In addition, 2% of total assets is allocated to iShares Global Clean Energy (ICLN), which will gradually increase to 5% of total assets to benefit from global shifts towards renewable energy.

Fixed income assets are entirely Canadian in the current portfolio. NLPIB should divest from the iShares Canadian Real Return Bond Index (XRB), as direct investments will serve as inflation-hedging assets in the proposed portfolio. As higher yielding bonds are expected to outperform under stable interest rates, the fund should replace the two other bond ETFs in the portfolio with North American corporate bond indices and the emerging market sovereign debt index to increase returns and exposure to international corporate debt.

Alternative investments should be increased to 32% to benefit from higher returns, which include the current direct investment holdings and previously mentioned direct PE expansion. Due to underperformance relative to the S&P 500 index, the fund's holdings of publicly traded private equity should be reallocated to real estate and infrastructure partnerships with larger institutional investors, and possibly, acquisitions or creation of companies involved in the two asset classes.



Expanded Reach into NL Economy

NLPIB's investment reach into the provincial economy should be expanded by investing 3% of current AUM in small and medium enterprises (SME), which generate positive economic and environmental impacts and support the development of local industries including ocean technology, aquaculture, and tourism.

The global ocean technology industry is expected to double in growth and be valued at 3 trillion USD by 2030. Fortunately, NL provides the harsh climate needed for ocean technology development, and St. John's is an industry hub for innovators and academic institutions.

The aquaculture industry is backed by the current intellectual and capital resources that NL possesses, in addition to the rising global seafood market with a 274.8 billion USD valuation by 2025. Already attracting corporate salmon farmers, NLPIB could help create employment growth by investing in development of supply chains in the industry.

As part of an increase in alternatives, MTG proposes investments in offshore wind farms and green real estate as real assets in renewables hedging against inflation, but more importantly, they support sparse rural communities and their economic growth. NLPIB should also have teams with mandates revolving around NL-specific investments, including those in PE, real estate, and infrastructure. The fund could even develop local innovation initiatives, such as start-up hubs and sponsored competitions to discover promising talent among NL's SMEs.

Final Considerations

MTG proposes an in-depth strategy to solve NLPIB's issues surrounding sustainable investments mainly through the lens of macroeconomic factors. To be more environmentally responsible, they recommend a partial divestment of the South White Rose oil field and allocated indirect investments to an ESG ETF. Differing from other teams, MTG recommends reorganizing NLPIB's indirect investments to reduce Canadian exposure in favor of higher-return international markets, while increasing alternative holdings with a focus on NL's most competitive industries. The increased risk-adjusted returns, the committed investments to the local economy, and a more ESG-concerned strategy will benefit stakeholders and enable the fund to better reach its targeted return.