How Does Macroeconomics Affect Your
Fiduciary Duty in Evaluating Investment Risk?

Remarks by

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Congratulations on graduating from the Directors College. I would like to extend special congratulations to John Weatherup, Darren Soanes, Peter Paul Bloemen, John Fleming and Marnie Niemi-Hood --- all from OMERS -- who graduate with this class… as you can see, OMERS is a big supporter of the Directors College.

You have learned a great deal about the mechanics of governance … how boards can work better and govern better. This education will serve you well in clarifying your role as a director in relation to your board colleagues, management and stakeholders.

But being a good director … being an *exceptional* director … is much more than governance manuals and boardroom dynamics. It is much more than legal compliance and financial metrics.

It's about *passion* for the enterprise you will be charged with supervising.

What is the enterprise good at?

Is it well managed and properly financed?

Does it have a vision? Is the vision embedded in a strategic plan that defines the entity's long-term purpose?

What are the risks from forces outside the control of the board and management?

Trying to answer these questions is why I say to you that being a director is more an art than a science. It is a *qualitative* experience based on knowledge and judgment … rather than a *quantitative* experience driven by binders on governance and computer-generated numbers.

Early on, you took a course on strategic thinking versus strategic planning. The course material included a McKinsey survey of 4,200 directors at companies around the world.

These directors complained that they spend too much time on short-term financial matters and performance … and not enough on strategy and risk.

The very surprising finding was that only a tiny percentage of directors fully understood their company's long-term strategic direction.

And only one director in ten had a complete understanding of the risks the company faces.

So the next time you are asked to join a board, call a couple of directors on that board and ask them to explain to you the organization's strategy and principal risks… in particular, how the organization develops its strategic plan… and how directors participate in the evolution of such a plan and the ongoing monitoring of the plan.

When I became CEO at OMERS in March 2007 … one of my first initiatives was to develop a rolling five-year enterprise-wide strategic plan rather than the customary one-year plan… as organizations such as ours need to look far out into the future.

I engaged senior and middle managers from various functions to research opportunities and risks and make recommendations.

I involved OMERS board of directors in the strategic planning through special board meetings and questionnaires … as well as in many informal discussions.

The board's involvement simply does not end there.

Our directors meet every month as a board or as the investment committee.

One month, as the board, the directors review what's going on in the entire enterprise through reports from the audit, governance and other committees of the board.

In addition, the Chair and CEO provide regular reports on strategic, regulatory and reputational issues that impact the pension plan and its brand.

The next month the directors, as the investment committee, focus exclusively on specific investment updates and proposals and investment performance metrics.

Here's the important point. Every board and investment meeting includes time for a strategic discussion or questioning.

At these meetings, OMERS management provides the directors with an update on strategic initiatives and the broad economic environment in which we operate… then the discussion starts… The discussion may last 30 minutes or an hour.

In short, the OMERS directors are engaged in strategy on a regular basis throughout the fiscal year.

I have learned from this experience … and from serving on corporate and not-for-profit boards … that it is essential for directors to be in continuous touch with strategy.

There is however a caveat.

To get comfortable with strategy … it is essential to stay on top of macroeconomic forces at home and abroad. Such knowledge will help you to anticipate risks that could surprise the enterprise you govern.

So let me comment briefly on three macro-issues.

First, how macroeconomics creates context for viewing strategy from the boardroom table.

Secondly, how macroeconomics helps to define risk.

Thirdly, how macroeconomics shines the light on excessive leverage as a root cause of many bad strategic decisions.

Let's start with macroeconomics as a context for strategy.

A common macroeconomic tool of policymakers is fiscal policy … ostensibly to create economic stability. Fiscal policy is supposed to create surpluses in the good times when tax revenues are rising … and tolerate deficits in the hard times to stimulate the economy and help the unemployed.

Consequently, any deficit should be eliminated over the business cycle … hence the expression *cyclical deficit*.

There is another deficit which I call the hideous deficit. It is referred to as the structural deficit. It does not disappear over the business cycle and is a killer of economic growth.

It is the equivalent of an individual making a net salary of $100 and spending $150 year-in, year-out.

A structural deficit can only be corrected by either raising taxes or cutting government programs… or for the individual, making a higher net salary or cutting his or her expenses.

At its core, structural deficits are primarily driven by demographic change … typically an ever declining taxpaying workforce and an expanding retired population. Both of these forces create financial havoc on the finances of governments.

For you as a director, structural deficits will change the economy's fundamental supply/demand equation of the entities which you will oversee. It will ultimately drive up interest costs of entities which rely on access to the debt markets.

It will increase the tax obligations of the entities you will govern.

Structural deficits will ultimately lead to inflationary pressures which will lead to increased salary costs and pension costs.

These increased costs will reduce profit margins and negatively affect everything from research and development to productivity gains through investments in technology.

Your task as directors… and it is not an easy one… will be to shift through these factors and understand the impact on the particular entity you govern.

In an economically integrated world, the fiscal policies of other nations should also be of keen interest to you as a director.

It is unwise for any country to continuously spend far more than its income. But that is what is happening in many nations. Greece, Spain, Portugal, Italy, the United Kingdom, Japan and now the United States have deficits now greater than 10 per cent of their GDP. That is well above an economically sustainable level.

Fiscally failing states can spell trouble for the corporate strategy you oversee. So how should you react?

Here's one idea for tonight.

Skilled professionals and trades people tend to emigrate from economically distressed countries to those with a more promising future.

As a director, maybe you encourage management to look abroad for skilled personnel as part of a long-term strategy.

Such an initiative could compensate for the skills that will be lost as our trained Canadian workforce shrinks in the not too distant future. It will also help to sustain and increase productivity.

So take an interest in the federal government's immigration policy and how it will bring to Canada the skills we need.

In short, paying attention to the fiscal policies of other nations can have strategic benefits for the companies you will supervise.

Let's turn to how macroeconomics helps to define risk.

This is where monetary policy is relevant. It attempts to manage credit and inflation through the money supply and interest rates.

Recent experience shows how the nasty impact of persistently low interest rates encouraged businesses and consumers to borrow heavily beyond their means.

Many companies bought other companies with little regard for price and risk because money was so cheap.

Consumers in the United States bought homes because their mortgage payments were unbelievably low, on the belief that house prices will rise forever.

Cheap money created the illusion that risk had disappeared. And that led to the housing bubble that shook the world.

Even institutional investors … including pension funds … got sucked in. They bought credit-based securities on real property that had no risk history or certainty of repayment.

I'm glad to say that OMERS did resist. These newly created credit securities carried too much risk for us. I am happy to tell you that we only invest in securities that we understand and can explain.

In the wake of the 2008 financial crisis something ironic has happened … everyone is treating risk as an infectious disease. Risk has become cloaked in legalistic layers of anxiety and potential reprisals.

In essence, in our rush to find blame and fault, we have lost the purpose of risk. Risk-taking by business drives – and should drive – strategic vision and corporate creativity. It should advance product and service innovation, economic growth and job creation.

The problem is not -- and should not be -- risk-taking … but rather understanding risk and managing it responsibly.

And that's your job as a director.

This brings me to my third point -- excessive leverage.

Excessive risk-taking using borrowed money is the common thread in recent financial crises … in the failure of firms, regulatory systems and economies.

And it applies as much to governments as to businesses. Greece is a current example that has sent concerns through the Euro-zone.

At OMERS, we have a disciplined approach to risk and leverage. Let me use the example of infrastructure investing.

In 2005, we decided to be very cautious in investing in infrastructure. Cheap money encouraged many competitors to borrow heavily and bid up prices just to win deals. We passed on many projects and lost bidding wars on others – all with no regrets.

Look… I understand that this is a very simplistic way to look at leverage.

There is a fine balance between protecting the liquidity of a company and satisfying the interests of its shareholders … between keeping the company solvent and financially rewarding the shareholders.

Leverage plays a pivotal role in this equation. So what is your responsibility as a director to get this equation right?

There is no magical solution. At a minimum, you are expected to understand the company's leverage practices and how they change over time. You are expected to know how its debt/equity ratio compares with competitors. You are expected to find out whether all its financial obligations are clearly outlined on the balance sheet.

My suggestion to you, from the macroeconomic view, is to consider the macro-prudential approach recommended by Bank of Canada governor Mark Carney… as a way of getting an overall feel for leverage. It involves looking at broad economic and financial conditions that can contribute to the buildup of leverage in the financial system and economy.

Mr. Carney suggests that a combination of growth in business credit and real estate prices is a good predictor of pending financial stress in the economy and should give you ample warning of when change will occur… and help to protect against being caught in an asset bubble.

In recent years, we have witnessed bubbles ranging from commodities and commercial real estate to the dot.com catastrophe earlier this decade and the global credit crisis of 2008.

What's the next bubble? Is it the domino effect of debt-ridden nations in Europe and potentially the United States? Or is it economic turmoil in China? Or perhaps something else?

The China/U.S. situation could be a big worry. As a matter of state policy, China produces far more than it consumes. The U.S. historically consumes far more than it produces.

The difference between Chinese production and U.S. consumption flows as U.S. dollars to China – which are then lent back to the U.S.

There is growing anxiety that a new global economic crisis could be triggered should China decide for political or economic reasons to dump large amounts of U.S. dollars.

So, as you can see, there are lots of macroeconomic forces to worry about, synthesize and apply to the organization you will govern.

In conclusion, let me restate what I said at the beginning.

Being an effective director is not only about governance manuals and legalities. It is mainly an art.

Being an effective director means understanding the strategy of the company you govern – and the risks it faces in pursuing that strategy.

Consequently, making the effort to stay in touch with strategy at every board meeting … and making the effort to understand macroeconomic forces that can throw that strategy off track … will serve you well in carrying out your duties.

My final point.

If you do not understand this macroeconomic stuff – you have two choices.

Don't serve as a director. Just kidding!!!

My recommendation is for you to ensure the board on which you serve is properly briefed on macroeconomic issues by internal and/or external experts. After all, it is your fiduciary responsibility to understand what you are supervising.

Thank you … and once again, congratulations on your graduation.