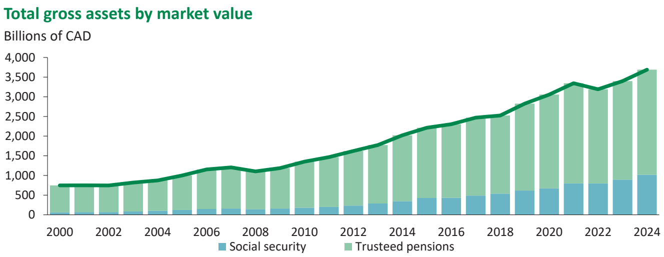
ECONOMIC VIEWPOINT

Pension Funds Bringing Home the Bacon?

By Mirza Shaheryar Baig, Foreign Exchange Strategist

Canada's pension funds manage around CAD3.6 trillion in gross assets. Of this, about $1 trillion is managed by social security (CPP and QPP) and the remaining $2.6 trillion is managed by various employer-based or trusteed pension plans. Pension funds primarily operate as "real money" investors with limited leverage. Most of their investments are in foreign assets, while their liabilities are predominantly denominated in CAD. Due to their large size relative to the domestic market, any shift in their asset allocation or currency hedge ratios can have a significant impact on financial markets, and current market dynamics suggest that there is some scope for change.

Graph 1
Canadian Pension Funds Have over CAD3.5 Trillion in Assets



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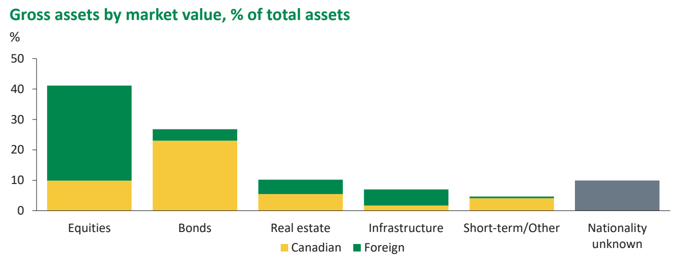
Buy, Buy, Diversify!

Canadian pension funds are widely regarded as trailblazers in the industry, particularly for their innovative approach to international portfolio management. They have consistently outperformed their international peers over the last decade. Their success is attributed to independent governance, professional in-house management, scale and extensive geographic and asset-class diversification. Their portfolio construction incorporates objectives such as long-term growth, asset and geographic diversification and risk mitigation. Investment teams typically have some discretion to manage exposures in each asset class or factor beta within strategic ranges set by their boards.

Larger institutions often remark that they have outgrown the opportunity set available in Canadian markets. This is evident in the overall trend in asset allocation, which increasingly favours foreign assets and a higher share for private equity and real assets (infrastructure and real estate). The charts below illustrate this.

Graph 2
Asset Allocation of Trusteed Pension Plans, Q3 2024



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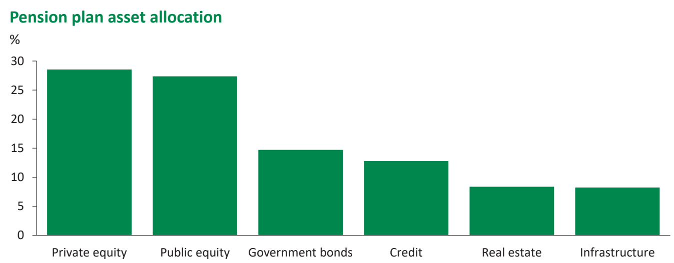
Graph 3
Asset Allocation of Social Security, 2024



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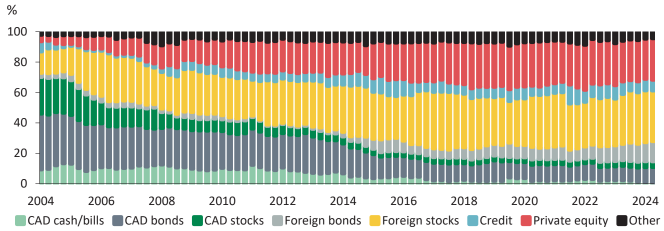
Graph 4
Asset Allocation of Social Security

Gross assets by market value, % of total assets



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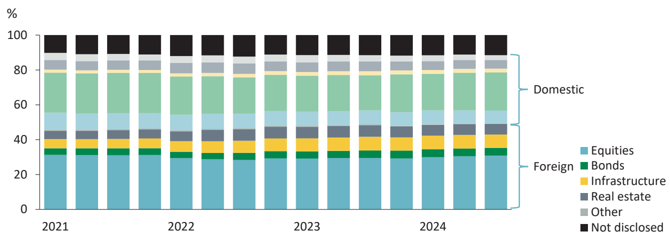
Graph 5
Trusteed Pension Plans: Allocation to Foreign and Canadian Assets

Gross assets by market value (% of total assets)



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Passive Flows

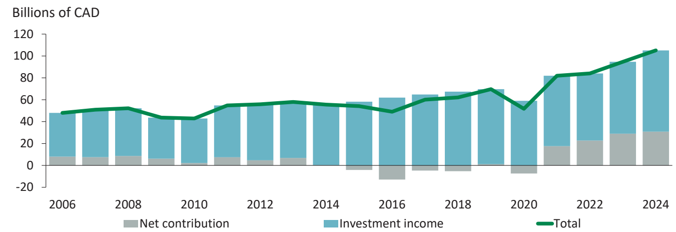
Pension funds need to purchase financial assets to put their net cash surplus to work. This approach is essential to increase their asset base and meet future pension liabilities. The net cash flow for pension funds consists of three key components: contributions from active workforce members, benefit withdrawals to retirees and investment income from financial assets.

In 2024 this net cash surplus was around CAD105 billion, of which CAD31 billion was derived from a surplus in net contributions and the remainder was derived from investment income. Net contributions have increased since COVID thanks to a surge in nominal GDP and population growth. Investment income was boosted by higher interest rates. Looking forward, Canada's population growth is set to slow sharply this year, and interest rates are going down in most countries. As such, we estimate that the net cash flow-driven purchase of financial assets will likely remain around the 2024 level.

Pension funds typically need to sell CAD to buy USD. Our very rough calculations suggest they need to place CAD45 billion into foreign stocks and bonds alone. However, since a portion of the investment income they would reinvest is earned in US dollars, the funds can be recycled without any need for forex conversion. Unfortunately, we don't have data on the currency composition of investment earnings, which makes it difficult to make an accurate estimate for this. Moreover, ex-post relative market returns force pension funds to rebalance their portfolios regularly. This typically includes selling outperforming assets and buying underperforming ones to ensure the portfolio remains aligned with its targeted allocation weights.

Graph 6
Net Cash Flows to Canadian Pensions (Net Contributions + Investment Income)

Around CAD150 billion needs to be invested in financial assets per year



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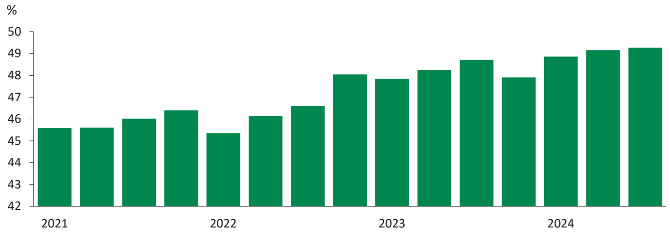
Bring It Home!

Recently, there has been talk about encouraging Canadian pension funds to invest more in local assets. The 2024 Fall Economic Statement adopted several initiatives to improve the investment environment for pension funds. These are tweaks, not major shifts. But it's something the new government could build upon. In fact, there is a potential for a win-win here. Canada will need to expand investment in infrastructure in the coming years, and these projects could be well suited to the funds' long-term investment objectives. Moreover, deepening capital markets and encouraging more corporate listings in Canada would help too. Overall, good macroeconomic policies and an investment-friendly environment could achieve the best of both worlds.

There are big gains to be had. All else equal, a 1% shift of social security funds out of foreign assets would translate to net buying of Canadian assets of around CAD10 billion, and a similar shift for trusteed pensions would translate to CAD24 billion. To put this into perspective, total net issuance of Government of Canada bonds in 2024 was about CAD230 billion. Realistically, the bar is high for this. Foreign assets have returned more than local assets for several years. And it could take time for any changes in government policies to translate to a shift in strategic asset allocation targets.

Graph 7
Trusteed Pension Plans Have Increased Their Overseas Allocations

Percentage of net assets outside Canada



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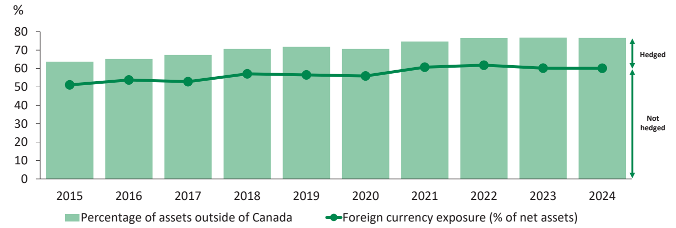
Graph 8
Pension Funds Are Largely FX Unhedged on Foreign Assets

Weighted average of the five largest pension funds



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Currency Hedging

One area where pension funds might move more quickly is to raise their currency hedge ratios. A major share of pension funds' assets are denominated in foreign currencies. Thus, changes in FX rates affect their financial results, which are reported in CAD. While pension funds have different hedging policies, the largest institutions tend to leave their US dollar exposures largely unhedged. This practice is based on the belief that the US dollar is a safe haven currency. Historically, during equity market meltdowns, the US dollar appreciated versus CAD. Thus CAD-based investors would have suffered less mark-to-market volatility in their US equity holdings if they remained unhedged.

However, this belief is now being openly questioned. The loonie has become very undervalued on a range of metrics. And market correlations have shifted—the US dollar was no haven during the meltdown this year, nor in the sell-off last summer. Pension funds are required to be long-term, value-oriented thinkers. The depreciation of the loonie has boosted earnings in recent years. But it would be a mistake to expect this source of alpha to continue indefinitely.

The jury is out on whether the US dollar has lost its safe haven appeal. But if pension funds decide to hedge their bets, even a small shift in their currency exposure would have a significant market impact. We estimate that the largest five pension funds have about CAD1.1 trillion in foreign assets between them, of which about CAD0.9 trillion is not hedged. In short, even a modest hedging program would lead to the Canadian dollar outperforming its usual relationship with fundamental drivers.

Conclusions

- Canadian pension funds will need to invest new cash of around CAD105 billion this year. With their globally diversified portfolio, they are poised to remain major buyers of foreign assets.

- A shift in strategy to increase investments in Canada would significantly enhance local market liquidity. The most promising area for this initiative is long-term infrastructure projects. This would require a larger opportunity set to choose from, which the government can help with.

- Most pension funds have a sizable exposure to the US dollar through unhedged positions in US assets. However, the greenback seems to have lost its safe haven appeal. If pension funds raise their hedge ratios even marginally, the loonie would significantly outperform its traditional drivers like interest rate differentials. Perhaps this has already begun.