Market View
Economics and Strategy
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Climate-aligned asset growth continues apace at la Caisse

By Warren Lovely & Alpa Atha

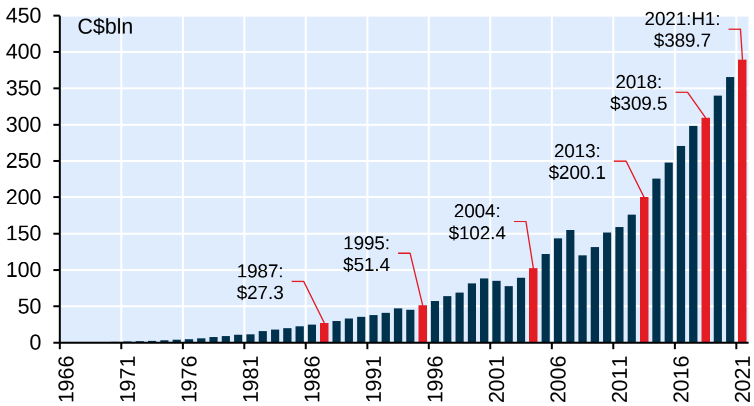
Canada is home to a dynamic and growing array of public-sector entities, a list that includes (but is not limited to) a number of highly rated pension asset managers. Here, we offer something of a close-up on one of the more established names in this class: the Caisse de dépôt et placement du Québec (CDPQ).

Assets ascending

Established in 1965, CDPQ's net assets had blossomed to C$390 billion as of mid-2021 (Chart 1), making it one of the 15 largest pension fund managers on the planet. Looking back, net assets reached C$100 billion in 2004, hit C$200 billion by 2013 and eclipsed C$300 billion in 2018. Barring a major setback in the final stages of the year, net assets are poised to end 2021 north of C$400 billion—this major net asset milestone having been approached quickly.

Chart 1: CDPQ net assets close in on $400 billion

CDPQ net assets: Inception to 2021:H1, highlighting select milestones



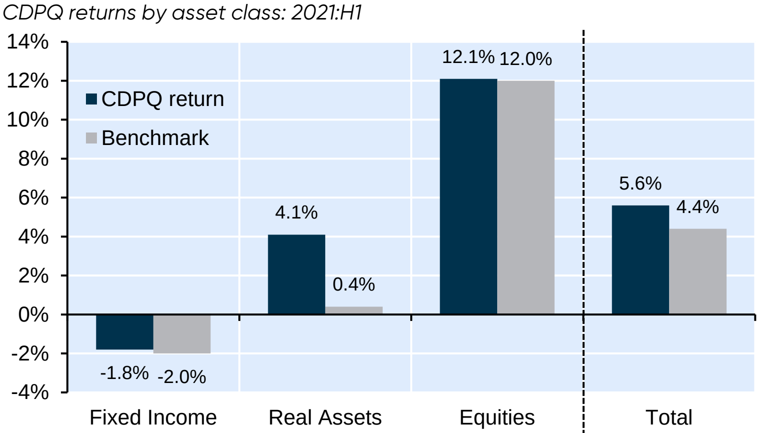
Source: NBF, CDPQ | Note: 2021 as at 30-Jun

Beating the benchmark in 2021 & longer term

The value of depositor holdings at the pension fund manager jumped more than C$24 billion in the first half of the year alone, the vast majority of that growth spurred by solid investment returns. Indeed, a first half investment return of 5.6% bettered the benchmark by some 120 basis points (Chart 2).

Chart 2: First half returns topped benchmark by 1.2%-pts

CDPQ returns by asset class: 2021:H1



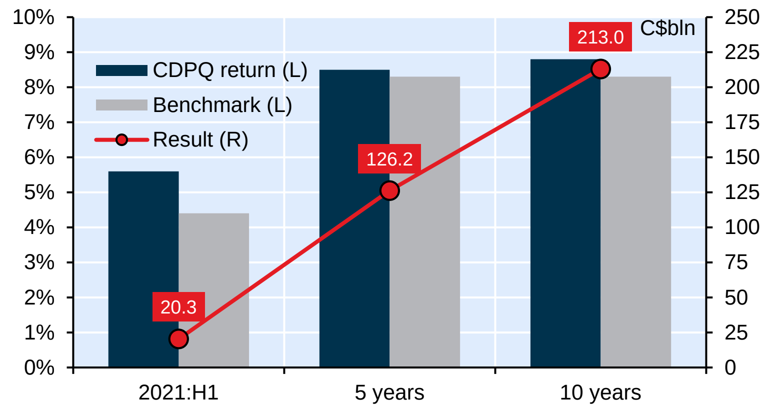
Source: NBF, CDPQ

Real asset returns topped the benchmark by the widest margin in the first half, a performance driven by 'new economy assets' as the portfolio was repositioned. Fixed income was down 1.8% but bettered the benchmark thanks to a short duration call, bond market returns generally feeling the impact of a 'swift and substantial rise in rates'. The equity asset class, meanwhile, posted a 12.1% half-year gain 'benefitting from investor appetite for risk', returns likewise aided by more dynamic management.

Investment results contributed over C$20 billion to net asset growth in the first half of 2021 (Chart 3). CDPQ's investment strategy has secured in excess of C$125 billion over the past five years, where the corresponding 8.5% annualized rate of return compares to 8.3% for the benchmark. The ten-year rate of return likewise tops the benchmark (8.8% vs. 8.3%). Notwithstanding benchmark-beating returns, the depositor base is both broad (40+) and stable (the vast majority of depositor holdings tied to exclusive legislative mandates).

Chart 3: Benchmark-beating performance longer term

CDPQ returns by asset class & net investment results



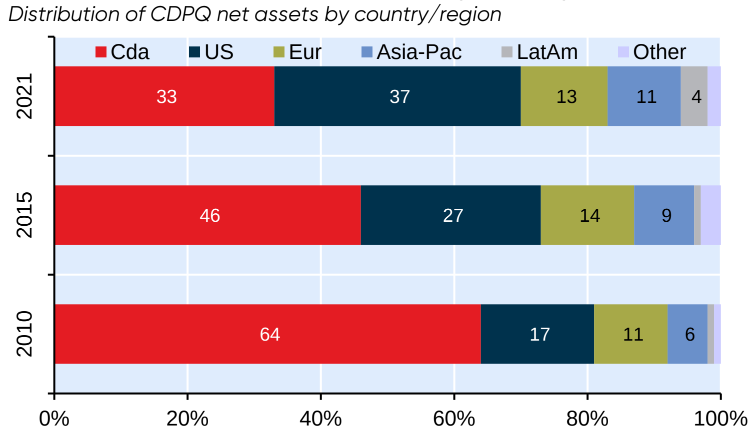
Source: NBF, CDPQ | Note: Investment results net of operating expenses

Portfolio diversification & strategic repositioning

CDPQ undertook a series of strategic global investments in the first half, while at the same time continued to support the reopening of the Quebec economy. A steady stream of acquisitions/investments were outlined in Q3, consistent with an expanding asset base.

Chart 4: International exposure has grown significantly

Distribution of CDPQ net assets by country/region

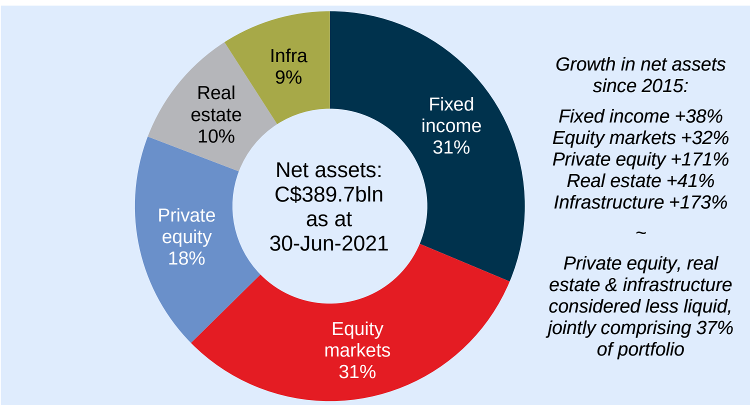


Source: NBF, CDPQ | Note: 2021 as at 30-Jun

CDPQ's net assets are increasingly diversified, both geographically and by asset class. International exposure has been amped up in recent years, non-Canadian assets comprising fully two-third of the portfolio as of 2021:H1 vs. barely one-third a decade ago (Chart 4). Note: Geographic distribution is not to be confused with currency risk. Net exposure to the Canadian dollar was 46% at mid-year, followed by the U.S. dollar (27%), euro (6%) and pound sterling (3%). Net exposure to the Mexican peso, Brazilian real, Indian rupee and Chinese yuan was 2% apiece as of June 2021.

Private equity and infrastructure have accounted for the fastest growth in the past five years, both segments expanding in excess of 170%. Adding real estate, the share of less-liquid assets has increased from 27% in 2015 to 37% as of mid-2021. Mind you, a sizeable and growing liquidity reserve defuses liquidity risk. Cash and high-quality, liquid government securities were worth roughly C$60 billion at the end of June (vs. ~C$50 billion at the end of last year).

Chart 5: Private equity & infra portfolios expand quickest
Distribution of CDPQ net assets by asset class: 2021:H1



Source: NBF, CDPQ

A clear and growing focus on climate change

A new climate strategy was announced in late September, part of the organization's ever-growing emphasis on sustainable investing. The strategy extends some pre-existing goals (e.g., carbon intensity and low-carbon investments) (Charts 6/7), while simultaneously placing a new focus on transition and also confirming a full exit from oil production. Refer to Topic Box 1 for details of the new strategy.

Topic Box 1: CDPQ's New Climate Strategy
(Announced 28-Sep-2021)

With a fresh climate strategy, CDPQ aims to do its part to address climate change. Updated targets build on success initiated via a 2017 climate strategy and are consistent with a broader objective of achieving a net-zero portfolio by 2050.

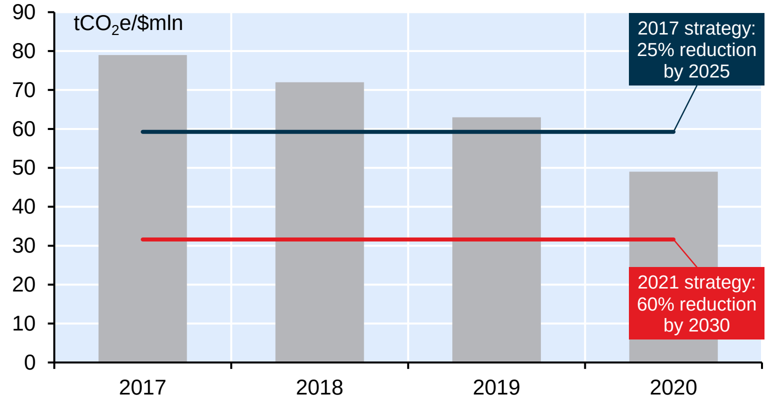
The latest strategy is comprised of four main pillars:

1. Triple holdings of green/low-carbon assets to C$54 billion by 2025, using Climate Bonds Initiative criteria for asset selection;
2. Achieve a 60% reduction in carbon intensity of the total portfolio by 2030, relative to 2017 intensity;
3. Create a C$10 billion 'transition envelop' for decarbonizing the real economy, targeting sectors such as raw materials production, transportation, agriculture;
4. Complete exit from oil production by end of 2022 in order to avoid contributing to growth in global oil supply, with related assets currently 1% of CDPQ portfolio (~C$4 billion).

Details of the 2021 climate strategy can be found here. Additionally, the 2020 Stewardship Investing Report can be accessed here.

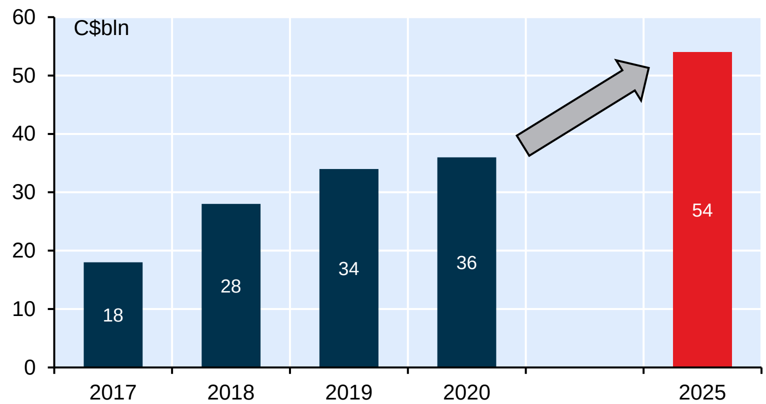
Complementary initiatives like Equity 25[3] aim to advance corporate diversity/inclusion, while a C$4 billion investment envelop helps various Quebec businesses cope with ongoing COVID-related pressures.

Chart 6: CDPQ exceeded initial carbon intensity targets
CDPQ portfolio carbon intensity & climate strategy targets



Source: NBF, CDPQ | Note: Carbon-intensity reduction targets are relative to 2017 level

Chart 7: An expanding pool of low carbon investments
CDPQ low carbon investments, including latest climate strategy target



Source: NBF, CDPQ | Note: 2025 target is 3X the 2017 level

Issuance strategy evolves, broader investor base sought

Consistent with growing climate sensitivity, CDPQ launched its first ever Green Bond in May 2021 (CADEPO USD1 billion 1% 05/2026). This inaugural green financing was issued pursuant to an April 2021 Green Bond Framework (link) that received a second-party opinion from Sustainalytics (link).

The CDPQ's spring green bond was distributed broadly (Chart 8) and represents the sole bond issuance this year… at least so far. We'd note that CDPQ's issuance strategy calls for 'regular benchmark issuance', predominantly in USD but potentially in EUR or CAD, depending on underlying market conditions. Any prospective move to issue outside the U.S. would presumably be consistent a stated desire to 'increase and diversity the investor base globally'.

Credit fundamentals as solid as ever

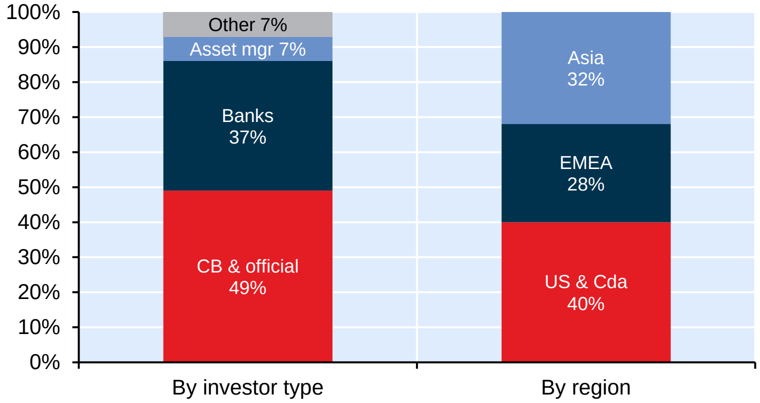
CDPQ's credit fundamentals remain well supported. Top-tier and stable credit ratings are a hallmark here, as at select other large Canadian public-sector entities. Refer to Topic Box 2, page 3 for recent credit rating agency comments.

There are currently US$11.5 billion of marketable bonds outstanding (Chart 9), three quarters of which are due to mature before the end of

2025. Adding in short-term outstandings (primarily sourced from the U.S.), CDPQ's total senior debt ratio remains comfortably below the 10% Board-established limit (Chart 10).

Chart 8: CDPQ launched first-ever green bond in May

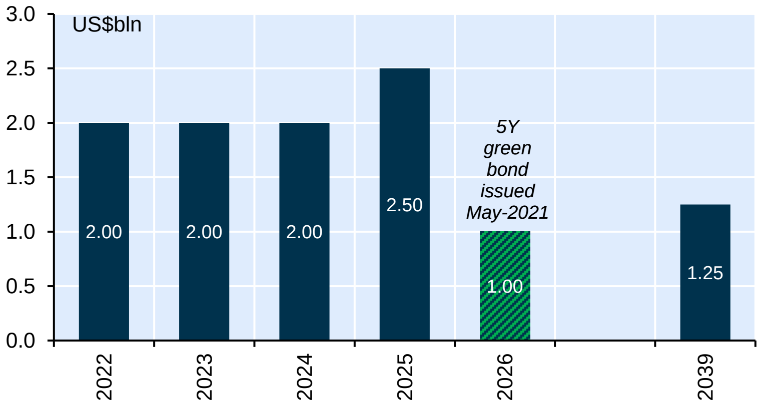
Primary distribution of US$1 billion CADEPO 1% 05/2026 green bond offering



Source: NBF, CDPQ

Chart 9: For now, all outstanding bonds denominated in USD

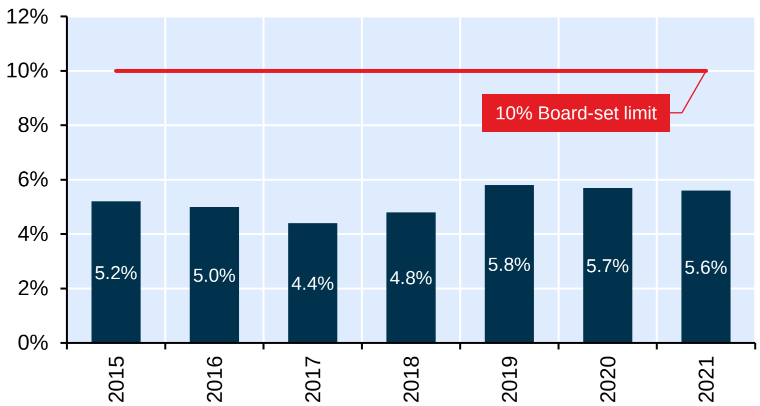
CDPQ outstanding term notes



Source: NBF, CDPQ, Bloomberg | Note: All bonds currently denominated in USD

Chart 10: Debt ratio consistently & considerably below limit

CDPQ senior debt ratio (fair value)



Source: NBF, CDPQ | Note: 2021 as at 30-Jun

Topic Box 2: CDPQ Credit Rating Developments

For as long as CDPQ has been issuing debt, via explicitly guaranteed CDP Financial Inc. (Bloomberg ticker: CADEPO), long-term credit ratings have been top-notch and stable. Recent rating affirmations reiterated core credit strengths, namely: low leverage, ample liquidity, captive depositor base, astute risk management, strong governance, demonstrated independence, solid investment track record and creditor priority vs. depositors.

S&P: AAA/A-1+, 'Stable' outlook | Stand-alone credit profile 'aaa'

"The stable outlook reflects … expectation that Caisse de depot et placement du Quebec will continue to realize good medium-term investment returns, liquidity levels will not materially weaken, leverage will remain low and manageable, and risk management practices will remain sound in the next two years. It also reflects our belief that CDPQ will remain independent of the provincial government." [13-Sep-2021 rating report]

Moody's: Aaa/P-1, 'Stable' outlook | Baseline credit assessment 'aa2'

"[Rating/BCA] reflects the pension asset manager's strong liquidity and predictability of future cash flows, as well as sound financial policies and low leverage. CDPQ's BCA is further supported by our positive view of its funding profile because as a pension asset manager, in contrast to a public pension plan, it does not have a direct funding obligation to pensioners." [25-Jun-2021 credit opinion]

DBRS Morningstar: AAA/R-1(high), 'Stable' outlook

"The ratings are supported by a legislative framework that results in a substantial and captive asset base, a low-recourse debt burden, ample liquidity, and strong operating performance." [2-Jul-2021 rating report]

Fitch: AAA/F1+, 'Stable' outlook

"CDPQ's ratings reflect its exceptionally strong asset overcollateralization and liquidity levels, the creditor priority of debtholders to pensioners, the captive nature of inflows, its experienced management team, solid investment track record, strong corporate governance, and a supportive operating environment and regulatory framework. The ratings also reflect CDPQ's role as an investment manager, which means it is not directly responsible for the payment of pension obligations… this profile is incrementally favorable relative to peers that are pension funds." [8-Jul-2021 rating action commentary]

As previously noted, a sizeable liquidity buffer remains, while stress testing implies substantial asset coverage (17X) relative to senior unsecured debt in the face of a severe stress event. Refer to CDPQ's Interim Consolidated Financial Statements, as at 30-Jun-2021, for additional details on risk metrics.

All told, CDPQ remains a fundamentally strong credit, with a proven performance record and scope for continued, climate-sensitive asset growth. Having long-ago established a name for itself in U.S. debt capital markets, it may be time to consider issuing in other core currencies, namely CAD and/or EUR.

With markets still awash in excess liquidity, there appears ample scope to accommodate marginal issuance, today's tight credit spreads testifying to underlying investor demand. We'd note that Canada's domestic bond market is currently seeing provincial bond issuance projections marked down massively as budget deficits evaporate. With gross provincial bond requirements down as much as 40% vs. earlier budget projections, Canadian dollar bond investors may be casting about for alternative product. For investors hungry for high quality, attractively priced AAA-rated product, CDP Financial and select other public-sector entities would appear to have a growing role to play.

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