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A conversation with CDPQ's Michael Sabia

A leading institutional investor reflects on the industry.

Peter Bisson and Jonathan Tétrault

Michael Sabia joined la Caisse de dépôt et placement du Québec (CDPQ) in 2009, at the depths of the global financial crisis. Since then, the industry has recovered, as has CDPQ, which now has $226 billion under management. In April 2015, he spoke with McKinsey's Peter Bisson and Jonathan Tétrault about what he's learned in his six years on the job.

McKinsey on Investing: *You joined CDPQ at a difficult time for investors. What was your approach to leading the organization's transformation?*

Michael Sabia: First, we looked very closely at the needs of the people whose assets we manage. That was our starting point—we wanted to understand our depositors, their obligations, and what kind of returns they needed in order to meet them. Then, as is the case with all turnarounds, we broke the challenge we faced into two questions: what to do and how to do it.

The "what" of the transformation was a new investment strategy, based on what we call a "business-owner mind-set." Investing as a business owner is the key to everything we do. We have a deeply held belief that operations and operational excellence—not financial engineering—are the sources of durable value creation. I think my experiences working in two industrial companies before joining CDPQ have influenced how I think about this.

Here's an example. When I got here, I met with some of our transportation-research people and I asked for a summary of a particular railroad company's strategy for managing its rail yards. At

the time, they couldn't do it—but now they can. This kind of information is important. What happens in a rail yard is the source of service quality for railroads, and it's the source of cost management. It's fundamental to the creation of value in the business. If you can't answer that question, you shouldn't invest in railroads, because you can't differentiate one company from another.

The "how" was about changing the culture of the organization—that is, how work gets done. This change had three parts. One: we did a lot of work on recruitment and personnel development. Two: we created decision-making processes that are more rigorous and collaborative. A big part of this was breaking down silos—things like changing IT platforms so that the platforms themselves support collaboration, which hadn't been the case in the past. And the third part was a revamp of our compensation program. This is important everywhere, but it's particularly important in an investment institution.

McKinsey on Investing: *Can you expand on the concept of the business-owner mind-set? What does it mean for institutional investors like CDPQ?*

Michael Sabia: If you own a business, you have a deep knowledge of the fundamentals—knowledge that goes way beyond the P&L and the balance sheet. The fundamentals of the business involve, in our minds, its culture, its people, its operations—essentially, the company's value drivers. Having a business-owner mind-set also means understanding

Michael Sabia

Vital statistics

Born September 11, 1953, in St. Catharines, Ontario

Education

Bachelor of arts in economics and politics from the University of Toronto

Graduate degrees in economics and politics from Yale University

Career highlights

La Caisse de dépôt et placement du Québec
(2009–present)
President and chief executive officer

Bell Canada Enterprises
(2002–08)
President and chief executive officer

Canadian National Railway
(1993–99)
Various roles, including chief financial officer

Fast facts

Member of the governing council of Finance Montréal

Former member, North American Competitiveness Council

Honorary chairman of the Bal du Centre hospitalier universitaire de Québec

Cochair, Campaign for Centraide du Grand Montréal

the industry and the competition. And it means being patient, too. But, of course, being patient doesn't mean being complacent. We expect performance over the medium and longer term.

Now, how does that translate into the principles of an investment strategy for a firm like us? It means we have a strong preference for investing in assets that people use every day and that are rooted in the real economy—buildings, ports, IT services, consumer products, and so on. It also means we stay focused on the intrinsic value of a business, which is largely based on a deep understanding of its operations, rather than getting caught up in the smoke screen of its market value. We stay focused on the fundamentals, rather than relying on market indexes. In fact, we're agnostic about benchmarks.

Because of all of those things, and because of the depth of analysis we do, we are very comfortable taking concentrated positions without being overly preoccupied with diversifying within each portfolio—because diversification has steeply diminishing marginal returns. Our view is that the best risk-management tool is deep diligence—not just due diligence, but deep diligence.

McKinsey on Investing: *What does it mean to be agnostic about benchmarks?*

Michael Sabia: Take public equity, for instance. The traditional approach starts with a market index like the S&P 500. By and large, you buy the stocks in the index and adjust the size of your position relative to their market weight depending upon what you like and what you don't like. That style of investing assumes that the market itself is a compass that shows where true north is. Well, I don't believe that markets show you where true north is. I think markets are subject to all kinds of vagaries and exogenous influences. They often reflect fads, not fundamentals—as they say, more noise than signal. We don't believe that an index should be the starting point for an investment process. A benchmark-agnostic approach means proceeding in a bottom-up way, by focusing only on companies you like. In other words, if you believe in fundamentals, and if you believe in operational excellence as a source of value, you build a portfolio from the bottom up, without using the composition of a market as your compass.

So in late 2012, we started building a benchmark-agnostic portfolio in global, high-quality public equities from the bottom up. Today it's a $20 billion portfolio, invested in about 70 different securities, and it's performing well beyond our expectations. We're committed to this path. We've just recently finished converting $20 billion in Canadian equities to the same approach. Of course, investments like real estate, infrastructure, and private equity are—or should be—inherently benchmark agnostic. When we've finished the conversion process a couple of years from now, almost 80 percent of our total portfolio assets will be managed this way.

McKinsey on Investing: *You mentioned a difference between "deep diligence" and "due diligence." Can you talk a bit about your research capabilities, then versus now?*

Michael Sabia: The railroad story I shared earlier is an example of the kind of thing we've changed. Our people are able to answer those kinds of questions now—deep questions about the operations, strategy, and vision of the companies we're investing in. We've also hired geologists, mining engineers, people with experience in consumer products, people with experience in IT companies—people who bring a deep understanding of how value is created in each of these sectors.

I think of it this way: an analysis of a P&L or a balance sheet is like taking a photograph of a company. It's one-dimensional. Our approach to research is more like an MRI. It goes beyond a single

dimension. If you're going to be a fundamentals-oriented investor with concentrated positions, you have to go much deeper than a snapshot.

McKinsey on Investing: *How did you transform these principles—deep diligence, business-owner mind-set—into organizational changes?*

Michael Sabia: Obviously, the first element is people. The change in research is one example of a broader change in the profile of the people we hire. All of our employees are financially capable, of course, but we needed people who are comfortable letting go of indexes, investing for the long term, and who have a deep grounding in operations—be it in companies, infrastructure, or real estate. More than half of our 800 staff members are new since 2009. So there's been a substantial shift in the people we hire. That's one organizational change.

It's not just about new hires though. I don't think the investment industry puts enough emphasis on leadership. Good investors are not always good leaders. So we spent a lot of time and effort on building leadership and structuring compensation, so that we got incentives pointing in the direction we wanted to go.

Finally, in a turnaround situation, you have to take specific steps that demonstrate to the organization that the changes you're suggesting are actually doable. If that demonstration isn't done, the organization will either have a lot of self-doubt, or it will resist change because of the usual status quo bias. For instance, the idea of a benchmark-agnostic portfolio was new at CDPQ. The success we've had so far in converting public equities to this approach has been especially important in mobilizing change because it signaled to the organization that it is, in fact, possible to step out of the traditional thinking. This experience has made it a lot easier to make other changes.

McKinsey on Investing: *How were you able to convince the different stakeholders—the board, the depositors—to embrace such a different approach?*

Michael Sabia: First and foremost, it's important to remember that the financial crisis of 2008–09 was very fresh in everyone's memory. The need for change was obvious. That made building a consensus around a long-term, fundamentals-based investment strategy a lot easier. And as far as becoming benchmark agnostic, whenever I met our depositors or members of our board, I spent a lot of time discussing this simple question: "If there are six Canadian banks, using the traditional investing logic you'd underweight the three you don't like and overweight the three you like. But if you don't like three of them, why would you invest in them at all?" And the answer was always, "That's a good question."

That simple question took us pretty far. If you're a fundamentals-oriented investor and you don't like three banks, don't own them. It doesn't matter that they're in the index. We never had any serious pushback from any of our stakeholders. On the benchmark-agnostic issue, the biggest challenge was internal. There were a lot of people in the organization who just didn't believe the new strategy was doable. That's why it was so important to take steps to demonstrate it was possible. We were fortunate that the creation of the first benchmark-agnostic portfolio went so well and could serve as proof.

McKinsey on Investing: *Investors are deploying more and more capital in alternative investments. What's your sense of the rise in competition? How is CDPQ approaching alternatives?*

Michael Sabia: Increasing our exposure to alternative assets is a centerpiece of our plan. That said, when faced with a crowded market, you

have to differentiate. Capital is a commodity, it's not a differentiator. In our minds, our ability to differentiate involves two things: how we analyze the investment opportunity and the operational value added that we bring.

Our work in real estate is a good example. Our subsidiary Ivanhoé Cambridge runs our $32 billion real-estate portfolio. This is a group of 1,700 people who not only invest in but also build and operate shopping centers and office towers. Because of that, because they are in the market, operating buildings, finding tenants, they have much deeper insights into the intrinsic value of a property, beyond the traded value of properties. That's the analytics part.

The second point is that when we acquire a building, alone or with partners, we're not just bringing capital to the table. We're bringing an operating capability that enriches the product. This is why we're planning to build a new subsidiary to handle our infrastructure business in a manner that will be similar to what we do in real estate. Again, it comes back to operations. Investment expertise is always important when it comes to differentiation, but it's not enough. It's about marrying investment and operational expertise.

McKinsey on Investing: *Your new model for infrastructure has attracted a lot of international attention. What is it exactly, and what's your plan for it? And can you say how it differs from the classical public–private partnership?*

Michael Sabia: As we all know, there is a tremendous need for new and better public infrastructure, and not just in places like India and China—the United States needs trillions of dollars of infrastructure, too. But governments are significantly limited when it comes to providing that infrastructure—there are fiscal constraints and constraints from indebtedness as well.

Our new platform will do several things. First, it will take greenfield-infrastructure projects off governments' balance sheets—a significant difference from typical public–private partnerships—while still safeguarding government's role in defining a project's public-policy dimensions: where it's built, how big it is, how it will be priced, and so on. Those are fundamental public-policy issues. So this platform allows governments to act as the guardian of the public interest but transfers the execution and financial risk to us. We know that managing those risks is a challenge. With the expertise we've built and with the right partners, we believe it is very doable.

Second, the platform creates a one-stop shop for all aspects of project development, financing, and coordination, including a heavy emphasis on tendering for every service so that costs stay low.

And finally, the new platform makes us responsible for ongoing operations of the infrastructure project, which furthers the goal of keeping the infrastructure off the government balance sheet. As an institutional investor, we won't handle operations ourselves; CDPQ will partner with world-class infrastructure operators. This brings me back to one of my earlier points—that operational precision can have a big impact on the value of the asset. The platform is in its early stages, but we're very encouraged by the amount of interest it has been receiving, in the United States, Europe, and elsewhere.

McKinsey on Investing: *Your investment strategy hinges on a deep understanding of the companies in which you invest. Given that, is there a role for external managers?*

Michael Sabia: We manage 90 percent of our assets internally, first because it's essential for the strategy to work and second because we believe

it is—by far—the most economical way to manage. That said, we will continue to work with external managers in a few areas. First, we'll look for expertise in highly specialized areas where we just don't have sufficient expertise, such as value investing in emerging markets. Second, there are areas—distressed debt is a good example—where we're building knowledge, but it's not quite there yet. So we will continue to rely on the expertise of others as we're building up our own. And there's a third area that's slightly more abstract. Increasingly we want to work with external experts in a way that ensures we're involved in decision making, especially in private equity. We want to be part of the process itself. Being the recipient of external expertise is great, but working with outside experts also creates an opportunity for knowledge transfer. We want to work with people who are going to give us an opportunity to learn and to participate; we don't want to just write a check to someone else, who then goes about investing it.

More broadly speaking, I think partnerships are the future of large-scale institutional investing. Pension funds and sovereign funds are getting large enough that many of the organizations managing them are now developing substantial expertise across many asset classes. As the industry evolves, we're going to see big transactions across all kinds of asset classes, through partnerships among long-term institutional investors. I think these partnerships are going to become a bigger and more influential voice in the capital market. So learning how to truly partner with other organizations is a really important part of building investment capability for the future. It won't be possible to be a lone wolf anymore.

McKinsey on Investing: *You're a strong advocate of long-term capitalism. In your view, what are the changes that would most affect how capital-market participants think about the balance between short-term and long-term horizons?*

Michael Sabia: There's certainly an important public-policy dimension to long-term capitalism. There are tax- and corporate-law changes that are needed as well as changes in voting rights—a whole range of things. And those things are both important and challenging. But these are going to take time. So I think we have the responsibility to kick-start the process ourselves. We need to just do it. Institutional investors like CDPQ and our counterparts, which have long-dated assets managed in the interest of long-dated liabilities, need to become much more visible, active, long-term investors.

So what does "just doing it" mean? Some things are simple, like changing the way we interact with the companies we operate or invest in. We shouldn't be asking a CEO to simply help fill in an earnings model for the next two quarters. We should be asking, "How do you manage talent development? What are the biggest obstacles to your strategic plan for the company? What's it going to look like five years from now? How can we help you get there?"

Having been the CFO of one publicly traded company and the CEO of another, I can tell you that the shareholders you hear from most often are only worried about next week. The shareholders who are thinking longer term tend to be less vocal. That has to change. ■

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