Caisse de dépôt et placement du Québec

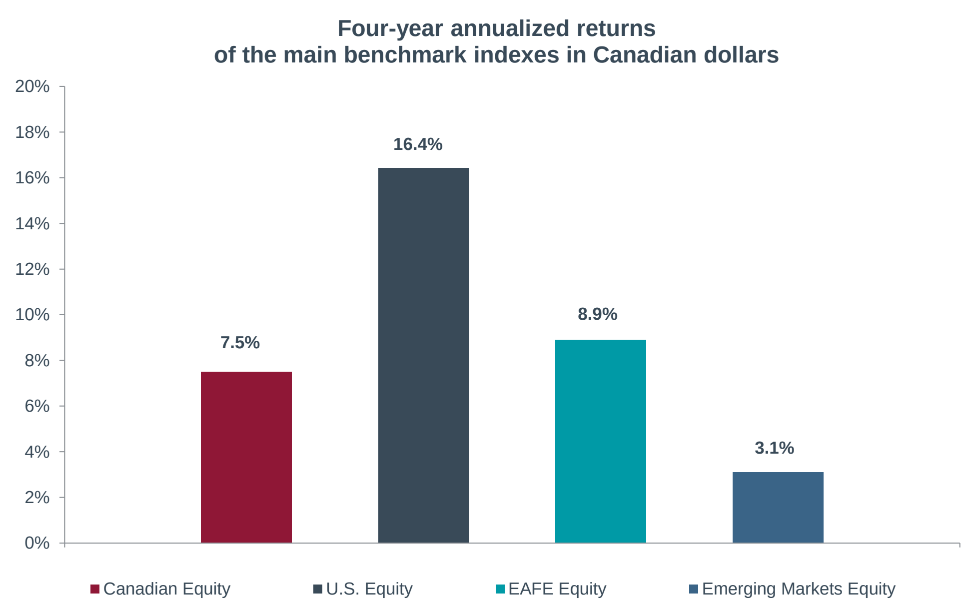
EQUITY

DESCRIPTION

The Equity asset class comprises seven portfolios. The Canadian Equity, Global Quality Equity, Global Equity (being wound down), Emerging Markets Equity and Private Equity portfolios, with net assets totalling $74.3 billion, are managed actively. The U.S. Equity portfolio and the EAFE (Europe, Australasia and Far East) Equity portfolio, with net assets totalling $19.5 billion, are indexed.

MARKET CONTEXT

Since their low point in 2009, the equity markets in developed countries have made strong gains. Monetary easing by central banks has whetted investor appetite for equities, especially on U.S. markets. Even in the context of a generally rising market, the differences in returns from one region to another are significant; over four years they range from 3.1% to 16.4% on an annualized basis.



The economic fundamentals have improved significantly in the United States over the past four years as the excess supply of houses decreased and household balance sheets improved. The four-year return is due mainly to improved corporate earnings. In 2013, the advances in the equity markets were especially strong, despite modest growth in revenues and profits during the year.

In Europe, the initial recovery quickly ran out of steam because of inadequate structural reform and ineffective monetary policy. In 2013, the international markets benefited from the highly expansionary monetary policies adopted by the Japanese government, as well as the euro zone's emergence from recession, although its recovery continues to be anemic.

In Canada, weak commodity prices combined with a strong currency over a substantial part of the past four years held back the stock market in comparison with other developed countries. In 2013, disappointing employment and international trade data gave way to modest growth in the second half of the year. This renewed vigour is due to factors that include an increase in U.S. demand for Canadian products and the depreciation of the Canadian dollar. Over four years, as well as for 2013, the gains on the Canadian stock market fell short compared to the U.S. and international markets.

Narrower corporate profit margins and higher risk premiums detracted from the performance of emerging markets over the past four years. In 2013, the probability of monetary tightening in the United States caused capital to flow out of emerging markets and into the developed countries. Some currencies depreciated significantly, especially those of countries that rely on foreign capital to finance their large current account deficits, such as India, Brazil, South Africa and Turkey.

NEW INVESTMENT STRATEGY

In the deployment of its new investment strategy emphasizing absolute-return management, exposure to emerging markets and depth of expertise, La Caisse made three major changes to the active management of its publicly traded equity portfolios.

1. **Global Quality Equity**. In 2013, La Caisse launched this new portfolio whose investment philosophy is based on an absolute-management approach and in-depth fundamental analysis. The portfolio focuses on securities of large, established companies with considerable exposure to global growth and stable, long-term earnings. With a risk level lower than that of the equity markets of developed countries as a whole, this portfolio is designed to be defensive in down markets, consequently benefiting less when markets advance strongly.

2. **Canadian Equity**. In the past 18 to 24 months, La Caisse made significant changes to the management of this portfolio. It enhanced its security selection strategy by considerably strengthening its research capability and establishing major themes to guide its choices. The portfolio's positioning is based on convictions that include relatively weak economic growth in Canada, a more favourable outlook in the United States and a gradual increase in interest rates.

3. **Emerging Markets Equity**. This year, La Caisse strengthened its research teams and significantly enhanced its emerging markets expertise, notably by creating a team responsible for developing an investment strategy for these markets. In July 2013, it began adding active external management to the portfolio, which was previously indexed. The external mandates awarded to date cover China, Brazil and India.

HIGHLIGHTS OF RESULTS

	At Dec. 31, 2013	4 years			1 year		
Specialized portfolio	**Net assets ($ billions)**	**Return ($ millions)**	**Return (%)**	**Index (%)**	**Return ($ millions)**	**Return (%)**	**Index (%)**
Canadian Equity	23.1	5,071	6.4	7.5	3,368	16.3	14.8
Global Quality Equity	17.2	2,587	s.o.	s.o.	2,587	32.4	26.1
Global Equity	3.5	3,422	s.o.	s.o.	2,024	32.2	31.0
Emerging Markets Equity	10.3	976	3.1	3.1	384	4.0	3.7
U.S. Equity	9.7	5,538	16.5	16.4	3,639	41.3	41.3
EAFE Equity	9.8	3,547	9.3	8.9	2,733	31.5	31.0
Equity Markets[1]	**73.6**	**22,853**	**9.5**	**9.7**	**14,735**	**23.7**	**22.4**
Private Equity	20.2	9,978	16.5	11.3	3,426	19.7	22.7
Equity	**93.8**	**32,831**	**10.9**	**10.0**	**18,161**	**22.9**	**22.6**

[1]The Québec International portfolio closed out on November 30, 2012. Its contribution is included in these figures.

Over four years, the Equity asset class is the one that has contributed the most to La Caisse's overall return, with $32.8 billion of net investment results, of which almost $10 billion was contributed by the Private Equity portfolio. The annualized return is 10.9%, outperforming the benchmark index by 0.9%. For 2013, the return is 22.9%.

GLOBAL QUALITY EQUITY

- The Global Quality Equity portfolio returned 32.4% in 2013. Even though this period is too short to draw conclusions, this result exceeded expectations, especially in the context of rapidly rising valuation multiples.
  - The return is due mainly to substantial exposure to major international companies established in the United States, including a number in the health care and consumer products sectors. These companies include Colgate, Unilever, PepsiCo and 3M.
- The net assets of the Global Equity portfolio, which is being wound down as a result of the creation of the Global Quality Equity portfolio, decreased from $13.8 billion as at December 31, 2012, to $3.5 billion at year-end. The portfolio should be fully wound down early in 2014.
  - As a result of rising U.S and international equity markets, this portfolio returned 32.2% in 2013.

CANADIAN EQUITY

- This portfolio recorded $5.1 billion of net investment results and an annualized return of 6.4% over four years, underperforming its benchmark index by 1.1%. In 2013, the portfolio's significant repositioning bore fruit: it had a 16.3% return, or 1.5% more than its index.
  - Security selection in the materials and industrials sectors, underweight positions in health care and telecommunications and under-representation of securities paying high dividends are the reasons for the variance vis-à-vis the index over four years.
  - In 2013, the portfolio benefited from its exposure to companies in cyclical sectors that are not related to resources and have strong exposure to the United States, as well as underweight positions in the materials sector – specifically gold stocks – and the telecom sector.
- The Morningstar National Bank Québec Index, which was included in the portfolio index in 2011, posted a 32% return and significantly outperformed the S&P/TSX Index, which advanced 13% in 2013. At year-end, Québec securities accounted for 32% of La Caisse's portfolio, while on the Toronto Stock Exchange they represented 15.1%.
- The Canadian market advanced strongly in 2013 but underperformed the other global markets mainly because of the large proportion of companies in the materials and energy sectors, both of which underperformed.

EMERGING MARKETS EQUITY

- The annualized return on this portfolio, which was indexed until June 2013, is 3.1% over four years. The gradual introduction of active management starting at mid-year contributed to the 4.0% return for 2013.
  - Emerging markets underperformed developed markets in the past four years, amid slowing growth in the main countries – South Korea, China, Brazil and India.

- In 2013, weakness in the materials sector as well as uncertainties surrounding the eventual tapering of quantitative easing by the U.S. Federal Reserve also detracted from returns in these markets.

- Nevertheless, emerging markets' transition to a growth model based on an increasing middle class should make it possible to take advantage of these expanding markets in the years to come.

U.S. EQUITY AND EAFE EQUITY

- The U.S. Equity portfolio and the EAFE Equity portfolio, which are both indexed, had annualized returns of 16.5% and 9.3%, respectively, over four years. For 2013, their returns were 41.3% and 31.5%.

  - The United States, Japan, France, Germany and Switzerland were the markets with the best results in 2013.

PRIVATE EQUITY

- Over the past four years, the Private Equity portfolio generated a substantial $10.0 billion of net investment results, with an annualized return of 16.5%, or 5.3% more than its benchmark index. For 2013, the portfolio had a substantial 19.7% return.

  - The excellent performance over four years is due to solid earnings by the portfolio companies as a result of their improved operational performance and reduced debt levels. The favourable valuations of a number of companies in the portfolio, as multiples increased on the markets, also contributed positively to the return.

  - Both direct investments and those made through investment funds contributed positively to the portfolio's absolute return over four years.

- In 2013, La Caisse took advantage of the sharply rising stock markets to realize some of the gains on a number of investments it has held for several years. Private investments in publicly traded companies contributed a large share of the results. CGI Group made a notable contribution to the return as its share price rose considerably with the successful integration of Logica.

- La Caisse continued its strategy of adding to its direct investments. It is increasingly making relationship-based investments to establish long-term business partnerships with the promising companies in the portfolio.

- Investments in funds round out the portfolio's management strategy by allowing it to position itself with agility in the business cycle. During the year, the portfolio was repositioned to take advantage of opportunities that will arise in the years to come, especially in distressed debt funds.